Report of the
Task Force on
Investment Company Use of Derivatives and Leverage

Committee on Federal Regulation of Securities
ABA Section of Business Law

Task Force Members

Jay G. Baris, Chair
Alison M. Fuller, Vice Chair
Craig S. Tyle, Vice Chair

E. Carolan Berkley
Fabien Carruzzo
Matthew R. DiClemente
Amy R. Doberman
Joel H. Goldberg
Nathan J. Greene
Daniel O. Hirsch
Martin E. Lybecker
Bradley W. Paulson
Mark D. Perlow
Walter Pollard
Robert A. Robertson
Jeffrey W. Rubin

July 6, 2010
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Summary of Key Recommendations</td>
<td>1</td>
</tr>
<tr>
<td>I. INTRODUCTION</td>
<td>3</td>
</tr>
<tr>
<td>A. Genesis of this Paper</td>
<td>3</td>
</tr>
<tr>
<td>B. How Funds Typically Use Derivative Instruments</td>
<td>5</td>
</tr>
<tr>
<td>II. SUBSTANTIVE REGULATION OF FUND USE OF DERIVATIVES</td>
<td>10</td>
</tr>
<tr>
<td>A. Introduction</td>
<td>10</td>
</tr>
<tr>
<td>B. Section 18 Issues – Limits on Leverage</td>
<td>11</td>
</tr>
<tr>
<td>C. Outstanding Issues under Current Section 18 Regulation</td>
<td>15</td>
</tr>
<tr>
<td>D. Section 5(b) and Diversification</td>
<td>21</td>
</tr>
<tr>
<td>E. Section 8(b)(1) Concentration Limitations</td>
<td>29</td>
</tr>
<tr>
<td>F. Section 12(d)(3): Securities-Related Business Considerations</td>
<td>31</td>
</tr>
<tr>
<td>G. Valuation of Derivative Instruments</td>
<td>35</td>
</tr>
<tr>
<td>H. Liquidity Limitations and Derivative Instruments</td>
<td>36</td>
</tr>
<tr>
<td>I. Custody</td>
<td>37</td>
</tr>
<tr>
<td>J. Disclosure</td>
<td>39</td>
</tr>
<tr>
<td>K. Compliance Programs - Rule 38a-1</td>
<td>42</td>
</tr>
<tr>
<td>III. FUND DIRECTOR OVERSIGHT</td>
<td>43</td>
</tr>
<tr>
<td>A. Introduction</td>
<td>43</td>
</tr>
<tr>
<td>B. Elements of Knowledgeable and Meaningful Oversight</td>
<td>44</td>
</tr>
<tr>
<td>IV. PROCESS AND IMPLEMENTATION OF CHANGES TO REGULATORY OVERSIGHT</td>
<td>47</td>
</tr>
</tbody>
</table>

* * *
SUMMARY OF KEY RECOMMENDATIONS

- **Principles-based approach.** The Task Force favors a principles-based approach to the regulation of derivatives. The Task Force recommends that the Securities and Exchange Commission (the “SEC”) or its staff adopt new rules and/or issue new interpretive guidance to implement and facilitate those principles, coupled with enhanced disclosure.

- **Diversification.** The Task Force recommends a bifurcated approach to regulating diversification. That is, funds should measure diversification for purposes of Section 5(b) of the Investment Company Act of 1940 (the “1940 Act”) by looking at reference assets, when applicable.
  - Broad-based indices, or reference assets such as commodities or currencies, should be excluded.

- **Counterparties.** The Task Force recommends that the SEC should regulate counterparty risk under Section 12(d)(3) of the 1940 Act, including counterparties that are not in a traditional securities-related business.
  - The need for counterparty diversification would be limited to the extent that a fund holds bankruptcy-remote collateral from a particular counterparty.

- **Limits on leverage.** The Task Force recommends that the SEC or its staff regulate compliance with Section 18 of the 1940 Act by applying a principles-based approach:
  - The SEC or its staff should require funds to develop and maintain “Risk-Adjusted Segregated Amounts” (“RAS Amounts”). Funds would establish minimum amounts of required segregated assets based on the risk profiles of derivative instruments.
  - Funds should establish policies and procedures that cover both the value of assets and the types of assets that are appropriate for RAS Amounts.
  - Fund policies and procedures should also describe what will constitute an “offsetting transaction” for purposes of coverage requirements.
• **Concentration.** The Task Force observes that many funds measure concentration based on reference assets and believes that this measurement is appropriate.

• **Fund names.** The Task Force recommends that the SEC or its staff clarify that Rule 35d-1 under the 1940 Act should be interpreted like Section 5(b) as noted above. Specifically, funds would invest in accordance with their name by looking to the reference assets.

• **Disclosure.** The Task Force recommends that funds enhance disclosure of how derivative instruments affect actual investment results.

• **Director oversight.** The Task Force recommends that the SEC or its staff emphasize that the role of the fund board with respect to a fund’s use of derivatives and leverage is one of oversight, rather than micro-management. The SEC or its staff should consider proposing guidance for public comment on the proper role of fund directors in overseeing derivatives and leverage.

• **Additional insight.** The Task Force suggests that the SEC or its staff consider additional means to better develop insight into current practices of investment company use of derivatives and leverage and the appropriate level of regulatory oversight. For example, an SEC roundtable would give the SEC and its staff the opportunity to learn how portfolio managers, traders, operations personnel and compliance officers manage the risks of derivatives and leverage.
I. INTRODUCTION

A. Genesis of this Paper

In his April 2009 address to the Subcommittee on Investment Companies and Investment Advisers of the American Bar Association’s Section of Business Law’s Committee on Federal Regulation of Securities,1 Andrew J. Donohue, Director of the Division of Investment Management of the Securities and Exchange Commission (“SEC”), raised the question of whether the SEC’s regulation of investment companies’ use of derivatives has resulted in funds2 achieving technical compliance with applicable law but with the potential for outcomes that might be outside the investor protection expectations of policy makers. Mr. Donohue challenged the Subcommittee to address those concerns and specifically to consider how funds approach the use of derivatives. Mr. Donohue also questioned whether investors fully appreciate the risks that derivatives create for investment companies, and specifically asked the Subcommittee to consider that:

i. Funds should have a means to deal effectively with derivatives outside of disclosure (that is, funds should have procedures in place to guide their investments in derivatives effectively);

ii. A fund’s approach to leverage should address both implicit and explicit leverage; and

iii. A fund should address diversification from investment exposures taken on versus the amount of money invested.

In response, the Task Force on Investment Company Use of Derivatives and Leverage (the “Task Force”) was formed by the Committee on Federal Regulation of Securities of the Section of Business Law. The Task Force recognized that to consider appropriately the three issues that Mr. Donohue identified, it needed first to examine how the Investment Company


2 The terms “investment company” and “fund,” both singular and plural, refer to investment companies that are registered with the SEC under the Investment Company Act of 1940, as amended (the “1940 Act”). 15 U.S.C. §§ 80a–1 to 80a–64 (2000). The term “mutual fund” refers to an open-end management company, and the term “closed-end fund” refers to a management company that is not open-ended.
Derivative instruments present unique regulatory challenges because they allow funds to gain exposure to the value of particular assets—often called “reference assets”—without actually owning the assets. In contrast, the regulatory framework under the 1940 Act, as it applies to fund investments, generally addresses only direct investments in underlying assets. This, coupled with the leverage that is embedded in many derivative instruments, has presented issues concerning how funds should appropriately use derivatives, how they should disclose the related risks, and how the positions should be treated under applicable law. These issues are further complicated by operational issues that funds and their managers face in using derivative instruments. For instance, while much trading today is highly automated, certain derivatives require manual operational processes to ensure proper clearance, settlement, and accounting for the positions, as well as monitoring for “life cycle” events like collateral calls and coupon payments.

The legal and practical considerations identified above are not new, as funds have been using derivatives, such as written options, for decades. In the 1980s, funds managers, along with other sophisticated market participants, began to use derivatives to a greater degree. Fund use of derivatives first attracted public attention in the aftermath of losses incurred

---

3 This Paper represents the views of the Committee only and has not been approved by the House of Delegates or Board of Governors of the American Bar Association (“ABA”) and, therefore, does not represent the official position of the ABA. In addition, this Paper does not represent the official position of the Section of Business Law. It does not necessarily reflect the views of any one member of the Task Force, or their respective firms or clients.

4 As a preliminary matter, we note that there is no formal definition of the term “derivative” in the federal securities laws. A derivative instrument, however, is commonly understood as any contract the value of which is derived from another asset or index that is extrinsic to the contract. See Letter from Arthur Levitt, Chairman, SEC, to Edward J. Markey and Jack Fields, Representatives, U.S. Cong., at 2, n. 2 (Sept. 26, 1994) [hereinafter 1994 SEC Study] [the letter and the accompanying memorandum convey the SEC derivatives study], http://www.sec.gov/news/studies/deriv.txt.

5 The leveraging effect of certain types of derivatives is discussed below.

by funds as a result of investments in “mortgage derivatives” and “adjustable rate notes,” which generated Congressional interest. At Congress’ request, in 1994 the SEC’s Division of Investment Management provided a report on fund use of derivatives (the “1994 SEC Study”). Since that time, neither the SEC nor its staff has provided any formal guidance regarding fund use of derivatives and, over time, the use of derivatives by funds has evolved beyond the scope of the limited regulatory guidance that exists. Thus, the Task Force hopes that this Paper will assist the fund industry and fund shareholders, and the SEC and its staff with respect to appropriate regulatory treatment of funds’ use of derivative instruments.

This Paper is divided into four Sections. Section I provides background explaining how funds generally use derivative instruments. Section II describes the existing regulatory framework that applies to fund use of derivatives, including considerations with respect to leverage, investment limitations, valuation, liquidity, custody, disclosure and compliance. Section III explains the role of the fund board in connection with fund use of derivatives. Finally, Section IV sums up the conclusions and recommendations of the Task Force.

B. How Funds Typically Use Derivative Instruments

What are Derivative Instruments? This Paper primarily focuses on forwards, futures, options, and swaps because they are the kinds of derivatives that funds most commonly use. In addition, these derivatives present the regulatory challenges briefly noted above. In common usage in both the press and among legal practitioners, the term “derivatives” is often expanded to include various other complex financial instruments. This Paper does not address those other instruments, although it may provide guidance that is relevant to them.

---


8 Although the Task Force assumes that the readers of this Paper have a basic understanding of how these instruments function, we include some description of how these instruments work. For additional information, see INVEST. CO. INST., INVESTMENTS IN DERIVATIVES BY REGISTERED INVESTMENT COMPANIES § II.A (1994), available at http://www.ici.org/pdf/6109.pdf.

9 Specifically, instruments such as mortgage-backed securities and collateralized debt obligations, which are designed to pool and reallocate the risk of other instruments, are often referred to as derivatives. Unlike derivatives, however, those products represent the right to a stream of payments from a specific and identifiable pool of underlying assets.

10 Although this Paper refers to the use of derivatives by mutual funds, exchange-traded funds (“ETFs”) employ derivatives as part of their investment strategies as well. Certain types of ETFs, like their mutual fund counterparts, may use derivatives quite extensively as
All derivative instruments deliver to the holder particular rights and/or obligations concerning the reference asset that vary depending on the type of derivative. For instance, futures, forwards, and options can obligate a fund to purchase or sell specified amounts of the reference asset or settle in cash based on the value of such amounts of reference assets. Additionally, structured notes may provide exposure to certain reference assets. Fund managers use derivatives for funds as a means to pursue a fund’s stated investment objectives, policies and strategies. As with any other kind of investment, derivatives affect the risk/return profile of a fund. As a general matter, derivatives are used to hedge a fund’s investments from a decline in value or for efficient portfolio management purposes (e.g., as a substitute for a cash investment), or both.

The following portion of this Paper describes five broad categories of derivatives that fund managers typically use, and explains how certain derivative instruments can have a leveraging effect on a fund’s portfolio.

**Currency Derivatives.** Currency derivatives include forward currency contracts, currency futures contracts, and currency swaps and options on currency futures contracts. Currency derivatives provide a fund with increased or decreased exposure to specific currencies. Fund managers use currency derivatives in various ways. For example, currency derivatives can provide a hedge against the risk that a fund’s investment in a foreign debt security will decline in value because of a decline in the value of the foreign currency in which the foreign security is denominated. By entering into a short currency forward that calls for the obligation to sell, at a future date at a predetermined price, the currency in which the foreign security is denominated, a fund’s exposure to a decline in the value of the currency is reduced. Similarly, when a fund manager expects the value of a foreign currency to rise, and the manager is about to purchase a debt security that is denominated in the currency, the manager may use currency derivatives to hedge against that increase. Fund managers use “cross-currency” hedging or “proxy” hedging when, for instance, it is difficult or expensive to hedge a particular currency against the U.S. Dollar. For example, a fund may use a forward contract on one foreign currency (or a basket of foreign currencies) to hedge against adverse changes in the value of another foreign currency (or basket or currencies).

---

Aside from hedging transactions, fund managers may also use currency derivatives to seek returns on the basis of anticipated changes in the relative values of two currencies (e.g., that the U.S. Dollar will increase in value compared to the Euro). As a general matter, futures, forwards, swaps and options can all be used to increase or decrease exposures to the reference currencies. A fund manager selects the particular instrument based on the level and type of exposure the manager seeks to obtain and the costs that are associated with the particular instrument.

**Interest Rate Derivatives.** Interest rate derivatives include interest rate or bond futures, Eurodollar futures, caps, floors, overnight indexed swaps (“OIS”), interest rate swaps, and options on futures and swaps. Fund managers may use interest rate derivatives to hedge a fund’s portfolio against changes in interest rates. For example, a fund manager may use an interest rate swap to hedge against the risk of a decline in the prices of bonds owned by a fund due to rising interest rates. Similarly, a fund manager could shorten the duration of the fund’s portfolio by selling futures contracts on Treasury bonds or notes or Eurodollar futures. Some fund managers also use interest rate derivatives to enhance a fund’s returns based on the manager’s views concerning future interest rate movements or changes in the shape of the yield curve. For example, if a manager believes that LIBOR will decrease compared to the Federal Funds Rate, the manager could enter into an interest swap whereby a fund would be obligated to make payments based upon the application of LIBOR to an agreed “notional” amount\(^{11}\) in exchange for payments from the counterparty based upon the application of the Federal Funds Rate to the notional amount. The fund will benefit to the extent that LIBOR is lower than the Federal Funds rate.

**Credit Derivatives.** Single-name and index-linked (or basket) credit default swaps (“CDS”) are credit derivatives (as are options on those swaps). These derivatives allow a fund manager to take a position concerning the likelihood that a particular bond, or a group of bonds, will be repaid in full upon maturity. In particular, a fund may use credit derivatives to hedge against particular risks that are associated with a bond that is owned by the fund or a counterparty of the fund, such as the risk that the bond issuer will default, a rating agency will downgrade the bond or the credit of the counterparty, and market credit “spread” risk. When a fund (or other person) “sells” or writes credit protection, the fund may seek to obtain investment exposure to the reference asset (that is, the underlying bond), without actually

---

\(^{11}\) The term “notional amount” is used differently by different people and in different contexts. In this Paper it refers to the nominal or face amount that is used to calculate payments made on a particular instrument, without regard to whether its obligation under the instrument could be netted against the obligation of another party to pay the fund under the instrument.
owning the bond. Quite often, selling protection can be more cost-effective than an outright purchase of the bond.

**Equity Derivatives.** Equity derivatives include equity futures contracts, options on equity futures contracts, equity options and various kinds of equity-related swaps (such as a total return swap on an equity security). Fund managers use equity derivatives to broaden investment opportunities (*e.g.*, by using foreign index futures to obtain exposure to a foreign equity market). Equity derivatives also can be used as an income producing strategy by, for example, permitting a fund to sell equity call options on a particular security that is owned by the fund. By selling the options, the fund can earn income (in the form of the premium received for writing the option) while at the same time permitting the fund to sell the underlying equity securities at a targeted price set by the manager.

A fund also may use equity derivatives (usually stock index futures) to “equitize” cash. Specifically, when a fund has a large cash position for a short amount of time, the fund can acquire long futures contracts to retain (or gain) exposure to the relevant equity market. When the futures contracts are liquid (as is typically the case for broad market indices), the fund can eliminate the position quickly and frequently at lower costs than had the fund actually purchased the reference equity securities. Similarly, a fund could write a CDS, offering credit protection to its counterparty. In doing so the fund gains the economic equivalent of owning the security on which it wrote the CDS, while avoiding the transaction costs that would have been associated with the purchase of the security.

**Other Derivatives.** In addition to these four broad categories, funds may utilize derivatives to gain other types of exposures, such as commodity exposures.

**The Leveraging Effect of Derivatives.** Futures contracts, forward contracts, written options and swaps can produce a leveraging effect on a fund’s portfolio. That is, for a relatively small up-front payment made by a fund (or no up-front payment, in the case with many swaps and written options), the fund contractually obligates itself to one or more potential future payments until the contract terminates or expires. For example, a fund that enters into an interest rate swap with a counterparty undertakes to make payments that are dependent upon changes in the relative levels of two interest rates. Thus, the swap presents the possibility that the fund will be required to make payments out of its assets. The same possibility exists when a fund writes puts and calls, purchases short and long futures and forwards, and buys or sells credit protection through CDSs. When a fund’s positions in a derivative instrument are used as a direct hedge to a specific risk to which a fund is exposed, that leveraging effect is reduced. For example, when a fund
sells a call option on a security that the fund owns, the fund can deliver that security upon exercise of the option.

It is useful to distinguish the leveraging effects of a fund’s use of derivatives from the leverage that is created when a fund invests without recourse in another vehicle or company that is itself leveraged (e.g., structured notes). In the latter case, the maximum amount a fund can lose is the amount of its initial investment in the security. In the case of a non-recourse investment, the fund cannot be called upon to contribute additional capital to the vehicle or company. As explained below, the regulatory framework that applies to funds’ use of derivatives distinguishes between leverage arising from potential future payment obligations (which is similar to the explicit leverage that results when a fund borrows money from a bank, or issues preferred stock or debt securities in the case of a closed-end fund) on the one hand, and indirect or “economic” leverage on the other hand. The Task Force believes that, by and large, those distinctions are appropriate on policy grounds.

**Special Contexts – Funds that Use Derivatives Extensively.**

Some investment companies use derivatives extensively as part of their investment strategies. For example, leveraged and inverse funds seek to replicate a multiple of the return (or the inverse of the return) of a reference benchmark or index, on a daily basis. This exposure may be obtained through a combination of options, futures and swaps, along with using baskets of stocks in appropriate circumstances. Other funds that may utilize derivatives extensively include long/short funds and hedge fund replication funds.

The SEC staff has expressed concern that investors may not understand the risks associated with an investment in these funds. In addition, the ambiguity and inconsistency that exists in the treatment of various derivative instruments for various regulatory purposes has a disproportionate effect on these funds.12 The recommendations contained in this Paper concerning asset segregation requirements and proposed counterparty limits, combined with clear disclosure, should be effective to address the staff’s concerns relating to these types of funds.

The Task Force also notes that many fund managers that extensively use derivatives (and other complex instruments) have established formal committees to approve the use of a new derivative and the use of a derivative in a new way (e.g., allowing a manager to use a derivative for purposes other than hedging). These committees are generally made up of personnel from the legal, compliance, tax, operations, portfolio management,

---

12 See Donohue Speech, supra note 1.
risk and accounting departments of the firm. Such committees serve as valuable resources to fund boards.

**Fund Collateralization Practices.** Many funds monitor their exposure to counterparties with respect to various over-the-counter (“OTC”) derivatives. Some funds negotiate arrangements that require the counterparties to post collateral with an eligible fund custodian to address their obligations to the funds. In these contracts, the parties agree on protocols for the valuation of the derivatives position and the underlying collateral. Collateral calls are made at predetermined asset value thresholds. By posting the collateral with an eligible fund custodian, the funds are significantly protected in the event that the counterparty breaches material provisions of a derivatives contract or becomes insolvent. In such events, derivatives contracts generally provide that the fund may terminate the contract. A fund may be deemed to be “fully collateralized” to the extent that the counterparty’s obligations to it are addressed by posting bankruptcy-remote collateral.

II. **SUBSTANTIVE REGULATION OF FUND USE OF DERIVATIVES**

A. **Introduction**

Investments in derivatives by investment companies implicate a number of regulatory provisions of the 1940 Act. In many cases, these provisions do not easily accommodate a fund’s use of derivatives. Moreover, as already noted, the SEC and its staff have provided limited guidance concerning how these provisions apply to derivatives.

In the absence of detailed guidance or clear statutory provisions, each fund company has been left to analyze the relevant requirements on its own, though common practices and approaches have developed around a number of regulatory requirements. This section of this Paper sets forth those common practices and approaches. Of course, other approaches may also be effective and appropriate under the law.

After identifying and applying the relevant regulatory provisions to derivatives, we also offer some suggestions for modifications by the SEC or its staff to the regulatory framework, which the Task Force believes would benefit the fund industry and fund shareholders.

---

13 The Task Force understands that forward currency contracts often entail documentation practices that differ from the protocols of the International Swap Dealers Association (“ISDA”), and may not involve collateralization.
B. Section 18 Issues – Limits on Leverage

Background and Early SEC/Staff Positions. The SEC and its staff traditionally have applied the prohibitions of Section 18 of the 1940 Act to a fund’s use of derivative instruments. That section, on its face, prohibits an open-end fund from issuing any “senior security” (e.g., most claims senior to common stock), although it allows a fund to borrow from a bank within certain limits. The SEC’s staff has taken the position that the use of certain derivative instruments may entail the issuance of prohibited senior securities. In this way, the SEC is equating a fund’s obligation to make payment on the derivative instrument with a note written by, or an evidence of indebtedness of, the fund that has a payment priority senior to payment on the shares issued by the fund.

Rather than prohibiting funds from engaging in derivative transactions, the SEC staff has established an interpretive approach pursuant to which funds may enter into offsetting transactions or by segregating fund assets in amounts that would cover some amount of the fund’s potential liabilities under the instruments. This section of this Paper explains and provides a short history of the SEC’s approach to derivatives under Section 18.

As background, two SEC releases from the 1970s laid the foundation for the SEC’s approach to regulating fund use of leverage through derivatives. First, Investment Company Act Release No. 7221 (“Release 7221”), issued in 1972, acknowledged staff positions that short sales, written options by an investment company, and use of “commodity futures contracts” implicated Section 18’s prohibitions against the issuance of senior securities.

14 Section 18(f) of the 1940 Act provides that it shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security (except that a registered company may borrow from a bank if the registered company maintains at least 300% asset coverage over all such bank borrowings). 15 U.S.C. § 80a-18(f). The effect of this provision is to prohibit funds from borrowing an unlimited amount of money and from borrowing from persons that are not banks. Additionally, Section 18(a) of the 1940 Act limits a closed-end fund’s issuance of an evidence of indebtedness, unless the fund has 300% asset coverage, and preferred stock, unless the fund has 200% asset coverage. 15 U.S.C. § 80a-18(a).

15 Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 Fed. Reg. 12790 (June 29, 1972). With respect to “commodity futures contracts,” Release No. 7221 stated that “[a]lthough commodities and commodity futures contracts themselves may not be securities, the purchase of a commodities futures contract and the ensuring leverage may involve the creation of a senior security.” Release No. 7221 went on to note that, despite this concern, the staff had not objected if an investment company registrant engaged in commodities futures contract trading within the following limits:
Release 7221 addressed a limited number of instruments and transactions that entail leverage, but did not address the creation of newer financial instruments in the marketplace, such as new types of futures. Also, as a technical matter, Release 7221 only represented the views of the SEC staff; it did not necessarily represent legal conclusions of the SEC.

In 1979, the SEC expressed official SEC policy through Investment Company Act Release No. 10666 (“Release 10666”). Release 10666 does not specifically address derivatives. Release 10666 focused specifically on three types of financial instruments: reverse repurchase agreements, firm commitment agreements, and standby commitment agreements. The SEC essentially acknowledged that, if a fund “covered” its obligations under those transactions, the fund would not be deemed to have issued a senior security. Release 10666 explained that a fund could “cover” the transaction by: (i) maintaining segregated assets sufficient to satisfy 100% of the fund’s obligations under the transaction; or (ii) entering into transactions that offset the fund’s obligations. The SEC advised fund boards to analyze other transactions that should be subject to this “cover” regime due to the leverage implicit in those other transactions. As a practical matter, the obligation to segregate or offset transactions and instruments that would otherwise be senior securities placed a ceiling on the amount of leverage a fund could employ.

1. Its net assets plus borrowings and commodities futures contract obligations will equal at least 300% of the value of any commodities futures contracts (measured by multiplying the number of units to which the contracts refer by the price per unit specified) and any borrowings;

2. If its net assets fall below the 300% requirement of (1) above, then the registrant will take the necessary steps to restore the 300% coverage within three business days;

3. It will segregate, and maintain in a segregated account until the contract is closed out, cash or U.S. Government securities equal to the amount of original margin deposit required on each contract;

4. It will not invest (including the placing of additional margin deposits) more than twice the amount of the original margin deposit in any commodities contract;

5. It will not invest in, or be contingently obligated in connection with, commodities contracts in an amount exceeding 10% of its assets.

16 Non-recourse investments in companies or vehicles that are themselves leveraged are not subject to the Section 18 limitations (e.g., many structured notes and companies with heavy balance sheet leverage).

Release 10666 states that only liquid assets, including cash, U.S. Government securities, or other appropriate high-grade debt obligations, could be used as cover for the foregoing transactions. As discussed below, the SEC staff subsequently relaxed this restriction in a 1996 no-action letter.

Staff Guidance Subsequent to Release 10666. Between 1979 and 1987, the SEC staff issued a series of no-action letters that continued to develop the regulatory landscape by, among other things, applying the asset segregation/offsetting scheme to futures contracts, options transactions, and forward contracts. The SEC staff also confirmed that funds could use derivatives for investment purposes. The significant positions taken after Release 10666 are described below.

Dreyfus No-Action Letter (1987)

The Dreyfus no-action letter (the “Dreyfus Letter”) did not discuss any new types of financial instruments. Instead, it was significant because the SEC staff concurred with the view of Dreyfus that derivatives transactions could be conducted pursuant to an asset segregation/offsetting scheme. The staff also noted that if a derivatives transaction has sufficient asset coverage or an offsetting transaction, no senior security would be present and the 300% asset-coverage requirement would not apply. The Dreyfus Letter specifically addressed futures, forwards, options, and short sales.

Non-Public Position on Interest Rate Swaps (1989)

In 1989, the SEC staff first acquiesced to the segregation of the net amount due under an interest rate swap that required, by its terms, the netting of the payments that each party was required to make under the swap. Under an interest rate swap, a fund and its counterparty exchange their respective commitments to pay or receive interest (e.g., an exchange of floating

18 Id.


20 See Dreyfus Letter, supra note 6.


22 Eaton Vance Prime Rate Reserve, Registration Statement for Closed-End Investment Companies (Form N-2) (July 13, 1989)
rate payments for fixed rate payments) with respect to an agreed-upon amount of money (again, the “notional” amount, with payments under the swap a function of the interest rate differential applied to that notional amount). For example, the fund could agree to make payments based upon the Federal Funds Rate, while the counterparty agrees to make payments at a 1.00% fixed rate on a quarterly basis for the two-year life of the swap. Under that swap, in each quarter, the fund would have no obligation to pay any amount if 1.00% exceeds the Federal Funds Rate for the quarter – and, for periods when no amount is due – the fund would not be required to segregate any assets.

The SEC staff considered that segregation approach when it reviewed and commented on the disclosure in a fund’s registration statement that explained what amount of assets the fund would segregate for the interest rate swap. The SEC staff allowed the registration statement to become effective with a detailed description of an asset segregation policy based on net amounts as just described above. Over time, other funds disclosed that they would segregate that amount of assets. To our knowledge, the SEC staff has neither publicly confirmed that position in writing, nor addressed the segregation requirements that apply to other kinds of swaps.


Through the Merrill Lynch no-action letter (the “Merrill Lynch Letter”), the SEC staff agreed that segregated assets that are used to cover derivatives (or other transactions that could entail the issuance of senior securities) need not be limited to cash or cash equivalents.23 The staff stated that any asset, including equity securities and non-investment grade debt, may be used so long as the asset is liquid and marked to market daily. This position greatly increased the degree to which funds could use derivatives because all or substantially all of their portfolio securities could be used to “cover” their derivatives positions.

Cash-Settled Futures and Forwards (2005)

In December 2005, the SEC staff informally embraced a flexible approach for covering cash-settled futures and forwards. As in the case of interest rate swaps, in connection with the review and comment on fund registration statements, the staff acquiesced to the segregation of the net amount due on the contract, rather than the larger amount required to be segregated under the Dreyfus Letter.24 To our knowledge, the staff has not

23  Merrill Lynch Letter, supra note 19.

24  The following illustrates the difference between the amount to be segregated under the Dreyfus Letter, and the amount under the “cash settled” position. Under the Dreyfus Letter, a fund that owns a short stock index futures contract must segregate the market
confirmed this position in writing. As we note below, reducing the amount of assets subject to segregation increased the practical ability of funds to engage in derivatives on an increasing scale.

For cash-settled futures and forwards, the SEC staff indicated that a fund may segregate assets equal to the net amount owed under the contract, as determined daily, less any margin that must be posted with a futures commission merchant. For purposes of the SEC staff's position, a cash-settled contract is one in which no physical delivery is permitted on the settlement date; instead, the parties to the contract must settle with cash. Not all futures or forwards are required to be cash settled. For instance, Treasury futures are not cash-settled because they allow for the physical delivery of Treasuries upon expiration of the contract, while index futures must cash-settle (no one is called upon to deliver the component parts of the index).

C. Outstanding Issues under Current Section 18 Regulation

As the foregoing discussion illustrates, there are open issues and inconsistencies in the current SEC and staff guidance regarding the application of Section 18 of the 1940 Act to transactions in derivatives.

First, the SEC has never explicitly endorsed the staff’s policies concerning segregation of assets and offsetting transactions with respect to derivatives, and, to our knowledge, the staff has not addressed in writing the appropriate treatment of all of the various kinds of derivative instruments.

value of the reference assets that underlie the contract, regardless of whether the value of the assets has declined in value such that the fund is “in the money” on the future. In contrast, pursuant to the cash settled position, the fund merely segregates the net amount due under the contract. See Dreyfus Letter, supra note 6. Therefore, when the futures contract is “in the money,” the fund need not segregate any amount.


26 It is possible that a fund manager could negotiate with a fund’s futures commissions merchant to provide that all of the fund’s futures contracts must settle for cash and under no circumstances would allow for physical settlement.

27 The staff appears to believe that every fund that uses derivatives will disclose its particular policy concerning how it segregates the amount of assets in order to avoid issues under Section 18 (and perhaps due to the wording of Section 8, which calls for disclosure of a fund’s borrowing policies). This disclosure is not, however, specifically called for under Form N-1A. Funds that provide the disclosures do not do so in the same detail. As a result, there is uncertainty among fund groups as to the proper application of the Section 18 limits. Fund shareholders, however, may not benefit from detailed information about complicated asset segregation policies.
Second, existing formal and informal guidance is not theoretically consistent. In the case of certain instruments, funds apparently are expected to segregate assets that are equivalent in value to the notional value of the instrument; in other cases, however, it is sufficient to segregate only an amount equal to the daily marked-to-market value of the obligation.

Third, some have expressed concerns that the staff’s position in the Merrill Lynch Letter, which greatly broadened the types of fund assets that could be segregated in order to satisfy Section 18, could expose a fund to the possibility that it would not have sufficient assets to meet its obligations under the derivative contract (as those segregated assets could have declined significantly in value).

Fourth, there are other open issues as well, such as what constitutes an “offsetting transaction.”

As a result of the foregoing, there are questions regarding whether the policy objectives of Section 18, as applied in Release 10666, are still being satisfied, or will continue to be satisfied in the future. In order to address these questions, further SEC guidance and/or rulemaking in certain areas would be useful.

At the same time, the Task Force believes it is important to note that, despite these outstanding issues, the basic framework as articulated in Release 10666 has worked very well. With additional guidance and clarifications recommended below, the Task Force believes that the Release 10666 framework will continue to provide an appropriate structure for funds’ investments in derivatives.

Amount to be segregated. As noted above, current guidance on segregation takes an “either/or” approach – in some cases requiring segregation of the full notional amount; in others the daily market value.

The latter standard raises a potential concern – namely, that a fund’s exposure under a derivative contract could increase significantly on an intraday basis, resulting in the segregated assets being worth less than the fund’s obligations (until the fund is able to place additional assets in the segregated account; typically, this would be done on a daily basis). To the extent a fund relying on the Merrill Lynch Letter segregates assets whose prices are somewhat volatile, this “shortfall” could be magnified.

On the other hand, it is clear that a requirement to use notional value as the standard for all types of derivatives would be unnecessarily restrictive. This is perhaps best illustrated by way of example – consider a fund that has entered into a currency forward contract pursuant to which it will buy British Pounds in exchange for U.S. Dollars. The only way that the
fund could be liable for the full (notional) amount of the contract (in dollars) is if the pound fell to zero.

The Task Force believes that the SEC should issue revised guidance in this area, which would set forth an approach to segregation that would cover all types of derivative instruments in a comprehensive manner. One possible approach would be to adopt either notional value or market value as the standard across-the-board. As the above suggests, however, either standard is unlikely to reflect accurately the risks embedded in various types of instruments.

Another approach would be for the SEC to establish a detailed schedule, which would list various types of derivatives along with the amount required to be segregated for Section 18 purposes. Those amounts could be market value, notional value or something in between (e.g., market value plus an additional amount). While this would theoretically establish tailored segregation requirements, the Task Force believes that it would not be a workable solution, for at least two reasons. First, the appropriate amounts are likely to vary based upon a variety of factors. These would include not only the type of derivative (e.g., swap, future, forward, option), but also the specific transaction (e.g., a currency swap involving a volatile currency might be treated differently) and the nature of the assets segregated. Second, it is unlikely that any list could cover all present and future types of derivative instruments. Even in the case of those that would be included, future market developments might warrant different standards in the future, and limiting future adjustments to changes through formal rulemaking would be far too inflexible.

Accordingly, the Task Force recommends a more principles-based and flexible approach. In particular, we recommend that funds that invest in derivative instruments that involve leverage within the meaning of Release 10666 adopt policies and procedures that would include, among other things, minimum asset segregation requirements for each type of derivative instrument, which would be based on relevant factors, such as those noted above. These would be termed “Risk Adjusted Segregated Amounts.”

While the Task Force believes this type of principles-based flexible approach is optimal, the SEC could set forth some general guidance. For example, derivative instruments that exhibit issuer or transaction-specific risk (e.g., credit risk when writing single-issuer CDSs) should generally require greater Risk Adjusted Segregated Amounts (e.g., close or equal to the full notional amount if the risk of losing the full notional amount is high). In contrast, Risk Adjusted Segregated Amounts equivalent in value to the daily market value of “plain vanilla” interest rate swaps, as under current informal guidance, should be sufficient in most cases. In developing standards for Risk Adjusted Segregated Amounts, fund advisers could take into account various
measures such as “value at risk.”\textsuperscript{28} The Task Force notes, however, that any such measures may have limitations.

The Task Force further recommends that a fund’s policies and procedures on asset segregation be subject to approval by the fund’s board of directors.\textsuperscript{29} While the investment adviser is in the best position to determine and establish a fund’s segregation policies, the fund’s board should provide oversight of these policies.\textsuperscript{30} In addition, funds should be required to disclose their policies (including the principles underlying the Risk Adjusted Segregation Amounts for different types of derivatives). Given the detailed and somewhat technical nature of this disclosure, it should appear in the fund’s Statement of Additional Information (“SAI”).

\textit{Types of assets to be segregated.} The Task Force believes that the policies and procedures referred to above should cover not only the value of segregated assets, but also the types of such assets. As a preliminary matter,

\begin{quote}
\textsuperscript{28} Generally, “value at risk” attempts to quantify the amount an investor can lose over a period of time, based upon historical probability levels. For a discussion of how the financial industry and the SEC have used the value at risk concept, see Henry T. C. Hu, \textit{The New Portfolio Society, SEC Mutual Fund Disclosure, and the Public Corporation Model}, 60 BUS. LAW. 1303 (2005). Other regulators have adopted a “value at risk” approach to regulating fund derivatives use. In 2004, the European Commission published a series of recommendations addressed to European member state regulators that aimed to harmonize the various approaches to risk measurement utilized by undertakings for collective investment in transferable securities ("UCITS"). \textit{See Commission Recommendation 2004/383 2004 O.J. (L144) 33 (EC).} Included was a recommendation that the value at risk approach be used by “sophisticated” UCITS (i.e., those funds making extensive use of derivatives) to measure market risk. The value-at-risk approach estimates the maximum potential loss that a UCITS portfolio could suffer within a certain time horizon and a certain degree of confidence. The European Commission recommended that the adopted value at risk approach use a 99\% confidence interval, a holding period of one month, and take into account “recent” volatilities (e.g., a one-year historical observation period). Following publication of the recommendations, various European member states promulgated regulations mandating the use of a value-at-risk approach for UCITS domiciled in the member state’s jurisdiction in line with the European Commission’s recommendations. \textit{See e.g., CSSF Circular 07/308, Commission de Surveillance du Secteur Financier (2004) (Luxembourg); Guidance Note 3/03, Undertakings for Collective Investment in Transferable Securities (UCITS) Financial Derivative Instruments (2008) (Ireland).} The strengths and weaknesses of “value at risk” are beyond the scope of this Paper.

\textsuperscript{29} As a general matter, the Task Force believes that the entity responsible for developing the policies and procedures should be the same one that is responsible for managing the fund’s derivative investments.

\textsuperscript{30} The Task Force believes that the board’s oversight of derivatives is analogous to its oversight of a fund’s investments and/or compliance program. That is, oversight of derivatives should not create any new or different responsibilities for a board. Section III below discusses board oversight responsibilities in greater detail.

\end{quote}
the Task Force does not believe that the SEC should revert to the standard in effect prior to the issuance of the Merrill Lynch Letter (i.e., limit the types of segregated assets to only cash, U.S. Government securities and other high grade obligations). For many funds, holding more than a minimal amount of such securities would be inconsistent with the fund’s investment objectives and policies; thus, the practical consequence of such a limitation would be that such funds would be unable to invest in various derivative instruments that otherwise would be appropriate. Such a result is neither necessary nor in the best interests of fund shareholders.

At the same time, the Task Force believes that there may be other times when it would be prudent for all, or a portion of, a fund’s segregated assets to consist of very liquid, high-quality securities. (Among the factors that could be relevant to this determination are the types of derivative instrument and the amount of segregated assets.) As discussed above, the Task Force believes that the best approach would be for these matters to be covered in policies and procedures developed by the fund’s adviser, approved by the fund’s board, and disclosed in the SAI.

“Offsetting” transactions. As noted above, Release 10666 allows funds to cover their obligations either by segregating assets or by entering into offsetting transactions. It is not always clear, however, what constitutes an “offsetting” transaction. For example, assume a fund enters into two currency forward contracts. In the first contract it agrees to deliver Currency X in 90 days; in the second it will receive Currency Y, also in 90 days. Currency X is formally “pegged” to Currency Y. Should these be treated as offsetting transactions? Similarly, what if the currencies are the same, but the counterparties are different? Consistent with our general approach, the Task Force believes that the policies and procedures referred to above also should define which transactions would be considered offsetting, by addressing matters such as pegged currencies, substantially correlated offsetting positions, different counterparties, and the like.

---

31 For example, some funds may wish to stress test their derivative obligations and segregated assets under various adverse market conditions and, depending on the results of those tests, determine to keep a certain portion of the segregated assets in highly liquid, high-quality securities.

32 Of course, in many cases the existence of an offsetting transaction is straightforward (e.g., when a fund writes an option and owns the underlying security).

33 For example, a fund may conclude that offsetting should be allowed in cases of transactions with different counterparties when both counterparties present minimal credit risks. Other funds may determine to take a more conservative approach, and only permit offsetting when the counterparty in both transactions is the same.
“Implicit leverage.” A final set of issues involves whether investments that do not result in the possibility of a fund incurring obligations beyond its initial investment, but that nonetheless permit a fund to gain exposure that is greater than would be the case in investing in a corresponding long or conventional security should be considered to involve the creation of a senior security and thus, under the approach taken in Release 10666, require asset segregation. (An example of such an investment would be certain types of structured notes.)

The Task Force does not believe that Section 18 does, or should be interpreted to, cover these types of investments. While such investments could (and in many cases, would be intended to) increase the volatility of a fund’s returns, Section 18 does not purport to limit volatility per se. Rather, it restricts the issuance of senior securities, which can (among other things) increase the volatility of the common shares. Where there is no senior security, however, there can be no Section 18 violation. In the case of synthetic instruments like the example above, the fund incurs no actual or contingent liability beyond the purchase price. Thus, there is no entity that has a prior claim on the fund’s assets (unlike, say, a swap counterparty or purchaser of an option written by a fund).

Moreover, in many cases funds could achieve a similar result through investments in stocks and/or bonds. In comparison to the example above involving the purchase of an instrument that produces a multiple of the return of an index, a fund could instead invest, for example, in high beta securities and achieve a similar result. The Task Force does not believe that there is any sound policy basis for distinguishing between these two cases for purposes of Section 18.

Nevertheless, questions have been raised regarding whether these types of investments could raise issues under Section 48(a) of the 1940 Act. Section 48(a) of the 1940 Act provides that “[i]t shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this title or any rule, regulation, or order thereunder.”

The SEC staff has in the past invoked Section 48(a) in prohibiting investments in complex securities; the specific case involved investments by money market funds in inverse floaters. The staff took the position that

---

34 15 U.S.C. § 80a-47(a). The Second Circuit Court of Appeals has held that no implied private right of action exists under Section 48(a) of the 1940 Act. See Bellikoff v. Eaton Vance Corp., 481 F. 3d 110, 117 (2d Cir. 2007).

inverse floaters were not appropriate investments for money market funds, because they created leverage, which was inappropriate for a fund designed to maintain a stable net asset value. The staff said that the derivative exposure would “ordinarily expose the money market fund to a degree of interest rate risk and volatility more characteristic of a long-term instrument” and thus were not consistent with the restrictions concerning maximum maturity of money market fund investments.\textsuperscript{36}

Money market funds are, however, a special case in that they are managed with the objective of maintaining a stable net asset value. Other funds are not so constrained and offer investors different risk-return characteristics. Instruments that involve “implied” or “economic” leverage are not necessarily inconsistent with a given fund’s investment policies and, if they are consistent with those policies, there can be no violation of Section 48(a) of the 1940 Act. The proper way to address these types of investments is the same as it is for fund investments generally – ensuring that the investments are disclosed and are consistent with the fund’s disclosed investment practices and risk factors.

Finally, the Task Force notes that applying Section 48(a) to these types of investments would open a Pandora’s Box, as it would be all-but-impossible for regulators and fund companies to know where to draw the line. For example, would investments by a stock fund in highly leveraged companies raise Section 18 issues?

For all of the above reasons, the Task Force believes that the approach taken by the SEC in Release 10666 – applying Section 18 to derivative investments that could result in a fund owing money, but not to other types of derivatives or complex securities – remains correct.

\section*{D. Section 5(b) and Diversification}

\textbf{Introduction.} Each SEC-registered fund must declare a policy regarding the diversification of its assets. That is, a fund must identify itself as either “diversified” or “non-diversified.”

It is not clear, however, under the wording of the relevant statutory provisions how a fund should treat various derivatives in determining whether it complies with its diversification policy, and the SEC and its staff have

\begin{flushright}
interest rates that move in the opposite direction of short-term interest rates, at an accelerated rate.
\end{flushright}

\textsuperscript{36} \textit{Id.}
provided little or no guidance in this area.\(^{37}\) Below we examine these difficulties in more detail by explaining how the 1940 Act operates in this regard, and describing why the statute is not clear. We then describe a common approach that is followed by many funds, although other approaches could be acceptable and consistent with the purposes of Section 5(b). We also suggest how the SEC or its staff may address the challenges created by the use of derivatives.

**The Law and Its Purposes.** Pursuant to Section 8(b)(1)(A) of the 1940 Act, a fund must disclose in its registration statement its policy concerning the diversification of its assets. Section 5(b) of the 1940 Act defines diversification for that purpose and provides that a diversified fund meets the following requirements:

\[
\text{at least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of [the fund] and to not more than 10 per centum of the outstanding voting securities of such issuer. (emphasis added).}\(^{38}\)
\]

Under Section 5(b)(2), a non-diversified fund means any management investment company other than a diversified fund. Section 8(b) of the 1940 Act was designed “to apprise the prospective purchaser of the investment company's security of the nature of its activities.”\(^{39}\) Under Section 5(b), a fund must maintain its diversification status continuously, that is, on each day that it purchases or acquires securities. However, a diversified fund

---

\(^{37}\) In contrast, the SEC has provided limited guidance concerning how funds can take derivative instruments into account under Rule 35d-1, 17 C.F.R. § 270.35d-1, under the 1940 Act (the “Names Rule”). *See infra* Section II.J.

\(^{38}\) Rule 5b-1 under the 1940 Act provides, as relevant here, that “total assets” means the gross assets of a fund. 17 C.F.R. § 270.5b–1.

\(^{39}\) *Investment Trusts and Investment Companies: Hearings on S.3580 before the Senate Subcomm. on Banking and Currency, 76th Cong., 188 (1940)(statement of David Schenker).* Pursuant to Section 8(b)(1) of the 1940 Act a fund could reserve the freedom to switch from a non-diversified fund to a diversified fund. 15 U.S.C. § 80a-8(b)(1). Section 13(a)(1) of the 1940 Act and Rule 13a-1 thereunder together allow a fund to make that switch without obtaining shareholder approval. 15 U.S.C. § 80a-13(a)(1); 17 C.F.R. § 270.13a–1. Under Section 13(a)(1) a fund must obtain shareholder approval to switch from diversified to non-diversified. 15 U.S.C. § 80a-13(a)(1).
that has been affected adversely by market movements may acquire assets so long as the acquisition does not move the fund out of compliance.\textsuperscript{40}

For ease of reference, this section of this Paper refers to the amount of total assets that are attributable to a single issuer for purposes of Section 5(b)(1) as an “Issuer Position.” Both diversified and non-diversified funds must calculate their Issuer Positions to ensure that they comply with their stated diversification policies.

As explained below, it is not clear how a fund should treat derivatives in calculating Issuer Positions and complying with its diversification status when the status of many derivative instruments as securities is not entirely clear. Further challenges arise when derivative instruments are securities, because funds must identify the “issuer” of the security, and determine how to treat the reference asset, in calculating Issuer Positions.

This section of this Paper describes how funds apply Section 5(b) by making a threshold determination as to whether the derivative instrument in question is a security. Below we explain the further challenges funds face in identifying the appropriate issuer of a derivative instrument and in making the appropriate calculations for Issuer Positions.

**Derivative Instruments that Are Securities.** On its face, Section 5(b) addresses the amount of a fund’s assets that are represented by the securities of one issuer. Consequently, it would be reasonable to conclude that the Section applies to, and the SEC could only enforce, calculations that include securities.

Only some derivative instruments are specifically identified as securities in Section 2(a)(36) of the 1940 Act,\textsuperscript{41} including certain options (\textit{e.g.}, options on securities) and certain futures contracts (\textit{e.g.}, “security futures”).\textsuperscript{42}

\textsuperscript{40} A fund that holds itself out as diversified or non-diversified when the opposite is true may violate, among other things, Section 34(b) of the 1940 Act, which prohibits the use of false or misleading statements in a document that is filed with the SEC. 15 U.S.C. § 80a-33(b).

\textsuperscript{41} Section 2(a)(36) of the 1940 Act provides, as relevant here, that security means: any note, stock, . . . \textit{security future}, bond, debenture, \textit{evidence of indebtedness} . . . any put, call, straddle, option, or privilege on any security (including any certificate of deposit) or on any group or index of securities . . . or any put, call, straddle, options, or privilege entered into on a national securities exchange relating to a foreign currency . . . [or any] guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing [emphasis added]. 15 U.S.C. § 80a-2(a)(36).

\textsuperscript{42} \textit{See} Section 2(a)(36) of the 1940 Act (specifically including a “security future” as a security). Other futures contracts are not securities under the 1940 Act. 15 U.S.C. § 80a-2(a)(36). Section 2(a)(52) of the 1940 Act provides that the terms “security future” and “narrow-based security index” have the same meanings as provided in Section 3(a)(55) of the
The status of other instruments, like swaps and forwards, as securities under Section 5(b) is not clear, although many funds treat some swaps and forwards as securities for purposes of Issuer Positions, if the instruments provide exposures to specific securities.43

In particular, many funds view as securities CDS, equity swaps and other swaps that use specific securities (or baskets of securities) as reference assets. We note, however, that whether or not a particular derivative instrument for purposes of the 1940 Act is or should be considered a security is beyond the scope of this Paper. Rather, we attempt to provide a framework for analyzing Section 5(b), and suggest approaches that the SEC or its staff may take, without having to reach a conclusion that any particular derivative instrument is or should be considered a security for purposes of Section 5(b).

**Derivative Instruments that Are Not Securities.** Some types of derivatives are not securities under the 1940 Act. These derivatives include, for example, Treasury futures and futures on broad-based security market indexes, even though they provide exposure to the securities of certain issuers.

We believe it is appropriate not to include any such instruments in Issuer Positions in light of the purposes of Section 5(b), which is to alert fund shareholders to the risks of investments in only a few issuers. It is appropriate to exclude a broad-based stock index future from an Issuer Position because it provides very diverse exposures. If the index were deconstructed into its component parts, the value of any one component security would be immaterial in most cases. Similarly, Treasury futures should not be included in Issuer Positions because U.S. Government securities are the reference assets for Treasury futures, and Section 5(b) specifically excludes U.S. Government securities from Issuer Positions. Also, commodity index-linked futures in Issuer Positions should not be included because they do not reference

---

43 Prior to the enactment of the Commodity Futures Modernization Act of 2000 (“CFMA”) App. E., Publ. L. No. 106-554, 114 Stat. 2763, the application of the Securities Act of 1933 (the “1933 Act”) and the 1934 Act to swaps was a matter of some uncertainty. The CFMA amended the 1933 Act and the 1934 Act to specify that swap agreements, whether or not relating to securities, are generally not securities for purposes of those Acts. The CFMA, however, did not make any comparable or similar amendments to the 1940 Act or the Investment Advisers Act. The SEC, however, has anti-fraud authority over “security-based swaps.” See, e.g., Section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a), Sections 10(b) and 15(c)(1)(A), (B) and (C) of the 1934 Act, 15 U.S.C. § 78j(b) and 15 U.S.C. § 78o(c)(1)(A)-(C).
Identification of the Issuer of the Security. After identifying the derivatives to which a fund’s diversification policy may apply, the next step of the analysis is to identify the issuer of the “security” at hand.44

The SEC staff has provided guidance concerning the definition of “issuer” under the 1940 Act (although not in the context of derivative instruments). That guidance suggests that the person to whom an investor looks for payment on an instrument will be deemed to be the issuer of the instrument.45 A fund looks to payment from its counterparties, in the case of OTC derivatives, and its market intermediary, and possibly the exchange, in the case of exchange-traded derivatives. A fund does not look to the reference security for payment although the value of the reference security/asset is used to determine the amount of a payment to be made under a derivative instrument. The issuer of that reference security has no legal or other obligation to make any payment to the owner of a derivative instrument (unless the issuer is the counterparty). This is true in the case of most derivative instruments.

44 Section 2(a)(22) of the 1940 Act defines issuer to mean “every person who issues or proposes to issue a security, or has outstanding any security which it has issued.” 15 U.S.C. § 80a–2(a)(22).

45 See, e.g., Dreyfus New York Tax-Exempt Bond Fund, Inc., SEC No-Action Letter, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,416 (May 16, 1977), in which the SEC staff indicated that the issuer of a municipal bond is the state that backed the issue with its full faith and credit rather than the particular municipality that structured it; T. Rowe Price Tax-Free Funds, SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,686 (June 24, 1993) (for purposes of Section 5(b)(1), municipal bonds refunded by escrowed U.S. Government securities are deemed to be issued by the U.S. Government when the securities deposited are not subject to the claims of the municipalities creditors); see also Pilgrim Prime Rate Trust, SEC No-Action Letter, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,321 (June 29, 1989) (“Pass through” interests in a loan to a corporate borrower are deemed to have been issued by the lending bank that originated the loan even though the lending bank did not guarantee the loan because, in part, the loan may have been included in the lending bank’s estate in the event of its bankruptcy); Comdisco, Inc., SEC No-Action Letter, 2000 WL 1585639 (Oct. 25, 2000) (establishing a test for identifying an issuer in the case of a corporation that issues stock that tracks the performance of a single business unit. In some circumstances, the business unit could be the issuer); cf. Hyperion Capital Management, Inc., SEC No-Action Letter, 1994 WL 420077 (Aug. 1, 1994) [hereinafter Hyperion Letter], in which the SEC staff agreed not to recommend enforcement action with respect to treatment under Section 5(b) of the pool of assets as the issuer of certain ABS (versus the sponsor or depositor). The staff allowed a “look through” with respect to “concentrated pools.” Id.
Treatment of Counterparties under Section 5(b). Thus, arguments can be made that funds may be technically required to calculate Issuer Positions in derivative instruments by including the person that they look to for payment. In the case of the OTC derivatives, like swaps, forwards and certain options, which may be considered to be securities, some funds treat their counterparties as issuers.

The issuer of exchange-traded derivatives that are securities (like exchange-traded options on securities and security futures) may, as a technical matter, be the exchange upon which the instrument trades. It does not make sense, however, to include a securities exchange in an Issuer Position, because the diversification rules are not intended to address the slim possibility that an exchange might default, and funds typically do not do so.

The Task Force generally agrees, however, that Section 5(b) does not supply an appropriate framework for regulating fund counterparty exposures. The Task Force’s recommendations in this respect are set forth below under Alternative Approaches to Diversification and Counterparties.

Treatment of Reference Assets. Many funds currently calculate Issuer Positions taking the reference assets into account when they calculate “long exposures” to the fund.

For example, a fund may enter into an equity swap with counterparty A that provides the fund with exposure to the security of “Issuer B.” As the value of the reference security increases, so does the value of the swap. The fund may include the value of the swap in an Issuer Position relating to the issuer of the reference security on the theory that the exposure created by the derivatives is economically equivalent to the exposure that Section 5(b) was designed to address.46

Many funds may include reference assets in Issuer Positions when the derivative instrument requires the fund under certain circumstances to accept delivery of the reference assets. For instance, when a fund writes a put

---

46 By rule, the SEC has allowed funds to “look-through” certain instruments to the underlying assets for purposes of identifying an issuer under Section 5(b)(1) (and Section 12(d)(3), which is discussed in another section below), but only in very limited circumstances, and the SEC has not required it. See, e.g., Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25058 (July 5, 2001), 66 Fed. Reg. 36156 (July 11, 2001) (adopting Rules 5b-3 and 12d3-1 under the 1940 Act, which prescribe the circumstances in which a fund may look through the obligation of a counterparty to the collateral securing the repurchase agreement in identifying the issuer for purposes of Sections 5(b) and 12(d)(3)). See also note 37, supra, discussing the Names Rule, and note 46, supra, discussing the Hyperion Letter.
option, it must accept the delivery of securities upon exercise of the option. Certain funds may test for compliance with its diversification policies by assuming that the put option had been exercised. This is particularly appropriate when the put option is likely to be exercised.

**Alternative Approaches to Diversification and Counterparties.** The Task Force suggests that the SEC consider an alternative approach to measuring diversification and dealing with counterparty exposures. Specifically, the SEC should recognize the need to bifurcate the regulatory treatment of counterparties and reference securities to achieve diversification in a manner consistent with the purposes of the statute and the regulatory concerns of the SEC.

Under this approach, the SEC would acknowledge that diversification should be measured for purposes of Section 5(b) by looking only at the reference securities. The SEC could acknowledge that it will not enforce Sections 5(b) and 8 with respect to the counterparty exposures of a diversified fund and Section 8 with respect to a non-diversified fund. In addition, as discussed above, broad-based indices or other reference assets such as commodities or currencies should be excluded from these calculations.

The Task Force recommends further that the SEC address counterparty diversification separately under Section 12(d)(3) of the 1940 Act, which is described in detail below under Securities-Related Business Considerations.

Section 12(d)(3) offers the SEC a more comprehensive mechanism for dealing with counterparty risks than does Section 5(b) of the 1940 Act. On its face, it appears that by including counterparties in Issuer Positions, Section 5(b) of the 1940 Act could limit a fund’s exposure to a single counterparty. For instance, a diversified fund that enters into a large number of swaps with a single counterparty could, at least theoretically, fail to meet the diversification limits of Section 5(b)(1).47 As described in the next section of this Paper, however, funds typically calculate Issuer Positions using the market values of their positions based on the wording of the Section. As a result, Section 5(b) may not provide an effective means to regulate counterparty risks. In addition, reliance on Section 5(b) to regulate counterparty exposures would ignore all non-diversified funds, which by definition are not subject to the limits of Section 5(b).48


48 The Task Force recognizes that registered investment companies, including non-diversified funds, are subject to the diversification limits of Subchapter M of the Code to the extent that the funds seek “pass through” tax treatment. The Task Force believes that the SEC is
The Task Force believes that Section 12(d)(3) of the 1940 Act offers a better framework for addressing counterparty exposures because it applies to all funds without regard to their diversification status.

**Issuer Position Should Be Calculated Using Market Values.** To our knowledge, neither the SEC nor its staff has provided guidance on how to make calculations under the diversification tests.

It seems reasonable to conclude that the calculations should be made using market values due to the wording of the statute. The tests require the determination of “the value” of the “total assets” of a fund. Section 2(a)(41) of the 1940 Act defines the term “value” with respect to the assets of a fund as follows: (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the fund’s board.

Thus, for purposes of calculating an Issuer Position, the market values (or fair values) of the relevant derivative instruments should be used. Consequently many funds determine compliance with their diversification policies by using market values that could be associated with derivatives.49

It is not clear, however, how to apply the diversification tests when there is a negative market value for a derivative instrument (i.e., when the fund owes money to its counterparty in connection with the position). For one thing, when the market value of a derivative instrument is negative (and the fund owes money under the instrument), that negative amount may not be reflected in the “gross assets”50 of the fund, which is the denominator in the diversification test. In addition, a negative market value used as the numerator would result in a negative percentage, which, by definition, is less than the 5% limit. How funds should treat instruments with negative market value for measurement purposes is not addressed in this Paper. The Task Force recommends that the SEC invite comment on this issue.

---

49 The calculation of an Issuer Position for a non-diversified fund presents the concern that an Issuer Position will be inappropriately overstated and the SEC or its staff would conclude that the fund was, in fact, diversified. In that case, the fund may have lost its non-diversified status. In particular, using the notional value, rather than the market value, of a derivative instrument would inflate an Issuer Position because the larger notional value would inflate the denominator.

50 Section 5(b)(1) of the 1940 Act states that the calculation of an issuer’s position should be based on a fund’s “total assets,” which is defined in Rule 5b-1 as a fund’s gross assets taken as of the end of the fund’s fiscal quarter last preceding the date of computation. 15 U.S.C. § 80a-5(b)(1).
E. Section 8(b)(1) Concentration Limitations.

Introduction. Pursuant to the 1940 Act, each SEC-registered fund must declare a policy concerning whether and how it concentrates its investments in the securities of issuers within a particular industry. Derivative instruments can be used to obtain industry exposure through the particular reference assets of the instruments. As explained below, funds typically comply with their concentration policies by looking to the reference asset and not any counterparty to the derivative instrument. Funds typically use market values for these calculations consistent with their approach to Section 5(b). Again, neither the SEC nor its staff has provided any guidance in this area.

The Law. Section 8(b)(1) of the 1940 Act requires a fund’s registration statement to include a statement indicating the extent to which a fund intends to engage in certain activities, including “concentrating investments in a particular industry or group of industries.” A fund is concentrated if it invests more than 25% of the value of its assets in any one industry or group of industries.

As is the case with the diversification requirements that are discussed above, the requirements relating to the concentration policies generally are disclosure-based. The SEC has indicated that the requirement to disclose a concentration policy “reflects the view that such a policy is likely to be central to a fund’s ability to achieve its investment objectives, and that a fund that concentrates its investments will be subject to greater risks than funds that do not follow the policy.”

Application to All Kinds of Instruments. The test may be deemed to apply to all kinds of investments and not merely to securities. This

---

51 Instruction 4 of Item 9 of Form N-1A requires a fund to “[d]isclose any policy to concentrate in securities of issuers in a particular industry or group of industries (i.e., investing more than 25% of a fund’s net assets in a particular industry or group of industries).” Section 13 of the 1940 Act provides that a fund cannot, unless authorized by the vote of its shareholders, deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement. 15 U.S.C. § 80a-13.

52 Id.


is because of the use of the word “investments” in Section 8(b) of the 1940 Act and the purpose of the requirement to disclose a policy to concentrate.55

**Treatment of Reference Assets.** Many funds deem the test to apply to the reference asset underlying any derivative based on the purposes of the disclosure requirements. It would lead to odd results to take the counterparty for OTC derivatives into account (e.g., the counterparty on a forward contract or swap agreement) 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. The concentration provisions were not designed to set rules around exposures to financial intermediaries and counterparties, which is addressed in other sections of the 1940 Act.56

Due to the disclosure-based nature of the concentration requirements under the 1940 Act, it would seem reasonable to include reference assets in the calculation, and ignore the counterparty. Such an approach would be consistent with that recommended above for purposes of the diversification test. The Task Force therefore recommends that the SEC or its staff issue guidance affirming this approach.57

**How the Test Should Be Calculated.** Many funds calculate concentration using market values. This position is based on the wording of the test, which focuses on a percentage of “the value” of the “total assets” of a fund, which is defined in Section 2(a)(41) of the 1940 Act to mean market value or fair value. (Refer to the similar analysis under Diversification, above.)

We believe that a calculation based on market value is the correct test.

---


56 As explained below, the wording of Section 12(d)(3) of the 1940 Act is more suited to addressing the issues raised by counterparty exposures. 15 U.S.C. § 80a-12(d)(3).

57 The calculation of an industry position for a fund that concentrates its investments presents concerns similar to those presented by non-diversified funds (i.e., that an industry position will be inappropriately overstated and the SEC or its staff would conclude that the fund was, in fact, not concentrating in accordance with its stated investment policy). In particular, using the notional value, rather than the market value, of a derivative instrument may inflate an industry position relative to the fund’s current economic exposure.
F. Section 12(d)(3): Securities-Related Business Considerations

The Law. Section 12(d)(3) of the 1940 Act generally prohibits a fund’s investments in any security issued by, or any other interest in the business of, any broker, dealer, underwriter or SEC-registered investment adviser (each, a “securities-related issuer”). Rule 12d3-1 thereunder provides an exception for a fund’s investment in a company that derives no more than 15% of its gross revenues from securities-related activities, and a further exception for investments in securities-related issuers if:

i. immediately after the acquisition of any equity security, the fund owns not more than 5% of the outstanding securities of that class of the issuer's equity securities;58

ii. immediately after the acquisition of any debt security, the fund owns not more than 10% of the outstanding principal amount of the issuer’s debt securities; and

iii. immediately after any such acquisition, the fund has invested not more than 5% of the value of its total assets in the securities of the issuer.

The SEC has taken the position that Section 12(d)(3) was principally designed to prevent funds from “exposing their assets to the entrepreneurial risks of securities-related businesses.”59 The SEC has also taken the position that the Section was designed to prevent conflicts of interest and reciprocal practices between funds and companies that are engaged in a securities-related business.60

58 Rule 12d3-1(d)(3) under the 1940 Act, 17 C.F.R. § 270.12d3-1(d)(3), provides that an equity security is as defined in Rule 3a11-1 under the 1934 Act. A debt security is any other kind of security. Id. at § 270.12d3-1(d)(4).

59 See Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities Related Businesses, Investment Company Act Release No. 13725, 29 SEC Docket 793-1 (Jan. 17, 1984). The SEC focused on the organization of such businesses as general partnerships that could expose investing funds to the risk of being called upon to contribute more money to the partnerships. Id.

60 See Exemption of Acquisitions of Securities Issued by Persons Engaged in Securities-Related Businesses, Investment Company Act Release No. 19716, 54 SEC Docket 2190-1334 (Sept. 16, 1993). The SEC has indicated that such reciprocal practices include the possibility that a fund might purchase securities or other interests in a broker-dealer to reward that broker-dealer for selling fund shares, and that a fund might direct brokerage to a broker-dealer in which the fund has invested to enhance the broker-dealer’s profitability or to assist it during financial difficulty, even though that broker-dealer may not offer the best price and execution.
A fund that invests in securities-related issuers in excess of the limits of Rule 12d3-1 violates Section 12(d)(3).

**Analysis of the Provision.** As with diversification, the wording of Section 12(d)(3) suggests that its prohibitions may not apply with respect to derivative instruments that are not securities, or with respect to the reference assets for any derivative instrument. Section 12(d)(3) on its face makes it unlawful for a fund “to purchase or otherwise acquire any security issued by or any other interest in the business of” a securities-related issuer. There is no guidance concerning whether the phrase also is meant to cover a broader indirect interest. The wording of the statute suggests that there must be a direct connection between the issuer and the person owning the “interest in the business.” Many funds, therefore, include in their Section 12(d)(3) calculations their exposures to their OTC counterparties.

As indicated above, Rule 12d3-1 establishes different investment limitations depending upon whether a fund’s investment is in equity securities or debt securities of a securities-related issuer. In drawing this distinction, Rule 12d3-1 incorporates the definition of “equity security” under Rule 3a11-1 of the Securities Exchange Act of 1934, as amended (“1934 Act”). All other securities are “debt securities.” Derivative instruments generally do not incorporate the types of equity interests contemplated by the definition in Rule 3a11-1. Funds therefore generally consider derivatives to be debt securities for purposes of Rule 12d3-1.

Derivative instruments do not provide for direct connections between the holder of the instrument and the issuer of a reference asset. Yet many funds also include reference assets in applying Section 12(d)(3) and Rule 12d3-1. Other funds take into consideration reference assets when the derivative instrument entails an obligation to accept delivery of the securities of securities-related issuers (e.g., a put option written by a fund would require the fund to accept delivery of securities upon exercise and certain equity swaps may require physical settlement of the securities). This is an area that would benefit from clarification by the SEC or its staff.

**Apply Test Based on Market Values.** Again, as is the case with the diversification analysis above, the prohibitions under Section 12(d)(3) and

---

61 Given that in 1940 most securities-related issuers were organized privately as general partnerships and that Rule 12d3-1 explicitly does not exempt the acquisition of general partnership interests, it is likely that “any other interest in the business of,” was intended to refer to a general partnership interest. 17 C.F.R. § 270.12d3-1.
the exemption in Rule 12d3-1 appear to apply to the market values of the instruments due to the use of the word “value” in Rule 12d3-1.62

**Counterparties.** As explained above under Section 5(b), Diversification, the Task Force believes that Section 12(d)(3) of the 1940 Act provides an appropriate framework for dealing with fund counterparty exposures. Simply stated, those exposures present the concern that a counterparty cannot pay a fund the amount that the fund is due under the derivative instrument (known as “counterparty risk”).63 The counterparties to the derivative instruments that funds use generally fall within the list of securities-related issuers that Section 12(d)(3) applies to – thus, all of the relevant kinds of counterparties would be addressed. In addition, Section 12(d)(3) applies to all registered investment companies, without regard to their diversification status.

The Task Force recommends that in applying Section 12(d)(3) to limit counterparty exposure, the SEC acknowledge a fund’s derivative positions that are collateralized. Fund managers that use derivatives to a large degree are establishing collateralization protocols that require fund counterparties to post collateral in respect of their obligations to the fund. Those protocols call for the protection of the posted collateral from other potential creditors of the counterparty. Collateralization whereby the amount owed to a fund is protected addresses the concerns raised by counterparty exposures. Full collateralization refers, therefore, to the situation in which the payments due to a fund under a derivative instrument are fully protected through collateral that the counterparty has posted in a bankruptcy-protected manner.

The Task Force recognizes that from time to time a fund may not have full collateralization relating to a particular derivative instrument. The Task Force recommends that in that case, the SEC address the fund’s exposure through application of Section 12(d)(3). Specifically, the SEC could adopt a new rule to place limitations on the amount of uncollateralized exposure a fund could have to a single counterparty.64 A new rule should distinguish between

---

62 The exposure to a single counterparty with respect to multiple derivative instruments under an ISDA agreement that allows netting could be netted.

63 In contrast, when a fund owes money on a derivative position, generally it does not have current counterparty exposure with respect to that position.

64 The new rule should acknowledge the fact that collateral calls are made by the parties to OTC derivative contracts when the value of a contract has moved by a predetermined amount. The new rule should acknowledge this practice, which is a practical necessity, and allow funds to be deemed to be fully collateralized when a predetermined level has not been reached (i.e., a fund would be deemed to be fully collateralized when its counterparty must post collateral to the fund upon a $500,000 change in the market value of the contract, even though the market value only moved by $450,000).
investments made for the purpose of exposing a fund’s assets to securities-related issuers, which Rule 12d3-1 addresses, from the credit risks presented by derivatives counterparties. In addition, the SEC could look to the disclosure regime for funds to address significant uncollateralized positions.65

**Additional Issues.** Listed below are additional issues that are raised under Section 12(d)(3) and Rule 12d3-1 thereunder that the SEC staff might consider clarifying.

Rule 12d3-1(d)(6) provides that:

> Where an acquiring company is considering acquiring or has acquired options, warrants, rights or convertible securities of a securities related business, the determination required by paragraph (b) . . . shall be made as though such options, warrants, rights, or conversions privileges had been exercised.66

The wording of this provision suggests that a fund could evade the prohibitions of the statute by owning a large position in a securities-related issuer, and purchasing a put option with respect to those securities. The fund could assume that it exercised the put and no longer owned the securities of the securities-related issuer, even though the strike price on the put option made it unreasonable for the fund to exercise the option. To avoid this odd result, we believe that an option, warrant, right or convertible security should be deemed to be of a securities-related issuer only when the instrument is a direct obligation of (i.e., issued by) the securities-related issuer.67

In addition, in the case of an option that requires a fund to pay cash in order to exercise the option, an argument may be made that having to treat such options as exercised causes a fund to overstate (sometimes to a very significant extent) a fund’s exposure to the issuer and the class of securities underlying the option. This result seems particularly illogical when it is unlikely that the fund would ever exercise the options – e.g., the options are far out of the money. We note that there is no SEC authority to support an interpretation of Rule 12d3-1(d)(6) that requires its application only to those

65 Any effort by the SEC to regulate a fund’s use of counterparties should be based on an examination of the empirical evidence of fund losses during the market crisis due to counterparty exposures.

66 17 C.F.R. § 270.12d3-1(d)(6).

67 Some on the Task Force believe that Rule 12d3-1 should be revised to clarify that in the case of options or similar instruments, the test will be applied at the time of exercise, rather than at the time of purchase.
instruments which, by their terms, do not require the payment of any additional consideration.

G. Valuation of Derivative Instruments

The Law. The term “value,” as used in several of the above described investment limitations, is defined in Section 2(a)(41) of the 1940 Act to mean:

(A) as used in Sections 3, 5 and 12 of [the 1940 Act] (i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, the market value at the end of such quarter; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value at the end of such quarter, as determined in good faith by the board of directors; and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, the cost thereof; and

(B) as used elsewhere in [the 1940 Act], (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors;

in each case, as of such time or times as determined pursuant to the 1940 Act, and the rules and regulations issued by the SEC thereunder.

Section 2(a)(41) also provides that the SEC may, by rule, regulation or order, permit any security held by a diversified fund to be carried at cost, if it shall determine that such procedure is consistent with the general intent and purpose of the 1940 Act. Section 2(a)(41) further provides the SEC flexibility to draft rules that permit other methods of valuing securities for purposes of Section 5 and 12 in lieu of values determined as provided in Section 2(a)(41)(A).

Analysis. The investment limitations on diversification (required by Section 5(b)(1)) and investments in securities-related business (required by Rule 12d3-1) both include the term “value” in the description of the limitation. A fund’s portfolio securities should therefore be valued in accordance with Section 2(a)(41)(A) for purposes of these calculations, which requires the use of market value (where available), fair value or cost. The concentration test also focuses on a percentage of “the value” of a fund’s total assets. Disclosure of a fund’s concentration policy is required by Section 8(b)(1) of the 1940 Act and, therefore, the definition of “value” in Section 2(a)(41)(B) should be applied in calculating concentration limits.
As discussed above, for purposes of regulatory limitations (such as qualification as a diversified fund or concentration status), market value is the appropriate measure and the one contemplated in the 1940 Act. Some fund complexes also apply certain voluntary limits on their investments in particular types of derivative instruments. These limits may be based on market value or on other measures (such as notional value). The Task Force believes that funds should clearly disclose how they are calculating limits in these cases.

H. Liquidity Limitations and Derivative Instruments

The Law. Mutual funds typically disclose that no more than 15% of the fund’s net assets may be invested in illiquid investments. The disclosure derives from prior SEC staff positions. An illiquid security includes any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the fund has valued the instrument.

Analysis of the Provisions. Funds that make this disclosure should apply it to all fund assets without regard to whether they are securities under Section 2(a)(36) of the 1940 Act. This position is based on the wording of the SEC staff's prior position (referring to “assets” and not merely “securities”) and its purposes.

Specifically, at least one articulation of the position referred to investments, and not merely securities. In 1994, the SEC staff addressed the application of the liquidity “requirements” to derivative instruments, indicating

68 The SEC staff's position that no more than 15% of an open-end fund's net assets may be invested in illiquid investments was set forth in the Guidelines on Form N-1A that were published by the SEC along with the Form. The SEC explicitly repealed all of the Guidelines in 1998, including Guide 4, which set forth the liquidity position, indicating that the Guidelines would be reviewed and reconsidered. No such reconsideration has taken place. Money market funds, which had been subject to a 10% limitation, will now, under the SEC's recently adopted amendments to Rule 2a-7, be subject to a 5% limitation in illiquid assets. In addition, such funds will be subject to a general requirement that such funds hold assets that are sufficiently liquid to meet reasonably foreseeable redemptions and minimum amounts of ‘daily liquid’ and ‘weekly liquid’ assets. See Money Market Fund Reform, Investment Company Act Release No. 28807 (proposed June 30, 2009), 74 Fed. Reg. 32688 (July 8, 2009) (discussing Rule 2a-7(c)(5)(j), as revised).


70 Note that the Money Market Fund Reform proposing release referred to money market funds not investing in “illiquid securities” rather than assets. The release contained no analysis on whether this prohibition applied to non-securities. Money Market Fund Reform, supra note 68.
that the liquidity of particular derivatives depends on relevant market conditions. The staff suggested that derivative instruments that are “designed to meet the needs of a particular investor” are more likely to be illiquid.\textsuperscript{71} The staff made no distinction between instruments that are securities and those that are not.

Embedded in the definition of illiquid securities (or investments) is the term “value.” As noted above, Section 2(a)(41) of the 1940 Act provides a definition of that term. Thus, for purposes of the liquidity calculations, it seems reasonable to conclude that the market value (or fair value) of the particular instrument should be used.

Many exchange-traded derivatives trade in markets that are deep and liquid. Additionally, while some OTC derivatives are not liquid, others are highly liquid in practice. As many funds’ disclosures limit their holdings of illiquid instruments to 15% of a mutual fund’s portfolio’s value, fund managers maintain procedures to monitor the liquidity of their funds’ derivatives positions.

The SEC’s guidance regarding factors to consider in making liquidity determinations is helpful, but only to a point: while it is appropriate to look to significant developments involving the counterparty or the reference entity, to the relative frequency of trades or quotes in an instrument’s primary markets, and to the number of market makers or dealers in the instrument, in practice there are no clear lines along what is truly a continuum of degrees of liquidity. Thus, many funds negotiate into their contracts seven-day termination rights in their favor. That practice is consistent with existing staff guidance.\textsuperscript{72} Consequently, the Task Force does not request additional SEC or staff guidance in this area.

I. Custody

Maintaining Assets with Custodian. Section 17(f) of the 1940 Act requires registered management companies to place and maintain their investment securities and similar investments in the custody of a bank, or subject to such rules and regulations as the SEC may prescribe, a member of a national securities exchange or the registered investment company. Although rules have been adopted with respect to maintaining custody with members of national securities exchanges and self-custody, the onerous nature of the rule

\textsuperscript{71} See 1994 SEC Study, supra note 4.

\textsuperscript{72} For instance, this is the SEC’s approach to liquidity for certain money market instruments under Rule 2a-7 under the 1940 Act. 17 C.F.R. § 270.2a-7.
requirements result in investment companies maintaining their assets with banks. Rules have also been adopted with respect to custody of securities of investment companies with a securities depository (Rule 17f-4), and with futures commission merchants and commodity clearing organizations (Rule 17f-6). Neither the SEC nor its staff has provided guidance concerning the custody of fund assets in connection with forward contracts, swaps or options (other than options on futures).

The very wording of Section 17(f), “place and maintain,” does not effectively embrace derivatives instruments. Funds may not place and maintain futures, options, forwards and swaps with any other person because, by their nature, they are contracts providing for certain rights and obligations that depend upon future events. Many funds have not attempted to place and maintain copies of the contracts relating to the derivatives with an eligible fund custodian because such attempts at safekeeping have appeared to offer little value relative to the practical burdens. Derivatives instruments, however, often require the movement of cash or other assets (e.g., when an option is exercised), in which case a fund places and maintains the cash or other assets with an eligible fund custodian, as described below.

**Treatment of Collateral/Margin.** Many derivatives by their terms require the deposit of collateral or margin to support the credit exposure to a counterparty. Futures require the deposit of initial margin and daily variation margin. Rule 17f-6 under the 1940 Act specifically addresses how margin (a fund asset) should be maintained in connection with exchange-traded futures contracts and commodity options. Specifically, the rule focuses on the potential insolvency of the futures commission merchants (“FCMs”) used by a fund to engage in futures and options by not allowing a fund to maintain excess cash with the FCM.

Swap counterparties increasingly require the posting of collateral, and funds themselves are requiring the posting of collateral by the counterparty under the terms of the Credit Support Annex (“CSA”), which is provided as part of the ISDA Master Agreement. The ability of a fund to accept collateral is generally a contractual matter with the fund’s custodian.

In order to maintain the fund’s assets with the fund’s custodian, while providing perfection of the security interest granted under the CSA in favor of the counterparty, many fund groups have developed specialized custody arrangements, which operate under the terms of a fund’s existing custodian agreement. In addition to perfecting the security interest of the counterparty, these custody arrangements establish certain rights for a fund with respect to any periodic collateral payment that a fund has to make. This is designed to address the risk that a counterparty will, for instance, become unable to return the fund’s collateral if required to do so.
Recently, central clearing houses have started clearing certain swap agreements. To date, mutual funds have not received clarity whether such central clearing complies with Section 17(f) and the associated rules.73

J. Disclosure

Fund Names. The name of a fund is often one of the first things an investor knows about the fund and can be the best way to communicate concisely a fund’s general focus. In 2001, the SEC adopted the “names rule,” Rule 35d-1 under the 1940 Act, in recognition of this notion. The rule essentially requires funds to consider the investor perceptions that attach to a fund’s name and to select names and manage fund assets accordingly.74 The SEC stated that “[i]n appropriate circumstances, this would permit an investment company to include a synthetic instrument in the 80% basket if it has economic characteristics similar to the securities included in the basket.”75

For a fund with a descriptive name, at least 80% of the investment assets must be invested in positions that under internal guidelines rationally “fit” with the name. Derivative instruments can “fit” with a name – that is, a fund manager may use derivatives in a manner that is consistent with investor perceptions of the name of the fund. Consider, for example, currency hedging programs in a fund with a name suggesting international investing, or commodity futures in a fund with a name suggesting commodities investing.

As a general matter, when considering derivative investments for purposes of the names rule, the Task Force believes that the reference asset, rather than the counterparty, would be the relevant focus for determining whether a fund invests in a manner that is consistent with its name. This is consistent with the approach recommended for diversification and concentration status. The Task Force recommends that the SEC or its staff clarify that this approach is appropriate.

Funds generally calculate their compliance with Rule 35d-1 using the market values of the instruments owned by the fund because of the use of the word “value” in paragraph (a)(2)(i) of that rule. Using market values is

73 Legislative proposals, if enacted, would require rulemaking with respect to margin of OTC derivatives.


75 Id.
consistent with the approach taken under Section 5 of the 1940 Act as described above.\textsuperscript{76}

**Plain English Considerations.** Derivatives can be among the most complex aspects of a fund’s investment program. “Telling their story” to investors thus puts plain-English issues front and center. This fact is not new, but bears continued emphasis.

**Disclosures Regarding Investment Objectives and Policies, Investment Strategies, and Risks.** Disclosure about use of derivatives in fund prospectuses and SAIs is generally effective at describing the following:

i. Types of derivatives used,

ii. Mechanics of how particular derivatives operate,

iii. Whether derivatives are used for hedging or investment purposes, and

iv. Key risks of derivatives, especially in terms of their volatility and their exposure to counterparty failures.

Funds that appear to make heavier use of derivatives generally are those most likely to include longer and more detailed disclosure. Thus, the length and detail of a fund’s prospectus/SAI disclosure can be said to generally correlate, as would be predicted, with the actual use of derivatives by a fund.\textsuperscript{77}

\textsuperscript{76} The Task Force recognizes, however, that by using those market values it is possible that a fund’s name may not take into account potential future gains and losses that may be associated with the fund’s 20% non-names rule basket, or that the fund’s return could differ dramatically from the investments supported by the fund’s name. We believe, however, that this concern is adequately addressed by current laws. In particular, the SEC in the names rule adopting release noted that the names rule is not a safe harbor and that a name may be materially deceptive and misleading even if the investment company meets the 80% requirement (and thus subject to SEC action under Section 35(d)). \textit{Id.} Additionally, we note that the names rule ultimately is concerned with adequate disclosure to investors and accordingly, we believe that funds should take steps to prominently and fully disclose any principal strategies that raise these concerns, and monitor their compliance with their stated investment strategies and names.

\textsuperscript{77} That said, funds that rely heavily on derivatives to achieve their investment objectives, including but not limited to leveraged and inverse funds, should clearly and prominently disclose the role that derivatives play in implementing the funds’ investment strategies, as well as the attendant risks.
That is not to say that there are no avenues for improved disclosure. But continuing to build up descriptions of derivatives practices in the prospectus/SAI may not be the most effective means towards that end.\footnote{Also arguing against ever more disclosure in the prospectus/SAI is the ongoing effort by the SEC and the fund industry to develop – in the form of the summary prospectus – a significantly slimmer offering document that crisply delivers essential investor information. New rules or interpretive recommendations that add prospectus-level disclosures must be considered critically in that light.}

Turning to periodic shareholder reports, which are the other primary fund disclosure documents, there has been a substantial and, the Task Force believes, positive overhaul of the treatment of derivatives as the fund industry incorporated new requirements over the course of 2009. FASB Accounting Standards Codification (“ASC”) 815-10 (formerly Statement of Financial Accounting Standards No. 161) addresses a number of concerns that had previously been raised, \textit{e.g.}, that different fund firms “housed” information about derivatives in different places within the fund financial statements and that different fund firms described their funds’ derivative contracts in different levels of detail within the financial statements. The new disclosures under ASC 815-10 allow for cleaner, fund-to-fund comparisons of derivatives-related financial information than was previously possible.

**Possible Disclosure Enhancements.** One area of enhanced disclosure that could be useful is more concrete and accessible insight into how derivatives affect a fund’s actual results. If derivatives account for a meaningful portion of a fund’s performance results (positive and negative) over a particular period, for example, that could be of interest to investors. Similarly, highlighting instances when significant performance results are realized from derivative positions representing relatively small segments of a fund’s portfolio is useful as a concrete illustration of the volatility of the particular instrument.

A portfolio manager letter to shareholders could, for example, deliver the following message:

Consistent with the fund’s stated strategy to use futures and other types of derivatives as a substitute for “direct” investing in stocks and bonds, securities futures positions held by the fund contributed 28% of overall gains for the period.

Note that we have intentionally offered the shareholder letter as an example for placement for this type of information. The very concreteness of statements of results like that just offered reflects a “snapshot-in-time” nature that can be less well suited to prospectuses/SAIs, which are designed to
present a broader view of the fund that, while evergreen, does not and should not chart fluctuations in the same way. By way of contrast, presentations like a shareholder letter are necessarily dynamic. Their nature and usefulness change – and can be readily tailored – over time.

**Need for New Regulation/Guidance.** While it would be useful to have additional guidance confirming the use of the reference asset, rather than the counterparty, as the focus for determining whether a fund invests in a manner that is consistent with its name, the disclosure approaches discussed above do not appear to require new regulation. Names rule monitoring is already part of industry practice, but individual funds could heighten sensitivity to that issue as needed. Similarly, more concrete discussion of derivatives in fund shareholder letters can be readily implemented by funds.

The Task Force also reiterates that the disclosures called for under ASC 815-10 go a long way toward providing shareholders with meaningful information about fund derivatives use, and also address many regulatory concerns with the utility of disclosures. With those new requirements in place, it would appear to be premature to revisit the financial statements at this time.

**K. Compliance Programs - Rule 38a-1**

Rule 38a-1 requires fund boards to approve written policies and procedures reasonably designed to prevent a fund from violating the federal securities laws (“compliance policies”). The board’s approval must be based on a finding by the board that the compliance policies are reasonably designed to prevent violation of the federal securities laws by the fund and its service providers. The rule on its face does not require a fund to adopt a compliance policy specifically relating to derivative instruments.79

Some funds that use derivatives extensively have adopted policies that attempt to address many of the 1940 Act’s rules and regulations that we discuss above. Other funds rely upon their general compliance policies and procedures to address the use of derivatives. For instance, a compliance policy relating to adherence to a fund’s stated investment strategies may embrace derivative instruments along with all of the other investments of the fund. Pursuant to such a compliance policy, a fund’s portfolio manager may be called upon to review the fund’s public disclosures concerning the use of derivatives and confirm to the fund’s chief compliance officer that the disclosure appropriately reflects the actual uses of derivatives by the fund.

---

79 Nor has the SEC indicated that such a compliance policy should be adopted. See Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299, 81 SEC Docket 2775-61 (Dec. 17, 2003).
Rule 38a-1 also provides for board designation of a person to act as the chief compliance officer of a fund (a “CCO”). The CCO is supposed to act as the “eyes and ears” of the board to enhance the ability of the board to oversee fund compliance matters. Fund boards look to their CCOs to develop and implement compliance programs that are reasonably designed to prevent violations of the federal securities laws. Typically, the boards of funds that use derivatives extensively work with their CCOs to develop appropriate compliance policies for derivatives or to envelop derivatives practices into existing compliance policies, in a manner that corresponds to the level of derivatives usage by the fund.

While uniform practices have not yet developed in this area, most funds have established compliance policies to address the segregation of assets or the use of offsetting transactions under Section 18. In many fund complexes, this is the only compliance policy that specifically addresses derivatives, although some funds also have “complex instrument” procedures that treat leverage, operational issues, valuation and disclosure more holistically.

III. FUND DIRECTOR OVERSIGHT

A. Introduction

Fund directors’ responsibilities with respect to a fund’s use of derivatives are generally the same as for other portfolio instruments and derive from their overall duty of care and responsibilities with respect to oversight of the fund’s investment strategies. The SEC and its staff have emphasized, however, that fund directors may need to pay special attention to a fund’s use of derivatives, most likely because of their potential complexity and leveraging effect.

In 1994, then-SEC Chairman Arthur Levitt stated that:

[Trustees] have critical oversight responsibilities for their fund’s use of derivatives. . .[i]t is their job to review and approve fund disclosures, and to oversee pricing issues, suitability, trading strategies, accounting questions, and internal controls. [Trustees] who authorize the use of derivatives need not micromanage the

---

As a general matter, directors should oversee fund use of derivatives in much the same way that they oversee other aspects of fund operations, including compliance with its investment objectives and policies generally. That is, fund managers are in the best position to establish policies and procedures designed to manage risk. Fund directors should be satisfied that those policies and procedures are reasonably designed to achieve their objectives, and monitor the investment managers’ adherence to those policies and procedures.

In order to meet their responsibilities, it would be prudent for directors to:

(i) review each fund’s use of derivatives in order to ascertain whether such use is appropriate for the fund, taking into account the fund’s investment objectives and policies and the general manner in which the fund is marketed;

(ii) discuss with management whether the fund’s use of derivatives is achieving its objectives within the risk tolerances established by the fund manager as disclosed in the fund’s registration statement;

(iii) be familiar with the public disclosures concerning derivatives that the fund makes pursuant to the federal securities laws;

(iv) be confident that the relevant operations of the investment manager, including its risk management systems, are adequate to accommodate the use of derivatives;

(v) discuss relevant information with the fund’s CCO concerning the fund and investment manager’s compliance with the legal requirements that apply to derivatives; and

(vi) look out for “red flags” that indicate undue risk or that derivatives are not achieving their intended use.

B. **Elements of Knowledgeable and Meaningful Oversight**

**Investment Management.** A fund’s investment objectives and policies, including a fund’s policies concerning the use of derivative
instruments, should be set forth in its registration statement. Based on information provided by the investment manager, fund directors generally determine that the authorized uses of derivatives (e.g., for hedging or efficient portfolio management) are suitable for the fund.

Through an ongoing dialogue with investment managers, fund directors work to understand the types of derivative instruments used by their funds, the investment managers' strategies for these uses, as well as the related risks to the funds. Directors generally oversee a fund’s use of derivative instruments as they oversee other fund investments, including endeavoring to evaluate the investment manager’s success with the investment strategy. Directors generally discuss with the investment manager proposals to change the fund’s investment policies and strategies with respect to derivative instruments. Fund policies should include a mechanism for reviewing or approving new instruments or new uses for previously approved instruments. Directors are also generally familiar with the disclosures concerning derivatives that are set forth in a fund’s registration statement.

**The Investment Manager’s Operations and Risk Management.** Directors should be confident that the relevant operations of the investment manager, including its risk management systems, are adequate to accommodate the actual and proposed uses of derivatives. The investment manager should have the capacity to accommodate each type of derivative instrument used, as well as the anticipated magnitude of that use. Similarly, directors should be confident that the investment manager has the capacity to measure and monitor a fund’s risk exposures generally, and from the use of derivatives in particular. Directors should be satisfied that fund accounting personnel can address the accounting issues presented by each type of derivative instrument used by a fund. Directors should also be confident that fund derivatives use will not jeopardize a fund’s qualification for pass-through taxation.

**Compliance Monitoring.** Compliance procedures offer directors a valuable tool in exercising knowledgeable and meaningful oversight over a fund’s use of derivative instruments. Pursuant to the rule, the fund’s CCO should report to the directors material issues and violations arising under the

---

82 In this regard, Andrew J. “Buddy” Donohue, Director of the SEC’s Division of Investment Management, has emphasized the role of the investment manager in connection with fund use of derivatives stating that “it is imperative that the legal, compliance and accounting groups understand the instrument. . . and have implemented the proper legal, accounting and compliance techniques and controls.” Andrew J. Donohue, Dir., SEC, Div. of Inv. Mgmt., Keynote Address at the 2007 Mutual Funds and Investment Management Conference (Mar. 26, 2007), available at http://www.sec.gov/news/speech/2007/spch032607ajd.htm.
compliance procedures, including with respect to derivative instruments. Through dialogue with the CCO, directors can evaluate the investment manager’s compliance with the fund’s authorized investment objectives and policies and legal obligations with respect to the use of derivatives.

**Board Communications.** Periodic reports to boards that disclose the degree to which a fund has employed derivatives at given points in time can be a useful tool. Information about derivative investments may be highlighted within existing reports and/or presented in separate reports. Some fund boards have worked with the investment manager to develop a report that discloses counterparty exposures, the market values of the various derivative positions, as well as other indicators of the amount of risk associated with those positions when the positions are used for investment purposes. The need for specific risk reporting depends on the inherent risk that is associated with the kinds of derivative instruments being used and if the derivatives are being used to hedge or for investment. In some instances, boards receive information about the notional values of positions outstanding, although many boards find that information to be of limited utility in and of itself. Derivative reporting is most useful to fund directors when it confirms to directors that the reported positions are consistent with the board-approved investment strategies and public disclosures relating to the fund.

In addition, some boards take steps to evaluate whether the degree of risk taken on by a fund through its derivative positions has provided commensurate returns to the fund. That evaluation entails extensive discussions with management about past events.

**Role of the Board.** Under the “business judgment rule,” board actions are protected from judicial inquiry so long as the board acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the fund. When directors engage in a robust process, their decisions relating to evaluating derivatives strategies and valuation procedures should be given great deference. We emphasize, however, that the role of fund directors should be limited to that of oversight, and that directors should not be required to cross the line to micro-manage a fund’s use of derivatives. As a general matter, fund directors need not understand how a manager engages in complex calculations to assess risk, but should be satisfied that the manager has the requisite skills to use derivatives and brings them to bear with respect to the fund’s use of derivatives. Fund directors should be allowed, to a reasonable extent, to rely upon reports and other presentations made to the board on many of the details noted above in performing their oversight responsibilities.
IV. PROCESS AND IMPLEMENTATION OF CHANGES TO REGULATORY OVERSIGHT OR GUIDANCE

In this section, we suggest various approaches that the SEC could take to address its concerns with respect to fund use of derivatives and leverage.

**Limits on leverage.** The SEC and its staff, most notably in Release 10666, determined that certain types of derivative investments (those that can cause a fund to incur contingent liabilities beyond the initial investment) involve the *de facto* issuance of “senior securities” and thus are subject to Section 18. The SEC and its staff further took the position that, to the extent a fund “covered” these obligations through offsetting transactions or the establishment of a segregated account, no violation of Section 18 would occur.

The Task Force believes that this position has proven very effective. However, over the years, as funds have expanded their use of derivatives, questions have been raised concerning the size and nature of the segregated accounts contemplated under this guidance. To address these issues, the Task Force believes that the SEC, through rulemaking or interpretation, should publish new standards in this area. In particular:

- Funds should be required to adopt written policies and procedures that establish minimum asset segregation requirements for each type of derivative instrument using RAS Amounts.

- The amount of the RAS Amounts would be based on relevant factors attributable to each derivative instrument, taking into consideration the risk applicable to each particular instrument, as well as any offsetting transactions.

- Higher risk instruments would require greater RAS Amounts (*e.g.*, close to or equal to full notional amount), while “plain vanilla” instruments with low price volatility and risk may require segregation close to or equal to daily market value.

- These policies and procedures also should address the types of assets that will make up the segregated amounts, taking into account the risk profile of the individual instruments.

- The policies and procedures would describe what constitutes an offsetting transaction.

- The policies and procedures should be approved by the fund’s board.
• Disclosure about a fund’s segregation policies should be made in the fund’s SAI.

• Asset segregation should not be required in cases that do not involve explicit leverage (e.g., an investment in shares of a leveraged ETF, while it carries implicit leverage, presents no need for asset segregation).

**Counterparty exposure.** Counterparty exposure remains a significant market and regulatory concern. Counterparty exposure, however, is not adequately regulated under the current regulatory structure. That is, a fund could technically satisfy the technical diversification requirements of Section 5(b), yet invest in derivative instruments that provide economic exposure to a single issuer. This concern exists for diversified and non-diversified funds alike. With that as background, we believe:

• The SEC should consider regulation of counterparty risk outside of Section 5(b) through new rulemaking or interpretive guidance published by the SEC or its staff. In particular, the Task Force suggests that the SEC regulate counterparty risk within the framework of Section 12(d)(3) by adopting a new rule thereunder.

• Regulations or guidance should recognize that the amount of acceptable risk may vary by type of fund, consistent with existing statutory requirements. To the extent that the risk of a counterparty is mitigated by possession of bankruptcy-remote collateral, a fund may decrease its exposure to risk of a single counterparty.

• Nationally recognized exchanges or clearing houses would be excluded from the definition of counterparties.

**Diversification and concentration of issuers.** Diversification and concentration tests should be based on the exposure to values of reference assets, rather than counterparties (which, as described above, would be regulated separately).

• Broad-based indices, or other reference assets that do not lend themselves to the concept of diversification (e.g., commodities) would be excluded from the calculation.

**Compliance with investment objectives and policies.** We believe that the SEC or its staff should provide guidance that funds, when measuring compliance with their disclosed investment objectives and policies,
should look through to a derivative’s reference assets (or the nature of the economic exposure, when applicable), rather than to the issuer.

**Disclosure.** Finally, we emphasize that there is significant merit to the SEC’s and the industry’s traditional approach to many matters relating to derivatives, *i.e.*, relying on individual funds to determine limits and practices appropriate to their investors and then to summarize clearly those limits, practices and related risks.

Accordingly, in lieu of setting some of the specific limits contemplated as options above, the SEC or its staff could further develop disclosure expectations as they relate to some these substantive areas.

We observe that ongoing disclosure documents (like shareholder letters and financial reports) may be better suited than the prospectus or SAI to further disclosure initiatives in this area. While not discussed in detail above, concepts of “value at risk” or other standardized risk measures also might be useful disclosure metrics for consideration – again, we believe, in the context of ongoing disclosure documents. The Task Force cautions, however, against requirements for disclosures in a fund’s prospectus that are forward looking in nature because of the impossibility of predicting future market events and a portfolio manager’s appropriate response to them. Also, we ask that the SEC and its staff, if proposing any new disclosure requirements, be sensitive to the concern that overly complicated disclosure requirements may not achieve their intended result and recognize the positive impact of ASC 815-10.

**Fund directors.** The Task Force recommends that the SEC or its staff publish guidance for fund directors, incorporating the principles discussed above. Specifically, the guidance should clarify that the role of fund directors is that of oversight, and not of micro-management, of derivatives.83

**Additional insight.** The Task Force suggests that the SEC or its staff consider additional means to better develop insight into current practices of investment company use of derivatives and the appropriate level of regulatory oversight. For example, an SEC roundtable would provide the SEC and its staff the opportunity to learn how portfolio managers, traders, operations personnel and compliance officers manage the risks of derivatives.

---