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SEC Reviewing Funds' Use Of Derivatives

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On March 25, 2010, the U.S. Securities and Exchange Commission announced that its staff is conducting a review of the use of derivatives by mutual funds, exchange-traded funds (ETFs) and other investment companies. The objectives of the review are to evaluate the current regulatory scheme and to determine whether additional regulations or guidance may be necessary to protect investors. In connection with its review, the SEC staff is deferring consideration of exemptive requests for ETFs that rely to a significant degree on derivatives to leverage their returns.

In announcing the review, Andrew J. "Buddy" Donohue, Director of the SEC's Division of Investment Management, stated: "Although the use of derivatives by funds is not a new phenomenon, we want to be sure our regulatory protections keep up with the increasing complexity of these instruments and how they are used by fund managers. This is the right time to take a step back and rethink those protections."

In many areas, derivatives present issues for funds that are different and more complex than those presented by more traditional investments in securities. The SEC has in the past adopted rules and provided guidance on the use of derivatives by funds that are registered under the Investment Company Act of 1940 (Investment Company Act). However, as a result of the increased use of derivatives strategies by funds and the increasing complexity of certain derivatives, some fund industry participants believe that there is a need for the SEC to provide updated and more detailed guidance.

Industry reaction to the SEC's announcement has been mixed. The Investment Company Institute (ICI), the industry association whose membership consists of mutual funds, ETFs and other registered investment companies, said in a statement that it "strongly supports" the SEC staff's review, but noted its disappointment with the staff's decision to defer consideration of ETF exemptive requests. Some in the industry are concerned that principles regarding funds' use of derivatives that have long been accepted by the SEC staff will be overturned.

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The SEC staff is seeking input from a variety of sources. The Director of the SEC's Office of Compliance Inspections and Examinations, Carlo di Florio, said in a recent interview that his office was conducting sweep examinations of fund groups to collect information on how mutual funds and ETFs use derivatives. Information gathered in these examinations will be considered by the staff in connection with its review. In addition, in April 2009, the American Bar Association (ABA) formed its Task Force on Investment Company Use of Derivatives and Leverage. The ABA formed the Task Force at the request of Mr. Donohue. The Task Force is charged with evaluating and recommending how the SEC can improve regulations and regulatory guidance with respect to funds' use of derivatives and leverage. Mr. Donohue has indicated that the SEC staff is looking forward to reviewing the Task Force's report when it is issued, and that the recommendations contained in the report will help inform the staff's analysis.

Key Areas Of Focus

It is clear that the primary theme of the SEC staff's review is to comprehensively examine the full range of regulations relating to derivatives. Mr. Donohue emphasized this in recent remarks, noting that there is a need "to develop a complete picture of the current landscape in this area and develop an appropriate regulatory approach." Although the review is intended to be broad in scope, it is likely that certain key areas will receive significant attention, and it is reasonable to expect that any rulemaking or guidance resulting from the review will address these areas.

Leverage.

The SEC staff has identified leverage associated with funds' use of derivatives as an area of concern. The Investment Company Act and relevant SEC positions impose certain restrictions on the ability of mutual funds or ETFs to use leverage. These include restrictions on a fund's ability to borrow money as well as requirements that a fund segregate liquid assets or establish offsetting positions in certain circumstances in order to cover its future obligations. The SEC's review will examine the ways in which funds are using derivatives to obtain leverage, and, more specifically, whether such leverage is consistent with the restrictions contained in the Investment Company Act. A particular concern that Mr. Donohue has articulated is whether funds are obtaining degrees of leverage indirectly through derivatives strategies that the Investment Company Act prohibits the funds from obtaining directly. It appears very likely that additional guidance specific to leverage will be forthcoming.

Diversification and Concentration.

Another important area of the SEC staff's review is how the Investment Company Act's provisions relating to diversification and concentration of investments should be applied to a fund's investments in derivatives. Under the Investment Company Act, a registered fund must be classified as "diversified" or "non-diversified," and diversified funds must meet certain asset diversification requirements relative to individual issuers. That is, a diversified fund is limited with respect to the portion of its portfolio that it may invest in any one issuer. The Investment Company Act also requires a fund to describe its policy on investment concentration (i.e., investing more than 25 percent of its assets in a particular industry or group of industries) in its registration statement. With certain types of derivatives, identification of the "issuer" or appropriate industry classifications may not always be clear. Guidance or new regulations on the proper treatment of derivatives for diversification and concentration purposes might well be provided as a result of the SEC staff's review.

Risk Management.

As part of its review, the SEC staff will be examining the risk management processes that funds have in place with respect to derivatives. Many funds that use derivatives extensively, and their investment advisers, have robust compliance programs in place that include detailed compliance policies and procedures for managing the risks associated with derivatives. These policies and procedures usually are tailored specifically to the types of derivatives strategies employed by a fund, but additional guidance from the SEC would still be useful for many funds.

Pricing and Liquidity.

In areas such as liquidity and valuation of portfolio holdings, risk management practices adopted by funds and their investment advisers should be carefully adapted to apply to the unique issues presented by derivatives. Certain types of derivatives are less liquid and may be more difficult to value accurately than investments in securities. The SEC staff's review will explore whether existing regulatory requirements appropriately address these matters.

Board Oversight.

The Investment Company Act requires that a mutual fund or ETF that is registered under the Act have a board of directors that oversees the fund's operations, including the fund's use of derivatives. Mr. Donohue has indicated that the SEC staff will be focused on this area, as it is critically important that boards are engaged in providing appropriate oversight. Boards are generally expected to understand the types of derivatives strategies and instruments that their funds use, as well as the associated risks. Boards must be comfortable that the portfolio managers responsible for investing in these instruments, as well as the personnel who are responsible for the operational aspects of a fund's use of derivatives, have appropriate levels of skill and expertise. Mr. Donohue noted that the SEC staff is considering how it might offer additional guidance to assist directors in their oversight efforts.

Disclosure and Reporting.

The SEC staff's review will also examine the current reporting and disclosure obligations applicable to fund investments in derivatives. Many funds that use derivatives strategies already include significant disclosure in their prospectus and other documents relating to these risks. Nonetheless, Mr. Donohue has expressed concern that while fund disclosure documents may contain extensive risk disclosure related to derivatives, investors – especially retail investors – may not adequately understand the risks involved. The staff's review could potentially result in funds having to provide enhanced risk disclosure related to their use of derivatives strategies.

Current Impact On Product Development

The SEC's announcement of its review also specifically mentions certain types of ETFs, including leveraged and inverse ETFs, which are specialized products that seek to deliver returns that are multiples or inverse multiples of the daily performance of a specific market index. It is not surprising that these ETFs would be a focus of the staff's review given the extensive use of derivatives necessary to pursue their leveraged and inverse investment strategies.

Before an ETF can be launched, the ETF and its investment adviser must apply for, and the SEC must grant, relief from certain provisions of the Investment Company Act. This exemptive relief is necessary to permit, among other things, the ETF's shares to trade on an exchange. In connection with its review, the SEC staff has announced that it will defer consideration of applications seeking exemptive relief for any ETFs that plan to use swaps and other derivative instruments extensively. The deferral does not affect any existing ETFs, nor does it affect any applications filed with the SEC seeking other types of exemptive relief. The SEC staff has not provided any estimate of when its review will be completed.

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