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DANCING WITH THE DERIVATIVES DEVIL: MUTUAL FUNDS' DANGEROUS LIAISON WITH COMPLEX INVESTMENT CONTRACTS AND THE FORGOTTEN LESSONS OF 1940

*Kelly S. Kibbie**

This Article examines the implications of the drastic increase in the use of complex derivative instruments by mutual funds in recent years and the inadequacies of the current statutory and regulatory framework to effectively protect investors. Astonishingly, there is no reliable information regarding the nature and extent of derivatives use by mutual funds. A series of derivatives disasters demonstrating the catastrophic possibilities of these complex contracts, juxtaposed with the clearly announced purposes of the Investment Company Act of 1940 ("1940 Act") to protect investors from the dangers of leverage, emphasize the need for prompt reform. With \$11.6 trillion in the mutual fund purse, and with 94% of individual mutual fund investors saving for retirement, this situation is particularly timely.

The Article asserts that the doctrinal foundations of the 1940 Act are being undermined by mutual funds' pervasive use of derivatives. Enacted to regulate investment companies following abuses during the Great Depression, the 1940 Act arguably prohibits many types of derivative transactions by mutual funds. Further complicating matters, the SEC has not engaged in any rulemaking with respect to derivatives transactions by mutual funds and has not provided any formal guidance regarding the same since 1979, years before swaps were even invented. Reforms should be enacted to prevent the types of harms to investors and the financial markets that the 1940 Act was designed to prevent, while preserving the unique benefits that derivatives trading can offer.

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I. INTRODUCTION

This Article examines the implications of the drastic increase in the use of complex derivative instruments¹ by mutual funds² in recent years and the inadequacies of the current statutory and regulatory framework to effectively protect investors. In its recent Concept Release on the use of derivatives by investment companies,³ the U.S. Securities and Exchange Commission (“SEC”) noted the “dramatic growth in the volume and complexity of derivatives investments over the past two decades,” but stated that “complete data concerning the nature of derivatives activities of funds is unavailable”⁴ The U.S. Commodity Futures Trading Commission (“CFTC”) echoed this alarm, stating that “trading by . . . [registered investment companies] in derivatives including swaps has exploded to proportions far beyond anything contemplated by the SEC’s governing statutes.”⁵ Currently, there “is *no source of reliable information* regarding the general use of derivatives by registered investment companies,”⁶ as much derivatives

1. Derivatives are broadly defined as financial instruments whose value is derived from other variables (referred to as “reference assets” or “underliers”). See, e.g., Use of Derivatives by Investment Companies under the Investment Company Act of 1940, U.S. Sec. and Exch. Comm’n Concept Release (Aug. 31, 2011) [hereinafter the SEC Concept Release] at 4–5, available at <http://www.sec.gov/news/press/2011/2011-175.htm>; JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 1 (8th ed. 2012); Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOYOLA U. CHI. L.J. 1, 1 (2011). Often, such variables are the prices of specified traded assets; for example, stock options are derivatives based on the value of the specified underlying stocks. See, e.g., HULL, *supra*, at 1. However, derivatives can be built on “almost any variable, from the price of hogs to the amount of snow falling at a certain ski resort.” *Id.*; see also *infra* text accompanying notes 30 and 31.

2. Although the scope of this Article is limited to the use of derivatives by mutual funds, there is obvious applicability to other types of investment companies as well. In the United States, there are four main types of investment companies registered under the Investment Company Act of 1940 (“1940”): open-end investment companies (mutual funds), closed-end investment companies, unit investment trusts (“UITs”), and exchange-traded funds (“ETFs”). See, e.g., INVESTMENT COMPANY INSTITUTE, 2012 INVESTMENT COMPANY FACT BOOK 198 (52d ed. 2012); cf. 15 U.S.C. § 80a-4 (2006) (dividing investment companies into “three principal classes:” face-amount certificate companies, unit investment trusts, and management companies).

3. The stated purpose of the SEC Concept Release was to seek public comment regarding whether “regulatory initiatives or guidance are needed to improve the current regulatory regime and the specific nature of any such initiatives.” SEC Concept Release, *supra* note 1, at 7.

4. *Id.* at 5 n.7 and accompanying text.

5. Defendant Commodity Futures Trading Commission’s Cross-Motion for Summary Judgment, Opposition to Plaintiffs’ Motion for Summary Judgment, and Motion to Dismiss in Part at 2, Inv. Co. Inst. v. U.S. Commodity Futures Trading Comm’n, No. 1:12-cv-00612 (D.D.C., June 18, 2012) [hereinafter CFTC Summary Judgment Motion].

6. CFTC Summary Judgment Motion, *supra* note 5, at 42 (emphasis added) (citing Commodity Pool Operators and Commodity Trading Advisers: Compliance Obligations, 77 Fed.

trading information has historically not been required to be reported to *any* regulator.⁷ As set forth herein, the fragments of information that are available regarding derivative use by investment companies highlight the need for attention to this issue.⁸

The Investment Company Act of 1940 (“1940 Act”),⁹ enacted to regulate investment companies following abuses endemic during the Great Depression,¹⁰ is inadequate to deal with the complex derivative instruments utilized today.¹¹ Arguably, a plain reading of the 1940 Act prohibits many types of derivative transactions by mutual funds.¹² Furthermore, the SEC has not engaged in any rulemaking with respect to derivatives transactions by mutual funds and has not provided any formal guidance regarding the same since 1979, years before swaps¹³ were even invented.¹⁴

Without doubt, the agency charged with overseeing most derivatives activity, the CFTC, is working diligently to implement reforms effectuating the Dodd-Frank Wall Street Reform and

Reg. 11,252, 11,275 (Feb. 24, 2012) (to be codified at 17 C.F.R. pt. 4, 145, 147) [hereinafter Final CPO Rules], as corrected due to publication errors in 77 Fed. Reg. 17,238 (Mar. 26, 2012)).

7. *Id.* at 15 (emphasis added) (citing Final CPO Rules at 11,253). The Final CPO Rules would require a significant amount of such information to be reported to the CFTC, if such regulations are able to withstand current judicial attack. *See* discussion *infra* Part III(B).

8. *See infra* Part III.

9. 15 U.S.C. §§ 80a-1–80a-64 (2006 & Supp. 2010).

10. *See, e.g.*, TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 29 (3rd ed. 2011); *see also infra* Part IV.

11. As the Chairman of the SEC recently explained, “when the Investment Company Act [of 1940] was adopted, derivatives as we now know them did not exist.” Mary Schapiro, Chairman, Securities and Exchange Commission, Opening Remarks at SEC Open Meeting (Washington, D.C., Aug. 31, 2011), available at <http://www.sec.gov/news/speech/2011/spch083111mls-item1.htm>. “The [1940] Act imposes important leverage, valuation, diversification, and industry concentration requirements to help protect fund investors. However, those limitations were written with stocks and bonds in mind, not complex financial derivatives.” *Id.* (emphasis added).

12. *See infra* Part V(B).

13. Swaps, first developed in the 1980s, are merely OTC agreements in which the parties thereto agree to exchange cash flows at a future date. *See, e.g.*, HULL, *supra* note 1, at 148; SEC Concept Release, *supra* note 1, at 11–12 n.25. Such cash flows may involve varying interest rates, exchange rates or other market variable considerations. *See, e.g., id.*; *see infra* note 67. Swap agreements may assume many forms, with exotic swap instruments increasing in number in recent years. *See, e.g.*, HULL, *supra* note 1, at 175. The Dodd-Frank Act enacted statutory definitions of the terms “swap” and “security-based swap,” along with other related terms, which have been further clarified by the CFTC and SEC. *See* discussion *infra* Part II(B).

14. The subsequent releases and informal opinions from the SEC Staff offer only piecemeal (and sometimes contradictory) guidance. *See* discussion *infra* Part V(B). As noted by a task force of the ABA Section of Business Law studying the issue, “the use of derivatives by funds has evolved beyond the scope of the limited regulatory guidance that exists.” *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, COMM. ON FED. REG. OF SEC., A.B.A., SEC. OF BUS. LAW, 5 (2010), <http://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf> (emphasis added) [hereinafter *ABA Task Force Report*].

Consumer Protection Act (“Dodd-Frank Act”),¹⁵ reversing the long period of deregulation following the enactment of the Commodity Futures Modernization Act (“CFMA”)¹⁶ in 2000. However, certain aspects of the CFTC’s key efforts aimed at providing transparency to this “previously opaque area of investment activity”¹⁷ are being challenged by the mutual fund industry.¹⁸

In light of the recent global financial crisis ignited by credit default swaps,¹⁹ which caught the entire financial world by surprise, and the industry’s resistance to certain reform endeavors,²⁰ scholarly sunshine into the dark area of derivatives use by mutual funds is both timely and important. This is especially true given that 44% of households in the United States own shares of registered investment companies,²¹ expecting them to be relatively safe, well-regulated investments; in fact, an overwhelming 94% of individual mutual fund investors indicate that the reason they invest in mutual funds is to save for retirement.²² However, there is a strong concern that most investors understand neither the use of derivatives by mutual funds nor the risks inherent therewith.²³ With \$13 trillion in the U.S. registered

15. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of titles 12 & 15 of the U.S. Code). Title VII of the Dodd-Frank Act, captioned “Wall Street Transparency and Accountability Act of 2010,” sets forth the provisions applicable to derivatives reform.

16. Commodity Futures Modernization Act, Pub. L. No. 106-554, 114 Stat. 2763 (2000). The CFMA “was the culmination of the deregulation of the 1990s and set the stage for an explosion in derivatives trading.” Eric A. Posner & Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First Century Financial Markets*, NW. U. L. REV. (forthcoming Vol. 107) (manuscript at 6), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2010606 (noting that after the enactment of the CFMA, “from 2000 to 2008, trade in over-the-counter derivatives increased from \$95.2 trillion to \$592 trillion—522 percent” and that “[t]he growth in credit default swaps . . . alone was even more extreme . . .”). Thus, importantly, “what seems like an age-old commitment to deregulated financial markets is in fact an ‘invented tradition’ that goes back only 15–20 years. With the benefit of hindsight, the deregulation of financial markets that began in the 1990s was a serious mistake.” *Id.* at 54.

17. CFTC Summary Judgment Motion, *supra* note 5, at 42 (citing Final CPO Rules at 11,281).

18. *See infra* Part III(B).

19. *See infra* notes 53–55.

20. *See infra* text accompanying notes 83 and 121–24.

21. *See, e.g.*, 2012 INVESTMENT COMPANY FACT BOOK, *supra* note 2, at 86. Of these households, approximately 25 percent had household incomes of less than \$50,000. *Id.* at 88. Sixty-two percent of households owning mutual funds had household incomes of less than \$100,000. *Id.* Approximately 90 million individuals owned mutual fund shares in 2011, representing 89% of total mutual fund assets. *Id.* at 86.

22. 2012 INVESTMENT COMPANY FACT BOOK, *supra* note 2, at 87.

23. *See* Andrew J. Donahue, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Speech by SEC Staff: Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality? (Apr. 17, 2009), available at www.sec.gov/news/speech/2009/spch041709ajd.htm [hereinafter the 2009 Donahue Speech]. *See, e.g.*, SEC Seeks Public Comment on Use of Derivatives by Mutual Funds and

investment company purse as of the end of 2011,²⁴ the issue is a critical one that deserves attention.

The doctrinal foundations of the 1940 Act are currently being undermined by mutual funds' pervasive use of complex derivative instruments. The current statutory and regulatory framework is inadequate to deal with this complicated issue. Reforms should be made to prevent the types of harms to investors and the financial markets that the 1940 Act was designed to prevent, while preserving the unique benefits that derivatives trading can offer. This Article is intended to assist legislators, investment companies, investors and scholars in understanding and analyzing this complex area of the law.

Part II of this Article provides an overview of the derivatives market, including descriptions of commonly used derivative instruments and a summary of the goals of the Dodd-Frank Act with respect to derivative reforms. Part III examines the dramatic rise in the use of derivatives by mutual funds and the opposition of the industry to certain reform efforts. Part IV examines the history of widespread financial abuses in the United States during the Great Depression and the doctrinal underpinnings of the 1940 Act, with specific emphasis placed upon issues of relevance to the derivatives discussion. Part V discusses the ways in which current mutual fund derivative trading practices may be misaligned with core 1940 Act provisions and foundational doctrinal principles and proposes legislative amendments and new regulations consistent with the doctrinal bases of the 1940 Act. Part VI concludes.

II. DERIVATIVES: THE CURRENT PICTURE

A. OVERVIEW OF THE DERIVATIVES MARKET

The derivatives market has increased exponentially in the last thirty years.²⁵ In December 2011, the estimated value of assets

Other Investment Companies, U.S. Sec. & Exch. Comm'n (Aug. 31, 2011) [hereinafter, SEC Fact Sheet], www.sec.gov/news/press/2011/2011-175.htm; *ABA Task Force Report*, *supra* note 14, at 3.

24. 2012 INVESTMENT COMPANY FACT BOOK, *supra* note 2, at 7. At year-end 2011, U.S. mutual fund assets totaled \$11.6 trillion; U.S. ETF assets totaled \$1 trillion; U.S. closed-end fund assets totaled \$239 billion; and U.S. UIT assets totaled \$60 billion. *Id.* at 9. There were over 650 sponsors managing mutual fund assets in the U.S. in 2011. *Id.* at 24.

25. *See, e.g.*, HULL, *supra* note 1, at 1.

underlying exchange-traded derivatives contracts²⁶ was \$56.6 trillion.²⁷ At the same time, the estimated principal amount of transactions underlying over-the-counter (“OTC”) derivatives contracts²⁸ was \$647.8 trillion.²⁹ The value of the reference assets underlying derivatives transactions is currently “several times the world gross domestic product.”³⁰

The types of derivatives possible “are limited only by the imagination of the prospective counterparties,”³¹ with derivatives based on concepts such as the weather, inflation, election results, terrorism occurrences, airline seat availability, Higgs Boson discovery, and “various so-called ‘synthetic’ securities, such as synthetic collateral debt obligations and synthetic stocks.”³² At their essence, “[d]erivatives are *literally* bets—agreements between parties that one will pay the other a sum of money that is determined by whether or not a particular event occurs in the future.”³³

There are two main categories of derivatives: exchange-traded derivatives and OTC derivatives. Exchange-traded derivatives are standardized agreements that are traded on regulated exchanges,³⁴ including futures,³⁵ some options³⁶ and options on futures.³⁷ While

26. See *infra* text accompanying notes 33–41 discussing exchange-traded derivatives.

27. Bank for Int’l Settlements, *Derivative Financial Instruments Traded on Organized Exchanges*, BIS.ORG (June 2012), http://www.bis.org/publ/qtrpdf/r_qa1206_anx23a.pdf.

28. See *infra* text accompanying notes 42–52 discussing OTC derivatives.

29. Bank for Int’l Settlements, *Amounts Outstanding of Over-the-Counter (OTC) Derivatives*, BIS.ORG (Sept. 2012), <http://www.bis.org/statistics/otcder/dt1920a.pdf>. As discussed in Part V(A)(1), *infra*, the market value of an OTC contract is not necessarily equivalent to the principal amount of the transaction underlying such derivative contract (referred to as the “notional amount”). For example, an OTC agreement to buy ten million U.S. dollars with euros in one year at a certain exchange rate has an underlying principal amount of \$10 million (the notional amount), but the market value of the contract may only be \$9 million. See, e.g., HULL, *supra* note 1, at 4. As of December 2011, the Bank for International Settlements estimated the gross market value of outstanding over-the-counter contracts at \$27.3 trillion. Bank for Int’l Settlements, *Amounts Outstanding of Over-the-Counter (OTC) Derivatives*, BIS.ORG (Sept. 2012), <http://www.bis.org/statistics/otcder/dt1920a.pdf>.

30. HULL, *supra* note 1, at 1.

31. Lynch, *supra* note 1, at 24–27 (footnotes omitted).

32. *Id.* “Synthetic” derivatives are merely instruments that mimic the attributes of other financial instruments. See, e.g., Marilyn Geewax, *J.P. Morgan’s Troubles and the Price of Eggs*, NPR.ORG (May 18, 2012), available at <http://www.npr.org/2012/05/18/152934962/jpmorgans-troubles-and-the-price-of-eggs>.

33. Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 6 (2011) (footnote omitted) (emphasis in original).

34. See, e.g., SEC Concept Release, *supra* note 1, at 11. For a listing of major exchanges that trade futures and options today, see, e.g., HULL, *supra* note 1, at 817.

35. Futures are exchange-traded contracts to buy or sell a specified asset at a fixed future date and price. See, e.g., HULL, *supra* note 1, at 7. In order to facilitate trading and provide mechanisms to protect parties against counterparty default, exchanges standardize the terms of

exchange markets do not offer the flexibility of OTC markets,³⁸ they have been quite effective at drastically reducing credit risk due to margin account³⁹ and clearing requirements.⁴⁰ In fact, “[a]part from the occasional market manipulation scandal (e.g., onions in the 1950s, silver in the 1980s), during most of the twentieth century organized

the contract, including acceptable grades of the commodity to be delivered, the quantity to be delivered, the delivery date (usually sometime within a specified month), position limits (specifying the maximum amount of contracts that a trader may hold in order to prevent undue influence on the market by speculators), intra-day price limits, and delivery arrangements. *See, e.g., id.* at 24–26. Reference assets for futures contracts include financial assets, such as stock indices, Treasury bonds and currencies, and commodities, such as sugar, wool, copper, gold, aluminum, pork bellies and live cattle. *See, e.g., id.* at 7. In contrast to futures contracts, “spot contracts” are agreements to buy or sell assets today. *See, e.g., id.* at 5.

36. An option is “an agreement, contract, or transaction that is of the character of, or is commonly known to the trade as, an “option,” “privilege,” “indemnity,” “bid,” “offer,” “put,” “call,” “advance guaranty,” or “decline guaranty.” Commodity Exchange Act (the “CEA”), 7 U.S.C. § 1a(36) (2006 & Supp. 2010). Practically speaking, options, which are traded both on exchanges and OTC markets, are of two basic types. “Call options” confer on the holder the right to purchase the underlying asset at a fixed price on a fixed date, while “put options” allow the holder the right to sell the underlying asset at a fixed price on a fixed date. *See, e.g.,* SEC Concept Release, at 11 n.23; HULL, *supra* note 1, at 7. While the holder of an option has a *right* to buy or sell, the holder of a future or forward contract is *obligated* to buy or sell. *Id.* at 8. Accordingly, options are sold for a price, while futures and forwards have no up-front costs. *Id.* As with futures and forwards, buyers of options acquire “long” positions, while sellers acquire “short” positions. *See, e.g., id.* at 9. Selling an option is also referred to as “writing” the option. *Id.*

37. *See, e.g.,* SEC Concept Release, *supra* note 1, at 11.

38. OTC markets have historically allowed traders great flexibility to negotiate the terms of their trades, but have also presented concerns of counterparty default and catastrophic financial loss. *See, e.g.,* HULL, *supra* note 1, at 3–4; *see infra* text accompanying notes 53–63. As discussed herein, the Dodd-Frank Act, when effectuated, will completely overhaul the OTC derivatives market. *See infra* Part II(B).

39. For example, to initiate a futures contract, an investor contacts his broker, who requires the investor to deposit money in a margin account in the amount of the initial margin amount required by the exchange. *See, e.g.,* HULL, *supra* note 1, at 27. At the close of each trading day, the investor’s gain or loss is reflected in the margin account in the process of daily settlement, otherwise known as “marking-to-market.” *See, e.g., id.* at 27–28. If the reduction in the margin account passes a limit set by the exchange referred to as the maintenance margin, which is lower than the initial margin amount, the investor will receive a margin call and must deposit funds in the margin account by the end of the next trading day in an amount equal to the initial margin amount. *See, e.g., id.* at 28. The funds deposited in response to a margin call are referred to as the “variation margin amount.” *Id.* If the investor fails to deposit the required funds, the broker will close out the investor’s position. *See, e.g., id.* at 28–29. This process of daily marking-to-market results in a futures contract effectively being closed out and reissued at an altered price every trading day, whereas forward contracts, discussed in note 43, *infra*, are only settled at the end of the contract. *See, e.g., id.* at 29.

40. HULL, *supra* note 1, at 3–4. Exchange clearing houses serve as intermediaries in futures transactions, guaranteeing the performance of the parties on each side of the deal. *See, e.g., id.* at 29. Brokers that are not clearing house members must establish a margin account with such a member, who, in turn, maintains a margin account with the clearing house (referred to as a clearing margin). *See, e.g., id.* at 30. Clearing margin accounts are adjusted daily for gains and losses, just as is the case with broker margin accounts and investor margin accounts. *See, e.g., id.*

future exchanges functioned so smoothly they received little or no media public attention.”⁴¹ Even on October 19, 1987 (known in finance circles as “Black Monday”), for example, when the S&P 500 index plummeted by more than 20%, leaving long investors with negative balances in their margin accounts, although some brokers went bankrupt due to the failure of their investors to meet their margin calls, the clearing houses ensured that all short futures investors received their profits.⁴²

OTC derivatives, the newer category of derivatives, are negotiated agreements that are executed without exchange involvement. OTC derivatives include swaps,⁴³ forwards,⁴⁴ certain options,⁴⁵ and “combination products”⁴⁶ such as forward swaps⁴⁷ and swaptions.⁴⁸ OTC derivative transactions (which historically have not been subject to margin or clearing requirements) have often presented complexities with respect to valuation, transferability and liquidation that do not typically arise in connection with exchange-traded derivatives.⁴⁹ Due to the counterparty credit risk issues presented by uncleared OTC derivatives, parties have often entered into collateralization agreements⁵⁰ designed to mimic the effect of the exchange margin account process.⁵¹ However, as discussed in Part II(B) herein, Title VII

41. Stout, *supra* note 33, at 18 (footnotes omitted).

42. See, e.g., HULL, *supra* note 1, at 30.

43. See *supra* note 13; see *infra* Part II(B) defining “swaps.”

44. A forward is an over-the-counter contract to buy or sell a specified asset at a fixed future date and price. See, e.g., HULL, *supra* note 1, at 5. One party to a forward takes a long position, while the other takes a short position. See, e.g., *id.* As forward contracts cost nothing to enter into, each party’s payoff from the forward will be their gain or loss when the contract is performed. See, e.g., *id.* at 6.

45. See *supra* note 36.

46. See, e.g., SEC Concept Release, *supra* note 1, at 11–12.

47. A forward swap, also known as a “deferred swap,” is a contract to enter into a swap at a date certain in the future. See, e.g., SEC Concept Release, *supra* note 1, at 12 n.27.

48. A swaption is an agreement giving the holder the option to enter into an interest rate swap exchanging a specified fixed rate for a floating rate. See, e.g., SEC Concept Release, *supra* note 1, at 12 n.26.

49. See, e.g., SEC Concept Release, *supra* note 1, at 12 (noting that many OTC contracts provide for non-transferability without counterparty consent or are too customized to attract purchases).

50. See, e.g., ABA Task Force Report, *supra* note 14, at 10; HULL, *supra* note 1, at 31. Although the terms of collateralization agreements vary, a typical agreement might require daily valuation of the transaction at issue, with losses required to be deposited in an interest-bearing security account for the benefit of the other party. See, e.g., HULL, *supra* note 1, at 31.

51. The AIG bailout in 2008 highlights the disastrous effects of a *failure* to collateralize OTC derivatives. By selling credit default swaps (described in note 97, *infra*), AIG in essence provided insurance to buyers against credit risks related to very risky subprime mortgages. See, e.g., HULL, *supra* note 1, at 33. Because AIG had an extremely high credit rating of AAA, the buyers of the credit default swaps did not require collateralization which encouraged AIG to write an

of the Dodd-Frank Act, when fully implemented, will completely overhaul the OTC derivatives market, mandating new clearing, reporting and execution requirements for “swaps” and “security-based swaps.” As such, it is expected that the Dodd-Frank Act will serve to greatly reduce the counterparty credit risks historically associated with OTC derivatives.⁵²

Examples of disastrous losses that spotlight the dangerous nature of derivatives trading are plentiful. Although some derivatives catastrophes have resulted from rogue traders hiding fraudulent trading activity from their employers,⁵³ a significant amount of damage from derivatives trading has resulted from the simple inability of financial professionals to understand the complexity and global interconnectedness of the risks inherent in derivative trading, as was evidenced by the 2008 financial meltdown, where venerable institutions such as Bear Stearns, Lehman Brothers, Merrill Lynch, and insurance giant AIG were devastated by trading and speculation in mortgage-backed bonds and derivatives.⁵⁴ “Banks and financial firms began refusing to lend to each other out of fear that their counterparty might already be insolvent due to bad derivatives bets. The Federal Reserve was forced to act as a lender of last resort, injecting more than \$3.3 trillion in short-term loans and other assistance into the economy to prevent collapse.”⁵⁵

astronomical amount of the instruments, since it could collect fees without any expenditure of its own. As such, AIG failed to appreciate the risk that it had assumed. *Id.* When the subprime market plummeted, AIG suffered huge losses on the credit default swaps, precipitating an \$85 billion bailout by the U.S. government to prevent a systemic crash. *Id.*

52. That being said, because the clearing and margin requirements of the Dodd-Frank Act will not apply to all swaps, collateralization agreements will continue to have applicability with respect to uncleared swaps. *See, e.g.,* HULL, *supra* note 1, at 33.

53. For example, in 2005, a Societe General junior trader, unbeknownst to the bank, created fictitious trades to make it appear that he had hedged huge positions that he had taken in equity indices; however, he had, in reality, assumed unhedged bets of over tens of billions of euros. *See, e.g.,* HULL, *supra* note 1, at 17. When the bank discovered his fraud, it unwound his trades for a total loss of 4.9 billion euros. *Id.*

54. Stout, *supra* note 33, at 26–29 (footnotes omitted). Numerous other factors have been identified as having contributed to the crisis, including, rating inadequacies by the leading rating agencies, slack lending standards by mortgage lenders, inadequate monetary policy, and increased proprietary trading by banks. *See, e.g.,* Stout, *supra* note 33, at 3 (citing FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT XV (2011) [hereinafter the 2011 CRISIS REPORT]). It should be noted that the body of literature analyzing the crisis is quite extensive and will continue to increase as distance provides increased perspective. *See, e.g.,* 2011 CRISIS REPORT, *supra*; ANDREW ROSS SORKIN, TOO BIG TO FAIL (2003); DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE’S WAR ON THE GREAT PANIC (2009); SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010).

55. *See supra* note 54.

Additionally, “[r]ecent history is rife with [pre-2008] examples of firms and municipalities suffering severe and sometimes disastrous economic losses as a result of losing their derivatives bets.”⁵⁶

For example, Metallgesellschaft, formerly one of Germany’s largest industrial conglomerates, lost approximately \$1.4 billion in 1993 speculating in oil futures. Barings Bank went bankrupt in 1995 after losing approximately \$1.3 billion in speculative derivatives In the mid-nineties, Orange County, California lost \$1.7 billion of taxpayer money on speculative derivatives, and the Sumitomo Corporation lost an estimated \$2.6 billion on speculative derivatives, many of them copper futures. The hedge fund Long-Term Capital Management lost approximately \$1.3 billion in 1998 speculatively selling options More recently, IKB Deutsche Industriebank lost approximately \$4 billion in 2007, much of it speculating in derivatives referencing American subprime mortgages.⁵⁷

The latest highly-publicized derivative disaster is J.P. Morgan’s enormous \$6 to \$8 billion loss,⁵⁸ which has “cost the bank \$17 billion of market value and have tarnished the reputation of Chief Executive James Dimon, long viewed as one of Wall Street’s savviest risk managers.”⁵⁹

The foregoing losses have highlighted the potential for such instruments to cause catastrophic systemic risk.⁶⁰ Because of the lack of trading transparency, the high degree of interconnectedness among global financial institutions, and the astronomical scale of derivatives trading volume among them, a default by one institution could have an almost instantaneous disastrous domino effect throughout the financial industry.⁶¹ During the crisis, in order to prevent a systemic

56. Lynch, *supra* note 1, at 7 (footnote omitted).

57. Lynch, *supra* note 1, at 7 (footnotes omitted). Numerous short-term government bond funds and money market funds also incurred significant losses due to complex mortgage derivatives in 1994. *See infra* text accompanying notes 226–27; *see also, e.g.*, Eric D. Roiter, *Investment Companies’ Use of OTC Derivatives: Does the Existing Regulatory Regime Work?*, 1 STAN. J.L. BUS. & FIN. 271, 273–74 (1995).

58. *See, e.g.*, Dan Fitzpatrick & Gregory Zuckerman, ‘Whale’ Tab Hits \$5.8 Billion, WALL ST. J., July 14, 2012, at B1, B2. MF Global also made the news recently with its highly-publicized derivatives losses. Gretchen Morgenson, *Sad Proof of Europe’s Fallout*, NYTIMES.COM (Nov. 5, 2011), http://www.nytimes.com/2011/11/06/business/in-mf-global-sad-proof-of-europes-fall-out.html?_r=0 (stating that “the brokerage firm . . . was felled by over-the-top leverage and bad derivative bets on debt-weakened European countries”).

59. Gregory Zuckerman & Dan Fitzpatrick, *J.P. Morgan Unit Shifts Operations*, WALL ST. J., June 25, 2012, at C1, C3.

60. *See, e.g.*, HULL, *supra* note 1, at 172.

61. *Id.*

crash, governments across the globe were forced to institute highly publicized, costly bailout programs.⁶² Thereafter, in September 2009, G-20 leaders met and “agreed that swaps, which were basically not regulated in the United States, Asia or Europe, should now be brought into the light of regulation.”⁶³ The following Section briefly details U.S. efforts in that regard.

B. DODD-FRANK ACT REFORMS

The Dodd-Frank Act, signed into law by President Obama on July 21, 2010, establishes a “comprehensive new regulatory framework for two broad categories of derivatives;”⁶⁴ “swaps,”⁶⁵ which will be regulated by the CFTC, and “security-based swaps,”⁶⁶ which will be regulated by the SEC. In practice, “swaps” may assume many forms,⁶⁷ with the number of “exotic” swaps increasing in recent years. It is

62. See, e.g., HULL, *supra* note 1, at 172.

63. Gary Gensler, CFTC Chairman, Testimony Before the U.S. Senate Committee on Agriculture, (Washington D.C., July 17, 2012), available at www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-118 [hereinafter Gensler Testimony]. Due to the interconnected global nature of the financial markets, global leaders are working to harmonize the derivatives regulations worldwide, which is, of course, an intensely complicated endeavor. *Id.*

64. See, e.g., SEC Concept Release, *supra* note 1, at 12.

65. A lengthy definition of the term “swap” is provided in section 1a(47) of the CEA. 7 U.S.C. § 1a(47) (Supp. 2010). Section 3(a)(69) of the Securities Exchange Act of 1934 (the “Exchange Act”) adopts the foregoing CEA definition. In addition to this statutory definition, the CFTC and SEC have provided certain clarifications in their recent 600-page release. See Further Definition of “Swap,” “Security-based Swap,” and “Security-Based Swap Agreement,” Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Securities Act Release No. 33-9338; 34-67453, File No. S7-16-11 (July 18, 2012) [hereinafter the Final Definitions Release]. An exhaustive exploration of the statutory and regulatory parameters of the swap and security-based swap definitions is beyond the scope of this Article.

66. A lengthy definition of the term “security-based swap” is provided in section 3(a)(68) of the Exchange Act; section 1a(42) of the CEA adopts this definition. 7 U.S.C. § 1a(42) (Supp. 2010). In addition to this statutory definition, the CFTC and SEC have provided certain clarifications in the Final Definitions Release, *supra* note 65. As previously stated, an exhaustive exploration of the statutory and regulatory parameters of the swap and security-based swap definitions is beyond the scope of this Article.

67. For example, interest rate swaps are extremely common and include, without limitation, “plain vanilla” interest rate swaps (exchanging a fixed rate on a principal amount for a specified time period with a floating rate on the same principal for such period of time); overnight indexed swaps (allowing overnight borrowing and lending by banks to be swapped for such activity at a fixed rate); floating-for-floating interest rate swaps (exchanging two different floating rates, such as LIBOR and the commercial paper rate); amortizing swaps; step-up swaps; forward swaps; constant maturity swaps; constant maturity Treasury swaps; compounding swaps; and accrual swaps. See, e.g., HULL, *supra* note 1, at 148, 174. Other common types of swaps are currency swaps, equity swaps, commodity swaps, volatility swaps, and swaps imbedding options. See, e.g., *id.* at 174–75.

expected that the counterparty credit risks historically associated with many of such swaps will be alleviated with the Title VII Dodd-Frank Act reforms when they are finally implemented.⁶⁸

Importantly, Title VII of the Dodd-Frank Act seeks “to reduce risk, increase transparency, and promote market integrity within the financial system,”⁶⁹ mandating new clearing, reporting and execution mandates for both swaps and security-based swaps.⁷⁰ As in the traditional exchange clearing mechanism discussed above,⁷¹ a clearing house will become the intermediary between the two parties to most swap transactions and will assume the credit risk of both, requiring initial and variation margins to prevent losses.⁷² Although the goal of these arrangements is to reduce systemic risk and increase transparency in the OTC market, it remains to be seen how effective these arrangements will prove.⁷³

Although a full discussion regarding the regulatory efforts to implement the Dodd-Frank Act is beyond the scope of this Article,⁷⁴ it has become apparent that crafting the precise definition of the three main types of derivative trading activity⁷⁵—hedging,⁷⁶ speculating⁷⁷

68. See *infra* notes 70–72.

69. SEC Concept Release, *supra* note 1, at 12.

70. See, e.g., *id.* at 12 n.29. A full overview of these reforms, most of which have not yet been implemented, is beyond the scope of this Article. As a result of the 2008 financial meltdown, governments across the globe have enacted similar legislation requiring certain OTC derivative transactions to pass through clearing houses. See, e.g., HULL, *supra* note 1, at 32.

71. See *supra* notes 37–41.

72. See, e.g., HULL, *supra* note 1 at 32; Gensler Testimony, *supra* note 63, at 2–3.

73. The effect of over-the-counter clearing houses will depend on the number of such clearing houses, as well as the proportion of trades that they clear. See, e.g., HULL, *supra* note 1, at 32, note 2 (citing D. Duffie and H. Zhu, *Does a Central Clearing Counterparty Reduce Counterparty Risk?*, STAN. UNIV. WORKING PAPER (2010)).

74. For updated status information regarding Title VII rulemaking efforts, including the text of proposed and final rules and posted comment letters, see the SEC’s website at <http://www.sec.gov> and the CFTC’s website at <http://www.cftc.gov>. See also, e.g., Gensler Testimony, *supra* note 62 (summarizing the status of CFTC rulemaking efforts); *Summary of the Dodd-Frank Act: Swaps and Derivatives*, PRACTICALLAW.COM, <http://u.s.-practicallaw.com/3-502-8950> (last visited July 28, 2012) (providing a detailed overview of Title VII with frequently updated regulatory information).

75. See, e.g., HULL, *supra* note 1, at 10–17.

76. Hedgers use derivative transactions to *reduce* their level of risk from changes in the market. See, e.g., *id.* at 10; SEC Concept Release, *supra* note 1, at 5. For example, a fund that must pay one million euros in three months may hedge against unfavorable exchange rate moves by buying one million euros three months forward, thus effectively locking in its exchange rate. See, e.g., *supra* note 43; HULL, *supra* note 1, at 10. For a description of various hedging strategies, see, e.g., *id.* at 47–69.

77. Speculators *increase* their level or risk in the market by effectively taking a position in a reference asset with only a small initial outlay in the derivative transaction. See, e.g., HULL, *supra* note 1, at 10–15. As further discussed herein, speculative derivative transactions were at the

and arbitraging⁷⁸—has become a central issue for regulators.⁷⁹ As was recently demonstrated by J.P. Morgan's \$6 billion to \$8 billion derivative loss, disastrous consequences can arise when a trader charged with hedging risk or effectuating an arbitrage strategy either consciously or unconsciously morphs into a speculator.⁸⁰

With respect to investment companies, the most controversial reforms to date are those instituted by the Final CPO Rules, which require registered investment companies “that engage in significant commodity trading activity to register [with the CFTC] and report certain information about their investments”⁸¹ The mutual fund industry is seeking to have such rules stricken in a federal lawsuit.⁸² However, because such reforms are critical to mutual fund derivative transparency and the prevention of systemic risk, it is important that the CFTC act to ensure their implementation.

Despite the Sisyphean challenges that regulators face with respect to the implementation of reforms,⁸³ one lesson to be learned from the 2008 crisis is that “law matters.”⁸⁴

heart of the recent financial meltdown. See *supra* text accompanying notes 53–63; see also, e.g., Stout, *supra* note 32, at 1 (asserting that speculative derivatives trading reduces social welfare).

78. Arbitrageurs exploit anomalies in the market by taking offsetting positions that result in a net profit. See, e.g., HULL, *supra* note 1, at 10.

79. See, e.g., Dan Fitzpatrick & Gregory Zuckerman, ‘Whale’ Tab Hits \$5.8 Billion, WALL ST. J., July 14, 2012, at B1, B2; Carol E. Lee & Damian Paletta, White House Steps Up Push To Toughen Rules on Banks, WALL ST. J., May 17, 2012, at A1, A6 (explaining the fight over whether to incorporate hedging definitions based on the entire portfolio or individual trades with respect to Dodd-Frank’s “Volker Rule”); Katy Burne, Aaron Lucchetti & Gregory Zuckerman, Hedge or Bet? Parsing a Trade, WALL ST. J., May 16, 2012, at C1, C2.

80. See, e.g., Floyd Norris, Lessons from Trades Big and Bad, N.Y. TIMES, May 18, 2012, at B1, B3 (quoting J.P. Morgan’s chief executive, “What this hedge morphed into violates our own principles”).

81. CFTC Summary Judgment Motion, *supra* note 5, at 3; see also *infra* Part III(B).

82. See *infra* Part III(B). On December 12, 2012, the U.S. District Court for the District of Columbia dismissed the mutual fund industry’s lawsuit against the CFTC, but an appeal was quickly filed with the U.S. Court of Appeals for the District of Columbia. See, e.g., Jamila Trindle, Mutual Funds Appeal CFTC Rule, WALL ST. J., Dec. 28, 2012, at C2; Memorandum Opinion, Inv. Co. Inst. v. U.S. Commodity Futures Trading Comm’n, No. 1:12-cv-00612 (D.D.C., June 18, 2012).

83. Such challenges include (1) jurisdictional complexities, (2) significant resistance from industry groups and politicians, and (3) serious staffing and budgetary issues. See, e.g., Stout, *supra* note 33, at 36; Julia La Roche, Here’s the Massive Chart Jamie Dimon Used To Explain Why More Regulations Are Going To Screw Up Wall Street, BUSINESSINSIDER.COM (April 5, 2012, 9:56 AM), www.businessinsider.com/jpmorgan-jamie-dimon-letter-chart-2012-4; Gretchen Morgenson, At JPMorgan, the Ghost of Dinner Parties Past, N.Y. TIMES, June 12, 2012, at BU1; New York Times Editorial, Lost the Vote? Deny the Money, N.Y. TIMES, June 10, 2012, at SR10 (detailing Republican efforts to slash the CFTC’s budget to a mere \$180 million and noting that “[w]ith 710 employees, the C.F.T.C. is barely big enough for its current responsibilities, let alone its new mission under Dodd-Frank to oversee the huge . . . [OTC] swaps market”).

84. Stout, *supra* note 33, at 37.

[F]inancial markets, must be built on some underlying legal infrastructure. (A completely “free” market without laws is a Hobbesian world where the strong and fast seize what they want from the weak and slow.) Without a deep understanding of the nature and importance of the legal rules that organize financial markets it is impossible either to understand the markets, or to predict their behavior.⁸⁵

III. DERIVATIVES USE BY MUTUAL FUNDS

A. AN OVERVIEW

Mutual funds use derivatives for a variety of reasons, some of which are very beneficial to investors.⁸⁶ For example, derivatives can be very effective tools at hedging interest rate⁸⁷ and credit risks.⁸⁸ Derivatives are also useful to gain exposure to markets otherwise difficult to access.⁸⁹ In fact, derivatives can sometimes provide greater efficiency than transacting in the underlying reference asset, providing increased liquidity at a lower cost.⁹⁰ The leverage inherent in

85. Stout, *supra* note 33, at 37.

86. *See, e.g.*, SEC Concept Release, *supra* note 1, at 5.

87. By way of illustration, a fund owning bonds could hedge against a price decline in such bonds due to increasing interest rates by entering into an interest rate swap. *See, e.g.*, SEC Concept Release, *supra* note 1, at 14–16.

88. *See, e.g.*, SEC Concept Release, *supra* note 1, at 5. For instance, a fund that owns bonds could use credit derivatives to protect against the risk that the issuer of the bonds will default or that the bond will be downgraded. *See, e.g.*, SEC Concept Release, *supra* note 1, at 16–17.

89. This concept is illustrated by a fund’s routine use of foreign index futures to gain exposure to foreign equity markets. *See, e.g.*, SEC Concept Release, *supra* note 1, at 17.

90. *See, e.g.*, SEC Concept Release, *supra* note 1, at 5. For example, funds often use derivatives to “equitize” cash, as explained by the ABA Task Force Report:

[W]hen 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.*

ABA Task Force Report, *supra* note 14, at 8 (emphasis added); *see also, e.g.*, SEC Concept Release, *supra* note 1, at 17 n.46. Another example in which derivatives can be more efficient than transacting in the underlying asset involves the use of credit default swaps in lieu of purchasing the referenced bonds. ABA Task Force Report, *supra* note 13, at 8; *see also, e.g.*, SEC Concept Release, *supra* note 1, at 17 n.43 and accompanying text. As noted by the SEC Concept Release, “[i]ndustry participants believe that derivatives may also provide a more efficient hedging tool than reducing exposure by selling individual securities, offering greater liquidity, lower round-trip transaction costs, lower taxes, and reduced disruption to the portfolio’s longer-term

derivatives transactions can also greatly magnify gains;⁹¹ however, the converse is also true: such leverage can drastically magnify losses.⁹² Further, derivatives present numerous very complex legal and management issues for mutual funds, including issues with respect to valuation, illiquidity, disclosure, accounting and counterparty risk.⁹³

As explained above, there is “is no source of reliable information regarding the general use of derivatives by registered investment companies,”⁹⁴ as much derivatives trading information has historically not been required to be reported to any regulator.⁹⁵ However, it is

positioning.” SEC Concept Release, *supra* note 1, at 14 n.33 (citing *Board Oversight of Derivatives*, Independent Directors Council Task Force Report (July 2008), available at http://www.ici.org/pdf/ppr_08_derivatives.pdf [hereinafter the 2008 IDC Report]).

91. Notably, as the management fees that a fund typically charges are based on a percentage of the fund’s assets, such managers may be incentivized to make riskier bets to increase fund performance. See, e.g., Tim Adam & Andre Guettler, *The Use of Credit Default Swaps by U.S. Fixed-Income Mutual Funds*, FDIC Center for Financial Research Working Paper No. 2011-01 (Nov. 19, 2010), available at www.fdic.gov/bank.analytical/cfr/2011/wp2011/CFR_WP_2011_01.pdf, at 5–6.

[Existing] literature focuses on the strategies fund managers use to alter the performance and risk characteristics of their funds. . . . [Some scholars] interpret the mutual fund industry as a tournament. The winners of this tournament, i.e., the best performing funds, receive the highest inflows of new money This benefits fund managers because some of their compensation is linked to the size of the fund and hence new fund inflows. Therefore, managers of underperforming funds have an incentive to increase their funds’ risk levels in order to close the return gap with competitor funds. Consistent with this prediction, the authors find that growth-oriented U.S. mutual funds, which underperformed during the first half of a fiscal year, increase fund volatility in the second half of the fiscal year to a greater extent than overperforming funds. . . . [Other scholars] argue that managers of underperforming funds face a higher risk of job termination than managers of overperforming funds. Underperforming managers therefore have an incentive to increase fund risk in order to increase the chance to exceed the termination threshold. Finally, . . . [some] find that younger funds are more likely to participate in the tournament game than older funds. . . . [This article] adds to this strand of literature by showing that underperforming corporate bond funds increase risk by increasing the size of their short, multi-name . . . [credit default swap] positions.

Id. (citations and footnotes omitted) (emphasis added); see also, e.g., Mutual Funds and Derivative Instruments, United States Securities and Exchange Commission Division of Investment Management Memorandum transmitted by Chairman Levitt to Representatives Markey and Fields (Sept. 26, 1994) [hereinafter the 1994 Report], at 13 (noting that studies demonstrate that investor money flows to the “funds with superior near-term performance” and that “competition may . . . play some role in encouraging mutual fund use of derivatives to enhance yield”).

92. See *supra* text accompanying notes 54–63 (discussing various derivative disasters); see also, e.g., SEC Concept Release, *supra* note 1, at 5.

93. See *infra* Part V; see also, e.g., SEC Concept Release, *supra* note 1, at 5.

94. CFTC Summary Judgment Motion, *supra* note 5, at 42 (emphasis added) (citing Final CPO Rules at 11,275).

95. CFTC Summary Judgment Motion, *supra* note 5, at 15 (citing Final CPO Rules at 11,253). As discussed in Part III(B), *infra*, the Final CPO Rules require a significant amount of such

widely accepted that derivatives use by investment companies has soared beyond the regulatory framework of the 1940 Act.⁹⁶ The fragments of information that are available highlight the need for attention to this issue.

Although specific numbers are not available, numerous agency representatives have noted the disconcerting levels of derivatives use by mutual funds; Andrew Donohue, then-Director of the SEC's Division of Investment Management, explained:

I have, for some time, made no secret of my concerns regarding funds' use of derivatives and my belief that these instruments, while affording the opportunity for efficient portfolio management and risk mitigation, also can present *potentially significant additional risk* as well as raise issues of investor protection. As funds' investments in these instruments are increasing, and the spectrum of derivative instruments available continuously broadening . . . I would like to reiterate my concerns

In the past two decades, the investment company marketplace has been significantly reshaped by the use of derivative instruments. During this period, investment companies have moved from relatively modest participation in derivatives transactions limited to hedging or other risk management purposes to a broad range of strategies that rely upon derivatives as a substitute for conventional securities. Mutual funds that mimic hedge fund strategies, typically involving derivative products, have become *commonplace*. New categories of investment companies have emerged: absolute return funds, commodity return funds, alternative investment funds, long-short funds and leveraged and inverse index funds, among others.

It is also not uncommon for investment companies with traditional investment objectives to obtain synthetic market exposure through derivative products, such as credit default swaps, rather than invest directly in the underlying "cash" market. The embrace of derivatives by investment companies may be most dramatically illustrated by funds, such as leveraged ETFs, which are designed for the singular purpose of

information to be reported to the CFTC.

96. See *infra* Part III.

achieving a leveraged return through the use of derivatives, in most cases to a degree not possible using traditional investments.⁹⁷

One recent study offering concrete numbers examined the use of credit default swaps⁹⁸ by the 100 largest U.S. bond funds.⁹⁹ Although fixed-income mutual funds are perceived by most to be relatively safe investment vehicles, by 2008, the top 100 corporate bond funds in the United States were “as likely to hold . . . [credit default swap] positions as hedge funds were to hold derivatives.”¹⁰⁰ As previously discussed, credit default swaps, which have been referred to as “financial weapons of mass destruction,”¹⁰¹ are the well-known cause of disastrous losses during the recent financial crisis.¹⁰² The study found that, while 20% of such funds used credit default swaps in 2004, 60% were using them in 2008.¹⁰³ The study also found that the average credit default swap position of such funds increased from 2% of net

97. Andrew J. Donohue, Dir. of Inv. Mgmt., U.S. Sec. and Exch. Comm'n, Speech by SEC Staff: Remarks Before the Practicing Law Institute's Investment Management Institute 2010 (Apr. 8, 2010), <http://www.sec.gov/news/speech/2010/spch040810ajd.htm> [hereinafter 2010 Donohue Speech] (emphasis added); see also, e.g., ABA Task Force Report, *supra* note 14, at 9 (detailing the “extensive” use of derivatives by some investment companies). It should be noted that the SEC's Division of Investment Management recently advised that it would once again begin considering the use of derivatives by actively-managed ETFs under certain conditions, a reversal of the SEC's position in March 2010 deferring consideration of exemptive requests relating to derivatives use by such ETFs. See, e.g., Joe Light, *Make Way for Active ETFs*, WALL ST. J., Dec. 29-30, 2012, at B8. However, such consideration will not extend to leveraged and inverse ETF products. See, e.g., *id.*

98. Credit default swaps are agreements “in which the protection seller agrees to make a payment to the protection buyer in the event of a specified credit event (such as a default on an interest or principal payment of a reference entity) in exchange for a fixed payment or series of payments.” INDEPENDENT DIRECTORS COUNCIL, BOARD OVERSIGHT OF DERIVATIVES: INDEPENDENT DIRECTORS COUNCIL TASK FORCE REPORT 6 (July 2008), available at http://www.ici.org/pdf/ppr_08_derivatives.pdf. For a detailed example of how a fund uses a credit default swap in order to obtain exposure to a corporate debt issuer, see *id.* at D3–D4 (Example 2).

99. Adam & Guettler, *supra* note 91; see generally Robert W. Helm, David M. Geffen & Stephanie A. Capistrone, *Mutual Funds' Use of Credit Default Swaps—Part 1*, 16 THE INVESTMENT LAWYER 1 (December 2009); Robert W. Helm, David M. Geffen, & Stephanie A. Capistrone, *Mutual Funds' Use of Credit Default Swaps—Part II*, 17 THE INVESTMENT LAWYER 1 (2010).

100. Adam & Guettler, *supra* note 91, at 16. Fixed-income mutual funds use credit default swaps mainly to assume credit risk and leverage and not to hedge. *Id.* See Lewis Braham, *Credit Default Swaps: Is Your Fund at Risk?*, BLOOMBERG BUSINESSWEEK (Feb. 20, 2008), www.businessweek.com/stories/2008-02-20/credit-default-swaps-is-your-fund-at-risk.

101. Berkshire Hathaway Inc., 2002 Annual Report 15, <http://www.berkshirehathaway.com/2002ar/2002ar.pdf>; see also Lynch, *supra* note 1, at 9. Of course, it must be noted that credit default swaps have very beneficial uses as well.

102. See, e.g., Adam & Guettler, *supra* note 91, at 1. AIG, the largest insurance company in the world, was “brought to the brink of collapse due to its . . . [credit default swap] positions.” *Id.*

103. *Id.* at 2; see also, e.g., SEC Concept Release, *supra* note 1, at 5 n.7.

asset value in 2004 to approximately 14% in 2008.¹⁰⁴ Although credit default swaps represented less than 10% of net asset value for most funds, certain funds exceeded this percentage by a large margin, with the notional values of credit default swap positions exceeding 50% of net asset value for six funds in the sample.¹⁰⁵ In fact, the credit default swap notional values of three funds actually *exceeded* the net asset values of such funds in 2008,¹⁰⁶ with one fund losing 74% of its net asset value due in part to its large position in credit default swaps.¹⁰⁷

One reason that the level of derivative use by mutual funds has been difficult to ascertain is due to funds' increasing investments through controlled foreign corporations ("CFCs") and non-registered investment vehicles that have the effect of masking transparency of the mutual funds' actual exposures.¹⁰⁸ Concerned about the widespread use of CFCs and other vehicles, the National Futures Association ("NFA")¹⁰⁹ in June 2010 petitioned the CFTC "to amend Regulation [CFTC] 4.5(c) to restore operating restrictions on registered investment companies that are substantially similar to those in effect prior to 2003."¹¹⁰ Specifically, the NFA Petition requested the CFTC to reverse its 2003 regulations exempting registered investment

104. Adam & Guettler, *supra* note 91, at 2. The size of the position was measured by the notional value of the credit default swaps relative to the net asset value of the bond fund. *Id.* For a discussion regarding various valuation methods, see *infra* Part V(A)(1).

105. Adam & Guettler, *supra* note 91, at 2 n.3. Such funds included the Intermediate Term Bund Fund (First American Investment Funds), the Oppenheimer Champion Income fund, the Putnam Diversified Income Trust, the Putnam Income Fund, the Western Asset Core Bond Portfolio, and the Western Asset Core Plus Bond Portfolio. *Id.*

106. *Id.* at 12.

107. Adam & Guettler, *supra* note 91, at 12-13; see also, e.g., 2009 Donohue Speech, *supra* note 23, (referencing one-year losses by "a number of" fixed income funds in excess of 30% and suggesting that derivatives use may have been a significant factor in such losses).

108. In order to obtain favorable pass-through tax treatment, registered investment companies must comply with Subchapter M under the Internal Revenue Code, which, in essence, provides that a fund's income will only be taxed at the shareholder level (and not at the fund level) if, among other things, at least 90% of the fund's income is derived from stocks and securities ("Qualifying Income"); although direct investments by a fund in commodities and certain derivatives would not constitute Qualifying Income, indirect investments in such assets through a CFC would constitute Qualifying Income. See, e.g., Inv. Co. Inst. Response to Permanent Subcomm. on Investigations Hearing on "Compliance with Tax Limits on Mut. Fund Commodity Speculation" (Jan. 26, 2012). For a discussion regarding such tax issues, which are beyond the scope of this Article, see, e.g., *id.*; see also, e.g., Letter from Senator Carl Levin, Chairman, Permanent Subcomm. on Investigations, to Elizabeth Murphy, Secretary, U.S. Sec. and Exch. Comm'n (Mar. 19, 2012).

109. The NFA is "the primary self-regulatory organization . . . in the derivatives industry . . ." CFTC Summary Judgment Motion, *supra* note 5, at 11.

110. Petition for Rulemaking to Amend CFTC Regulation 4.5, National Futures Association (June 29, 2010), www.nfa.futures.org/news/newsPetition.asp?ArticleID=2491 [hereinafter NFA Petition].

companies from CFTC supervision as “commodity pool operators” (“CPOs”).¹¹¹

In its petition, the NFA alerted the CFTC that certain mutual funds were exploiting SEC regulations and IRS letter rulings to market “manufactured futures strateg[ies]” to U.S. investors, executed through subsidiaries neither registered with the CFTC nor the SEC, and “not subject to the Investment Company Act of 1940’s customer protection regime.” . . . Under this technique, a parent company would register with the SEC as a . . . [registered investment company] and would hold ordinary assets such as money market instruments, but would use those assets as collateral for derivatives trading by its subsidiary The investments would be highly leveraged to achieve derivatives exposure equal to the full net value of the fund The unregistered subsidiary would invest, for example, in “exchange traded futures and options contracts, forward contracts, swaps, and other over the counter derivatives and fixed income securities,” yet “the subsidiaries’ daily operations, including their actual derivatives positions (including the positions’ leverage amounts) and fees charged” would be allowed to remain “not entirely transparent.” . . . Investments in the parent . . . [registered investment company] would then be “marketed to consumers, including retail investors, as commodity futures investments. . . . According to NFA, exemplar “offering material omit[ted] substantial disclosures” to investors “that would otherwise be mandated by” CFTC regulations”¹¹²

As of December 2011, approximately seventy-two mutual funds were using CFCs (commonly set up in the Cayman Islands) to circumvent U.S. regulation and taxation.¹¹³ “That the Cayman CFCs are empty shells designed to allow U.S. mutual funds to create commodity

111. The Dodd-Frank Act amended the CEA to provide that a “commodity pool operator” includes “any person or entity operating a business in which they solicit or accept value for the purpose of trading in commodity interests, including *any* commodity future, option, swap, or certain other specified instruments.” CFTC Summary Judgment Motion, *supra* note 5, at 5 (quoting § 1a(11)(A) of the CEA) (internal quotation marks omitted).

112. CFTC Summary Judgment Motion, *supra* note 5, at 11–12 (citations omitted).

113. CFTC Summary Judgment Motion, *supra* note 5, at 12. One such fund “reported having over \$22 billion invested in commodity related assets with approximately 900,000 investors, 75% of which [we]re individuals.” *Id.* at 12–13 (internal quotations omitted) (quoting Letter from Senators Carl Levin and Tom Coburn to the U.S. Internal Revenue Service (Dec. 20, 2011) [hereinafter the Levin-Coburn Letter], at 3) (internal quotations omitted).

related investment portfolios, run by their own U.S. employees, is openly acknowledged.”¹¹⁴

After a long and robust comment period, the CFTC acted on the NFA Petition and promulgated the Final CPO Rules in February 2012, the details of which are beyond the scope of this Article, but due to their importance to the discussion herein, are briefly summarized below.

B. THE FINAL CPO RULES AND THE FEDERAL LAWSUIT BY THE MUTUAL FUND INDUSTRY CHALLENGING SAME

Pursuant to the Final CPO Rules¹¹⁵ (filling ninety-one pages in the Federal Register), amended Rule 4.5 allows a registered investment company to qualify for exclusion from CPO regulation “if, *inter alia*, its trading in commodity futures, commodity options, or swaps does not exceed one of two thresholds: (1) 5 percent or less of its portfolio liquidation value is used for initial margin and premiums; or (2) the net notional value of all such investments does not exceed 100 percent of the liquidation value of the pool’s portfolio.”¹¹⁶ Importantly, under either threshold above, funds may “exclude all bona fide hedging transactions from the calculation.”¹¹⁷ The amended rule also provides marketing restrictions to investment companies claiming the exclusion from CPO status.¹¹⁸

The Final CPO Rules also amend CFTC Rule 4.7 to require detailed reporting by registered CPOs regarding derivatives positions, “information concerning derivatives trading that . . . registered investment companies do not currently report to any regulator.”¹¹⁹ Additional compliance obligations with respect to registered CPOs that

114. CFTC Summary Judgment Motion, *supra* note 5, at 12 (quoting the Levin-Coburn Letter, at 3) (internal quotation marks omitted).

115. For a complete discussion, see, e.g., Final CPO Rules, *supra* note 6; Complaint, Inv. Co. Inst. v. U.S. Commodity Futures Trading Comm’n, No. 1:12-cv-00612, 2012 WL 129673 (Dist. D. C., Apr. 17, 2012) [hereinafter the ICI Complaint]; CFTC Summary Judgment Motion, *supra* note 5.

116. CFTC Summary Judgment Motion, *supra* note 5, at 14 (citing Final CPO Rules, at 11,283). The net notional test defines notional value by asset class and provides that certain asset classes may net notional values under certain circumstances. See Final CPO Rules, at 11,257-58.

117. *Id.*

118. CFTC Summary Judgment Motion, *supra* note 5, at 14 (citing Final CPO Rules, at 11,283-59).

119. *Id.* at 14-16 (citing Final CPO Rules, at 11,252). For a summary of such reporting requirements, see, e.g., *id.*

are also registered investment companies are being crafted by both the CFTC and the SEC, in an effort to harmonize rulemaking efforts.¹²⁰

The mutual fund industry is challenging the Final CPO Rules. On April 17, 2012, the Investment Company Institute (the "ICI")¹²¹ and the Chamber of Commerce of Commerce of the United States of America (the "Chamber") brought suit against the CFTC in the Federal District Court for the District of Columbia seeking to invalidate the Final CPO Rules.¹²² The U.S. District Court for the District of Columbia dismissed the lawsuit on December 12, 2012, but the ICI and Chamber quickly filed an appeal with the U.S. Court of Appeals for the District of Columbia on December 27, 2012.¹²³ The suit alleges violations of the CEA and the Administrative Procedures Act (i.e., insufficient evaluation of costs and benefits, arbitrary and capricious agency action, and failure to provide an opportunity to meaningfully participate in the rulemaking, among other claims).¹²⁴ No matter the outcome of this litigation, the mutual fund industry has made it clear that it is determined to resist certain regulatory reforms.¹²⁵

120. CFTC Summary Judgment Motion, *supra* note 5, at 16 (citing Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as CPOs, 77 Fed. Reg. 11,345 (Feb. 24, 2012)).

121. ICI "is an association that represents United States registered investment companies . . ." ICI Complaint, *supra* note 114, at 6.

122. See ICI Complaint, *supra* note 114, at 1. Notably, the suit is brought by Eugene Scalia, whose father is Supreme Court Justice Antonin Scalia. Chris Dolmetsch & Robert Schmidt, *CFTC Sued By Fund Industry To Overturn Registration Rule*, BUSINESSWEEK.COM (Apr. 17, 2012), <http://www.businessweek.com/printer/articles/46898?type=bloomberg>. The younger Scalia has won four cases in recent years challenging SEC regulations, and another in late September 2012 challenging a CFTC regulation that was designed to limit speculative trading, which case the CFTC is appealing. See, e.g., *id.*; David Clarke & Sarah N. Lynch, *U.S. Trade Groups Sue CFTC Over Mutual Fund Rule*, THOMSONREUTERS.COM (Apr. 17, 2012), http://newsandinsight.thomsonreuters.com/Securities/News/2012/04_-_April/U_S_trade_groups_sue_CFTC_over_mutual_fund_rule/; Alexandra Alper, *U.S. Court Throws Out Landmark Commodity Trading Crackdown*, THOMSONREUTERS.COM (Sept. 29, 2012), <http://www.reuters.com/assets/print?aid=USBRE88R1FN20120928>; Emily Stephenson, *Trade Groups Appeal U.S. Decision on CFTC Mutual Funds Rule*, THOMSONREUTERS.COM (Dec. 27, 2012), http://newsandinsight.thomsonreuters.com/Legal/News/2012/12_December/Trade_groups_appeal_U_S_decision_on_CFTC_mutual_funds_rule/.

123. See, e.g., Jamila Trindle, *Mutual Funds Appeal CFTC Rule*, Wall St. J., Dec. 28, 2012, at C2; Memorandum Opinion, *Inv. Co. Inst. v. U.S. Commodity Futures Trading Comm'n*, No. 1:12-cv-00612 (D.D.C., June 18, 2012)

124. ICI Complaint, *supra* note 115, at 3.

125. Another example of the industry's resistance to reform efforts hit the papers recently in the context of its opposition to the SEC's proposals to shore up the money market rules. See, e.g., Floyd Norris, *Funds and Allies Defend the Buck*, N.Y. TIMES, June 29, 2012, at B1, B6 (noting that the SEC's efforts are "being fought bitterly by the fund companies and by the U.S. Chamber of Commerce, which has established a Web site and blanketed the Washington subway station near the S.E.C. offices with ads denouncing such rules as outrageous").

IV. THE LESSONS OF 1940: DOCTRINAL FOUNDATIONS OF THE 1940 ACT

Against the current snapshot of derivative markets provided in Parts II and III, this Part offers a retrospective look at investment company abuses during the Great Depression and the doctrinal underpinnings of the 1940 Act, with specific emphasis on issues of relevance to the derivatives discussion.¹²⁶

A. AN OVERVIEW

In the turbulent years following the Great Stock Market Crash of 1929, endemic problems in the then-unregulated investment company industry became distressingly manifest.¹²⁷

The close relationships between investment companies and their sponsors proved disastrous as a group of unscrupulous sponsors treated fund assets as their own. Many funds failed, and many shareholders lost their investments. The SEC estimated that between 1929 and 1936, investment company shareholders lost 40 per cent of their investments.¹²⁸

The widespread abuse precipitated Congress to commission a comprehensive study of the investment company industry in 1935, referred to as the “Investment Trust Study,” which confirmed virulent fraudulent activity.¹²⁹

The Investment Trust Study, and the subsequent Congressional hearings, found that, to an alarming extent, investment companies were being organized and operated to benefit the

126. For a thorough history of the regulation of derivatives, including the legislative history of the CEA, see Stout, *supra* note 33, at 11–31.

127. Remarks by Paul F. Roye, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Before the American Law Institute/American Bar Association Investment Company Regulation and Compliance Conference, The Exciting World of Investment Company Regulation (June 14, 2001), reproduced in TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 30–33, at 32 (3d ed. 2005) [hereinafter Roye Speech]; see also, e.g., Kelly S. Kibbie, *The Newly-Mandated Myopia of Rule 10b-5: Pay No Attention To that Manager Behind the Mutual Fund Curtain* (to be printed in 78 MO. L. REV. 1)(2013).

128. Roye Speech, *supra* note 126, at 32; see also, e.g., Jones v. Harris Associates L.P., 130 S. Ct. 1418, 1422 (2010) (explaining that the 1940 Act was premised on Congress’ “concern with the potential for abuse inherent in the structure of investment companies” and its realization “that the relationship between a fund and its investment adviser was fraught with potential conflicts of interest . . .”) (citing Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 536 (1984)) (internal quotation marks omitted).

129. Roye Speech, *supra* note 126, at 32.

interests of their affiliates rather than the interests of their shareholders. The highly liquid nature of fund assets made them easy targets for embezzlement by affiliates, who often viewed them as a source of private capital. Transactions between investment companies and their affiliates, which were expressly permitted to allow investment companies to participate in the business dealings of affiliated financial firms, often resulted in improper transactions.

Underwriters found it convenient to dump into the portfolios of affiliated funds securities that they found to be unmarketable.

Furthermore, investment companies were structured to ensure that they remained under the control of their sponsors . . .

Finally, the fact that investment companies generally attracted small, unsophisticated investors, allowed sponsors to mislead these investors as to the actual nature of their investment. These investors often did not understand their rights, the sales charges they were obligated to pay, or how the investment company's manager was managing the company's assets.¹³⁰

The investment company industry of 1930s post-Crash America was so corrupt that it was characterized as a "parasite upon the stream of industrial earnings."¹³¹

This stark landscape motivated Congress, the SEC and the industry to work together to craft the 1940 Act, which was "truly a negotiated statute."¹³² The 1940 Act is a complex, creative statute that built on concepts from the banking laws, the 1933 Act, the 1934 Act, the Chandler Act (regulating bankruptcies), the Public Utility Holding Company Act of 1935, and the Civil Aeronautics Act.¹³³ The end result

130. Roye Speech, *supra* note 126, at 32.

131. *Id.* at 32-33.

132. *Id.* at 33.

133. Kibbie, *supra* note 125 (citing Roye Speech, *supra* note 126, at 33). As noted by the then-Director of the SEC's Division of Investment Management, "Louis Loss called the 1940 Act 'the most complex of the entire SEC series' as reflective of the fact that it specifically addresses virtually every aspect of investment companies' operations." Speech by SEC Staff: Luncheon Address Before a Meeting of the Business Law Section of the American Bar Assoc. Comm. on Federal Regulation of Securities, by Andrew J. Donohue, Director of Investment Management, U.S. Sec. and Exch. Comm'n (Denver, Co., Apr. 24, 2010), *reprinted in* CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES, INVESTMENT MANAGEMENT INSTITUTE 2011, PLI ORDER NO. 28697 (Practising Law Institute, ed., Feb. 10-11, 2011).

was a statute specifically designed to deal with the unique complexities of the investment company industry.

Several doctrinal foundations of the 1940 Act are specifically implicated in the derivatives discussion herein. Those include restrictions regarding “senior securities” (discussed in Section B); requirements regarding diversification classification (discussed in Section C); restrictions regarding exposure to “securities-related issuers” (discussed in Section D); and restrictions regarding portfolio concentration (discussed in Section E).

B. RESTRICTIONS REGARDING “SENIOR SECURITIES”

A “core purpose” of the drafters of the 1940 Act was to protect investors against the dangers of “senior securities.”¹³⁴ Section 18(g) of the 1940 Act defines “senior securities,” in pertinent part, as “any bond, debenture, note, or similar obligation or instrument constituting a security and *evidencing indebtedness*,” as well as “any stock of a class having priority over any other class as to the distribution of assets or payment of dividends.”¹³⁵ The 76th Congress was specifically concerned about abuses during the 1920s and 1930s of senior security holders by investment companies; sponsors would commonly keep “junior, voting securities for themselves [so that] they could operate the company in their own interests,” while selling the risky senior securities “to the public as low risk investments.”¹³⁶ Further, Congress was concerned about investment companies that had unduly increased the speculative nature of their junior securities by issuing excessive amounts of senior securities and by borrowing excessively.¹³⁷ Investment companies using excessive amounts of leverage were

134. See, e.g., SEC Concept Release, *supra* note 1, at 19.

135. 15 U.S.C. § 80a-18(g) (2006); see also, e.g., SEC Concept Release, *supra* note 1, at 19 (emphasis added). The statutory definition excludes certain temporary borrowings.

136. See, e.g., Memorandum transmitted by Chairman Levitt to Representatives Markey & Fields, Mut. Funds & Derivative Instruments, U.S. Sec. & Exch. Comm’n Div. of Inv. Mgmt. (Sept. 26, 1994) [hereinafter the 1994 Report], at 23 (discussing other abusive practices, such as pyramiding and issuing multiple classes of senior securities); SEC Concept Release, *supra* note 1, at 19; Comm’r Robert Healy, Comm’r, Sec. & Exch. Comm’n, Inv. Trusts and Inv. Co.: Hearings on S. 2580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, 265-78 (1940) [hereinafter the 1940 Senate Hearings].

137. See, e.g., SEC Concept Release, *supra* note 1, at 19; 15 U.S.C. § 80a-1(b)(7) (2006); Sec. Trading Practices of Registered Inv. Co., Inv. Co. Act Release No. 10666, 44 F.R. 25128 (Apr. 18, 1979) [hereinafter Release 10666], at n.8.

essentially operating without sufficient assets and reserves.¹³⁸

The 1940 Act is prefaced with the following declaration:

[I]t is hereby declared that the national public interest and the interest of investors are adversely affected— . . .

(3) when investment companies . . . fail to protect the preferences and privileges of the holders of their outstanding securities;

. . .

(7) when investment companies by *excessive borrowing* and the *issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities*; or

(8) when investment companies *operate without adequate assets or reserves*.

It is hereby declared that the policy and purposes of this title . . . are *to mitigate and, so far as is feasible, to eliminate* the conditions enumerated in this section which [*sic*] adversely affect that national public interest and the interest of investors.¹³⁹

Congress set forth limitations regarding an investment company's use of senior securities in Section 18(f) of the 1940 Act, which *prohibits* an open-end investment company¹⁴⁰ from issuing or selling "*any senior security* of which it is the issuer," except that such investment company may "borrow from *any bank*" if "immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings of such registered company . . ." ¹⁴¹ "Asset coverage" is defined in section 18(h) of the 1940 Act as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not

138. See, e.g., SEC Concept Release, *supra* note 1, at 19; Release 10666, *supra* note 137, at 25130 n.8.

139. 15 U.S.C. § 80a-1(b) (2006) (emphasis supplied). See *infra* note 245 regarding additional nuances of the senior security definition.

140. An "open-end company" is defined in section 5(a)(1) of the 1940 Act as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." 15 U.S.C. § 80a-5(a)(1) (2006). Mutual funds are open-end funds.

Congress also set forth senior security restrictions for closed-end funds and business development companies in sections 18(a)(1) and 61(a)(1). 15 U.S.C. §§ 80a-18(a)(1), 61(a)(1) (2006). As previously stated, a specific discussion regarding derivatives use by investment companies other than mutual funds is beyond the scope of this Article.

141. 15 U.S.C. § 80a-18(f)(1) (2006) (emphasis added); see also, e.g., SEC Concept Release, *supra* note 1, at 19. See *infra* note 245 regarding additional nuances of the senior security definition.

represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer."¹⁴²

As discussed in Part V(B), the SEC has recognized that the use of derivatives by investment companies may involve the issuance of senior securities, resulting in violations of the provisions and doctrinal policies discussed above.

C. REQUIREMENTS REGARDING DIVERSIFICATION

Under the 1940 Act, mutual funds must specify whether they are "diversified"¹⁴³ or "non-diversified"¹⁴⁴ in their registration statements.¹⁴⁵ Once this designation is made, a diversified fund must remain diversified unless it obtains shareholder approval to become non-diversified.¹⁴⁶

In enacting the foregoing diversification requirements, Congress was attempting to thwart the specific abuses outlined in Section A above and "to prevent a fund that holds itself out as diversified from being too closely tied to the success of one or a few issuers or controlling portfolio companies."¹⁴⁷ Further "the requirements are

142. 15 U.S.C. § 80a-18(h) (2006). For examples of asset ratio calculations, *see, e.g.*, Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987) [hereinafter the Dreyfus No-Action Letter], *available at* <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>; and Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996), *available at* www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm [hereinafter the Merrill No-Action Letter].

143. Pursuant to § 5(b)(1) of the 1940 Act, a "diversified company" is a fund that "with respect to 75% of the value of its total assets (the '75 bucket'), has (among other things) no more than 5% of the value of its total assets invested in the securities of any one issuer." SEC Concept Release, *supra* note 1, at 49 (footnotes omitted). Further, with respect to the 75% bucket, a diversified fund is prohibited from owning more than 10% of the outstanding voting securities of any single issuer. *Id.* Rule 5b-1 under the 1940 Act defines "total assets" as "the gross assets of the company with respect to which the computation is made, taken as of the end of the fiscal quarter of the company last preceding the date of computation." 17 C.F.R. § 270.5b-1 (2010); *see also, e.g.*, SEC Concept Release, *supra*, at 49 n. 127. Sections 2(a) and 2(a)(22) of the 1940 Act define "issuer" as follows: "unless the context otherwise requires, . . . every person who issues or proposes to issue any security, or has outstanding any security which it has issued." SEC Concept Release, *supra*, at 49 n.128 (quoting 15 U.S.C. §§ 80a-2(a), 80a-2(a)(22) (2006)).

144. Pursuant to § 5(b)(2) of the 1940 Act, a "non-diversified company" is "any management company other than a diversified company." 15 U.S.C. § 80a-5(b)(2) (2006).

145. 15 U.S.C. § 80a-8(b)(1)(A) (2006); *see also, e.g.*, SEC Concept Release, *supra* note 1, at 49 n.125 (citing SEC Form N-1A (Items 16, 4(a) and 4(b)(1)) and Form N-2 (Item 17)).

146. 15 U.S.C. § 80a-13(a)(1) (2006); *see also, e.g.*, SEC Concept Release, *supra* note 1, at 49.

147. SEC Concept Release, *supra* note 1, at 49 (citing the 1940 Senate Hearings, *supra* note 134, at 188 (Statement of David Schenker, SEC Investment Trust Study Chief Counsel, regarding a draft of § 5(b)(1) similar to the current statute)).

designed to ensure that investors receive a clear statement of the character of the portfolio of the fund in which they are invested, and are intended to prevent any diversified fund from becoming non-diversified without the prior approval of its shareholders.”¹⁴⁸

Section 1(b)(6) of the 1940 Act expressly states that “the national public interest and the interest of investors are adversely affected . . . when investment companies . . . change the character of their business . . . without the consent of their security holders.”¹⁴⁹

Part V(C) below discusses specific issues that derivative transactions by mutual funds present with respect to the foregoing 1940 Act diversification requirements, as well as proposed legislative and regulatory fixes regarding the same.

D. RESTRICTIONS REGARDING EXPOSURE TO SECURITIES-RELATED ISSUERS

Section 12(d)(3) of the 1940 Act generally prohibits investment companies from (1) purchasing or otherwise acquiring any *security* that is issued by an underwriter, broker, dealer or investment adviser (collectively, “securities related issuers”) and (2) acquiring *any other interest* in the business of a securities related issuer.¹⁵⁰

There are two reasons for this prohibition. First, it limits a fund’s exposure to the entrepreneurial risks of securities-related issuers, including the *fund’s potential inability to extricate itself from an illiquid investment in a securities-related issuer*. Second, it is one of several . . . [1940 Act] provisions which [*sic*], taken together, *prohibit fund sponsors*, which also include broker-dealers, underwriters, and investment advisers, *from taking advantage of the funds that they sponsor*. Specifically, the prohibition has the effect of limiting the possibility of abusive reciprocal practices between funds and securities-related issuers.¹⁵¹

As discussed above in Section A, the abuses by fund sponsors in the Great Depression were many.¹⁵² Reciprocal abusive practices have also been a constant concern of the SEC and Staff:

148. SEC Concept Release, *supra* note 1, at 49–50 (footnotes omitted) (citing Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, WASH. U. L.Q. 303, 314, 316–17 (April 1941)).

149. 15 U.S.C. § 80a-1(b)(6) (2006).

150. 15 U.S.C. § 80a-12(d)(3) (2006); *see also, e.g.*, SEC Concept Release, *supra* note 1, at 57.

151. SEC Concept Release, *supra* note 1, at 57–58 (emphasis added) (footnotes omitted); *see also, e.g.*, ABA Task Force Report, *supra* note 14, at 31.

152. *See supra* text accompanying notes 125–31.

Such reciprocal practices include the possibility that an investment company might purchase securities or other interests in a broker-dealer to reward that broker-dealer for selling fund shares, rather than solely on investment merit. Similarly, . . . an investment company might direct brokerage to a broker-dealer in which the company has invested to enhance the broker-dealers profitability or to assist it during financial difficulty, even though that broker-dealer may not offer the best price and execution.¹⁵³

Section 1(b)(2) of the 1940 Act states that “the national public interest and the interest of investors are adversely affected . . . when investment companies are organized, operated managed, or when their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers or dealers . . . rather than in the interest of all classes of such companies’ security holders[.]”¹⁵⁴

Part V(D) below discusses issues that derivative transactions by mutual funds present with respect to Section 12(d)(3) prohibitions, as well as proposed regulatory solutions.

E. RESTRICTIONS REGARDING PORTFOLIO CONCENTRATION

Section 8(b)(1)(E) of the 1940 Act requires investment companies to disclose their policies regarding “concentrating investments in a particular industry or group of industries” in their registration statements.¹⁵⁵ The doctrinal policies regarding this requirement are similar to those supporting the diversification requirements discussed in Part IV(C) above.¹⁵⁶

This requirement reflects the view that . . . [a portfolio concentration 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

153. SEC Concept Release, *supra* note 1, at 58 (quoting *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, 49 Fed. Reg. 9652 (Jan. 17, 1984), at n.9 and accompanying text).

154. 15 U.S.C. § 80a-1(b)(2) (2006).

155. 15 U.S.C. § 80a-8(b)(1)(E) (2006); *see also* SEC Concept Release, *supra* note 1, at 64 (citing Form N-1A (Items 4, 9 (instruction 4) and 16(c)(1)(iv)) and Form N-2 (Items 8.2.b(2) and 17.2.e)).

156. *See supra* text accompanying notes 142–47.

follow the policy. The concentration requirements also are intended to prevent funds from substantially changing the nature and character of their businesses without shareholder approval.¹⁵⁷

As with the diversification requirements, an investment company is prohibited from changing its concentration policy as set forth in its registration statement unless it obtains shareholder approval.¹⁵⁸

Part V(E) discusses issues that derivative transactions by mutual funds present with respect to concentration requirements, as well as proposed regulatory solutions.

V. CERTAIN CORE 1940 ISSUES ACT WITH RESPECT TO DERIVATIVES TRANSACTIONS

Since 1940, the mutual fund industry¹⁵⁹ has grown and evolved beyond anything the 76th Congress could have possibly imagined. In 1940, there were 68 mutual funds, with total assets of \$450 million; today there are 7,637 mutual funds with total net assets of \$11.6 trillion.¹⁶⁰ Further, as specifically relevant to the discussion herein, the complex derivatives widely used today did not exist in 1940.¹⁶¹

Against this backdrop, this Part examines several core 1940 Act issues with respect to derivatives transactions by mutual funds.¹⁶² As neither the 1940 Act nor the rules promulgated thereunder specifically address the complicated issues created by mutual funds' use of derivatives, numerous areas of misalignment arise between current industry practice, on the one hand, and law and foundational policies,

157. SEC Concept Release, *supra* note 1, at 64 (footnotes omitted).

158. 15 U.S.C. § 80a-13(a)(3) (2006); *see also, e.g.*, SEC Concept Release, *supra* note 1, at 64. *See* Part IV(C) for the doctrinal considerations behind this requirement.

159. In addition to the Investment Company Act of 1940 and the rules promulgated thereunder, investment companies are also subject to the statutory and regulatory provisions of the 1933 Act, the 1934 Act, the CTA, the Internal Revenue Code and Regulation T of the Federal Reserve Board. *See, e.g.*, SEC Concept Release, *supra* note 1, at 4 n.2.

160. INVESTMENT COMPANY INSTITUTE, *supra* note 2, at 134.

161. *See supra* note 11; *see also infra* note 243 (discussing the 1940 Act's prohibitions on purchasing securities on margin and short selling securities in contravention of SEC rules, regulations or orders).

162. Due to the complex nature of both the 1940 Act and derivative transactions in general, issues other than those addressed herein arise under the statute. *See, e.g.*, ABA Task Force Report, *supra* note 14, at 36-37 (discussing 1940 Act liquidity issues); *id.* at 37-39 (discussing 1940 Act custody issues); *id.* at 39-42 (discussing 1940 Act issues with respect to fund names and disclosure issues); *id.* at 42-43 (discussing compliance programs); *id.* at 43-46 (discussing board oversight issues); *see also* SEC Concept Release, *supra* note 1, at 6, 8; 2009 Donohue Speech, *supra* note 23, at 4).

on the other. Arguably, a plain reading of the 1940 Act prohibits many types of derivative transactions by mutual funds.¹⁶³ Further, the guidance that the SEC and its Staff have provided has been sporadic and sometimes contradictory;¹⁶⁴ the SEC has not issued any formal guidance since 1979, years before swaps were even invented.¹⁶⁵ As such, given the importance of these issues to investors, Congress and/or the SEC should act.

Section A address two foundational issues under the 1940 Act that are critical to the derivatives discussion: valuation and leverage. Section B analyzes the complex senior security issues under Section 18 of the 1940 Act and traces the “thirty year patchwork”¹⁶⁶ of SEC and Staff releases on the subject; offers alternative approaches to resolve the misalignment between the law and current practice; and proposes legislative amendments and new regulations consistent with the doctrinal bases of the 1940 Act. Section C examines issues that arise under the diversification provisions under the 1940 Act and offers regulatory solutions. Section D analyzes complex matters with respect to the 1940 Act’s prohibitions regarding exposure to “securities-related issuers” and sets forth proposed regulations reflecting modern derivatives practice. Finally, Section E addresses issues with respect to concentration requirements and proposes regulatory reforms.

A. TWO FOUNDATIONAL ISSUES: VALUATION AND LEVERAGE

1. *Different Methods of Valuing Derivatives*

Numerous provisions of the 1940 Act require valuation of a fund’s assets.¹⁶⁷ The determination of the value of an investment company’s derivatives positions are complex, because the 1940 Act contemplates “at least two potential measures” of derivative valuation:¹⁶⁸ (1) the

163. See, e.g., *supra* Part V(B).

164. See, e.g., ABA Task Force Report, *supra* note 14, at 16; 2009 Donohue Speech, *supra* note 22, at 6.

165. See *supra* Part V(B).

166. See, e.g., *supra* note 160.

167. See generally SEC Concept Release, *supra* note 1, at 8–10. It should be noted that the accounting standards applicable to derivative contracts are extremely complex and beyond the scope of this Article. See, e.g., *Accounting for Derivative Instruments and Hedging Activities*, Financial Accounting Standards Board Statement No. 133 (June 1998); HULL, *supra* note 1, at 39–40.

168. SEC Concept Release, *supra* note 1, at 8–9.

current market value of the derivative (also referred to as the *fair value*), which is generally defined as the liquidation value of the derivative,¹⁶⁹ and (2) the *notional amount*, which equals the “contract size (number of units per contract) multiplied by the current price of the reference asset on which payment obligations are calculated.”¹⁷⁰

Market value can be a complex notion with respect to certain derivatives. For example, at the inception of a simple interest rate swap, the value of the swap is zero; when the applicable interest rate begins to move, the swap becomes negative to one party and positive to the other.¹⁷¹ Further, OTC derivatives have customized terms, including terms that may restrict transferability or the ability to enter into offsetting transactions.¹⁷² “Marking-to-market” with respect to a futures or option contract is accomplished at the end of each trading session by subtracting any loss (or adding any gain) in the day’s contract position from (or to) the account balance for the derivative.¹⁷³

“Notional amount,” as recognized in the ABA Task Force Report, “is used differently by different people and in different contexts.”¹⁷⁴ This fact alone underscores the difficulty of even beginning a meaningful discussion in this area. However, although notional value is, “a notoriously imperfect measure of the size of the derivatives market . . . [it] gives at least a weak sense of the magnitude of the risks

169. See discussion in Part V(C)(1) regarding the calculation of market values and fair values.

170. SEC Concept Release, *supra* note 1, at 8–10; see also, e.g., *id.* at 9 n. 19 (listing numerous definitions of “notional amount”). For example, “notional value” has also been defined as “the value of a derivative’s underlying assets at the spot price.” *Id.* (internal quotation marks omitted). Another useful definition of “notional amount” is that it is “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.” ABA Task Force Report, *supra* note 14, at 7 n.11; see also, e.g., SEC Concept Release, *supra* note 1, at 9 n.19.

171. SEC Concept Release, *supra* note 1, at 8–9 n.18 (citing Sarah Sharer Curley & Elizabeth Fella, *Where to Hide? How Valuation of Derivatives Haunts the Courts—Even After BAPCPA*, 83 AM. BANKR. L.J. 297, 298–99 (Spring 2009) (explaining that the “value of the swap is the net difference between the present value of the payments each party expects to receive and the present value of the payments each party expects to make.”)).

172. See, e.g., SEC Concept Release, *supra* note 1, at 69 (noting that with respect to some derivatives, the only pricing information available may be from the fund’s counterparty in the transaction). In light of these complex considerations, the SEC should issue guidance with respect to the determination of “fair value.”

173. SEC Concept Release, *supra* note 1, at 8–9 n.18 (citing *CFTC Glossary Mark-to-Market Definition*, CFTC.GOV, available at http://cftc.gov/ConsumerProtection/EducationCenter/CFTC_Glossary/index.htm).

174. ABA Task Force Report, *supra* note 14, at 7 n.11; see also, e.g., SEC Concept Release, *supra* note 1, at 9 n.19; *supra* note 116 (referencing that the net notional test set forth in the Final CPO Rules defines notional value by asset class).

created by derivatives trading and the potential losses to which derivatives traders might be exposed.”¹⁷⁵

Further complicating matters of valuation is the fact that derivative transactions typically involve exposures to many variables that have the potential to affect the value of the instrument.¹⁷⁶ These variables include counterparty credit risk and a myriad of variables that could potentially affect the value of the reference asset.¹⁷⁷

Valuation issues are specifically addressed below in Part B(3)(c) (with respect to Section 18 senior security issues); Part C(1) (with respect to 1940 Act diversification provisions); Part D(3) (with respect to exposure to securities-related issuers); and Part E(1) (with respect to 1940 Act concentration provisions).

2. Various Concepts of Leverage

The SEC has recognized that “[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return.”¹⁷⁸

The ABA Task Force Report provides the following description of the effects of leverage in derivatives:

Market participants are able to acquire exposure (either long or short) to a large dollar amount of an asset (the notional value) with only a small down payment, enabling parties to shift risk more efficiently and with lower costs. The leverage inherent in these instruments magnifies the effect of changes in the value of the underlying asset on the initial amount of capital invested. For example, an initial 5% collateral deposit on the total value of the commodity would result in 20:1 leverage, with a potential 80% loss (or gain) of the collateral in response to a 4% movement in the market price of the underlying commodity.¹⁷⁹

175. Stout, *supra* note 33, at 23.

176. See, e.g., SEC Concept Release, *supra* note 1, at 9–10.

177. *Id.*

178. Release 10666, *supra* note 135, at 25129 n. 5; SEC Concept Release, *supra* note 1, at 13 n.30.

179. ABA Task Force Report, *supra* note 14, at 8–9; SEC Concept Release, *supra* note 1, at 13–14 n.32. For example, if the value of the underlying asset is \$100, the collateral deposit would be \$5. A 4% price increase of the reference asset would equal \$4, which is 80% of the collateral deposit of \$5.

“Indebtedness leverage” exists in instruments that “create obligations, or potential indebtedness, to someone other than the fund’s shareholders, and enable the fund to participate in gains and losses on an amount that exceeds the fund’s initial investment.”¹⁸⁰

Additionally, some types of derivatives, including purchased call options, “provide the economic equivalent of leverage because they convey the right to a gain or loss on an amount in excess of the fund’s investment but do not impose a payment obligation on the fund above its initial investment.” This type of leverage is called “economic leverage” or “implied leverage.”¹⁸¹ Derivatives providing economic leverage “display heightened price sensitivity to market fluctuations . . . such as changes in stock prices or interest rates . . . [and, in] essence, . . . magnify a fund’s gain or loss from an investment in much the same way that incurring indebtedness does.”¹⁸²

B. RESTRICTIONS REGARDING “SENIOR SECURITIES”

As discussed above in Part IV(B), a “core purpose” of the drafters of the 1940 Act was to protect investors against the dangers of “senior securities.” This section discusses the fact that the widespread use of derivatives by investment companies may be misaligned with this important doctrinal foundation of the 1940 Act, as well as the provisions of Section 18(f)(1). Although the SEC and SEC Staff have sporadically spoken on this issue, as referenced above, the guidance has been sometimes contradictory; as recognized by the SEC Concept Release, no comprehensive definitive guidance exists. For the reasons set forth herein, Congress and/or the SEC should decisively speak on this issue for the protection of investors.

Subsection (1) below discusses Release 10666, the SEC’s “General Statement of Policy” issued in 1979, which constitutes the sole formal piece of guidance from the SEC on this matter. Subsection (2) addresses the “patchwork”¹⁸³ of subsequent releases from the SEC Staff

180. SEC Concept Release, *supra* note 1, at 13 (citing 1994 Report, *supra* note 91, at 22).

181. SEC Concept Release, *supra* note 1, at 19 n.32 (citing 1994 Report, *supra* note 91, at 23).

182. *Id.* (citing 1994 Report, *supra* note 91, at 23). For example, assume that a fund buys an option for \$1 to call X stock on December 1st at a price of \$10. If on December 1st the market price of X stock is \$100, the fund will exercise its call option and purchase the stock for \$10. For an initial outlay of \$1, the fund obtains a right to a profit of \$89. Similarly, if today’s market price for X stock is \$10, and the fund buys one share using \$1 of its own and \$9 borrowed from a bank, when the price of X stock hits \$100, the fund will have a profit of \$90 for its initial outlay of \$1 (less borrowing costs).

183. See *supra* note 160 and accompanying text.

regarding various types of instruments. Subsection (3) examines possible alternative approaches to the treatment of derivatives under Section 18 of the 1940 Act. Finally, Subsection (4) proposes specific legislative and regulatory solutions.

1. The SEC's 1979 "General Statement of Policy"

The SEC first framed the issue in 1979 with its "General Statement of Policy" in Release 10666.¹⁸⁴ Specifically, in Release 10666, the SEC considered the applicability of the 1940 Act's senior security limitations with respect to the following three types of agreements: reverse repurchase agreements,¹⁸⁵ firm commitment agreements,¹⁸⁶ and standby commitment agreements.¹⁸⁷ The Commission found that while such agreements may not be "securities" for all purposes,¹⁸⁸ they "fall within the functional meaning of the term 'evidence of indebtedness' for purposes of Section 18 of the Act,' which generally would include 'all contractual obligations to pay in the future for

184. See *supra* note 135. This release is referred to in the industry as "ten-triple-six." 2009 Donohue Speech, *supra* note 23, at 1.

185. In a typical reverse repurchase agreement, a fund that owns a debt security transfers possession of such security to a broker-dealer or a bank in return for proceeds constituting a percentage of the market value of such debt security; however, the fund retains record ownership of the debt security, as well as the right to receive interest and principal payments. See, e.g., Release 10666, *supra* note 135, at 25130 n. 10; SEC Concept Release, *supra* note 1, at 20 n.56.

186. In a typical firm commitment agreement (also referred to as a "when-issued security" or a "forward contract"), a fund agrees to purchase a debt security from a seller, typically a broker-dealer, at a specified future date, price and yield. See, e.g., Release 10666, *supra* note 135, at 25130; SEC Concept Release, *supra* note 1, at 20 n. 56; see also, e.g., *supra* note 43.

187. In a standby commitment agreement, a fund effectively writes a put agreement, giving the counterparty the option to require the fund to purchase a debt security at a specified date, price and yield. See, e.g., Release 10666, *supra* note 135, at 25130; SEC Concept Release, *supra* note 1, at 20 n. 56; see also, e.g., *supra* note 35.

188. SEC Concept Release, *supra* note 1, at 20. Given the "policies and purposes" of the 1940 Act, the definition of "security" contained therein in section 2(a)(36) (and the SEC's interpretation of same) is broader than the definition contained in other securities laws. SEC Concept Release, *supra* note 1, at 20 n.57. For example, the 1940 Act's definition of "security" includes any "evidence of indebtedness," whereas the 1934 Act's definition in section 3(a)(10) does not. See 15 U.S.C. § 80a-2(a)(36) (2006 & Supp. 2010). It should be noted that the ABA Task Force Report interprets Section 2(a)(36)'s specific reference to security futures to mean that "[o]ther futures contracts are not securities under the 1940 Act." ABA Task Force Report, *supra* note 13, at n.42. However, this analysis fails to consider the "evidence of indebtedness" prong of the definition. See, e.g., SEC Concept Release, *supra* note 1, at n.134 (stating that "[a]s a general matter, most derivatives appear to be notes or evidence of indebtedness and thus securities for purposes of the diversification requirements").

consideration presently received."¹⁸⁹ As such, the Commission acknowledged that such agreements "may" constitute senior securities, *which are prohibited under Section 18(f)(1).*¹⁹⁰ The SEC noted that "[t]he gains and losses from the transactions can be extremely large relative to invested capital; for this reason, each agreement has speculative aspects."¹⁹¹ Further, the SEC stated that its view that such agreements could be senior securities was "based not so much on the conclusion that reverse repurchase agreements and firm commitment agreements, considered in isolation, are inherently securities for all purposes, but more upon the proposition that *trading practices involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging fall within the legislative purposes of Section 18.*"¹⁹²

Leverage exists when an investor achieves the *right to a return* on a capital base *that exceeds the investment* which he has personally contributed to the entity or instrument achieving a return Through a reverse repurchase agreement, an investment company can achieve a return on a very large capital base relative to its cash contribution. Therefore, the reverse repurchase agreement is a highly leveraged transaction.¹⁹³

"[B]ecause of the additional risk of loss created by the substantial leveraging in each agreement, and in light of the volatility of interest rates in the marketplace," each of the instruments addressed by Release 10666 potentially constituted "a substantially higher risk environment."¹⁹⁴ In fact, for investments that require no up-front investment, such as the firm commitment, "*unlimited leverage*" is created.¹⁹⁵

189. SEC Concept Release, *supra* note 1, at 20–21 (emphasis added) (quoting Release 10666, *supra* note 135, at 25131–32).

190. *See supra* note 189.

191. Release 10666, *supra* note 135, at 25131–32; SEC Concept Release, *supra* note 1, at 21–22 n. 62.

192. Release 10666, *supra* note 135, at 25131–32 (emphasis added); SEC Concept Release, *supra* note 1, at 21. "Leveraging of a fund's portfolio through the issuance of senior securities 'magnifies the potential for gain or loss on monies invested, and therefore, results in an increase in the speculative character of the investment company's outstanding securities.'" SEC Concept Release, *supra* note 1, at 21 (quoting Release 10666, *supra* note 135, at 25129).

193. Release 10666, *supra* note 135, at 25129 n. 5; SEC Concept Release, *supra* note 1, at 21.

194. Release 10666, *supra* note 135, at 25129 n. 5; SEC Concept Release, *supra* note 1, at 21.

195. Release 10666, *supra* note 135 at 25130 (explaining that "[i]f the investor puts up nothing, leverage cannot be measured in ratio terms, and therefore can be said to be unlimited or infinite").

Although Release 10666 found that the agreements addressed were “functionally equivalent to senior securities,” it held that “these and similar arrangements nonetheless could be used by funds in a manner that would not warrant application of the section 18 restrictions.”¹⁹⁶ Specifically, the SEC found that if an investment company using such agreements set up segregated accounts, that were “properly created and maintained,” such segregated accounts “would limit the investment company’s risk of loss.”¹⁹⁷ The Commission stated that such segregated accounts should be established with the fund’s custodian and contain liquid assets (including “cash, U.S. government securities, or other appropriate high-grade debt obligations”) equal in amount to the indebtedness created by the senior security.¹⁹⁸ The liquid assets contained in the segregated account would be “deemed frozen and unavailable for sale or other disposition” and would be marked-to-market daily, with additional assets added when necessary to maintain the required amount in the account.¹⁹⁹

The SEC noted that a properly maintained segregated account would function as “a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock” and that it would also serve to “assure the availability of adequate funds to meet the obligations arising from such activities.”²⁰⁰

The amount of assets required to be maintained in each segregated account would differ for each such agreement, depending on the amount of indebtedness created with respect thereto. For example, the amount required to be segregated under a reverse repurchase agreement that specified a repurchase price would be the repurchase price.²⁰¹ For both firm and standby commitment agreements, the segregated amount would be equal to the specified purchase price to be paid for the underlying security at issue.²⁰² Thus, the SEC adopted the notional amount as the proper amount to be segregated for these instruments.²⁰³

196. SEC Concept Release, *supra* note 1, at 22.

197. Release 10666, *supra* note 135, at 25131–32; SEC Concept Release, *supra* note 1, at 22.

198. SEC Concept Release, *supra* note 1, at 22.

199. *Id.*; Release 10666, *supra* note 135, at 25131–32. This method is hereinafter referred to as the “Segregated Account Approach.”

200. Release 10666, *supra* note 135, at 25131–32; *see also* SEC Concept Release, *supra* note 1, at 22–23.

201. SEC Concept Release, *supra* note 1, at 22–23; Release 10666, *supra* note 135, at 25131–32.

202. SEC Concept Release, *supra* note 1, at 22–23; Release 10666, *supra* note 135, at 25131–32.

203. *See supra* Part V(A)(1).

The SEC asserted an important caution in Release 10666 that “as the percentage of a fund’s portfolio assets that are segregated assets increases, *the fund’s ability to meet current obligations, to honor requests for redemption, and to manage properly the investment portfolio in a manner consistent with its stated investment objective may become impaired.*”²⁰⁴

For example, in an extreme case, an investment company which [*sic*] has segregated all of its liquid assets might be forced to sell non-segregated portfolio securities to meet its obligations upon shareholder requests for redemption. Such forced sales could cause an investment company to sell securities which [*sic*] it wanted to retain or to realize gains or losses which it did not originally intend. Therefore, directors should consider such potential loss of flexibility when determining the extent to which the investment company should engage in such transactions.²⁰⁵

Because of the dearth of information available regarding mutual fund derivative transactions, it is uncertain at this point whether mutual fund investors are adequately protected in this regard.

It should be noted that Release 10666 departs from a previous analysis by the SEC Staff (“Staff”) in 1972.²⁰⁶ Consistent with Release 10666, the 1972 Staff Release found that “[a]lthough commodities and commodity futures contracts themselves may not be securities, the purchase of a commodities futures contract and the ensuring [*sic*] leverage may involve the creation of a senior security.”²⁰⁷ Nonetheless, the Staff stated that it would not object if an investment company traded in commodities futures contracts with the imposition of the following limitations: (a) a 300% *asset coverage requirement* applicable to bank borrowings, (b) an *asset segregation requirement* applicable to the original margin deposited with respect to each contract, and (3) *exposure limitations* restricting investment in any commodity contract to no more than twice the original margin and

204. SEC Concept Release, *supra* note 1, at 22 n.65 (emphasis added); *see also* Release 10666, *supra* note 135, at 25131–32.

205. Release 10666, *supra* note 135, at 25131–32.

206. *See* Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972) [hereinafter the 1972 Staff Release]. As discussed in notes 206–07, *infra*, releases by the Staff are not binding on the Commission.

207. ABA Task Force Report, *supra* note 14, at 11–12 n.15 (quoting the 1972 Staff Release, *supra* note 204).

restricting total commodities contract investments to 10% of its assets.²⁰⁸

In contrast, Release 10666 required a 100 percent asset segregation requirement, but made no mention of the 300 percent asset coverage requirement or an exposure limitation. Unfortunately, the SEC in Release 10666 did not set forth any analysis regarding the 1972 Staff Release or its decision to depart from the multi-pronged limitations set forth therein.

The SEC has not issued any formal guidance regarding derivatives transactions by mutual funds since Release 10666 was issued in 1979.

2. SEC Staff No-Action Letters Regarding the Segregated Account Approach

Since 1979, the Staff has issued over twenty no-action letters²⁰⁹ to investment companies regarding the Segregated Account Approach with respect to various types of senior securities, including stock index futures, interest rate futures, currency forwards and associated options.²¹⁰ It should be noted that, although the SEC Concept Release discusses certain no-action letters in its analysis, it states clearly that its “discussion of staff statements is provided solely for background and to facilitate comment on issues that the Commission might address” and that such “discussion is in no way intended to suggest that the Commission has adopted the analysis, conclusions or any other portion of the staff statements” discussed.²¹¹

In 1987, the Staff issued a no-action letter to two Dreyfus funds²¹² expanding on the ways that obligations could be “covered” by

208. ABA Task Force Report, *supra* note 14, at 12 n.15 (citing the 1972 Staff Release, *supra* note 204).

209. SEC Staff no-action letters are issued by the Staff in response to written requests for advice regarding how the federal securities laws apply with respect to certain transactions. SEC Concept Release, *supra* note 1, at 23 n. 68. As such, they are not binding as to how the Commission would actually address a given situation. *Id.*; see also, e.g., TAMAR FRANKEL, INVESTMENT MANAGEMENT REGULATION 32 (4th ed., 2011). In contrast to non-precedential Staff releases, Release 10666 was issued by the Commission as a “General Statement of Policy” of the SEC.

210. SEC Concept Release, *supra* note 1, at 23 n. 69 and accompanying text. For a complete list of these no-action letters, see *Registered Investment Company Use of Senior Securities—Select Bibliography*, U.S. Sec. and Exch. Comm’n Staff, available at <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

211. SEC Concept Release, *supra* note 1, at 23 n.68.

212. Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987) [hereinafter the Dreyfus No-Action Letter], available at <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

funds with respect to futures, forwards, short sales and written options.²¹³ With respect to long positions in futures²¹⁴ and forwards²¹⁵ and written put options,²¹⁶ the Staff stated that the funds could avoid senior security treatment by establishing a segregated account containing certain liquid assets equal to the *purchase price* of the contract or the *strike price* of the put (minus any margin amounts that had been deposited).²¹⁷ As for short positions in futures²¹⁸ and forward contracts,²¹⁹ written call options,²²⁰ and short sales of securities,²²¹ the Staff stated that the funds could avoid senior security treatment by establishing a segregated account with certain liquid assets in an amount that, when added to any margin amounts deposited with a broker or futures commission merchant, would total the *market value* of the assets underlying the futures, forwards, call options and short sales (but would not be less than the strike price of the call or the market price at which the short positions were established).²²²

The Dreyfus No-Action Letter also stated that, instead of segregating liquid assets to avoid senior security treatment, the funds could also “cover” by “owning, or holding the right to obtain, the instrument or cash that the fund has obligated itself to deliver.”²²³ The

213. SEC Concept Release, *supra* note 1, at 23–24.

214. For a description of a long futures position, see *supra* notes 34–35.

215. For a description of a long forward position, see *supra* note 43.

216. For a description of a written put option, see *supra* note 35.

217. SEC Concept Release, *supra* note 1, at 24 (summarizing the Dreyfus No-Action Letter).

218. For a description of a short futures position, see *supra* notes 34–35.

219. For a description of a short forward position, see *supra* note 43.

220. For a description of a written call option, see *supra* note 35.

221. A short sale occurs when, believing that the price of a certain stock will fall, an investor borrows stock and sells it; if the price decreases, the investor will buy the stock at the decreased price and make a profit, but if the price increases, the investor will incur a loss when buying it at the increased price. See, e.g., *U.S. Sec. & Exch. Comm'n Investor Glossary*, INVESTOR.GOV (site last visited July 25, 2012) http://investor.gov/glossary/glossary_terms/short-sale, [hereinafter the SEC Investor Glossary]; see also, e.g., Georgia Bullitt, Thomas Harman, Christopher Menconi, Bill Zimmerman & Christopher Jackson, *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, 17 THE INVESTMENT LAWYER 12, at 14 (2010) (discussing issues faced by registered investment companies transacting in short sales with respect to margin-related rules under Regulation T of the Board of Governors of the Federal Reserve System; New York Stock Exchange Rule 431; and Rule 2520 of the Financial Industry Regulatory Authority).

222. SEC Concept Release, *supra* note 1, at 24 (summarizing the Dreyfus No-Action Letter). However, as noted in the SEC Concept Release, a subsequent no-action letter stated that the Staff would not recommend enforcement action where, with respect to a short position in a security, the amount segregated was equal to the daily market price of the security sold short (less collateral amounts pledged to a broker), even if such amount was less than the price establishing the short position. *Id.* at 24 n.71 (citing Robertson Stephens Investment Trust, SEC Staff No-Action Letter (Aug. 24, 1995), available at www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm).

223. SEC Concept Release, *supra* note 1, at 24 (summarizing the Dreyfus No-Action Letter).

Staff explained that a fund holding a long position in a futures or forward contract could cover by buying a put option on the same contract with a strike price no less than price of the long contract.²²⁴ With respect to a written put option, a fund could cover by (1) selling short the assets underlying the put at a price no less than the strike price of the put or (2) purchase a put with a strike price equal to or greater than the strike price of the fund's written put option.²²⁵ Importantly, the Dreyfus No-Action Letter confirmed that, if a fund met the foregoing asset segregation or cover requirements, the 300 percent asset coverage requirement of Section 18(f) would not apply.

The 1994 Report, a Staff study by the Division of Investment Management, was written in response to a congressional subcommittee request at the wake of the drastic decline of the collateralized mortgage obligation ("CMO") market, which "resulted in the liquidation of hundreds of millions of dollars of CMO derivatives, further depressing the market and negatively impacting funds that had invested in them."²²⁶ The 1994 Report concluded that although "several funds had recently experienced *significant losses* from investments in mortgage derivatives," in general, the use of derivatives by investment companies was "limited."²²⁷ The 1994 Report concluded that the use of derivatives by investment companies should not be prohibited or restricted for three reasons:

First, a prohibition or restriction on derivatives use could chill the use of instruments in a manner that is beneficial for mutual funds, such as hedging. Second, a prohibition or restriction on derivatives use would be inconsistent with the general approach of the Investment Company Act, which imposes few substantive limits on mutual fund investments. Funds generally are permitted to make investments without regard to their volatility, *e.g.*, emerging market securities and small company stocks, and we are not persuaded that derivatives should be treated differently. Third, it would be extremely difficult, if not impossible, to devise appropriate prohibitions or restrictions on the use of derivatives by mutual funds because of the wide variety of instruments that may be considered "derivatives." The available "derivatives" are likely to change as innovation occurs in the marketplace, possibly

224. SEC Concept Release, *supra* note 1, at 24–25.

225. *Id.*

226. See 2009 Donohue Speech, *supra* note 23.

227. *Id.* (emphasis added) (summarizing the 1994 Report).

rendering substantive prohibitions or restrictions ineffective within a short time.²²⁸

The 1994 Report concluded that “one of the most effective means for addressing leverage concerns associated with mutual fund use of derivatives is improved risk disclosure.”²²⁹

Thereafter, in a 1996 no action letter to Merrill Lynch Asset Management,²³⁰ the Staff expanded upon the description in Release 10666 of the types of assets that could be segregated to avoid Section 18’s senior security limitations.²³¹ While Release 10666 stated that appropriate liquid assets for segregation included “cash, U.S. government securities, or other appropriate high-grade debt obligations,”²³² the Staff in the Merrill No-Action Letter took the view that “any liquid asset, including equity securities and non-investment grade debt securities”²³³ would constitute sufficient cover.²³⁴ In defending this position, the Staff explained that this revised approach would still “place a practical limit on the amount of leverage that a fund may undertake and on the potential increase in the speculative character of its outstanding shares.”²³⁵

In 1997, the Staff once again extended Release 10666 by stating that a fund could segregate liquid assets merely by making the designation in its books and that there was no need to establish a segregated account with the fund’s custodian in accordance with the custody provisions of the 1940 Act.²³⁶

228. See 1994 Report, *supra* note 91, at 24–25 (footnotes omitted); see also, e.g., 2009 Donohue Speech, *supra* note 23.

229. 1994 Report, *supra* note 91, at 25; see also, e.g., 2009 Donohue Speech, *supra* note 23. Although the Commission issued a concept release shortly after the 1994 Report seeking comments regarding the improvement of mutual fund disclosure, it has not taken any action to date with respect to mutual fund risk disclosure regarding derivative use. See, e.g., 2009 Donohue Speech, *supra*. However, the Staff did issue a letter to the Investment Company Institute in 2010 regarding such issues. *Derivatives-Related Disclosures by Investment Companies*, Letter from Barry D. Miller, Assoc. Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, to Karrie McMillan, Gen. Counsel, Inv. Co. Inst. (July 30, 2010)(the “2010 Staff Disclosure Letter”), available at www.sec.gov/divisions/investment/guidance/ici073010.pdf. It is recommended that such guidance be formalized by action from the Commission, with the inclusion of additional disclosure recommendations made throughout this paper.

230. Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996), available at <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm> [hereinafter the Merrill No-Action Letter].

231. SEC Concept Release, *supra* note 1, at 19, 25.

232. *Id.*

233. SEC Concept Release, *supra* note 1, at 19, 25.

234. *Id.*

235. *Id.* (interpreting the Merrill No-Action Letter).

236. *Id.* at 25–26 (citing “Dear Chief Financial Officer Letter from Lawrence A. Friend, Chief Accountant, Div of Inv. Mgmt. (Nov. 7, 1997) [hereinafter the 1997 Friend Letter], available at

The SEC Concept Release concluded its discussion of post-1979 Staff releases regarding Section 18 issues by stating:

Asset segregation practices with respect to other derivatives investments *have not been addressed by the Commission, or by the staff in no-action letters*. Certain swaps, for example, that settle in cash on a net basis, appear to be treated by many funds as requiring segregation of an amount of assets equal to the fund's *daily mark-to-market liability, if any*. Similarly, some funds have disclosed that they segregate only their *daily, mark-to-market liability, if any*, with respect to futures and forward contracts that are contractually required to cash-settle.²³⁷

The SEC Concept Release summarizes that the Staff has generally taken the position that, with respect to *long* positions, the amount to be segregated should be the *purchase or exercise price* of the relevant contract (deducting any deposited margin amounts); whereas, with respect to *short* positions, the amount to be segregated should be the *market value* of the underlying asset "measured by the *full amount of the reference asset, i.e., the notional amount* of the transaction rather than the unrealized gain or loss on the transaction, i.e., its current mark-to-market value."²³⁸ However, the ABA Task Force Report notes that the Staff has informally acquiesced (1) "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"²³⁹ and (2) "to the segregation of the net amount due" on cash-settled futures and forwards.²⁴⁰ The ABA Task Force Report concludes:

[E]xisting 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.²⁴¹

Further, as noted by the 1994 Report, "[t]he Commission and

<http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

237. SEC Concept Release, *supra* note 1, at 26 (emphasis added) (footnotes omitted); *but see infra* text accompanying notes 235–37. For a discussion of the asset segregation treatment of cash-settled futures and forwards, see *ABA Task Force Report, supra* note 14, at 14–15.

238. SEC Concept Release, *supra* note 1, at 26–27 (citing Release 10666, *supra* note 137, at 25131–32).

239. *ABA Task Force Report, supra* note 14, at 13–14 (noting that, to the task force's knowledge, "the SEC staff has neither publicly confirmed that position in writing, nor addressed the segregation requirements that apply to other kinds of swaps").

240. *Id.* at 13.

241. *ABA Task Force Report, supra* note 14, at 16.

the . . . [S]taff have not applied section 18 of the . . . [1940 Act] to derivatives that create economic leverage, such as purchased stock call options and leveraged inverse floating rate bonds.”²⁴²

The following Subsection addresses possible resolutions of this complex matter.

3. Possible Alternative Approaches To the Treatment of Derivatives Under Section 18 of the 1940 Act

As there is no comprehensive guidance from the SEC regarding these very complicated and nuanced senior security issues, especially given that the framers of the 1940 Act considered the protection of investors from the dangers of senior securities to be a “core issue” of the statute,²⁴³ Congress and/or the SEC should promptly institute reforms. Following is a discussion of various alternative approaches to the treatment of derivatives under Section 18.²⁴⁴ For further discussion regarding suggested legislative and regulatory solutions, see Subsection 4 below.

a. The Strictest Approach: A Prohibition of Mutual Fund Derivatives Transactions Evidencing Indebtedness

Under a plain reading of Section 18(f)(1), mutual funds are *prohibited* from issuing senior securities, with certain limited exceptions, including bank borrowings, which require 300% asset coverage.²⁴⁵ Thus, if the SEC was correct in its analysis in Release 10666 that certain derivative transactions “may” constitute the issuance of senior securities (and if that were indeed the case), then such transactions would be prohibited under a plain reading of Section 18(f)(1). The SEC recognized this fact in its analysis.²⁴⁶ However, if such a prohibition were enforced, investors would lose the positive benefits of such derivatives, such as for *bona fide* hedging purposes.

242. 1994 Report, *supra* note 91, at 24.

243. *See supra* Part IV(B).

244. *See* SEC Concept Release, *supra* note 1, at 26–48.

245. 15 U.S.C. § 80a-18(d), (f)(1), (f)(2) and (g) (2006); 17 C.F.R. §§270.18f-1, 270.18f-2 and 270.18f-3. It should be noted that Section 12(a) of the 1940 Act also prohibits mutual funds from purchasing securities on margin or short selling securities “in contravention of such rules and regulations or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. §80a-12(a)(2006).

246. *See supra* Part V(B)(1); *see also*, SEC Concept Release, *supra* note 1, at 42.

That being said, the question arises regarding whether the SEC acted outside the scope of its authority in issuing Release 10666 (and whether the Staff has overstepped its bounds in penning the release's progeny). Section 6(c) of the 1940 Act provides:

The Commission, by rules and regulations upon its own motion, or by order upon application, *may conditionally or unconditionally exempt* any person, security, or transaction, or any class or classes of persons, securities, or *transactions*, from *any provision or provisions of this title* or of any rule or regulation thereunder, *if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.*²⁴⁷

Thus, to exempt senior securities issued by mutual funds from the prohibition contained in Section 18(f)(1), the SEC would need to find that the exemption from prohibition was (1) necessary or appropriate in the public interest, (2) consistent with the protection of investors, *and* (3) consistent with "the purposes fairly intended by the policy and provisions" of the 1940 Act. It is not apparent from a reading of Release 10666 that the SEC ever undertook this analysis, perhaps because the release does not set forth concrete findings of, and exemptions from, senior security status, but rather issues a statement of policy. In any event, even if the SEC undertook such an analysis in 1979 when Release 10666 was issued, the explosive growth of mutual funds and derivatives trading since that time would basically render such original analysis largely moot. In 1979, total mutual fund net assets were \$94.5 billion; at year-end 2011, net assets totaled \$11.6 trillion.²⁴⁸ In 1979, swaps had not even been invented;²⁴⁹ as of year-end 2011, the notional amount of outstanding OTC derivatives transactions was \$647.8 trillion.²⁵⁰

Obviously, this is not an issue that the mutual fund industry will be asserting. And the easiest course for the grossly understaffed SEC, overwhelmed with rulemaking efforts to effectuate the Dodd-Frank

247. 15 U.S.C. § 80a-6(C) (2006) (emphasis added). Section 2(c) further provides:

Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

15 U.S.C. § 80a-2(c) (2006). *See also supra* note 245 (discussing Commission rules, regulations and orders under Section 12(a)).

248. *See* INVESTMENT COMPANY INSTITUTE, *supra* note 2, at 132.

249. *See supra* note 13.

250. *See supra* text accompanying note 28.

Act, is to defer the issue. However, the issue is an important one for individual mutual fund investors, 94% of whom are counting on their mutual fund investments to finance their retirements.²⁵¹ For the foregoing reasons, given the importance of the topic, it would be best for Congress to address the issue. However, such action by Congress will most likely not happen in the near term, if the political efforts to repeal the Dodd-Frank Act and to cut critical agency budgets are any indication of general attitudes towards financial reform efforts.²⁵² Therefore, the SEC must act.

b. A More Realistic Approach: Imposition of Derivative Transaction Restrictions Drawn from the 1972 Staff Release

Given the enormous size of the mutual fund industry and its widespread use of derivatives, a more realistic approach would be for the SEC to allow derivatives transactions evidencing indebtedness by mutual funds, but to impose limitations drawn from the 1972 Staff Release.²⁵³ Of course, if the SEC were to formally find that derivatives transactions evidencing indebtedness were senior securities, then any exemption from the plain text of the statute would require the Section 6(c) analysis discussed in Part V(B)(3)(a).

As explained above, with respect to commodities futures contracts, the 1972 Staff Release imposed (1) the *300% asset coverage requirement* applicable to bank borrowings, (2) plus an *asset segregation requirement* applicable to the original margin deposited with respect to each contract, (3) plus *exposure limitations* restricting investment in any commodity contract to no more than twice the original margin and restricting total commodities contract investments to 10% of a fund's assets.²⁵⁴ Of course, the foregoing limitations would have to be tailored to the reality of today's market after a thorough analysis.²⁵⁵ However, in theory, this three-pronged approach would

251. See *supra* text accompanying note 21.

252. See, e.g., Edward Wyatt, *Dodd-Frank Act a Favorite Target for Republicans Laying Blame*, NYTIMES.COM (Sept. 20, 2011), <http://www.nytimes.com/2011/09/21/business/dodd-frank-act-is-a-target-on-gop-campaign-trail.html?pagewanted=all>; Editorial, *Lost the Vote? Deny the Money*, N.Y. TIMES (June 10, 2012), at SR10.

253. See *supra* text accompanying notes 203–04.

254. See *supra* text accompanying notes 243–46. Note that this approach would impose features of the regulatory segregated assets approach (discussed in Subsection (c) below) and the global exposure limitation approach (discussed in Subsection (e) below).

255. Additionally, under any of the proposed solutions detailed in this Subsection, the issues of valuation and leverage specifically addressed in Part V(B)(3)(c) would be implicated.

certainly be more in line with the doctrinal foundations of the 1940 Act discussed in Part IV(B) than the current “patchwork” approach to the matter.

An approach based on the 1972 Staff Release could draw a distinction between hedging and speculative derivatives trading by investment companies.²⁵⁶ This approach was taken by the CFTC in crafting the Rule 4.5 *de minimis* exception discussed above.²⁵⁷ However, as previously noted, crafting and enforcing a definition of *bona fide* hedging activity has proven to be an immense task for regulators, fraught with strong resistance from the industry.²⁵⁸

The foregoing tiered approach to leverage limitations would more closely address the doctrinal foundations of the 1940 Act, highlighted in Part IV(B), than the SEC’s present course.

c. A Comprehensive Version of the Current “Patchwork” Approach: Definitive Regulatory Segregated Account Regulations

A third approach would involve the SEC issuing a comprehensive policy elaborating on its current Segregation Account Approach.²⁵⁹ Industry criticism regarding this approach has been centered on the fact that, because it is premised on “an instrument-by-instrument assessment of the amount of cover required,” the treatment of new products will be uncertain.²⁶⁰ Further, some have argued that this approach has resulted in “differing treatment of arguably equivalent products.”²⁶¹

These criticisms aside, a policy utilizing this approach must specify whether the segregation standard would be the notional amount or the mark-to-market amount.²⁶² Industry participants have made arguments against both approaches.²⁶³ With respect to segregation of notional amounts, some have argued that such amounts may often exceed the maximum risk of loss on the contract, resulting in

256. See *supra* text accompanying notes 74–79.

257. See *supra* Part III(B).

258. See *supra* text accompanying notes 74–79, 83, 120–23.

259. See SEC Concept Release, *supra* note 1, at 26–29.

260. *Id.* at 27.

261. *Id.* For example, some have argued that a physically settled future (requiring segregation of the amount of the delivery obligation) and a cash-settled future (treated by some funds as requiring segregation of only the typically smaller mark-to-market obligation) are equivalent products, but that they are treated differently. *Id.* at 27 n.79.

262. See *supra* Part V(A)(1).

263. See, e.g., SEC Concept Release, *supra* note 1, at 27–28.

unnecessary limitations of the use of derivative strategies that could be of potential benefit to investors.²⁶⁴ However, jurisdictions across the globe that have enacted limitations on fund leverage exposure have commonly relied on the notional approach “as a conservative measure of the exposure created by derivatives.”²⁶⁵ As for the segregation of daily mark-to-market liabilities, such amounts may be inadequate to compensate for potential future losses sustained with regard to such derivative transactions in contravention of the purposes of section 18.²⁶⁶

To illustrate the “significant disparity” between the notional and mark-to-market approaches, the SEC Concept Release points to the previously referenced study of credit default swap (“CDS”) transactions by the largest one hundred U.S. corporate bond funds from 2004 through 2008.²⁶⁷ The study found that, with respect to the 65 funds transacting in CDS transactions during the relevant time period, the total notional amount of such positions ballooned from a fund average of \$103 million in 2004 to a fund average of \$632 million in 2008.²⁶⁸ Further, “[t]he mean total notional amount of a fund’s CDS positions relative to its net asset value (“NAV”) increased from 2% to almost 14%.”²⁶⁹ Strikingly, the notional amounts of CDS positions held by three funds in 2008 actually *exceeded* such funds’ NAVs.²⁷⁰ In stark contrast to these notional statistics, the average unrealized CDS “book” losses of a fund were less than 1% of NAV.²⁷¹

An alternative to the notional and mark-to-market approaches would require segregation of an amount equal to the amount that a fund is at risk of losing in the transaction, measured by a complex model such as the “Value at Risk” (“VaR”) model.²⁷² VaR models have come under increasing scrutiny since J.P. Morgan’s recent derivatives

264. See, e.g., SEC Concept Release, *supra* note 1, at 27–28.

265. See, SEC Concept Release, *supra* note 1, at 31.

266. *Id.* at 27–28. As the *ABA Task Force Report* noted: “[A] fund’s exposure under a derivative contract could *increase significantly* on an intraday basis, resulting in the segregated assets [of only the daily mark-to-market liability amount] being worth less than the fund’s obligations (until the fund is able to place additional assets in the segregated account . . .) To the extent that a fund relying on the . . . [Merrill No-Action Letter] segregates assets whose prices are somewhat volatile, this ‘shortfall’ could be magnified.”

ABA Task Force Report, *supra* note 14, at 16 (emphasis added); see also SEC Concept Release, *supra* note 1, at 28 n.83.

267. SEC Concept Release, *supra* note 1, at 28–29 (citing Adam & Guettler, *supra* note 91); see *supra* discussion at text accompanying notes 98–107.

268. SEC Concept Release, *supra* note 1, at 29 (citing Adam & Guettler, *supra* note 91, at 12).

269. *Id.*

270. *Id.*

271. SEC Concept Release, *supra* note 1, at 29 (citing Adam & Guettler, *supra* note 91, at 12).

272. See, e.g., *id.* at 29. For a discussion of VaR, see *infra* note 282.

loss of approximately \$6 to \$8 billion dollars, which J.P. Morgan has blamed, in part, on a faulty VaR model.²⁷³ In addition to concerns regarding unreliability, such an approach would also be extremely difficult to regulate, especially if regulators were to rely on each fund's unique VaR model.²⁷⁴

Also as discussed above, issues regarding the types of assets to be segregated (i.e., "liquid assets" as defined by Release 10666,²⁷⁵ or by the more expansive Merrill No-Action Letter definition²⁷⁶) and the manner in which such assets are to be segregated (i.e., with the fund's custodian as specified by Release 10666²⁷⁷ or merely as a book entry as discussed in the 1997 Friend Letter²⁷⁸) must be clearly addressed.

d. The ABA Task Force Report's Proposed Approach: Fund-Generated Segregated Account Policies

The ABA Task Force Report "considers comprehensive guidance [with respect to the Asset Segregation Approach] unlikely to be achievable, given that any generalized approach . . . [would] likely fail to take into account significant variations in individual transactions."²⁷⁹ As such, the ABA Task Force Report recommends an asset segregation approach in which each fund would create its own asset segregation policies for derivatives that involve leverage as defined by Release 10666. In developing such standards, fund advisers "could take into account a variety of risk measures, including . . . [VaR models]²⁸⁰ and other quantitative measures of portfolio risk, and would not be limited to the notional amount or mark-to-market standards."²⁸¹ Although

273. See, e.g., Dan Fitzpatrick & Gregory Zuckerman, *Losses on 'Whale' Tab Hits \$5.8 Billion*, WALL ST. J., July 14, 2012, at B1, B2; David Reilly, *Did J.P. Morgan Fiddle While Risk Burned*, WALL ST. J., May 21, 2012, at C8; Julie Steinberg & Dan Fitzpatrick, *J.P. Morgan Models Get Regulatory Spotlight*, WALL ST. J., June 29, 2012, at A13.

274. See, e.g., Reilly, *supra* note 273 (quoting former FDIC Chairman Sheila Bair explaining that banks have an "incentive to game their model to lower their regulatory capital requirement).

275. See *supra* text accompanying note 196.

276. See *supra* text accompanying notes 231–32.

277. See *supra* text accompanying note 196.

278. See *supra* text accompanying note 234.

279. SEC Concept Release, *supra* note 1, at 30.

280. VaR is a "[p]rocedure for estimating the probability of portfolio losses exceeding some specified proportion based on a statistical analysis of historical market price trends, correlations, and volatilities." *NASDAQ Investor Glossary*, NASDAQ.COM (last visited July 25, 2012), <http://www.nasdaq.com/investing/glossary/v/value-at-risk-model>. As noted above, VaR has come under intense scrutiny following J.P. Morgan's recent derivatives debacle resulting in a loss of over \$6 billion. See, e.g., *supra* notes 274–75.

281. SEC Concept Release, *supra* note 1, at 30.

such policies would be approved by the mutual fund board and disclosed in fund literature, placing such broad powers in the hands of investment advisers, who are compensated based on the amount of fund assets, and thus, may be incentivized to increase fund risk,²⁸² would undermine the senior security provisions of the 1940 Act.²⁸³ As noted above, such protections were considered by the framers of the 1940 Act to be a “core purpose” of the statute.²⁸⁴ For these reasons, the ABA Task Force Report’s proposed approach, despite its practical feasibility, should be rejected.

e. The European Approach: “Global Exposure” Limitations

Another approach to regulating funds’ use of derivatives leverage is the approach taken by the Committee of European Securities Regulators (“CESR”), which became the European Securities and Markets Authority on January 1, 2011. After conducting an “extensive review . . . [of] exposure measures for derivatives”²⁸⁵ utilized by Undertakings for Collective Investment in Transferable Securities (“UCITS”), which are “investment vehicles authorized for sale to retail investors,”²⁸⁶ CESR’s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (hereinafter, the “CESR Guidelines for UCITS”) was issued in 2010.²⁸⁷ The CESR Guidelines for UCITS implemented the European

282. See Adam & Guettler, *supra* note 91, at 5–6 (discussing the mutual fund “tournament” theory and noting that underperforming bond funds are incentivized to increase risk to boost returns, often utilizing credit default swap positions).

283. See, e.g., 2009 Donohue Speech, *supra* note 23 (stating that “[o]ne of my recurring concerns has been investment companies’ use of derivatives and what I perceive as the increasing gap between how the . . . [1940 Act] and investors look at fund portfolios versus how investment advisers look at them”).

284. See *supra* Part IV(B). Overarching the senior security protections of the 1940 Act is the notion that the entire statute was enacted to protect investors from the inherent conflict between the adviser/shareholder relationship. See, e.g., *supra* Part IV(A).

285. SEC Concept Release, *supra* note 1, at 31.

286. *Id.*

287. CESR’s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, Committee of European Securities Regulators (July 28, 2010) [hereinafter the CESR Guidelines for UCITS], available at <http://www.esma.europa.eu/popup2.php?id=7000>. For the CESR Guidelines for UCITS to be effective in a European Union Member State, such Member State must expressly adopt them. SEC Concept Release, *supra* note 1, at n. 92. The SEC Concept Release notes that, to date, a “few EU Member States, e.g., Ireland and Luxembourg” have adopted the CESR Guidelines for UCITS. SEC Concept Release, *supra* note 1, at n. 92.

Commission's 2009 directive²⁸⁸ permitting UCITS to engage in derivatives transactions "subject to a 'global exposure' limitation, under which the derivatives exposure of a UCITS may not exceed the total net value of the UCITS' portfolio."²⁸⁹ As further set forth below, the CESR Guidelines for UCITS "extensively address the calculation of derivatives exposure under the 'global exposure' limit" and set forth two alternative calculation methods: (1) the "commitment approach" and (2) the "advanced risk measurement method."²⁹⁰

Under the commitment approach, global exposure is calculated by reference to a detailed schedule setting forth various types of derivatives and specific conversion methods to be applied to calculate global exposure.²⁹¹ Typically, the market value of the underlying reference asset is utilized (in other words, the "notional amount," as defined above²⁹²), but this may be "replaced by the notional value or the price of the futures contract where this is more conservative."²⁹³ For example, for plain vanilla interest rate swaps, the applicable conversion method is the reference asset's market value; however, with respect to the portion of the swap requiring payment of a fixed rate, the notional value may also be utilized.²⁹⁴ The applicable conversion method for foreign exchange forwards is the notional value of the applicable currency.²⁹⁵ With respect to bond futures, the number of contracts is "multiplied by the notional contract size multiplied by the market price of the cheapest-to-deliver bond."²⁹⁶ Finally, for "non-standard derivatives, where it is not possible to convert the derivative into the market value or notional value of the equivalent underlying asset, the . . . [schedule notes] that 'an alternative approach may be used provided that the total amount of the derivatives represent a negligible portion of the UCITS portfolio.'"²⁹⁷ The CESR Guidelines for

288. Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations, and Administrative Provisions Relating To Undertakings for Collective Investment in Transferable Securities [hereinafter the 2009 EC Directive], available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OH:L:2009:302:0032:0096:en:PDF>.

289. SEC Concept Release, *supra* note 1, at 31-32 (citing the 2009 EC Directive, Article 51(3), at 62); see also, e.g., Karrie McMillan, *The Regulation of Derivatives: Under UCITS and the Investment Company Act*, in CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES, INVESTMENT MANAGEMENT INSTITUTE 2012, PLI ORDER No. 34297 (Practicing Law Institute, ed., Feb. 9-10, 2012).

290. SEC Concept Release, *supra* note 1, at 32.

291. *Id.* at 32 (citing the CESR Guidelines for UCITS, *supra* note 291, at 7-12).

292. See *supra* Part V(A)(1).

293. SEC Concept Release, *supra* note 1, at 32 (quoting the CESR Guidelines for UCITS, *supra* note 291, at 7).

294. *Id.* at 32 n.98 (citing the CESR Guidelines for UCITS, *supra* note 289, at 8).

295. *Id.* (citing the CESR Guidelines for UCITS, *supra* note 289, at 9).

296. *Id.* at 32 n.98 (citing the CESR Guidelines for UCITS, *supra* note 289, at 8).

297. *Id.* at 32 (quoting the CESR Guidelines for UCITS, *supra* note 289, at 7).

UCITS state that the “commitment approach should not be applied to UCITS using, to a large extent and in a systemic way, financial derivative instruments as part of complex investment strategies.”²⁹⁸

The advanced risk measurement method utilizes VaR, or a similar risk measurement method, to attempt “to measure the maximum potential loss due to market risk rather than leverage.”²⁹⁹ “[T]he VaR approach measures the maximum potential loss at a given confidence level (probability) over a specific time period under normal market conditions.”³⁰⁰ Importantly, using all of a UCITS’ portfolio, “[t]he VaR approach measures the *probability of risk of loss rather than the amount of leverage in portfolio.*”³⁰¹ The CESR Guidelines for UCITS specify that either an “absolute VaR approach” or a “relative VaR approach” may be utilized.³⁰² Under the “absolute VaR approach,” “[t]he absolute VaR of a UCITS cannot be greater than 20% of its NAV.”³⁰³ When using the “relative VaR approach,” the VaR of the fund’s portfolio must be equal to or less than twice the VaR of a reference portfolio that is unleveraged.³⁰⁴

It should be noted that, on top of the global exposure limitation of the CESR Guidelines for UCITS, “cover rules” for derivative investments are also imposed.³⁰⁵ These cover rules require that UCITS ensure that they can meet all of their delivery and payment obligations with respect to their derivative transactions.³⁰⁶

Other jurisdictions have adopted similar approaches to those set forth in the CESR Guidelines for UCITS. For example, the Central Bank of Ireland’s guidelines with respect to publicly offered non-UCITS investment companies are “analogous to a ‘notional amount’ or commitment approach and generally limit the maximum potential exposure to 25% of the investment company’s NAV”³⁰⁷; in addition, the

298. SEC Concept Release, *supra* note 1, at 32 n.95 (quoting the CESR Guidelines for UCITS, *supra* note 289, at 6).

299. *Id.* at 33 (citing the CESR Guidelines for UCITS, *supra* note 289, at 22).

300. *Id.* at 33 n.99 (quoting the CESR Guidelines for UCITS, *supra* note 289, at 22).

301. *Id.* at 33 n.100 (quoting the CESR Guidelines for UCITS, *supra* note 289, at 30–40).

302. *Id.* at 33 (citing the CESR Guidelines for UCITS, *supra* note 289, at 23).

303. *Id.* at n.100 (quoting the CESR Guidelines for UCITS, *supra* note 289, at 30–40).

304. SEC Concept Release, *supra* note 1, at 33 (citing the CESR Guidelines for UCITS, *supra* note 289, at 24). “[T]he relative VaR approach does not measure leverage of the UCITS’ strategies but instead allows the UCITS to double the risk of loss under a given VaR model.” *Id.* at n.101 (citing the CESR Guidelines for UCITS, *supra* note 291, at 24).

305. *Id.* at 33 (citing the CESR Guidelines for UCITS, *supra* note 289, at 40).

306. *Id.*

307. *Id.* at 35 (citing Central Bank of Ireland, NU SERIES OF NOTICES, *Conditions Imposed in Relation to Collective Investment Schemes Other than UCITS* (July 2011) at 13.12, available at www.centralbank.ie/regulation/industry-sectors/funds/non-ucits/Docuemnts/Non%20UCITS%20Notices.pdf).

guidelines impose certain cover requirements.³⁰⁸ The Canadian Securities Administrators follow a similar approach.³⁰⁹

f. Minimizing Credit Risks: The Counterparty Limitation

Some jurisdictions, in addition to imposing limitations such as the Segregated Account Method and the Global Exposure Method, also impose limitations restricting the amount of a fund's exposure to individual counterparties.³¹⁰ For example, Singapore has adopted an approach similar to the "commitment approach" under the CESR's Guidelines for UCITS, in which an investment company's derivatives exposure must not exceed 100 percent of its NAV.³¹¹ In addition to this requirement, an investment company's exposure to any individual OTC counterparty cannot exceed 10 percent of its NAV "and is measured on a maximum potential loss basis that may be incurred by the investment company if the counterparty defaults."³¹² Under this system, liquid assets (including cash, AAA-rated government bonds, and money market instruments) may be utilized as collateral in order to reduce counterparty exposure.³¹³ The Hong Kong Securities and Futures Commission has adopted a similar approach.³¹⁴

Mindful of the doctrinal foundations of the 1940 Act, and informed by the nuances of the alternative approaches discussed above, the following section proposes specific reforms with respect to the Section 18 treatment of derivatives trading by mutual funds.

308. SEC Concept Release, *supra* note 1, at 35.

309. *Id.* at 36 (citing National Instrument 81-102 *Mutual Funds*, at §§ 2.7, 2.8 (Jan. 2011), available at www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy8/81-102%20Mutual%20Funds%205BNI%5D%20Jan-1-11.pdf).

310. *See supra* note 319, at 31.

311. *Id.* at 34 (citing The Monetary Authority of Singapore, *Code on Collective Investment Schemes*, Chapter 3, § 3.1(f) (April 2011) [hereinafter the Singapore Code], available at http://www.mas.gov.sg/resource/legislation_guidelines/securities_futures/sub_legislation/110408%20Revised%20Code_8%20April_final.pdf).

312. *See supra* note 319, at 34–35 (citing the Singapore Code, *supra* note 313, at Appendix 1, §§ 5.2 and 5.4).

313. *See supra* note 319, at 34–35 (citing the Singapore Code, *supra* note 313, at Appendix 1, §§ 5.7 and 5.8).

314. *Id.* at 36–37 (discussing Hong Kong Securities and Futures Commission, *Code on Unit Trusts and Mutual Funds*, Chapter 7 (June 2010), available at www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng_UT.pdf).

4. *Suggested Reforms*

Legislative and/or regulatory action should be taken, as from a plain reading of Section 18, any mutual fund trading in derivatives that “evidence indebtedness” raises senior security issues.³¹⁵ Further, the existing guidance from the SEC and its staff, in light of the current widespread use of derivatives, is misaligned with the doctrinal principles of the 1940 Act.³¹⁶ This Section outlines reform proposals.³¹⁷

First, the ideal resolution would be for Congress to address the matter, as discussed above in Part V(B)(3)(a), given the high volume of derivatives trading by mutual funds; the limited information available regarding such trading; the numerous highly publicized derivative disasters of late; the doctrinal foundations of the 1940 Act; and the conservative investment goals of the overwhelming majority of individual mutual fund investors.³¹⁸ The issue is too important, and too immense, to be left to the agency rulemaking process. That being said, it is unlikely that any such action would happen in the near term, given the significant political opposition to financial reform efforts.³¹⁹

As such, the SEC must take action. As a prefatory matter, the SEC must continue to gather and thoroughly analyze current industry information, carefully evaluating the considerations set forth in Section 6(c) of the 1940 Act;³²⁰ the comment letters and information gathered in response to the SEC Concept Release are obviously geared to that end.³²¹ Further, the detailed information required by the CFTC’s Final CPO Rules with respect to derivatives transactions of funds and CFCs that meet the “commodity pool” definition³²² will assist the SEC in understanding the types and magnitudes of current transactions by mutual funds.

The following paragraphs outline the parameters of the regulations that the SEC should implement, with details to be filled in depending on the results of the information-gathering process. The

315. *See supra* Part V(B).

316. *See supra* text accompanying notes 243–46.

317. This discussion is informed, in part, by the “Request for Comment” section set forth in the SEC Concept Release, *supra* note 1, at 37–48.

318. *See supra* text accompanying notes 20–22.

319. *See supra* text accompanying note 252.

320. *See supra* text accompanying notes 243–46.

321. *See Comments on Concept Release: Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, SEC.GOV, available at <http://www.sec.gov/comments/s7-33-11/s73311.shtml> (last visited July 15, 2012); *see also* SEC Concept Release, *supra* note 1, at n.7 and 8.

322. *See supra* Part III(B).

recommendations below draw from various alternative approaches detailed above in the preceding section and are built on the doctrinal foundations of the 1940 Act discussed above in Part IV(B), including (1) the drafters' "core purpose" of protecting investors from the dangers of senior securities, (2) prohibiting funds' excessive use of leverage; and (3) ensuring that funds operate with sufficient assets and reserves.

Senior Security Treatment: Although derivative transactions that "evidence indebtedness" may be senior securities under a plain reading of Section 18(f)(1), because of their importance to investors for various reasons, they should be exempted from prohibition, as long as the following requirements are met.

Asset Coverage Requirement: Under Section 18, conventional bank borrowings by mutual funds require 300% asset coverage. As derivative transactions with indebtedness leverage may be understood as the functional equivalent of such borrowings, asset coverage requirements should be imposed.³²³ Thus, the 300% asset coverage requirement of Section 18 with respect to bank borrowings should apply to derivative transactions that evidence indebtedness as well, unless the SEC determines, after its detailed analysis, that a different percentage should be applicable.

Asset Segregation/Cover: The current 100% asset segregation and cover requirements should continue, with the following qualifications.

Valuation: Until the SEC has sufficient information to adequately assess various types of transactions, asset segregation and cover requirements should be calculated with respect to notional amounts for all derivative transactions evidencing indebtedness, with netting of such amounts permitted in certain circumstances. The CFTC's net notional test referenced in Part III(B) above would be informative in this regard. Alternative valuation methods are simply inadequate to protect investors and to ensure adequate coverage of a fund's potential obligations consistent with the provisions of Section and the doctrinal foundations of the 1940 Act at this time. (However, if after sufficient information regarding derivatives practices has been gathered, it may be justified at some time to convert to a regulation system that sets forth in a detailed schedule all derivative types and corresponding appropriate segregation/ cover requirements.)

Segregated Securities: Securities may be segregated in accord with the Merrill No-Action Letter; however, such securities should be

323. See, e.g., SEC Concept Release, *supra* note 1, at 42.

marked-to-market at least twice daily, with additional amounts segregated to maintain the 100 percent asset segregation requirement. Although this approach presents the risk of intraday price decreases in securities, which may result in insufficient amounts to meet the fund's obligations under its derivative transactions, the benefits to investors of not locking up the fund's "liquid assets," as was previously required under Release 10666, outweighs such risks.

Schedule of Appropriate Offsetting Transactions: The regulations should set forth a detailed schedule of appropriate offsetting transactions, which could be effectuated in lieu of segregating assets. Leaving such matters to the discretion of the investment adviser, which is the case now, is inconsistent with the doctrinal principles of the 1940 Act.

Indebtedness Leverage: The restrictions would be applicable only with respect to instruments that present indebtedness leverage (as is currently the approach used by the SEC). However, as more information becomes available, it may be appropriate to include instruments presenting economic leverage as well. In addition, further regulation of derivatives transactions through CFCs and other similar structures must be considered.

Stress-Testing Policies: In addition to the foregoing, funds should be required to implement "rigorous, comprehensive and risk-adequate stress testing program[s]," as required by the CESR's Guidelines for UCITS under certain circumstances.³²⁴

Counterparty Limitations: Funds should be required to disclose counterparty percentages in all quarterly and annual reports that exceed a certain threshold level (with such level to be determined by the SEC after a thorough review and analysis of available information). Additionally, if the Section 6(c) analysis warrants, it may be appropriate to enact single exposure limitations with respect to counterparties and clearing houses.

Conclusion: The approach outlined above presents a good starting place for addressing the misalignment between Section 18's strict prohibitions against the issuance of senior securities and today's widespread use of derivatives evidencing indebtedness by mutual funds. This approach recognizes the beneficial uses that derivatives trading can afford mutual fund investors, striking a fair balance between strictly prohibiting derivative transactions that evidence indebtedness and constitute senior securities, as a plain reading of Section 18 would require, and letting funds decide the matter for

324. SEC Concept Release, *supra* note 1, at 46 (quoting CESR's Global Guidelines for UCITS, *supra* note 289, at 35).

themselves, as is now, pretty much, the case. As previously stated, the parameters above should be modified as needed, based upon the outcome of the SEC's detailed analysis, in accordance with the doctrinal principles set forth in Part IV(B) above.

C. REQUIREMENTS REGARDING DIVERSIFICATION

As discussed above in Part IV(C), the 1940 Act requires mutual funds to specify whether they are "diversified" or "non-diversified" in their registration statements. Once this designation is made, a diversified fund cannot change its status without shareholder approval. The increased use of derivatives by mutual funds has presented complex issues not foreseen by the drafters of the 1940 Act. The 1940 Act truly contemplated a different world. Engrained in the Act, and assumed until not that long ago, is that investment companies were investing in a market of stocks, bonds and similar securities. It also approaches many areas such as concentration and diversification, to name but two, based on the *amount of money invested, rather than the degree of exposure the fund has undertaken*. That of course is not always the case now. With so many derivative instruments available to enhance an investment strategy, a fund's manager can design a portfolio in a multitude of ways to create different exposures that are *unrelated to the amount of money invested* and are not necessarily reflective of the types of instruments the fund holds.

With respect to derivatives transactions, two main issues under the anachronistic provisions of the 1940 Act arise: (1) valuing such derivatives and (2) identifying the issuer of each derivative.³²⁵

1. Valuing Derivatives for Purposes of the Diversification Classifications

For purposes of determining the appropriate diversification classification under the 1940 Act, all fund assets, including derivatives, must be valued using "market values" or "fair values" as of the end of the last preceding fiscal quarter, "unless the context otherwise requires;" if such derivatives were acquired after the fiscal quarter end, then they should be valued at cost.³²⁶ Section 2(a)(41) requires that,

325. See, e.g., SEC Concept Release, *supra* note 1, at 51-53.

326. See *supra* Part V(A)(1); see also, 15 U.S.C. § 80a-2(a)(41) (2006) (defining "value"); SEC Concept Release, *supra* note 1, at 50-52.

with respect to securities and other assets owned at the end of the preceding fiscal quarter, “unless the context otherwise requires,” (1) if market quotations are “readily available” for a specific portfolio security, the value of such security is the market quotation, and (2) for other securities and assets, the value is the “fair value . . . as determined in good faith by the board of directors”³²⁷ Typically, exchange-traded derivatives are valued using market quotations, and OTC derivatives are given a “fair value” determination by the board.³²⁸

“Under either measure, the value of a derivative would appear to be the value at which the derivative could be sold or otherwise transferred at the relevant time.”³²⁹ However, the problem arises that such “mark-to-market values at a given point *do not reflect the asset base on which future gains and losses will be based or otherwise represent the potential future exposure of the fund under the derivatives investment.*”³³⁰ Thus, under the current mark-to-market valuation standards, a fund could fall below the 5% threshold with respect to exposure to any single issuer and classify itself as diversified, *while maintaining exposure above the 5% threshold on a notional basis.*³³¹ Although the ABA Task Force Report recommends this mark-to-market approach,³³² it is misaligned with the doctrinal foundations of the 1940 Act set forth in Part IV(C) above.

To remedy the above-stated problems, the SEC could make a determination that the valuation procedures set forth in Section 2(a)(41) are inappropriate with respect to determining the value of derivative positions for diversification calculations and that notional amounts should instead be used. Additionally, the SEC could require disclosure of both values, so that investors are adequately informed. Another approach would be to require subclassifications of the diversification classification to reflect the notional exposures.³³³

Specific proposed reforms are set forth in Section (3) below.

327. 15 U.S.C. § 80a-2(a)(41)(A) (2006) (defining “value”); SEC Concept Release, *supra* note 1, at 49–53. The SEC Concept Release notes that, “[a]s a general matter, most derivatives appear to be notes or evidences of indebtedness and thus securities for purposes of the diversification requirements.” SEC Concept Release, *supra* note 1, at 50–51 n.132; *see also supra* note 186 (referencing the view of the ABA Task Force Report that futures other than security futures are not securities).

328. SEC Concept Release, *supra* note 1, at 52.

329. *Id.*

330. *Id.*

331. *See, e.g., id.*

332. ABA Task Force Report, *supra* note 14, 28.

333. *See* SEC Concept Release, *supra* note 1, at 54.

2. Identifying the Issuer of Each Derivative

As previously explained in Part IV(C), in performing the diversification calculations, each fund must determine whether it has invested more than 5% of its total assets in any single issuer (with respect to its 75% bucket). As derivative transactions include exposure both to a reference asset and to a counterparty, a question arises as to whether the issuer is the issuer of the reference asset or the counterparty.³³⁴

The SEC Concept Release states that “[i]n general, the ‘issuer’ of an OTC derivative entered into by a fund would appear to be the fund’s *counterparty*, and the ‘issuer’ of an exchange-traded derivative would appear to be the *clearinghouse* due to the novation.”³³⁵ However, the question remains as to how to account for the exposure to the issuer of the reference asset.

The ABA Task Force Report recommends disregarding counterparty exposures for purposes of the diversification classifications and determining the Section 5(b) calculations only with respect to the reference asset issuers.³³⁶ However, a more conservative approach might be to treat the “issuer” as the reference asset issuer, but require disclosure of a parallel set of calculations treating the counterparty or clearinghouse, as the case may be, as the issuer.³³⁷ Another approach would be to require sub-classifications of the diversification classification to reflect both “issuer” concepts.³³⁸

Proposed regulatory reforms are set forth in the next Section.

334. See, e.g., SEC Concept Release, *supra* note 1, at 53–54.

335. SEC Concept Release, *supra* note 1, at 53 (emphasis added) (citing Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, Securities Act Release No. 9222, 76 Fed. Reg. 34920 (June 9, 2011), at n. 18). However, it should be noted that, after Title VII of the Dodd-Frank Act is fully implemented, many OTC derivatives will be cleared as well.

336. ABA Task Force Report, *supra* note 14, at 27–28; SEC Concept Release, *supra* note 1, at 55. Specifically, the ABA Task Force Report recommends that counterparty exposures should be addressed under §12(d)(3) of the 1940 Act (which restricts purchases from various securities-related issuers), as further set forth below.

337. Such disclosures should set forth single issuer exposure percentages, as well as a disclosure of whether the transactions are cleared or uncleared (and if any collateralization agreements are in place). It should be noted that if an uncleared transaction incorporates an appropriate collateralization agreement giving the fund first priority access to bankruptcy-remote collateral from the counterparty, such transaction might be able to be treated as a cleared transaction. See, e.g., ABA Task Force Report, *supra* note 14, at 10.

338. See SEC Concept Release, *supra* note 1, at 54.

3. *Suggested Reforms*

The following paragraphs propose regulations that the SEC should implement as an initial approach to the diversification issues discussed above, with details to be filled in depending on the results of the SEC's information-gathering process. These recommendations incorporate the doctrinal policies discussed above in Part IV(C), including (1) preventing a diversified fund from being "too closely tied to the success of one or a few issuers or controlling portfolio companies,"³³⁹ and (2) ensuring that investors receive clear and accurate disclosure regarding the nature of the fund's portfolio.

Valuation: Until complete information regarding derivatives transactions by mutual funds is gathered and analyzed, the SEC should declare that the valuation procedures set forth in Section 2(a)(41) are inappropriate with respect to determining the value of derivative positions for diversification calculations and that notional amounts should instead be used. Again, the CFTC's net notional test referenced in Part III(B) above would be informative in this regard. Additionally, the SEC should require disclosure of calculations based on both valuation methods, so that investors are adequately informed.

Determination of the Issuer: The SEC should adopt rules designating the "issuer" of a derivative security for purposes of the diversification requirements as the reference asset issuer. In addition, the SEC should require disclosure of a parallel set of calculations treating the counterparty or clearinghouse, as the case may be, as the issuer (with accompanying disclosure) regarding (i) single issuer exposure percentages, (ii) designations of the transactions as cleared or uncleared, and (iii) descriptions of collateralization agreements specifying bankruptcy-remote, first-priority collateral. If the SEC's analysis warrants, it could also establish subclassifications of the diversification classification to reflect both "issuer" concepts.

Conclusion: The approach outlined above incorporates the doctrinal foundations of the 1940 Act and would ensure that investors receive more accurate information regarding the diversification of their investments and the multiple exposures generated by derivative instruments. As previously indicated, such recommendations should be modified as needed, based upon the outcome of the SEC's analysis, in accordance with the principles set forth in Part IV(C) above.

339. SEC Concept Release, *supra* note 1, at 49 (citing the 1940 Senate Hearings, *supra* note 136, at 188 (Statement of David Schenker, SEC Investment Trust Study Chief Counsel, regarding a draft of § 5(b)(1) similar to the current statute)).

D. RESTRICTIONS REGARDING EXPOSURE TO SECURITIES-RELATED ISSUERS

As referenced above in Part IV(D), Section 12(d)(3) of the 1940 Act generally prohibits investment companies from (1) purchasing or otherwise acquiring any *security* that is issued by an underwriter, broker, dealer or investment adviser (collectively, “securities related issuers”) and (2) acquiring any other *interest* in the business of a securities related issuer. However, as set forth below, Rule 12d3-1 offers some relief from these prohibitions.

Rule 12d3-1 allows a fund to acquire the *securities* of (1) “any person that, in its most recent fiscal year, derived 15 percent or less of its gross revenues from securities related activities unless . . . [such fund] would control such person after the acquisition”³⁴⁰ and (2) “a person that, in its most recent fiscal year, derived more than 15 percent of its gross assets from securities related activities”³⁴¹ provided that such acquisition (a) of equity securities³⁴² will not result in the fund owning “more than [5%] of the outstanding securities of that class of the issuer’s equity securities;”³⁴³ (b) of debt securities³⁴⁴ will not result in the fund owning “more than [10%] of the outstanding principal amount of the issuer’s debt securities;”³⁴⁵ and (c) will not result in the fund investing “more than [5%] of the value of its total assets in the securities of the issuer.”³⁴⁶ The rule specifies other prohibitions, including a proscription on the acquisition of general partnership interests in securities-related issuers and of securities issued by the principal underwriter, promoter or investment of a fund (of affiliates of such persons), subject to certain exceptions.³⁴⁷

As discussed below, issues under Section 12(d)(3) can arise if (1) the counterparty to a derivative transaction is a securities-related issuer or (2) the reference asset issuer is a securities-related issuer. Further, valuation issues similar to those previously discussed may be

340. 17 C.F.R. § 270.12d3-1(a) (2010).

341. *Id.*

342. Rule 12d3-1(d)(3) adopts the definition of “equity security” contained in Rule 3a11 of the Exchange Act, which includes certain derivatives. 17 C.F.R. §240.3a-11; *see also, e.g.*, SEC Concept Release, *supra* note 1, at 58 n.151.

343. 17 C.F.R. § 270.12d3-1(b)(1) (2010).

344. Rule 12d3-1(d)(4) defines “debt securities” as “all securities other than equity securities.” 17 C.F.R. § 270.12d3-1(d)(4) (2010); *see also, e.g.*, SEC Concept Release, *supra* note 1, at 58 n.149.

345. 17 C.F.R. § 270.12d3-1(b)(2) (2010).

346. 17 C.F.R. § 270.12d3-1(b)(2)

347. *Id.* § 270.12d3-1(c)(2010); *see also, e.g.*, SEC Concept Release, *supra* note 1, at 58.

implicated with respect to Section 12(b)(3) calculations. Such issues are discussed below.

1. Section 12(d)(3) Counterparty Issues

Issues arise under Section 12(d)(3) if the counterparty to an OTC derivatives transaction is a securities-related issuer; in that event, “a fund’s acquisition of that obligation may constitute an acquisition of a security or another interest in a securities-related issuer within the scope of section 12(d)(3) of the . . . [1940 Act].”³⁴⁸ In a 2001 release, the SEC acknowledged that, with respect to a repurchase agreement with a securities-related issuer, an investment company may be acquiring a prohibited interest in such counterparty.³⁴⁹ However, if the counterparty is a security-related issuer, Rule 12d3-1 may allow the transaction, if the derivative at issue is a “security issued by that counterparty.”

Rule 12d3-1 would *not* provide relief from the Section 12(d)(3) prohibition if the derivative is *not* a “security issued by the counterparty,” but rather “*an interest in a securities related issuer*” because the rule applies only to “securities.”³⁵⁰ In that event, the transaction would be prohibited under Section 12(d)(3).

Because of the dearth of information regarding mutual fund derivatives trading activity, the most prudent approach would be for the SEC to gather the required information, in connection with the CPO reporting requirements of the CFTC, and make a determination then of whether further action is required with respect to derivatives that are not “securities,” but “interests” in a securities-related issuer.

348. SEC Concept Release, *supra* note 1, at 59. With respect to exchange-traded derivatives, the clearing house is usually considered the issuer of the derivative. *See, e.g., id.* In a 1984 no-action letter, the Staff adopted the reasoning that a fund acquiring exchange-traded options would not be acquiring securities issued by a securities-related issuer. *Id.* (citing Institutional Equity Fund, SEC Staff No-Action Letter (Feb. 27, 1984)).

349. SEC Concept Release, *supra* note 1, at 59 (emphasis added) (citing Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25058, 66 Fed. Reg. 36156 (July 5, 2001), at n. 5 and accompanying text).

350. SEC Concept Release, *supra* note 1, at 59–60 (emphasis added); *see also, e.g., ABA Task Force Report, supra* note 14, at 32.

2. Section 12(d)(3) Reference Asset Issues

In addition to the counterparty issues discussed above, “[i]f the derivative transaction is based upon the price or value of securities issued by, or interests in, a securities-related issuer, the fund’s relationship to the issuer of the reference asset may raise both of the concerns underlying section 12(d)(3)—the fund’s exposure to the risks of the securities-related issuer and the potential for reciprocal practices.”³⁵¹ For example, if the reference asset issuer is a broker-dealer, the fund could direct brokerage to such broker-dealer to enhance the value of such reference asset, thus increasing its own position; such actions by the fund would violate Section 12(d)(3), and the fund would have to consider whether a Rule 12d3-1 exemption was available.³⁵²

As set forth below in Subsection (4), the SEC should engage in rulemaking to clarify that, if a fund enters into a derivative transaction in which the reference asset issuer is a securities-related issuer, such derivative transaction is prohibited by Section 12(d)(3), as it constitutes an “interest” in the securities related issuer.

3. Section 12(d)(3) Valuation Issues

As discussed in connection with diversification calculations above in Part V(C), the calculations required by Rule 12d3-1 may be understated where derivative valuations are based on market value or fair value. Although some funds use notional amounts for these calculations, “the practice is not uniform.”³⁵³ In fact, the ABA Task Force Report notes that “the exemption in Rule 12d3-1 appear[s] to apply to the market values of the instruments”³⁵⁴ As the SEC has not spoken on this issue,³⁵⁵ guidance is necessary.

The following Subsection sets forth suggested regulatory reforms.

351. SEC Concept Release, *supra* note 1, at 60–61.

352. SEC Concept Release, *supra* note 1, at 61.

353. SEC Concept Release, *supra* note 1, at 62.

354. ABA Task Force Report, *supra* note 14, at 33.

355. *Id.*

4. *Suggested Reforms*

This Subsection proposes regulations that the SEC should enact as an initial approach to the Section 12(d)(3) issues discussed above, with details to be filled in depending on the results of the SEC's information-gathering process. The recommendations below incorporate the doctrinal policies discussed above in Part IV(D), including (1) limiting "a fund's exposure to the entrepreneurial risks of securities-related issuers,"³⁵⁶ (2) prohibiting fund sponsors from taking advantage of their sponsored funds,³⁵⁷ and (3) limiting "abusive reciprocal practices between funds and securities-related issuers."³⁵⁸

Counterparty Issues: If a derivative is a "security" for purposes of Section 12(d)(3), which the SEC Concept Release notes is typically the case, then Rule 12d3-1 adequately addresses the doctrinal principles discussed in Part IV(D) above. However, if a derivative instrument is deemed to be an "interest" in a securities-related issuer, which the SEC Concept Release implies happens rarely, then Rule 12d3-1 would not apply, and the transaction would be prohibited under Section 12(d)(3). Because most derivatives are "securities" for purposes of these provisions, the SEC does not need to take any action with respect to counterparty issues at this time. Of course, this position should be modified should additional information warrant.

Reference Asset Issues: The SEC should enact regulations to clarify that, if a fund enters into a derivative transaction in which the reference asset issuer is a securities-related issuer, such derivative transaction is prohibited by Section 12(d)(3), as it constitutes an "interest" in the securities related issuer. The regulations should clearly define, and provide examples of, derivatives that constitute "interests" in the reference asset issuer. This approach is in accord with the foundational principles discussed above in Part IV(D). Specifically, exposure to a reference asset through a derivative transaction makes the fund vulnerable to the "entrepreneurial risks" of the reference asset issuer and creates a landscape ripe for abusive reciprocal practices.³⁵⁹

Valuation: For reasons previously stated, as a starting point, notional amounts should be used for all Rule 12d-3 calculations. Again, the CFTC's net notional test referenced in Part III(B) above would be

356. SEC Concept Release, *supra* note 1, at 57.

357. *Id.* at 57-58.

358. SEC Concept Release, *supra* note 1, at 58.

359. *See supra* Part IV(D).

informative in this regard. However, the SEC should require disclosure of calculations based on both valuation methods, so that investors are adequately informed.

Conclusion: The approach outlined above incorporates the doctrinal foundations set forth in Part IV(D) in light of today's market realities and would serve to protect investors from potential abuses by fund sponsors, as well as abusive reciprocal practices. As previously discussed, such recommendations should be modified as needed, based upon the outcome of the SEC's Section 6(c) analysis.

E. RESTRICTIONS REGARDING PORTFOLIO CONCENTRATION

1. Overview

As set forth above, Section 8(b)(1)(E) of the 1940 Act requires investment companies to disclose their policies regarding "concentrating investments in a particular industry or group of industries" in their registration statements.³⁶⁰ Oddly, neither the 1940 Act nor the rules promulgated thereunder contain definitions of "concentration" or "industry or groups of industries."³⁶¹ However, the SEC has addressed the concentration threshold issue, stating that "a fund is concentrated in a particular industry or group of industries if the fund invests or proposes to invest more than 25% of the value of its net assets in a particular industry or group of industries."³⁶² The SEC has given funds the discretion to determine industry concentrations, as long as they are "reasonable" and narrow enough "that the primary economic characteristics of the companies in a single class are materially different."³⁶³

By entering into one derivative transaction, a fund may gain exposure to numerous industries or groups of industries, giving rise to issues under the concentration provision of the 1940 Act.³⁶⁴ The SEC Concept Release gives the example that by entering into a total return swap on a pharmaceutical stock with a bank, an investment company would gain exposure to the pharmaceutical industry, as well as the

360. See *supra* Part IV(E).

361. SEC Concept Release, *supra* note 1, at 65; see also, e.g., ABA Task Force Report, *supra* note 14, at 29.

362. *Id.*

363. SEC Concept Release, *supra* note 1, at 65.

364. *Id.*

banking industry.³⁶⁵ The SEC has not provided guidance as to how the 25 percent concentration limit should be addressed with derivative instruments that provide multiple exposures.

The ABA Task Force Report states that “funds typically comply with their concentration policies by looking to the reference asset and not any counterparty to the derivative instrument . . . [and that] [f]unds typically use market values for these calculations”³⁶⁶ A more conservative approach to the one recommended by the ABA Task Force Report would be to require the use of notional amounts in the 25 percent threshold calculation, and to require industry concentration calculation based on the reference asset issuer, but to require disclosure of a parallel set of calculations treating the counterparty or clearinghouse, as the case may be, as the issuer.³⁶⁷ Another approach would be to require subclassifications of the diversification classification to reflect both “issuer” concepts.³⁶⁸

The following Section sets forth suggested regulatory reforms.

2. Suggested Reforms

Following is an outline of proposed regulations to remedy the issues with respect to the 1940 Act concentration provisions detailed above. As with other proposed reform discussions, modifications to the following should be made as the SEC’s information gathering process warrants. The regulations proposed below incorporate the doctrinal policies of full and fair disclosure to investors regarding the nature of portfolio concentrations and corresponding implied risk levels discussed in Part IV(E).

Industries and Industry Groups: The SEC should create a clear schedule of industries and industry groups applicable to all funds with respect to concentration classifications, rather than leaving these definitions up to the funds to create.

365. SEC Concept Release, *supra* note 1, at 65–66.

366. *ABA Task Force Report*, *supra* note 14, at 29; *see, e.g.*, SEC Concept Release, *supra* note 1, at 66.

367. Such disclosures should set forth single issuer exposure percentages, as well as a disclosure of whether the transactions are cleared or uncleared (and if any collateralization agreements are in place). It should be noted that if an uncleared transaction incorporates an appropriate collateralization agreement giving the fund first priority access to bankruptcy-remote collateral from the counterparty, such transaction might be able to be treated as a cleared transaction. *See, e.g.*, *ABA Task Force Report*, *supra* note 14, at 10.

368. *See* SEC Concept Release, *supra* note 1, at 54.

Concentration Calculations: The SEC should enact regulations requiring industry concentration calculations to be based on exposure to the reference asset issuer; however, the SEC should also require funds to disclose a parallel set of calculations treating the counterparty or clearinghouse, as the case may be, as the issuer.

Valuation: For reasons previously stated, as a starting point, notional amounts should be used for all concentration calculations. Again, the CFTC's net notional test referenced in Part III(B) above would be informative in this regard. However, the SEC should require disclosure of calculations based on both valuation methods detailed above, so that investors are adequately informed.

Conclusion: The foregoing recommendations are based on the doctrinal foundations of the 1940 Act seeking to ensure that investors receive complete and truthful information regarding the nature of the portfolio holdings of their mutual funds, as well as corresponding risk levels. As indicated above, such proposals should be modified as needed, based upon the outcome of the SEC's information gathering process, in accordance with the doctrinal principles set forth in Part IV(E) above.

VI. CONCLUSION

It is astounding that there is no reliable information regarding the general use of derivatives by registered investment companies. Congress has not revisited the 1940 Act to address the complicated issues addressed herein. Further, the SEC has not provided formal guidance regarding the matter since 1979, years before swaps were even invented. Given the numerous examples of derivatives disasters highlighting the catastrophic possibilities of these complex contracts, juxtaposed with the clearly announced purposes of the 1940 Act to protect investors from the dangers of leverage, reform is needed.

The doctrinal foundations of the 1940 Act, built from lessons learned during the endemic financial abuses of the 1930s, are being undermined by mutual funds' pervasive use of complex derivative instruments. The current statutory and regulatory framework is inadequate to deal with this complicated issue; reforms must be made to prevent the types of harms to investors and the financial markets that the 1940 Act was designed to prevent, while preserving the unique benefits that derivatives trading can offer. Congress and the SEC must decisively turn the lights on the mutual fund industry's dance with the derivatives devil and ensure that what is now a dangerous liaison evolves into a risk-appropriate rapprochement.