**Boston University** School of Law
Eric D. Roiter, Lecturer in Law
[redacted]
765 Commonwealth Avenue
Boston, MA 02215

BU School of Law

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Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

**File No. S7-24-15; Use of Derivatives**
**by Registered Investment Companies and Business Development Companies**

In response to the invitation for public comments in Release No. IC-31933 (the "Proposing Release"),[1] I write to suggest an alternative route for the Commission to take to achieve the results and further the purposes of proposed Rule 18f-4. One need not endorse all of the technical details of the proposed rule in order to support the important regulatory policies prompting it. As the Commission notes, the purposes of Section 18 of the Investment Company Act ("ICA") are to curb the speculative character of funds' common shares arising from excessive borrowing and issuance of senior securities, and to constrain funds from operating without adequate assets and reserves.[2] Rather than a new exemptive rule, however, I recommend that the Commission engraft the substantive features of the proposed rule as conditions onto other, outstanding exemptive rules and orders applying to mutual funds and ETFs. Doing so will eliminate unnecessary legal uncertainty and risk, strengthen the SEC's authority and the rule's validity, and enhance the Commission's flexibility in dealing with other financially engineered instruments in the future.

The ICA clearly confers broad discretionary authority on the SEC to prescribe conditions in its exemptive rules and orders.[3] And it seems that all or virtually all mutual

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015).

[2] *Id*. at text accompanying n.31.

[3] *See* U.S. Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133, 138-39 (D.C. Cir. 2005) ("*Chamber of Commerce I*")(noting that § 6(c) of the ICA "conspicuously confers upon the [Commission] broad authority to exempt transactions from rules promulgated under the ICA, subject only to the public interest and the purposes of the ICA."). Although the SEC's fund governance rules, added as conditions to a wide range of exemptive rules, including Rule 12b-1, were eventually set aside due to procedural missteps, the D.C. Circuit upheld the SEC's broad powers under the ICA to require, as conditions to its exemptive rules, an independent chairman and a 75% supermajority of independent directors on fund boards, notwithstanding the ICA's silence on who may serve as a fund board chairman and a lower statutory threshold allowing independent directors to constitute only 40% of a fund's board.

funds and ETFs that engage in derivatives transactions can be reached by this means. The Commission thus need not predicate its actions on a categorical legal determination that derivatives constitute "senior securities" under the Investment Company Act. In Release 10666[4], the Commission in 1979 took obvious pains to stop short of just such a determination with regard to reverse repurchase agreements[5], firm commitment agreements[6] and standby commitment agreements,[7] stating that each instrument "may" be (not "is") a senior security under Section 18(g) of the ICA. The Commission did not limit the scope of Release 10666 to these three specified instruments, but rather emphasized that the release was "intended to address generally the *possible* economic effects and legal implications of all comparable trading practices which may affect the capital structure of investment companies in a manner analogous to the securities trading practices specifically discussed. . . ."[8] Because the Commission did not reach a definitive legal conclusion as to the senior security status of any particular instrument, Release 10666 was not configured as an exemptive rule. The thrust of Release 10666 instead was to enlist fund boards "to consider whether the investment company has appropriately segregated assets in a manner which would satisfy the legislative purposes of Section 18 of the ICA." The Commission had good reason to invoke the purposes of Section 18 rather than its strict letter: it is questionable whether the segregation of assets can change the character of a senior security. If so, it would be difficult to see why mutual funds should not be able to issue secured bonds or for that matter unsecured bonds where a fund simply segregates assets with its own custodian.

Not only is there no need now for the Commission to stretch the definition of "senior security" to reach derivatives, it is not altogether clear that the courts would agree that interest rate swaps and currency swaps, for example, are, in the first instance, "securities," particularly in light of the allocation of regulatory authority for swaps laid down by the Dodd-Frank Act. As the Commission has itself noted:

> The Dodd-Frank Act divides regulatory authority over swap agreements between the CFTC and SEC. . . . The SEC has regulatory authority over "security-based swaps," which are defined as swaps based on a single security or loan or a narrow-based group or index of securities . . . or events relating to a single issuer or issuers of securities in a narrow-based

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[4] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979).

[5] *Id.* at 25129 ("[A]n investment company which enters into a reverse repurchase agreement may be involved in the issuance of a security which, in turn, may be a senior security as defined in Section 18(g)" of the ICA.)

[6] *Id*. at 25131 ("[I]f a firm commitment agreement is a security . . . it also may be a senior security as defined in Section 18(g) of the [ICA], and an investment company entering into such agreements may be in violation of Section 18(f)(1).)

[7] *Id.*("An investment company's participation in a standby commitment agreement may involve the issuance of a security by the investment company. . . . [A]n investment company involved in standby commitment agreements, if they are senior securities as defined by Section 18(g) of the [ICA], may be in violation of Section 18(f)(1). . . .)

[8] *Id*. at 25129 (emphasis supplied).

> security index. . . . The CFTC has primary regulatory authority over all other swaps . . ."[9]

To be sure, Dodd-Frank amended the definition of "security" under the Securities Act of 1933 and Securities Exchange Act of 1934, but not the ICA, to add "security-based swaps" and a negative implication thus can arguably be drawn that non-security based swaps, such as interest rate swaps and currency exchange swaps, fall within the ICA's definition of "security," notably as an "evidence of indebtedness." But the ICA's definition of "security" does not make any explicit reference to swaps of any sort, and there seems at least a risk that a court might quite reasonably construe "evidence of indebtedness" not to include all payment obligations (or contingent payment obligations) of a fund but only those that constitute a borrowing of monies where repayment amounts are a function, at least in part, of the time value of money over the period where the borrowing remains outstanding. If all payment obligations were to constitute securities then the accrual of management fees, transfer fees and other expenses incurred by funds would seem to fall within the definitional net. And if all contingent payment obligations were also to be swept up, then the contingent obligation of a fund to pay its adviser a performance fee, based upon outperformance of a benchmark index, would be a security.

In short, there is little reason for the Commission to test the bounds of the definition of "security" in order to achieve all of its policy objectives; it can simply incorporate as conditions all of the substantive terms of proposed Rule 18f-4 into its existing exemptive rules and orders. This approach has the added virtue of preserving the SEC's flexibility to deal in the future with instruments which entail economic leverage but impose not payment obligations, contingent or otherwise, upon a fund. The Commission, as explained in the Proposing Release, appears to contemplate a disclosure-based approach for these instruments rather than substantive limits, but the Commission might come to a later judgment that disclosure alone might not be sufficient to protect the interests of retail investors. If so, the Commission could simply add instruments with economic leverage to its list of instruments subject to the conditions for its exemptive rules for funds.

Thank you for the opportunity to comment.

Respectfully submitted,

Eric D. Roiter

[9] Dodd-Frank Spotlight, https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml