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Stephen A. Keen
Direct Phone: (970) 689-3153
Email: stevekeen4@comcast.net

Andrew P. Cross
Direct Phone: (412) 288-2614
Email: across@reedsmith.com

Reed Smith LLP
Reed Smith Centre
225 Fifth Avenue
Pittsburgh, PA 15222-2716
+1 412 288 3131
Fax +1 412 288 3063
reedsmith.com

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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

File No. S7-33-11: Use of Derivatives by Investment Companies under the Investment Company Act of 1940

Ladies and Gentlemen:

We are writing in advance of submitting general comments regarding the recent concept release on the use of derivatives by investment companies because we believe the Commission may have overlooked an important issue—namely the custody of derivative contracts. Although custody was referred to in a litany of "other" issues under the Investment Company Act, Investment Company Act Release No. IC-29776, Use of Derivatives by Investment Companies under the Investment Company Act of 1940 at 8 n.16 (Aug. 31, 2011) (the "Concept Release"), the Commission did not request any comments on this point. We are concerned that the lack of clear standards for the custody of over-the-counter derivative contracts ("OTC Derivatives") may create unnecessary risks for investment companies and other clients of registered investment advisers. We hope that the Commission will agree that this is a sufficiently significant issue to warrant consideration in connection with the Concept Release and will request further comments on the matter.[1]

As background, Reed Smith is a global law firm that has represented banks and financial institutions for more than 130 years. Presently, more than 200 lawyers in Reed Smith's Financial Industry Group advise the majority of the world's top financial institutions with respect to complex regulatory, transactional and litigation matters, including several of the United State's largest mutual fund and investment advisory firms.

On a personal level, we have been advising investment managers regarding derivatives for 20 years. Mr. Keen's analysis of inverse floating rate securities while at Federated Investors contributed to the Commission staff's decision to prohibit money market funds from investing in these derivative securities, *see*, Investment Company Institute, [1991-1992 Trans. Binder] Fed. Sec. L. Rep. ¶ 76,052

[1] These comments express our personal views, and should not be attributed to any of our firm's current or former clients.

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(Dec. 6, 1991), and throughout the 1990s he was involved in the review and development of a variety of derivatives used by mutual funds. Since 2004, Mr. Cross has been a regular participant in derivatives-related discussions among the membership of the Asset Managers Group of the Securities Industry and Financial Markets Association, and advocated using collateral support for OTC Derivatives and preparing for the insolvency of OTC Derivatives dealers years before the financial crisis began in 2007. Mr. Cross also maintains a blog, The Swap Report, dedicated to regulatory and transactional issues related to derivatives and regularly features a "Mutual Fund Corner" that is specifically dedicated to the use of derivatives by registered investment companies. Our joint experience has led us to analyze in depth the full range of issues faced by investment companies and their managers when dealing with derivatives.

1. Custody Risks of OTC Derivatives

Our concerns arise from the terms of the Master Agreement (the "Master Agreement"), a form contract published by the International Swaps and Derivatives Association ("ISDA").[2] The Master Agreement, as supplemented by various definitions and annexes also published by ISDA, provides the framework for most of the OTC Derivatives executed in the United States and throughout the world. Generally, the parties use a single Master Agreement to document all of their OTC Derivatives. Frequently, the parties will agree to net any payments due on any OTC Derivatives denominated in the same currency. As a result of these netting arrangements, OTC Derivative payments generally flow from one party to the other, rather than bilaterally, and may aggregate to millions of dollars.

The key custody issue for OTC Derivatives is who controls where these payments are made. Section 2(a)(ii) of the Master Agreement provides that:

> Payments under this Agreement will be made on the due date for value on that date *in the place of the account specified in the relevant Confirmation* or otherwise pursuant to this Agreement, in freely transferable funds and in the manner customary for payments in the required currency. Where settlement is by delivery (that is, other than by payment), such delivery will be made for receipt on the due date in the manner customary for the relevant obligation unless otherwise specified in the relevant Confirmation or elsewhere in this Agreement. [Emphasis added]

The "Confirmation" referred to in the Master Agreement are "the documents and other confirming evidence ... exchanged between the parties confirming [an OTC Derivative]."[3] A Confirmation sets forth all of the specific terms and details of an individual OTC Derivative and, typically, incorporates one or more sets of definitional booklets published by ISDA. Consequently, Confirmations require an

[2] There are two versions of the ISDA Master Agreement – the 1992 Master Agreement and the 2002 Master Agreement. For purposes of our comments, the distinctions between these versions are not relevant, so we will refer to the 1992 Master Agreement for purposes of illustration.

[3] OTC Derivatives counterparties may exchange a paper or electronic version of a Confirmation. For certain types of OTC Derivatives (*e.g.*, credit default swaps), an electronic Confirmation may be maintained at a central "warehouse" operated by The Depository Trust & Clearing Corporation.

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intimate understanding of the Master Agreement and ISDA's definitions incorporated into the Confirmation.

Ordinarily, the investment adviser to an investment company will provide the information necessary to complete the Confirmation—including the investment company's payment and delivery information. The investment adviser will also review the completed Confirmation and may forward it to the investment company's custodian as part of the documentation of the OTC Derivative. Custodians generally do not review the Confirmation, because, in addition to the Confirmation's complexity, they have no means of independently verifying the terms agreed to by the parties to the OTC Derivative.

This practice allows the investment adviser's traders to direct where payments are to be made on an investment company's OTC Derivatives without verification by its custodian. Unless the investment adviser and the custodian voluntarily implement additional controls, nothing in the process of confirming, clearing and settling payments on OTC Derivatives prevents a trader from, intentionally or accidently, providing incorrect payment instructions in a Confirmation. The other party to the OTC Derivatives is legally obligated to pay in accordance with the instructions provided in the Confirmation, so the investment company would not have any legal recourse against the other party for lost or misappropriated payments. Payments by the investment company to the other party to an OTC Derivative can also be misdirected if the Confirmation provided to the custodian includes erroneous information regarding the other party's payment account.

Even if the custodian voluntarily implements a procedure to review the payment directions on each Confirmation, this would not prevent a trader from subsequently directing OTC Derivative payments to another account. The trader could modify payment instructions in accordance with Section 2(b) of the Master Agreement, which provides that:

> Either party may change its account for receiving a payment or delivery by giving notice to the other party at least five Local Business Days prior to the scheduled date for the payment or delivery to which such change applies unless such other party gives timely notice of a reasonable objection to such change.

We are not aware of any law or regulation that would require an investment adviser or the other party to an OTC Derivative to notify an investment company's custodian of such a change.

2. Application of Custody Requirements to OTC Derivatives

Section 17(f) of the Investment Company Act of 1940 requires an open or closed-end investment company to "place and maintain its securities and similar investments in the custody of" a bank or a registered broker-dealer. Self-custody is also permitted, "but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors." As a practical matter, most investment companies employ banks as their custodians.

Section 17(f) applies to OTC Derivatives entered into by investment companies. The Concept Release at 20 n. 57 provides a summary of why derivatives should qualify as "securities" for purposes of the Investment Company Act. Even if derivatives were not securities, it would be hard to dispute that they are "similar investments" also subject to Section 17(f). What is not clear is what is required to "place and maintain" an OTC Derivative with an investment company's custodian.

We are not aware of any guidance from the Commission or its staff on this point. Rule 17f-6 governs the placement of "cash, securities, and similar investments with a Futures Commission Merchant in amounts necessary to effect the Fund's transactions in Exchange-Traded Futures Contracts and Commodity Options," but does not deal with the custody of exchange-traded futures contracts and commodity options themselves. Rule 17f-4 does not apply to OTC Derivatives because they are not currently cleared by securities depositories as defined by that rule. Although rules have been proposed to require central clearing of most OTC Derivatives, these clearing arrangements may not be structured to treat OTC Derivatives as "financial assets" under the Uniform Commercial Code. Unless OTC Derivatives can be designed to qualify as financial assets, Rule 17f-4 will not provide any additional guidance as to how they should be "maintained" at the clearing corporation.

In the absence of specific guidance on the application of Section 17(f) to OTC Derivatives, it is common to refer to the custody requirements of the Investment Advisers Act of 1940 for guidance. Rule 206(4)-2(a)(1) makes it "a fraudulent, deceptive, or manipulative act, practice or course of business … for [a registered investment adviser] to have custody of client funds or securities unless … [a] qualified custodian maintains those funds and securities." Although the rule does not apply to registered investment companies (Rule 206(4)-2(b)(5)), it provides some insight into what it means to have custody of a security. In particular, Rule 206(4)-2(d)(2) provides the following definition of custody:

> "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes —
>
> (i) Possession of client funds or securities, (but not of checks drawn by clients and made payable to third parties,) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;
>
> (ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and
>
> (iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

An investment adviser's ability to direct payments from the other party to an OTC Derivative by providing payment instructions in the Confirmation gives the adviser's "access" to any securities or funds to be delivered under the OTC Derivative. This would appear to give the investment advisers "custody" of these funds and securities, while the investment company's custodian, who has no authority over the terms of the Confirmation, would not appear to have "custody" until these funds and securities are transferred to a custodial account. If "custody" means the same thing for purposes of Section 17(f) as it does for purposes of Rule 206(4)-2, then this arrangement for OTC Derivatives might be found to violate Section 17(f).

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On the other hand, the ability to designate or modify payment instructions in a Confirmation may not constitute "custody" so long as it is for the purpose of authorized trading. The Commission has stated that:

> An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute "custody." Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This "delivery versus payment" arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.

Custody of Fund or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176, 68 Fed. Reg. 56692, 56693 n.10 (Sep. 25, 2003).

Certain OTC Derivatives, such as forward contracts, are essentially trades with extended settlement periods. Confirmations provide instructions to the parties to the OTC Derivative to "effect or settle" these trades, and should therefore not be deemed to give the investment adviser custody of the OTC Derivative or the securities and funds to be delivered thereunder. Although this does not strictly answer the question of whether such an OTC Derivative is maintained with the investment company's custodian as required by Section 17(f), it shows that the Commission is aware of the practice of investment advisers providing settlement instructions for their clients' trades and has not found this inconsistent with the requirements of Section 17(f).

It is difficult to apply this analysis to other types of OTC Derivatives, however. Many OTC Derivatives require only payments of cash. As noted before, the Master Agreement typically nets these payments obligations, so that rather than making bilateral exchanges, only one party is required to make a net payment to the other party. Thus, there is no "delivery versus payment" arrangement for these OTC Derivatives to "minimize the risk that an adviser could misappropriate the funds" paid. Whereas a securities trade will "fail" (*i.e.*, no exchange of securities and funds will occur) if the securities are not delivered to the custodian's account, there is no mechanism to stop a net payment from going to the account specified in the Confirmation, even if that is not actually an account of the investment company or the other party to the OTC Derivative.

3. The Commission Should Consider Requiring Adequate Controls to Safeguard Payments under OTC Derivatives

Given an investment adviser's ability to direct payments under OTC Derivatives without verification by its client's custodian, it is reasonable to wonder why there have not been reported cases of such payments being lost, misused or misappropriated. This may be due to the voluntary implementation of controls by professional investment managers and custodian banks. For example, we believe it is a common practice for custodians and OTC Derivatives dealers to contact one another to confirm payment instructions. This allows them detect and correct errors before payments are due, and also serves to deter traders from attempting to misdirect payments.

Other, relatively simple, controls may also serve this purpose. For example, we have developed an addendum to the Master Agreement that sets forth payment instructions to custodial accounts in the

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standard schedule to the Master Agreement and requires the specified custodian to verify any change in the instructions. This eliminates the need for a custodian to review each Confirmation and prevents an investment adviser from changing payment instructions without notifying the custodian.

It would also be possible to utilize technological and structural changes in OTC Derivatives trade flow that will result from the implementation of Titles VII and VIII of the Dodd-Frank Act to further safeguard payments under OTC Derivatives. By way of example, utilizing a central payment settlement system, a fund's custodian could be required to provide electronic approval of any changes to a fund's OTC Derivatives settlement instructions. For certain OTC Derivative asset classes (*e.g.*, credit and equity derivatives), third-party service providers already offer a central settlement function that allows for net payments to be calculated and exchanged between the parties.

The Nick Leeson and Jérôme Kerviel cases illustrate the dangers of lax controls over derivatives trading. Scandals during the recent financial crisis also have illustrated the importance of having an independent custodian as a check against an investment adviser's misuse of its clients' assets. We therefore urge the Commission not to leave the implementation of adequate controls over OTC Derivatives to chance. We recommend that the Commission request comments on what controls are currently employed, whether these controls have been found to be effective, and whether these controls could be improved through the central clearing of OTC Derivatives or other requirements. After reviewing these comments, the Commission should consider whether to adopt regulations, or amend existing regulations, to clarify what controls are necessary to "maintain" OTC Derivatives with an investment company's custodian for purposes of Section 17(f).

Thank you for considering these comments. If you have any questions, please do not hesitate to contact us.

Respectfully submitted,

Stephen A. Keen/sj

Stephen A. Keen

Andrew P. Cross