



November 7, 2011

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

Re: Use of Derivatives by Investment Companies Under the Investment Company Act of 1940; File Number S7-33-11

Dear Ms. Murphy:

Better Markets, Inc.<sup>1</sup> appreciates the opportunity to comment on the above-captioned concept release and request for comments (“Release”) of the Securities and Exchange Commission (“Commission”). The Commission and its staff are reviewing the use of derivatives by management investment companies registered under the Investment Company Act of 1940 (the “Investment Company Act” or “Act”) and companies that have elected to be treated as business development companies under the Act (collectively, “Funds”). In the Release, the Commission seeks comments to assist in this undertaking.

## **INTRODUCTION**

The Release is aimed at a review of a series of actions by the Commission and its staff over a period exceeding three decades in which funds have been allowed to introduce derivatives risk into portfolios in increments, each of which was founded in reasoned arguments, but many of which are now clearly imprudent when viewed as a group.

The Release recognizes that Funds use derivatives for a variety of purposes, “including to increase leverage to boost returns, gain access to certain markets, achieve greater transaction efficiency, and hedge interest rate, credit, and other risks.”<sup>2</sup> At the same time, derivatives pose a number of risk management issues for Funds. The Commission is considering reviewing these risk management issues in the context of several regulatory principles, specifically senior security restrictions on open-ended Funds, diversification requirements, portfolio concentration, limitations on exposure to securities-related issuers and valuation.

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<sup>1</sup> Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

<sup>2</sup> Release, 76 FR at page 55238.

At the heart of the review is the complexity— often artificially created, profit-maximizing complexity— of derivatives which prompted Warren Buffet famously to refer to them as “financial weapons of mass destruction.” Since the markets for these instruments have existed largely in the shadowy world of OTC, bi-lateral transactions, meaningful analysis of their characteristics outside of the self-interested financial services industry has been relatively slow to emerge.

The review raises an important question: realistically, how effective is disclosure regarding instruments which the Fund advisors, and even the financial institutions which market derivatives, can understand only within limits? In an insightful article on information asymmetry in financial markets, Markus Brunnermeier draws the following conclusion:

One of our main results suggests that it may be computationally intractable to price derivatives even when buyers know almost all of the relevant information, and furthermore this is true even in very simple models of asset yields.<sup>3</sup>

Even at large international financial institutions, there are few individuals who can appreciate the implications of complex derivatives and the interaction of positions within a portfolio.<sup>4</sup> **Brunnermeier concludes that the seller of a derivative will often, in fact, cherry pick facts for disclosure to actively disguise information relating to the value of the transaction.**<sup>5</sup>

It is helpful to lay out some basic principles in advance of the review. Derivatives are fundamentally different from investments in equity shares, bonds or other assets. They are executory contracts whose value is wholly dependent upon the probability that the contractual counterparty will perform and the value (positive or negative) of that performance, based on changing market prices.

As a result, derivatives constitute bundles of risk and potential reward. The underlying transaction, which is generally an exchange of values of a referenced asset, can provide a profit or loss or offset the profit or loss from a portion of the Fund’s portfolio. However, even the simplest derivative involves a dual credit transaction as well because performance by both parties is required under the executory contract. It is essential to view these as separate transactions.

In practice, there are two categories of contractual arrangements for bi-lateral derivatives: those which are governed by ISDA Credit Support Annexes to Master Swap Agreement (together with the Master Swap Agreements to which they are annexed, “CSAs”)

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<sup>3</sup> Arora, Barak, Brunnermeier and Ge, Computational Complexity and Information Asymmetry in Financial Products, page 2, October 19, 2009, available at <http://www.cs.princeton.edu/~rongge/derivative.pdf>

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

and those in which margining arrangements are established in less formal short-form confirmations, which typically mimic the CSAs but using a “one-off” approach. The most significant contractual arrangements for bi-lateral derivatives are those governed by CSAs.

The CSAs typically establish the procedures for margining credit exposures. CSAs apply to all swaps between the parties (or sometimes all swaps of specific categories) rather than individual swaps. Exposures are measured on a net portfolio basis by mark-to-market calculations, plus (in some, but by no means all, cases) an “additional amount” that serves as a rough analog to initial margin.

In many instances, counterparties forbear from collecting margin up to a cap. Such forbearance arrangements are the most significant obligations that Funds using derivatives must meet because they almost invariably include “credit triggers,” which are generally based on credit ratings. **If a credit trigger is tripped, the Fund is required to fully fund collateral that has been previously forborne, at the very time it is most difficult to do so.** Because these forbearance arrangements can have such a dramatic and debilitating impact on an end-user, they must be a primary focus of the Review. History provides many examples (not the least of which was AIG) that the terms and conditions of credit triggers define the most important obligations associated with entering into an uncleared swap.

The use of forbearance under a CSA between a dealer and a Fund can be usefully understood as a revolving loan of funds (from the dealer to the Fund and *vice versa*) to provide required collateral, where the “loan” can be called for repayment upon the occurrence of a credit trigger event.<sup>6</sup> In fact, the practice by dealers is to estimate the average daily outstanding (but uncollected) collateral (i.e., principal) over the expected life of the swap (i.e., loan term) and calculate an appropriate charge for extending the credit (i.e., interest). That charge is then added to and embedded unseen into the cost of the swap to the Fund.

It is telling that the FDIC and other prudential regulators applied this logic specifically in its requirements relating to derivatives entered into by insured financial institutions with their counterparties in a recent notice of proposed rulemaking.<sup>7</sup>

In summary, in reviewing the application of various restrictions on the use of derivatives by Funds, the embedded transactions must be analyzed separately. One is the

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<sup>6</sup> Professor John Parsons of MIT and Professor Antonio Mello of the University of Wisconsin have written extensively on the forborne derivatives collateral and the embedded loan. Some of these materials can be found at:

<http://bettingthebusiness.com/2010/10/25/otc-5-the-collateral-boogeyman-%E2%80%93-packaging-credit-implicitly-and-explicitly/>

<http://bettingthebusiness.com/2010/10/07/otc-3-the-collateral-boogeyman-%E2%80%93-the-delusion-of-%E2%80%9Cfree%E2%80%9D-credit-from-your-friendly-neighborhood-derivatives-dealer/>

<http://bettingthebusiness.com/2010/10/11/otc-4-the-collateral-boogeyman-%E2%80%93-lobbyists-trot-out-the-free-lunch/>

<sup>7</sup> Notice of Proposed Rulemaking on “Margin and Capital Requirements for Covered Swap Entities”, 76 Fed. Reg. 27,564 (May 11, 2011)

underlying derivative. The other is a two-way callable revolving loan which may be collateralized in whole or in part.

## **DISCUSSION**

### **The credit arrangements embedded in derivatives entered into by open-ended Funds must be considered senior securities under the Investment Company Act.**

The senior securities provision of the Act is referred to eloquently in the Release as a “core purpose” of the Act. Senior securities are defined as:

any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness... [and] any stock of a class having priority over any other class as to the distribution of assets or payment of dividends.<sup>8</sup>

As described above, the embedded credit arrangement in most derivative transactions is, simply stated, a callable revolving loan. Margining or collateralization is a mitigant against loss by the lender, but it does not mean that the credit arrangement does not exist. Derivatives values fluctuate constantly. Any form of margin is merely an estimate of the amount of credit extended at any given point in time. Moreover, the final amount of credit in any default situation could involve price movements from the final time the margin is calculated until the actual resolution of the default, which is in many instances an uncapped amount.

The Commission has adopted a policy that a Fund may enter into similar arrangements so long as it covers the obligations associated with derivatives credit exposures with securities set aside in a segregated account.<sup>9</sup> The fundamental danger of derivatives is that the amount needed to “cover” can never be known and it is subject to volatile market forces. Therefore, this approach must be abandoned.

The approach suggested by the American Bar Association described as “Risk Adjusted Segregated Amounts” is not only inadequate under the same logic, it actually demonstrates the fundamental problem.<sup>10</sup> This approach asserts that guidelines for determining segregated amounts are impossible given the complexity and unique characteristics of individual derivatives. It proposes providing general principles to Funds and allowing them to develop valuation methodologies on an *ad hoc* basis. If the valuation of derivatives is so complex and unique to the particular derivative in question, the segregation principle itself is by definition inadequate for compliance with the senior

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<sup>8</sup> Investment Company Act, Section 18(g).

<sup>9</sup> *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) (“Release 10666”) [44 FR 25128 (Apr. 27, 1979)].

<sup>10</sup> *The Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) (“2010 ABA Derivatives Report”), available at [http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest\\_files/DerivativesTF\\_July\\_6\\_2010\\_final.pdf](http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf).

securities prohibition of the Act. The ABA approach must be rejected out of hand as a recipe for disaster.

Even if the segregation approach is retained, the further interpretations by the Commission must be reversed. A 1996 no-action letter provided to Merrill Lynch Asset Management is described in detail in the Release:

[T]he staff took the position that a fund could cover its derivatives related obligations by depositing any liquid asset, including equity securities and non-investment grade debt securities, in a segregated account. In the Merrill Lynch no-action letter, the staff explained that, in the staff's view, segregating any type of liquid asset would be consistent with the purposes underlying the asset segregation approach because it would 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. With respect to the manner in which segregation may be effected, the Commission staff took the position that a fund could segregate assets by designating such assets on its books, rather than establishing a segregated account at its custodian.<sup>11</sup>

This raises two critical concerns. First, the broadening of segregated assets increases the probability that the embedded credit associated with the derivatives will result in a senior payment of money from the Funds. Even worse, in addition to the liquidation value being uncertain, the assets could be positively correlated with the derivatives risk being offset. Loss on the derivatives risk could be compounded by loss on the asset.

In addition, setting aside assets on the books of the Fund may be a modest impediment to the incurrence of credit through derivatives, but it provides no protection against an actual loss which is senior to the interests of fund investors. Preventing such a loss is the underlying purpose of the senior security provision and it is better served by actual segregation.

**Diversification, concentration and securities-related entity exposure requirements must use valuation procedures which recognize the underlying derivative exposures as well as the embedded counterparty credit exposures.**

The Commission has largely used mark-to-market valuation techniques to assess the implications of derivatives transactions to requirements related to diversification, concentration and exposure to securities-related entities. The exposure to the credit of counterparties of a Fund has largely been ignored. These approaches must be abandoned.

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<sup>11</sup> Release, 76 FR at page 55244.

Using mark-to-market values is completely inadequate to measurement of diversification and concentration. Derivatives effectively transfer exposure to a notional quantity of securities or other assets without actual ownership. A Fund with an equity derivative on 1000 shares of company X is fully exposed to the market value of those shares. For purposes of diversification and concentration calculations, the derivative should be measured on an apples-to-apples basis with outright ownership of the shares. Therefore, when measuring diversification and concentration, the derivative should be valued as if the shares were owned, meaning equal to the notional quantity of shares (or other underlying referenced asset) at the current market value.

The same approach must be taken with respect to the underlying referenced securities or assets in a derivative in connection with the prohibition against acquiring securities issued by or any other interest in a securities-related entity.<sup>12</sup> The Release describes the purpose of 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 Investment Company Act provisions which, taken together, prohibit fund sponsors, which include broker-dealers, underwriters, and investment advisers, from taking advantage of the funds that they sponsor.<sup>13</sup>

Both of these purposes would be frustrated if the prohibition could be avoided merely by using a derivative on equity securities, debt or other interests.

In addition, the counterparty credit transaction must be viewed separately (unless the transaction is cleared simultaneously with execution). If the Fund is in-the-money on the derivative, it is exposed to the counterparty in a credit transaction. Such a transaction should be treated no differently in principle from holding a note or commercial paper of the counterparty. To the extent that the counterparty's business conducts its business so that it is a securities-related entity, the relevant rules must apply. Therefore, if the counterparty is a broker, dealer, underwriter or financial advisor, the transaction must be deemed impermissible.<sup>14</sup>

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<sup>12</sup> Investment Company Act, Section 12(d)(3).

<sup>13</sup> Release, 76 FR at page 55252.

<sup>14</sup> Investment Company Act, Section 12(d)(3).

**CONCLUSION**

We hope these comments are helpful to the Commission in preparing for its Review.

Sincerely,



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