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Mutual Funds' Use of Credit Default Swaps—Part I

by Robert W. Helm, David M. Geffen, and Stephanie A. Capistron

At some point in 2008, the term "credit default swap" entered the vernacular. Hedge fund manager George Soros has called credit default swap contracts "toxic" and called for banning their use.[1]

Despite the negative connotation that accompanies most discussions of credit default swaps (CDSs),[2] purely as a factual matter, since their genesis, CDSs have been used successfully by institutional investors, including registered open-end investment companies (Funds), for a number of years.

This article sidesteps the debate over the toxicity of CDSs[3] and, instead, focuses on what mutual fund practitioners should know about CDSs. First, a brief description of how a CDS is intended to work, along with a brief history of CDSs' genesis, is provided. After that background, the discussion describes the economic rationale for a Fund's use of a CDS and, at greater length, examines the principal issues that are implicated by a Fund's CDS use under the Investment Company Act of 1940, as amended(ICA).[4] Finally, the article summarizes the effects that the recent economic crisis is likely to have on Funds' prospective use of CDSs. Part I includes all of the principal ICA issues, except the senior security issues that arise under Section 18 of the ICA. Part II of this article, which includes the discussion of CDSs and Section 18, will appear in an upcoming issue of *The Investment Lawyer.*

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CDS Basics

A CDS is simply a means to transfer the risk that a debt issuer will default (credit risk) from one party to another. A CDS is a bilateral contract between a "protection buyer" and a "protection seller." The CDS provides that, if there is a default by a debt issuer on a particular debt instrument, the protection seller must pay the protection buyer an amount calculated, in effect, to compensate for the debt instrument's decrease in value.

The issuer of the debt protected by a CDS is called the "reference entity." Under the terms of the CDS, when a "credit event" occurs with respect to the specified debt instrument, for example, the reference entity's insolvency or failure to pay amounts due on the debt instrument, the protection seller is required to purchase the reference debt instruments at their face (maturity date) value from the protection buyer.[5] The aggregate face value of the debt protected by the CDS is called the CDS's "notional amount."

In return for providing protection, the protection seller is entitled to receive from the protection buyer a periodic payment, usually payable in quarterly installments, until the expiration of the CDS or the occurrence of a credit event, whichever occurs first. The premium typically is a fraction, stated in basis points, of the notional amount. For example, if the notional amount of a CDS is $10 million, the premium would be expressed as, say, 330 basis points (3.3 percent), and the protection buyer would pay $330,000 annually to the protection seller.

CDSs were created by J.P. Morgan's derivatives group in 1994 to permit a bank to reduce its capital reserve requirement, which is based on a bank's loan portfolio.[6] While 1994 marked the advent of CDSs, the International Swaps and Derivatives Association (ISDA) reports that it was not until 2002 that the number of CDSs began to expand rapidly beyond banks' hedging their exposure to large institutional borrowers.[7] The expansion of CDSs that began in 2002 is attributed to, among other things, CDS protection purchased by trusts holding collateralized debt obligations.[8] In January 2009, the Securities and Exchange Commission (Commission) similarly noted that CDSs were created to meet the demand of banking institutions looking to hedge and diversify the credit risk attendant with their lending activities.[9] However, in recent years, the Commission stated, CDS market volumes had grown rapidly, with the growth coinciding with the significant increase in the types and number of entities participating in the CDS market, including insurance companies, pension funds, securities firms, and hedge funds.[10]

Recent estimates of the total *notional* amount of outstanding CDSs vary—$30 trillion to $62 trillion are cited—nevertheless, the estimates report that 2008 and 2009 saw significant decreases in the total notional amount of outstanding CDSs.[11] With respect to notional amount estimates, it is worthwhile to note that the market value of the underlying CDSs is substantially less. ISDA's 2007 Year End Market Survey reported that the gross market (or replacement) value of outstanding CDSs was just over $2 trillion, or less than 3.5 percent, of the corresponding December 31, 2007, notional amount of $62 trillion.[12]

At present, CDSs are unregulated. The Commodity Futures Modernization Act of 2000 (CFMA)[13] amended the Securities Act of 1933, as amended, (Securities Act)[14] and the Securities Exchange Act of 1934, as amended, (Exchange Act)[15] to specify that swap contracts between "eligible contract participants" are not securities for purposes of each Act's registration provisions.[16] Thus, today, CDSs remain exempt from the registration provisions of the Securities Act, and no provision of the Exchange Act requires periodic reporting or disclosure from participants in the CDS market.[17]

CDSs, as well as other OTC derivative transactions, are documented using the agreements and definitions published by ISDA. The ISDA Master Agreement, the Schedule to the ISDA Master Agreement and the Credit Support Annex (together, the Master Agreement) set forth both standard and negotiated terms that apply to all CDSs between a Fund and the bank or broker-dealer counterparty to the Master Agreement. The Master Agreement contains terms that are not transaction specific and specifies the credit relationship between the Fund and counterparty. The specific terms of a CDS or other OTC derivative transaction are memorialized in a trade confirmation, which supplements the Master Agreement.[18]

In addition to identifying the reference entity and providing the definition of what constitutes a "credit event," the trade confirmation specifies the assignability (novation) provisions that permit CDSs to be traded. A party also can unwind a CDS position with the original counterparty by entering into an offsetting CDS based on the same reference entity, but with the buyer-seller roles reversed, or by a party entering into a similar offsetting CDS with a different counterparty.

CDSs are OTC instruments. Large banks serve as dealers in the market for CDSs, and publish bid and offer prices with respect to CDSs in the same manner that market makers for traditional fixed-income instruments publish bid and offer prices.

Corporations, banks, and sovereign entities serve as CDS reference entities. In addition to CDSs with a single reference entity, investors may obtain exposure to a broad index of issuers through credit default indices, which, in some cases, are based on the CDSs of more than 100 reference entities (for example, North American investment grade issuers).[19]

Mutual Funds' Use of CDSs

The most straightforward use of a CDS by a Fund is to hedge the Fund's credit risk with respect to a bond already owned by the Fund. Thus, if a Fund owns a bond of a particular reference entity, buying credit protection for the bond by entering into a CDS moves the risk of the reference entity's default from the Fund to a protection seller.[20]

In addition to hedging, Funds utilize CDSs when they do not own the debt of the reference entity. A Fund may seek incremental returns by buying or selling credit protection for a reference entity's bond when the total return profile (which includes any protection premiums paid or received) of buying or selling protection is perceived to be more favorable than transacting directly in a comparable bond of the reference entity. For example, an adviser that believes that a particular reference entity's credit risk will increase can direct a Fund to purchase protection on the reference entity by entering into a CDS. Thereafter, as the reference entity's default risk changes, the market value of the protection accorded by the CDS increases or decreases. If the adviser's expectations are correct, the value of the CDS will increase as the credit risk of the reference entity increases, and the Fund will earn a positive return. Thus, a CDS permits a Fund to obtain exposure to the reference entity's debt without ever owning the debt.

CDSs also are used when the pricing and liquidity of a CDS for a single reference entity appear more attractive to an adviser relative to the cash market for the underlying reference entity's bond. For example, without a CDS, an adviser that wishes to underweight a particular reference entity can reduce a Fund's holdings of the entity's bonds only to zero. If the bond is unavailable or in limited supply for borrowing, a CDS permits a Fund to underweight its holdings of the reference entity's bond (that is, take a short position) without borrowing the bond and, then, selling the bond short in the cash market.

General Regulatory Issues Raised by Mutual Funds' Use of CDSs

In the Hands of a Fund, Is a CDS a Security?

A preliminary and critical ICA question is whether a CDS is a "security" as defined in Section 2(a)(36) of the ICA. The CFMA amended the Securities Act and the Exchange Act to provide, in effect, that CDSs are not securities for purposes of both Acts.[21] The CFMA did *not* make any comparable or similar amendments to the ICA.

Although ICA Section 2(a)(36) does not specifically mention swap agreements, CDSs bear a close resemblance to several instruments enumerated in the section.[22] Therefore, the plain language of Section 2(a)(36) supports treating CDSs as securities for ICA purposes.

Moreover, the Commission has given Section 2(a)(36) of the ICA a broad construction, especially where exclusion of an instrument from the definition of a security under the ICA would seriously undermine the protections contemplated by Congress.[23]

Therefore, the better-reasoned approach is to deem a CDS to be a security for purposes of the ICA. This is true regardless of whether the Fund is the protection buyer or protection seller.

Who is the Issuer of a CDS?

The ICA's provisions concerning diversification, concentration, and purchasing the securities of an issuer in a securities-related business each depend on identifying the issuer of a particular security. Therefore, to apply these ICA provisions correctly with respect to a CDS, it is first necessary to determine the identity of the CDS's issuer.

The definition of "issuer" in the ICA is circular and does not provide useful guidance.[24] Much of the guidance available on when an entity is deemed to be an issuer of a security has arisen from no-action letters. From this guidance, certain principles emerge.

The general rule is that the nominal issuer of a security is deemed to be the issuer of the security. Deviation from this general rule should occur only when the nominal issuer of an instrument either has no legal obligation to repay, or when a different person's assets and revenues secure repayment (whether or not the nominal issuer remains obligated).

Dreyfus New York Tax Exempt Bond Fund, Inc.[25] is an example of the general rule. In that no-action letter, the Commission Staff differentiated between bonds guaranteed by the State of New York and bonds that were mere "moral obligations" of the State. For purposes of Section 5(b)(1), a security legally backed by the credit of the State of New York is a New York bond issue, while a security backed merely by the moral obligation of the State is not deemed issued by the State.

There are some interpretations from the Commission Staff indicating the limited circumstances when it would be appropriate to deviate from the general rule. Securities for which the nominal issuer is a municipality may involve complex legal structures in which the nominal issuer, a municipal conduit, bears no responsibility for payments on the bonds.[26]

Institutional Equity Fund[27] is noteworthy because it illustrates a deviation from the general rule in the context of derivative instruments. The no-action letter concerned exchange-traded stock index options issued by The Options Clearing Corporation (OCC), a clearing agency registered under Section 17A of the Exchange Act. The Fund requested that OCC be treated as a securities depository for purposes of Rule 17f-4.[28] The requesting Fund explained that such options were issued after the execution of a trade between two participating exchange-member brokers, or "Clearing Members," one of which represents the purchaser and the other the seller, or writer. Each Clearing Member reports the trade to the exchange on which it occurred and issues a confirmation thereof to its respective customer. Upon exercise of a stock index option, OCC becomes obligated to pay the cash settlement amount by issuing a credit to the account of the exercising party's Clearing Member. The requesting Fund stated that OCC's bylaws: (1) permit only registered broker-dealers to become Clearing Members, and OCC could issue options only to Clearing Members; and (2) deem OCC to be the issuer of all exchange-traded options and require that OCC remain the ultimate obligor with respect to payment of the cash settlement amount upon exercise. Thus, the requesting Fund stated, because OCC is the issuer, the Fund's purchase of an option does not contravene Section 12(d)(3) of the ICA.

Without analysis, the Commission's Staff agreed that it would not recommend any enforcement action under Section 17(f) of the ICA or the rules thereunder if the Fund's bank custodian maintained the stock index put options owned by the Fund at OCC. Implicitly, the Staff accepted that OCC was the issuer of the options instead of any individual Clearing Member broker-dealer (or the broker-dealer's client) because the Staff did not disagree with the Fund's Section 12(d)(3) analysis.

Specific ICA Provisions Implicated by Mutual Funds' Use of CDSs

A Fund's use of CDSs raises a number of interesting issues under the ICA and rules promulgated thereunder.

Issuer Diversification

Pursuant to the ICA, a diversified Fund is required to identify the issuers of its portfolio holdings for purposes of calculating whether it meets the 75/25 diversification test of Section 5(b)(1).[29] For a CDS, it is appropriate to use the market value of a CDS instead of its notional amount.[30]

From a Fund's perspective, identifying the issuer of a CDS follows the general rule described above; namely, the nominal issuer of a security is deemed to be the issuer of the security. This means that, with respect to any particular CDS, the counterparty to the contract, for example, the counterparty bank or a broker-dealer, should be deemed to be the issuer of the CDS.[31]

Section 5(b)(1) applies to the (gross) value of a Fund's total assets. Consistent with Section 2(a)(41)(B) of the ICA, which defines "value," the term "value" in Section 5(b)(1) logically means market value. In addition, because Section 5(b)(1) applies to the total assets of a Fund, liabilities would not be deducted from the value of the Fund's assets when testing for compliance with Section 5(b)(1). Thus, the test would exclude any CDSs having a market value of zero or less.[32]

For purposes of compliance with Section 5(b)(1), a Fund could net the value of any CDSs that exactly offset each other (that is, a CDS based on the same reference entity with the same counterparty, but with the buyer-seller roles reversed). Thus, the effect of a Fund holding an offsetting CDS with a negative market value would be to reduce the value (and percentage) of the Fund's assets that are represented by securities of the counterparty.

Industry Concentration

Section 8(b)(1) of the ICA requires a Fund's registration statement to disclose the Fund's policies with respect to concentration. The Commission takes the position that investment of more than 25 percent of a Fund's total assets in a single industry represents concentration.[33]

While the ICA guidance does not discuss the appropriate treatment by a Fund of CDSs for concentration purposes, it would be reasonable, in light of the purpose of Section 8(b)(1)—to highlight concentrated economic exposure to an industry—and the Commission's general guidance concerning disclosure of Fund concentration, for the Fund to "look through" a CDS to the reference entity.[34] For a CDS, the Fund would disregard the contract's counterparty and, instead, look to the industry or industries of the CDS's reference entity.[35]

Securities Issued by Entities Engaged in a Securities-Related Business

Section 12(d)(3) of the ICA prohibits a Fund and any company controlled by such Fund from "acquiring any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, an investment adviser to a registered investment company, or a registered investment adviser." Because a Fund's counterparty to a CDS may be a broker-dealer or underwriter, a Fund must monitor its CDSs to avoid violating Section 12(d)(3).

Rule 12d3-1 contains two exemptions from this statutory prohibition. Rule 12d3-1(a) provides a blanket exemption for a Fund's acquisitions of securities of an issuer that derives 15 percent or less of its gross revenues from "securities related activities,"[36] unless the acquiring Fund would control the issuer after the acquisition.

Rule 12d3-1(b) provides a conditional exemption for a Fund's acquisitions of securities of an issuer that derives more than 15 percent of its gross revenues from securities related activities, provided that the acquiring Fund meets each of the following three conditions immediately after any such acquisition:

1. For an equity security,[37] the Fund does not own more than 5 percent of that class of the issuer's equity securities;
2. For a debt security,[38] the Fund does not own more than 10 percent of the outstanding principal amount of all classes of the issuer's debt securities; and
3. Regardless of whether the Fund acquires an issuer's equity security or a debt security, the Fund does not have more than five percent of the value of its total assets invested in securities of that issuer.

From a Fund's perspective, identifying the issuer of a CDS follows the general rule described above; namely, the nominal issuer of a security is deemed to be the issuer of the security. This means that, with respect to any particular CDS, the counterparty to the contract, for example, the counterparty bank or a broker-dealer, should be deemed to be the issuer of the CDS.[39]

NOTES

1. James Cullen, "Soros wants to ban credit default swaps. Is he blaming a cause or a symptom?," *Daily Finance*, June 18, 2009, *http://www.dailyfinance.com/2009/06/18/soros-wants-to-ban-credit-default-swaps-is-he-blaming-a-cause-o/* (last visited Oct. 8, 2009).

2. For an example of such a discussion, *see* Nick Paumgarten, "Wiz Bucks," *The New Yorker,* Sept. 29, 2008, available at *http://www.newyorker.com/talk/2008/09/29/080929ta_talk_paumgarten* (last visited Oct. 8, 2009) (CDSs are "one of several inventions that may sink this city, and maybe the country, into a new era of penury and thrift, if not downright depression"); Floyd Norris, "Out of the Shadows and Into the Harsh Light," *N.Y. Times*, Sept. 27, 2008, at C3, available at *http://www.nytimes.com/2008/09/27/business/27charts.html* (last visited Oct. 8, 2009).

3. *See, e.g.*, René Stulz, "Financial Derivatives: Lessons from the Subprime Crisis," 11 *Milken Inst. Rev*. 58 (2009).

4. 15 U.S.C. §§ 80a−1 *et seq*. This article does not address the tax treatment of credit default swaps.

5. For a CDS that specifies physical settlement, following the occurrence of the credit event, the protection buyer delivers the reference instrument with a face value equal to the notional amount specified in the CDS to the protection seller, who pays the face value to the protection buyer. The introduction of multi-issuer index CDSs expanded the CDS market, and has pushed the industry to cash settlement of CDSs. Specifically, upon the occurrence of a credit event under a cash-settled CDS, an auction of the credit-event debt instrument is held in order to determine the market value of the instrument. Thereafter, the protection seller pays the buyer the difference between the par value, which is equal to the CDS notional amount, and the post-default market value determined at the auction.

6. Gillian Tett, Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe, 46-47 (2009). CDSs were first used by banks because a CDS moved the risk of a bank borrower defaulting from the bank to the CDS's counterparty. As a result, the bank is able to reduce its required capital reserve.

7. *See* ISDA Market Survey, Notional amounts outstanding at year-end, all surveyed contracts, 1987-present, 2007, *http://www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf* (last visited Oct. 8, 2009). In July 2002, a spokesman for Standard & Poor's (S&P) reported that, during the first half of 2002, the number of CDSs reviewed by S&P had increased by approximately 50 percent compared to the first half of 2001. "S&P: Credit-Default Swaps Gain Market Acceptance," July 18, 2009, *http://www.thefreelibrary.com/S&P:Credit-Default+Swaps+Gain+Market+Acceptance-a089231712* (last visited Oct. 8, 2009).

8. "S&P: Credit-Default Swaps Gain Market Acceptance," *supra* n.7. Collateralized debt obligations (CDOs) are special purpose vehicles, usually organized as trusts, that issue debt and use the proceeds to purchase interests in so-called structured products (*e.g*., an interest in a pool of residential mortgage-backed securities). The problems that American International Group, Inc. (AIG) encountered arose from the CDSs for which AIG acted as protection seller. The CDOs that AIG protected contained mostly subprime mortgage-backed securities that plunged in value. *See* Maurna Desmond, "AIG. CDOs. CDS. It's A Mess," *Forbes,* Nov. 15, 2008, *http://www.forbes.com/2008/11/15/aig-credit-default-markets-equity-cx_md_1110markets24.html* (last visited Oct. 8, 2009).

9. *See Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps,* Rel. No. 34-59246 n.12 (Jan. 14, 2009).

10. *Id.*

11. ISDA reported that the total notional amount outstanding of CDSs dropped from $62 trillion to approximately $55 trillion during the first six months of 2008. *See* ISDA Research Notes, The ISDA Market Survey: What the results show and what they don't show, 2008, *http://www.isda.org/researchnotes/pdf/researchnotes-Autumn2008.pdf* (last visited Oct. 8, 2009). The Bank for International Settlements reported that the total notional amount outstanding of CDSs was approximately $57 trillion in June 2008, but dropped to $42 trillion by the end of 2008. *See* BIS Quarterly Review, Statistical Annex A103, June 2009, *http://www.bis.org/publ/qtrpdf/r_qa0906.pdf* (last visited Oct. 8, 2009). The Depository Trust and Clearing Corporation (DTCC), which arguably does a better job of estimating CDS data by not double counting the same parties to a CDS, reported that the total notional amount outstanding of CDSs was approximately $34 trillion on October 31, 2008 and $26 trillion by October 2, 2009. *See* DTCC Deriv/SERV, Trade Information Warehouse Data (Section I), *http://www.dtcc.com/products/derivserv/data_table_i.php* (last visited Oct. 8, 2009).

12. *See* ICE Trust, ICE Trust Frequently Asked Questions 5, *https://www.theice.com/publicdocs/clear_us/ICE_Trust_FAQ.pdf* (last visited Oct. 8, 2009).

13. App. E., Pub. L. No. 106-554, 114 Stat. 2763.

14. 15 U.S.C. § 77a *et seq.*

15. 15 U.S.C. § 78a *et seq*.

16. The CFMA added Section 2A to the Securities Act, and Section 3A to the Exchange Act. These new sections specify that (1) non-security-based swap agreements and (2) security-based swap agreements between "eligible contract participants" (as defined in Section 1a(12) of the Commodity Exchange Act) are not securities for purposes of the Securities Act and the Exchange Act, respectively. The CFMA defines a security-based swap agreement as a type of swap agreement "of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein." CFMA § 301. The term "eligible contract participants" includes investment companies. *See* Commodity Exchange Act § 1a(12)(A)(iii). The CFMA did *not* make any comparable or similar amendments to the ICA.

17. With respect to the applicability of the Exchange Act's antifraud provisions to CDSs, *see* Part II of this article, which will appear in an upcoming issue of *The Investment Lawyer*.

18. If a counterparty becomes financially distressed, the source for any credit protection for the Fund will be the Master Agreement, not the trade confirmation. Therefore, a first and crucial step is for a Fund adviser to ensure the Fund has signed Master Agreements with all trading counterparties.

19. The indices are produced by Markit Group Limited. *See* Markit, *http://www.markit.com/en/products/data/indices/credit-and-loan-indices/cdx/cdx.page* (last visited Oct. 8, 2009).

20. The protection purchased by the Fund is only as good as the credit quality of the protection seller and, for this reason, an adviser should evaluate the creditworthiness of proposed CDS counterparties to establish a list of approved counterparties and the aggregate exposure that any one Fund, and Funds within the same complex, have to the counterparty. The adviser should monitor each approved counterparty for any changes in the counterparty's creditworthiness. As part of the Fund board's oversight responsibilities, the adviser should report to the board periodically on any changes to the list of approved counterparties and changes to the aggregate exposure to each counterparty.

21. *See* n.16, *supra*.

22. A CDS resembles a put option, and puts and options are among the instruments expressly identified as securities by Section 2(a)(36). A CDS also resembles a standby commitment, which is a delayed-delivery agreement in which a buyer contractually binds itself to accept delivery of a security at a predetermined price, upon the exercise of the right of the other party to the agreement to so deliver, at a stated future date. The Commission has stated that it "believes that the standby commitment agreement involves, in economic reality, the issuance and sale by the investment company of a 'put.'" *Securities Trading Practices of Registered Investment Companies*, Rel. No. IC-10666 (Apr. 18, 1979). The Commission was expressing its views on evidences of indebtedness under the senior security provisions of Section 18(f) of the ICA, and not Section 2(a)(36). A CDS also resembles an "evidence of indebtedness" for purposes of Section 2(a)(36).

23. The individual statutes comprising the federal securities laws contain separate definitions of "security," and the scope of these definitions is not necessarily identical. The courts and the Commission have confirmed that the distinct regulatory purposes of these statutes must be taken into account in applying their definitional provisions, because the reach of the "security" definition depends upon its context. *See* Bank of America Canada, SEC No-Action Letter (pub. avail. July 25, 1983), *citing* Marine Bank v. Weaver, 455 U.S. 551, 558-559 (1982) (rejecting the Securities Act and Exchange Act's definition of "security" with respect to a certificate of deposit because "the context otherwise require[d]").

24. Section 2(a)(22) of the ICA provides that an "issuer" of a security is a "person who issues or proposes to issue any security, or has outstanding any security which it has issued."

25. SEC No-Action Letter (pub. avail. May 16, 1977). *See also* Dreyfus Capital Growth Fund, SEC No-Action Letter (pub. avail. Sept. 16, 1992).

26. *See* Pennsylvania Tax Free Income Trust, SEC No-Action Letter (pub. avail. Mar. 4, 1977); *Certain Matters Concerning Investment Companies Investing in Tax-Exempt Securities*, Rel. No. IC-9785 (May 31, 1977) (the issuer is determined by which entity's assets and revenues back the security).

27. SEC No-Action Letter (pub. avail. Feb. 27, 1984).

28. The requesting Fund stated that Rule 17f-1 under the ICA would require the physical segregation and the marking of securities certificates (as property of the Fund), as well as periodic actual inspection by auditors, of all securities maintained by the Fund directly in the custody of a member of a national securities exchange such as a Clearing Member. However, because the stock index put options were uncertificated and, thus, could not be physically segregated, marked or inspected, the Fund could not maintain them in compliance with Rule 17f-1.

29. To be deemed a diversified Fund, no more than 25 percent of the Fund's total assets may consist of: (i) securities of an issuer representing more than 5 percent of the total assets of the Fund, plus (ii) securities of an issuer of which the Fund owns more than 10 percent of that issuer's voting securities. *See* ICA Section 5(b)(1).

30. The use of market value instead of notional amount is discussed *infra*.

31. The implications of deeming a central clearing corporation to be the issuer of a CDS, following Institutional Equity Fund, *supra* n.27, is discussed *infra*.

32. The Fund's Rule 38a-1 written policies and procedures should reflect the issuer-diversification testing methodology described here.

33. *See Registration Form Used by Open-End Management Investment Companies*, Rel. No. IC-23064 (Mar. 13, 1998) (1998 Form N-1A amendments). The ICA does not specify the meaning of an "industry" for the purpose of a Fund's concentration policy. However, the Staff has stated its view in Guide 19 to Form N-1A, which states that a registrant:

> may select its own industry classifications, but such classifications must be reasonable and should not be so broad that the primary economic characteristics of the companies in a single class are materially different. Registrants selecting their own industry classifications must be reasonable and should disclose them . . . .

Guidelines to Form N-1A, Guide 19 (1983).

34. *See* Guide 19, *supra* n.33. The underlying purpose of Section 8(b)(1) and the Commission's permissive guidance support departing from the general rule, which is that the nominal issuer of a security is deemed to be the issuer of the security.

35. The Fund's mandated disclosure of its concentration policy should disclose this practice, and the Fund's Rule 38a-1 written policies and procedures should reflect the concentration testing methodology described here.

36. Rule 12d3-1(d)(1) provides that "'securities related activities' are a person's activities as a broker, a dealer, an underwriter, [or a registered] investment adviser."

37. Rule 12d3-1(d)(3) provides that an "equity security" has the same meaning accorded to that term by Rule 3a11-1 under the Exchange Act.

38. Rule 12d3-1(d)(4) provides that a "debt security" includes all securities other than an equity security and, therefore, would include CDSs.

39. The implications of deeming a central clearing corporation to be the issuer of a CDS following Institutional Equity Fund, *supra* n.27, is discussed *infra*.

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