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Mutual Funds' Use of Credit Default Swaps—PART II

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In Part I of this article, which appeared in the December 2009 issue of *The Investment Lawyer*, the authors focused on what mutual fund practitioners should know about credit default swaps (CDSs). Part I provided a brief description of how a CDS is intended to work, along with a brief history of CDSs' genesis. Part I then described the economic rationale for a registered open-end investments company's (Fund) use of a CDS and, at greater length, examined the principal issues that are implicated by a Fund's CDS use under the Investment Company Act of 1940 (ICA), except the senior security issues that arise under Section 18 of the ICA in connection with a Fund's use of CDSs. Here, in Part II, the authors examine the senior security issues and discuss ICA valuation issues. Finally, the authors discuss the effect that the recent economic crisis is likely to have on Funds' prospective use of CDSs.

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Specific ICA Provisions Implicated by Funds' Use of CDSs

Senior Security Concerns

Section 18 of the ICA is designed to diminish the leveraging effects that excessive borrowing or the issuance of "senior securities" may have on the investments of a Fund's senior and junior security holders.[1] Other than certain permitted bank borrowings, Section 18(f) of the ICA prohibits a Fund from issuing any "senior security." Section 18(g) defines "senior security" to include "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness, and any such stock of a class having priority over any other class as to distributions of assets or payment of dividends."

A derivative has been defined as "an instrument whose value is based upon, or derived from, some underlying index, reference rate (for example, interest rates or currency exchange rates), security, commodity, or other asset."[2] A CDS is a derivative. Most, but not all, derivatives create leverage for a Fund because they create an obligation, or indebtedness, to someone other than the Fund's shareholders and enable the Fund to participate in gains and losses on an amount that exceeds its initial investment.[3] Other derivatives create leverage because they display heightened price sensitivity to market fluctuations, such as changes in stock prices or interest rates.[4]

The Securities and Exchange Commission (Commission) and its Staff interpret Section 18(g)'s definition of senior security to encompass instruments, such as derivatives, that create the same type of risk for a Fund as the other instruments enumerated in Section 18(g). In its 1979 interpretive release (Release 10666),[5] the Commission interpreted Section 18 broadly and stated that trading practices used by Funds to "accomplish leveraging fall within the legislative purposes of Section 18" because these trading practices pose a risk of loss to Funds "analogous to the danger caused by leverage." Release 10666 specifically discussed the treatment of reverse repurchase agreements, firm commitment and standby commitment agreements; however, it stated that "if an investment company were to issue a security which affected its capital structure in a manner analogous to the agreements discussed [in Release 10666], and barring other material differences, the Commission believes it would view that transaction from a similar analytical posture."

When a Fund is a protection seller under a CDS, without investing any cash, the Fund receives periodic payments from the protection buyer. In return, if a credit event occurs, the Fund is obligated to purchase the protected debt instrument at a fixed price, and thereby participates in losses on the full value of the instrument. Thus, protection selling is a form of leverage.[6] Alternatively, if the Fund is a protection buyer, it becomes indebted to the protection seller to make periodic payments that are typically a small percentage of the notional amount of the CDS. As a result, the Fund receives the notional amount under the CDS if a credit event occurs with respect

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to the protected debt instrument. The Fund achieves the right to a return that exceeds the investment that the Fund made[7] and, accordingly, protection buying is a form of leverage.

Accordingly, in addition to the instruments enumerated in Release 10666, it is reasonable to conclude that the Commission would deem a CDS to be a senior security for purposes of Section 18(g) and, therefore, subject to the Section 18(f) senior security prohibition.

Avoiding the Creation of a Senior Security

The Commission and Staff pronouncements permit a Fund to avoid the problem by maintaining liquid assets to "cover" the Fund's obligations[8] to prevent derivatives from being characterized as "senior securities" and violating Section 18(f) of the ICA. Any Fund asset, including equity securities and debt obligations of any grade, may serve as cover by being placed in a segregated account or earmarked on the Fund's books to cover these obligations, provided such assets are liquid[9] and marked-to-market daily. If a Fund covers its leveraged positions by segregating or earmarking assets, there is no senior security.[10]

Alternatively, instead of segregating assets, a Fund may cover its leveraged positions by maintaining an equivalent offsetting position. For example, a Fund that is party to a CDS may cover its leveraged position by entering into an offsetting CDS based on the same reference entity with the same counterparty, but with the buyer-seller roles reversed. If a Fund covers a leveraged position by holding an offsetting position, there is no senior security.

How to Measure Cover: Market Value or Notional Amount?

Certain derivatives, including, but not limited to, index futures and Eurodollar contracts, have contractual terms that require "cash settlement." Such contracts are marked-to-market daily and, thereby, these contracts' gains and losses are settled daily. These contracts can be thought of as a series of one-day contracts, where the maximum exposure is the change in the value of the contract between mark-to-market settlements. Thus, the risk of loss—the amount of leverage—on these contracts is more accurately represented by the Fund's daily net obligation, rather than the full notional amount of the contract.[11] Arguably, the daily net obligation is the value that should be covered.[12] However, only recently has the Commission Staff seemed to accept this position with respect to cash-settled futures contracts.[13]

This reasoning is consistent with the underlying rationale for segregating assets in connection with leveraged transactions because the Fund segregates its obligations under these cash-settled contracts (that is, the daily net obligation). Accordingly, for derivative contracts that require daily mark-to-market payments, it is reasonable for a Fund to segregate liquid assets in an amount equal to the Fund's daily net obligation, as opposed to the full notional amount of the cash-settled contract.

While the Commission has not formally extended this reasoning to OTC derivatives, the same logic should apply to derivatives that are not required by their terms to mark-to-market, such as CDSs. That is, consistent with Release 10666, the calculation of a Fund's cover obligation should be based on the CDS's market value (for example,the cost to the Fund to unwind the CDS, enter into an offsetting CDS, or pay a third-party to relieve the Fund of its obligation).

Valuation

Compliance with each of the ICA issues discussed above involves satisfying an asset-based test. Each test requires the Fund to value the CDSs to which it is a party. Valuation or pricing data for CDSs may be obtained from dealer quotations and from pricing services. To determine the value of a CDS in a manner consistent with Section 2(a)(41) of the ICA, and to calculate that Fund's net asset value in a manner consistent with Rule 2a-4, on any given day, the Fund should deem the quotations and pricing service data as readily available market quotations that reflect current market values.[14] In effect, the valuation issues raised in connection with CDSs are not substantively different from valuation issues raised for other OTC instruments.

Thus, in relying on dealer quotations or pricing service data,[15] the accuracy of the quotations should be tested periodically to test their reliability. Pursuant to written pricing procedures, a Fund's board should review and consider annually the continued use of particular dealers' quotations or pricing services' data used to calculate the value of the Fund's CDSs, including the methodology used, to test reliability.

Recent Developments Concerning CDSs

Suit Brought by Commission under Rule 10b-5

The Commission recently filed an insider trading suit that should provide guidance regarding the status of CDSs under the antifraud provisions of the federal securities laws.

On May 5, 2009, the Commission filed a civil action in the United States District Court for the Southern District of New York against a bond and CDS salesman at Deutsche Bank Securities Inc. and a trader at Millennium Partners, L.P., a hedge fund investment adviser.[16] The Commission alleged that the defendant salesman misappropriated and tipped the defendant trader to material, non-public information about a bond issuance by VNU N.V. (VNU). According to the Commission, the defendants expected that the inside information, once known publicly, would drive an increase in the price of CDSs referencing a specific bond issued by VNU. The trader's CDSs transactions based on the inside information resulted in profits of $1.2 million to the hedge fund.

The defendants each filed a motion for judgment on the pleadings asserting, among other things, that the Commission lacks jurisdiction over the CDSs.[17] Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) gives the Commission antifraud authority with respect to "security-based swap agreements," as defined in Section 206B of the Gramm-Leach-Bliley Act, as amended,[18] (GLBA). The defendants asserted that the CDSs referencing the VNU bonds were not security-based swap agreements, which GLBA Section 206B defines as any swap agreement "of which a material term is based on the price, yield, value, or volatility of any security or . . . any interest therein." Focusing on the credit events specified in the CDSs, both defendants argued that no material term of the CDSs was based on the "price, yield, value or volatility" of the VNU bonds, as required by the GLBA definition and incorporated by Exchange Act Section 10(b).[19]

The Commission's September 25, 2009, memorandum of law[20] (Memorandum), filed in response to the defendants' motions, rejected the defendants' interpretation of security-based swap agreements. The Memorandum stated that the "Defendants cherry pick certain terms of the standard-form [ISDA documentation], and claim there is no term derived by reference to the price, yield, value or volatility of the VNU bond." In particular, the Memorandum argued, a CDS's price (that is, the amount paid for protection) is "derived from and closely related to the equivalent spread of the bond's yield in the cash market."[21] Therefore, the price of the CDSs in question was, in fact, "based on" the price, yield, value, and/or volatility of a security.

Regardless of the lawsuit's outcome, a decision will provide guidance on whether Rule 10b-5 under the Exchange Act applies to CDSs.

The Advent of a Clearing Corporation for CDSs

In January 2009, the Commission adopted interim rules to permit a clearing agency, acting as a central counterparty (CCP), to operate without registration as a clearing agency under Section 17A of the Exchange Act.[22] The Commission stated that the interim rules were designed to address regulators' concerns that the OTC market posed a systemic risk due to the possibility that counterparties to CDSs would be unable to meet their obligations.[23]

A CCP acts as a central counterparty in CDSs entered into by its members, and clears and settles CDSs. OTC CDSs are bilateral, and each party remains exposed to the risk

that the other party will not perform under the CDS. In contrast, with a CCP in place, both parties to a CDS novate their trades to the CCP, and the CCP stands in as the counterparty to each of the parties of the CDS cleared by the CCP.

Through the novation process, the counterparty risk of each CDS resides in the CCP. The CCP is backed by the combined credit of the CCP's members, which reduces the risk of non-payment if a single CCP member-counterparty defaults on a CDS. The CCP also enhances market transparency by providing a central location for regulators to view traders' positions and prices.

In September 2009, the Commission extended the pendency of the January interim rules from September 25, 2009, to November 30, 2010.[24] The Commission noted that following the January 2009 release of the interim rules, only one CCP, ICE Trust U.S. LLC (ICE Trust), had cleared and settled CDSs.[25] In a press release dated September 3, 2009, ICE Trust reported that, since beginning operations in March 2009, it had cleared CDSs with a notional amount of $1.9 trillion.[26] Other entities are reported to be developing CCPs for CDSs, including the Chicago Mercantile Exchange and, in Europe, Eurex Clearing AG.[27]

Separately, in August 2009, the Obama Administration sent a bill to Congress containing its proposed "Over-the-Counter Derivatives Markets Act of 2009." Among other things, the proposed legislation would require that certain swaps be defined as "standardized," exchange traded and centrally cleared.[28]

The creation of a clearing corporation for CDSs would benefit Funds that employ CDSs as part of their investment strategy. Most important, the advent of a clearing corporation for CDSs would diminish a Fund's counterparty risk. If a clearing corporation had existed at the time of Lehman's bankruptcy, Funds that were owed amounts by Lehman under CDSs would have avoided their losses.

Compliance with provisions of the ICA by Funds that utilize CDSs would become easier if there were a clearing corporation for CDSs. Following the *Institutional Equity Fund* letter,[29] described in Part I of this article, it is likely that a Fund could deem the clearing corporation to be the issuer of a CDS. Therefore, a diversified Fund that already has CDS assets or other derivative assets through swap contracts with a bank or CDS dealer would have greater flexibility in avoiding a violation of Section 5(b)(1) with respect to its CDS and derivative transactions with that bank or dealer.

Similarly, for a Fund with exposure to an issuer that derives more than 15 percent of its gross revenues from securities-related activities, the advent of a clearing corporation for CDSs would provide the Fund with greater flexibility to satisfy the requirements of Rule 12d3-1(b). As a result, the Fund should find it easier to avoid violating ICA Section 12(d)(3) with respect to that issuer.

Conclusion

CDSs have been used successfully by Funds for a number of years. In addition to hedging, Funds utilize CDSs to seek incremental returns by buying or selling credit protection when the total return profile of buying or selling protection on a bond of the reference entity is more favorable than transacting directly in a comparable bond of the same issuer. In addition, CDSs permit a Fund to obtain synthetic exposure to a reference entity when direct exposure in the cash market is deemed less desirable or is impracticable.

The use of CDSs raises a number of challenging compliance issues under the ICA, including Section 5(b)(1) diversification, Section 8(b)(1) concentration, Section 12(d)(3) investments in securities-related issuers, Section 18(f) senior securities and, of course, valuation. While the Commission and its Staff have not provided formal guidance with respect to each of these issues, this article prescribes reasonable approaches.

Finally, as a result of the credit crisis, the creation of one or more CDS clearing corporations appears imminent. In addition to reducing systemic risk for the economy generally, a CDS clearing corporation should reduce the compliance burden faced by Funds that utilize CDSs.

Notes

1. *See* ICA §§ 1(b)(3) and 1(b)(7).

2. Mutual Fund Use of Derivatives 4, 1994 SEC No-Act. LEXIS 952 (Sept. 26, 1994) [hereinafter *Mutual Fund Use of Derivatives*]. The term "derivative" encompasses forward contracts, futures, swaps, and options.

3. Purchased call options are an example of a derivative that does not have the effect of leveraging a Fund.

4. *Mutual Fund Use of Derivatives*, *supra* n.2, at 58.

5. *See Securities Trading Practices of Registered Investment Companies*, Rel. No. IC-10666 (April 18, 1979). *See also-Guidelines for the Preparation of Form N-8B-1*, Rel. No. IC-7221 (June 9, 1972) (Funds avoid senior security problem with respect to short sales and written options if these positions are covered with an offsetting position or with segregated cash, US government securities or high-grade debt securities).

6. A protection seller is like the seller of a put option. *See Mutual Fund Use of Derivatives, supra* n.2, at 57.

7. A protection buyer is like the purchaser of a put option contract or like the purchaser of a futures contract (which makes an initial margin payment that is typically a small percentage of the contract price). *See id.*

8. *See* Release 10666, *supra* n.5; Merrill Lynch Asset Management L.P., SEC No-Action Letter (pub. avail. July 2, 1996). According to the Commission, a Fund's segregation or earmarking of liquid assets as cover serves the following purposes: (1) it places a practical limit on the amount of leverage that a Fund may undertake and on the potential increase in the speculative character of its shares; and (2) the cover assures the availability of adequate funds to meet the obligations arising from the transactions in which leverage is created. *See* Release 10666, *supra* n.5.

9. The Commission Staff considers "liquid" assets to be assets that can be disposed of within seven days in the ordinary course of business at approximately the amount at which the Fund has valued the assets. *See Revisions of Guidelines to Form N-1A*, Rel. No. IC-18612 (Mar. 12, 1992).

10. Liquid assets used as cover are not required to be maintained in a segregated account, and may be created simply by earmarking assets on the books of the custodian or even directly on the books of the Fund.

11. While the notional amount of the contract has been relied upon as the measure for determining a Fund's maximum exposure on a futures contract, notional amount has been widely recognized as a misleading measure of risk. Former Federal Reserve Board Chairman Alan Greenspan has observed that "notional values are not meaningful measures of the risks associated with derivatives." *See* Alan Greenspan, Fed. Reserve Bd. Chairman, "Financial Derivatives" (Mar. 19, 1999), available at *http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm* (last visited Oct. 8, 2009).

12. The Commission Staff formerly took the position that a Fund must cover the full notional amount of the Fund's leveraged positions. *See* Dreyfus Strategic Investing, SEC No-Action Letter (pub. avail. June 22, 1987). Under this interpretation, a Fund was required to segregate an amount that, when added to margin posted on those positions, would equal the current market value of the position. Market value of futures contracts, for this purpose, has been understood to mean their notional value. For example, one S&P 500 Index futures contract obligates the buyer to 250 units of the S&P 500 Index. When each unit is trading at $1,000, then a single futures contract is similar to investing $250,000 (250 x $1,000). The notional amount of the futures contract is $250,000.

13. *See, e.g.*, Schroder Capital Funds (Rule 497 filing, May 16, 2006); Nuveen Global Government Enhanced Income Fund (Form N-2 filing, Apr. 21, 2006).

14. With respect to pricing OTC instruments, the Commission stated:

> Quotations [for OTC securities] are available from various sources for most unlisted securities traded regularly in the over-the-counter market. . . . These quotations generally are in the form of inter-dealer bid and asked prices. Because of the availability of multiple sources, a company frequently has a greater number of options open to it in valuing securities traded in the over-the-counter market than it does in valuing listed securities. A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any of these policies is acceptable if consistently applied.

Accounting for Investment Securities by Registered Investment Companies, Rel. No. IC-6295, ASR Rel. No. 118 (Dec. 23, 1970).

15. *See, e.g.*, Guidelines to Form N-1A, Guide 28 (1983); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Investment Company Registrants, SEC No-Action Letter (pub. avail. Dec. 2, 1992).

16. Sec. & Exch. Comm'n v. Rorech, No. 09-CV-4329 (JGK) (S.D.N.Y. May 5, 2009).

17. *See* Memorandum in Support of Defendant Jon-Paul Rorech's Motion for Judgment on the Pleadings, Sec. & Exch. Comm'n v. Rorech, No. 09-CV-4329 (JGK) (S.D.N.Y. Aug. 13, 2009) [hereinafter Rorech's Memorandum]; Defendant Renato Negrin's Memorandum of Law in Support of His Rule 12(c) Motion for Judgment on the Pleadings, Sec. & Exch. Comm'n v. Rorech, No. 09-CV-4329 (JGK) (S.D.N.Y. Aug. 24, 2009) [hereinafter Negrin's Memorandum].

18. *See* Exchange Act § 10(b).

19. Rorech's Memorandum at 11-15; Negrin's Memorandum at 9-14.

20. Memorandum of Law in Opposition to Defendants' Motion for Judgment on the Pleadings, Sec. & Exch. Comm'n v. Rorech, No. 09-CV-4329 (JGK) (S.D.N.Y. Sept. 25, 2009).

21. *Id.* at 5.

22. *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 (Jan. 14, 2009).

23. *Id.* The Commission noted that, in November 2008, the President's Working Group on Financial Markets called for the creation of a CCP for CDSs and, in response, the Commission, the Federal Reserve Board and the Commodity Futures Trading Commission signed a Memorandum of Understanding that provided for consultation and information sharing on issues related to CCPs for CDSs.

24. *See Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps*, Rel. No. 34-60663 (Sept. 14, 2009) [hereinafter Release 60663].

25. As of August 6, 2009, ICE Trust clearing members were Bank of America, Barclays, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Merrill Lynch, Morgan Stanley, RBS and UBS. *See* ICE Trust U.S. LLC Clearing House for Credit Default Swaps, *https://www.theice.com/publicdocs/clear_us/ICE_Trust_Overview.pdf* (last visited Oct. 8, 2009). BNP Paribas joined in September. *See* Press Release, ICE Trust, "ICE CDS Clearing Reaches $2.2 Trillion and 24,000 Transactions Cleared to Date; ICE Trust Announces Addition of Newest Clearing Member; Global Buy-Side Solution on Track for October" (Sept. 3, 2009), *http://ir.theice.com/releasedetail.cfm?ReleaseID=406881* (last visited Oct. 8, 2009).

26. *See* ICE Trust Press Release, *supra* n.25.

27. *See* Release 60663, *supra* n.24.

28. *See* Press Release, "US Dept of the Treasury, Administration's Regulatory Reform Agenda Reaches New Milestone: Final Piece of Legislative Language Delivered to Capitol Hill" (Aug. 11, 2009), available at *http://www.treas.gov/press/releases/tg261.htm* (last visited Oct. 8, 2009). There have been other legislative initiatives related to regulating derivatives, including CDSs. *See* Release 60663, *supra* n.24, at n.17.

29. Institutional Equity Fund, SEC No-Action Letter (pub. avail. Feb, 27, 1984).

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