THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 44 No. 11 June 8, 2011

INVESTMENTS IN DERIVATIVES BY U.S. AND EUROPEAN MUTUAL FUNDS

U.S. regulation of mutual fund derivative activities is based on older SEC guidance not originally designed for derivatives. In Europe it is based on E.U. law specifically addressed to UCITS derivative investments, and is newer and more comprehensive. The authors discuss and contrast the two regimes with regard to a variety of issues, including limits on leverage, issuer diversification, and counterparty exposure limitations.

By Robert W. Helm, Douglas P. Dick, and Gared S. Schneberger *

Recent regulatory changes in the U.S. and Europe may affect the way that investment funds in each jurisdiction use derivatives. In the U.S., Title VII of the Dodd-Frank Act provides, for the first time, a comprehensive regulatory framework for the OTC derivatives markets. Dodd-Frank will require clearing and exchange trading for certain eligible OTC derivatives contracts, which should mitigate some of the valuation and counterparty risk issues currently encountered by U.S. mutual funds in using OTC derivatives. It remains to be seen how or if the implementation of Dodd-Frank will affect the way in which mutual funds use derivatives.

In Europe, new guidelines designed to harmonize the measure of risk presented by a fund's use of derivatives will accompany the implementation of the Undertakings for Collective Investments in Transferable Securities ("UCITS") IV Directive.[1] In light of the revised risk measurement methodologies set forth by these guidelines, funds may be forced to reevaluate their use of derivatives to ensure compliance with the UCITS Directive's risk limitations.

With an eye toward these developments, this article compares the permitted use of derivative instruments by U.S. mutual funds with similar practice by UCITS. We then turn to recent industry developments with respect to derivatives in the U.S. and Europe and briefly discuss the effect that these developments might have on the use of derivatives by investment funds in these jurisdictions. (Readers should note that for purposes of this article, other issues important to the use of derivatives by U.S. mutual funds have been omitted or only briefly mentioned herein because analogous issues do not arise under European law. Specifically, U.S. mutual funds investing in derivatives must address issues that arise under the Investment Company Act of 1940 ("1940 Act" or "Act") with respect to custody, under the Commodity Exchange Act ("CEA"), and under U.S. tax laws.)

[1] Council Directive 2009/65, 2009 O.J. (L302) 32 (EC).

* *ROBERT W. HELM and DOUGLAS P. DICK are partners in Dechert LLP's financial services group in Washington, D.C. Their e-mail addresses are robert.helm@dechert.com and douglas.dick@dechert.com.*

IN THIS ISSUE

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@hotmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

U.S. REGULATORY LANDSCAPE

U.S. mutual funds engaging in derivatives transactions do so under a regulatory framework designed for a less complicated investment environment. Over the years, the SEC has provided guidance concerning the application of the 1940 Act to various aspects of mutual fund derivatives activities as they have existed at a given point in time, but the evolution and usage of derivatives has outpaced existing regulatory guidance.[2]

Limits on Leverage and Asset Coverage Requirements

Among the various limitations on a fund's operations contained in the 1940 Act is the Section 18 prohibition on leverage. Section 18(f)(1) generally prohibits registered open-end investment companies from issuing "senior securities" other than bank borrowings. ICA Release No. 10666,[3] issued by the Commission in 1979, is the cornerstone of SEC guidance concerning the "senior security" prohibition. Release 10666 is notable for setting the bounds of this prohibition by reference to the underlying purposes of Section 18 rather than its literal terms. In Release 10666, the SEC noted that leveraging "without any significant limitation" was identified in the SEC's Investment Trust Study of 1939 as a major problem among mutual funds prior to passage of the 1940 Act. Reverse repurchase agreements, firm commitment agreements, and standby commitment agreements were each specifically addressed by the SEC in Release 10666, and all were found to fall "within the functional meaning of the term 'evidence of indebtedness' for purposes of Section 18 of the Act."[4] The Commission advised that this functional definition of evidence of indebtedness would include, at least for Section 18 purposes, "*all contractual obligations to pay in the future for consideration presently received.*"[5]

Prior to Release 10666, the SEC, in ICA Release No. 7221,[6] stated that a fund desiring to write put and call options should maintain a segregated account consisting of cash, U.S. government securities, or high-grade debt securities equal to the fluctuating market value of the optioned securities (for call options) or equal to the option price (for put options). In Release 10666, the Commission stated that segregated accounts, in which the fund "freezes" certain assets making them unavailable for sale, if properly created and maintained, would limit a fund's risk of loss from a leveraged transaction, and thereby serve "as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock."[7] In other words, maintenance of a segregated account may result in an agreement otherwise characterized as a senior security not being treated as such. Release 10666 required that segregated accounts consist of liquid assets, such as cash, U.S. government securities, and investment grade debt. In 1996, the SEC staff in *Merrill Lynch Asset Management, L.P.*, expanded the types of assets

[2] In addition to complying with the SEC regulatory regime, entities that engage in certain derivatives transactions, including futures and options on futures, are generally required to register with the CFTC pursuant to the CEA. The CFTC has by rule, however, exempted registered investment companies from registration as a commodity pool operator, subject to certain conditions, including the filing of a "notice of eligibility." 17 CFR § 4.5. Note, however, that the CFTC has recently proposed to amend the conditions under which registered investment companies would be exempt from registration as a commodity pool operator. *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Proposed Rule*, 76 Fed Reg. 7976 (Feb. 11, 2011) (to be codified at 17 C.F.R. Parts 4, 145, and 147).

[3] ICA Rel. No. 10666, 17 SEC Docket 319 (Apr. 18, 1979). For a more complete discussion of senior security issues and other 1940 Act requirements relevant to registered investment companies, *see* Susan C. Ervin, *Mutual Funds and Derivatives: Defining the Regulatory Boundaries* (pts. 1 & 2), 19 FUTURES & DERIVATIVES L. REP. No. 7 at 1 (1999), *id*. No. 8 at 15 (1999).

[4] Rel. No. 10666, *supra* note 3, at text accompanying note 14.

[5] *Id.,* at text accompanying note 18 (emphasis added).

[6] Guidelines for Preparing Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972).

[7] Rel. No. 10666, *supra* note 3.

that may be placed in segregated accounts to include liquid equities and debt securities of any grade.[8]

In *Dreyfus Strategic Investing*,[9] a 1987 no-action letter, the SEC's Division of Investment Management utilized the segregation concept to address the potential leverage created when a fund obtains exposure in excess of the amount of capital allocated to the transaction. In such cases, the objective is to segregate assets equal in value to the potential exposure to the fund created by the leveraged transaction. Specifically, the SEC staff noted that a fund may purchase a futures contract or forward contract or sell a put option if the fund segregates (not with a futures commission merchant or broker) cash or liquid assets equal to the purchase price of the contract or the strike price of the put, less any margin on deposit. With respect to sales of futures contracts, forward contracts and call options or short sales of securities, the staff in *Dreyfus* explained that a fund may comply with the segregation requirements and avoid Section 18(f) concerns by establishing a segregated account containing cash or liquid assets which, when added to margin deposits, equal the market value of the instruments underlying the relevant transaction, but not less than the strike price of the call option or the market price at which the short position or short sale was established.

Dreyfus also clarifies that covering a derivatives position with an offsetting position effectively eliminates the derivatives exposure and obviates the need to segregate assets to comply with the prohibition on senior securities contained in Section 18(f). The staff in *Dreyfus* noted, by way of example, that a fund that has purchased a futures or forward contract can cover that position by purchasing a put option on the same futures or forward contract with a strike price equal to or higher than the futures or forward contract price. *Dreyfus* also provided that a fund that has sold a put option could cover its position by selling short the instrument or currency underlying the put option at the same or a higher price than the strike price of the original put. In addition, *Dreyfus* permits funds selling call options, futures or forwards, or engaging in short sales of securities to cover these positions by holding the asset sold or its equivalent, or having the right to obtain the asset at a price no higher than the price at which it was sold or the strike price of the option the fund has written on that asset.

Prior to *Dreyfus*, the value of a fund's derivative transactions was effectively limited to one-third of its assets by virtue of the 300% asset coverage requirement imposed by Section 18(f). *Dreyfus* recognized, however, that the segregation requirements act in lieu of, rather than as an adjunct to, the 300% asset coverage requirements in eliminating senior security issues under Section 18(f). Furthermore, *Dreyfus* made clear that if a fund adequately covers a derivatives position, a fund may engage in derivatives transactions with respect to more than one-third of its assets.

Post-*Dreyfus*, funds engaging in certain types of derivatives transactions may cover such positions by holding the asset sold or its equivalent, or having the right to obtain the asset at a price no higher than the price at which it was sold or the strike price of the option it has written on that asset. In post-*Dreyfus* no-action letters, the SEC staff has permitted segregation of the current market value of securities sold short or optioned under a written call, without regard to the original price of the short sale or the strike price at which the options were written.[10]

Diversification Requirements and Concentration Limits

In addition to the leverage limitations contained in Section 18, the 1940 Act also limits the amount of securities of any one issuer that may be held by an investment company classified as a "diversified company."[11] A diversified fund must, with respect to at least 75% of the value of its total assets, limit its investment in the securities of any single issuer to (i) 5% of the value of the fund's total assets and (ii) 10% of the outstanding voting securities of the issuer.[12] Similar requirements arise under the Internal Revenue Code.[13]

[8] Merrill Lynch Asset Management, L.P., SEC No-Action Letter (pub. avail July 2, 1996).

[9] Dreyfus Strategic Investing, SEC No-Action Letter, (pub. avail. June 22, 1987).

[10] Robertson Stephens Investment Trust, SEC No-Action Letter (pub. avail. Aug. 24, 1995) (short sales of securities); Sanford C. Bernstein Fund, Incorporated, SEC No-Action Letter (pub. avail. June 25, 1990) (written call options).

[11] Section 5(b)(1) of the 1940 Act.

[12] As long as a diversified fund meets the 75% diversification test in Section 5(b)(1) of the 1940 Act, the fund is permitted to invest the remaining 25% of its total assets in a single issuer.

[13] The Code also imposes requirements with respect to a fund's source of income. Under Subchapter M's income test, a regulated investment company must derive at least 90% of its income in each taxable year from "securities." The Code does not, and the IRS has not in its guidance, set forth a definition of securities for this purpose. Accordingly, difficult questions arise with respect to whether certain types of derivative instruments, particularly those derivatives for which the

Defining the "issuer" of a derivative instrument for purposes of compliance with both the 1940 Act and the Code diversification provisions may be difficult. Unlike conventional debt or equity securities, some derivative instruments' performance may be affected by the performance of more than one entity (*e.g.*, that of the "selling" or dealing entity and that of an issuer, reference entity or instrument on which the derivative contract is based). Section 8 of the 1940 Act also requires a fund to disclose in its registration statement the fund's policy with respect to concentration in any industry. In this respect, a fund that does not concentrate in an industry may not invest more than 25% of its assets in any one industry. Funds are thus forced to consider whether both the counterparty to the derivative contract and/or the underlying reference entity may be viewed as issuers for purposes of compliance with the diversification and concentration requirements of the 1940 Act.[14]

Like the diversification requirements above, Section 12 of the 1940 Act provides for asset-based limitations on a fund's investments. Section 12(d)(3) generally bars a fund from investing in a security issued by, or any other interest in, a broker, dealer, underwriter or investment adviser if the investment would exceed 5% of the investment company's total assets, or the investment company would own more than 5% of the issuer's outstanding equity securities of a class, or more than 10% of the outstanding principal amount of the issuer's debt securities, unless the issuer did not derive more than 5% of its gross revenue from securities-related activities during its most recent fiscal year. As with complying with the diversification requirements described above, to ensure compliance with the prohibitions in Section 12(d)(3), a fund should consider whether the contract counterparty as well as the underlying reference entity may be considered an issuer.

Illiquid Investments

Section 22(e) of the 1940 Act requires that an open-end fund redeem its shares within seven days of tender, subject to limited exceptions. To foster compliance with Section 22(e), the SEC has stated that a fund should limit its investments in illiquid portfolio securities to 15% of its net assets.[15] An asset will be considered illiquid if a fund cannot, in the ordinary course of business, sell it within seven days at the approximate price at which the fund has valued the asset. The liquidity of a given derivative investment is generally a factual question to be addressed on a case-by-case basis. Facts relevant to a liquidity determination include contractual restrictions on transferability, the availability of market quotes from independent sources, and the ability to close out the contract or enter into an offsetting transaction.

Valuation

Mutual funds generally must value their assets daily. The Act provides, in general, that the appropriate value of securities for which market quotations are readily available is their market value and that the value of other securities and assets is their fair value, as determined in good faith by a fund's board of directors. The proper measure of market value in the case of exchange-traded futures or options thereon generally is their price as quoted on the relevant exchange, absent a market disturbance or other cause for questioning the validity of the quoted price. Valuation of OTC derivatives is by its nature more difficult given that such contracts are not traded on an exchange. In practice, many funds rely on dealer quotations and pricing service data to determine the value of an OTC derivative contract similar to the manner in which most funds determine the value of other OTC instruments.

UCITS REGULATORY LANDSCAPE

Unlike the 1940 Act, the UCITS regulatory regime in Europe contains provisions specifically applicable to a fund's investments in derivatives. This is at least partly due to the relative youth of the UCITS regulatory structure as compared to the regulatory structure surrounding U.S. mutual funds, as well as the efforts by the European Union to regularly update the regulatory scheme. The UCITS III Product Directive (the "Product Directive") was adopted in 2001 by the European Union with the goal of expanding the universe of eligible instruments in which a UCITS fund is permitted to invest.[16] In addition to the guidance set forth in the

footnote continued from previous page…

reference entity is not a traditional security or securities index, are securities for purposes of the Code and the income test thereunder.

[14] For a discussion of mutual funds' use of credit default swaps, including a discussion of identifying the issuer of a credit default swap, *see* Robert W. Helm, David M. Geffen, and Stephanie A. Capistron, *Mutual Funds' Use of Credit Default Swaps – Parts I & II*, THE INVESTMENT LAWYER, Vol. 16, No. 12 (Dec. 2009) and Vol. 17, No. 1 (Jan. 2010).

[15] ICA Rel. No. 18,612, 50 SEC Docket 1659 (Mar. 12, 1992).

[16] Council Directive 2001/108, 2002 O.J. (L 41) 35 (EC). The Directive may be accessed at a website maintained by the European Union and providing access to European law *at*: http://eur-lex.europa.eu/en/index.htm.

Product Directive, the European Commission published a set of recommendations to be taken into account by EU Member States when implementing the Product Directive (the "Recommendations").[17] The discussion below addresses guidance from both the Product Directive and the Recommendations.

OTC Derivative Eligibility Requirements

The Product Directive permits funds to invest in, *inter alia*, "financial derivative instruments" for general investment and/or hedging purposes.[18] For OTC derivatives, the Product Directive imposes additional requirements on a fund with respect to eligible counterparties, underlying instruments, liquidity, and risk monitoring. Specifically, UCITS are permitted to invest in OTC derivatives based on financial indices, interest rates, and foreign exchange rates or currencies in which the fund is permitted to invest.[19] Additionally, OTC derivatives are subject to certain counterparty eligibility requirements that in essence require that counterparties to OTC derivatives be credit institutions subject to prudential supervision by an appropriate regulator.[20] Finally, OTC derivatives must be subject to reliable and verifiable valuation on a daily basis that permits them to be sold, liquidated, or closed by the fund via an offsetting transaction at any time at the derivatives' fair value.[21]

Global Exposure / Leverage

The Product Directive states that a fund's exposure to derivatives is limited to the total net value of the fund's portfolio. The Directive notes that exposure should be calculated taking into account the value of the assets underlying the derivatives, counterparty risk, future market movements, and the time required to liquidate a position.[22] The Recommendations state that Member States should ensure that both market risk and leverage are accounted for in applying the exposure limit.[23] In this regard, the global exposure limitation is somewhat similar to the Section 18 prohibition discussed above with respect to U.S. mutual funds. The UCITS exposure limitation is designed to ensure that a fund's derivative investments will not result in future losses to the fund from market risk or leverage that exceed the current market value of the fund's portfolio. The Recommendations also suggest that Member States distinguish between sophisticated and non-sophisticated UCITS in measuring exposure.[24] As such, both Ireland and Luxembourg (the two preeminent jurisdictions for UCITS formation) provide for the calculation of global exposure in a different manner depending upon whether a UCITS classifies itself as sophisticated or non-sophisticated. In Luxembourg, non-sophisticated UCITS are required to use the commitment approach but may use a different approach with the approval of the *Commission de Surveillance du Secteur Financier* ("CSSF").[25] In Ireland, non-sophisticated UCITS are permitted to use either the commitment approach or an advanced risk metric approach, as discussed below.[26]

The Recommendations suggest that Member States advocate the use of the commitment approach by non-sophisticated UCITS for calculating market risk.[27] Under the commitment approach, the positions on derivative instruments are converted into equivalent positions in the underlying assets.[28] Such equivalent positions must be limited to no more than 100% of the fund's total net value in accordance with the Product Directive's limitation on exposure. This approach is meant to limit any future commitments to which the fund is obligated, ensuring that its future commitments do not exceed 100% of the total value of its portfolio. Each Member State's regulations generally provide calculation principles to value a UCITS' derivative

---

[17] Commission Recommendation 2004/383 2004 O.J. (L 144) 33 (EC). The Recommendations may be accessed at the same E.U. website as the Product Directive.

[18] Council Directive s*upra* note 16 at 36.

[19] Council Directive s*upra* note 16, Art. 1(5)(g) amending Art. 19(1) of the Directive.

[20] *Id.*

[21] *Id.*

[22] *Id.* Although the Recommendations use the term "sophisticated UCITS," the Recommendations do not define sophisticated UCITS. Regulators in both Ireland and Luxembourg have taken an approach that requires a fund to classify itself as either sophisticated or non-sophisticated based on the fund's risk profile. Regulators in both countries, however, require that a

footnote continued from previous column…

fund that makes extensive use of derivatives classify itself as a sophisticated UCITS. *Commission de Surveillance du Secteur Financier*, Circular 07/308 § III.1 at 6 (2004); *see also* Guidance Note 3/03, Financial Regulator, § 1.1 at 3 (2008).

[23] Commission Recommendation *supra* note 17 at 36.

[24] *Id.*

[25] CSSF Circular *supra* note 22 § III.1.2.1 at 7.

[26] Guidance Note *supra* note 22 § 1.1 at 4.

[27] Commission Recommendation *supra* note 17 at 36.

[28] *Id.*

investments under the commitment approach.[29] Depending upon the Member State and type of derivative, a UCITS may be required to take into account a derivative contracts' notional value, while at other times a UCITS may be able to account for a probability factor, or delta, in valuing the derivative contract for purposes of converting derivative instruments to equivalent underlying positions.[30]

With respect to sophisticated UCITS, the Recommendations suggest the use of a Value at Risk ("VaR") approach.[31] Under the more complicated VaR approach used in both Ireland and Luxembourg, a sophisticated UCITS must use an advanced risk measurement methodology to calculate global exposure.[32] The VaR approach is meant to estimate the maximum potential loss that a UCITS portfolio could suffer within a certain time horizon.[33] The Recommendations also suggest that Member States require stress tests to help manage risks related to abnormal market movements.[34] Both Luxembourg and Ireland permit a sophisticated UCITS to use either a relative VaR or an absolute VaR measurement.[35] Under the relative VaR approach, a UCITS' global exposure may not exceed twice that of a reference portfolio or benchmark similar to the fund that does not include derivatives.[36] Under the absolute VaR approach, a fund's VaR is capped as a percentage of the fund's net asset value ("NAV") (not to exceed 20% in Ireland and Luxembourg).[37]

Diversification, Concentration and Counterparty Requirements

In addition to exposure limits, the Product Directive also imposes a limit on issuer concentration similar to the diversification requirements imposed on U.S. mutual funds.[38] For the sake of comparison, we will refer to the Product Directive's issuer concentration limits as diversification limits. Unlike the regulatory regime in the U.S., the Recommendations make clear that a UCITS should look to the underlying reference instrument of a derivative contract in complying with the diversification limits.[39] Generally, the Product Directive imposes a limit of 5% of a UCITS' assets invested in one issuer; however, this limit may be increased to up to 10% with respect to 40% of a UCITS' assets if permitted by the home jurisdiction.[40] The Product Directive makes an exception for index-based derivatives such that UCITS are not required to take into account each index component for purposes of this calculation.[41] Additionally, the Product Directive requires that embedded derivatives be taken into account when calculating the issuer concentration limits.[42]

The Product Directive also limits counterparty risk exposure in connection with OTC derivative investments to 10% of a fund's assets with authorized credit institution credit parties.[43] OTC derivative transactions with a single counterparty other than an authorized credit institution are limited to 5% of a fund's assets.[44] The

[29] For example, in Luxembourg, a UCITS must use the notional amount of a total return swap contract in calculating the fund's exposure under the commitment approach. CSSF Circular *supra* note 22, Appendix I at 21. On the other hand, a UCITS domiciled in Ireland must use the positive market value of the underlying reference asset in a total return swap to calculate the fund's exposure under the commitment approach. Guidance Note 3/03 *supra* note 22, Appendix II at 26.

[30] CSSF Circular *supra* note 22 Appendix I at 20; Guidance Note *supra* note 22 § 1.3 at 5.

[31] Commission Recommendation *supra* note 17 at 37.

[32] CSSF Circular *supra* note 22 § III.1.3.1 at 8; Guidance Note *supra* note 22 § 1.1 at 4.

[33] *See, e.g.*, CSSF Circular *supra* note 22 § III.1.3.1 at 8. For example, if a UCITS has a 20-day 1% VaR of $1 million, there is a 1% probability that the value of the portfolio will fall by more than $1 million over the course of those 20 days.

[34] Commission Recommendation *supra* note 17 at 37.

[35] CSSF Circular *supra* note 22 § III.1.3.2 at 9; Guidance Note *supra* note 22 § 1.4 at 6.

[36] *Id.* Regulations in both Ireland and Luxembourg generally require the use of a 99% confidence level and 20-day holding period in a VaR model, although deviations from the confidence level and holding period are permitted with adequate justification to the regulator. As such, a fund would

footnote continued from previous column…

be required to ensure that the probability of the value of its portfolio falling by more than twice that of a reference portfolio over a 20-day period be 1%.

[37] *Id.* As noted above, the use of a 99% confidence level and 20-day holding period would result in a probability of 1% of a fund losing more than 20% of the fund's NAV over a 20-day holding period.

[38] Council Directive s*upra* note 16, Art. 22 replacing Art. 22 of the Directive.

[39] Commission Recommendation *supra* note 17 at 39.

[40] *Id.*

[41] Council Directive s*upra* note 16, Art. 21 replacing Art. 21 of the Directive.

[42] *Id.*

[43] *Id.*

[44] *Id.*

Recommendations suggest that in calculating the percentage limitations noted above, a fund use the maximum potential loss rather than the notional value of a derivatives contract.[45] The Recommendations also suggest that to the extent that Member States permit funds to cover transactions to eliminate risk, the collateral used to cover the contracts be marked to market and be subject to daily margin requirements.[46]

Netting

Regulations in both Ireland and Luxembourg permit funds to net positions to comply with the exposure and counterparty limitations discussed above.[47] In each jurisdiction, netting is permitted between not only purchased and sold positions on derivatives, but also between derivatives and other assets held by the fund.[48] In each case, the underlying reference asset must be the same asset against which the position will be netted (*i.e.*, in netting offsetting derivative positions, the underlying asset must be the same and in netting a derivative position and an asset held by the fund, the reference asset of the derivative must be the same asset as held by the fund).[49]

Risk Management Process

As required by the Product Directive, any UCITS investing in derivatives must have a risk management process or system that includes a process for providing an independent valuation of OTC derivatives.[50] The Recommendations suggest that Member States ensure that a risk management process be appropriately tailored to the risk profile of a particular UCITS fund.[51] In both Ireland and Luxembourg, the complexity of the risk management process may vary depending upon whether a fund is classified as sophisticated or non-sophisticated, and in turn, the extent of the fund's use of derivatives.[52] Regulations in both jurisdictions state that any fund that uses derivatives extensively or often uses complex derivatives should be classified as a sophisticated UCITS, and thus subject to a more rigorous risk management process.[53] Conversely, those funds that make limited use of simple derivatives need not have as rigorous a risk management process.[54] In any event, the Directive requires that the risk management process applicable to both sophisticated and non-sophisticated UCITS must define the types of derivatives to be used, the risks inherent in the use of such derivatives, and any limits on the fund's use of derivatives.[55]

Disclosure

In addition to the more specific risk limiting restrictions noted above, the Directive requires a UCITS' prospectus to include prominent disclosure describing the extent to which such UCITS uses derivatives (*e.g.,* hedging vs. investment purposes) and the effect of such use on the risk profile of the fund.[56]

COMPARISON OF REGIMES

As described above, the UCITS regulatory regime is relatively clear with respect to the use of derivatives, while the U.S. regulatory regime presents a substantially more opaque picture. Additionally, the UCITS framework is implemented by each individual member state, which at times results in differing regulatory requirements. The relative lack of clarity in U.S. regulatory guidance combined with European member state regulatory variance makes a comparison of the two regimes rather complicated, but there are at least a few areas worthy to highlight.

With respect to leverage, the U.S. regulatory regime imposes implicit limits on leverage via the Section 18(f) prohibition on senior securities, while the UCITS regime imposes a more explicit limit via the global exposure requirements. It is worth noting, however, that global exposure is a somewhat malleable concept, as it may be calculated in a number of different ways (*e.g.*, the commitment approach, relative VaR, or absolute VaR), each of which may produce differing results. As a result, even the UCITS regime's explicit leverage limit should not be viewed as a hard limitation on a UCITS' use of leverage.

---

[45] Commission Recommendation *supra* note 17 at 38.

[46] *Id.*

[47] CSSF Circular *supra* note 22 § III.2.3.2 at 12; Guidance Note *supra* note 22 § 1.5 at 8.

[48] *Id.*

[49] *Id.*

[50] Council Directive s*upra* note 16, Art. 21 replacing Art. 21 of the Directive.

[51] Commission Recommendation *supra* note 17 at 35.

[52] CSSF Circular *supra* note 22 § II.1 at 3-4; Guidance Note *supra* note 22 § 1.1 at 3.

[53] CSSF Circular *supra* note 22 § III.1.1 at 6; Guidance Note *supra* note 22 § 1.1 at 4.

[54] *Id.*

[55] Council Directive s*upra* note 16, Art. 21 replacing Art. 21 of the Directive.

[56] Council Directive s*upra* note 16, Art. 24a.

Each regime also imposes issuer diversification limits. As noted above, however, the determination of the identity of the issuer of a derivative instrument for the purpose of compliance with U.S. law is far from clear. On the other hand, under the UCITS regime, the Recommendations make clear that UCITS should look to the underlying reference instrument of a derivative contract in complying with the issuer diversification limits.

One notable area of divergence between the regimes is with respect to counterparty exposure limitations. The UCITS regulatory regime imposes strict counterparty risk exposure limits on UCITS, while the U.S. regulatory regime does not contain an explicit limitation on counterparty exposure. Note, however, that if a diversified U.S. mutual fund considers a counterparty to a derivative instrument to be an issuer of such instrument, then arguably the issuer diversification limits contained in Section 5 of the 1940 Act would limit a U.S. mutual fund's counterparty exposure, and the limitations of Section 12 of the 1940 Act (limiting a fund's investments in securities-related issuers) also may be implicated.

It is also worth noting that each regime has been relatively accommodating of the implementation of hedge fund-like strategies, which make substantial use of derivatives, by registered fund products. Following this trend, Europe has also seen a recent increase in the implementation of these strategies by UCITS (these hedge fund-like UCITS have been termed "newcits"). Many of these strategies make extensive use of derivative instruments while operating under the U.S. mutual fund or European UCITS regime, which speaks to the flexibility of each system.

RECENT DEVELOPMENTS

U.S. Developments

On March 25, 2010, the SEC announced that the Commission staff was conducting a review of the use of derivatives by, among others, mutual funds.[57] In the press release, SEC Chairman Mary Schapiro noted that "It's appropriate to engage in a more thorough review of the use of derivatives by ETFs and mutual funds given the questions surrounding the risks associated with the derivative instruments underlying many Funds."[58] The press release also notes that the staff is engaging in a general review of the use of derivatives by mutual funds in an effort to determine whether any changes to the existing regulatory regime and regulatory guidance may be warranted.[59] In a July 30, 2010 letter to the Investment Company Institute,[60] the SEC also expressed concern that mutual funds are not adequately describing the extent to which the funds may invest in derivatives, and the risks associated with such investments. The letter notes that the SEC's review of the use of derivatives by mutual funds is ongoing, but the letter is provided in order to "… give investment companies immediate guidance to provide investors with more understandable disclosures related to derivatives, including the risks associated with them."[61] The letter suggests that mutual funds consider the amount of economic exposure created by a fund's investment in derivatives and describe the purpose that derivatives are intended to serve in the portfolio.[62] Interestingly, these are both concepts that the UCITS regime explicitly requires a UCITS to disclose in its prospectus.

On July 6, 2010, the Task Force on Investment Company Use of Derivatives and Leverage of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association sent a copy of the report of the Task Force to the SEC's then-Director of the Division of Investment Management, Andrew J. Donohue.[63] The 49-page report includes a number of recommendations, including, but not limited to the following: (i) a principles-based approach to the regulation of derivatives and limits on leverage that includes rules and/or interpretive guidance to implement and facilitate those principles; (ii) an approach to the measurement of diversification by looking at reference assets, when applicable, with broad-based indices and commodities or currencies excluded; (iii) a recommendation that the SEC should regulate counterparty risk under Section 12(d)(3) of the 1940 Act, including with respect to

[57] Press Release, SEC Staff Evaluating the Use of Derivatives by Funds (Mar. 25, 2010) (*available at*: http://www.sec.gov/news/press/2010/2010-45.htm).

[58] *Id.*

[59] *Id.*

[60] Letter from Barry D. Miller, Associate Director, Office of Legal Disclosure, SEC, to Karrie McMillan, Esq., General Counsel, Investment Company Institute (July 30, 2010) (*available at*: http://www.sec.gov/divisions/investment/guidance/ici073010.pdf).

[61] *Id.*

[62] *Id.*

[63] *See Report of the Task Force on Investment Company Use of Derivatives and Leverage* (July 6, 2010) (*available at*: http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf).

counterparties that are not in a traditional securities-related business; and (iv) a recommendation that funds should enhance disclosure of how derivative instruments affect actual investment results.

European Developments

The Committee of European Securities Regulators ("CESR") recently proposed guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS.[64] CESR's proposed guidelines will harmonize the methodology used to calculate global exposure when using the commitment and VaR approach as described above.[65] As discussed, a fund's global exposure cannot exceed the fund's NAV. However, because of differing calculation methodologies among various Member States, there are differences in terms of leverage and market risk that a UCITS may assume. Accordingly, CESR's guidelines seek to harmonize the calculation methodology in order to eliminate these discrepancies. The guidelines are meant to accompany implementing measures for a revised UCITS directive ("UCITS IV"), which will take effect in July 2011.[66]

In February 2010, the UK Financial Services Minister, Paul Myners, stated that he was not in favor of requiring the trading of standardized derivatives on organized trading platforms.[67] Myners is, however, in favor of retaining authorization and supervision of central counterparties at the national level, rather than handing such powers over to the EU.[68] Myners' comments came in response to news that the European Commission plans to publish draft regulations on derivatives clearing. On September 15, 2010, the European Commission published draft regulations proposing that information on OTC derivative contracts be reported to trade repositories and be accessible to supervisory authorities.[69] The draft regulations also propose that OTC derivative contracts be cleared through central counterparties.[70] The draft regulations require approval from EU member states and the European Parliament before becoming law.

CONCLUSION

The U.S. regulatory regime surrounding the use of derivatives by mutual funds is one applied by analogy from law not originally designed to apply to derivatives. In addition, much of the interpretive guidance on which mutual funds rely in managing their derivatives programs is more than 20 years old. Nonetheless, the SEC, through its authority to issue no-action letters and interpretive releases, has been able to craft a workable and flexible regime that has evolved along with mutual funds' use of derivatives, but one that still involves substantial uncertainty. On the other hand, the UCITS regime has been more recently developed, with regulations specifically addressing the use of derivatives by UCITS. The recent publication by CESR of guidelines clarifying risk measurement and the calculation of global exposure and counterparty risk by UCITS only serves to highlight the distinction between the U.S. and UCITS regulatory approaches. It remains to be seen how the implementation of Dodd-Frank and the SEC's ongoing review of the use of derivatives by U.S. mutual funds may close this gap in regulatory guidance. ■

---

[64] The Committee of European Securities Regulators, *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (Apr. 2010).

[65] *Id.* at 3.

[66] Council Directive 2009/65 *supra* note 1. The UCITS IV Directive's largest changes are aimed not at derivatives, but at the cross-border provision of management services, rules to facilitate fund mergers, master-feeder structures, fund disclosure changes, and supervisory cooperation arrangements.

[67] Huw Jones, *UK Opposes Mandatory Exchange Trading of Derivatives*, Reuters (Feb. 2, 2010), http://uk.reuters.com/article/idUKTRE6112AJ20100202.

[68] *Id.*

[69] European Commission, *Proposal for a Regulation of European Parliament and of the Council on OTC Derivatives, Central Counterparties, and Trade Repositories*, (Sept. 15, 2010), COD/2010/0250.

[70] *Id.*

The Review of Securities & Commodities Regulation