April 28, 2016
Asset Management ADVocate

Limitations on the Limitation of Leverage in Investment Companies

A CLE presentation gave me an excuse to read many of the comment letters regarding the SEC's proposed Rule 18f-4, which would regulate the amount of "senior security transactions" in which an investment company could engage. I filed a personal comment letter responding to the SEC's initial concept release in 2011. The proposed rule and most of the comments have moved well beyond the "conceptual" stage and my understanding of quantitative risk management. But several comments reveal some conceptual confusion that a thoughtful review of the law might dispel. **Objectives of Section 18** One of the great things about the Investment Company Act of 1940 (the "1940 Act") is that Section 1(b) lists the problems it was intended to address. Section 18 of the 1940 Act was directed at three of these problems:

> (3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities; … (7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or (8) when investment companies operate without adequate assets or reserves.

In the case of mutual funds (treating each series of a series company as a separate fund), Section 18(f) addresses the first problem by limiting a fund to one class of common shares, so there cannot be any "discriminatory provisions." Section 18(f) addresses the second problem by prohibiting mutual funds from issuing senior securities and only permitting borrowing from banks. Any borrowing must satisfy a 300% asset coverage ratio, which limits the "speculative character" of the shares and assures the fund maintains "adequate assets." **Section 18 Limits the Means, but not the Ends** Section 18(f) limits the extent to which mutual fund shares may increase their "speculative character" "by borrowing and the issuance of senior securities." Mutual funds remain free to increase their speculative character by other means. For example, a fund may increase its volatility by investing in the stock of highly leveraged companies. Section 18 also doesn't limit purchases of put and call options, which are more volatile that their underlying assets. If mutual fund shareholders need protection from undue speculation, what difference should it make whether the speculation results from leveraging by the fund or leveraging by portfolio companies? The explanation is pragmatic: it is one thing to limit how much a regulated mutual fund may borrow, and quite another to limit borrowings by every company in which mutual funds might invest. Section 18 also does not regulate how borrowings are used. As far as the 1940 Act is concerned, borrowing to buy Treasury bills is the same as borrowing to buy lottery tickets. The only nuance is an exception for "temporary" borrowings of up to 5% of the fund's total assets. A borrowing is presumed temporary if repaid (without extension or renewal) within 60 days. Such borrowings are more likely to be used to cover cash flow imbalances than to be used for investment leverage. **Section 18 Regulates Fund Leverage, Not Risk** One theme in the comment letters is that proposed Rule 18f-4 would regulate senior security transactions without regard for the risks of such transactions. (Although there would be a value at risk limit for funds engaging in senior security transactions in excess of 150% of their net assets). This reflects the limitations of Section 18 itself, which restricts only the amount borrowed relative to the fund's assets, without limiting the use of borrowings or investments in leveraged portfolio companies. Any regulation that simply implements Section 18 will be subject to the same shortfalls of regulating leverage rather than the consequences of leverage. The important conceptual question is whether, in crafting an exemptive rule, the SEC should move beyond the limitations of Section 18. Section 6(c) gives the SEC broad powers to provide exemptions "consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the 1940 Act]." Can the SEC find a better approach than Section 18 provides?

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