10666 and All That

[Click here for the obscure title reference.] Release No. IC-10666 ("Release 10666"), issued in 1979 under the direction of my partner Marty Lybecker, was the starting point for the SEC's regulation of derivatives under Section 18 of the Investment Company Act. This release would provide the basis for proposed Rule 18f?4's regulation of "financial commitment transactions." Many of the comment letters on the proposed rule refer to Release 10666, and many of these assert that subsequent no-action letters extended Release 10666 to derivatives. Their assertion underestimates the original scope of Release 10666, which extended to all derivative contracts commonly used at the time. **The Scope of Release 10666** Release 10666 covered "securities trading practices known as the reverse repurchase agreement, the firm commitment agreement, and the standby commitment agreement." Using Ginnie Mae securities for purposes of illustration, the release described a "firm commitment agreement" as "a buy order for delayed delivery in which an investment company agrees to purchase a Ginnie Mae from a seller (usually a broker/dealer) at a future date, stated price, and fixed yield." Footnote 10 noted:

> The firm commitment is known by other names such as a "forward contract" ….

A standardized forward contract trading on an exchange is a "futures contract." Thus, Release 10666 covered two common forms of derivatives: futures and forwards. Release 10666 also covered writing options. The release defined a "standby commitment agreement" as:

> a delayed delivery agreement in which the investment company contractually binds itself to accept delivery of a Ginnie Mae with a stated price and fixed yield upon the exercise of an option held by the other party to the agreement at a stated future date. The investment company receives an individually negotiated, non-refundable commitment fee in consideration for its agreement …. The Commission believes that the standby commitment agreement involves, in economic reality, the issuance and sale by the investment company of a "put."

If the standby commitment obligated a fund to sell the underlying security upon exercise, then it would be a call. The only derivative contracts missing from Release 10666 are swaps, which is understandable insofar as "IBM and the World Bank entered into the first formalized swap agreement in 1981." **Conflicting Definitions** Even the SEC may not fully appreciate the scope of Release 10666. Proposed Rule 18f-4 relies on Release 10666 to define "financial commitment transactions" to include firm and standby commitments. The rule would also define "derivative transactions" to include "any swap, security-based swap, *futures contract, forward contract, [or] option* …." As we've just seen, financial commitment transactions already include futures, forwards and written options. In other words, under proposed Rule 18f-4, these contracts would be both derivative and financial commitment transactions. These overlapping definitions are problematic because Rule 18f-4 would lower the asset segregation requirements for a derivative transaction. It would also place greater restrictions on the types of assets that may be segregated for derivative transactions than for financial commitment transactions. Finally, a fund with greater than 50% exposure to derivative transactions would be required to adopt a risk management program, while a fund with the same exposure to financial commitment transaction would not. The overlap of the proposed definitions appears unwitting. At one point, the Rule 18f-4 proposal differentiates derivatives from financial commitments by noting that, "under many types of derivatives transactions, a fund would generally not expect to make payments or deliver assets equal to the full notional amount." Release 10666 anticipated this as well, noting that—

> On or before settlement date, the investment company generally has the option of closing out the purchase obligation, rather than purchasing the security, by assigning the contract.

The closeout price would be the current market value of the contract, rather than the full notional amount. Perhaps the SEC intended to differentiate between cash settlement derivatives, which require payment of only the difference between the contract price and the spot value of the underlying asset, and physical delivery derivatives, which technically require delivery of the notional amount of the underlying asset (although, as noted in Release 10666, actual delivery rarely occurs). The proposed definitions of derivative and financial commitment transactions do not hint at such a distinction, however.

Explore more in

Investment Management

Blog series

Asset Management ADVocate

The Asset Management ADVocate provides unique analysis and insight into legal developments affecting asset managers in the United States.

View the blog