



IE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

September 26, 1994

The Honorable Edward J. Markey  
Chairman  
Subcommittee on Telecommunications and Finance  
Committee on Energy and Commerce  
U.S. House of Representatives  
2125 Rayburn House Office Building  
Washington, D.C. 20515

The Honorable Jack Fields  
Ranking Republican Member  
Subcommittee on Telecommunications and Finance  
Committee on Energy and Commerce  
U.S. House of Representatives  
2125 Rayburn House Office Building  
Washington, D.C. 20515

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*by Congressional Subcommittee*

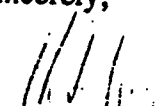
Dear Chairman Markey and Representative Fields:

Thank you for your letter dated June 15, 1994 concerning mutual fund use of derivatives. Your letter raises a number of important questions concerning the framework for the regulation and oversight of these activities. I share your concern for these important investor protection issues, and am particularly committed to finding improved ways for funds to communicate to shareholders the risks of investment.

Your letter requested that the Commission undertake a comprehensive study of the use of derivatives by mutual funds. I am enclosing a memorandum prepared by the Division of Investment Management that comprises the requested study.

Mutual funds are the investment vehicle of choice for funding Americans' essential needs -- for educating their children, for retiring with dignity. The Commission considers the protection of mutual fund investors absolutely essential. We have been, and will be, vigilant in addressing the issues raised by mutual fund use of derivatives, and we look forward to working with you in this endeavor.


Sincerely,

  
Arthur Levitt  
Chairman

Enclosure

## MEMORANDUM

September 26, 1994

**TO:** Chairman Levitt  
**FROM:** Division of Investment Management   
**RE:** Mutual Funds and Derivative Instruments

This memorandum responds to a letter dated June 15, 1994 (the "Letter"), from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce ("Subcommittee"), requesting that the Commission undertake a study of the use of derivatives by mutual funds and, more particularly, the adequacy of laws and regulations governing their disclosure and use. The Letter raises questions about (1) Commission knowledge of mutual fund use of derivatives, (2) disclosure of mutual fund use of derivatives, (3) the effect of mutual fund competition on derivatives use, (4) mutual fund pricing of derivatives, (5) liquidity of derivatives held by mutual funds, (6) leverage available to mutual funds through derivatives, (7) risks faced by investors in bank-advised mutual funds, and (8) derivative use by money market funds.

As you are aware, investor protection issues raised by mutual fund use of derivatives have received heightened attention by the Commission since you became Chairman. You have urged fund directors and trustees to exercise meaningful oversight of fund derivative investments and have encouraged the management of every fund using derivatives to manage their derivatives risks effectively. In addition, you have directed the Division to make mutual fund use of derivatives a priority -- in the disclosure review process, in fund inspections, and in policy considerations. In responding to the Letter, this memorandum also reviews the steps taken to date by the Commission and the Division to address investor protection issues raised by mutual fund use of derivatives and describes the further actions that the Division recommends.

### Background

#### A. The Use of the Term "Derivative"

The term "derivative" is generally defined as an instrument whose value is based upon, or derived from, some underlying index, reference rate, (*e.g.*, interest rates or currency exchange rates), security, commodity, or other asset.<sup>1</sup> "Derivative" may cover a wide variety of instruments,<sup>2</sup> and public debate concerning issues raised by derivatives is

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<sup>1</sup>See, *e.g.*, GROUP OF THIRTY GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 2 (July 1993) [hereinafter G-30 REPORT].

<sup>2</sup>The term "derivative" generally is used to embrace forward contracts, futures, swaps, and options. See, *e.g.*, *id.* at 28-34; U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 5 (May 1994). The term is also commonly used to describe instruments that are created by separating other financial instruments into constituent  
(continued...)

often complicated by imprecision regarding the instruments that raise a particular issue. Indeed, the public debate about "derivatives" sometimes suggests that a "derivative" is any complicated instrument that has caused losses. Mutual fund investments in derivatives raise significant investor protection concerns, which are addressed in this memorandum, but these concerns typically relate to specific instruments used by specific funds and not to all derivatives and all funds. Derivatives may be standard or customized, traded on an exchange or over-the-counter, liquid or illiquid, novel or familiar, leveraged or unleveraged. Derivatives may increase or reduce portfolio risk. As the Subcommittee and the Commission continue to address the important issues raised by mutual fund use of derivatives, it will be important in each case to focus on the specific parameters of the problems to be addressed.

## B. Mutual Fund Use of Derivative Instruments

Mutual funds, other than money market funds, use derivative products for a wide variety of purposes, including hedging interest rate, currency, and other market risks; substituting for a direct investment in the underlying instrument; or increasing returns. Money market funds also invest in debt instruments sometimes referred to as derivatives that have interest rates that are adjusted periodically based on changes in market interest rates. Many non-money market funds have the authority to use derivative instruments, but the Division's inspections to date suggest that the use of derivatives by most of these funds is limited. There are exceptions, however, to this general observation. Funds primarily investing in mortgage-backed securities, for example, generally have significant investments in derivatives. Long-term municipal bond funds use derivatives to seek increased tax-exempt returns. In addition, funds investing internationally may use derivative investments to lessen currency risks.

A recent industry survey of non-money market funds also suggests that mutual fund use of derivatives is limited.<sup>3</sup> The survey reported that the total market value of all derivatives held by participating funds was \$7.5 billion, representing 2.13% of the total net assets of all funds reporting derivatives holdings and 0.78% of the total net assets of all funds participating in the survey. The total notional amount of these derivatives was \$54.3 billion, representing 15.51% of the total net assets of all funds reporting derivatives holdings and 5.67% of the total net assets of all funds participating in the survey.<sup>4</sup> The survey also indicated that the level of use of derivatives varied by fund type, with fixed income funds accounting for 84% of the total market value of all derivatives held by reporting funds and 62% of the notional amount.

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<sup>2</sup>(...continued)

pieces, e.g., mortgage derivatives. See, e.g., James K. Glassman, *Mortgages, and Governments, Can Get Sliced and Diced*, WASH. POST, Sept. 7, 1994, at F1.

<sup>3</sup>Investment Company Institute, *Derivative Securities Survey*, Feb. 1994. Survey respondents included 52 fund complexes with 1,728 non-money market funds holding aggregate net assets of \$958 billion (76% of industry assets in non-money market funds). The survey was limited to a quantitative investigation of the use of derivatives by mutual funds and did not attempt to measure associated risks. *Id.* at 1.

<sup>4</sup>"Notional amount" was defined in the survey as "the maximum theoretical exposure presented by the instrument, i.e., the amount whose *changes in value* impact the fund's net asset value." *Id.* at 2.

### C. Investor Protection Concerns and Commission Actions

Although the use of derivatives by mutual funds generally appears to be limited, some funds have recently experienced problems relating to derivative investments. Several short-term government bond funds have experienced significant losses from mortgage derivatives.<sup>5</sup> In addition, losses in the value of certain adjustable rate notes held by some money market funds have resulted in the funds' advisers electing to take actions, including contributing capital or purchasing instruments held by the funds, designed to prevent the funds' per share net asset values from falling below \$1.00.<sup>6</sup> Although the reported problems to date have affected a limited number of funds and fund types, they raise investor protection issues that merit serious consideration.

As you are aware, months before these reports surfaced, the Commission expressed concern about investor protection issues raised by mutual fund investments in derivatives. Since the summer of 1993, the Commission has taken a multi-faceted approach to mutual fund use of derivative instruments, focusing on a broad range of issues, including disclosure, pricing, liquidity, leverage, and risk management. A Division task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types, and the Division's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses. In addition, the Division's inspection staff is examining and reporting on the derivatives activities of each fund inspected, and has conducted special examinations of certain funds holding significant positions in derivatives.

### D. Division Recommendations

This memorandum makes a number of recommendations for further action by the Commission to address mutual fund use of derivatives. The principal recommendations are the following:

- The Commission should consider requiring some form of quantitative risk measure in mutual fund prospectuses and should seek public comment on this topic no later than early 1995.
- The Commission should promptly consider reducing the ceiling on fund illiquid holdings. In addition, the Commission should continue to evaluate liquidity and pricing issues raised by derivatives through the mutual fund inspection process. If it appears appropriate as a result of these inspections, the Commission should consider issuing rules to address matters such as proper procedures for mutual fund pricing and liquidity determinations.

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<sup>5</sup>See, e.g., Robert McGough, *Piper Jaffray Acts to Boost Battered Fund*, WALL ST. J., May 23, 1994, at C1; Andrew Bary, *Derivatives Undo a Popular PaineWebber Fund, Triggering 4% One-Day Drop in Value*, BARRON'S, May 16, 1994, at MW12 [hereinafter *PaineWebber Fund*].

<sup>6</sup>See, e.g., *A History of Stepping up to the Plate*, FUND ACTION, Sept. 12, 1994, at 9 [hereinafter *Stepping up to the Plate*].

- The Commission should reexamine the application of the leverage restrictions of the Investment Company Act of 1940 ("Investment Company Act" or "Act")<sup>7</sup> to derivative instruments and should seek public comment on whether regulatory and legislative solutions are necessary to address the leverage created by mutual fund use of derivatives.
- The Commission should recommend that Congress enact legislation to enhance the Commission's ability to obtain information required to monitor fund use of derivatives.

#### E. Management and Board Responsibilities

The Commission has a critical role to play in enhancing investor protection in the area of mutual fund derivative investments. As you have noted, however, responsibility for managing a mutual fund's derivative investments falls, in the first instance, on the fund's management and board of directors or trustees.<sup>8</sup> To that end, you have urged fund boards to exercise meaningful oversight of fund derivative investments by becoming more involved in portfolio strategies, risk management, disclosure and pricing issues, accounting questions, and internal controls.<sup>9</sup> In correspondence with the chief executive officers of the 80 largest fund complexes, you encouraged the management of every fund that holds derivative instruments to take steps that will ensure the proper understanding and effective management of derivatives risk.<sup>10</sup> The Division's inspection staff examines mutual fund management controls, and is giving particular emphasis to controls relating to derivatives risk. On the basis of our findings during inspections and discussions with fund industry participants, we will determine whether to recommend that the Commission consider rulemaking to encourage better mutual fund management controls of derivatives risk.

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<sup>7</sup>15 U.S.C. § 80a.

<sup>8</sup>Strong management controls are generally recognized as essential to monitoring and controlling the derivatives activities and risks of derivatives dealers and end-users. *See, e.g.*, Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Securities and Investments Board, OTC Derivatives Oversight 3-4 (Mar. 15, 1994); The Technical Committee of the International Organization of Securities Commission, Operational and Financial Risk Management Control Mechanisms For Over-the-Counter Derivatives Activities of Regulated Securities Firms (July 1994); G-30 REPORT, *supra* note 1, at 9-13; Investment Company Institute, Investments in Derivatives by Registered Investment Companies 4-6 (Aug. 1994).

<sup>9</sup>Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors as Investor Advocates, Remarks at the Investment Company Institute Investment Company Directors Conference, Washington, D.C. (Sept. 23, 1994) [hereinafter Levitt Remarks, Directors as Investor Advocates]; Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors: On the Front Line for Investors, Remarks at the Mutual Funds and Investment Management Conference, Scottsdale, Arizona (Mar. 21, 1994).

<sup>10</sup>Letters from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to chief executive officers of 80 largest fund complexes (June 16, 1994) [hereinafter Levitt Letters].

## Responses to Questions Raised by the Letter

Set forth below are the questions contained in the Letter, followed by the Division's responses.

### 1. Does the SEC Have Adequate Knowledge of Industry Practices

#### a. Please identify the information needed by the SEC to fulfill its responsibilities.

The Commission's responsibility with respect to mutual funds is to administer and enforce the Investment Company Act and other applicable provisions of the federal securities laws. Through its inspection and registration processes, the Division can and does monitor individual mutual fund policies and portfolios, including derivatives activities. The Investment Company Act requires funds to maintain and provide to the Commission records reflecting much of this information.<sup>11</sup> In addition, during the course of examinations, funds generally voluntarily provide the Division with additional documents and access to fund personnel and often make records available in electronic media. Information concerning a fund's investments in derivatives is also contained in the fund's registration statement and amendments thereto, which describe investment policies and practices, and semi-annual reports on Form N-SAR and reports to shareholders, which contain information about portfolio activities. The information needed by the Commission, much of which is generally available to it, includes the following:

- complete information concerning the purchase and sale of portfolio instruments (*e.g.*, date and time of trade, counterparty, transaction price, identity of instrument traded);
- detailed information concerning each portfolio instrument (*e.g.*, for mortgage-backed securities, cash flow projections, including prepayment assumptions with respect to underlying mortgages);
- information regarding portfolio strategies and the manner in which each portfolio instrument contributes to portfolio strategies (*e.g.*, identity of portfolio positions that hedge other positions);
- valuations of fund assets and liabilities; and
- information relating to fund risk monitoring, *e.g.*, analyses of fund performance under various market scenarios.

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<sup>11</sup>Section 31(a) of the Investment Company Act requires every registered investment company to maintain and preserve those accounts, books, and other documents that constitute the basis for its financial statements. 15 U.S.C. § 80a-30(a). Section 31(b) of the Investment Company Act provides that investment company records required to be maintained under section 31(a) are subject to examination by the Commission. 15 U.S.C. § 80a-30(b).

**b. What obstacles, if any, prevent the Commission from obtaining and processing this information?**

Resource constraints are the principal obstacle to improved Commission monitoring of mutual funds. Although the Division generally can obtain the information it requires to monitor funds, the scope and frequency of our inspections are severely constrained by available resources.<sup>12</sup> Aside from information contained in a mutual fund's periodic filings, our knowledge of the fund's investment practices, including its derivatives holdings, is no more current than our most recent inspection. In addition, the increasing use of derivatives and other complex portfolio strategies has heightened the Commission's need to hire, train, and retain a highly skilled mutual fund inspection force.

The recordkeeping, reporting, and inspections provisions of the Investment Company Act also impose some limits on the Commission's authority to obtain information required to monitor mutual funds. In practice, these limits often do not hinder the Commission's fulfillment of its responsibilities, but they may do so in some circumstances, including, for example, when a fund does not voluntarily cooperate with the Commission; when, in times of market stress, rapid access to fund information is important; when the unavailability of electronic records in a format usable by the Division interferes with an efficient inspection; or when a fund does not maintain records that, if available, would improve Commission understanding of the fund's operations. These limits are described in detail below.

We emphasize that most investment companies cooperate fully with the Division's inspection staff and produce not only records required to be kept under the Commission's investment company recordkeeping rules, but other requested records. Most funds also allow Division inspection staff to interview employees responsible for maintaining these records, as well as portfolio managers, who are in the best position to explain many fund investments. And many funds make their records available electronically.

**i. Recordkeeping Authority**

Section 31(a) of the Investment Company Act requires every registered investment company to "maintain and preserve for such period . . . as the Commission may prescribe . . . such accounts, books, and other documents as constitute the record forming the basis for financial statements required to be filed pursuant to [the Investment Company Act] . . ."<sup>13</sup> This provision presents two potential limitations for the Commission, one relating to the scope of required recordkeeping and the other relating to the form in which the required records are kept.

First, as a general matter, the Commission may require investment companies to keep records forming the basis for the preparation of financial statements. These records alone, however, often do not provide the Commission with enough information to evaluate the portfolio strategies that may underlie a mutual fund's use of derivatives. For example, these records may not disclose the relationships among portfolio instruments, *e.g.*, the identities of positions that hedge other positions. Nor is it clear that they include records

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<sup>12</sup>*See, e.g.*, Testimony of Arthur Levitt, Concerning Appropriations for Fiscal Year 1995, Before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the Senate Committee on Appropriations 4-6 (May 5, 1994).

<sup>13</sup>15 U.S.C. § 80a-30(a).

related to portfolio management strategies, such as computer models that funds may use to evaluate the expected volatility of a specific derivative or the portfolio as a whole or the records generated by these models.<sup>14</sup>

Second, the Investment Company Act's recordkeeping provisions do not specifically address the medium in which records are required to be kept. In particular, the Commission would like specific authority to require that fund records be kept in an electronic medium.<sup>15</sup> Given the growth of the investment company industry, the size of individual funds, and the volume of transactions in which they engage, paper records are extremely cumbersome. Using paper records, the staff can only review a limited sample of the securities transactions in which a fund has participated over a specified period. Moreover, paper-based records do not facilitate modern examination techniques, such as computerized analysis to check for "red flags" that suggest the need for an inspection. Many funds voluntarily make their records available electronically, but fund records are not always maintained in an electronic format that is usable by the Division.

## ii. Inspection Authority

Section 31(b) of the Investment Company Act provides that investment company records "required to be maintained . . . shall be subject at any time and from time to time to such . . . examinations by the Commission . . . as the Commission may prescribe."<sup>16</sup> This provision presents an issue that may affect the scope of the Commission's inspection authority.

Under section 31(b), there is no explicit requirement that funds provide records that are not required to be maintained under a specific provision of the Investment Company Act or Commission rules. The required records often cannot be understood without referring to other documents that are not required to be kept by Commission rules. These additional records, for example, may explain innovative products and investments. They may also provide important insights into the portfolio management strategies of a fund. At present, in the inspection context, the Commission often relies on voluntary fund production of these

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<sup>14</sup>The Division is currently preparing rulemaking recommendations that should increase the Commission's access to information concerning fund portfolios. For example, in light of the recent proliferation of derivatives and other novel financial instruments, the Division is reviewing the books and records rules to ensure that fund records are required to contain all information necessary to determine an investment's suitability for the fund and its value for the daily net asset value calculation. The Division previously recommended, and the Commission proposed, amendments to the recordkeeping requirements for money market funds that would require more detailed description of portfolio instruments. Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959, Part II.D.7. (Dec. 17, 1993), 58 FR 68585, 68604 (Dec. 28, 1993) [hereinafter Release 19959]. These amendments, when adopted, should facilitate the ability of the Division staff to identify instruments that have interest rate provisions that are inconsistent with the limitations imposed by the Commission's money market fund regulations. See the answer to question 8, below. The Division also intends to recommend revisions to Form N-SAR that should result in the Commission having more information concerning the nature of fund portfolios.

<sup>15</sup>In 1986, the Commission amended rule 31a-2 to permit investment companies to maintain their records electronically. 17 C.F.R. § 270.31a-2(f)(ii).

<sup>16</sup>15 U.S.C. § 80a-30(b).

records to examine fund transactions in investments that present novel investor protection issues, such as derivative instruments.<sup>17</sup>

### iii. Frequency of Fund Reporting

Section 30(b) of the Investment Company Act authorizes the Commission to require a fund to file with the Commission "such information and documents (other than financial statements) as the Commission may require, on a semi-annual or quarterly basis, to keep reasonably current the information and documents contained in the [fund's Investment Company Act] registration statement . . . ."<sup>18</sup> The limitation to periodic reporting restricts the Commission's ability to monitor funds, particularly in times of market stress. For example, recent events have demonstrated that sudden changes in interest rates can have significant effects on fund portfolios that can be magnified by substantial derivative exposure.<sup>19</sup> The Commission is not now in a position to require prompt reports from funds on the effects of these interest rate changes, but must await the next periodic reports or initiate inspections.

#### c. What steps should be taken to insure that the Commission is able to obtain accurate and reliable information quickly and efficiently?

The Division recommends that the Commission seek legislative clarification and expansion of its existing authority to address the issues identified above. In particular, the Division intends to submit to the Commission recommended legislation that would do the following.

First, the Investment Company Act would be amended to authorize the Commission to require investment companies to "maintain and preserve such records as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."<sup>20</sup> This provision would authorize the Commission to require any additional records that are necessary to enable its inspection staff, among other things, to analyze a fund's derivative investments.

Second, the Investment Company Act would be amended to expressly authorize the Commission to specify the medium and format in which records must be kept, including electronic media. Electronic recordkeeping in a usable format would enable the Division's inspection staff to review an entire portfolio at multiple points in time, and transaction flows

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<sup>17</sup>In the context of an enforcement investigation, the Commission may require the production of all records that may be related to the inquiry. *See, e.g.*, Investment Company Act § 42(b), 15 U.S.C. § 80a-41(b).

<sup>18</sup>15 U.S.C. § 80a-29(b). Currently, the Commission requires funds to file semi-annual reports on Form N-SAR. 17 C.F.R. § 270.30b1-1.

<sup>19</sup>*See, e.g., PaineWebber Fund, supra* note 5; G. Bruce Knecht, *Piper Manager's Losses May Total \$700 Million*, WALL ST. J., Aug. 25, 1994, at C1 [hereinafter *Piper Fund*].

<sup>20</sup>This is the same grant of recordkeeping authority that Congress has provided the Commission with respect to broker-dealers in Section 17(a)(1) of the Securities Exchange Act of 1934 and investment advisers in Section 204 of the Investment Advisers Act of 1940. 15 U.S.C. §§ 78q(a)(1), 80b-4.

over time, to evaluate a fund's portfolio activities. This ability is particularly important in analyzing derivative investments, which are often used together with other instruments in the portfolio. Electronic recordkeeping would also facilitate the use of developing technologies that would make the Commission's investment company examination program more efficient. For example, if fund information were supplied electronically to the Commission's offices prior to an inspection, the inspection staff could analyze the data prior to commencing field work and target their efforts in the field on issues raised by that analysis.

Third, the Investment Company Act would be amended to require explicitly that a fund provide the Commission with all records that are kept by the fund, whether or not required by Commission rule to be kept.<sup>21</sup> Documents that are not required to be kept often provide the best description of the risks of a particular derivative instrument and may point to operational deficiencies.

Fourth, the Investment Company Act would be amended to authorize the Commission to specify the frequency of reporting by investment companies. This authority would assist the Commission by providing more timely access to information on fund portfolios and sales and redemption activity in times of market stress.<sup>22</sup> This authority would also enable the staff to obtain information that would help to identify particular funds or patterns of events that require closer scrutiny.

We believe that the legislation described above, if enacted, would increase the availability to the Commission of the data required to monitor adequately mutual fund investments, including investments in derivatives. We would emphasize, however, that, absent significant additional resources for the highly-qualified staff necessary to perform fund inspections and analyze available data, the Commission will remain constrained in its ability to monitor mutual funds even if the recommended legislation is adopted.

2. **Better Disclosure May be Critical to Help the SEC, but Will it be Accomplished in a Manner that Makes a Significant Difference to Average Investors?**
  - a. **First, we suspect that investors often develop general expectations about risk based on how their fund is categorized, and would like to know if the Commission agrees.**

Neither the Commission nor the Division establishes, regulates, or gives guidance with respect to fund categories. Fund categories develop, over time, through use by the fund industry and rating services such as Lipper Analytical Services, Inc., and Morningstar,

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<sup>21</sup>*Cf.* Section 17(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78q (making all records of broker-dealers subject to Commission examination); 12 U.S.C. § 248 (authorizing the Board of Governors of the Federal Reserve System to "examine at its discretion the accounts, books, and affairs of each Federal reserve bank and of each member bank and to require such statements and reports as it may deem necessary"); 12 U.S.C. § 481 (authorizing Comptroller of Currency to appoint bank examiners who "have power to make a thorough examination of all the affairs of" national banks).

<sup>22</sup>*Cf.* Section 17(h)(2) of the Exchange Act, 15 U.S.C. § 78q(h)(2) (authorizing the Commission, in times of adverse market conditions, to require registered broker-dealers to make reports concerning the financial and securities activities of their associated persons).

Inc. As a general matter, certain categories of funds tend to be more or less risky than other categories. For example, among fixed income funds, a portfolio comprised of short-term bonds is normally less volatile than one comprised of long-term bonds. Acknowledging these general characteristics, investors presumably do develop general expectations about risk based on how their fund is categorized.

The Commission does regulate fund names, which often convey information about a fund's category. The Investment Company Act makes it unlawful for a registered investment company to use as part of its name any word that the Commission finds to be deceptive or misleading.<sup>23</sup> A Division guideline states that if a registrant's name suggests a certain type of investment policy, its name should be consistent with its statement of investment policy. The guideline also provides generally that if a fund's name implies that it invests primarily in a particular type of security, its investment policy should require that, under normal circumstances, at least 65 percent of the value of the fund's total assets will be invested in that type of security.<sup>24</sup> The Division also takes the position that where a fund has a name or investment objective that characterizes the maturity of its portfolio, the dollar-weighted average portfolio maturity of the fund must reflect that characterization.<sup>25</sup>

We would emphasize that a name, or any single piece of information about a mutual fund, cannot tell the whole story of mutual fund risk. The prospectus is a mutual fund's basic disclosure document. Fund prospectuses convey a range of information to investors, including the fund's name, investment objectives and policies, permitted investments, and risk descriptions.<sup>26</sup> This information, taken together, should communicate to investors a comprehensible and accurate picture of fund risk.

The Division is taking several steps to help ensure that a fund's name is consistent with the fund's use of derivatives and educate investors regarding the danger of relying too heavily on fund names. First, on an ongoing basis, in the review of fund registration statements, the staff looks for, and requests changes to, disclosure that is inconsistent with a fund's name. Second, because there are inherent limitations on the usefulness of fund names, the Division is undertaking consumer education efforts to alert investors to the need to read prospectuses and periodic reports and the danger of relying too heavily on fund names as the sole source of information regarding the fund's investments. Third, the Division is reevaluating the current requirements regarding fund names to determine whether they should be revised. In particular, the Division contemplates reevaluating the

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<sup>23</sup>Investment Company Act § 35(d), 15 U.S.C. § 80a-34(d). Under section 35(d), the Commission may bring an action to enjoin a registered investment company from using a materially deceptive or misleading name.

<sup>24</sup>Guidelines for Form N-1A, Guide 1. Commission rules restrict the use of the term "money market" in fund names. See section 8.a., below.

<sup>25</sup>Form N-7 for Registration of Unit Investment Trusts Under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Release No. 15612 (Mar. 9, 1987), 52 FR 8268, 8301. The Division takes the position that fund portfolios must have the following dollar-weighted average maturities: short-term fund - not more than three years; short/intermediate-term fund - more than two years but less than five years; intermediate-term fund - more than three years but not more than ten years; intermediate/long-term fund - more than ten years but less than fifteen years; long-term fund - more than ten years. *Id.*

<sup>26</sup>Investment Company Act Form N-1A, Items 1 and 4.

requirements applicable to a fund whose name suggests that its portfolio is limited to instruments of a particular maturity. The Division also expects to review the use by funds of the word "government" in their names.

- b. Second, even if the fund's disclosures are presented clearly, concisely, and in a manner designed to maximize comprehensibility, it is still questionable whether investors would be able to understand and assimilate information that is useful to their investment decision. A discussion of how 'inverse floaters' work, or definitions of 'principal-only strips of CMOs,' will involve unavoidable elements of abstraction. Are there alternative ways of creatively presenting the critical information needed by investors, such as the effect on risk and volatility created by the fund's holdings of derivatives, that avoid the dilemma of attempting to define these instruments and strategies?**

Since the summer of 1993, the Division's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses; and a Division task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types. We have found that funds generally provide investors with a list and technical description of instruments, including derivatives, that are permissible fund investments. Funds often describe the purposes for using particular derivative instruments (*e.g.*, to hedge currency risks), but typically provide only the most general information on the risk level of the fund taken as a whole or on how derivative instruments, taken as a group, modify that risk level.

The Division has advised mutual fund registrants that, in many cases, it has found fund disclosures regarding derivative instruments to be highly technical and has encouraged registrants to modify their existing disclosure to enhance investor understanding of pertinent risks.<sup>27</sup> The Division is also considering possible modifications of the Commission's disclosure requirements. In the Division's view, a potentially better form of disclosure may be some means of describing the risk profile of a fund's portfolio as a whole with greater specificity. This information would assist an investor in determining whether a fund's risk characteristics are consistent with his or her own investment objectives. Consumer focus groups conducted on the Division's behalf early this year indicated that investors may in fact find this information helpful.

In order to address investors' need for information about portfolio risk characteristics, the Division recommends that the Commission issue a release seeking public comment on whether mutual fund disclosure of some quantitative risk measure should be required and what that measure should be. This action would enable the Commission to obtain investor and industry input regarding the utility of various risk measures and the feasibility of their computation. A quantitative risk measure could have significant benefits for investors by providing a means of comparing risks across and within fund categories, particularly for fixed income funds whose market risks may be less well understood by investors than those associated with equity funds.

There are a number of quantitative risk measures that deserve consideration, and the comment process should help the Commission determine which, if any, of the available

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<sup>27</sup>Letter to Registrants from Carolyn B. Lewis, Assistant Director, Division of Investment Management (Feb. 25, 1994).

measures would be most helpful to investors and feasible for funds to calculate. The following are among the possibilities.

- **Duration:** a measure of the price sensitivity of a fixed income fund to changes in interest rates.
- **Standard deviation:** a measure of the volatility of a mutual fund's total return over specified time periods.
- **Beta:** a measure of a mutual fund's risk relative to the market.

We acknowledge that the selection of an appropriate risk measure is a difficult task because all measures have limitations. Most measures rely on historical data and can only estimate the level of risk that was incurred in the past, not what will happen in the future. In addition, measurements will change depending on the time period over which risk is measured and the benchmark against which a fund is compared. Some measures (*e.g.*, duration) are not applicable to all funds. And each measure would require investor education regarding the proper interpretation of the measure and its limited predictive value.<sup>28</sup>

- c. Finally, formal disclosure to investors takes place annually in the prospectus. But various derivatives positions, each with distinctly different possible risks, can change by the hour, or even by the minute. So it's not clear how much value there is in knowing what the fund held at a particular past moment in time. Does the Commission agree that this quality should be considered when evaluating the utility of requiring enhanced disclosure of derivatives holdings?**

The Division agrees that the fluid nature of the investment management process limits the utility of reviewing specific portfolio positions previously taken by a fund. Nonetheless, the Division believes that historical data does provide fund shareholders with important information.

A mutual fund is required to provide a schedule of portfolio holdings to its shareholders semi-annually.<sup>29</sup> This requirement ensures that shareholders receive a twice-yearly snapshot of a fund's investments. The snapshot is important in that it provides shareholders with a concrete, historical picture of how the fund has been managed.

The portfolio schedule is not, however, a complete guide to the portfolio manager's strategy. Other forms of disclosure help to enhance the picture. For example, non-money market mutual funds are required to include "Management's Discussion of Fund Performance" in their prospectus or annual report, discussing the investment strategies and

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<sup>28</sup>The standardized measures of fund yield and total return that are currently required to be disclosed in the prospectus are subject to similar limitations. Form N-1A, Item 22.

<sup>29</sup>Investment Company Act § 30(d)(2), 15 U.S.C. § 80a-29(d)(2); 17 C.F.R. § 270.30d-1; Form N-1A, Item 23; 17 C.F.R. §§ 210.6-05.1, .6-10(c)(1), .12-12.

techniques that materially affected fund performance during the preceding year.<sup>30</sup> Thus, a fund whose performance was materially affected by derivatives would be required to discuss that fact -- whether or not derivatives were reflected in the portfolio schedule at the close of the year. As another example, the use of quantitative risk measures, as described in the preceding section, could enhance investor understanding of a portfolio manager's strategy.

**3. Is Intense Competition in the Fund Industry (or Any Other Reason) Leading Some Portfolio Managers to Move Risky Derivatives Into Otherwise Risk Averse Funds?**

**a. Is the competition for assets within the industry so intense that otherwise conservative funds take on disproportionate risks in order to outperform rivals?**

In recent years, there has been tremendous growth in the number of mutual funds competing for investor dollars.<sup>31</sup> There have also been recent reports of significant losses by several short-term government bond funds, which generally are considered to be relatively conservative investments, and reports of losses on some adjustable rate instruments held by money market funds.<sup>32</sup> These facts, taken together, suggest that competition may, at present, play some role in encouraging mutual fund use of derivatives to enhance yield.

With more than 4,700 mutual funds competing vigorously for investor dollars, superior investment performance is one key way in which a fund can distinguish itself from rivals. Studies generally show, however, that it is much more difficult to maintain a high level of performance over a long period of time than over a short period of time.<sup>33</sup> Studies also show that investor money tends to flow toward funds with superior near-term performance.<sup>34</sup>

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<sup>30</sup>Form N-1A, Item 5A(a). Non-money market funds also are required to provide a graph comparing the fund's performance over the past 10 years with an appropriate broad-based market index. Form N-1A, Item 5A(b).

<sup>31</sup>In June 1994, there were 4,901 separate mutual fund portfolios, an increase of 769% from the 564 that existed at the beginning of 1981. Investment Company Institute Press Release, June Mutual Fund Sales Total \$36.8 Billion, July 28, 1994; INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 101 (1993).

<sup>32</sup>See, e.g., *PaineWebber Fund*, *supra* note 5; *Piper Fund*, *supra* note 19; *Stepping up to the Plate*, *supra* note 6.

<sup>33</sup>Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 23, 389 (1968); Edwin J. Elton, Martin J. Gruber, Sanjiv Das, & Matthew Hlavka, *Efficiency With Costly Information: A Reinterpretation of Evidence From Managed Portfolios*, 6 REV. FIN. STUD. 1 (1993).

<sup>34</sup>Erik R. Sirri & Peter Tufano, Competition in the Mutual Fund Industry, Paper Presented at Harvard Business School Colloquium, *Managing the Financial Service Firm in a Global Environment* (Aug. 26, 1992).

Thus, it would not be surprising if some mutual fund managers perceive pressure to take on additional risk in order to attain at least a short-term performance "boost."<sup>35</sup>

**b. Is the Commission concerned that the cause of the losses reported at two short-term government bond funds may represent a growing trend?**

It is unclear whether the recent losses by short-term government bond funds represent a growing trend. The losses reported to date, however, do not appear to be evidence of a systemic problem in the mutual fund industry. It is also worth noting that losses by mutual funds from strategies undertaken to boost current yield are not a new phenomenon, but, unfortunately, recur from time to time in various forms. In the 1980s, for example, similar problems were associated with so-called "government-plus funds."<sup>36</sup> In addition, the recent losses have been a forceful reminder to the fund industry that the upside rewards of assuming increased risk also carry downside penalties. This market lesson may significantly dampen industry enthusiasm for competition through assuming increased risk.

**c. Does the Commission believe that a legislative or regulatory response is needed to address any issues related to the derivatives losses reported at these funds?**

In general, competition within the mutual fund industry should be a positive force, encouraging funds to improve performance, lower costs, and reduce risks; and the Division believes that each individual mutual fund must determine how to respond to competitive market forces. We also believe that the regulatory structure established by the Investment Company Act, through the disclosure and fiduciary obligations it imposes, generally provides an adequate framework for ensuring that investors are adequately protected. A mutual fund, for example, is currently required to disclose to investors material information regarding the fund, including the risks of investing in the fund.<sup>37</sup> Accordingly, it is a violation of existing laws and rules for a fund to mislead investors materially as to its risk profile, including the effect that derivatives have on that risk profile.

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<sup>35</sup>A recent news article suggested that many fund portfolio managers have compensation arrangements with their employers that encourage them to take inappropriate risks. Robert McGough, *Taking Chances: Risk in Mutual Funds is Rising as Managers Chase After Bonuses*, WALL ST. J., Aug. 11, 1994, at A1. The Investment Advisers Act of 1940 prohibits most types of performance fees for registered investment advisers, but this prohibition does not apply to the compensation arrangements that investment advisers have with their employees, including mutual fund portfolio managers. Investment Advisers Act § 205(a)(1), 15 U.S.C. § 80b-5(a)(1). The Division is not persuaded that there is sufficient evidence of abuse to support extending the performance fee prohibition to mutual fund portfolio managers at the present time. At the same time, however, we believe that fund managers and boards of directors or trustees should review portfolio manager compensation arrangements to ensure that they are designed with sufficient controls and other oversight mechanisms to protect the interests of fund shareholders. See Levitt Remarks, Directors as Investor Advocates, *supra* note 9, at 8-9.

<sup>36</sup>See, e.g., Jane Bryant Quinn, *No Place to Hide*, NEWSWEEK, May 11, 1987, at 62 (use of options to boost income on portfolio of government bonds at potential cost of diminished capital).

<sup>37</sup>See, e.g., Securities Act § 17(a), 15 U.S.C. § 77q(a); Exchange Act § 10(b), 15 U.S.C. § 78j(b); Exchange Act rule 10b-5, 17 C.F.R. § 240.10b-5; Form N-1A, Item 4(c).

The Division believes, however, that the risks assumed by some funds that use derivatives to enhance performance could be better disclosed to shareholders. Funds are presently required to disclose significant quantitative information in the areas of performance<sup>38</sup> and costs<sup>39</sup>, and the Division is recommending that the Commission consider requiring disclosure of some form of quantitative risk measure in mutual fund prospectuses. This is discussed in greater detail in response to question 2.

#### **4. Are Mutual Funds Experiencing Problems Pricing Exotic Derivatives?**

##### **a. Pricing requirements**

Mutual fund share pricing policies and practices are governed generally by sections 2(a)(41) and 22(c) of the Investment Company Act and rules 2a-4 and 22c-1 thereunder.<sup>40</sup> Section 22(c) provides the Commission with the authority to make rules governing the methods for computing the prices for mutual fund shares. Rule 22c-1 provides in part that a mutual fund may not sell or redeem its securities "except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."<sup>41</sup>

Rule 22c-1 generally provides that the current net asset value of a mutual fund's securities must be calculated every business day during which an order is received either to purchase or redeem a share of the fund.<sup>42</sup> Section 2(a)(41) and rule 2a-4 require a fund to mark its assets to market in computing net asset value. In the marking to market process, market quotations are required to be used for those securities for which the quotations are readily available. For all other securities and assets, a fund is required to use fair values as determined in good faith in accordance with procedures approved by its board of directors or trustees.<sup>43</sup>

##### **b. Pricing v. price reporting**

Before addressing the issue of mutual fund pricing of derivative investments, we believe it would be useful to distinguish between pricing and price reporting.<sup>44</sup> Although the Investment Company Act, and thus the Commission, regulate the *pricing* of fund shares in

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<sup>38</sup>Form N-1A, Item 2.

<sup>39</sup>Form N-1A, Item 3.

<sup>40</sup>15 U.S.C. § 80a-2(a)(41), -22(c); 17 C.F.R. § 270.2a-4, .22c-1.

<sup>41</sup>17 C.F.R. § 270.22c-1(a).

<sup>42</sup>17 C.F.R. § 270.22c-1(b)(1).

<sup>43</sup>15 U.S.C. § 80a-2(a)(41)(B); 17 C.F.R. § 270.2a-4(a)(1); Restricted Securities, Investment Company Act Release No. 5847 (Oct. 21, 1969) [hereinafter Release 5847].

<sup>44</sup>A fuller discussion of this issue appears in our August 22, 1994 Memorandum on Mutual Fund Share Price Reporting, responding to a letter dated June 30, 1994, from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce.

the manner described above, neither the Investment Company Act nor the Commission regulates -- or even requires -- the *reporting* of share prices to the news media. The incident referred to in the Letter, the absence of a reported price in the morning paper for a fund with derivative investments, is not the subject of either federal law or Commission regulation and is a separate issue from the question of whether purchasing and redeeming shareholders receive the correct price for their shares. Although share prices may be unreported because they are not calculated in time to meet newspaper deadlines, and the presence of certain derivatives in a fund's portfolio may make it more difficult to meet publication deadlines, *this does not mean that investors receive an incorrect price upon redemption, or pay an incorrect price at purchase.*<sup>45</sup>

### c. Pricing and derivatives

The obligation of a mutual fund to calculate daily net asset value accurately for purposes of share sales and redemptions is critical to investor confidence. If net asset value is incorrectly computed, purchasing or redeeming shareholders may pay or receive too little or too much, and the interests of other shareholders may be overvalued or diluted. The accurate valuation of each portfolio asset, including derivative instruments, is the foundation for computing fund net asset value.

Funds normally obtain market quotations from one or more sources, such as last sale prices reported by service vendors or bid and asked quotations supplied by market makers. Many derivatives may be priced in this manner. Exchange-traded derivatives, such as futures and exchange-traded options, for example, generally can be priced based on last sale prices or market quotations.

Prior to purchasing an instrument, derivative or otherwise, a mutual fund typically evaluates the availability of market prices for the instrument. If market quotations are not readily available for the instrument, the fund must be prepared to use fair value as determined in good faith in accordance with procedures approved by its board of directors or trustees. When a fund decides to purchase an instrument, it typically will have determined either that market quotations are readily available or that it can implement fair value procedures. This decision-making process acts as a brake on a fund's acquisition of an instrument when it is evident, from the outset, that pricing will be problematic.

Market conditions change over time, and a fund may find that an instrument that had readily available market prices when it was acquired ceases to have such price availability. This appears to have been the situation during recent months in the mortgage-backed

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<sup>45</sup>Chairman Levitt recently requested that the National Association of Securities Dealers, Inc. ("NASD"), and the Investment Company Institute ("ICI") address issues relating to fund price reporting. Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink, President, ICI (June 28, 1994). The NASD and the mutual fund industry have taken some steps to alleviate the time pressures and technological problems that may result in reporting problems, including an extension of the NASD's price reporting deadline, and are considering others. See Letters from Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink, President, ICI, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission (July 13, 1994). We are monitoring further developments in this area and working with the NASD and the mutual fund industry to ensure that the reporting system serves the interest of investors in obtaining accurate price information.

securities market, where decreased liquidity has resulted in the deterioration of accurate market pricing information for some derivative securities -- such as certain collateralized mortgage obligations. In these circumstances, it may be more difficult to establish reliable prices.<sup>46</sup>

The changing nature of markets makes it difficult, if not impossible, to ensure that mutual funds will never purchase instruments that become illiquid and, consequently, difficult to price. Nevertheless, the statutory and regulatory pricing requirements discussed above, together with the liquidity requirements discussed in response to question 5, act as significant checks on mutual fund investments in instruments that are difficult to price. Indeed, fund sponsors face substantial liabilities for pricing errors. In those instances when fund transactions occur at incorrect prices, it is the Division's policy that errors should be corrected when discovered, and fund sponsors should reimburse shareholders who have experienced a material economic loss due to the errors. Fund sponsors' own economic interests therefore militate against significant use of instruments that will cause pricing problems.

In order to provide assurances of price accuracy, funds typically employ extensive control procedures. For many funds, the control process begins with the use of independent pricing services to value fund holdings. Because pricing services compete for business, it is in their best interests to provide accurate prices. At the fund level, validation procedures, tolerance checks, and other reviews are often employed to test and control the validity of pricing.<sup>47</sup>

The Division does not believe that legislative changes are needed at this time to address pricing issues raised by derivatives. The Division intends, however, to continue to evaluate pricing issues in our inspections and will perform targeted examinations to obtain more information on these issues. If appropriate, we will consider issuing rules to address proper procedures for pricing determinations.

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<sup>46</sup>See, e.g., *PaineWebber Fund*, *supra* note 5; Robert McGough, *Baird Fund Spurs Worries About Pricing*, WALL ST. J., Aug. 15, 1994, at C1 [hereinafter *Baird Fund*].

<sup>47</sup>For example, many funds employ automated exception reports that compare the current day's price for each portfolio instrument to the previous day's closing price and note any instrument that has changed by more than a preset limit. A second typical procedure identifies any portfolio instrument price changes that cause the fund's share price to move more than a preset amount. A third common procedure compares portfolio transaction prices to price quotations obtained from pricing services and/or dealers. A fourth procedure involves portfolio manager review of the "price make-up sheet," the detailed listing of each instrument held by the fund and the associated price.

At the share price level, changes in share price are compared to changes in comparable indices to assure reasonableness. Price changes that exceed preset levels must be reverified and explained before they are entered into the accounting system for share price computation. Fund pricing staff may also look for corporate actions, news stories, or other developments to explain price changes.

**5. Are Mutual Funds Experiencing Liquidity Problems Because of Exotic Derivatives?**

- a. Does the Commission believe that some of the more exotic and volatile derivatives should be considered "illiquid?" Has the Commission considered whether the 15% rule should be applied to any types of derivative products?**

Section 22(e) of the Investment Company Act generally requires that a mutual fund make payment for redeemed shares within seven days after the tender of the shares.<sup>48</sup> Because mutual funds hold themselves out to investors as being prepared at all times to meet redemptions within seven days, it is essential that funds maintain investment portfolios that will enable them to fulfill this obligation. For this reason, and because the extent of redemption demands are not predictable, mutual funds must maintain highly liquid portfolios.<sup>49</sup>

The Commission has published a guideline requiring that mutual funds generally limit their investments in illiquid assets to 15% of net assets. The guideline limit is 10% in the case of money market funds.<sup>50</sup> An asset is considered "illiquid" if a fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the instrument.<sup>51</sup>

On occasion, the Commission and the Division have taken the position that certain classes of instruments are generally illiquid.<sup>52</sup> Generally, however, the determination of whether a particular mutual fund asset, including a derivative instrument, is illiquid should be made under guidelines and standards established by the fund's board of directors or

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<sup>48</sup>15 U.S.C. § 80a-22(e). This requirement does not apply during any period that (1) the New York Stock Exchange ("NYSE") is closed other than customary weekend and holiday closings or trading on the NYSE is restricted; (2) an emergency exists as a result of which disposal by the fund of securities owned by it is not reasonably practicable or it is not reasonably practicable for the fund fairly to determine the value of its net assets; or (3) the Commission permits for the protection of shareholders of the fund. *Id.*

<sup>49</sup>See Release 5847, *supra* note 43.

<sup>50</sup>See Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992), 57 FR 9828 (raising guideline for non-money market funds from 10% to 15% to facilitate capital raising by small businesses) [hereinafter Release 18612]; Letter from Marianne K. Smythe, Director, Division of Investment Management, to Matthew P. Fink, President, Investment Company Institute (Dec. 9, 1992) (clarifying that change in limit from 10% to 15% does not apply to money market funds); Release 5847, *supra* note 43, at 7.

<sup>51</sup>Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986), 51 FR 9773, 9777; Guidelines for Form N-1A, Guide 4.

<sup>52</sup>Release 5847, *supra* note 43 (restricted securities generally illiquid).

trustees.<sup>53</sup> Examples of factors that may be taken into account in determining liquidity include (1) the frequency of trades and quotes for the instrument, (2) the number of dealers willing to purchase or sell the instrument and the number of other potential purchasers, (3) dealer undertakings to make a market in the instrument, and (4) the nature of the instrument and the nature of the marketplace in which the instrument trades, including the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer.<sup>54</sup> Ultimate responsibility for liquidity determinations rests with the fund's board, but the board may delegate the day-to-day function of determining liquidity to the fund's investment adviser, provided the board retains sufficient oversight.<sup>55</sup>

The Division believes that particular derivative instruments may be illiquid under all or most market conditions. This will more likely be the case if a derivative is designed to meet the needs of a particular investor. Such a derivative, almost by design, would not have the broad market required to support a finding that the instrument is liquid. The liquidity of other derivative instruments, however, may vary depending on market conditions. An instrument that is liquid in one market environment may become illiquid in another market environment. This has recently been the case, for example, for certain collateralized mortgage obligations. Recent interest rate increases and full dealer inventories apparently caused markets for these instruments virtually to disappear, leaving previously liquid instruments illiquid.<sup>56</sup>

Fund management's obligation to make liquidity determinations is a continuing one in the case of instruments, including derivatives, whose liquidity may vary under different market conditions. If changed market conditions result in previously liquid portfolio holdings becoming illiquid, fund management should determine whether any steps are required to assure that the fund continues to meet the 15% guideline.<sup>57</sup>

We note that, in general, there is a close relationship between the liquidity of an instrument, derivative or otherwise, and the ease with which the instrument may be priced, the subject of question 4. If a security trades in a liquid market, there is a strong likelihood

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<sup>53</sup>See Merrill Lynch Money Markets Inc. (pub. avail. Jan. 14, 1994) (commercial paper issued in reliance on registration exemption in section 4(2) of Securities Act of 1933); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Investment Company Registrants (Jan. 17, 1992) (government-issued interest-only and principal-only securities backed by fixed-rate mortgages, municipal lease obligations); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Catherine L. Heron, Investment Company Institute (June 21, 1991) (municipal lease obligations) [hereinafter ICI letter]; Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990), 55 FR 17933, 17940-41 (Rule 144A securities, foreign securities) [hereinafter Release 17452].

<sup>54</sup>See Release 17452, *supra* note 53, at 55 FR 17940-41; ICI Letter, *supra* note 53, at 1.

<sup>55</sup>Release 17452, *supra* note 53, at 55 FR 17940 n.61.

<sup>56</sup>See, e.g., Saul Hansell, *Markets in Turmoil: Investors Undone: How \$600 Million Evaporated -- A special report; Fund Manager Caught Short By Crude and Brutal Market*, N.Y. TIMES, Apr. 5, 1994, at A1 [hereinafter *Markets in Turmoil*]

<sup>57</sup>Release 17452, *supra* note 53, at 55 FR 17940 n.61.

that reliable market prices will be readily available. Conversely, reliable prices for securities traded in an illiquid market are often difficult to obtain.

- b. Has the Commission considered whether the 15% figure itself should be revisited?**

In 1992, the Commission raised the limit on illiquid assets from 10% to 15% for non-money market funds to facilitate capital raising by small businesses.<sup>58</sup> The limit for money market funds remains 10%. Recent illiquidity in the market for certain mortgage derivatives raises once again the question of what limit is appropriate.<sup>59</sup>

The Division has been focusing on the illiquid assets limit in its inspections of mutual funds to determine whether funds are complying with the limit on an ongoing basis, whether funds are holding illiquid investments to the maximum amount permitted, and whether there is a need to reduce the limit. We recommend that the Commission act promptly to consider reducing the ceiling.

- 6. Does the Use of Derivatives Permit Mutual Funds to Avoid Limitations on the Use of Leverage Mandated by the Investment Company Act of 1940?**

- a. Please describe for the Subcommittee the original purpose of the restrictions on leverage contained in the Investment Company Act.**

Investment company abuse of leverage was a primary concern that led to enactment of the Investment Company Act.<sup>60</sup> In the Act's preamble, Congress cited excessive leverage as a major abuse that it meant to correct, declaring that the public interest and the interest of investors are adversely affected "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities."<sup>61</sup>

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<sup>58</sup>Release 18612, *supra* note 50.

<sup>59</sup>*See, e.g., Baird Fund, supra* note 46; Robert McGough & Anita Raghavan, *PaineWebber Again Props Up Bond Fund*, WALL ST. J., July 25, 1994, at C1 [hereinafter *PaineWebber Again Props Up Bond Fund*].

<sup>60</sup>In 1939, the Commission released an exhaustive study of the investment company industry that laid the foundation for the Investment Company Act. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 707, 75th Cong., 3d Sess. pt. 1 (1939) [hereinafter INVESTMENT TRUST STUDY PT. 1]; SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 70, 76th Cong., 1st Sess. pt. 2 (1939); SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 279, 76th Cong., 1st Sess. pt. 3 (1939) [hereinafter INVESTMENT TRUST STUDY PT. 3]. For a discussion of leveraged capital structures of investment companies, see INVESTMENT TRUST STUDY PT. 3, Ch. V, "Problems in Connection with Capital Structure," 1563-1940.

<sup>61</sup>Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7). The preamble also refers to "investment companies operat[ing] without adequate assets or reserves." Investment Company Act § 1(b)(8), 15 U.S.C. § 80a-1(b)(8).

Section 18(f) of the Investment Company Act restricts leveraged capital structures, generally prohibiting mutual funds from issuing any class of "senior security."<sup>62</sup> Funds may, however, borrow from banks if they maintain 300% asset coverage for all such borrowings.<sup>63</sup> Section 12(a) authorizes the Commission to regulate two trading practices that may result in leverage, margin purchases and short sales.<sup>64</sup>

One reason for limiting investment company leverage was to prevent abuse of the purchasers of senior securities, which were sold to the public as low risk investments.<sup>65</sup> Investment company assets during the 1920s and 1930s consisted mostly of common stocks that did not provide the stable asset values or steady income stream necessary to support senior charges.<sup>66</sup> Because the sponsors often kept all or most of the junior, voting securities for themselves, they could operate the company in their own interests.<sup>67</sup> Senior securities tended to lead to speculative investment policies to the detriment of senior securityholders because the common stockholder/sponsors, who often had a relatively small investment at risk in the fund, looked to capital gains for profit.<sup>68</sup> Multiple classes of senior securities and

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<sup>62</sup>15 U.S.C. § 80(a)-18(f). "Senior security" is defined to include preferred stock, bonds, debentures, notes, and other securities evidencing indebtedness. Investment Company Act § 18(g), 15 U.S.C. § 80a-18(g).

<sup>63</sup>Investment Company Act § 18(f)(1), 15 U.S.C. § 80a-18(f)(1).

<sup>64</sup>15 U.S.C. § 80a-12(a)(1), (3). The Commission has not adopted any rules under section 12(a); instead it has regulated margin purchases and short sales under section 18. *E.g.*, Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 FR 12790 [hereinafter 1972 Guidelines].

<sup>65</sup>*Id.* at 1583; *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. 265, 272 (1940)* (statements of David Schenker, Chief Counsel, and L. M. C. Smith, Associate Counsel, SEC Investment Trust Study) [hereinafter *Senate Hearings*].

<sup>66</sup>*Senate Hearings, supra* note 65, at 265; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1587-89.

<sup>67</sup>*Senate Hearings, supra* note 65, at 239-40, 268-71, 273; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1594-98. *See* Investment Company Act § 1(b)(3), 15 U.S.C. § 80a-1(b)(3) (public interest and interest of investors adversely affected "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").

<sup>68</sup>*Senate Hearings, supra* note 65, at 239-40; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1615, 1668-74.

The relatively small investment of the common stockholders meant that the equity "cushion" protecting senior securityholders was small. INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1665-68. Senior securityholders of a mutual fund could be further compromised because the right of redemption held by the fund's common stockholders could erode the "cushion" of equity protecting the senior securityholders. *Investment Trusts and Investment Companies: Hearings on H. R. 10065 Before a Subcomm. of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess 121 (1940)* (statement of David Schenker, Chief Counsel, SEC Investment Trust Study); INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1870-71. At the time of the study, however,  
(continued...)

pyramiding frustrated senior securityholders' attempts to determine whether secure returns were likely.<sup>69</sup>

Another reason for limiting investment company leverage was to protect public common stockholders by limiting the volatility of their investments. This purpose was a motivating factor for restricting the issuance of senior securities to the public because the leverage of the senior-junior capital structure magnified losses suffered by common stockholders.<sup>70</sup> This purpose also motivated the Investment Company Act restrictions on mutual fund bank borrowings.<sup>71</sup> The provisions authorizing the Commission to regulate margin purchases and short sales implicate similar concerns.

- b. Is the leverage that is made available to funds through the use of derivatives inconsistent with the intent underlying the Investment Company Act?**
- i. Derivatives and leverage**

Certain derivatives involve 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 (referred to herein as "indebtedness leverage"). Examples are futures, forward contracts, and written options. The writer of a stock put option, for example, makes no initial investment, but instead receives a premium in an amount equal to a fraction of the price of the underlying stock. In return, the writer is obligated to purchase the underlying stock at a fixed price, thereby participating in losses on the full stock price.<sup>72</sup> As another example, a fund purchasing a futures contract makes an initial margin payment that is typically a small

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<sup>68</sup>(...continued)

mutual funds almost invariably had only one class of securities outstanding. INVESTMENT TRUST STUDY PT. 1, *supra* note 60, at 29; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1563.

<sup>69</sup>INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1665, 1674-75. Section 12(d)(1) of the Investment Company Act controls pyramiding by restricting an investment company's acquisition of securities issued by other investment companies. 15 U.S.C. § 80a-12(d)(1).

<sup>70</sup>Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7); *Senate Hearings, supra* note 65, at 1027-31 (Commission memorandum to the effect that dangers to common stock at least as important as senior securities with respect to ends sought by section 18).

<sup>71</sup>*See Senate Hearings, supra* note 65, at 288 (statement of John H. Hollands, Attorney, SEC staff) ("[B]ank borrowings will be a fixed charge against the company; and, because of the fixed charge, the value of the common stock will shoot up and down in the same way that it would if they had debentures outstanding.").

<sup>72</sup>THE OPTIONS CLEARING CORPORATION, CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS 17-18 (1985) [hereinafter OCC GUIDE].

percentage of the contract price.<sup>73</sup> As a result of this margin payment, the fund participates in gains and losses on the full contract price.<sup>74</sup>

Other derivatives provide the economic equivalent of leverage because they display heightened price sensitivity to market fluctuations (referred to herein as "economic leverage"), such as changes in stock prices or interest rates. In essence, these derivatives magnify a fund's gain or loss from an investment in much the same way that incurring indebtedness does.<sup>75</sup> One example is a purchased stock call option. In return for the payment of a premium in an amount equal to a fraction of the stock price, the holder of a stock call option participates in gains on the full stock price. If there are no gains, the holder generally loses the entire initial premium.<sup>76</sup> Another example is a leveraged inverse floating rate bond, with an interest rate that moves inversely to a benchmark rate. A leveraged inverse floating rate bond displays heightened price sensitivity to interest rate changes, resulting in the holder experiencing market value fluctuations equivalent to those that he or she would experience on a conventional bond of larger principal amount.<sup>77</sup>

## ii. Derivatives and Investment Company Act leverage restrictions

The leverage of derivatives raises concerns related to the volatility of fund common stock, but does not raise concerns related to the protection of public senior securityholders. In the case of derivatives that create indebtedness leverage, the fund assumes a future obligation or indebtedness. While this obligation or indebtedness does not run to public senior securityholders, it does expose the fund to gains and losses on an amount that exceeds its initial investment. In the case of derivatives that create economic leverage, the fund does not assume a future obligation or indebtedness. Investing in these derivatives, however, magnifies the fund's gains or losses in much the same way that incurring indebtedness does.

The Commission and the Division have applied section 18 of the Investment Company Act to derivatives that create indebtedness leverage, such as futures, forward contracts, and written options.<sup>78</sup> In applying section 18 to these instruments, the Commission and the Division have required funds to "cover" the obligations these derivatives create by establishing and maintaining segregated accounts consisting of cash, U.S. government securities, or high-grade debt securities in an amount at least equal in

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<sup>73</sup>ROBERT E. FINK AND ROBERT B. FEDUNIAK, *FUTURES TRADING: CONCEPTS AND STRATEGIES* 137 (1988).

<sup>74</sup>*Id.* at 39.

<sup>75</sup>*See, e.g.*, Lee Berton, *Understanding the Complex World of Derivatives*, WALL ST. J., June 14, 1994, at C1.

<sup>76</sup>OCC GUIDE, *supra* note 72, at 15-17.

<sup>77</sup>James E. Leberherz, *'Inverse Floaters' Offer Potential Benefits, and Dangers*, WASH. POST, Aug. 29, 1993, at H7.

<sup>78</sup>*E.g.*, Sanford C. Bernstein Fund, Inc. (pub. avail. June 25, 1990); Dreyfus Strategic Investing (pub. avail. June 22, 1987) [hereinafter Dreyfus]; Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Securities Trading Practices of Registered Investment Companies: General Statement of Policy, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 FR 25128 [hereinafter Release 10666]; 1972 Guidelines, *supra* note 64.

value to the obligations.<sup>79</sup> The Division also has permitted funds to cover certain derivatives by holding the underlying instruments or other offsetting instruments.<sup>80</sup> The Commission and the Division have not applied section 18 of the Investment Company Act to derivatives that create economic leverage, such as purchased stock call options and leveraged inverse floating rate bonds.

- c. **Apart from its relation to existing provisions in the statute, is the Commission concerned about the leverage available to funds that hold derivatives? If so, how does the Commission propose to address those concerns?**

The Division is concerned about both indebtedness and economic leverage that are potentially made available to funds through the use of certain derivatives. The potential for increased volatility from such leverage may result in significant losses to investors.

One approach to the issue of leverage would be to prohibit directly, or restrict, the use of derivatives by mutual funds. The Commission has imposed requirements on derivative investments by money market funds,<sup>81</sup> but we do not recommend this approach for non-money market funds for three reasons. First, a prohibition or restriction on derivatives use could chill the use of instruments in a manner that is beneficial for mutual funds, such as hedging. Second, a prohibition or restriction on derivatives use would be inconsistent with the general approach of the Investment Company Act, which imposes few substantive limits on mutual fund investments.<sup>82</sup> Funds generally are permitted to make investments without regard to their volatility, *e.g.*, emerging market securities and small company stocks, and we are not persuaded that derivatives should be treated differently.<sup>83</sup> Third, it would be extremely difficult, if not impossible, to devise appropriate prohibitions or

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<sup>79</sup>Release 10666, *supra* note 78, at 44 FR 25131-32. The rationale is that covered transactions do not raise concerns about undue leverage and speculation that section 18 was intended to address. *Id.*

<sup>80</sup>For example, instead of maintaining a segregated account, a fund that sells a call option may cover the position by owning the securities against which the call is written (or securities convertible into the underlying securities without additional consideration) or by purchasing a call on the same securities at the same price. 1972 Guidelines, *supra* note 64. For additional examples of cover, see Dreyfus, *supra* note 78.

<sup>81</sup>These requirements are discussed in response to question 8, below.

<sup>82</sup>The provisions of the Investment Company Act that prohibit or restrict certain types of investment are quite narrow. *See, e.g.*, § 12(d), 15 U.S.C. § 80a-12(d) (investments in other investment companies, insurance companies, or securities-related businesses). *See also* Investment Company Act rule 2a-7, 17 C.F.R. § 270.2a-7 (limiting portfolio investments of money market funds). The framers of the Investment Company Act specifically disavowed any attempt to prohibit speculative mutual fund investments. *See, e.g., Senate Hearings, supra* note 65, at 44, 247.

<sup>83</sup>The legislative history of the Investment Company Act indicates that the Act was not intended to eliminate all leverage from fund investments. *See, e.g., INVESTMENT TRUST STUDY PT. 3, supra* note 60, at 1580-81 (common stocks held by investment companies are leveraged in that issuing companies have senior securities in their capitalization); *Id.* at 1592-93 (leverage easier to increase or decrease in investment company with only one class of securities outstanding, where leverage attributable to portfolio securities).

restrictions on the use of derivatives by mutual funds because of the wide variety of instruments that may be considered "derivatives." The available "derivatives" are likely to change as innovation occurs in the marketplace, possibly rendering substantive prohibitions or restrictions ineffective within a short time.

The Division believes that one of the most effective means for addressing leverage concerns associated with mutual fund use of derivatives is improved risk disclosure. It is crucial that investors understand the risks of investing in a mutual fund, including the risks of the fund's intended use of various derivatives. The risk/return profile of a mutual fund may be affected significantly by derivatives that are potentially volatile, and we believe that it is critical that fund investors understand this profile. For this reason, we have given heightened scrutiny to derivatives disclosure in prospectuses, and a Division task force has examined the derivatives disclosures of 100 investment companies. The Division has encouraged registrants to modify their existing disclosure to enhance investor understanding of pertinent risks. We are engaged in fundamental reconsideration of mutual fund disclosure, assessing whether the use of quantitative risk measures would improve investor understanding of fund risk. Because fund use of derivatives is relatively new and evolving, the Division is continuing to develop approaches to improving disclosure about derivatives. If these approaches do not prove to be sufficiently protective of the interests of fund shareholders, the Division may reconsider whether to recommend that the Investment Company Act be amended to place substantive limits on derivatives use.

The Division also recommends that the Commission reexamine the application of section 18 to derivative instruments. In practice, section 18 has proven to be a somewhat crude tool for addressing the leverage issues raised by derivatives, largely because it was originally designed to address a different problem, namely, the leverage created by the issuance of public senior securities.<sup>84</sup> Given the recent proliferation of derivatives, we believe that it is appropriate to reexamine both the way in which section 18 has been applied to derivatives that create indebtedness leverage and the differential treatment under section 18 of derivatives that create indebtedness and economic leverage. These are complicated issues that are not susceptible to a simple solution. For this reason, we recommend that the Commission issue a release seeking public comment on appropriate regulatory and legislative solutions to address the issues raised by leverage resulting from fund use of derivatives.

**7. Do the Recent Capital Infusions by Two Fund Complexes Indicate that Bank Mutual Fund Investors may be Facing Special Undisclosed Risks?**

The questions raised by the Letter in the area of bank-advised mutual funds relate primarily to the interpretation and application of federal banking laws. The Division's responses are based on our understanding of the banking laws and informal discussions with the staffs of the federal banking agencies. It also may be advisable for Congressmen Markey and Fields to contact the federal banking agencies directly, however, as they have the greatest expertise in interpreting the federal banking laws and are in the best position to predict how they might exercise their authority in specific circumstances.

We emphasize, as a preliminary matter, that a mutual fund's adviser, regardless of whether it is a bank (or a subsidiary or affiliate of a bank), is **not** legally obligated to infuse

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<sup>84</sup>Bank debt was generally the only significant form of short-term or current indebtedness incurred by the investment companies that the Commission studied prior to passage of the Investment Company Act. INVESTMENT TRUST STUDY PT. 1, *supra* note 60, at 28 n.23.

