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Nov. 7, 2011

Attention: Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549-1090

RE: File Number S7-33-11/ Use of Derivatives by Investment Companies under the Investment Company Act of 1940.

Dear Ms. Murphy:

As the leading independent mutual fund and exchange-traded fund research provider, we are writing to comment on the three questions posed by the commission to the general public in the above-referenced file: What are the costs and benefits to funds from the use of derivatives? Do different types of funds use different types of derivatives or use derivatives for different purposes? How do ETFs use derivatives?

Costs and Benefits

Rather than addressing the cost and benefits to fund companies, we will address the cost and benefits of the use of derivatives from the perspective of the investor who owns a fund. The benefit of derivatives to investors is that they are primarily used to manage risk. The cost is that investors are frequently unable to discern the impact of derivatives in their funds. This is because fund companies are not reporting derivative holdings in a consistent manner and are not reporting derivative holdings in a manner that identifies the underlying risk exposure.

Fund companies, and therefore their investors, sorely need more tools to manage risk. During the Oct. 9, 2007-March 9, 2009, financial crisis, every risky, non-government-bond asset class lost money, as did 75 of Morningstar's 85 mutual fund categories. Funds that performed relatively better were those that were able to move more assets to cash or government bonds, but many funds' mandates require them to be fully invested. Increased usage of derivatives could have helped the funds temporarily reduce risk exposure without necessarily selling positions. Alternative mutual funds, which use derivatives and shorting to a great extent, lost significantly less than traditional funds during this period.

Avoiding downside risk is key to building wealth. Even investors who held a "balanced" portfolio of stocks and bonds (60% in the S&P 500 Stock Index and 40% in the Barclays Aggregate Bond Index, rebalanced quarterly) going into the financial crisis would have lost 35% of their assets. This loss was only recently recovered, two and a half years later, putting many far behind their retirement goals. In reaction to the crisis, investors have poured more

than $500 billion into taxable-bond mutual funds. This may not be prudent going forward, however, as we may be entering a rising interest-rate environment where traditional bond funds may pose greater risk to investors. Mutual funds of all types should be allowed to use derivatives to manage risk.

Derivatives usage in mutual funds is difficult to detect. While we realize the Commission may address disclosure issues at a later point in time, we would like to highlight some issues that are primary to the discussion of suitable use. First, there is an identification issue. Funds do not report the same type of derivatives in the same manner. For example, exchange-traded futures and options contracts are standardized, so there should be standardization in the way these derivatives are reported and identified. But funds trading commodity futures often use a controlled foreign corporation for tax purposes and may only disclose the controlled foreign corporation holding, rather than the underlying futures contracts. This is an issue with some (but not all) of the new managed futures mutual funds.

The identification and reporting problem is magnified for funds trading over-the-counter derivatives such as interest-rate swaps and credit default swaps, a practice of many traditional bond mutual funds. A clearly labeled, detailed listing of interest-rate swaps and credit default swaps in Western Asset Core Plus Bond WACPX, for example, can be found only in the notes to its financial statements, while PIMCO Total Return PTTRX, in contrast, clearly lists all of its derivative holdings alongside its traditional investments in downloadable spreadsheet format on its website. Furthermore, the disclosed terms of the over-the-counter derivatives are not always the same between fund companies.

In addition, derivatives are typically reported in a manner that is not useful to investors. Investors need to know where the risk (and therefore the return) in their investments comes from. When derivatives are involved, however, risk assessment becomes complicated. For example, futures contracts have notional exposure. It may only take $5 to initially get $100 worth of exposure to the S&P 500, and the other $95 is held in cashlike instruments. On a financial statement, fund companies typically report only this $5 initial margin, or the unrealized appreciation or depreciation, as a percentage of net assets, which may leave investors believing that their investment is primarily a cash investment, when in fact it is effectively a 100% equity investment. Options are reported similarly to future contracts by fund companies, as they typically require a small amount of upfront premium. Notional exposure, to the extent that the options move with the underlying assets (also called delta-adjusted notional exposure), is a better measure of risk, however.

Most fund companies are able to clearly identify the derivatives they use, and they are also able to calculate notional and delta-adjusted notional risk exposures. After talking to several fund companies, however, it appears not all service providers (administrators, for example) are currently equipped to handle derivatives.

Usage of Derivatives by Mutual Funds

Derivatives are used by a wide variety of mutual funds. Morningstar currently collects holdings information on 6,809 distinct (excluding multiple share classes) U.S.-domiciled open-end funds

(mutual funds) on a quarterly or more-frequent basis. We classify the holdings of these 6,800-plus funds into stocks, bonds, cash, and "other." Most derivatives holdings fall into this "other" category, as they are so difficult to identify. However, by our measure, 1,855, or 27% of U.S. mutual funds, held at least one derivative as of the date of its last-reported portfolio. The average fund that owned derivatives held approximately 12 derivatives positions, 40 funds held at least 100, and one held more than 500.

The categories of funds with derivative holdings ranged widely. As of the last-reported portfolio, funds in 83 categories held derivatives, including stock funds, bonds funds, allocation funds, target-date funds, and alternative funds. Funds in the intermediate-term bond category were the largest users of derivative holdings, with 5,154 total derivative positions among 128 funds. Funds in world-bond, conservative-allocation, nontraditional bond (a new category of bond funds that hedge credit and/or interest-rate risk), foreign large-blend (stock), and multisector bond categories were the next largest users, with each category holding more than 1,000 derivative positions in aggregate.

For stock funds, derivative holdings typically include future or forward contracts on equity indexes and currencies, as well as options on indexes or individual equities. For bond funds, derivatives holdings include bond index and currency futures (or forwards), options on bond index and currencies, interest-rate swaps, credit default swaps, and total return swaps (on various securities), and interest-rate or credit default swaptions. Target-date and allocation funds, which use a combination of stocks and bonds, use a combination of the derivatives found in stock and bond funds. Alternative mutual funds also use a combination of the above-mentioned securities, both long and short. In additional to all of the above-mentioned derivatives, alternative mutual funds and long-only commodity funds also use total return swaps or offshore structures (which are not considered derivatives) to take long and short commodity futures positions.

Derivatives are primarily used to gain, hedge, or short exposure to a certain type of asset. If a derivative is exchange-traded (such as futures and options on futures), it often offers exposure that is cheaper and more efficient than taking a position in the underlying asset, as it requires less use of cash, low transaction fees, and no counterparty credit risk. For short positions, exchange-traded derivatives may provide the only reasonable means to hedge long position risk or to take a short bet on the underlying asset (U.S. Treasury or stock index futures and options, for example). Over-the-counter derivatives, which are used heavily by traditional bond funds, may also be used as a way to cheaply and efficiently gain or hedge long or short exposure to various risks, such as interest rates, credit, or currencies. Over-the-counter derivatives, however, contain counterparty credit risk and are by definition nonstandardized, which poses significant problems to a data aggregator such as Morningstar in terms of identification and classification.

Use of Derivatives in Exchange-Traded Funds

Exchange-traded funds are a boon for investors. They have provided a low-cost and easily accessible means to gain or hedge exposure to all kinds of asset classes. Currently, ETFs hold almost $1.1 trillion, which is more than quadruple the assets held in 2005.

ETFs are clearly popular, but there is still much confusion as to their inner workings and the effect that they may have on the overall market. Morningstar is working hard to clear this confusion through its research and educational outreach. One source of much confusion is ETFs' use of derivatives in leveraged funds, commodity funds, and actively managed funds.

In March 2010, the Commission effectively embargoed the use of derivatives in any exchange-traded funds currently awaiting approval or wishing to come to market, citing issues all related to leveraged exchange-traded funds: First, these leveraged funds are more suitable for trading than for longer-term investing; second, these funds are confusing to investors; and third, investors who don't understand them are pouring more and more money into them. Since 2010, Morningstar has led an effort into educating the consumer about these leveraged vehicles, publishing numerous free articles and videos and holding educational seminars. We have even re-categorized such funds into categories clearly labeled "trading." The sponsors of leveraged ETFs themselves have also participated in this education initiative. While more and continued education will always be beneficial, we feel that investors and, more importantly, gatekeepers at broker-dealer firms are now more educated as to how these products function and have the tools available to help become educated.

Besides the lack of clarity surrounding leveraged ETFs, commodity-futures based ETFs have also been the source of much controversy. Congress has effectively blamed commodity-trading ETFs funds for causing excess speculation in futures markets, which may be causing undue volatility, and which may be changing how futures track their underlying markets. In response, the Commodity Futures Trading Commission has drafted new position limit rules, which many industry participants fear will decrease liquidity and prevent hedging. We believe that another, and perhaps the most dangerous, effect of this proposed regulation is that the largest commodity ETF sponsors, the ones most affected by the position limit regulation, are already accessing futures contracts indirectly through over-the-counter swaps. The move from on-exchange to off-exchange will not only confuse investors (as we have previously discussed the difficulties of discerning over-the-counter derivatives) but also likely cost them more in terms of transaction fees and counterparty credit risk. Again, we think that the real solution lies in more transparency on behalf of ETF sponsors and more education.

The final area of controversy about derivatives in ETFs relates to actively managed funds. These ETFs are not designed to track a stated benchmark and may use derivatives to gain access to, short, or hedge risk in various assets in order to outperform a benchmark, similarly to actively managed mutual funds. Active ETFs are more transparent than mutual funds, though, and are generally cheaper than mutual funds, characteristics that benefit investors. Like mutual funds, however, active ETF sponsors do not use derivatives solely to speculate but also to manage risk. Restricting the use of derivatives in ETFs prevents investors' access to active ETF products that manage risk (nontraditional fixed-income ETFs, for example).

In conclusion, as long as ETFs, whether active, leveraged, or commodity-based, adhere to reporting standards that clearly identify derivatives and their underlying risks, we believe ETFs should be allowed to use derivatives. Education and independent research on derivatives usage

in ETFs is still necessary, but it is readily available to investors through companies such as Morningstar.

Outreach

We appreciate the opportunity to address the Commission on what we believe is an important subject. We are open to any dialogue. Should you wish to discuss our comments on derivatives or Morningstar's views on any other matters, please do not hesitate to contact John Rekenthaler, senior vice president of research, at (312) 696-6350, or Nadia Papagiannis, director of alternative fund research, at (312) 384-4100.

Sincerely,

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