

MEMO# 6253

September 30, 1994

SEC STAFF MEMORANDUM ON MUTUAL FUNDS AND DERIVATIVES

September 30, 1994 TO: ACCOUNTING/TREASURERS MEMBERS NO. 28-94 BOARD OF GOVERNORS NO. 101-94 FEDERAL LEGISLATION MEMBERS NO. 28-94 MEMBERS - ONE PER COMPLEX NO. 72-94 SEC RULES MEMBERS NO. 69-94 RE: SEC STAFF MEMORANDUM ON MUTUAL FUNDS AND DERIVATIVES

On September 26th, the Securities and Exchange Commission released a memorandum prepared by the Division of Investment Management entitled "Mutual Funds and Derivative Instruments." A copy of the memorandum is attached. The memorandum was drafted in response to a June 15th letter from House Telecommunications and Finance Subcommittee Chairman Edward Markey (D-MA) and Ranking Minority Member Jack Fields (D-TX) requesting that the Commission undertake a comprehensive study of the use of derivatives by mutual funds and the adequacy of laws and regulations governing their disclosure and use. The letter also posed a series of specific questions. The staff's memorandum includes responses to these questions, which relate to: (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. The memorandum also reviews steps taken to date by the Commission and the Division of Investment Management to address investor protection issues raised by mutual fund use of derivatives, and further actions recommended by the Division. The Division's principal recommendations are as follows: (a) the Commission should seek public comment on requiring some form of quantitative risk measurement in fund prospectuses; (b) the Commission should consider reducing the ceiling on fund illiquid holdings to 10% of net assets; and should continue to evaluate liquidity and pricing issues raised by derivatives through the fund inspection process and determine on the basis of its findings whether rulemaking is necessary in these areas; (c) the Commission should reexamine the application of the leverage restrictions of the Investment Company Act to derivatives and seek public comment on whether regulatory or legislative action is needed to address the leverage created by fund use of derivatives; and (d) the Commission should recommend that Congress enact legislation to enhance the Commission's ability to obtain information necessary to monitor fund use of derivatives. The memorandum further states that "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." It indicates that the Division's inspection staff examines fund management controls, and is giving particular attention to controls relating to derivatives risk. Based upon the staff's findings and discussions with industry participants, the Division will determine whether to recommend

that the Commission consider rulemaking with respect to management controls of derivatives risk. Paul Schott Stevens General Counsel Attachment

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