MEMO# 6250

September 29, 1994

SEC CHAIRMAN, INSTITUTE AND OTHERS TESTIFY ON FUNDS' USE OF DERIVATIVES AND PERSONAL INVESTING BY PORTFOLIO MANAGERS

September 29, 1994 TO: BOARD OF GOVERNORS NO. 100-94 FEDERAL LEGISLATION COMMITTEE NO. 30-94 FEDERAL LEGISLATION MEMBERS NO. 27-94 MEMBERS - ONE PER COMPLEX NO. 70-94 RE: SEC CHAIRMAN, INSTITUTE AND OTHERS TESTIFY ON FUNDS' USE OF DERIVATIVES AND PERSONAL INVESTING BY PORTFOLIO MANAGERS ____ On September 27th, the House Energy and Commerce Subcommittee on Telecommunications and Finance held a hearing on mutual funds' use of derivatives and personal investing by fund portfolio managers. The opening witness, Securities and Exchange Commission Chairman Arthur Levitt, was followed by a panel of witnesses that included G. Oliver Koppell, Attorney General of the State of New York, Donald Phillips, Publisher of Morningstar, and the Institute. Copies of the Institute's oral and written statements, of the SEC's and other witnesses' testimony, and of Subcommittee Chairman Edward Markey's opening statement are attached. In connection with the hearing, the SEC released a memorandum prepared by the Division of Investment Management in response to a June 15th letter from Subcommittee Chairman Markey (D-MA) and Ranking Minority Member Jack Fields (R-TX) requesting that the SEC undertake a study of the use of derivatives by mutual funds and the adequacy of laws and regulations governing their disclosure and use. The SEC also released the report of the Division of Investment Management entitled "Personal Investment Activities of Investment Company Personnel," which summarizes the Division's findings and recommendations based upon its examination of the personal investment practices of 30 fund groups. The Institute is sending these documents to you under separate cover. SEC TESTIMONY Mutual Fund Investments in Derivatives With respect to fund investments in derivatives, Chairman Levitt indicated that there are two special challenges that need to be met -- first, improving communications with investors about the risks of funds that invest in derivatives; and second, ensuring that there is appropriate management of those risks. He briefly described the SEC's plans for responding to issues relating to fund 2investments in derivatives, based on the findings and conclusions of the Division of Investment Management in its study. Specifically, Mr. Levitt noted, the SEC would look at the possibility of developing a uniform, quantitative risk measure for mutual funds, would continue to monitor liquidity and pricing issues, would restore the 10% limit on illiquid investments for non-money market funds, and would seek legislation to expand the SEC's authority to obtain information concerning fund portfolio holdings. Chairman Levitt announced at the hearing that, the previous day, a small, institutional money market fund had notified its shareholders of plans to liquidate as a result of losses on investments in certain derivative instruments. He stated that this event would serve as a reminder that money market funds are not insured or guaranteed, and indicated that it did not represent a "market cataclysm" but rather was a sign of market efficiency. In response to questioning about how this had happened, Chairman Levitt said that the securities that led to the decline in the fund's net asset value probably were not appropriate investments for a money market fund, but he declined to discuss whether the SEC would bring an enforcement action against the fund. He further noted that the SEC would actively monitor the situation, which appeared to him to be an isolated and unusual case. He also indicated that the SEC would not tolerate violations of Rule 2a-7. Responding to questions concerning investments in derivatives by non-money market funds, Chairman Levitt said the moral to the story of certain funds that had experienced significant losses on their investments in derivative was that "any fund can lose money." He indicated that he would not recommend extending Rule 2a-7 or similar portfolio restrictions to short-term government bond funds, noting that if the SEC is successful in its efforts to increase consumer awareness (e.g., about the differences between money market and short-term bond funds), this would not be necessary. Chairman Levitt also expressed some concerns that it would be difficult to draw a line as to how far any such restrictions should be extended, and that certain investment opportunities would be lost. He therefore recommended that the SEC instead continue to look closely at short- term bond funds and crack down on any abuses. Chairman Levitt also took the opportunity to reiterate his views about the need for independent directors of funds to serve as the front line of protection for fund investors in the context of both fund investments in derivatives and personal investing issues. Personal Investing by Portfolio Managers Chairman Levitt reported on the results of the SEC's 3examination of the personal investing practices of 30 fund groups, as described in the report of the Division of Investment Management released in connection with the hearing. In his remarks, Mr. Levitt praised the efforts of the Institute and the report of the special industry Advisory Group on personal investing. He emphasized that the SEC's recommendations, which include among other things requiring disclosure to investors of fund policies on personal trading and board review of funds' codes of ethics and compliance with such codes, would not supplant those of the Advisory Group but rather were intended to complement and amplify them. He commented that the SEC's recommendations, along with self-regulation by the industry, were sufficient in his view to address concerns about portfolio managers' personal investing. Responding to Chairman Markey's questions, Chairman Levitt stated that the issue of personal investing is a moving target that requires continuing attention. He repeated his personal view that if he ran a fund group, he would not permit any personal trading. He nevertheless indicated that he thought the Institute acted very responsibly and was satisfied that the recommendations of the Advisory Group were an appropriate way to address the matter. Chairman Levitt expressed his hope and expectation that industry members would embrace the proposals and stated that if not, the SEC "will be back with a much stronger message." In this regard, he indicated that he expected the Institute to keep him apprised of the progress of its members' implementation of the various recommendations. Chairman Levitt stated that the SEC's examination of some of the fund groups included in its survey is continuing and should be completed within the next six months, at which point he would report back to the Subcommittee if any abusive practices were uncovered. INSTITUTE TESTIMONY Mutual Fund Investments in Derivatives In its testimony, the Institute stated that despite recent publicity about certain funds that suffered losses on their investments in derivatives, there is no widespread or systemic problem in the fund industry. The Institute commented that these cases have been relatively few in number, and that most have involved money market funds, where the SEC already has clarified the types of instruments that are eligible for money market portfolios. With respect to non-money market funds, the Institute noted that the existing strict regulatory system is fully applicable to fund investments in derivatives; that the overall level of fund investments in derivatives appears to be relatively modest; and that as a result of recent events, many funds already limit or have reduced their exposure to certain types of derivative instruments. 4The Institute nevertheless recommended certain refinements to address concerns that have been raised, including: 1) To enhance disclosure by -- (a) placing greater emphasis on disclosing the volatility of a fund's portfolio as a whole, possibly using existing numerical measures of risk such as duration; (b) changing accounting rules to require more meaningful descriptions of non-traditional investments in fund financial statements; (c) providing additional NASD direction to brokers on the need to understand and explain the risks of mutual funds they are offering, including risks posed by derivatives; and (d) adoption of the SEC's proposed Summary Prospectus; 2) Reinstating the 10% limit on investments in illiquid instruments by mutual funds; and 3) Increasing funding to the SEC so that oversight keeps pace with the growth of the industry. The Institute's testimony also recommended that all mutual funds that invest in derivatives ensure that their internal procedures are sufficient to reasonably ensure that these investments are consistent with the funds' stated objectives and otherwise in compliance with applicable law. Personal Investing by Portfolio Managers The Institute also addressed the topic of personal investing by mutual fund portfolio managers, noting that a special industry Advisory Group, made up of six senior fund executives, had been formed in February of this year to study the matter. The Institute's testimony summarized the Advisory Group's findings and recommendations, as set forth in the Group's report which was released in May. The testimony stated that the Advisory Group's recommendations were unanimously approved by the Institute's Board of Governors in June, and that it is anticipated that Institute members will implement the recommendations by the end of this year. Noting that implementation by some members had been awaiting the release of the SEC's report, the Institute stated that it was pleased that the SEC staff recommendations closely track those in the Advisory Group's report. * * * We will keep you informed as developments occur. For further information, please contact the Legislative Affairs Department at (202) 326-5890. Matthew P. Fink President 5Attachments

---