INVESTMENT COMPANY INSTITUTE

MEMO# 5989

June 23, 1994

CHAIRMAN LEVITT'S LETTERS ON MUTUAL FUND INVESTMENT IN DERIVATIVES; INSTITUTE'S RESPONSE

June 23, 1994 TO: BOARD OF GOVERNORS No. 55-94 SEC RULES COMMITTEE No. 69-94 RE: CHAIRMAN LEVITTGS LETTERS ON MUTUAL FUND INVESTMENT IN DERIVATIVES; INSTITUTEGS RESPONSE

____ Securities and Exchange Commission Chairman Arthur Levitt recently sent letters to the Institute and fund groups regarding mutual fund investments in derivatives. Attached are copies of Chairman LevittGs letters and the InstituteGs response. Chairman LevittGs Letters In his letter to the Institute, Chairman Levitt noted that "[w]hen a fund uses derivatives wisely, they can help manage risk or generate additional income. But derivatives can pose significant risks." Chairman Levitt expressed concern about recent press accounts of derivative instruments held by some government bond funds and money market funds that have declined in value, which he believes indicate that some fundsG derivatives risks may not have been well-managed. He was also troubled that these losses may have come as a surprise to shareholders. Chairman Levitt cautioned that "[f]und managers [particularly money market fund managers] must be prepared to evaluate the address the risks of derivatives." He set forth a number of specific issues that fund managers should consider in connection with their use of derivatives. In addition, he stated that funds should be providing disclosure to shareholders about the uses and risks of derivatives that not only meets regulatory requirements, but is also truly informative. Finally, Chairman Levitt noted that "fund directors have critical oversight responsibilities for their fundGs use of derivatives." In his letter to fund groups, Chairman Levitt expressed his "continuing concern that mutual funds utilize derivatives instruments wisely." He encouraged fund management to take appropriate steps to ensure the effective management of derivative risks, and he urged fund directors to become actively involved in the formulation of fund derivative policies and procedures and to exercise meaningful oversight of such internal controls. Chairman Levitt expressed particular concern about money market fund investments in derivatives. Finally, he stated that he would be working closely with the Institute on these issues. Institute Response The InstituteGs response to Chairman Levitt states that the Institute "share [his] belief that, while derivative instruments can provide additional return to investors and help manage risk when used wisely, it is vital that fund management evaluate and address the risks that such investments can pose, and that fund directors exercise appropriate oversight." The response goes on to describe some of the efforts the Institute has undertaken relating to mutual fundsG use of derivatives. Among other things, the Institute is finalizing a detailed memorandum for fund senior management and directors, which is intended to assist them in addressing the issues identified in Chairman LevittGs letter, and is reviewing whether mutual fund risk disclosure can be made more informative for fund shareholders. The response also points out the InstituteGs continuous support for efforts to tighten the CommissionGs portfolio quality requirements for money market funds and expresses hope that the latest rule proposals in this area will be adopted soon and will clarify any ambiguities that may currently exist with respect to the eligibility of certain instruments. Finally, the InstituteGs response notes that “to the best of our knowledge, it appears that the vast majority of mutual funds are managing their investments in derivatives successfully, even in the highly turbulent market conditions of recent months.” Matthew P. Fink President Attachments