The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

ICI VIEWPOINTS

February 23, 2012

Regulating Funds' Use of Derivatives: Striking a Fine Balance

Much has been written about the dangers of derivatives, from Warren Buffett's quote about "financial weapons of mass destruction" to media coverage of derivatives' role in various aspects of the financial crisis, such as the downfall of AIG. Far less attention has been paid to the benefits that derivatives can provide for mutual funds and their investors—allowing funds to mitigate risks, manage portfolios more efficiently, and access new strategies.

How do funds use derivatives? To name a few examples:

- Currency forwards enable funds to hedge the currency risks associated with investing in foreign markets.
- Stock index futures offer funds the ability to achieve an index-based return while keeping cash available to meet redemptions, preventing "cash drag."
- Treasury note futures can help fixed income funds adjust the duration of a fixed income portfolio without buying or selling bonds, which can be very expensive.
- Total return swaps provide funds an efficient way to gain investment exposures to asset classes that might be difficult or costly to access directly, such as some foreign markets.

These techniques are important, because, as ICI President Paul Schott Stevens says, "From their beginning, mutual funds have had a distinct mission—to bring the best of investment management to the investor of moderate means.…Some called it 'Mr. Rockefeller's portfolio manager working for you.'" Today, Stevens notes, "it's impossible to meet that promise efficiently without using options, futures, swaps, and other derivatives."

ICI wants to ensure that fund managers continue to have access to these important portfolio management tools. At the same time, we share regulators' concerns that lax rules on derivatives could permit some funds to take excessive risks.

That's a fine line to walk, which is why we're glad that the Securities and Exchange Commission (SEC) has taken a measured, thoughtful approach to modernizing the legal framework that governs funds' use of derivatives. We recognize that there are no easy answers here. All regulators concerned with these issues need to act thoughtfully and deliberately. A regulatory approach that allows funds sufficient flexibility to give investors access to the best possible portfolio management techniques, while minimizing the risk of potential misuse, is truly a fine balance.

One possible approach to striking this balance would be for the Commission to allow funds to establish tailored policies and procedures, while also establishing “guardrails” to ensure that funds have appropriate mechanisms in place to limit excessive risk taking. These guardrails would impose baseline requirements on funds that elect to engage in more than minimal use of derivatives. We outlined this approach in our comment letter to the SEC on its concept release. While we believe the approach is a good one, many of the details have yet to be worked out. If the Commission is willing to consider this approach, the ICI and its members are committed to helping find the right balance.

We commend the SEC and its staff for taking its review of these issues seriously. We look forward to continuing to work with the staff and the industry to protect the best interests of fund investors.
