UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

September 26, 1994

The Honorable Edward J. Markey
Chairman
Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, D.C. 20515

ACT ICA-40
SECTION 18(f)(1)
RULE
PUBLIC AVAILABILITY 9/26/94

The Honorable Jack Fields
Ranking Republican Member
Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Markey and Representative Fields:

Thank you for your letter dated June 15, 1994 concerning mutual fund use of derivatives. Your letter raises a number of important questions concerning the framework for the regulation and oversight of these activities. I share your concern for these important investor protection issues, and am particularly committed to finding improved ways for funds to communicate to shareholders the risks of investment.

Your letter requested that the Commission undertake a comprehensive study of the use of derivatives by mutual funds. I am enclosing a memorandum prepared by the Division of Investment Management that comprises the requested study.

Mutual funds are the investment vehicle of choice for funding Americans' essential needs -- for educating their children, for retiring with dignity. The Commission considers the protection of mutual fund investors absolutely essential. We have been, and will be, vigilant in addressing the issues raised by mutual fund use of derivatives, and we look forward to working with you in this endeavor.

Sincerely,

Arthur Levitt
Chairman

Enclosure

MEMORANDUM

September 26, 1994

TO: Chairman Levitt

FROM: Division of Investment Management BRB

RE: Mutual Funds and Derivative Instruments

This memorandum responds to a letter dated June 15, 1994 (the "Letter"), from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce ("Subcommittee"), requesting that the Commission undertake a study of the use of derivatives by mutual funds and, more particularly, the adequacy of laws and regulations governing their disclosure and use. The Letter raises questions about (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.

As you are aware, investor protection issues raised by mutual fund use of derivatives have received heightened attention by the Commission since you became Chairman. You have urged fund directors and trustees to exercise meaningful oversight of fund derivative investments and have encouraged the management of every fund using derivatives to manage their derivatives risks effectively. In addition, you have directed the Division to make mutual fund use of derivatives a priority -- in the disclosure review process, in fund inspections, and in policy considerations. In responding to the Letter, this memorandum also reviews the steps taken to date by the Commission and the Division to address investor protection issues raised by mutual fund use of derivatives and describes the further actions that the Division recommends.

## Background

### A. The Use of the Term "Derivative"

The term "derivative" is generally defined as an instrument whose value is based upon, or derived from, some underlying index, reference rate, (*e.g.*, interest rates or currency exchange rates), security, commodity, or other asset.[1] "Derivative" may cover a wide variety of instruments,[2] and public debate concerning issues raised by derivatives is

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[1]*See, e.g.*, GROUP OF THIRTY GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 2 (July 1993) [hereinafter G-30 REPORT].

[2]The term "derivative" generally is used to embrace forward contracts, futures, swaps, and options. *See, e.g., id.* at 28-34; U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 5 (May 1994). The term is also commonly used to describe instruments that are created by separating other financial instruments into constituent

(continued...)

often complicated by imprecision regarding the instruments that raise a particular issue. Indeed, the public debate about "derivatives" sometimes suggests that a "derivative" is any complicated instrument that has caused losses. Mutual fund investments in derivatives raise significant investor protection concerns, which are addressed in this memorandum, but these concerns typically relate to specific instruments used by specific funds and not to all derivatives and all funds. Derivatives may be standard or customized, traded on an exchange or over-the-counter, liquid or illiquid, novel or familiar, leveraged or unleveraged. Derivatives may increase or reduce portfolio risk. As the Subcommittee and the Commission continue to address the important issues raised by mutual fund use of derivatives, it will be important in each case to focus on the specific parameters of the problems to be addressed.

### B. Mutual Fund Use of Derivative Instruments

Mutual funds, other than money market funds, use derivative products for a wide variety of purposes, including hedging interest rate, currency, and other market risks; substituting for a direct investment in the underlying instrument; or increasing returns. Money market funds also invest in debt instruments sometimes referred to as derivatives that have interest rates that are adjusted periodically based on changes in market interest rates. Many non-money market funds have the authority to use derivative instruments, but the Division's inspections to date suggest that the use of derivatives by most of these funds is limited. There are exceptions, however, to this general observation. Funds primarily investing in mortgage-backed securities, for example, generally have significant investments in derivatives. Long-term municipal bond funds use derivatives to seek increased tax-exempt returns. In addition, funds investing internationally may use derivative investments to lessen currency risks.

A recent industry survey of non-money market funds also suggests that mutual fund use of derivatives is limited.[3] The survey reported that the total market value of all derivatives held by participating funds was $7.5 billion, representing 2.13% of the total net assets of all funds reporting derivatives holdings and 0.78% of the total net assets of all funds participating in the survey. The total notional amount of these derivatives was $54.3 billion, representing 15.51% of the total net assets of all funds reporting derivatives holdings and 5.67% of the total net assets of all funds participating in the survey.[4] The survey also indicated that the level of use of derivatives varied by fund type, with fixed income funds accounting for 84% of the total market value of all derivatives held by reporting funds and 62% of the notional amount.

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[2](...continued)
pieces, *e.g.*, mortgage derivatives. *See, e.g.*, James K. Glassman, *Mortgages, and Governments, Can Get Sliced and Diced*, WASH. POST, Sept. 7, 1994, at F1.

[3]Investment Company Institute, Derivative Securities Survey, Feb. 1994. Survey respondents included 52 fund complexes with 1,728 non-money market funds holding aggregate net assets of $958 billion (76% of industry assets in non-money market funds). The survey was limited to a quantitative investigation of the use of derivatives by mutual funds and did not attempt to measure associated risks. *Id.* at 1.

[4]"Notional amount" was defined in the survey as "the maximum theoretical exposure presented by the instrument, *i.e.*, the amount whose *changes in value* impact the fund's net asset value." *Id.* at 2.

### C. Investor Protection Concerns and Commission Actions

Although the use of derivatives by mutual funds generally appears to be limited, some funds have recently experienced problems relating to derivative investments. Several short-term government bond funds have experienced significant losses from mortgage derivatives.[5] In addition, losses in the value of certain adjustable rate notes held by some money market funds have resulted in the funds' advisers electing to take actions, including contributing capital or purchasing instruments held by the funds, designed to prevent the funds' per share net asset values from falling below $1.00.[6] Although the reported problems to date have affected a limited number of funds and fund types, they raise investor protection issues that merit serious consideration.

As you are aware, months before these reports surfaced, the Commission expressed concern about investor protection issues raised by mutual fund investments in derivatives. Since the summer of 1993, the Commission has taken a multi-faceted approach to mutual fund use of derivative instruments, focusing on a broad range of issues, including disclosure, pricing, liquidity, leverage, and risk management. A Division task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types, and the Division's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses. In addition, the Division's inspection staff is examining and reporting on the derivatives activities of each fund inspected, and has conducted special examinations of certain funds holding significant positions in derivatives.

### D. Division Recommendations

This memorandum makes a number of recommendations for further action by the Commission to address mutual fund use of derivatives. The principal recommendations are the following:

- The Commission should consider requiring some form of quantitative risk measure in mutual fund prospectuses and should seek public comment on this topic no later than early 1995.

- The Commission should promptly consider reducing the ceiling on fund illiquid holdings. In addition, the Commission should continue to evaluate liquidity and pricing issues raised by derivatives through the mutual fund inspection process. If it appears appropriate as a result of these inspections, the Commission should consider issuing rules to address matters such as proper procedures for mutual fund pricing and liquidity determinations.

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[5] *See, e.g.*, Robert McGough, *Piper Jaffray Acts to Boost Battered Fund*, WALL ST. J., May 23, 1994, at C1; Andrew Bary, *Derivatives Undo a Popular PaineWebber Fund, Triggering 4% One-Day Drop in Value*, BARRON'S, May 16, 1994, at MW12 [hereinafter *PaineWebber Fund*].

[6] *See, e.g.*, *A History of Stepping up to the Plate*, FUND ACTION, Sept. 12, 1994, at 9 [hereinafter *Stepping up to the Plate*].

- The Commission should reexamine the application of the leverage restrictions of the Investment Company Act of 1940 ("Investment Company Act" or "Act")[7] to derivative instruments and should seek public comment on whether regulatory and legislative solutions are necessary to address the leverage created by mutual fund use of derivatives.

- The Commission should recommend that Congress enact legislation to enhance the Commission's ability to obtain information required to monitor fund use of derivatives.

### E. Management and Board Responsibilities

The Commission has a critical role to play in enhancing investor protection in the area of mutual fund derivative investments. As you have noted, however, 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.[8] To that end, you have urged fund boards to exercise meaningful oversight of fund derivative investments by becoming more involved in portfolio strategies, risk management, disclosure and pricing issues, accounting questions, and internal controls.[9] In correspondence with the chief executive officers of the 80 largest fund complexes, you encouraged the management of every fund that holds derivative instruments to take steps that will ensure the proper understanding and effective management of derivatives risk.[10] The Division's inspection staff examines mutual fund management controls, and is giving particular emphasis to controls relating to derivatives risk. On the basis of our findings during inspections and discussions with fund industry participants, we will determine whether to recommend that the Commission consider rulemaking to encourage better mutual fund management controls of derivatives risk.

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[7]15 U.S.C. § 80a.

[8]Strong management controls are generally recognized as essential to monitoring and controlling the derivatives activities and risks of derivatives dealers and end-users. *See, e.g.*, Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Securities and Investments Board, OTC Derivatives Oversight 3-4 (Mar. 15, 1994); The Technical Committee of the International Organization of Securities Commission, Operational and Financial Risk Management Control Mechanisms For Over-the-Counter Derivatives Activities of Regulated Securities Firms (July 1994); G-30 REPORT, *supra* note 1, at 9-13; Investment Company Institute, Investments in Derivatives by Registered Investment Companies 4-6 (Aug. 1994).

[9]Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors as Investor Advocates, Remarks at the Investment Company Institute Investment Company Directors Conference, Washington, D.C. (Sept. 23, 1994) [hereinafter Levitt Remarks, Directors as Investor Advocates]; Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors: On the Front Line for Investors, Remarks at the Mutual Funds and Investment Management Conference, Scottsdale, Arizona (Mar. 21, 1994).

[10]Letters from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to chief executive officers of 80 largest fund complexes (June 16, 1994) [hereinafter Levitt Letters].

**Responses to Questions Raised by the Letter**

Set forth below are the questions contained in the Letter, followed by the Division's responses.

**1. Does the SEC Have Adequate Knowledge of Industry Practices**

**a. Please identify the information needed by the SEC to fulfill its responsibilities.**

The Commission's responsibility with respect to mutual funds is to administer and enforce the Investment Company Act and other applicable provisions of the federal securities laws. Through its inspection and registration processes, the Division can and does monitor individual mutual fund policies and portfolios, including derivatives activities. The Investment Company Act requires funds to maintain and provide to the Commission records reflecting much of this information.[11] In addition, during the course of examinations, funds generally voluntarily provide the Division with additional documents and access to fund personnel and often make records available in electronic media. Information concerning a fund's investments in derivatives is also contained in the fund's registration statement and amendments thereto, which describe investment policies and practices, and semi-annual reports on Form N-SAR and reports to shareholders, which contain information about portfolio activities. The information needed by the Commission, much of which is generally available to it, includes the following:

- complete information concerning the purchase and sale of portfolio instruments (*e.g.*, date and time of trade, counterparty, transaction price, identity of instrument traded);
- detailed information concerning each portfolio instrument (*e.g.*, for mortgage-backed securities, cash flow projections, including prepayment assumptions with respect to underlying mortgages);
- information regarding portfolio strategies and the manner in which each portfolio instrument contributes to portfolio strategies (*e.g.*, identity of portfolio positions that hedge other positions);
- valuations of fund assets and liabilities; and
- information relating to fund risk monitoring, *e.g.*, analyses of fund performance under various market scenarios.

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[11]Section 31(a) of the Investment Company Act requires every registered investment company to maintain and preserve those accounts, books, and other documents that constitute the basis for its financial statements. 15 U.S.C. § 80a-30(a). Section 31(b) of the Investment Company Act provides that investment company records required to be maintained under section 31(a) are subject to examination by the Commission. 15 U.S.C. § 80a-30(b).

**b. What obstacles, if any, prevent the Commission from obtaining and processing this information?**

Resource constraints are the principal obstacle to improved Commission monitoring of mutual funds. Although the Division generally can obtain the information it requires to monitor funds, the scope and frequency of our inspections are severely constrained by available resources.[12] Aside from information contained in a mutual fund's periodic filings, our knowledge of the fund's investment practices, including its derivatives holdings, is no more current than our most recent inspection. In addition, the increasing use of derivatives and other complex portfolio strategies has heightened the Commission's need to hire, train, and retain a highly skilled mutual fund inspection force.

The recordkeeping, reporting, and inspections provisions of the Investment Company Act also impose some limits on the Commission's authority to obtain information required to monitor mutual funds. In practice, these limits often do not hinder the Commission's fulfillment of its responsibilities, but they may do so in some circumstances, including, for example, when a fund does not voluntarily cooperate with the Commission; when, in times of market stress, rapid access to fund information is important; when the unavailability of electronic records in a format usable by the Division interferes with an efficient inspection; or when a fund does not maintain records that, if available, would improve Commission understanding of the fund's operations. These limits are described in detail below.

We emphasize that most investment companies cooperate fully with the Division's inspection staff and produce not only records required to be kept under the Commission's investment company recordkeeping rules, but other requested records. Most funds also allow Division inspection staff to interview employees responsible for maintaining these records, as well as portfolio managers, who are in the best position to explain many fund investments. And many funds make their records available electronically.

**i. Recordkeeping Authority**

Section 31(a) of the Investment Company Act requires every registered investment company to "maintain and preserve for such period . . . as the Commission may prescribe . . . such accounts, books, and other documents as constitute the record forming the basis for financial statements required to be filed pursuant to [the Investment Company Act] . . . ."[13] This provision presents two potential limitations for the Commission, one relating to the scope of required recordkeeping and the other relating to the form in which the required records are kept.

First, as a general matter, the Commission may require investment companies to keep records forming the basis for the preparation of financial statements. These records alone, however, often do not provide the Commission with enough information to evaluate the portfolio strategies that may underlie a mutual fund's use of derivatives. For example, these records may not disclose the relationships among portfolio instruments, *e.g.*, the identities of positions that hedge other positions. Nor is it clear that they include records

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[12] *See, e.g.*, Testimony of Arthur Levitt, Concerning Appropriations for Fiscal Year 1995, Before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the Senate Committee on Appropriations 4-6 (May 5, 1994).

[13] 15 U.S.C. § 80a-30(a).

related to portfolio management strategies, such as computer models that funds may use to evaluate the expected volatility of a specific derivative or the portfolio as a whole or the records generated by these models.[14]

Second, the Investment Company Act's recordkeeping provisions do not specifically address the medium in which records are required to be kept. In particular, the Commission would like specific authority to require that fund records be kept in an electronic medium.[15] Given the growth of the investment company industry, the size of individual funds, and the volume of transactions in which they engage, paper records are extremely cumbersome. Using paper records, the staff can only review a limited sample of the securities transactions in which a fund has participated over a specified period. Moreover, paper-based records do not facilitate modern examination techniques, such as computerized analysis to check for "red flags" that suggest the need for an inspection. Many funds voluntarily make their records available electronically, but fund records are not always maintained in an electronic format that is usable by the Division.

**ii. Inspection Authority**

Section 31(b) of the Investment Company Act provides that investment company records "required to be maintained . . . shall be subject at any time and from time to time to such . . . examinations by the Commission . . . as the Commission may prescribe."[16] This provision presents an issue that may affect the scope of the Commission's inspection authority.

Under section 31(b), there is no explicit requirement that funds provide records that are not required to be maintained under a specific provision of the Investment Company Act or Commission rules. The required records often cannot be understood without referring to other documents that are not required to be kept by Commission rules. These additional records, for example, may explain innovative products and investments. They may also provide important insights into the portfolio management strategies of a fund. At present, in the inspection context, the Commission often relies on voluntary fund production of these

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[14]The Division is currently preparing rulemaking recommendations that should increase the Commission's access to information concerning fund portfolios. For example, in light of the recent proliferation of derivatives and other novel financial instruments, the Division is reviewing the books and records rules to ensure that fund records are required to contain all information necessary to determine an investment's suitability for the fund and its value for the daily net asset value calculation. The Division previously recommended, and the Commission proposed, amendments to the recordkeeping requirements for money market funds that would require more detailed description of portfolio instruments. Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959, Part II.D.7. (Dec. 17, 1993), 58 FR 68585, 68604 (Dec. 28, 1993) [hereinafter Release 19959]. These amendments, when adopted, should facilitate the ability of the Division staff to identify instruments that have interest rate provisions that are inconsistent with the limitations imposed by the Commission's money market fund regulations. See the answer to question 8, below. The Division also intends to recommend revisions to Form N-SAR that should result in the Commission having more information concerning the nature of fund portfolios.

[15]In 1986, the Commission amended rule 31a-2 to permit investment companies to maintain their records electronically. 17 C.F.R. § 270.31a-2(f)(ii).

[16]15 U.S.C. § 80a-30(b).

records to examine fund transactions in investments that present novel investor protection issues, such as derivative instruments.[17]

### iii. Frequency of Fund Reporting

Section 30(b) of the Investment Company Act authorizes the Commission to require a fund to file with the Commission "such information and documents (other than financial statements) as the Commission may require, on a semi-annual or quarterly basis, to keep reasonably current the information and documents contained in the [fund's Investment Company Act] registration statement . . . ."[18] The limitation to periodic reporting restricts the Commission's ability to monitor funds, particularly in times of market stress. For example, recent events have demonstrated that sudden changes in interest rates can have significant effects on fund portfolios that can be magnified by substantial derivative exposure.[19] The Commission is not now in a position to require prompt reports from funds on the effects of these interest rate changes, but must await the next periodic reports or initiate inspections.

### c. What steps should be taken to insure that the Commission is able to obtain accurate and reliable information quickly and efficiently?

The Division recommends that the Commission seek legislative clarification and expansion of its existing authority to address the issues identified above. In particular, the Division intends to submit to the Commission recommended legislation that would do the following.

First, the Investment Company Act would be amended to authorize the Commission to require investment companies to "maintain and preserve such records as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[20] This provision would authorize the Commission to require any additional records that are necessary to enable its inspection staff, among other things, to analyze a fund's derivative investments.

Second, the Investment Company Act would be amended to expressly authorize the Commission to specify the medium and format in which records must be kept, including electronic media. Electronic recordkeeping in a usable format would enable the Division's inspection staff to review an entire portfolio at multiple points in time, and transaction flows

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[17]In the context of an enforcement investigation, the Commission may require the production of all records that may be related to the inquiry. *See, e.g.*, Investment Company Act § 42(b), 15 U.S.C. § 80a-41(b).

[18]15 U.S.C. § 80a-29(b). Currently, the Commission requires funds to file semi-annual reports on Form N-SAR. 17 C.F.R § 270.30b1-1.

[19]*See, e.g., PaineWebber Fund, supra* note 5; G. Bruce Knecht, *Piper Manager's Losses May Total $700 Million*, WALL ST. J., Aug. 25, 1994, at C1 [hereinafter *Piper Fund*].

[20]This is the same grant of recordkeeping authority that Congress has provided the Commission with respect to broker-dealers in Section 17(a)(1) of the Securities Exchange Act of 1934 and investment advisers in Section 204 of the Investment Advisers Act of 1940. 15 U.S.C. §§ 78q(a)(1), 80b-4.

over time, to evaluate a fund's portfolio activities. This ability is particularly important in analyzing derivative investments, which are often used together with other instruments in the portfolio. Electronic recordkeeping would also facilitate the use of developing technologies that would make the Commission's investment company examination program more efficient. For example, if fund information were supplied electronically to the Commission's offices prior to an inspection, the inspection staff could analyze the data prior to commencing field work and target their efforts in the field on issues raised by that analysis.

Third, the Investment Company Act would be amended to require explicitly that a fund provide the Commission with all records that are kept by the fund, whether or not required by Commission rule to be kept.[21] Documents that are not required to be kept often provide the best description of the risks of a particular derivative instrument and may point to operational deficiencies.

Fourth, the Investment Company Act would be amended to authorize the Commission to specify the frequency of reporting by investment companies. This authority would assist the Commission by providing more timely access to information on fund portfolios and sales and redemption activity in times of market stress.[22] This authority would also enable the staff to obtain information that would help to identify particular funds or patterns of events that require closer scrutiny.

We believe that the legislation described above, if enacted, would increase the availability to the Commission of the data required to monitor adequately mutual fund investments, including investments in derivatives. We would emphasize, however, that, absent significant additional resources for the highly-qualified staff necessary to perform fund inspections and analyze available data, the Commission will remain constrained in its ability to monitor mutual funds even if the recommended legislation is adopted.

**2. Better Disclosure May be Critical to Help the SEC, but Will it be Accomplished in a Manner that Makes a Significant Difference to Average Investors?**

**a. First, we suspect that investors often develop general expectations about risk based on how their fund is categorized, and would like to know if the Commission agrees.**

Neither the Commission nor the Division establishes, regulates, or gives guidance with respect to fund categories. Fund categories develop, over time, through use by the fund industry and rating services such as Lipper Analytical Services, Inc., and Morningstar,

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[21] *Cf.* Section 17(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78q (making all records of broker-dealers subject to Commission examination); 12 U.S.C. § 248 (authorizing the Board of Governors of the Federal Reserve System to "examine at its discretion the accounts, books, and affairs of each Federal reserve bank and of each member bank and to require such statements and reports as it may deem necessary"); 12 U.S.C. § 481 (authorizing Comptroller of Currency to appoint bank examiners who "have power to make a thorough examination of all the affairs of" national banks).

[22] *Cf.* Section 17(h)(2) of the Exchange Act, 15 U.S.C. § 78q(h)(2) (authorizing the Commission, in times of adverse market conditions, to require registered broker-dealers to make reports concerning the financial and securities activities of their associated persons).

Inc. As a general matter, certain categories of funds tend to be more or less risky than other categories. For example, among fixed income funds, a portfolio comprised of short-term bonds is normally less volatile than one comprised of long-term bonds. Acknowledging these general characteristics, investors presumably do develop general expectations about risk based on how their fund is categorized.

The Commission does regulate fund names, which often convey information about a fund's category. The Investment Company Act makes it unlawful for a registered investment company to use as part of its name any word that the Commission finds to be deceptive or misleading.[23] A Division guideline states that if a registrant's name suggests a certain type of investment policy, its name should be consistent with its statement of investment policy. The guideline also provides generally that if a fund's name implies that it invests primarily in a particular type of security, its investment policy should require that, under normal circumstances, at least 65 percent of the value of the fund's total assets will be invested in that type of security.[24] The Division also takes the position that where a fund has a name or investment objective that characterizes the maturity of its portfolio, the dollar-weighted average portfolio maturity of the fund must reflect that characterization.[25]

We would emphasize that a name, or any single piece of information about a mutual fund, cannot tell the whole story of mutual fund risk. The prospectus is a mutual fund's basic disclosure document. Fund prospectuses convey a range of information to investors, including the fund's name, investment objectives and policies, permitted investments, and risk descriptions.[26] This information, taken together, should communicate to investors a comprehensible and accurate picture of fund risk.

The Division is taking several steps to help ensure that a fund's name is consistent with the fund's use of derivatives and educate investors regarding the danger of relying too heavily on fund names. First, on an ongoing basis, in the review of fund registration statements, the staff looks for, and requests changes to, disclosure that is inconsistent with a fund's name. Second, because there are inherent limitations on the usefulness of fund names, the Division is undertaking consumer education efforts to alert investors to the need to read prospectuses and periodic reports and the danger of relying too heavily on fund names as the sole source of information regarding the fund's investments. Third, the Division is reevaluating the current requirements regarding fund names to determine whether they should be revised. In particular, the Division contemplates reevaluating the

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[23]Investment Company Act § 35(d), 15 U.S.C. § 80a-34(d). Under section 35(d), the Commission may bring an action to enjoin a registered investment company from using a materially deceptive or misleading name.

[24]Guidelines for Form N-1A, Guide 1. Commission rules restrict the use of the term "money market" in fund names. See section 8.a., below.

[25]Form N-7 for Registration of Unit Investment Trusts Under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Release No. 15612 (Mar. 9, 1987), 52 FR 8268, 8301. The Division takes the position that fund portfolios must have the following dollar-weighted average maturities: short-term fund - not more than three years; short/intermediate-term fund - more than two years but less than five years; intermediate-term fund - more than three years but not more than ten years; intermediate/long-term fund - more than ten years but less than fifteen years; long-term fund - more than ten years. *Id.*

[26]Investment Company Act Form N-1A, Items 1 and 4.

requirements applicable to a fund whose name suggests that its portfolio is limited to instruments of a particular maturity. The Division also expects to review the use by funds of the word "government" in their names.

**b. Second, even if the fund's disclosures are presented clearly, concisely, and in a manner designed to maximize comprehensibility, it is still questionable whether investors would be able to understand and assimilate information that is useful to their investment decision. A discussion of how 'inverse floaters' work, or definitions of 'principal-only strips of CMOs,' will involve unavoidable elements of abstraction. Are there alternative ways of creatively presenting the critical information needed by investors, such as the effect on risk and volatility created by the fund's holdings of derivatives, that avoid the dilemma of attempting to define these instruments and strategies?**

Since the summer of 1993, the Division's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses; and a Division task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types. We have found that funds generally provide investors with a list and technical description of instruments, including derivatives, that are permissible fund investments. Funds often describe the purposes for using particular derivative instruments (*e.g.*, to hedge currency risks), but typically provide only the most general information on the risk level of the fund taken as a whole or on how derivative instruments, taken as a group, modify that risk level.

The Division has advised mutual fund registrants that, in many cases, it has found fund disclosures regarding derivative instruments to be highly technical and has encouraged registrants to modify their existing disclosure to enhance investor understanding of pertinent risks.[27] The Division is also considering possible modifications of the Commission's disclosure requirements. In the Division's view, a potentially better form of disclosure may be some means of describing the risk profile of a fund's portfolio as a whole with greater specificity. This information would assist an investor in determining whether a fund's risk characteristics are consistent with his or her own investment objectives. Consumer focus groups conducted on the Division's behalf early this year indicated that investors may in fact find this information helpful.

In order to address investors' need for information about portfolio risk characteristics, the Division recommends that the Commission issue a release seeking public comment on whether mutual fund disclosure of some quantitative risk measure should be required and what that measure should be. This action would enable the Commission to obtain investor and industry input regarding the utility of various risk measures and the feasibility of their computation. A quantitative risk measure could have significant benefits for investors by providing a means of comparing risks across and within fund categories, particularly for fixed income funds whose market risks may be less well understood by investors than those associated with equity funds.

There are a number of quantitative risk measures that deserve consideration, and the comment process should help the Commission determine which, if any, of the available

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[27]Letter to Registrants from Carolyn B. Lewis, Assistant Director, Division of Investment Management (Feb. 25, 1994).

measures would be most helpful to investors and feasible for funds to calculate. The following are among the possibilities.

- Duration: a measure of the price sensitivity of a fixed income fund to changes in interest rates.

- Standard deviation: a measure of the volatility of a mutual fund's total return over specified time periods.

- Beta: a measure of a mutual fund's risk relative to the market.

We acknowledge that the selection of an appropriate risk measure is a difficult task because all measures have limitations. Most measures rely on historical data and can only estimate the level of risk that was incurred in the past, not what will happen in the future. In addition, measurements will change depending on the time period over which risk is measured and the benchmark against which a fund is compared. Some measures (*e.g.*, duration) are not applicable to all funds. And each measure would require investor education regarding the proper interpretation of the measure and its limited predictive value.[28]

**c. Finally, formal disclosure to investors takes place annually in the prospectus. But various derivatives positions, each with distinctly different possible risks, can change by the hour, or even by the minute. So it's not clear how much value there is in knowing what the fund held at a particular past moment in time. Does the Commission agree that this quality should be considered when evaluating the utility of requiring enhanced disclosure of derivatives holdings?**

The Division agrees that the fluid nature of the investment management process limits the utility of reviewing specific portfolio positions previously taken by a fund. Nonetheless, the Division believes that historical data does provide fund shareholders with important information.

A mutual fund is required to provide a schedule of portfolio holdings to its shareholders semi-annually.[29] This requirement ensures that shareholders receive a twice-yearly snapshot of a fund's investments. The snapshot is important in that it provides shareholders with a concrete, historical picture of how the fund has been managed.

The portfolio schedule is not, however, a complete guide to the portfolio manager's strategy. Other forms of disclosure help to enhance the picture. For example, non-money market mutual funds are required to include "Management's Discussion of Fund Performance" in their prospectus or annual report, discussing the investment strategies and

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[28]The standardized measures of fund yield and total return that are currently required to be disclosed in the prospectus are subject to similar limitations. Form N-1A, Item 22.

[29]Investment Company Act § 30(d)(2), 15 U.S.C. § 80a-29(d)(2); 17 C.F.R. § 270.30d-1; Form N-1A, Item 23; 17 C.F.R. §§ 210.6-05.1, .6-10(c)(1), .12-12.

techniques that materially affected fund performance during the preceding year.[30] Thus, a fund whose performance was materially affected by derivatives would be required to discuss that fact -- whether or not derivatives were reflected in the portfolio schedule at the close of the year. As another example, the use of quantitative risk measures, as described in the preceding section, could enhance investor understanding of a portfolio manager's strategy.

### 3. Is Intense Competition in the Fund Industry (or Any Other Reason) Leading Some Portfolio Managers to Move Risky Derivatives Into Otherwise Risk Averse Funds?

#### a. Is the competition for assets within the industry so intense that otherwise conservative funds take on disproportionate risks in order to outperform rivals?

In recent years, there has been tremendous growth in the number of mutual funds competing for investor dollars.[31] There have also been recent reports of significant losses by several short-term government bond funds, which generally are considered to be relatively conservative investments, and reports of losses on some adjustable rate instruments held by money market funds.[32] These facts, taken together, suggest that competition may, at present, play some role in encouraging mutual fund use of derivatives to enhance yield.

With more than 4,700 mutual funds competing vigorously for investor dollars, superior investment performance is one key way in which a fund can distinguish itself from rivals. Studies generally show, however, that it is much more difficult to maintain a high level of performance over a long period of time than over a short period of time.[33] Studies also show that investor money tends to flow toward funds with superior near-term performance.[34]

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[30]Form N-1A, Item 5A(a). Non-money market funds also are required to provide a graph comparing the fund's performance over the past 10 years with an appropriate broad-based market index. Form N-1A, Item 5A(b).

[31]In June 1994, there were 4,901 separate mutual fund portfolios, an increase of 769% from the 564 that existed at the beginning of 1981. Investment Company Institute Press Release, June Mutual Fund Sales Total $36.8 Billion, July 28, 1994; INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 101 (1993).

[32]*See, e.g., PaineWebber Fund, supra* note 5; *Piper Fund, supra* note 19; *Stepping up to the Plate, supra* note 6.

[33]Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 23, 389 (1968); Edwin J. Elton, Martin J. Gruber, Sanjiv Das, & Matthew Hlavka, *Efficiency With Costly Information: A Reinterpretation of Evidence From Managed Portfolios*, 6 REV. FIN. STUD. 1 (1993).

[34]Erik R. Sirri & Peter Tufano, Competition in the Mutual Fund Industry, Paper Presented at Harvard Business School Colloquium, *Managing the Financial Service Firm in a Global Environment* (Aug. 26, 1992).

Thus, it would not be surprising if some mutual fund managers perceive pressure to take on additional risk in order to attain at least a short-term performance "boost."[35]

**b. Is the Commission concerned that the cause of the losses reported at two short-term government bond funds may represent a growing trend?**

It is unclear whether the recent losses by short-term government bond funds represent a growing trend. The losses reported to date, however, do not appear to be evidence of a systemic problem in the mutual fund industry. It is also worth noting that losses by mutual funds from strategies undertaken to boost current yield are not a new phenomenon, but, unfortunately, recur from time to time in various forms. In the 1980s, for example, similar problems were associated with so-called "government-plus funds."[36] In addition, the recent losses have been a forceful reminder to the fund industry that the upside rewards of assuming increased risk also carry downside penalties. This market lesson may significantly dampen industry enthusiasm for competition through assuming increased risk.

**c. Does the Commission believe that a legislative or regulatory response is needed to address any issues related to the derivatives losses reported at these funds?**

In general, competition within the mutual fund industry should be a positive force, encouraging funds to improve performance, lower costs, and reduce risks; and the Division believes that each individual mutual fund must determine how to respond to competitive market forces. We also believe that the regulatory structure established by the Investment Company Act, through the disclosure and fiduciary obligations it imposes, generally provides an adequate framework for ensuring that investors are adequately protected. A mutual fund, for example, is currently required to disclose to investors material information regarding the fund, including the risks of investing in the fund.[37] Accordingly, it is a violation of existing laws and rules for a fund to mislead investors materially as to its risk profile, including the effect that derivatives have on that risk profile.

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[35]A recent news article suggested that many fund portfolio managers have compensation arrangements with their employers that encourage them to take inappropriate risks. Robert McGough, *Taking Chances: Risk in Mutual Funds is Rising as Managers Chase After Bonuses*, WALL ST. J., Aug. 11, 1994, at A1. The Investment Advisers Act of 1940 prohibits most types of performance fees for registered investment advisers, but this prohibition does not apply to the compensation arrangements that investment advisers have with their employees, including mutual fund portfolio managers. Investment Advisers Act § 205(a)(1), 15 U.S.C. § 80b-5(a)(1). The Division is not persuaded that there is sufficient evidence of abuse to support extending the performance fee prohibition to mutual fund portfolio managers at the present time. At the same time, however, we believe that fund managers and boards of directors or trustees should review portfolio manager compensation arrangements to ensure that they are designed with sufficient controls and other oversight mechanisms to protect the interests of fund shareholders. *See* Levitt Remarks, Directors as Investor Advocates, *supra* note 9, at 8-9.

[36]*See, e.g.*, Jane Bryant Quinn, *No Place to Hide*, NEWSWEEK, May 11, 1987, at 62 (use of options to boost income on portfolio of government bonds at potential cost of diminished capital).

[37]*See, e.g.*, Securities Act § 17(a), 15 U.S.C. § 77q(a); Exchange Act § 10(b), 15 U.S.C. § 78j(b); Exchange Act rule 10b-5, 17 C.F.R. § 240.10b-5; Form N-1A, Item 4(c).

The Division believes, however, that the risks assumed by some funds that use derivatives to enhance performance could be better disclosed to shareholders. Funds are presently required to disclose significant quantitative information in the areas of performance[38] and costs[39], and the Division is recommending that the Commission consider requiring disclosure of some form of quantitative risk measure in mutual fund prospectuses. This is discussed in greater detail in response to question 2.

## 4. Are Mutual Funds Experiencing Problems Pricing Exotic Derivatives?

### a. Pricing requirements

Mutual fund share pricing policies and practices are governed generally by sections 2(a)(41) and 22(c) of the Investment Company Act and rules 2a-4 and 22c-1 thereunder.[40] Section 22(c) provides the Commission with the authority to make rules governing the methods for computing the prices for mutual fund shares. Rule 22c-1 provides in part that a mutual fund may not sell or redeem its securities "except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."[41]

Rule 22c-1 generally provides that the current net asset value of a mutual fund's securities must be calculated every business day during which an order is received either to purchase or redeem a share of the fund.[42] Section 2(a)(41) and rule 2a-4 require a fund to mark its assets to market in computing net asset value. In the marking to market process, market quotations are required to be used for those securities for which the quotations are readily available. For all other securities and assets, a fund is required to use fair values as determined in good faith in accordance with procedures approved by its board of directors or trustees.[43]

### b. Pricing v. price reporting

Before addressing the issue of mutual fund pricing of derivative investments, we believe it would be useful to distinguish between pricing and price reporting.[44] Although the Investment Company Act, and thus the Commission, regulate the *pricing* of fund shares in

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[38]Form N-1A, Item 2.

[39]Form N-1A, Item 3.

[40]15 U.S.C. § 80a-2(a)(41), -22(c); 17 C.F.R. § 270.2a-4, .22c-1.

[41]17 C.F.R. § 270.22c-1(a).

[42]17 C.F.R. § 270.22c-1(b)(1).

[43]15 U.S.C. § 80a-2(a)(41)(B); 17 C.F.R. § 270.2a-4(a)(1); Restricted Securities, Investment Company Act Release No. 5847 (Oct. 21, 1969) [hereinafter Release 5847].

[44]A fuller discussion of this issue appears in our August 22, 1994 Memorandum on Mutual Fund Share Price Reporting, responding to a letter dated June 30, 1994, from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce.

the manner described above, neither the Investment Company Act nor the Commission regulates -- or even requires -- the *reporting* of share prices to the news media. The incident referred to in the Letter, the absence of a reported price in the morning paper for a fund with derivative investments, is not the subject of either federal law or Commission regulation and is a separate issue from the question of whether purchasing and redeeming shareholders receive the correct price for their shares. Although share prices may be unreported because they are not calculated in time to meet newspaper deadlines, and the presence of certain derivatives in a fund's portfolio may make it more difficult to meet publication deadlines, *this does not mean that investors receive an incorrect price upon redemption, or pay an incorrect price at purchase.*[45]

**c. Pricing and derivatives**

The obligation of a mutual fund to calculate daily net asset value accurately for purposes of share sales and redemptions is critical to investor confidence. If net asset value is incorrectly computed, purchasing or redeeming shareholders may pay or receive too little or too much, and the interests of other shareholders may be overvalued or diluted. The accurate valuation of each portfolio asset, including derivative instruments, is the foundation for computing fund net asset value.

Funds normally obtain market quotations from one or more sources, such as last sale prices reported by service vendors or bid and asked quotations supplied by market makers. Many derivatives may be priced in this manner. Exchange-traded derivatives, such as futures and exchange-traded options, for example, generally can be priced based on last sale prices or market quotations.

Prior to purchasing an instrument, derivative or otherwise, a mutual fund typically evaluates the availability of market prices for the instrument. If market quotations are not readily available for the instrument, the fund must be prepared to use fair value as determined in good faith in accordance with procedures approved by its board of directors or trustees. When a fund decides to purchase an instrument, it typically will have determined either that market quotations are readily available or that it can implement fair value procedures. This decision-making process acts as a brake on a fund's acquisition of an instrument when it is evident, from the outset, that pricing will be problematic.

Market conditions change over time, and a fund may find that an instrument that had readily available market prices when it was acquired ceases to have such price availability. This appears to have been the situation during recent months in the mortgage-backed

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[45]Chairman Levitt recently requested that the National Association of Securities Dealers, Inc. ("NASD"), and the Investment Company Institute ("ICI") address issues relating to fund price reporting. Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink; President, ICI (June 28, 1994). The NASD and the mutual fund industry have taken some steps to alleviate the time pressures and technological problems that may result in reporting problems, including an extension of the NASD's price reporting deadline, and are considering others. *See* Letters from Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink, President, ICI, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission (July 13, 1994). We are monitoring further developments in this area and working with the NASD and the mutual fund industry to ensure that the reporting system serves the interest of investors in obtaining accurate price information.

securities market, where decreased liquidity has resulted in the deterioration of accurate market pricing information for some derivative securities -- such as certain collateralized mortgage obligations. In these circumstances, it may be more difficult to establish reliable prices.[46]

The changing nature of markets makes it difficult, if not impossible, to ensure that mutual funds will never purchase instruments that become illiquid and, consequently, difficult to price. Nevertheless, the statutory and regulatory pricing requirements discussed above, together with the liquidity requirements discussed in response to question 5, act as significant checks on mutual fund investments in instruments that are difficult to price. Indeed, fund sponsors face substantial liabilities for pricing errors. In those instances when fund transactions occur at incorrect prices, it is the Division's policy that errors should be corrected when discovered, and fund sponsors should reimburse shareholders who have experienced a material economic loss due to the errors. Fund sponsors' own economic interests therefore militate against significant use of instruments that will cause pricing problems.

In order to provide assurances of price accuracy, funds typically employ extensive control procedures. For many funds, the control process begins with the use of independent pricing services to value fund holdings. Because pricing services compete for business, it is in their best interests to provide accurate prices. At the fund level, validation procedures, tolerance checks, and other reviews are often employed to test and control the validity of pricing.[47]

The Division does not believe that legislative changes are needed at this time to address pricing issues raised by derivatives. The Division intends, however, to continue to evaluate pricing issues in our inspections and will perform targeted examinations to obtain more information on these issues. If appropriate, we will consider issuing rules to address proper procedures for pricing determinations.

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[46]*See, e.g., PaineWebber Fund, supra* note 5; Robert McGough, *Baird Fund Spurs Worries About Pricing*, WALL ST. J., Aug. 15, 1994, at C1 [hereinafter *Baird Fund*].

[47]For example, many funds employ automated exception reports that compare the current day's price for each portfolio instrument to the previous day's closing price and note any instrument that has changed by more than a preset limit. A second typical procedure identifies any portfolio instrument price changes that cause the fund's share price to move more than a preset amount. A third common procedure compares portfolio transaction prices to price quotations obtained from pricing services and/or dealers. A fourth procedure involves portfolio manager review of the "price make-up sheet," the detailed listing of each instrument held by the fund and the associated price.

At the share price level, changes in share price are compared to changes in comparable indices to assure reasonableness. Price changes that exceed preset levels must be reverified and explained before they are entered into the accounting system for share price computation. Fund pricing staff may also look for corporate actions, news stories, or other developments to explain price changes.

**5. Are Mutual Funds Experiencing Liquidity Problems Because of Exotic Derivatives?**

**a. Does the Commission believe that some of the more exotic and volatile derivatives should be considered "illiquid?" Has the Commission considered whether the 15% rule should be applied to any types of derivative products?**

Section 22(e) of the Investment Company Act generally requires that a mutual fund make payment for redeemed shares within seven days after the tender of the shares.[48] Because mutual funds hold themselves out to investors as being prepared at all times to meet redemptions within seven days, it is essential that funds maintain investment portfolios that will enable them to fulfill this obligation. For this reason, and because the extent of redemption demands are not predictable, mutual funds must maintain highly liquid portfolios.[49]

The Commission has published a guideline requiring that mutual funds generally limit their investments in illiquid assets to 15% of net assets. The guideline limit is 10% in the case of money market funds.[50] An asset is considered "illiquid" if a fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the instrument.[51]

On occasion, the Commission and the Division have taken the position that certain classes of instruments are generally illiquid.[52] Generally, however, the determination of whether a particular mutual fund asset, including a derivative instrument, is illiquid should be made under guidelines and standards established by the fund's board of directors or

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[48]15 U.S.C. § 80a-22(e). This requirement does not apply during any period that (1) the New York Stock Exchange ("NYSE") is closed other than customary weekend and holiday closings or trading on the NYSE is restricted; (2) an emergency exists as a result of which disposal by the fund of securities owned by it is not reasonably practicable or it is not reasonably practicable for the fund fairly to determine the value of its net assets; or (3) the Commission permits for the protection of shareholders of the fund. *Id.*

[49]*See* Release 5847, *supra* note 43.

[50]*See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992), 57 FR 9828 (raising guideline for non-money market funds from 10% to 15% to facilitate capital raising by small businesses) [hereinafter Release 18612]; Letter from Marianne K. Smythe, Director, Division of Investment Management, to Matthew P. Fink, President, Investment Company Institute (Dec. 9, 1992) (clarifying that change in limit from 10% to 15% does not apply to money market funds); Release 5847, *supra* note 43, at 7.

[51]Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986), 51 FR 9773, 9777; Guidelines for Form N-1A, Guide 4.

[52]Release 5847, *supra* note 43 (restricted securities generally illiquid).

trustees.[53] Examples of factors that may be taken into account in determining liquidity include (1) the frequency of trades and quotes for the instrument, (2) the number of dealers willing to purchase or sell the instrument and the number of other potential purchasers, (3) dealer undertakings to make a market in the instrument, and (4) the nature of the instrument and the nature of the marketplace in which the instrument trades, including the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer.[54] Ultimate responsibility for liquidity determinations rests with the fund's board, but the board may delegate the day-to-day function of determining liquidity to the fund's investment adviser, provided the board retains sufficient oversight.[55]

The Division believes that particular derivative instruments may be illiquid under all or most market conditions. This will more likely be the case if a derivative is designed to meet the needs of a particular investor. Such a derivative, almost by design, would not have the broad market required to support a finding that the instrument is liquid. The liquidity of other derivative instruments, however, may vary depending on market conditions. An instrument that is liquid in one market environment may become illiquid in another market environment. This has recently been the case, for example, for certain collateralized mortgage obligations. Recent interest rate increases and full dealer inventories apparently caused markets for these instruments virtually to disappear, leaving previously liquid instruments illiquid.[56]

Fund management's obligation to make liquidity determinations is a continuing one in the case of instruments, including derivatives, whose liquidity may vary under different market conditions. If changed market conditions result in previously liquid portfolio holdings becoming illiquid, fund management should determine whether any steps are required to assure that the fund continues to meet the 15% guideline.[57]

We note that, in general, there is a close relationship between the liquidity of an instrument, derivative or otherwise, and the ease with which the instrument may be priced, the subject of question 4. If a security trades in a liquid market, there is a strong likelihood

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[53]*See* Merrill Lynch Money Markets Inc. (pub. avail. Jan. 14, 1994) (commercial paper issued in reliance on registration exemption in section 4(2) of Securities Act of 1933); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Investment Company Registrants (Jan. 17, 1992) (government-issued interest-only and principal-only securities backed by fixed-rate mortgages, municipal lease obligations); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Catherine L. Heron, Investment Company Institute (June 21, 1991) (municipal lease obligations) [hereinafter ICI letter]; Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990), 55 FR 17933, 17940-41 (Rule 144A securities, foreign securities) [hereinafter Release 17452].

[54]*See* Release 17452, *supra* note 53, at 55 FR 17940-41; ICI Letter, *supra* note 53, at 1.

[55]Release 17452, *supra* note 53, at 55 FR 17940 n.61.

[56]*See, e.g.*, Saul Hansell, *Markets in Turmoil: Investors Undone: How $600 Million Evaporated -- A special report; Fund Manager Caught Short By Crude and Brutal Market*, N.Y. TIMES, Apr. 5, 1994, at A1 [hereinafter *Markets in Turmoil*].

[57]Release 17452, *supra* note 53, at 55 FR 17940 n.61.

that reliable market prices will be readily available. Conversely, reliable prices for securities traded in an illiquid market are often difficult to obtain.

**b. Has the Commission considered whether the 15% figure itself should be revisited?**

In 1992, the Commission raised the limit on illiquid assets from 10% to 15% for non-money market funds to facilitate capital raising by small businesses.[58] The limit for money market funds remains 10%. Recent illiquidity in the market for certain mortgage derivatives raises once again the question of what limit is appropriate.[59]

The Division has been focusing on the illiquid assets limit in its inspections of mutual funds to determine whether funds are complying with the limit on an ongoing basis, whether funds are holding illiquid investments to the maximum amount permitted, and whether there is a need to reduce the limit. We recommend that the Commission act promptly to consider reducing the ceiling.

**6. Does the Use of Derivatives Permit Mutual Funds to Avoid Limitations on the Use of Leverage Mandated by the Investment Company Act of 1940?**

**a. Please describe for the Subcommittee the original purpose of the restrictions on leverage contained in the Investment Company Act.**

Investment company abuse of leverage was a primary concern that led to enactment of the Investment Company Act.[60] In the Act's preamble, Congress cited excessive leverage as a major abuse that it meant to correct, declaring that the public interest and the interest of investors are adversely affected "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities."[61]

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[58]Release 18612, *supra* note 50.

[59]*See, e.g., Baird Fund, supra* note 46; Robert McGough & Anita Raghavan, *PaineWebber Again Props Up Bond Fund*, WALL ST. J., July 25, 1994, at C1 [hereinafter *PaineWebber Again Props Up Bond Fund*].

[60]In 1939, the Commission released an exhaustive study of the investment company industry that laid the foundation for the Investment Company Act. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 707, 75th Cong., 3d Sess. pt. 1 (1939) [hereinafter INVESTMENT TRUST STUDY PT. 1]; SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 70, 76th Cong., 1st Sess. pt. 2 (1939); SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 279, 76th Cong., 1st Sess. pt. 3 (1939) [hereinafter INVESTMENT TRUST STUDY PT. 3]. For a discussion of leveraged capital structures of investment companies, see INVESTMENT TRUST STUDY PT. 3, Ch. V, "Problems in Connection with Capital Structure," 1563-1940.

[61]Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7). The preamble also refers to "investment companies operat[ing] without adequate assets or reserves." Investment Company Act § 1(b)(8), 15 U.S.C. § 80a-1(b)(8).

Section 18(f) of the Investment Company Act restricts leveraged capital structures, generally prohibiting mutual funds from issuing any class of "senior security."[62] Funds may, however, borrow from banks if they maintain 300% asset coverage for all such borrowings.[63] Section 12(a) authorizes the Commission to regulate two trading practices that may result in leverage, margin purchases and short sales.[64]

One reason for limiting investment company leverage was to prevent abuse of the purchasers of senior securities, which were sold to the public as low risk investments.[65] Investment company assets during the 1920s and 1930s consisted mostly of common stocks that did not provide the stable asset values or steady income stream necessary to support senior charges.[66] Because the sponsors often kept all or most of the junior, voting securities for themselves, they could operate the company in their own interests.[67] Senior securities tended to lead to speculative investment policies to the detriment of senior securityholders because the common stockholder/sponsors, who often had a relatively small investment at risk in the fund, looked to capital gains for profit.[68] Multiple classes of senior securities and

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[62]15 U.S.C. § 80(a)-18(f). "Senior security" is defined to include preferred stock, bonds, debentures, notes, and other securities evidencing indebtedness. Investment Company Act § 18(g), 15 U.S.C. § 80a-18(g).

[63]Investment Company Act § 18(f)(1), 15 U.S.C. § 80a-18(f)(1).

[64]15 U.S.C. § 80a-12(a)(1), (3). The Commission has not adopted any rules under section 12(a); instead it has regulated margin purchases and short sales under section 18. *E.g.*, Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 FR 12790 [hereinafter 1972 Guidelines].

[65]*Id.* at 1583; *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. 265, 272 (1940) (statements of David Schenker, Chief Counsel, and L. M. C. Smith, Associate Counsel, SEC Investment Trust Study) [hereinafter *Senate Hearings*].

[66]*Senate Hearings*, *supra* note 65, at 265; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1587-89.

[67]*Senate Hearings*, *supra* note 65, at 239-40, 268-71, 273; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1594-98. *See* Investment Company Act § 1(b)(3), 15 U.S.C. § 80a-1(b)(3) (public interest and interest of investors adversely affected "when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities").

[68]*Senate Hearings*, *supra* note 65, at 239-40; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1615, 1668-74.

The relatively small investment of the common stockholders meant that the equity "cushion" protecting senior securityholders was small. INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1665-68. Senior securityholders of a mutual fund could be further compromised because the right of redemption held by the fund's common stockholders could erode the "cushion" of equity protecting the senior securityholders. *Investment Trusts and Investment Companies: Hearings on H. R. 10065 Before a Subcomm. of the House Committee on Interstate and Foreign Commerce*, 76th Cong., 3d Sess 121 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study); INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1870-71. At the time of the study, however,

(continued...)

pyramiding frustrated senior securityholders' attempts to determine whether secure returns were likely.[69]

Another reason for limiting investment company leverage was to protect public common stockholders by limiting the volatility of their investments. This purpose was a motivating factor for restricting the issuance of senior securities to the public because the leverage of the senior-junior capital structure magnified losses suffered by common stockholders.[70] This purpose also motivated the Investment Company Act restrictions on mutual fund bank borrowings.[71] The provisions authorizing the Commission to regulate margin purchases and short sales implicate similar concerns.

**b. Is the leverage that is made available to funds through the use of derivatives inconsistent with the intent underlying the Investment Company Act?**

**i. Derivatives and leverage**

Certain derivatives involve leverage for a fund because they create an obligation, or indebtedness, to someone other than the fund's shareholders and enable the fund to participate in gains and losses on an amount that exceeds its initial investment (referred to herein as "indebtedness leverage"). Examples are futures, forward contracts, and written options. The writer of a stock put option, for example, makes no initial investment, but instead receives a premium in an amount equal to a fraction of the price of the underlying stock. In return, the writer is obligated to purchase the underlying stock at a fixed price, thereby participating in losses on the full stock price.[72] As another example, a fund purchasing a futures contract makes an initial margin payment that is typically a small

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[68](...continued)
mutual funds almost invariably had only one class of securities outstanding. INVESTMENT TRUST STUDY PT. 1, *supra* note 60, at 29; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1563.

[69]INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1665, 1674-75. Section 12(d)(1) of the Investment Company Act controls pyramiding by restricting an investment company's acquisition of securities issued by other investment companies. 15 U.S.C. § 80a-12(d)(1).

[70]Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7); *Senate Hearings*, *supra* note 65, at 1027-31 (Commission memorandum to the effect that dangers to common stock at least as important as senior securities with respect to ends sought by section 18).

[71]*See Senate Hearings*, *supra* note 65, at 288 (statement of John H. Hollands, Attorney, SEC staff) ("[B]ank borrowings will be a fixed charge against the company; and, because of the fixed charge, the value of the common stock will shoot up and down in the same way that it would if they had debentures outstanding.").

[72]THE OPTIONS CLEARING CORPORATION, CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS 17-18 (1985) [hereinafter OCC GUIDE].

percentage of the contract price.[73] As a result of this margin payment, the fund participates in gains and losses on the full contract price.[74]

Other derivatives provide the economic equivalent of leverage because they display heightened price sensitivity to market fluctuations (referred to herein as "economic leverage"), such as changes in stock prices or interest rates. In essence, these derivatives magnify a fund's gain or loss from an investment in much the same way that incurring indebtedness does.[75] One example is a purchased stock call option. In return for the payment of a premium in an amount equal to a fraction of the stock price, the holder of a stock call option participates in gains on the full stock price. If there are no gains, the holder generally loses the entire initial premium.[76] Another example is a leveraged inverse floating rate bond, with an interest rate that moves inversely to a benchmark rate. A leveraged inverse floating rate bond displays heightened price sensitivity to interest rate changes, resulting in the holder experiencing market value fluctuations equivalent to those that he or she would experience on a conventional bond of larger principal amount.[77]

### ii. Derivatives and Investment Company Act leverage restrictions

The leverage of derivatives raises concerns related to the volatility of fund common stock, but does not raise concerns related to the protection of public senior securityholders. In the case of derivatives that create indebtedness leverage, the fund assumes a future obligation or indebtedness. While this obligation or indebtedness does not run to public senior securityholders, it does expose the fund to gains and losses on an amount that exceeds its initial investment. In the case of derivatives that create economic leverage, the fund does not assume a future obligation or indebtedness. Investing in these derivatives, however, magnifies the fund's gains or losses in much the same way that incurring indebtedness does.

The Commission and the Division have applied section 18 of the Investment Company Act to derivatives that create indebtedness leverage, such as futures, forward contracts, and written options.[78] In applying section 18 to these instruments, the Commission and the Division have required funds to "cover" the obligations these derivatives create by establishing and maintaining segregated accounts consisting of cash, U.S. government securities, or high-grade debt securities in an amount at least equal in

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[73]ROBERT E. FINK AND ROBERT B. FEDUNIAK, FUTURES TRADING: CONCEPTS AND STRATEGIES 137 (1988).

[74]*Id.* at 39.

[75]*See, e.g.*, Lee Berton, *Understanding the Complex World of Derivatives*, WALL ST. J., June 14, 1994, at C1.

[76]OCC GUIDE, *supra* note 72, at 15-17.

[77]James E. Lebherz, *'Inverse Floaters' Offer Potential Benefits, and Dangers*, WASH. POST, Aug. 29, 1993, at H7.

[78]*E.g.*, Sanford C. Bernstein Fund, Inc. (pub. avail. June 25, 1990); Dreyfus Strategic Investing (pub. avail. June 22, 1987) [hereinafter Dreyfus]; Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Securities Trading Practices of Registered Investment Companies: General Statement of Policy, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 FR 25128 [hereinafter Release 10666]; 1972 Guidelines, *supra* note 64.

value to the obligations.[79] The Division also has permitted funds to cover certain derivatives by holding the underlying instruments or other offsetting instruments.[80] The Commission and the Division have not applied section 18 of the Investment Company Act to derivatives that create economic leverage, such as purchased stock call options and leveraged inverse floating rate bonds.

**c. Apart from its relation to existing provisions in the statute, is the Commission concerned about the leverage available to funds that hold derivatives? If so, how does the Commission propose to address those concerns?**

The Division is concerned about both indebtedness and economic leverage that are potentially made available to funds through the use of certain derivatives. The potential for increased volatility from such leverage may result in significant losses to investors.

One approach to the issue of leverage would be to prohibit directly, or restrict, the use of derivatives by mutual funds. The Commission has imposed requirements on derivative investments by money market funds,[81] but we do not recommend this approach for non-money market funds for three reasons. First, a prohibition or restriction on derivatives use could chill the use of instruments in a manner that is beneficial for mutual funds, such as hedging. Second, a prohibition or restriction on derivatives use would be inconsistent with the general approach of the Investment Company Act, which imposes few substantive limits on mutual fund investments.[82] Funds generally are permitted to make investments without regard to their volatility, *e.g.*, emerging market securities and small company stocks, and we are not persuaded that derivatives should be treated differently.[83] Third, it would be extremely difficult, if not impossible, to devise appropriate prohibitions or

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[79]Release 10666, *supra* note 78, at 44 FR 25131-32. The rationale is that covered transactions do not raise concerns about undue leverage and speculation that section 18 was intended to address. *Id.*

[80]For example, instead of maintaining a segregated account, a fund that sells a call option may cover the position by owning the securities against which the call is written (or securities convertible into the underlying securities without additional consideration) or by purchasing a call on the same securities at the same price. 1972 Guidelines, *supra* note 64. For additional examples of cover, see Dreyfus, *supra* note 78.

[81]These requirements are discussed in response to question 8, below.

[82]The provisions of the Investment Company Act that prohibit or restrict certain types of investment are quite narrow. *See, e.g.*, § 12(d), 15 U.S.C. § 80a-12(d) (investments in other investment companies, insurance companies, or securities-related businesses). *See also* Investment Company Act rule 2a-7, 17 C.F.R. § 270.2a-7 (limiting portfolio investments of money market funds). The framers of the Investment Company Act specifically disavowed any attempt to prohibit speculative mutual fund investments. *See, e.g., Senate Hearings, supra* note 65, at 44, 247.

[83]The legislative history of the Investment Company Act indicates that the Act was not intended to eliminate all leverage from fund investments. *See, e.g.*, INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1580-81 (common stocks held by investment companies are leveraged in that issuing companies have senior securities in their capitalization); *Id.* at 1592-93 (leverage easier to increase or decrease in investment company with only one class of securities outstanding, where leverage attributable to portfolio securities).

restrictions on the use of derivatives by mutual funds because of the wide variety of instruments that may be considered "derivatives." The available "derivatives" are likely to change as innovation occurs in the marketplace, possibly rendering substantive prohibitions or restrictions ineffective within a short time.

The Division believes that one of the most effective means for addressing leverage concerns associated with mutual fund use of derivatives is improved risk disclosure. It is crucial that investors understand the risks of investing in a mutual fund, including the risks of the fund's intended use of various derivatives. The risk/return profile of a mutual fund may be affected significantly by derivatives that are potentially volatile, and we believe that it is critical that fund investors understand this profile. For this reason, we have given heightened scrutiny to derivatives disclosure in prospectuses, and a Division task force has examined the derivatives disclosures of 100 investment companies. The Division has encouraged registrants to modify their existing disclosure to enhance investor understanding of pertinent risks. We are engaged in fundamental reconsideration of mutual fund disclosure, assessing whether the use of quantitative risk measures would improve investor understanding of fund risk. Because fund use of derivatives is relatively new and evolving, the Division is continuing to develop approaches to improving disclosure about derivatives. If these approaches do not prove to be sufficiently protective of the interests of fund shareholders, the Division may reconsider whether to recommend that the Investment Company Act be amended to place substantive limits on derivatives use.

The Division also recommends that the Commission reexamine the application of section 18 to derivative instruments. In practice, section 18 has proven to be a somewhat crude tool for addressing the leverage issues raised by derivatives, largely because it was originally designed to address a different problem, namely, the leverage created by the issuance of public senior securities.[84] Given the recent proliferation of derivatives, we believe that it is appropriate to reexamine both the way in which section 18 has been applied to derivatives that create indebtedness leverage and the differential treatment under section 18 of derivatives that create indebtedness and economic leverage. These are complicated issues that are not susceptible to a simple solution. For this reason, we recommend that the Commission issue a release seeking public comment on appropriate regulatory and legislative solutions to address the issues raised by leverage resulting from fund use of derivatives.

### 7. Do the Recent Capital Infusions by Two Fund Complexes Indicate that Bank Mutual Fund Investors may be Facing Special Undisclosed Risks?

The questions raised by the Letter in the area of bank-advised mutual funds relate primarily to the interpretation and application of federal banking laws. The Division's responses are based on our understanding of the banking laws and informal discussions with the staffs of the federal banking agencies. It also may be advisable for Congressmen Markey and Fields to contact the federal banking agencies directly, however, as they have the greatest expertise in interpreting the federal banking laws and are in the best position to predict how they might exercise their authority in specific circumstances.

We emphasize, as a preliminary matter, that a mutual fund's adviser, regardless of whether it is a bank (or a subsidiary or affiliate of a bank), is not legally obligated to infuse

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[84]Bank debt was generally the only significant form of short-term or current indebtedness incurred by the investment companies that the Commission studied prior to passage of the Investment Company Act. INVESTMENT TRUST STUDY PT. 1, *supra* note 60, at 28 n.23.

capital into or purchase depreciated instruments from a fund, absent a violation of law. Mutual funds invest in securities that carry market risk, and fund advisers are not required to guarantee or insure fund performance.

**a. Assume a bank was the adviser for a short-term government bond fund or money market fund that had suffered sharp unexpected losses. If the fund is not part of a separately capitalized subsidiary or affiliate, is there a risk that bank regulatory concerns might prevent the adviser from making a capital infusion into the fund, even if such an infusion was in the interest of the fund's shareholders?**

If a bank was the adviser for a fund that suffered a sharp unexpected loss, bank regulatory concerns could prevent the adviser from making a capital infusion into the fund, even if such an infusion was in the interest of the fund's shareholders. This risk is present whether the adviser is part of the bank itself or is a separately capitalized subsidiary or affiliate.[85]

We understand from our discussions with federal bank regulators that they view the decision to infuse capital into a fund as initially being a business decision of the bank adviser.[86] If, however, in the bank regulators' view, an adviser's capital infusion into a fund threatened the safety and soundness of the bank,[87] it is possible that the bank regulators would take steps to prevent the infusion, regardless of whether it was in the interest of fund shareholders.[88]

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[85]*Cf. Proposed Mellon-Dreyfus Merger: Hearings Before the Subcomm. on Oversight, and Investigations of the House Comm. on Energy and Commerce*, 103d Cong., 2d Sess. 292 (1994) [hereinafter *Mellon-Dreyfus Hearings*] (statement of Eugene A. Ludwig, Comptroller of the Currency) (risk of loss to bank exists whether activities conducted in subsidiary or division of bank).

[86]The questions in the Letter, and our discussion, specifically address the situation where the adviser infuses capital into or purchases instruments from a fund. It is possible, however, that an entity other than the adviser (*e.g.*, the adviser's parent or an affiliate) may assist the fund. Regardless of which entity makes the infusion or purchase, federal bank regulators could object to the infusion or the purchase by any bank affiliate if they believed that it constituted an unsafe or unsound banking practice.

[87]Federal banking laws focus on the safety and soundness of individual banks and the banking system as a whole. *See*, *e.g.*, Federal Deposit Insurance Act § 8, 12 U.S.C. § 1818 (authorizing federal bank regulators to bring enforcement actions against insured banks that engage in unsafe and unsound banking practices). *See also* MICHIE ON BANKS AND BANKING ch. 15, § 6 (1989 & Supp. 1994).

[88]Recently, however, the Federal Reserve Board did not object when a banking institution assisted a proprietary mutual fund that had sustained losses from derivatives. *See* Snigdha Prakash, *B of A's Bailout of Fund Raises No Red Flags at Fed*, AM. BANKER, July 7, 1994, at 12 (public statement by Federal Reserve Board Governor that bank's capital infusion was an "unusual circumstance" and did not raise concerns about the safety and soundness of the banking system)[hereinafter *B of A Article*]. Other banking institutions recently have taken similar actions, apparently without intervention by the bank regulators. *See*, *e.g.*, *Stepping up to the Plate*, *supra* note 6.

Even if an adviser was organized as a subsidiary of the bank, bank regulators still could cite bank safety and soundness as grounds for objecting to a capital infusion. The Office of the Comptroller of the Currency, for example, has traditionally viewed national bank operating subsidiaries as departments of the parent bank.[89] Thus, operating subsidiaries of national banks are subject to the same banking laws and regulations as the parent bank and to examination and supervision by the Office of the Comptroller of the Currency.[90] Consistent with this principle, the Comptroller of the Currency has indicated that, even if a fund adviser is a separately capitalized bank subsidiary, he still would have concerns about the adviser's activities and potential risks to bank capital.[91]

If advisory activities were conducted in a separately capitalized affiliate of a bank other than a bank subsidiary (*e.g.*, a holding company subsidiary or the holding company itself), there would be a clearer financial separation between the bank and the adviser than if the adviser was a bank subsidiary.[92] Because it is less likely that an affiliate adviser's activities would threaten the safety and soundness of the bank, it also may be less likely that bank regulators would object to the affiliate adviser infusing capital into a fund.[93]

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[89]*See* former OCC Interpretive Ruling 7.7376, 12 C.F.R. § 7.7376 (1983), *rescinded* 48 FR 48452 (1983); 12 C.F.R. § 5.34. Operating subsidiaries only can perform activities that the parent bank can perform. 12 C.F.R. § 5.34(c).

[90]12 C.F.R. §§ 5.34(d)(2)(i), 5.34(d)(3). *See also Mellon-Dreyfus Hearings*, *supra* note 85, at 284 (statement of Eugene A. Ludwig, Comptroller of the Currency).

[91]*Mellon-Dreyfus Hearings*, *supra* note 85, at 292. (statement of Eugene A. Ludwig, Comptroller of the Currency) ("[f]rom the perspective of bank safety and soundness, the most serious concern raised by a proposal such as Mellon's is the possibility of [bank] exposure to operational or fiduciary losses in its mutual fund subsidiary.") Specifically, Comptroller Ludwig expressed concern that "bank managers might feel strong pressure to reimburse an affiliated mutual fund or its customers for market losses, particularly if a money-market mutual fund managed by the bank would otherwise fail to maintain a constant net asset value" or "to provide emergency credit to or investments in a mutual fund subsidiary to cover an unexpected surge in redemptions." *Id.*

[92]This would be the case because an affiliate's capital is not tied to the bank's capital as directly as a subsidiary's. *Cf. Restructuring of the Banking Industry: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. Part II, 240 (1991) (statement of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, regarding bank conduct of broker-dealer activities).

[93]It should be noted, however, that banking law requires the Federal Reserve to assure the safety and soundness of bank holding companies and nonbank bank holding company subsidiaries. *See* 12 U.S.C. § 1818(b)(3).

**b. Would the adviser be able to repurchase instruments from the fund that were believed to be the source of the losses?**

In addition to the safety and soundness concerns discussed above, whether a bank adviser would be able to purchase instruments from a fund would depend on the types of instruments to be purchased and how they are treated under banking law.[94] For example, the Glass-Steagall Act generally prohibits a national bank from purchasing and selling securities for its own account.[95] The Act, however, excepts from this prohibition certain government obligations and "investment securities."[96]

Whether a derivative will be viewed as a security for purposes of the Glass-Steagall Act will depend on the particular type of instrument and its use. Federal bank regulators generally do not view futures contracts and related options, foreign currency contracts, swaps, and other commodities-related investments as securities under the Glass-Steagall Act.[97] Options (other than options on futures contracts), on the other hand, may be treated as securities under that Act.[98]

Even if a derivative is not viewed as a security subject to the restrictions of the Glass-Steagall Act, a bank still may not be free to purchase the derivative from a fund. The purchase also must conform with recently adopted bank regulatory guidelines on derivatives activities, which generally set forth managerial, operational, and internal control requirements for bank derivatives activities.[99]

In addition, whether a bank adviser would be able to purchase instruments from a fund depends on whether the purchase is restricted by Sections 23A and 23B of the Federal Reserve Act. These provisions restrict transactions (including the purchase and sale of securities or other assets) between banks and their affiliates by imposing aggregate

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[94]Section 17(a) of the Investment Company Act also restricts an investment adviser's ability to purchase instruments from a fund. 15 U.S.C. § 80a-17(a). *See* PaineWebber Managed Investments Trust (pub. avail. Aug. 4, 1994). See the discussion in section 8.b., below.

[95]Glass-Steagall Act, § 16, 12 U.S.C. § 24 (Seventh).

[96]Glass-Steagall Act, § 16, 12 U.S.C. § 24 (Seventh). The Glass-Steagall Act authorizes the Comptroller of the Currency to interpret the definition of investment securities. *Id.* The Comptroller of the Currency has used this authority to adopt regulations defining the term "investment securities" and limiting the purchase of such securities by national banks. *See* 12 C.F.R. Part 1.

[97]MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS § 13.01 (1991).

[98]*Id.*

[99]*See, e.g.*, Banking Circular No. 277 (Oct. 27, 1993) (risk management guidelines issued by the Comptroller of the Currency). The Office of the Comptroller of the Currency also recently proposed amending its risk-based capital guidelines to increase capital requirements for national banks that deal in certain derivatives. Capital Adequacy: Calculation of Credit Equivalent Amounts of Off-Balance Sheet Contracts, Docket No. 94-13 (Aug. 24, 1994), 59 FR 45243. *See also* Jay Matthews, *Rules for Banks' Use of Derivatives Issued*, WASH. POST, Sept. 2, 1994, at B2.

transaction limits, collateralization requirements, and arm's length dealing requirements.[100] Section 23A generally prohibits a bank and its subsidiaries from purchasing a low-quality asset from an affiliate.[101] For purposes of Sections 23A and 23B, the term "affiliate" includes any investment company advised by the bank or any affiliate of the bank.[102]

**c. Would you agree that the failure to permit such an injection or repurchase could result in a further downward spiral for the fund, leading to even greater losses for investors?**

If an adviser elects not to infuse capital into, or purchase a depreciated instrument from, a fund to compensate investors for their losses (or is prohibited from doing so), it is possible that dissatisfied investors may redeem their shares, causing the fund to sell portfolio securities to meet redemption requests.[103] These sales could (depending on the market), in turn, lead to greater losses for the fund, in effect causing a "downward spiral." Moreover, if the depreciated instrument is illiquid, the fund likely would choose to sell other, more liquid portfolio instruments to meet the redemption requests. Such sales would increase the percentage of fund assets held in the depreciated instrument, thereby increasing the fund's sensitivity to price fluctuations in that instrument and exposing investors to greater losses if the price of the instrument continues to decline. These losses could occur in any fund, whether or not advised by a bank, and no adviser is required to compensate fund shareholders for losses absent a violation of law.

**d. Should the prospect that such infusions or repurchases might not be permitted be disclosed to bank mutual fund investors?**

The Commission has broad authority under the Securities Act of 1933 and the Investment Company Act to require a fund prospectus to include any material information necessary to make the statements contained in the prospectus not misleading.[104] When the Commission or the Division has determined that there is a unique material risk associated with a particular type of fund, it has required particular disclosure in the prospectus of those funds. For example, the Division requires every bank-sold mutual fund and every mutual fund whose name is similar to a bank's name to disclose prominently on the cover page of

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[100] 12 U.S.C. §§ 371c and 371c-1.

[101] 12 U.S.C. § 371c(a)(3).

[102] 12 U.S.C. § 371c(b)(1)(D)(ii).

[103] The immediate effect of a capital infusion into, or a purchase of a depreciated instrument from, a fund is to increase the cash position of the fund, thereby increasing liquidity and enabling the fund to meet redemptions without having to sell portfolio securities.

[104] *See, e.g.*, Securities Act of 1933 §§ 6, 7, 8, 10, 19(a), 15 U.S.C. §§ 77f, 77g, 77h, 77j and 77s(a); Securities Act rule 408, 17 C.F.R. § 230.408; Investment Company Act §§ 8, 30(a), 38(a), 15 U.S.C. §§ 80a-8, -30(a), -38(a); Investment Company Act rule 8b-20, 17 C.F.R. § 270.8b-20.

its prospectus that the shares in the fund are not federally insured.[105] Similarly, the Commission also requires every money market fund to disclose, on the cover page of its prospectus and in its advertising, both that its shares are not insured or guaranteed by the U.S. government and that there is no assurance that the fund will be able to maintain a stable net asset value of $1.00.[106]

Bank regulators have not yet objected generally or, to our knowledge, specifically to bank advisers infusing capital into or purchasing depreciated instruments from their funds. In fact, one regulator reportedly has stated specifically that a capital infusion by one banking institution did not raise concerns.[107] In addition, a mutual fund's adviser, regardless of whether it is a bank, is not legally obligated to infuse capital or purchase depreciated instruments from the fund, absent a violation of law. Accordingly, it does not seem warranted at this time for the Commission or the Division to mandate disclosure for all bank-advised funds concerning the potential limits on a bank adviser's ability to assist its fund. Rather, we believe that each bank-advised fund individually should assess its own circumstances to determine whether this is a material risk that should be disclosed.

**e. Better still, is there a way to avoid the conflict between the bank and the fund?**

Under the current regulatory scheme, there is the potential for conflict between a bank's obligations under the banking laws and the interests of the fund and its shareholders with respect to capital infusions and purchases of securities. While it is unlikely, for the reasons discussed above, that requiring a bank to conduct its fund advisory activities in a separately capitalized subsidiary or affiliate would eliminate the conflict completely, it would appear to reduce the potential for conflict between the bank and the fund, particularly if such activities are conducted in a separately capitalized affiliate.

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[105]Letter from Barbara J. Green, Deputy Director, Division of Investment Management, to Investment Company Registrants (May 13, 1993). The Division was concerned that investors may mistakenly believe that these mutual funds are federally insured or similarly protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or some other agency. *Id.*

[106]Form N-1A, Item 1(a)(vi), 17 C.F.R. §§ 239.15A and 274.11A (registration statement of open-end management investment companies); Securities Act Rule 482(a)(7), 17 C.F.R. § 230.482(7) (advertising by an investment company). In the release proposing this money market fund disclosure, the Commission stated that "[w]hile money market funds have been one of the safest available investment options, the Commission believes it is important for investors to understand that money market funds are not risk-free." Investment Company Act Release No. 17589, at text accompanying n.68 (July 17, 1990) 55 FR 30239, 30247.

[107]*See B of A Article*, *supra* note 88, at 12 (public statement by Federal Reserve Board Governor that bank's capital infusion was an "unusual circumstance" and did not raise concerns about the safety and soundness of the banking system).

8. **Recent Instability of Money Market Mutual Funds. Please bring us up-to-date on the Commission's latest views about the appropriateness of derivatives for money market portfolios.**

a. Background

Money market funds generally seek to maintain a stable net asset value per share, typically $1.00. Many money market funds allow investors to use checks to redeem shares, and, because the value of an account generally does not change due to share value fluctuations, many investors use money market funds as alternatives to checking accounts since they can readily ascertain their account balances. While these features of money market funds may be responsible for their success, they may also be responsible for the erroneous perceptions of some investors that money market funds are "guaranteed" or for some other reason cannot lose value. To help reduce these misconceptions, the Commission in 1991 amended its rules governing money market fund disclosure to require money market fund prospectuses and sales material to disclose prominently (1) that the shares of the money market fund are neither insured nor guaranteed by the U.S. Government and (2) there is no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[108]

Prior to the adoption of 1991 amendments to rule 2a-7 under the Investment Company Act, the Commission's rule governing money market funds, a money market fund was required to comply with the rule only if the fund wished to take advantage of the rule's exemptive provisions that permit many money market funds to use the "amortized cost" method of valuing their portfolio.[109] As a result, some funds that held themselves out as money market funds routinely invested in risky securities that were inconsistent with developing investor expectations of money market funds, such as securities whose principal values or returns were based on non-dollar denominated indexes. To assist investors to better understand money market funds, the Commission in 1991 prohibited mutual funds from calling themselves money market funds unless they comply with the risk-limiting provisions of rule 2a-7.[110]

b. Money Market Funds and Derivatives

Money market funds invest in a variety of instruments that could be characterized as derivatives. Many of these securities are created especially for money market fund portfolios, have a very low level of risk, and have performed as expected during the recent series of short-term interest rate increases. There have, however, been an unfortunate

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[108]Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991), 56 FR 8113 (amendments to Form N-1A, Item 1(a)(ix)).

[109]Money market funds that seek to maintain a stable share price generally use either the amortized cost method of valuation or the penny-rounding method of share pricing. Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. 17 C.F.R. § 270.2a-7(a)(1). Share price is determined under the penny-rounding method by valuing securities at market value, fair value, or amortized cost and rounding the per share net asset value to the nearest cent. 17 C.F.R. § 270.2a-7(a)(11).

[110]17 C.F.R. § 270.2a-7(b). These provisions are designed to limit a fund's exposure to credit, interest rate, and currency risks. 17 C.F.R. § 270.2a-7(c)(2)-(4).

number of recent instances in which money market funds have invested in adjustable rate notes that have experienced significant volatility and losses. Losses in value attributable to these securities have resulted in a number of money market fund advisers electing to take actions, including contributing capital or purchasing instruments held by the funds, to prevent the funds' net asset values from falling below $1.00.[111]

Rule 2a-7 limits a money market fund's exposure to interest rate risk by generally prohibiting it from acquiring securities with remaining maturities that exceed 397 days.[112] The rule permits a money market fund to measure the maturity of a long-term adjustable rate security by reference to its interest rate readjustment date if the fund and its adviser "reasonably expect the value of the security to approximate par upon adjustment of the interest rate."[113]

Last year, the Division became aware that some funds were investing in adjustable rate securities that had interest rate adjustment formulae that would be unlikely to follow short-term interest rates if those interest rates increased.[114] A December 1993 Commission release proposing amendments to rule 2a-7 discussed the risks of money market fund investment in these types of adjustable rate securities.[115] In the release, the Commission noted that these types of securities "share the common characteristic that, at the time of issuance, changes in interest rates or other conditions that can reasonably be foreseen to occur during their term will result in their market values not returning to par at the time of an interest rate readjustment."[116] The Commission concluded that such securities are not appropriate investments for a money market fund.

Several months ago it became apparent that some funds continued to hold these types of securities. Because of an increase in interest rates, the volatility of these instruments increased. In June, you raised this issue in correspondence with the chief executive officers of the 80 largest fund complexes.[117] Later that month, the Division provided money market funds and their advisers with additional guidance concerning investments in adjustable rate securities.[118] The Division reminded fund managers of their general obligations under rule

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[111]*See, e.g., Stepping up to the Plate, supra* note 6.

[112]17 C.F.R. § 270.2a-7(c)(2).

[113]17 C.F.R. § 270.2a-7(a)(7), (21).

[114]These securities include capped floaters (whose floating rates will not adjust above a stated level), CMT floaters (whose floating rates are tied to long-term rates and which will not return to par if the relationship between short- and long-term rates changes), leveraged floaters (whose floating rates move at multiples of market interest rate changes), and COFI floaters (whose floating rates are tied to the Cost of Funds Index, representing the cost of funds to thrift institutions in the Eleventh Federal Home Loan Bank District, which substantially lags market rates).

[115]Release 19959, *supra* note 14, at Part II.D.2.d., 58 FR 68601-02.

[116]*Id.* at 58 FR 68601.

[117]Levitt Letters, *supra* note 10.

[118]Letter from Barry P. Barbash, Director, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (June 30, 1994).

2a-7 to ensure that money market funds invest only in those securities that are consistent with maintaining stable net asset values. The Division also urged money market fund advisers to reexamine all portfolio holdings to determine whether the funds hold adjustable rate securities that exhibit the characteristics described above. Funds that hold these securities were directed to work with their advisers in developing plans for their orderly disposition.

To maintain their funds' net asset values at $1.00, a number of fund advisers have purchased certain adjustable rate securities from their money market funds at their amortized cost value (plus accrued interest).[119] Such a transaction is prohibited by section 17(a) of the Investment Company Act unless the Commission issues an order approving the transaction as "reasonable and fair and . . . not involv[ing] overreaching on the part of any person concerned."[120] In each case, the adviser represented that the purchase price of the security exceeded the security's market value and the transaction assisted in maintaining a stable net asset value. Accordingly, the Commission could have been expected to make the finding necessary to issue an order permitting the transaction. Because of the need to consummate the transactions quickly, however, the Division, as it has done in the past in similar instances, granted oral "no-action" relief in which we assured fund advisers and related parties that we would not recommend enforcement action if the transaction was effected.[121]

Adoption of the Commission's proposed rule 2a-7 amendments and the June guidance given by you and the Division should provide additional protection for money market fund investors. No rule text, however, can anticipate events that may result in a fund's net asset value falling below $1.00. To date, a number of sponsors or advisers of money market funds with positions in the types of adjustable rate securities identified in the Commission's December 1993 proposal have taken actions to cause the net asset values of those funds not to fall below $1.00. The Division believes that the potential continues to exist that a sponsor or adviser of a fund holding these or other types of adjustable rate instruments that pose similar risks will be unable or unwilling to take similar actions, and that the net asset value of such a fund will fall below $1.00.

The Division will continue to be vigilant in enforcing compliance with all provisions of rule 2a-7. In addition, we will persist in our efforts to impress upon investors that money market funds are not insured or guaranteed.

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[119] *See, e.g., Stepping up to the Plate*, *supra* note 6.

[120] Investment Company Act § 17(a)(2), (b), 15 U.S.C. § 80a-17(a)(2), (b).

[121] In each case, the relief was limited to section 17(a). This procedure, and the criteria used by the Division for granting "no-action" relief, are discussed in Release 19959, *supra* note 14, at Part IV. In that Release, the Commission proposed a new rule 17a-9, which would exempt from section 17(a) certain purchases from a money market fund of securities that are no longer eligible money market fund investments. The proposed rule was originally designed to address situations where the security to be purchased was in default. In light of recent events, we are considering whether to recommend that the proposed rule also apply to securities that no longer satisfy the criteria for money market fund investment in adjustable rate instruments.

U.S. House of Representatives
Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

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DAVID H. MOULTON
CHIEF COUNSEL AND STAFF DIRECTOR

June 15, 1994

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C.

Dear Chairman Levitt:

Pursuant to Rules X and XI of the United States House of Representatives, and this Subcommittee's continuing responsibility to oversee the nation's mutual fund industry, we write to request that the Commission undertake a comprehensive study of the growing use of derivatives by mutual funds, and more particularly, the adequacy of laws and regulations governing their disclosure and use. We believe that such a study is warranted in light of a small but growing number of reports of substantial losses apparently attributable to derivatives holdings at certain mutual funds. Some of these losses were apparently incurred rapidly, and, more importantly, occurred at funds, such as short-term government bond funds and money market funds, which many individuals believe to be cautious and conservative (though obviously not entirely risk-free) investments.

As you may recall, we have discussed the general subject of derivatives and mutual funds several times during your tenure at the Commission. The first time was during the Subcommittee's oversight hearing on the fund industry in August 1993, when Chairman Markey asked whether some risks associated with derivatives were so substantial as to justify the consideration of limits on a fund's ability to include them as part of its portfolio. We addressed related issues at the Subcommittee's hearing several weeks ago, when we reviewed the conclusions and recommendations of a two-year General Accounting Office study (the GAO study) of how best to manage and oversee the risks associated with derivatives.

In your written testimony submitted in connection with the Subcommittee's hearing on the GAO study, you observed that the Commission's inspections of investment companies (as well as a recently conducted survey) appeared to indicate that derivatives have a limited though apparently growing role in the operation of some mutual funds, particularly fixed income funds. This conclusion is neither surprising nor, in general terms, unwelcome. As you know, we share your belief that many derivative financial products play an essential role in hedging against risks created by fluctuating interest and currency exchange rates. Other derivatives often are useful in reducing exposure to potential price changes in various equities or commodities.

It is now abundantly clear, however, that derivatives can create risk as well as hedge against it. And for a variety of reasons, derivatives can sometimes create an extraordinary amount of risk virtually overnight. A recent story in Time magazine quoted a derivatives dealer and effectively illustrated the dichotomy between hedging and speculation. The dealer said that "[w]e are almost equally divided between two groups of customers -- one that wants to protect everything it has and the other that wants to make a 200% killing overnight."[1/] Obviously, to the extent that mutual funds engage in speculative derivatives activity involving volatile derivatives instruments, they pass this risk on to their shareholders around the country.

To respond to the concerns that have recently been raised, the Subcommittee requests that the Commission undertake a comprehensive study of the use of derivatives by open-end investment companies. The study should, of course, address every issue related to the use of derivatives by mutual funds that the SEC deems to be important to its mission of protecting investors and promoting the integrity and health of the industry. The study should also respond to the following specific Subcommittee concerns:

1. *Does the SEC Have Adequate Knowledge of Industry Practices?*

We are pleased that you have focused the Commission's attention on this issue, as evidenced by your remarks to the Subcommittee and recent speeches. But it is nonetheless extremely unsettling to hear the SEC in effect conclude that they often don't know the identity of the funds that actually hold and trade derivatives, or the quantity or quality of the derivatives themselves. At most fixed income and equity funds, all the SEC apparently knows right now is whether the fund retains the option, usually under a broad range of circumstances, to invest in derivatives. It is going to be hard for the Commission to achieve its mandate of protecting investors if it doesn't know what to protect them from. Please identify the information needed by the SEC to fulfill its responsibilities. What obstacles, if any, prevent the Commission from obtaining and processing this information? What steps should be taken to insure that the Commission is able to obtain accurate and reliable information quickly and efficiently?

2. *Better Disclosure May Be Critical to Help the SEC, But Will It Be Accomplished in a Manner That Makes a Significant Difference to Average Investors?*

Several commentators have already suggested that enhanced disclosure about derivatives and associated risks will fully resolve whatever problems may be experienced by

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[1/] Similarly, a recent Institutional Investor survey of pension fund officers revealed that 27% use derivatives primarily to *enhance* the fund's returns. An additional 37% viewed enhancing returns as equal in importance to hedging against risk.

investors. While we are reluctant to question the redemptive power of improved disclosure, we believe there are reasons why we may need to rethink how we communicate with mutual fund investors about an issue as inherently complex as derivatives.

First, we suspect that investors often develop general expectations about risk based on how their fund is categorized, and would like to know if the Commission agrees. In practical terms, investors in short-term government bond funds appear to believe that they have taken on relatively modest risk, while investors in emerging markets funds hopefully understand that their investments are subject to a variety of relatively extreme risks. Disclosures buried in a prospectus that diverge from these expectations may never get read, or, if read, fully understood. A report in Barron's about one of the fund's that has experienced dramatic losses even indicated that the fund's own brokers, let alone their investors, "felt they had been misled about the fund's true risk," even though the prospectus indicated the fund retained the right to trade in mortgage-backed securities.

Second, even if the fund's disclosures are presented clearly, concisely and in a manner designed to maximize comprehensibility, it is still questionable whether investors would be able to understand and assimilate information that is useful to their investment decision. A discussion of how 'inverse floaters' work, or definitions of 'principal-only strips of CMOs', will involve unavoidable elements of abstraction. Are there alternative ways of creatively presenting the critical information needed by investors, such as the effect on risk and volatility created by the fund's holdings of derivatives, that avoids the dilemma of attempting to define these instruments and strategies?

Finally, formal disclosure to investors takes place annually in the prospectus. But various derivatives positions, each with distinctly different possible risks, can change by the hour, or even by the minute. So it's not clear how much value there is in knowing what the fund held at a particular past moment in time. Does the Commission agree that this quality should be considered when evaluating the utility of requiring enhanced disclosure of derivatives holdings?

3. *Is Intense Competition in the Fund Industry (or Any Other Reason) Leading Some Portfolio Managers to Move Risky Derivatives Into Otherwise Risk Averse Funds?*

In recent weeks, several mutual funds have reported substantial and dramatic losses in funds that occurred virtually overnight. There would be less cause for concern if these funds had told investors (clearly and concisely, of course) that the fund took big risks in the effort to achieve big returns, as is typically the case with aggressive equity and fixed income funds. But these were short term government bond funds. It is, or at least we thought it was, axiomatic that short term government bond funds are not terribly risky. In exchange for *relatively* low risk, investors willingly accept *relatively* modest returns. Of course, investors

in these funds (as in all mutual funds) should have understood that they might incur a loss, and that their investments were neither insured nor guaranteed. But confusion about the possibility of some loss, or about the existence of a federal guarantee, is not the issue. Instead, the issue here is whether a 25% loss in just three months, or a 4% loss in a single day, is consistent with a typical investor's understanding of the risks presented by investing in a short term government bond fund. We don't think losses of that magnitude are consistent with a reasonable investor's expectations, and we believe the actions of the respective fund companies suggest that they reached the same conclusion.

Some might respond that categories by themselves have virtually no meaning, and that investors should always review the contents of the fund's portfolio as reported in its disclosure documents. This is, however, a problematic suggestion at best. Michael Lipper, one of the country's most respected experts on the fund industry, recently was reported to have said that "many derivatives disappear [from the portfolio] by the statement date." Equally important, in an era when there are significant public policy concerns about whether investors understand the importance of properly allocating their assets, it would be extremely unfortunate to lose the general guidance that is presently provided by the existence of various fund categories.

Is the competition for assets within the industry so intense that otherwise conservative funds take on disproportionate risks in order to outperform rivals? Is the Commission concerned that the cause of the losses reported at the two funds may represent a growing trend? Does the Commission believe that a legislative or regulatory response is needed to address any issues related to the derivatives losses reported at these funds?

4. *Are Mutual Funds Experiencing Problems Pricing Exotic Derivatives?*

As you know, the establishment of a daily net asset value is one of the core requirements of the Investment Company Act of 1940, a bedrock part of the fund industry, and no doubt one of the key reasons for its great success. But the esoteric derivatives held by one fund that recently reported dramatic losses were apparently so complex that on some days, the firm couldn't establish their value. If we understand that particular issue properly, when that fund's investors turned to their morning paper to see the value of their mutual fund shares, they saw a blank line. The Subcommittee believes serious analysis should be given to financial products that are so exotic, risky and illiquid that they might interfere with the absolutely essential function of establishing a daily price for fund shares.

5. *Are Mutual Funds Experiencing Liquidity Problems Because Of Exotic Derivatives?*

Liquidity is obviously of enormous importance to mutual funds, because investors are entitled to redeem their shares at any time. That is one reason why the SEC expressly

requires that a fund hold no more than 15% of its assets in illiquid instruments. Some have argued that the reason one fund complex agreed to inject ten million dollars of its own capital into their fund was to ease the liquidity problems they had been encountering as they sought to unwind the fund's CMO's. While we don't know the details about these particular CMO's, we do know that some derivatives are custom designed for use by a single institution, which would seem to greatly reduce their liquidity. Does the Commission believe that some of the more exotic and volatile derivatives should be considered "illiquid?" Has the Commission considered whether the 15% rule should be applied to any types of derivative products, or whether the 15% figure itself should be revisited?

6. ***Does The Use Of Derivatives Permit Mutual Funds To Avoid Limitations On The Use Of Leverage Mandated By The Investment Company Act Of 1940?***

We have read that fund managers can make use of certain derivatives, such as structured notes, to build enormous leverage into their portfolios. Practices like this apparently led to substantial returns for investors as interest rates dramatically declined through 1992 and 1993, but have posed problems for some funds with the sharp reversal in rates experienced so far this year. While funds are permitted to borrow money and use some leverage, it is limited and must be collateralized. But structured notes enjoy no such limitations, and the amount of leverage can be substantial. Please describe for the Subcommittee the original purpose of the restrictions on leverage contained in the Investment Company Act of 1940. Is the leverage that is made available to funds through the use of derivatives inconsistent with the intent underlying the 1940 Act? Apart from its relation to existing provisions in the statute, is the Commission concerned about the leverage available to funds that hold derivatives? If so, how does the Commission propose to address those concerns?

7. ***Do The Recent Capital Infusions By Two Fund Complexes Indicate That Bank Mutual Fund Investors May Be Facing Special Undisclosed Risks?***

Assume a bank was the advisor for a short term government fund or money market fund that had suffered sharp unexpected losses. If the fund is not part of a separately capitalized subsidiary or affiliate, is there a risk that bank regulatory concerns might prevent the advisor from making a capital infusion into the fund, even if such an infusion was in the interest of the fund's shareholders? Would the advisor be able to repurchase instruments from the fund that were believed to be the source of the losses? Would you agree that the failure to permit such an injection or repurchase could result in a further downward spiral for the fund, leading to even greater losses for investors? Should the prospect that such infusions or repurchases might not be permitted be disclosed to bank mutual fund investors? Better still, is there a way to avoid the conflict between the bank and the fund?

8. *Recent Instability Of Money Market Mutual Funds.*

We understand that the Commission has spent a considerable amount of time and resources reviewing and studying questions related to money market funds, as evidenced by the proposed amendments to Rule 2a-7 under the Investment Company Act. We also know that you share our general concern that many money market fund investors appear to believe that these funds are the functional equivalent of insured bank accounts, despite significant efforts by the ICI and the funds themselves to demonstrate otherwise. Notwithstanding the perception problem, however, we believe that reasonable questions arise when it is discovered that money market funds have invested in sophisticated synthetic derivatives, that expose investors to significant risk of loss if interest rates move in unexpected directions. Please bring us up-to-date on the Commission's latest views about the appropriateness of derivatives for money market portfolios.

Given the importance of these issues, it is our hope that the Commission could complete its study and report back to the Subcommittee by July 18, 1994. If you have any questions concerning the Subcommittee's request or the specific issues raised by this letter, please contact Timothy Forde, Counsel to the Subcommittee, at (202) 226-2424, or Stephen A. Blumenthal, Republican Counsel to the Committee, at (202) 226-3400.

Sincerely,

Ed Markey
EDWARD J. MARKEY
CHAIRMAN

Jack Fields
JACK FIELDS
RANKING REPUBLICAN MEMBER