SEC Seeks Public Comment on Use of Derivatives by Mutual Funds and Other Investment Companies

FOR IMMEDIATE RELEASE
2011-175

Washington, D.C., Aug. 31, 2011 – The Securities and Exchange Commission today voted unanimously to seek public comment on a wide range of issues raised by the use of derivatives by mutual funds and other investment companies regulated under the Investment Company Act.

Video: Open Meeting

Chairman Schapiro discusses the use of derivatives:
Windows Media Player

Text of Chairman's statement

Additional Materials

- Concept Release; Request for Comments
- Submit Comments

The SEC is seeking public input through a concept release, which is a Commission-approved document that poses an idea or ideas to the public to get their views. The Commission will use the comments received in response to this concept release to help determine whether regulatory initiatives or guidance is needed that would continue to protect investors and fulfill the purposes underlying the Investment Company Act.

“The derivatives markets have undergone significant changes in recent years, and the Commission is taking this opportunity to seek public comment and ensure that our regulatory approach and interpretations under the Investment Company Act remain current, relevant, and consistent with investor protection,” said SEC Chairman Mary L. Schapiro.

The concept release is a continuation of the SEC’s ongoing review of mutual funds’ use of derivatives announced last year. The concept release requests public input on the issues that the SEC staff has been examining for potential ways to improve the regulation of mutual funds’ use of derivatives.

Public comments should be received within 60 days from the date of publication in the Federal Register.

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FACT SHEET

Soliciting Public Comment on the Use of Derivatives by Funds

Background

Investment Companies

Investment companies regulated under the Investment Company Act such as mutual funds, ETFs, and closed-end funds play a significant role in the U.S. economy and world financial markets. At the end of 2010, for example, registered investment companies held more than $13.1 trillion in assets and more than 40 percent of all U.S. households owned their shares. Investors in these funds rely on investment advisers as well as boards of directors to manage and oversee the funds.

Use of Derivatives

Subject to the various safeguards contained in the Investment Company Act as well as SEC rules and guidance, funds are permitted to invest in derivatives. Derivatives, which are a type of financial instrument whose value is derived from another underlying product, include such things as futures, certain options, options on futures, and swaps. A common characteristic of most derivatives, which are among a panoply of investments that a fund may make in managing its portfolio, is that they involve leverage.

Recent SEC Activity

When the Investment Company Act was enacted in 1940, it did not contemplate funds investing in derivatives as they may do today. Indeed, the use and complexity of derivatives have grown significantly over the past two decades.

Over the years, the Commission and its staff have addressed a number of issues raised by the use of derivatives on a case-by-case basis. In March 2010, the SEC announced that the staff had initiated a broad review to evaluate the use of derivatives by funds to determine whether and what additional protection might be necessary under the Investment Company Act: http://www.sec.gov/news/press/2010/2010-45.htm

Purpose of the Concept Release

To better inform its review, the staff is recommending that the Commission issue a Concept Release to solicit public comment on funds' use of derivatives and on the current regulatory regime under the Investment Company Act as it applies to funds' use of derivatives. The Commission would use the comments to help determine whether regulatory initiatives or guidance is needed that would continue to protect investors and fulfill the purposes underlying the Investment Company Act.

What Does the Concept Release Ask?

The Concept Release asks for information on how different types of funds use various types of derivatives as well as the benefits, risks and costs of using derivatives, among other things. Additionally, it asks for comment on several specific issues under the Investment Company Act implicated by funds' use of derivatives, such as:

Restrictions on Leverage – The Investment Company Act restricts the manner in which, and the extent to which, funds may incur indebtedness and may leverage their portfolios. The Concept Release discusses the treatment of derivatives under these restrictions. The Concept Release asks, among other things, how to measure the amount of leverage that a fund incurs when it invests in a derivative.

Fund Portfolio Diversification – The Investment Company Act does not require the portfolios of funds to be diversified, but does require them to disclose in their registration statements whether they are diversified or not. The Act also prohibits a fund from changing its classification from diversified to non-diversified without shareholder approval. The Concept Release asks, among other things, how a fund should value a derivative to determine the percentage of the fund's assets that's invested in a particular company for diversification purposes.

Fund Investments in Certain Securities-Related Issuers – The Investment Company Act generally prohibits funds from acquiring any security issued by, or any other interest in, the business of a broker, dealer, underwriter or investment adviser. However, funds that meet certain conditions may acquire some securities issued by companies engaged in such business. The Concept Release asks, among other things, how investing in a derivative issued by a broker-dealer may be different from, or similar to, investing in the broker-dealer's stock or bond.

Fund Portfolio Concentration – The Investment Company Act does not prohibit funds from concentrating their investments in a particular industry, but does require funds to disclose their industry concentration policies in their registration statements. It also prohibits funds from deviating from those policies without shareholder approval. The Concept Release asks, among other things, how funds determine the industry or industries to which they may be exposed through a derivative investment.

Valuation of Fund Assets – The Investment Company Act specifies how funds must determine the value of their assets. The Concept Release asks, among other things, whether the Commission should issue guidance on how funds should value derivatives in their portfolios.

What's Next?

The Concept Release will be published in the Federal Register and commenters will have 60 days from the date of publication to submit their comments.

http://www.sec.gov/news/press/2011/2011-175.htm