:E CHAIRMAN

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

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 2(a)(41)
RULE
PUBLIC AVAILABILITY 9/26/94 by Congressional Subcommittee

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 BPB

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.

[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

[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

[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.