Derivatives, Re-Revisited
SEC Official Voices Concern Over Funds’ Use of Derivatives

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Not surprisingly given the significant market declines of the last year, many are asking whether things could or should be done differently. In a recent speech to the American Bar Association, Andrew J. Donohue, Director of the Division of Investment Management of the Securities and Exchange Commission, joined the chorus of questioners, turning to the oft-visited topic of derivatives and their use by mutual funds and other investment companies. Mr. Donohue’s remarks may signal that the SEC intends to focus anew on regulating funds’ use of derivatives and on meaningful disclosure to retail investors about that use. His remarks raise issues that fund advisers and directors may wish to consider.

Noting at the outset of his remarks that his primary concern was the leverage that derivatives bring to funds, Mr. Donohue focused on what he called the “increasing gap” between technical compliance with the existing leverage limitations in the Investment Company Act of 1940, on the one hand, and actual fund performance and investor expectations, on the other hand. Mr. Donohue noted as an example that a number of fixed income funds suffered one-year losses in excess of 30% in 2008, losses likely magnified by the use of derivatives and their concomitant leverage. He posited that “many investors in these funds, particularly at the retail level, neither appreciated the potential magnitude of nor anticipated the actual diminution in value of these funds.” Mr. Donohue noted that while many funds have extensive risk disclosure about derivatives in their offering documents, that disclosure “may not equal a discussion readily understandable by investors.” He also questioned whether investors can reasonably synthesize statements proclaiming the substantial risks of using derivatives with stated fund investment objectives of investing with “reasonable market risk” or “without undue risk.”

Mr. Donohue went on to express three broad concerns regarding funds’ use of derivatives: first, funds “should have a means to deal effectively with derivatives outside of disclosure”; second, funds’ “approach to leverage should address both implicit and explicit leverage”; and third, funds “should address diversification from investment exposures taken on versus the amount of money invested.” Noting that there are many issues underlying his concerns as articulated, Mr. Donohue challenged his audience to consider whether the “thirty year patchwork” of Commission policy and staff positions regarding investment companies’ use of derivatives is sufficient, and whether the Investment Company Act’s leverage restrictions as applied to derivatives held by funds should be reexamined.

Several times in his remarks, Mr. Donohue noted the responsibilities of fund directors to exercise oversight of their funds’ use of derivatives, including by reviewing risk and other disclosures and by overseeing risk management, accounting and internal control processes. Advisers have corresponding duties to help directors fulfill these responsibilities. Both advisers and directors may be well served by taking another look at their disclosures concerning derivatives to be sure that their disclosures are understandable to investors, actually reflect what the funds are doing, and do not promise too much in terms of lack of risk or risk mitigation.

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