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SEC Staff Evaluating the Use of Derivatives by Funds

In a release issued yesterday, the Division of Investment Management of the Securities and Exchange Commission (SEC) announced that its staff is “conducting a review to evaluate the use of derivatives by mutual funds, exchange-traded funds (ETFs) and other investment companies.” The review will examine whether and what additional protections are necessary for those funds under the Investment Company Act of 1940. The SEC also stated that its staff would consider whether “existing rules sufficiently address matters such as the proper procedure for a fund’s pricing and liquidity determinations regarding its derivatives holdings” and whether “funds’ derivative activities should be subject to special reporting requirements.”

In a statement accompanying the release, SEC Chairman Mary Schapiro said, “It’s appropriate to engage in a more thorough review of the use of derivatives by ETFs and mutual funds given the questions surrounding the risks associated with the derivative instruments underlying many funds.”

Until the review is complete, the SEC also announced that it is deferring consideration of exemptive requests by ETF’s to make significant investments in derivatives. According to the release, the deferral will “affect new and pending exemptive requests from certain actively-managed and leveraged ETFs that particularly rely on swaps and other derivative instruments to achieve their investment objectives” but will not affect “any existing ETFs or other types of fund applications.”

Among the issues the staff of the SEC intends to explore are whether:

- Current market practices are in compliance with the leverage, concentration and diversification provisions of the Investment Company Act;
- Adequate risk management procedures are in place and fund boards are providing appropriate oversight; and
- Prospectus disclosures adequately address the unique risks of derivatives.

The release, which can be found at <http://www.sec.gov/news/press/2010/2010-45.htm>, does not distinguish between over-the-counter derivatives and futures and other exchange-traded derivatives. However, from its context it appears that the focus of the SEC staff’s review will be on over-the-counter derivatives.



If you have any questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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