News Bulletin

March 26, 2010

SEC Staff to Evaluate Use of Derivatives by Funds

On March 25, 2010, the Securities and Exchange Commission (the "SEC") announced that its staff is conducting a review of the use of derivatives by mutual funds, exchange-traded funds, and other investment companies (collectively, "funds").[1] The SEC staff will evaluate the use of derivatives by those funds and, to the extent that the review suggests that additional protections may be necessary under the Investment Company Act of 1940 (the "Investment Company Act"), will determine what changes in SEC guidance or rules may be warranted.

Although the SEC staff recognizes that funds' use of derivatives is not a new phenomenon, the review will provide it with an opportunity to rethink the SEC's current regulatory protections and conclude whether those protections have kept pace with derivatives' increasing complexity and how fund managers use them.[2] Specifically, the SEC staff expressed its intention to explore at least the following issues relating to the use of derivatives by funds:

- whether current market practices involving derivatives are consistent with the leverage, concentration, and diversification provisions in the Investment Company Act;
- whether funds that rely substantially upon derivatives, particularly funds that seek to provide leveraged returns, maintain and implement adequate risk management and other procedures in light of the nature and volume of the fund's derivatives transactions;
- whether fund boards of directors are providing appropriate oversight of the use of derivatives by funds;
- whether existing rules sufficiently address matters such as, the proper procedure for a fund's pricing and liquidity determinations regarding its derivatives holdings;
- whether existing prospectus disclosures adequately address the particular risks created by derivatives; and
- whether funds' derivatives activities should be subject to special reporting requirements.

The SEC also announced that, pending completion of the review, the SEC staff will defer consideration of exemptive requests under the Investment Company Act to permit exchange-traded funds to make significant investments in derivatives. While the deferral will not affect any existing fund applications, the SEC noted that it will affect new and pending exemptive requests "from certain actively-managed and leveraged exchange-traded funds that particularly rely on swaps and other derivative instruments to achieve their investment objectives."

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[1] The SEC's press release is available at www.sec.gov/news/press/2010/2010-45.htm.

[2] Although not expressly stated in the announcement, it appears that the review will address the use by funds of both over-the-counter derivatives and exchange-traded derivatives.

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