SEC: Stricter Rules for Derivatives May Be Needed to Protect Investors

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The Securities and Exchange Commission is seeking public comment on whether to adopt new regulations to better manage the risks posed by mutual funds, exchange-traded funds, and other investment companies that use derivatives, **Reuters** reports. The decision is part of the SEC's efforts to examine the effectiveness of current disclosure and leverage rules as they relate to derivatives.

For investors who may be unfamiliar with derivatives, the term is used to describe securities whose price is "derived from" one or more underlying assets. The derivative itself is merely a contract between two or more parties, and its value is determined by fluctuations in the underlying asset. The underlying assets commonly include stocks, bonds, commodities, currencies, interest rates, and market indexes.

Derivatives, namely credit swaps, played a central role in crises at Bear Stearns, Lehman Brothers, and American International Group Inc.

Notwithstanding the role derivatives may have played in the financial crisis, SEC Chairman Mary Schapiro said that taking a closer look at derivatives use by funds is warranted because a lot has changed since the 1940 Investment Company Act was written.

"The Act imposes important leverage, valuation, diversification, and industry concentration requirements to help protect fund investors. However, those limitations were written with stocks and bonds in mind, not complex financial derivatives," she said.

"As a result, fund investments in derivatives are not always wholly captured by the statutory limitations and requirements."

The problem is that while the 1940 Act places various restrictions on mutual funds, including the amount of money a fund can borrow, derivatives can be used as another means to achieve leverage, allowing funds potentially to exceed borrowing rules while still complying with the law.

In addition, since existing law primarily deals with direct investments by funds, it fails to address how swaps and other derivatives should be accounted for and valued on their books.

About Debra Speyer

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