SEC Chief Levitt Warns Mutual Funds To Be Cautious in Handling Derivatives

WSJ
6/21/94 B2

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WASHINGTON – Securities and Exchange Commission Chairman Arthur Levitt, in a rare letter-writing campaign, fired a salvo warning the mutual-fund industry to be cautious in its handling of financial derivatives.

The letter, sent last week to chief executives of about 50 fund complexes that control about 80% of the assets in the industry, lectures funds to grasp a full understanding of the sometimes complicated products.

"I strongly encourage the management of every fund that holds derivative instruments to take steps that will ensure the proper understanding and effective management of derivatives risk," Mr. Levitt said in the letter. The chairman also indicated SEC inspections have found reason to raise questions about mutual-fund derivative activities.

Derivatives are financial agreements whose value is linked to, or derived from, the performance of some underlying asset, such as bonds or commodities.

The correspondence, which steps up similar comments by Mr. Levitt in a recent speech to the industry, follows reports of fund bailouts needed because of declines from derivatives losses. Bailouts include **BankAmerica** Corp.'s Pacific Horizon Prime Money-Market Fund and Zweig Cash Fund, a government money-market fund. Mr. Levitt said the recent bailout reports indicate some funds haven't been "well-managed" and the losses were a shock to fund management and shareholders.

Mr. Levitt said he had particular concern about money-market funds – the primary type of fund reporting derivatives problems – which are considered to be more conservative investment vehicles.

The SEC also sent correspondence on this issue to the Investment Company Institute, the trade group for mutual funds, where Mr. Levitt posed several questions on derivatives use. The SEC chairman, for instance, said he wanted to know whether funds are developing limits on derivative investments, whether derivative-laced portfolios are stress-tested and whether managers are properly trained to handle derivative risks.

The SEC indicated it will work with the mutual-fund industry on derivatives. John Collins, an Investment Company Institute spokesman, said the group is ready to "act in the spirit of constructive cooperation" with the SEC requests. Mr. Collins said the institute is preparing a memorandum to senior executives and fund directors that will cover derivatives risks, as well as disclosure of use and risks to fund shareholders.

The SEC, separately, has said it is looking at its regulations on mutual-fund derivatives activities, and Rep. Edward Markey (D., Mass.) has requested a study of mutual-fund derivatives use.

SEC officials and the institute characterized the industry's use of derivatives as generally limited. Derivatives are more common in international funds, municipal-bond funds and funds that invest in mortgage-backed securities.