SEC assessment of mutual fund risk could lead to more disclosure

Questions abound in early stages of potential rulemaking to boost oversight

By Mark Schoeff Jr. **InvestmentNews** *September 8, 2014 - 1:46 pm EST*

The Securities and Exchange Commission has started to work on rules that could require more transparency about mutual fund portfolio holdings and limit their use of alternative investment strategies, according to a story in today's Wall Street Journal.

The agency is exploring the increasing use of derivatives and other hedging strategies in mutual funds to enhance their returns. Over the summer, it launched a sweep exam focused on alternative mutual funds that delves into liquidity, leverage and board oversight.

The SEC declined to comment.

The SEC's work appears to be the next step in determining whether a catastrophic event in the asset management industry could undermine the stability of the financial system.

The Financial Stability Oversight Council decided this summer not to designate large fund companies, such as Fidelity Investments or BlackRock Inc., as systemically important. But the FSOC did say it would look at activities and practices within the industry. SEC Chairman Mary Jo White is a member of the council, which is comprised of federal financial regulators.

“More transparency regarding the portfolios of [leveraged] funds is good for investors and their advisers,” said Niels Holch, executive director of the Coalition of Mutual Fund Investors. “I just hope they don't overreach and try to impose bank-like regulations on typical mutual funds that don't employ leverage, such as an equity or bond fund.”

New rules are not imminent, given the SEC rulemaking process can take years.

“The SEC is in extremely early stages of looking at these things,” said Scott Burns, director of global manager research at Morningstar. “It's this evolving complexity [of mutual funds] that's given the SEC reason to pause for a bit and [to] try to understand what's happening in the marketplace today.”

It's too early to tell whether SEC action could raise prices for risky funds, such as leveraged exchange-traded funds.

“More frequent disclosure of a portfolio should not be a costly exercise for a fund,” Mr. Holch said.

There's a possibility that some alternative funds could lose favor if the SEC follows up its sweep exams with enforcement.

“We're in an environment where the SEC has moved fairly quickly in bringing negligence-based enforcement actions,” said Joshua Deringer, a partner and head of the investment management practice at Drinker Biddle & Reath. Advisers “are wary of having their clients in products that are the subject of enforcement actions.”

The major trade group for the mutual fund industry, the Investment Company Institute, welcomes the SEC's review of asset managers and financial stability. The ICI had strenuously criticized the FSOC's deliberations over designating large asset management companies as systemically important, arguing that the body didn't have the regulatory expertise to make such a determination.

“Any risks that may arise in asset management are best addressed by the SEC, which has a highly successful track record of regulating funds and advisers under statutory authority for almost 75 years,” ICI President Paul Schott Stevens said in a statement.