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LEGAL ALERT

August 3, 2010

Securities and Exchange Commission Staff Urges More Tailored Derivatives-Related Disclosures by Investment Companies

Late last Friday, the staff of the Securities and Exchange Commission (SEC) issued guidance on disclosures relating to investments in derivatives by investment companies. In a letter to the Investment Company Institute (ICI), the SEC staff shared observations from its ongoing evaluation of existing disclosures in fund prospectuses and Statements of Additional Information and shareholder reports (including the financial statements included therein).[1] The staff indicated that, while its review was ongoing, it was taking what, in our view at least, is the relatively unusual step of providing interim guidance to encourage funds to proactively assess the adequacy of their disclosures in both registration statements and shareholder reports. The guidance applies to mutual funds, as well as other types of registered investment companies and business development companies.

Prospectus Disclosures

The Staff Letter urged funds that use derivatives to "assess the accuracy and completeness of their disclosures, including whether the disclosure is presented in an understandable manner using plain English." The staff noted the practice by some fund complexes of using standard, generic prospectus disclosure for multiple funds, even though the funds may have varying degrees of exposure to derivatives. The staff emphasized that derivative disclosure should be tailored to the particular fund, and should outline the strategies for which derivatives will be used to help the fund achieve its objectives and the expected impact of the investment in derivatives on performance.

The Staff Letter noted that, where current disclosures about the risks of derivative investing are too generic and abbreviated, they are of limited usefulness for investors in evaluating the investment strategy intended and the resulting risks. Such disclosures are not tailored to the specific instruments and, due to their brevity, may suggest that the fund does not invest significantly in derivatives when that is not the case. On the other hand, where more detailed information is provided about derivative strategies, it may be lengthy and overly technical and, in many cases, may suggest a more significant investment in derivatives than is the case.

The guidance instructs funds to provide more information about individual derivatives actually used — the type used, the extent of their use and the purpose of the derivative transactions. The disclosures also should provide an investor with a complete risk profile of the fund's investments as a whole, not just focus on the risks of various derivative strategies. Finally, all disclosures should be assessed in light of the fund's actual operations.

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[1] Letter to Karrie McMillan, General Counsel, Investment Company Institute, from Barry D. Miller, Associate Director, Office of Legal and Disclosure, Securities and Exchange Commission (July 30, 2010) (Staff Letter).

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Shareholder Reports and Financial Statement Disclosures

Importantly, the letter noted that the staff had actually compared derivatives-related disclosures in particular funds' prospectuses, the Management's Discussion of Fund Performance (MDFP) in the funds' annual reports to shareholders, and fund operations as reflected in their financial statements. The Staff Letter instructed that, for funds with significant derivatives exposure, the MDFP should discuss the impact of those derivatives on the fund's performance during the most recently completed fiscal year and the investment strategies and techniques employed. In cases where performance was significantly impacted by derivatives, this additional disclosure should be included even if derivatives are not reflected in the portfolio schedule at the close of the fiscal year.

The Staff Letter also included detailed observations relating to disclosures in fund annual and semi-annual financial statements. The staff found that "some funds can improve certain disclosures prescribed by FASB Accounting Standards Codification Topic 815: *Derivatives and Hedging* (Topic 815), which requires, among other things, that funds provide qualitative disclosures about their objectives and strategies for using derivative instruments."[2] Specifically, the staff noted that funds should provide qualitative information about how the funds achieved their objectives and strategies by using derivative instruments during the reporting period.

Among other things, the letter addressed the requirements of Topic 815 with respect to disclosures relating to credit derivatives, such as credit default swaps. For example, for funds using credit default swaps, funds should include disclosures explaining the relevance of the level of current credit spreads. Importantly, the Staff Letter also noted that some funds were inconsistent in their disclosures relating to counterparties to forward currency and swap contracts in the schedule of investments. On another note, the staff instructed that, where over-the-counter derivatives are subject to the risk of non-performance by a counterparty, the identity of the counterparty should be included in the fund financial statements.

Continued Review

The staff indicated its review of derivatives-related disclosures was ongoing and that it will continue to review the following areas:

- Whether principal investment strategies and risks are disclosed in plain English;
- Whether a fund's derivatives-related disclosures discuss the relevance of transactions to investment operations;
- Whether the risk disclosures are tailored to the principal investment strategies being used;
- Whether the disclosure of fund operations is consistent in the registration statement and shareholder reports; and
- Whether derivatives-related disclosures in the financial statements are consistent with the MDFP.

A copy of the Staff Letter may be found here. It is noteworthy that the staff did not explain its specific expectations on how quickly funds should act, or which form of filing they should make, if a review of their registration statements and shareholder reports determines that revisions are necessary.

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[2] *See* FASB ASC 815-10-50-1A.

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If you would like to discuss these and other important implications of the Staff Letter, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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