IM Guidance Update

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FUND DISCLOSURE REFLECTING RISKS RELATED TO CURRENT MARKET CONDITIONS

The staff is issuing this Guidance Update in order to foster investor protection by reminding mutual funds, exchange traded funds, and other registered investment companies of the importance to investors of full and accurate information about fund risks, including risks that arise as a result of changing market conditions. In particular, the staff believes that funds should review their risk disclosures on an ongoing basis and consider whether these disclosures remain adequate in light of current conditions.

Background: Importance of Risk Disclosure; Previous Commission and Staff Statements

Clear and accurate disclosure of the risks of investing in funds is important to informed investment decisions and, therefore, to investor protection. The Commission has long recognized the importance to investors of fund risk disclosure,[1] and the Commission's disclosure requirements reflect that recognition. A mutual fund, for example, is required to summarize the principal risks of investing in the fund, including the risks to which the fund's portfolio as a whole is subject and the circumstances reasonably likely to affect adversely the fund's net asset value, yield, and total return, in both its summary prospectus and at the front of its statutory prospectus.[2] In addition to this summary information, the fund's statutory prospectus must provide a fuller description of the principal risks of investing in the fund.[3]

Because of the importance of risk disclosure to investors, the staff has provided guidance on various aspects of risk disclosure on a number of occasions. For example, the staff has highlighted the importance of providing a concise summary of principal investment risks, rather than a long, complex, and detailed description of those risks, in the summary section of the prospectus.[4] The staff has also encouraged any fund that exposes investors to market, credit, or other risks, and whose name suggests safety or protection from loss, to reevaluate the name and to consider changing the name, as appropriate, to eliminate the potential for investor misunderstanding.[5] The staff has also noted important aspects of disclosures related to fund use of derivatives, including the staff's expectation that funds that use investment strategies that employ derivatives should disclose material risks relating to volatility, leverage, liquidity, and counterparty creditworthiness associated with the fund's trading and investments in derivatives.[6] Further, the staff has observed that it is of limited usefulness to investors for funds to provide disclosure about the risks of investing in derivatives that is generic and not tailored to the specific derivative instruments in which a fund invests or will invest principally.[7]

Risk Disclosure Addressing Changing Market Conditions

This Guidance Update is intended to address another important aspect of fund risk disclosure, namely, the changes in a fund's susceptibility to risk that may result from changes in market conditions and the need for funds to review and assess risk disclosures in light of changing market conditions. Degree of risk is dynamic in nature rather than static; it changes in response to market conditions, and different risks may be heightened or lessened at different points in time. As a result, a fund may determine that risk disclosure that may have been adequate at one time may need to be reconsidered in light of new or changed market conditions. If a fund determines that its risk disclosure is not adequate, the staff believes that the fund should consider the appropriate manner of communicating changed risks to existing and potential investors, for example, in the prospectus, shareholder reports, fund website, and/or marketing materials.[8] We understand that many fund boards request that the fund's adviser report to the board on its process for preparing the fund's disclosure materials.[9] As part of this process, the staff believes that a fund's adviser should consider providing information to the fund board on the steps taken by the adviser to evaluate fund risk disclosures and consider whether changes are appropriate.

In the staff's view, undertaking the following steps on an ongoing basis should help funds in providing risk disclosures to investors that remain robust in changing market conditions.

- **Monitor Market Conditions and their Impact on Fund Risks.** In order for a fund to determine whether its risk disclosures appropriately address current market conditions, the fund should effectively monitor market conditions on an ongoing basis and assess the impact of changing conditions on the fund and the risks associated with its investments. Monitoring market conditions for their impact on the fund is, of course, a part of prudent portfolio management by the adviser, so we would expect that funds would routinely engage in this practice as a normal part of day-to-day operations.

- **Assess Whether Fund Risks Have Been Adequately Communicated to Investors in Light of Current Market Conditions.** If a fund determines that changed market conditions have affected the risks associated with the fund, the fund should assess the significance of the change and whether it is material to investors. If so, a fund should consider whether its existing disclosures are adequate in light of the changed conditions.

- **Communicate with Investors.** A fund that determines that changes in current market conditions have resulted in changes to the fund's risks that are material to investors, and that its current disclosures do not adequately communicate the changes, should update its communications to investors as needed. The fund should provide any such updated communications to investors, at the time and in the manner required by the federal securities laws and as otherwise appropriate. Means of communication to be considered include the prospectus (which, for example, would be updated when the fund determines that the risk disclosure in its prospectus would be materially misleading) and shareholder reports, as well as less formal methods, such as website disclosure and letters to shareholders.

In its reviews of fund disclosures concerning risks, the staff has observed a number of instances where funds have updated disclosures to address current market conditions. To illustrate the types of disclosures that a fund may wish to consider, we describe below examples of disclosures we have seen in two circumstances where market conditions are changing. The first relates to disclosures by fixed income funds regarding interest rate risk, liquidity risk, and duration risk. The second relates to investments by funds in debt securities issued by the Commonwealth of Puerto Rico and its agencies and instrumentalities (together, "Puerto Rico debt"). In each case, we have observed disclosures that highlight current conditions in a manner that we believe can make risk disclosure more timely, more meaningful, and more complete. We have observed prospectuses, shareholder reports, and fund websites where such disclosures are included. We believe that such disclosures could help investors better evaluate the risks of investment in the fund in light of changing circumstances.

Fixed Income Funds

Following the financial crisis of 2008, the Federal Reserve Board lowered the target range for the federal funds rate to near zero and implemented quantitative easing programs. Quantitative easing ended in 2014. In a statement issued in March of 2015, the Federal Open Market Committee stated that it anticipated that it would be appropriate to raise the target range for the federal funds rate when it had seen some further improvement in the labor market and was reasonably confident that inflation would move back to its two percent objective over the medium term.[10] In December of 2015, the Federal Open Market Committee decided to raise the target range for the federal funds rate to one-quarter to one-half percent and addressed how it would determine the timing and size of future adjustments to the target range for the federal funds rate.[11]

Interest Rate Risk. We have observed that prospectus disclosure for a number of bond funds addresses these current conditions. We have also observed disclosure in shareholder reports, particularly in the Management's Discussion of Fund Performance and Presidents' letters, as well as fund websites, bearing on current conditions and the level of current interest rate risk. Some funds include in their disclosure references to current historically low interest rates. In addition, some funds also include references to recent and potential future changes in government policy that may affect interest rates. These disclosures indicate that current conditions may result in a rise in interest rates, which in turn may result in a decline in the value of the fixed income investments held by the fund. We believe that the benefit of addressing current conditions in this manner is that it can alert investors that, for the present, interest rate risk may be heightened.[12] Indeed, some fund disclosures expressly state that the current conditions may pose an increased risk.

Liquidity Risk. In addition, in connection with disclosure of interest rate risk, some funds are disclosing that a potential rise in interest rates may result in periods of volatility and increased redemptions. Some of these funds state that, as a result of increased redemptions, they may have to liquidate portfolio securities at disadvantageous prices and times, which could reduce the returns of the fund. Some funds are also disclosing that the reduction in dealer market-making capacity in the fixed income markets that has occurred in recent years has the potential to decrease liquidity. Disclosures such as these may be useful in alerting investors to the secondary impacts that could result from increased interest rates.

Duration risk. Many funds, in connection with disclosure of interest rate risk, also disclose that longer-term securities may be more sensitive to interest rate changes. Some funds provide numerical examples to illustrate how interest rate changes may have a greater impact on securities with longer terms. This disclosure, when coupled with disclosure about current, historically low interest rates and the potential for increases in those rates, may be effective in communicating to investors the heightened risk that rising interest rates may pose to a fund whose portfolios include longer-term fixed income securities.

Puerto Rico Debt

A number of funds have investments in Puerto Rico debt. For some time, there have been concerns that Puerto Rico would default on its debt or restructure its upcoming obligations.[13] Indeed, on August 3, 2015, the Puerto Rico Public Finance Corporation reportedly failed to make a bond payment that was due, because the Commonwealth's legislature had not appropriated the necessary funds.[14] Again, on January 4, 2016, Puerto Rico reportedly failed to make scheduled payments to some bondholders.[15]

Some tax-exempt funds have names that indicate that they invest in securities that are exempt from both federal income tax and the tax of a particular state (*e.g.*, the Florida Tax-Exempt Fund). Because Puerto Rico debt is exempt from taxation by all states,[16] some of these "single-state" funds may have significant exposure to Puerto Rico debt.[17] We have observed that a number of these funds, in addition to required disclosure that they may invest in tax-exempt securities of issuers located outside of the named state,[18] expressly disclose in their prospectus risk disclosure that they invest in Puerto Rico debt. This disclosure has also been included in the prospectuses of other types of funds that have significant exposure to Puerto Rico debt. We believe that this disclosure can help communicate to investors that the fund is exposed to risks associated with Puerto Rico.

We have also observed that some funds that include express disclosure about the risks associated with Puerto Rico debt have updated that disclosure to communicate the existence of heightened risk under current conditions. We have observed such disclosure in fund prospectuses, as well as shareholder reports and fund websites. These disclosures refer to current factors that may be expected to have an impact on the value of the Puerto Rico debt held by the fund. For example, some of the disclosures refer to significant financial difficulties, including budget deficits, that Puerto Rico is currently experiencing. Disclosures also refer to recent downgrades in ratings of Puerto Rico debt, and state that these downgrades may adversely affect market values and liquidity of the fund's securities. In the staff's view, any fund investing in Puerto Rico debt should consider, based on the nature and significance of its investments, whether such disclosure is appropriate.

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The Division believes that full and accurate information about fund risks, including risks that arise as a result of changing market conditions, is important to investors in mutual funds, exchange traded funds, and other registered investment companies. As noted above, in our disclosure reviews, we have observed instances of funds providing useful information to their investors regarding current market conditions. We encourage funds to review their risk disclosures on an ongoing basis and consider whether these disclosures remain adequate in light of current conditions.

Endnotes

1 For instance, in a 1998 release adopting amendments to Form N-1A, the form used by mutual funds to register under the Investment Company Act of 1940 and to offer their shares under the Securities Act of 1933, the Commission stated:

> A fund's prospectus principally should include essential information about the fundamental characteristics of, and risks of investing in, the fund. Whenever possible, a fund should present this information in a manner that:
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> — assists investors in comparing and contrasting the fund with other funds;
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> — avoids simply restating legal or regulatory requirements to which funds generally are subject; and
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> — avoids a disproportionate emphasis on possible investments or activities of the fund that are not a significant part of the fund's investment operations.

Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064 (March 13, 1998) [63 FR 13916 at 13919 (March 23, 1998)], *available at* http://www.sec.gov/rules/final/33-7512r.htm.

2 Item 4(b) of Form N-1A.

3 Item 9(c) of Form N-1A.

4 Guidance Regarding Mutual Fund Enhanced Disclosure, IM Guidance Update 2014-08 at 2-3 (June 2014).

5 Fund Names Suggesting Protection from Loss, IM Guidance Update 2013-12 (Nov. 2013).

6 Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests, IM Guidance Update 2013-05 at 2-3 (Aug. 2013).

7 Letter from Barry D. Miller, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Karrie McMillan, General Counsel, Investment Company Institute (July 30, 2010), *available at* https://www.sec.gov/divisions/investment/guidance/ici073010.pdf.

8 *See* Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Investment Company Registrants (Feb. 3, 1995) (It is a fund's responsibility, "on an ongoing basis to analyze fund risk and review prospectus risk disclosure, and to update prospectus disclosure when appropriate."); Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers, Securities Act Release No. 7558 (July 29, 1998) [63 FR 41394 at 41402 (Aug. 4, 1998)], *available at* http://www.sec.gov/rules/interp/33-7558.htm (". . . it is unlawful for investment companies to omit from registration statements and other public filings 'any fact necessary in order to prevent the statements made therein, in light of the circumstances under which they were made, from being misleading.' If investment companies determine that their Year 2000 risks are material, they are required to discuss such risks in their registration statements and other public documents . . . ."); Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (March 3, 1982) [47 FR 11380 at 11395 (March 16, 1982)] ("One of the basic concerns which must be met in the context of shelf registration is ensuring that investors are provided accurate and current information where offers or sales are not to be made immediately after the registration statement becomes effective.").

9 ABA Section of Business Law, Fund Director's Guidebook, § 11.A (1) (2015).

10 Federal Reserve Monetary Policy Release, Federal Reserve Issues FOMC Statement (March 18, 2015), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20150318a.htm.

11 Federal Reserve Monetary Policy Release, Federal Reserve Issues FOMC Statement (Dec. 16, 2015), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20151216a.htm.

12 *See* Risk Management in Changing Fixed Income Market Conditions, IM Guidance Update 2014-01 (Jan. 2014) (suggesting steps that fund advisers may consider with respect to risk management and disclosure matters relating to changing conditions in fixed income markets).

13 *See* Matt Wirz, Nick Timiraos, and Aaron Kuriloff, Puerto Rico, Treasury in Talks to Restructure Island's Debt, Wall Street Journal (Oct. 14, 2015), *available at* http://www.wsj.com/articles/puerto-rico-treasury-in-talks-to-restructure-islands-debt-1444853744; Michelle Kaske and Elizabeth Campbell, Puerto Rico Debt-Crisis Grows as Island Defaults, Conserves Cash, Bloomberg Business (Aug. 3, 2015), *available at* http://www.bloomberg.com/news/articles/2015-08-04/puerto-rico-debt-crisis-grows-as-payments-halt-agency-defaults; Elizabeth Foos, Puerto Rico Back in the Hot Seat, Morningstar (July 30, 2015), *available at* http://ibd.morningstar.com/article/article.asp?id=708465&CN=brf295,http://ibd.morningstar.com/archive/archive.asp?inputs=days=14;frmtId=12,%20brf295; Michael A. Fletcher, Puerto Rico Bonds Downgraded to Junk Levels, Washington Post (Feb. 4, 2014), *available at* http://www.washingtonpost.com/business/economy/puerto-rico-bonds-downgraded-to-junk-levels/2014/02/04/c9495a22-8ddf-11e3-833c-33098f9e5267_story.html.

14 Michael A. Fletcher, Debt-Plagued Puerto Rico Defaults on a Bond Payment for the First Time, Washington Post (Aug. 3, 2015), *available at* http://www.washingtonpost.com/business/economy/puerto-rico-defaults-on-a-bond-payment-for-the-first-time/2015/08/03/8a703c0a-3a20-11e5-9c2d-ed991d848c48_story.html.

15 Mary Williams Walsh, Struggling Puerto Rico Defaults on Its Debt Payments, New York Times (Jan. 4, 2016), *available at* http://www.nytimes.com/2016/01/05/business/dealbook/puerto-rico-defaults-on-debt-payments.html; Robert Slavin, It's Bondholders' Move After Puerto Rico Defaults, Bond Buyer (Jan. 5, 2016), *available at* http://www.bondbuyer.com/news/regionalnews/its-bondholders-move-after-puerto-rico-defaults-1093208-1.html.

16 48 U.S.C. 745 provides:

> All bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State, Territory, or possession of the United States, or by the District of Columbia.

17 Rule 35d-1(a)(4) under the Investment Company Act provides in part:

> A fund with a name suggesting that the fund's distributions are exempt from both federal and state income tax is required to adopt a fundamental policy

(i) To invest, under normal circumstances, at least 80% of the value of its assets in investments the income from which is exempt from both federal and state income tax; or

(ii) To invest, under normal circumstances, its assets so that at least 80% of the income that it distributes will be exempt from both federal and state income tax.

18 Frequently Asked Questions about Rule 35d-1 (Investment Company Names) at Question 3, *available at* https://www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm; Investment Company Names, Investment Company Act Release No. 24828 at n. 30 (Jan. 17, 2001) [66 FR 8509 at 8512 (Feb. 1, 2001)], *available at* http://www.sec.gov/rules/final/ic-24828.htm.

IM Guidance Updates are recurring publications that summarize the staff's views regarding various requirements of the federal securities laws. The Division generally issues *IM Guidance Updates* as a result of emerging asset management industry trends, discussions with industry participants, reviews of registrant disclosures, and no-action and interpretive requests.

The statements in this *IM Guidance Update* represent the views of the Division of Investment Management. This guidance is not a rule, regulation or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content. Future changes in rules, regulations and/or staff no-action and interpretive positions may supersede some or all of the guidance in a particular *IM Guidance Update*.

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