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SEC's Division of Investment Management Issues Guidance on Revising Fund Disclosure in Light of Changing Market Conditions

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Summary of the Guidance

On March 2, 2016, the Securities and Exchange Commission's ("SEC") Division of Investment Management issued new guidance (the "Guidance") to registered investment companies and their investment advisers regarding the dynamic effect that changing market conditions can have on fund investments and the appropriateness of related disclosures.¹ In the Guidance, the SEC staff recommends that funds review their risk disclosures on an ongoing basis to ensure that the disclosures remain materially accurate and complete in light of changing market conditions.

The Guidance provides three steps that, in the staff's view, should help funds assess and, if necessary, revise their risk disclosures in light of changing market conditions:

- Monitor Market Conditions and How They Impact Fund Risks. Funds should monitor market conditions on an ongoing basis and assess the impact of changing market conditions on the fund and the risks associated with its investments.
- Assess the Adequacy of Risk Disclosures. Funds should determine whether any significant market developments rise to the level of presenting material new risks to investors and, if so, determine whether the fund's existing risk disclosures accurately describe the risks associated with those changes in market conditions.
- Consider Appropriate Methods for Communicating with Investors. In the event that a fund determines that an update to its risk disclosures is appropriate, the Guidance encourages funds to consider all appropriate methods for communicating with investors, including disclosure in the fund's prospectuses and shareholder reports, as well as less formal methods, including the fund's website or letters directly to shareholders.

The Guidance also provides examples of recent disclosures that the staff believes appropriately highlight risks relating to certain current market conditions. The first relates to disclosures by fixed income funds regarding potentially heightened interest rate risk, liquidity risk and duration risk in connection with anticipated changes to the Federal Reserve Board's monetary policy; and the second relates to investments by funds in debt securities issued by the Commonwealth of Puerto Rico (and its agencies and instrumentalities) and the risks associated with the Commonwealth's current financial condition and the recent credit rating downgrades of its debt.

¹ SEC, Division of Investment Management, IM Guidance Update (March 2016), No. 2016-02, "Fund Disclosure Reflecting Risks Related to Current Market Conditions"; available at <https://www.sec.gov/investment/im-guidance-2016-02.pdf>.

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Shortly after the Guidance was issued, David Grim, the Director of the SEC's Division of Investment Management, referred to the Guidance as "best practices that funds should consider" in a speech given at the Investment Company Institute's 2016 Mutual Funds and Investment Management Conference.² In his remarks, Mr. Grim reiterated concepts addressed by the Guidance, specifically stating that "[c]hanging market conditions can dramatically heighten certain risks, while simultaneously causing other risks to wane." He too stressed the importance of disclosing changes to risks resulting from current market conditions, not only in a fund's prospectus and shareholder reports, but also, if appropriate, by posting updates to the fund's website or by sending letters directly to shareholders.

Analysis of the Guidance

Though not explicitly stated in the Guidance, the SEC's ongoing concerns about fund liquidity risk likely prompted the staff to issue the Guidance. Mr. Grim's speech focused mainly on the SEC's recently proposed liquidity management rules applicable to open-end funds, after which he segued into a discussion regarding Third Avenue Management LLC's decision in December 2015 to dissolve its Focused Credit Fund and the liquidity problems that came to widespread public attention in the process.

Through the Guidance, the staff reiterates what it believes to be an industry best practice to consider regularly whether prospectus risk disclosure remains accurate and complete in light of ever-evolving market, economic and political conditions. In the Guidance, the staff also indicated its understanding that many fund boards request from the fund's adviser information regarding its process for preparing the fund's disclosure materials. The staff further mentioned that it believes that a fund's adviser should consider providing information to the fund board about the steps taken by the adviser to evaluate fund risk disclosures and to consider whether changes to such disclosures would be appropriate.

Indeed, the process suggested by the Guidance seems a sensible approach in light of fund board due diligence obligations. The Securities Act of 1933 ("1933 Act") imposes liability for materially false or misleading registration statements on issuers (in this case, the funds), their officers and directors, and certain signatories to the registration statement, subject to certain defenses. For directors, one of those defenses is that the director in question "had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ." (Section 11(b)(3)(A)).

How does a fund board conduct due diligence? Fund operations are not like those of operating companies. Due diligence by the board of an industrial company, for example, would likely focus on tangible items and events—facilities, orders, shipments, returns, costs, etc. For a fund board, due diligence would likely focus on process—how the adviser ensures accurate disclosure of the investment program and identifies the attendant risks, and whether the adviser has compliance and risk management processes for ensuring that the fund stays within the parameters identified in the prospectus. With the Guidance, the staff is essentially reminding open-end funds that they have ongoing requirements to keep their risk disclosure current. For open-end mutual funds, consideration of appropriate risk disclosure is not necessarily a once-a-year matter, and the adviser's processes to address it should be

² <https://www.sec.gov/news/speech/grim-remarks-ici-2015-securities-law-development-conference.html>

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ongoing. A board might inquire about the adviser's processes in connection with periodic presentations to the board on disclosure matters.

In light of the Guidance, funds should also consider the best method to communicate to investors changes in fund risk profile. The Guidance states that a fund "should consider the appropriate manner of communicating changed risks, ... for example, in the prospectus, shareholder reports, fund website, and/or marketing materials." Elsewhere, it suggests letters to shareholders. The staff's suggestion that an open-end mutual fund use its website or letters to shareholders is curious in several respects.

First, an open-end mutual fund that discloses information on its website or in letters to shareholders but does not also supplement its prospectus could be exposing itself unnecessarily to a risk of liability under the 1933 Act. Would plaintiffs' lawyers point to the website to bolster an argument that the prospectus was materially deficient because it did not contain the same risk disclosure? The staff seems to clarify this matter later in the Guidance by noting that a fund should provide any such updated disclosure to investors "at the time and in the manner required by the federal securities laws [generally meaning in the summary and/or statutory prospectus] and as otherwise appropriate." With that said, a closed-end fund, whose shares trade only in the secondary market is not required to maintain a current registration statement; such a fund might well choose to disclose risks to investors via its website and shareholder reports.

Second, references in the Guidance to letters and website disclosure raise the question of whether funds have an obligation to provide updated risk disclosure to current shareholders. This may be a prudent business practice, but it is not required by the 1933 Act. (Note, however, that many fund groups do send their annual updates and interim prospectus supplements to existing shareholders, since those shareholders are often the most likely buyers of additional shares.) The staff's suggestion that funds update existing shareholders, however, is consistent with the notion that the Guidance's focus on the risks of volatility in the fixed income markets is related to agency concerns about shareholder reaction to abrupt dislocations in those markets in particular.

The global market, economic and political environments are in a continuous state of flux, and there may well be other developments that warrant consideration for disclosure of their potential impact on a fund's risk profile. Many of the events in question can, of course, be found in daily newspapers and on television. The Guidance seems to indicate that funds should be drawing lines for investors between those events and the funds' investment programs, to explain the impact that the events could have on a fund shareholder's investment.

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