

**MEMO# 24458**

August 2, 2010

## **SEC Staff Issues Letter on Derivatives-Related Disclosures by Investment Companies**

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TO: ACCOUNTING/TREASURERS MEMBERS No. 23-10  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 41-10  
COMPLIANCE MEMBERS No. 15-10  
ETF ADVISORY COMMITTEE No. 33-10  
EQUITY MARKETS ADVISORY COMMITTEE No. 30-10  
RISK MANAGEMENT COMMITTEE No. 14-10  
SEC RULES MEMBERS No. 72-10  
SMALL FUNDS MEMBERS No. 43-10 RE: SEC STAFF ISSUES LETTER ON DERIVATIVES-RELATED DISCLOSURES BY INVESTMENT COMPANIES

As we previously informed you, the SEC staff is conducting a review to evaluate the use of derivatives by mutual funds, exchange-traded funds (ETFs), and other investment companies. [\[1\]](#) On July 30, 2010, Barry Miller, Associate Director of the SEC's Division of Investment Management, sent a letter to Karrie McMillan, General Counsel of ICI, with some observations about current industry practices with respect to derivatives-related disclosures. [\[2\]](#) The letter addresses funds' disclosures related to derivatives that are included in the registration statement, shareholder reports, and financial statements. Mr. Miller requested that we communicate these observations to Institute members. The letter is briefly summarized below.

### **Registration Statement Disclosures**

The letter states that when the risk/return summary framework for fund prospectuses, which requires funds to disclose their principal strategies and risks, was adopted in 1998, the Commission "intended to focus the prospectus disclosure on how a fund achieves or intends to achieve its investment objectives, and to move the disclosure away from the

practice of listing all types of securities in which it may invest.” It states that some funds’ derivatives-related disclosures are not consistent with this intent, because they provide generic disclosures that may not help investors evaluate how an adviser actually intends to manage the fund’s portfolio and the consequent risks.

The letter states that these generic disclosures range from “highly abbreviated disclosures that briefly identify a variety of derivatives products or strategies, to lengthy, often highly technical disclosures that detail a wide variety of potential derivative transactions without explaining the relevance to the fund’s investment operations.” These disclosures typically state that a fund may invest in derivatives, and describe in more or less detail a wide range of instruments, but may not enable investors to “distinguish which, if any, derivatives are in fact encompassed in the principal investment strategies of the fund or specific risk exposures they will entail.” The letter notes that some fund complexes use the same disclosure for multiple funds with different exposures to derivatives, demonstrating the generic nature of such disclosure.

The letter states that funds that use or intend to use derivatives should assess the accuracy and completeness of their disclosure. Funds should tailor their disclosure to address how a fund expects to be managed, including the strategies a fund expects will be the most important means of achieving its objectives and that it anticipates will have a significant effect on its performance. This disclosure should include the purpose that derivatives are intended to serve in the portfolio.

Additionally, the principal risk disclosure should similarly be tailored to address the types of derivatives used by the fund, the extent and purpose of their use, and their risk profile. Finally, the letter recommends that funds should review their derivatives-related disclosure annually and assess whether it is complete and accurate in light of the funds’ actual operations.

## **Shareholder Reports and Financial Statements Disclosures**

The letter indicates that Management’s Discussion of Fund Performance (MDFP) must discuss the factors that materially affected the fund’s performance during its most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the fund’s investment adviser. The letter notes that certain funds disclose significant derivatives holdings in their financial statements, yet their MDFP includes limited or no discussion of the effect of those derivatives on the fund’s performance. The letter reminds funds that MDFP should be consistent with operations reflected in the financial statements, and a fund whose performance was materially affected by derivatives should discuss that fact, whether or not derivatives are reflected in the portfolio schedule at period end.

The letter indicates that staff reviews of financial statements have revealed that some funds could improve their disclosures required by FASB Accounting Standards Codification Topic 815. While many funds state that they “may” engage in certain types of derivatives transactions, they do not inform shareholders how a fund actually used derivatives during the period to meet its objectives and strategies. The letter indicates that those funds that sell credit default swaps and disclose credit spreads could improve their disclosures by explaining the relevance of those spreads. For example, these funds could explain the significance of the size of the credit spreads in relation to the likelihood of a credit event or

the possible requirement for these funds to make payments to counterparties.

The letter indicates that while most funds disclose counterparties to forward currency and swap contracts reported in the schedule of investments, some do not. The letter expresses the staff's view that identification of the counterparty is a material component of the description and should be disclosed.

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**endnotes**

[1] See SEC Staff Evaluating the Use of Derivatives by Funds, ICI [Memorandum](#) No. 24198 (March 26, 2010).

[2] The letter from Mr. Miller to Ms. McMillan is available on the SEC's website at <http://www.sec.gov/divisions/investment/guidance/ici073010.pdf>.

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