UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

July 30, 2010

Karrie McMillan, Esq.
General Counsel
Investment Company Institute
1401 H Street, NW
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Washington, DC 20005

Re: Derivatives-Related Disclosures by Investment Companies

Dear Ms. McMillan:

As you are aware, the staff of the Securities and Exchange Commission is conducting a review to evaluate the use of derivatives by mutual funds, exchange-traded funds, and other investment companies.[1] This review is ongoing, and includes, among other things, exploring whether existing prospectus disclosures adequately address the particular risks created by derivatives. At this time, we are writing to provide some observations we have made about current derivatives-related disclosures by investment companies in registration statements and shareholder reports. We are providing these observations now, prior to completion of our review, because we believe these observations may give investment companies immediate guidance to provide investors with more understandable disclosures related to derivatives, including the risks associated with them.[2] We request that you communicate our observations to all of your members.

Registration Statement Disclosures

Form N-1A, the form used by mutual funds to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act of 1933, requires a fund to disclose its principal investment strategies, including the type or types of securities in which the fund principally invests or will invest.[3] Further, Form N-1A

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1 See "SEC Staff Evaluating the Use of Derivatives by Funds," SEC Press Release 2010-45 (Mar. 25, 2010), available at: http://www.sec.gov/news/press/2010/2010-45.htm.

2 While we primarily refer to registered open-end management investment companies, or mutual funds, in this letter, our observations also generally relate to other types of registered investment companies and business development companies.

3 See Items 4(a) and 9(b) of Form N-1A. Whether a particular strategy, including a strategy to invest in a particular type of security, is a principal investment strategy depends on the strategy's anticipated importance in achieving the fund's investment objectives, and how the strategy affects the fund's potential risks and returns. See Instr. 2 to Item 9(b) of Form N-1A. In assessing what is a principal investment strategy, a fund should consider, among other things, the amount of the fund's assets expected to be committed to the strategy, the amount of the fund's assets expected to be placed at risk by the strategy, and the likelihood of the fund losing some or all of those assets from implementing the strategy. Id.

requires a mutual fund to disclose the principal risks of investing in the fund, including the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the fund's net asset value, yield, or total return.[4] Investment strategies used by a fund that are not principal strategies and the risks of those strategies should generally be disclosed in the fund's Statement of Additional Information.[5]

When this disclosure framework was adopted in 1998, the Commission noted that it intended the prospectus disclosure to focus on a fund's principal investment strategies in order to provide investors with more useful information about the fund's investment approach and how the fund's portfolio will be managed.[6] The Commission stated that a fund should disclose in its prospectus those strategies that it expects to be the most important means of achieving the fund's objectives and that the fund anticipates will have a significant effect on its performance.[7] The Commission also stated that it 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.[8] That is, the approach was designed to focus disclosure on a fund's anticipated investment operations, rather than on investments that the fund might make.[9]

We have observed derivatives-related disclosures by some funds that we believe may not be consistent with the intent of Form N-1A's requirements described above and which could be improved. Our primary observation is that some funds provide generic disclosures about derivatives that, in our view, may be of limited usefulness for investors in evaluating the anticipated investment operations of the fund, including how the fund's investment adviser actually intends to manage the fund's portfolio and the consequent risks.[10]

The generic disclosures vary from highly abbreviated disclosures that briefly identify a variety of derivative 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. Regardless of the style and format, funds with generic derivatives-related disclosures: (1) typically state as a principal investment strategy that they will or may engage in derivative transactions, and

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4 See Items 4(b) and 9(c) of Form N-1A.

5 See Item 16(b) of Form N-1A.

6 See Investment Company Act Release No. 23064 (Mar. 13, 1998) [63 FR 13916, 13926 (Mar. 23, 1998)].

7 Id.

8 Id. ("[D]isclosing information about all of the securities in which a fund might invest does not help a typical fund investor evaluate how the fund's portfolio will be managed or the overall risks of investing in the fund.").

9 Id.

10 Id. See also Items 4(a) and 9(b) of Form N-1A (requiring a fund to disclose how it "intends to achieve its investment objectives").

then often enumerate all or virtually all types of derivatives as potential investments; (2) may provide generic language about the purpose for using derivatives (e.g., derivatives may be used for "hedging or non-hedging purposes"); and (3) may characterize broadly the extent of the transactions (e.g., the fund may invest "all" of its assets in derivatives).[11] Whereas funds with abbreviated disclosures typically list the types of derivatives, with little or no explanation of the nature of the instruments, those with lengthy, often highly technical, disclosures typically provide an extensive and complex explanation of the various derivatives that might be used and is not always provided in plain English.

Funds that provide abbreviated disclosures typically also provide generic risk disclosure, which, while appropriately citing various potential risks (e.g., correlation, counterparty, credit, leverage, liquidity, market, and valuation risks), again provide limited explanation of those risks and may not be tailored to the specific derivative instruments in which a fund invests or will invest principally. Funds that provide lengthy, often highly technical, disclosures generally provide risk disclosure that is more tailored to each specific type of derivative, but the complex and lengthy disclosure reduces its usefulness for investors.

The types of generic disclosures discussed above 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. Indeed, while more abbreviated disclosures could lead some investors to believe that a fund's exposure to derivatives is minimal, we have observed that some funds employing this type of disclosure, in fact, appear to invest significantly in derivatives and thereby may have substantial exposure to derivatives-related risks. Conversely, the comprehensive nature of lengthy, often highly technical, derivatives-related disclosures could lead some investors to believe that a fund with such disclosure would have substantial exposure to derivative transactions, yet we have observed that some funds providing this disclosure actually appear to have relatively small exposure to derivatives.[12]

Reliance upon generic, even standardized, derivatives-related disclosures is further evidenced by the practice of some fund complexes that provide the same derivatives-related disclosures for multiple funds, even though the various funds have

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11 Our observation about the practice by some funds of listing under principal investment strategies all possible fund investments is not limited to derivatives. When the staff of the Division of Investment Management observes such disclosure, it will continue to provide comments, as appropriate, that consistent with the intent of Form N-1A's requirements, a fund should not list all types of possible investments, but rather focus on the principal strategies and investments that the fund intends to use to achieve its investment objectives.

12 We have also observed funds with derivatives-related disclosures in their registration statements that do not appear to communicate the significant derivatives exposure reflected in the financial statements or the Management's Discussion of Fund Performance ("MDFP"), contained in the annual reports to shareholders. Below, we include observations about derivatives-related disclosures included in fund shareholder reports and financial statements. See infra "Shareholder Reports and Financial Statements Disclosures"; see also infra footnotes 18 and 19 and accompanying text (describing MDFP disclosure requirements).

significantly different exposures to derivatives.[13] Such a practice again demonstrates that the disclosure is not always being tailored to each particular fund and thus may not provide investors with meaningful information about the fund's anticipated investment operations or how the fund's portfolio will be managed.

Given these observations, we believe that all funds that use or intend to use derivative instruments should assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner using plain English. Further, any principal investment strategies disclosure related to derivatives should be tailored specifically to how a fund expects to be managed and should address those strategies that the fund expects to be the most important means of achieving its objectives and that it anticipates will have a significant effect on its performance.[14] In determining the appropriate disclosure, a fund should consider the degree of economic exposure the derivatives create, in addition to the amount invested in the derivatives strategy.[15] This disclosure also should describe the purpose that the derivatives are intended to serve in the portfolio (e.g., hedging, speculation, or as a substitute for investing in conventional securities),[16] and the extent to which derivatives are expected to be used.

Additionally, the disclosure concerning the principal risks of the fund should similarly be tailored to the types of derivatives used by the fund, the extent of their use, and the purpose for using derivative transactions.[17] The risk disclosure in the prospectus for each fund should provide an investor with a complete risk profile of the fund's

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13 For example, some funds may use all types of derivatives, others use some types, and still others use derivatives sparingly. Investors are left with no way to distinguish the risk exposure of a particular fund. While the fund's financial statements and the MDFP in its annual report may help explain the risk exposure, the prospectus itself should include adequate disclosure for an investor to determine the principal investment strategies and risks of the fund.

14 In the staff's view, referencing all types of derivatives, if such derivatives are not expected to be used in connection with the fund's principal strategies, is not consistent with the intent of Form N-1A's requirements. Any strategy that is not a principal investment strategy, including one involving derivatives, should be clearly described as non-principal in the registration statement. See Item 16(b) of Form N-1A.

15 See Instr. 2 to Item 9(b) of Form N-1A. Derivatives-related disclosure should also be provided commensurate with the level of derivatives exposure of a fund. For example, a small investment in some derivatives does not necessarily correlate with little effect on a fund's performance because of the impact of leverage. Alternatively, a fund may have significant exposure to derivatives, but that exposure may not make the fund substantially riskier (e.g., exposure by an international fund to currency forwards, entered into to hedge against the currency risk of securities that trade in those currencies would more likely reduce the fund's overall risk, rather than increase it).

16 For example, some funds invest in the combination of an equity-linked derivative and fixed-income securities to create the economic equivalent of investing directly in the underlying equity security. Some funds invest in derivatives in an attempt to enhance returns, i.e., to magnify the gain. Still other funds may invest in interest rate swaps to hedge against their interest rate exposure.

17 As noted, some funds generically describe the risks of investing in derivatives, yet different derivatives are subject to varying risks. For example, derivatives that are not traded on an exchange may be subject to heightened liquidity and valuation risks.

investments taken as a whole, rather than a list of the risks of various derivative strategies, and should reflect anticipated derivatives usage.

Finally, a fund should assess the completeness and accuracy of the derivatives-related disclosures in its registration statement in light of its actual operations. In particular, a fund should assess, based upon its actual operations, whether it is meeting the disclosure requirements to completely and accurately disclose its anticipated principal investment strategies and risks. A fund should review its use of derivatives when it updates its registration statement annually – particularly disclosures in its shareholder reports – and assess whether it needs to revise the disclosures in its registration statement that describes its principal derivatives strategies and risks.

Shareholder Reports and Financial Statements Disclosures

We also have observations regarding mutual fund disclosures contained in shareholder reports and financial statements. Mutual funds (except for money market funds) must provide Management's Discussion of Fund Performance ("MDFP") in their annual report to shareholders.[18] Among other things, the 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.[19]

We have observed some funds that appear to have significant derivatives exposure in their financial statements, yet their MDFP includes limited or, in some cases, no discussion of the effect of those derivatives on the funds' performance. Other funds also include limited or, in some cases, no MDFP derivatives-related disclosure, yet their registration statements disclose principal investment strategies that include the use of derivatives. Additionally, we have observed some funds with MDFP derivatives-related disclosure that is solely forward looking and does not discuss the impact of derivatives on performance for the most recently completed fiscal year.

Given these observations, we remind funds that the MDFP is intended to provide shareholders with information about the factors that materially affected the fund's performance during its most recently completed fiscal year and also should not be limited solely to forward-looking information.[20] Further, the 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 the close of the fiscal year.

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[18] See Item 27(b)(7) of Form N-1A.

[19] Id.

[20] See Investment Company Act Release No. 19382 (Apr. 6, 1993) [58 FR 19050, 19053 (Apr. 12, 1993)] ("[T]he item [requiring MDFP disclosure] requires funds to explain what happened during the previous fiscal year and why it happened. The narrative must describe what techniques or strategies, within the fund's investment objectives and limitations, management used that, together with market conditions and events, resulted in the performance of the fund.").

Additionally, we have observations related to derivatives-related disclosures contained in the annual and semi-annual financial statements of funds required by U.S. GAAP and Regulation S-X. We note 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, funds to provide qualitative disclosures about their objectives and strategies for using derivative instruments.[21] Additionally, for sellers of credit derivative instruments, Topic 815 requires entities to disclose the payment/performance risk associated with the instruments.[22]

In our reviews of fund financial statements, we have found that some funds could improve their disclosures when meeting Topic 815's requirement to provide qualitative disclosures about their objectives and strategies for using derivative instruments by addressing the effect of using derivatives during the reporting period. While many funds state that they "may" engage in certain types of derivatives transactions, they do not provide qualitative information about how the funds achieved their objectives and strategies by using derivative instruments during the reporting period. The financial statements and accompanying notes should inform shareholders how a fund actually used derivatives during the period to meet its objectives and strategies.

Topic 815 also requires sellers of credit derivatives to disclose, among other things, the nature of the credit derivative, including, but not limited to, the current status of payment/performance risk of the credit derivative.[23] Funds that sell protection through credit default swaps often include credit spreads as part of their disclosures. We note that some of these funds 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 funds to make payments to counterparties.

Also in our reviews of fund financial statements, we have noted that, while most funds disclose counterparties to forward currency and swap contracts reported in the schedule of investments, some funds do not.[24] In addition to the risks associated with a particular derivative instrument (e.g., credit, currency, or interest rate risks), over-the-counter derivatives are subject to the risk of nonperformance by the counterparty. Accordingly, in the staff's view, the identification of the counterparty is a material component of the description and should be disclosed.

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We will continue to review fund registration statements and shareholder reports to evaluate fund disclosures related to derivatives. Among other things, we will continue to review fund registration statements to assess whether a fund's principal investment

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21 See FASB ASC 815-10-50-1A.

22 See FASB ASC 815-10-50-4K.

23 Id.

24 See generally Rule 12-13 of Regulation S-X, at footnote 1 [17 CFR 210.12-13].

strategies and risks are presented in plain English, and discuss the relevance of derivative transactions to the fund's investment operations. Where appropriate, we will query whether the strategies listed are, in fact, principal investment strategies and whether the risk disclosure is tailored to those strategies. We also will continue to compare a fund's investment objectives, strategies and risks in its registration statement to its shareholder reports to assess whether the disclosures regarding the fund's operations appear to be consistent with its registration statement disclosures. Similarly, we will continue to review financial statement disclosures, including assessing whether derivatives-related disclosures in financial statements appears to be consistent with the MDFP. Accordingly, we encourage all funds that use derivative transactions to review their disclosures related to derivatives to assess whether they are meeting their disclosure obligations and whether their disclosures could be improved.

We hope that this letter will help your members provide investors with more understandable disclosures related to derivatives. If you have any questions regarding our observations related to registration statement disclosures, please contact Frank J. Donaty at 202-551-6925 or Brent J. Fields at 202-551-6921, Assistant Directors in the Office of Disclosure and Review, or related to shareholder reports and financial statements disclosures, please contact Richard F. Sennett at 202-551-6918, Chief Accountant in the Office of the Chief Accountant, Division of Investment Management.

Sincerely,

Barry D. Miller
Associate Director
Office of Legal and Disclosure