

Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests

The staff of the Division of Investment Management has noted an increase in the use by investment companies that are registered under the Investment Company Act of 1940 (“funds”) of derivatives that are commodity interests under the rules of the Commodity Futures Trading Commission (“commodity interests”).¹ This Guidance Update summarizes views of the Division regarding certain disclosure and compliance matters relevant to funds that invest in commodity interests. The guidance is intended to assist those funds in preparing disclosure filings and in their consideration of compliance issues. In addition, the Division is continuing its ongoing review of funds’ use of derivatives, including commodity interests, and the associated regulatory issues.

In February 2012, the Commodity Futures Trading Commission (“CFTC”) revised its requirements for determining which sponsors of funds should be required to register as commodity pool operators (“CPOs”).² At the same time, the CFTC issued a rule proposal to address concerns that had been raised by commenters regarding the need for harmonization between Securities and Exchange Commission (“SEC”) disclosure and reporting requirements applicable to funds and CFTC requirements that would apply to sponsors of funds required to register as CPOs.³ Since that time, the staff of the Division of Investment Management and the staff of the CFTC have worked together, with a view to harmonizing the requirements of the SEC and CFTC in a manner that would result in the provision of material information to investors in funds that invest in commodity interests without imposing duplicative, inconsistent, and burdensome requirements on funds and their sponsors. It is our intent that the views expressed in this Guidance Update facilitate compliance with SEC and CFTC disclosure and reporting requirements by funds and their sponsors that are subject to regulation by both agencies.

I. Disclosure of Derivatives and Associated Risks

The staff of the Division has previously provided its observations regarding derivatives-related disclosures by funds in registration statements and shareholder reports.⁴ We wish to reiterate the views expressed previously and, in particular, to highlight our concern that funds adequately disclose the risks associated with investments in commodity interests.



Form N-1A, the form used by mutual funds to register under the Investment Company Act of 1940 (“Investment Company Act”) and to offer their securities under the Securities Act of 1933 (“Securities Act”), requires a fund to disclose in its prospectus its principal investment strategies, including the type or types of securities in which the fund principally invests or will invest.⁵ Further, Form N-1A requires a mutual fund to disclose in its prospectus 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.⁶ 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.⁷

Similarly, Form N-2, the form used by closed-end funds to register under the Investment Company Act and to offer their securities under the Securities Act, requires a closed-end fund to describe the investment objectives and policies that will constitute its principal portfolio emphasis, including the types of securities in which the fund invests or will invest principally.⁸ Form N-2 also requires a closed-end fund to discuss principal risk factors associated with investment in the fund specifically as well as factors generally associated with investment in a fund with investment objectives, investment policies, capital structure, or trading markets similar to those of the fund.⁹ Finally, Form N-2 also requires discussion of the types of investments that will be made by the fund, other than those that will constitute its principal portfolio emphasis, and any policies or practices relating to those investments.¹⁰

As we have previously stated, 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.¹¹ 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.¹² 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.¹³ 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),¹⁴ 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 derivatives transactions.¹⁵ The risk disclosure in the prospectus for each fund should provide an investor with a complete risk profile of the fund’s investments taken as a whole, rather than a list of risks of various derivative strategies, and should reflect anticipated derivatives usage. We note that investment strategies that employ

derivatives, including commodity interests, may introduce risks in addition to those associated with investments in the cash markets, and that we expect funds that use such strategies to address those risks in their disclosures where the information is material to investors. Such a fund should, for example, disclose material risks relating to volatility, leverage, liquidity, and counterparty creditworthiness that are associated with trading and investments in derivatives that are engaged in, or expected to be engaged in, by the fund.

Finally, a fund should assess on an ongoing basis 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 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 and assess whether it needs to revise the disclosures in its registration statement that describe its principal derivatives strategies and risks. Revisions may also be required at other times in light of a fund's actual operations.¹⁶

II. Performance Presentations

At times, a new fund, with no (or a short) performance track record of its own, may seek to include in its prospectus the performance record of other funds or private accounts managed by the fund's investment adviser. A fund that pursues a strategy of investing in commodity interests, for example, may seek to include in its prospectus the performance records of other funds or private accounts that are managed by the fund's investment adviser and that also invest in commodity interests.

Section 34(b) of the Investment Company Act makes it unlawful for a fund to include in a registration statement filed with the SEC any untrue statement of a material fact, or to omit to state any fact necessary in order to make the information in a registration statement not materially misleading.¹⁷ Section 34(b), however, does not prohibit a fund from including in its registration statement information that is not required by the applicable registration form. The general instructions for preparing a registration statement on Form N-1A or Form N-2 expressly contemplate that a fund may include non-required information. Those instructions state that a fund may include information in addition to that called for by the applicable items of the form, provided that "the information is not incomplete, inaccurate, or misleading and does not, because of its nature, quantity, or manner of presentation, obscure or impede understanding of" the required information.¹⁸ The staff of the Division of Investment Management has previously expressed the view that a fund may include in its prospectus information concerning the performance of private accounts and other funds managed by the fund's adviser that have substantially similar investment objectives, policies, and strategies to the fund, provided that the information is not presented in a misleading manner and does not obscure or impede understanding of information that is required to be included in the fund's prospectus (including the fund's own performance information).¹⁹

We wish to emphasize that a fund, such as a newly registered fund that invests in commodity interests, that includes in its registration statement information concerning the performance of private accounts or other funds managed by the fund's adviser is responsible for ensuring that the information is not materially misleading. Specifically, we expect that a fund that includes the performance of other funds or private accounts managed by the fund's adviser in its registration statement would generally include the performance of all other funds and private accounts managed by the adviser that have investment objectives, policies, and strategies substantially similar to those of the fund. We note, in particular, that a fund should not exclude the performance of any other funds or private accounts that have substantially similar investment objectives, policies, and strategies if the exclusion would cause the performance shown to be materially higher or more favorable than would be the case if the funds or accounts were included. A fund should only exclude funds or private accounts if the exclusion would not cause the performance to be materially misleading.²⁰

III. Legend Requirement

Rule 481 under the Securities Act requires a fund to provide a legend in plain English on the outside front cover page that indicates that the SEC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus and that any contrary representation is a criminal offense.²¹ Although rule 481 sets forth examples of language that may be used for the legend, the rule also permits funds to use other clear and concise language. As a result, the staff would not object if a fund that invests in commodity interests includes in the required plain English legend language that also indicates that the CFTC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus.

IV. Compliance and Risk Management

Effective implementation of a fund's investment objectives and policies requires effective management of the risks associated with those objectives and policies. A fund that uses commodity interests to implement its investment objectives and policies should effectively manage those derivatives, including their associated risks. Day-to-day responsibility for managing the fund's portfolio, including any commodity interests and their associated risks, rests with the fund's investment advisers. In addition, the fund's board generally oversees the adviser's risk management activities as part of the board's oversight of the adviser's management of the fund.

Rule 206(4)-7(a) under the Investment Advisers Act of 1940 ("Advisers Act") is a compliance rule for registered investment advisers. The rule makes it unlawful for an investment adviser registered with the SEC to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.²²

In adopting the compliance rule for advisers, the SEC stated its expectation that an adviser's policies and procedures would, among other things, address portfolio management processes, including consistency of portfolios with clients' investment objectives, as well as the accuracy of disclosures made to investors, clients, and regulators.²³

Rule 38a-1 under the Investment Company Act is a compliance rule for funds. The rule requires each fund to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and to obtain the approval of those policies and procedures by the fund's board of directors, including a majority of directors who are not interested persons of the fund.²⁴ The fund's policies and procedures are required to include provisions for the fund to oversee compliance by its investment advisers and other service providers. In adopting the compliance rule for funds, the SEC noted that funds' or their advisers' policies and procedures should address the same issues that it expected advisers to address under the advisers' compliance rule.²⁵ As noted in the preceding paragraph, this includes policies and procedures that address portfolio management processes, including consistency of portfolios with clients' investment objectives, as well as the accuracy of disclosures made to investors, clients, and regulators.

The staff would therefore expect that funds and their advisers would adopt policies and procedures that address, among other things, consistency of fund portfolio management with disclosed investment objectives and policies, strategies, and risks. We recognize that the policies and procedures of funds and their advisers may vary in the specificity with which they address consistency with particular disclosures, such as disclosures about the use of derivatives generally and commodity interests specifically. We would expect, however, that each fund would have in place policies and procedures that are sufficient to address the accuracy of disclosures made about the fund's use of derivatives, including commodity interests, and associated risks, as well as consistency of the fund's investments in these derivatives with the fund's investment objectives. These policies and procedures should be reasonably designed, for example, to prevent material misstatements about the fund's use of derivatives, including commodity interests, and the associated risks. In addition, the fund's annual review required under rule 38a-1 should assess the adequacy of such policies and procedures and the effectiveness of their implementation.

We also remind funds that they are required to disclose in the statement of additional information the extent of the board's role in the risk oversight of the fund, such as how the board administers its oversight function.²⁶ In adopting this requirement, the SEC noted that funds face a number of risks, including investment risk.²⁷ The SEC also stated its belief that the required disclosures would improve investor understanding of the role of the board in the fund's risk management practices and should provide important information to investors about how a fund perceives the role of its board and the relationship between the board and the fund's adviser in managing material risks facing the fund.²⁸

Finally, we note that a Risk and Examinations Office has recently been created within the Division of Investment Management. The Risk and Examinations Office is responsible for analyzing and monitoring the risk management activities of investment advisers, investment companies, and the investment management industry as well as new products. The group has already started to work closely with the SEC's Office of Compliance Inspections and Examinations to make onsite visits to investment management firms. These visits are designed to increase the staff's understanding of firms' risk management activities, including risk management activities related to commodity interests and other derivatives; generate an active dialogue between the staff and firms on key risk and other issues facing firms and the industry; and help inform policy and the examination process.

Endnotes

- 1 See 17 CFR 1.3(yy) (definition of "commodity interest," which includes commodity futures, commodity options contracts, and swaps).
- 2 Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 FR 11252 (Feb. 24, 2012).
- 3 Harmonization of Compliance Obligations for Registered Investment Companies Required To Register as Commodity Pool Operators, 77 FR 11345 (Feb. 24, 2012).
- 4 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).
- 5 See Items 4(a) and 9(b)(1) 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 Instruction 2 to Item 9(b)(1) 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.*
- 6 See Items 4(b)(1) and 9(c) of Form N-1A.
- 7 See Item 16(b) of Form N-1A.
- 8 See Item 8.2 of Form N-2.
- 9 See Item 8.3(a) of Form N-2.
- 10 See Item 8.4 of Form N-2.
- 11 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, at 4 (July 30, 2010).

- 12 In the staff's view, a fund that references types of derivatives in its principal investment strategies disclosure that the fund does not expect to use in connection with the fund's principal investment strategies has not provided disclosure that is consistent with the intent of the registration form 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; Item 8.4 of Form N-2.
- 13 See Instruction 2 to Item 9(b)(1) 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).
- 14 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.
- 15 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.
- 16 *See, e.g., In the Matter of OppenheimerFunds, Inc., and OppenheimerFunds Distributor, Inc.*, Admin. Proc. File No. 3-14909, Securities Act Release No. 9329 (June 6, 2012) (finding violations of Section 34(b) of the Investment Company Act and Section 17(a)(2) of the Securities Act when a fund, which had disclosed that its returns would mainly be a function of investments in high-yield bonds, failed to disclose its practice of using total return swaps to obtain leveraged exposure to residential mortgage-backed securities, and the risks associated therewith).
- 17 *See In the Matter of Fred Alger Management, Inc.*, Admin. Proc. File No. 3-7320, Investment Company Act Release No. 17358 (Feb. 26, 1990) (finding violation of Section 34(b) when a fund failed to include information in its prospectus necessary to make presentation of adviser's prior performance not materially misleading).

In addition, rule 10b-5 under the Securities Exchange Act of 1934 makes it unlawful to make any untrue statement of a material fact in connection with the purchase or sale of any security or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. 17 CFR 240.10b-5.

- 18 General Instruction C.3(b) to Form N-1A; General Instruction 2 for Parts A and B to Form N-2.
- 19 *See, e.g., ITT Hartford Mutual Funds* (pub. avail. Feb. 7, 1997) (fund may include in marketing materials performance information for other funds managed by the same adviser with investment objectives, policies, and strategies substantially similar to those of the fund); *Nicholas-Applegate Mutual Funds* (pub. avail. Aug. 6, 1996) (fund may include in prospectus performance information for private accounts managed by the fund's adviser with investment objectives, policies, and strategies substantially similar to those of the fund).

- 20 See Nicholas-Applegate Mutual Funds (pub. avail. Aug. 6, 1996) (fund may exclude similar accounts from a composite, so long as the exclusion would not cause the composite performance to be misleading).
- 21 17 CFR 230.481.
- 22 17 CFR 275.206(4)-7(a).
- 23 Investment Advisers Act Release No. 2204, text accompanying note 17 (Dec. 17, 2003) [68 FR 74714, 74716 (Dec. 24, 2003)].
- 24 17 CFR 270.38a-1.
- 25 Investment Advisers Act Release No. 2204, text accompanying note 37 (Dec. 17, 2003) [68 FR 74714, 74717 (Dec. 24, 2003)].
- 26 Item 17(b)(1) of Form N-1A; Item 18.5(a) of Form N-2.
- 27 Investment Company Act Release No. 29092 (Dec. 16, 2009) [74 FR 68334, 68345 (Dec. 23, 2009)].
- 28 *Id.*

This IM Guidance Update summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This IM Guidance Update is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this IM Guidance Update.

The Investment Management Division works to:

- ▲ protect investors
- ▲ promote informed investment decisions and
- ▲ facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

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