DechertOnPoint

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A legal update from Dechert's Financial Services Group

Risk Management by U.S. Mutual Funds Facing European Sovereign Debt Risk

Introduction

In the face of a potential sovereign debt crisis in one or more European countries, management and boards of registered investment companies (hereinafter "mutual funds" or "funds")[1] should consider a variety of potential hazards as part of an effective risk management program. The most obvious risks arise from direct investment exposure to the sovereign debt of Greece and the other potentially risky sovereign issuers in the European Monetary Union ("eurozone"). However, other material risks exist that may be harder to detect and quantify. These risks include indirect investment exposure (*e.g.*, banks that have exposure to sovereign debt) as well as liquidity and valuation risks, operational risks and risks from derivatives and other contracts in the aftermath of a default, redenomination or other deleterious event. In addition, it is critically important that the fund's disclosure documents adequately identify and explain any applicable material risks. This *DechertOnPoint* will highlight certain key considerations for mutual funds, particularly non-money market funds, as they navigate these events.[2]

Risk Management

Overview of the Risk Management Process

The 2007-08 financial crisis highlighted the importance of enterprise risk management for all types of financial institutions,[3] including mutual funds. In the aftermath of these events, most funds have taken steps to address risk management in a more systematic and comprehensive manner.[4] Some funds (and many fund advisers and other service providers) have appointed chief risk officers and/or established risk committees or other formalized processes to ensure that all aspects of potential risk (*e.g.*, investment, compliance, operational, credit/counterparty, financial

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1 While the term "mutual fund" typically refers to U.S. registered open-end investment companies and the focus of this *DechertOnPoint* is on U.S. open-end funds, certain of the concepts in this *DechertOnPoint* are more generally applicable to any pooled investment vehicle facing these risks. We have included below several notes that provide some specific regulatory discussion relating to UCITS. In addition, upcoming *DechertOnPoints* will more fully address Eurozone risks specific to hedge funds and UCITS.

2 For further information pertaining to financial developments related to the eurozone crisis, please refer to the following *DechertOnPoints*: U.S. Money Market Funds and the European Sovereign Debt Crisis, available at http://www.dechert.com/US_Money_Market_Funds_and_the_European_Sovereign_Debt_Crisis_02-14-2012/; The Eurozone Crisis: Risk Planning for Asset Managers, available at http://www.dechert.com/The_Eurozone_Crisis_Risk_Planning_for_Asset_Managers_03-19-2012/.

3 *See, e.g.*, *Risk Management Lessons from the Global Banking Crisis of 2008,* Senior Supervisors Group (October 21, 2009) (focuses primarily on liquidity risk management); S. Bainbridge, *Caremark and Enterprise Risk Management*, 34 Journal of Corporation Law, 967 (2009) (broad discussion of risk management and the failures of financial institutions generally to address risk management during this crisis) ("Bainbridge").

4 *See Risk Principles for Fund Directors*, Mutual Fund Directors Forum (May 2010) ("*MFDF Paper")*; *Fund Board Oversight of Risk Management*, Independent Directors Council (September 2011).

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reporting and reputational risk)[5] are adequately considered, addressed and disclosed by funds.[6] The Securities and Exchange Commission ("SEC or "Commission") has also added specific disclosure requirements relating to the fund board's role with respect to risk management.[7] Consequently, risk management issues have become a regular topic for discussion at many fund board meetings.[8]

As with other aspects of fund operations, the primary responsibility for risk management lies with the fund's management and service providers, while the board's responsibility is one of oversight, *e.g.*, verifying that fund management is considering these issues and that reasonably designed processes are being put in place and followed.[9]

No risk management program can eliminate all risk. In fact, some managers may take on additional eurozone risk voluntarily, in return for enhanced opportunities to profit from market uncertainty. The key issue is that funds should take reasonable efforts to identify, manage and disclose potentially applicable risks.

Risks Relating to a Potential Eurozone Crisis

There are a number of direct and indirect risks arising from a potential eurozone crisis. Because of the changing parameters of this situation (including the continuing European and international efforts to avoid a full-blown crisis, the nations identified as potentially troubled issuers[10] and uncertainties about the potential exposure of various financial institutions),[11] the list below is not intended to be exhaustive. Moreover, as events unfold, a fund's risk management efforts need to be ongoing and responsive to changing developments.[12] Following is a discussion of some of the most significant risks at the current time.

Defaults or Downgrades, Falling Values and Increased Volatility

Eurozone Sovereign Issuers

The most direct investment risk that a fund can face is where a fund holds a debt security from sovereign issuers that suffer downgrades or defaults. This direct exposure should be easy to quantify, although there are differing, and changing, views of the risks of certain European sovereign issuers, such as Spain and Italy. A fund's holding of a derivative instrument directly exposed to a sovereign issuer, such as a credit default swap under which the fund is selling protection, should also be considered when evaluating direct investment exposure.

As noted above, some funds may choose to invest in distressed sovereign debt or related derivatives that they believe present attractive investment opportunities. In such cases, these investment exposures should be reviewed to ensure that the investments are consistent with the fund's investment program and that all material risks have been disclosed to fund investors. Such exposures should generally be reported to, and discussed with, the fund's board.

5 While classified slightly differently, these are the most commonly identified risk areas for mutual funds. *See, e.g.*, PricewaterhouseCoopers, *Risk Management Oversight and Other Governance Challenges for Fund Directors,* webinar (November 9, 2011).

6 *Id*.

7 *Proxy Disclosure Enhancements*, SEC Release Nos. 33-9089; 34-61175; IC-29092 (December 16, 2009) (includes required risk oversight disclosure for a fund's statement of additional information).

8 UCITS are required to implement a documented risk management process that identifies the risks a UCITS may be exposed to. The risk management process should include procedures designed to assess and manage risks, such as exposure to market liquidity and counterparty risks and extend to the management of all other risks, including operational risks which may be material for a UCITS.

9 *See id*; *see also In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959, 968 (Del. Ch. 1996) (*Caremark* broadly discusses the duty of the directors of an operating company to oversee and monitor the operations of the company. Numerous commentators (*e.g.*, *Bainbridge*, *supra* n. 3 and *MFDF Paper, supra* n. 5) have observed that the *Caremark* standard could apply to a board's oversight of risk management.)

10 *See, e.g., Europe Default Risk Signal Flashing Red,* CNN Money (September 16, 2011) (available at http://money.cnn.com/2011/09/15/markets/europe_default_risk/index.htm).

11 *See, e.g., Euro Risks Hit Banks,* Wall Street Journal (November 14, 2011).

12 For example, on March 9, 2012, the International Swaps and Derivatives Association ruled that the Greek debt restructuring would trigger payments on collateral default swaps. *See, e.g., Greek Credit-Default Swaps Are Activated*, New York Times (March 9, 2012) (available at http://dealbook.nytimes.com/2012/03/09/greek-credit-default-swaps-are-activated/).

Indirect Exposure to the Eurozone

A fund's potential investment exposure is obviously not limited to direct holdings of sovereign debt. A number of large financial institutions, particularly in Europe, are known to have considerable exposure to the sovereign debt of Greece and other financially troubled countries. A financial institution's exposure can be both direct (holding sovereign debt) and indirect (writing credit protection). Other types of issuers may also have substantial exposure to the eurozone. For example, a company domiciled outside of the eurozone may be negatively impacted if it derives a substantial portion of its revenue from sales to European governments or European consumers. Because the austerity measures brought about by this crisis have also impacted the healthier European economies, including Germany, France, the UK and the Netherlands, these indirect investment impacts are likely to be wide-ranging. [13]

In contrast to direct exposure to sovereign issuers, these types of indirect exposures are more difficult to quantify. Nevertheless, fund advisers should be actively considering the ways that their funds may be indirectly exposed to the eurozone crisis and discussing these potential exposures with the fund's board as part of the board's ongoing assessment of investment risk.

Liquidity and Valuation Risks

Liquidity and Valuation Risks Relating to Currency Redenomination

There are a number of possible ways that liquidity could be impacted by developments in the eurozone. One example is if a country were to leave the Euro. While there is no formal mechanism currently in place to enable a country to leave the Euro and return to its local currency, there has been increased speculation that one or more eurozone countries may revert to their legacy currencies either voluntarily or by action of the EU. [14]

Depending upon how the currency denomination occurs (*i.e.,* negotiated exit versus unilateral withdrawal from the eurozone), there are numerous events that could impact liquidity, including market closures, mandatory bank holidays, restrictions on currency convertibility, rapid devaluation and other events. Moreover, it is conceivable that the economic contagion could result in more than one country leaving the eurozone and returning to its legacy currency, or the eurozone splitting into two groups: a "strong Euro" group and "weak Euro" group. [15] If any of these events occur, a fund would be forced to quickly assess both the valuation and liquidity of its impacted holdings. The SEC Staff has specifically cited to market closures as a type of situation where market prices would not be considered "readily available," and consequently assets that are located in an affected country would likely have be fair valued. [16] At the same time, securities impacted by any of these events (which may include the sovereign debt of other eurozone members facing financial difficulties) may not meet the test for being deemed a liquid security (*i.e.*, an asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment). [17]

In light of these risks, funds should review their current valuation and liquidity policies and procedures to determine whether they are adequate to address these types of events. In particular, fund management may want to consider whether any changes are needed to the fund's fair valuation procedures. For example, if a fund holds substantial amounts of sovereign debt or derivatives on such debt, management may want to consider the need for specific procedures for fair valuation of such securities and instruments, as well as whether additional sources for valuation should be readied for use in a distressed market.

Liquidity in the Event of a Potential Run on the Fund

If a fund has substantial exposure to eurozone risks, either directly or indirectly, care should be taken to try to maintain an appropriate level of portfolio liquidity

13 *See, e.g., How the Eurozone Debt Crisis Could Affect Developing Countries*, The Guardian (October 21, 2011) (available at http://www.guardian.co.uk/global-development/poverty-matters/2011/oct/21/eurozone-crisis-developing-countries).

14 *See e.g.*, *Germany Drawing Up Plans for Greece to Leave the Euro,* The Telegraph (February 18, 2012) (available at http://www.telegraph.co.uk/finance/financialcrisis/9091021/Germany-drawing-up-plans-for-Greece-to-leave-the-euro.html).

15 *See, e.g.*, *The Euro and the Scalpel*, Foreign Policy (August 9, 2011).

16 *See* SEC Division of Investment Management December 1999 Letter to the ICI Regarding Valuation Issues (December 8, 1999) (available at http://sec.gov/divisions/investment/guidance/tyle120899.htm).

17 *See* Investment Company Act Release No. 14983 (March 12, 1986).

below the 15% threshold for illiquid securities, [18] and to ensure that liquidity determinations are not based on overly optimistic scenarios that can be expected to be second guessed if the eurozone situation deteriorates. [19]

In the event of a sovereign default, redenomination, or other similarly significant event, an exposed fund could face substantial redemption activity as panicked investors move quickly to re-allocate assets. This could result in a liquidity crunch for the fund, particularly if it has to liquidate affected positions during a bank holiday or market closure. Even where markets remain open, a crisis can have the effect of substantially depressing market liquidity and causing precipitous declines in market prices.

Prime money market funds experienced this type of liquidity crunch in September and October of 2008 following the Reserve Primary Fund "breaking the buck." [20] As with the 2008 crisis, some type of precipitating event, such as a bank failure, could act as a catalyst impacting the entire market and placing numerous funds at risk. Open-end funds are particularly vulnerable to such liquidity crises, given their legal obligation to honor all redemption requests and to pay redemption proceeds within the seven-day period contemplated by Section 22(e) of the Investment Company Act of 1940, as amended (the "1940 Act"). [21]

Section 22(e) prohibits an investment company from suspending the right of redemption for more than seven days, [22] except for the following circumstances: [23]

- for any period (A) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (B) during which trading on the New York Stock Exchange is restricted;
- for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or
- for such other periods as the Commission may by order permit for the protection of security holders of the company.

Section 22(e) further provides that, "[t]he Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection."

The Commission has never issued such regulations and the SEC Staff takes the position that Section 22(e)(2) is not self-executing. Consequently, other than the NYSE closing, redemptions may only be suspended in the rare instances where the SEC has issued an order [24] or the SEC Staff provides industry-wide no-action relief. [25] Such instances are extremely rare and should not be expected in the event of a eurozone crisis. [26]

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18 Closed-end funds generally are not subject to this limitation.

19 UCITS are required to invest in transferable securities or other investment that are liquid, negotiable and have reliable valuations. Investments in illiquid securities are not permitted.

20 *See Money Market Reform*, Release No. IC-28807 (proposed amendments to Rule 2a-7) (June 30, 2009) for a good discussion of the market turmoil following the fall of the Reserve Primary Fund.

21 Similarly, UCITS are required to pay out redemption proceeds in a timely fashion. In particular, the period between the date of submission of a redemption request and the date of payment of redemption proceeds to an investor must not exceed 14 days.

22 In addition to the seven-day limit in Section 22(e), Rule 15c6-1 under the Securities Exchange Act of 1934, as amended, requires brokers to settle securities transactions, including transactions in mutual fund shares, within three days after the trade date (T+3).

23 UCITS are similarly prohibited from generally suspending an investor's right of redemption. UCITS may only temporarily suspend redemptions during periods where it is not possible to value investments, where markets on which the UCITS' investments are traded are closed or in similar circumstances where it is not possible to value or trade a substantial portion of the UCITS investments.

24 See T. Lemke, G. Lins and T. Smith, *Regulation of Investment Companies* at §9.02(5), notes 199-204 for a discussion of limited instances where the SEC has issued orders permitting delays in making redemptions.

25 *See, e.g.*, Investment Company Institute (pub. avail. March 20, 1986) (providing temporary relief from Section 22(e) in connection with a disruption in the municipal bond market).

26 For example, following the bankruptcy of Lehman Brothers and the Reserve Primary Fund "breaking the buck," the SEC issued an order suspending redemptions for both the Reserve Primary and the Reserve U.S. Government Fund. However, industry-wide relief under Section 22(e) was not provided.

While money market funds are now permitted to suspend redemptions pursuant to Rule 22e-3,[27] other funds must deal with the limitations of Section 22(e) as part of their contingency planning. As discussed above, such planning should not contemplate that the SEC would issue an order or provide other relief under Section 22(e). Consequently, a fund facing a run and liquidity pressures has a limited array of options to meet redemptions.

One of these options is to borrow cash to meet redemption requests. Most commonly, an open-end fund would borrow from a bank pursuant to Section 18(f), which permits bank borrowings of up to 300% of total assets, with an additional 5% permitted for temporary borrowings under Section 18(g).[28] A fund can also borrow by entering into a reverse repurchase agreement whereby the fund sells a security to a counterparty to raise cash and simultaneously agrees to buy it back later with interest. Reverse repurchase agreements are subject to SEC interpretive guidance that requires the fund to have sufficient otherwise unencumbered liquid assets to meet its repurchase obligations.[29]

While borrowing to meet redemption needs in the ordinary course is a common occurrence for many funds, a fund that borrows while in net redemptions is creating investment leverage for its remaining shareholders. Accordingly, unless redemption activity stabilizes relatively quickly and liquidity returns to the market in time for the fund to repay its borrowing, the fund would ultimately have to sell portfolio holdings into the distressed market, negatively impacting the non-redeeming shareholders. Recognizing this danger, the SEC was reluctant to provide no-action or exemptive relief to expand the ability of funds to borrow to meet redemptions during the 2008 money market fund crisis.[30]

Nevertheless, short-term borrowing often remains the first line of defense against a liquidity crunch. Consequently, funds should review the adequacy of their credit facilities.[31] In addition, borrowing policies should be reviewed to ensure that any expansion of a fund's capacity to borrow is consistent with the fund's investment restrictions. Any decision to increase a fund's borrowing capacity should also be discussed with, and may need to be approved by, the fund's board.

Another response that funds could have to mass redemptions is to make redemptions in-kind, giving redeeming shareholders portfolio securities in lieu of cash for their shares. Mutual funds have the ability to redeem in-kind, subject to the limitations under Rule 18f-1 for funds that have made an election under this Rule.[32] While many funds make an election pursuant to Rule 18f-1, that Rule still provides them the flexibility to redeem in-kind a portion of the shares held by large shareholders, particularly in cases where retail investors hold their shares through omnibus accounts so that the intermediary is the record owner of the shares.[33]

Redemptions in-kind present both operational difficulties and client relations concerns. With the exception of a few large institutional shareholders, fund shareholders are not typically equipped to receive an in-kind redemption from a fund. Fund management will need to work closely with the fund's custodian and transfer

27 Rule 22e-3 requires, among other things, that a money fund that suspends redemptions notify the SEC and also that such suspension be accompanied by the liquidation of the fund.

28 In contrast, UCITS are only permitted to temporarily borrow up to 10% of their net assets for the purposes of facilitating redemption requests.

29 Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (April 18, 1979).

30 The SEC does permit interfund borrowing pursuant to exemptive relief and, during the financial crisis, provided temporary no-action relief for affiliates to enter into reverse repurchase agreements with funds. These rulings did not expand the level of borrowing but did provide funds with additional counterparties that were helpful during the financial crisis when many banks refused to lend.

31 Many fund groups have in place committed or uncommitted joint lines of credit with one or more banks. The SEC Staff has taken a no-action position under Section 17(d) of the 1940 Act permitting such joint lines of credit under certain circumstances. *See T. Rowe Price Funds* (pub. July 31, 1995).

32 An 18f-1 election commits a fund to pay in cash all requests for redemption by any shareholder of record, limited in amount with respect to each shareholder during any 90-day period to the lesser of $250,000 or 1% of the fund's net asset value at the beginning of the period.

33 UCITS may also make in-kind redemptions. However, in-kind redemptions may only be made with the consent of the redeeming investor, unless the redeeming investor has submitted a redemption request that represents more than 5% of the UCITS' net assets. In such cases, an in-kind redemption may be made at the sole discretion of the UCITS, provided the UCITS will, on request from the redeeming investor, sell the assets on behalf of the investor.

agent to develop appropriate operating procedures to effectuate large-scale redemptions in-kind.[34]

A shareholder that is trying to exit a fund during a market crisis can be expected to be extremely unhappy to receive an in-kind redemption. As a result, funds are generally reluctant to force shareholders to accept in-kind redemptions, notwithstanding registration statement disclosure whereby the fund reserves this right. Nevertheless, an in-kind redemption may be viewed as a means to avoid favoring redeeming shareholders at the expense of the fund's long-term investors. In addition, the SEC Staff has spoken favorably of this option and remarked on the inconsistency between the standardized fund disclosure reserving the right to effectuate in-kind redemptions and the absence of such redemptions during the money fund crisis and other distressed situations.[35]

Another option in the face of liquidity pressures is for a fund with exposure to eurozone risk to adopt a "temporary defensive position" and increase its holdings of cash and other liquid securities. While this would provide an additional cushion in the face of large-scale redemptions, there is an obvious downside to a fund deviating from its main investment strategy, particularly for any significant period of time. While funds are permitted to deviate from their principal investment strategy as a temporary defensive measure, anticipating a crisis in advance is difficult. Moreover, a fund that continues to remain in a temporary defensive position could underperform its peer funds and, in any event, could tend to deviate substantially from any applicable benchmarks. Institutional investors, in particular, would not be likely to tolerate a large temporary defensive position for very long.

Operational Risks

The potential eurozone crisis presents a number of operational risks for funds. For example, a currency redenomination could impact systems that are used by a fund for various trading, financial reporting and compliance functions. In addition, there could be delays in the settlement and clearing of trades. Assuming that the fund has maintained proper custody of its assets, it is not expected that these events would impact the actual safekeeping of the subject assets; however, delays in settlement and clearing and questions about valuation would still pose significant concerns for affected funds.

While the risks discussed above primarily focus on the fund's investment adviser, planning for operational risks requires a broader focus that should also include the fund's custodian and transfer agent, as well as the administrator and accounting agent if those roles are handled by a different entity.

Other Risks

A eurozone country's return to its legacy currency could create other complications for funds that have contractual arrangements with an entity located in that country, particularly where the counterparty's obligations are denominated in Euros. In many cases, an exit from the Euro and redenomination is not likely to be explicitly addressed in existing contracts for currency trades or the terms of derivatives or fixed income securities denominated in the Euro. This is particularly true in the case of contracts that were entered into some time ago. Similarly, the impacts of capital or exchange controls could also impact the ability of a party to perform under certain agreements. Accordingly, the interpretation of these agreements presents a fund with a degree of legal uncertainty that, depending on the size and nature of these agreements, could have a material impact on the value of fund shares, as well as the liquidity of the fund's portfolio.

Any potentially impacted agreement should be reviewed with this scenario in mind. Choice of law and dispute resolution provisions should be considered and, if necessary, experts on the local jurisdictions should be consulted.

Finally, another risk faced by funds is that a default or other negative event in Europe in connection with the sovereign debt crisis (*e.g.*, bank failures, downgrades, etc.) could potentially prompt many investors to move out of investments that they perceive to be risky, even if the fundamentals of those investments remain strong. For example, emerging market debt funds and equity funds may face redemptions following investor movement into asset classes viewed as less risky, such as U.S. government securities. This type of risk may be harder to anticipate, particularly where a fund does not have direct exposure to the eurozone. Nevertheless,

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34 A redemption in-kind involving an affiliated person is subject to the conditions of the *Signature Financial Group* (December 28, 1999) no-action letter.

35 *See, e.g., Speech by SEC Chairman Mary L. Schapiro at the SEC Open Meeting* (June 24, 2009) ("Specifically, the Commission is seeking comment on whether to require that money market funds have the ability to redeem investors in-kind in order to stem the dilutive effect of redemptions and maintain a stable net asset value.") (available at http://www.sec.gov/news/speech/2009/spch062409mls.htm).

advisers to funds that invest in asset classes generally viewed as more risky should consider the degree to which increased difficulties in the eurozone could impact those funds.

Developing and Implementing a Risk Management Process for the Potential Eurozone Crisis

Fund management should consider each of the areas of potential risk discussed (as well as any other potential areas of risk), in consultation with all relevant service providers. The chief compliance officer and fund counsel should be active participants in this review. It is advisable that somebody be designated as responsible for leading this effort to ensure that all of the relevant parties are identified and involved in the process. Depending on the fund's investment strategy, risk profile and exposure to the eurozone, some or all of these risk areas may not be relevant to a particular fund. As areas of risk are evaluated, contingency plans should be developed to address any material risk exposures that have been identified.[36]

Both the risk identification and contingency planning processes should be undertaken in full consultation with the fund's board. Fund management should ensure that there is open communication with the board and its counsel and that an agreed-upon oversight process has been established. This process should include a means for intra-meeting communications in the event that the crisis worsens in advance of a planned meeting date. If they have not already done so, fund management and the board should also reach an understanding on how emergency communications should be conducted. It would also be advisable to clarify the degree of delegation that will be permitted both within the board itself (*i.e.*, determining whether a board committee or subcommittee can address these issues), as well as the extent that the board is comfortable in delegating to fund management the ability to take certain actions prior to receiving board approval in the event of a crisis. While some funds may be able to leverage from prior experience with these types of crisis communication protocols, other funds may need to develop these processes for the first time.

While the recent actions by the European Central Bank to add liquidity to the eurozone have been viewed by many as reducing the immediate risks of a eurozone crisis, there is a debate as to whether these events reflect a general lessening of risks or simply a postponing of them. In any event, a robust and transparent risk management plan developed by fund management will assist the board in conducting its oversight role over fund operations and ensure that the fund's officers and directors do the best job possible to protect fund shareholders from unnecessary risks.

Disclosure

Overview

While it is crucial that funds and their boards take steps to consider and address the risks relating to a potential eurozone crisis, these efforts are incomplete without also considering how to disclose such risks to fund investors. One lesson learned from the financial crisis is that plaintiffs' lawyers, and regulators, will seek to turn unsuccessful investment decisions into legal violations, and inadequate disclosure is typically the "hook" for doing so. Following is a discussion of various disclosure issues that funds should be addressing in connection with these risk management efforts. All of these areas should be considered. Any "weak link" in a fund's disclosure, whether it is the fund's registration statement, shareholder reports, marketing materials or any other public pronouncement, represents an area of potential exposure.

Registration Statement Disclosure

Because the registration statement serves as the fund's selling document under the Securities Act of 1933, as amended (the "Securities Act"), it is the starting point for evaluating the adequacy of risk disclosure relating to the potential crisis. Moreover, due to the strict liability standard under Section 11 of the Securities Act, any material misstatement or omission is of potential concern.[37] With respect to any fund that has material direct or indirect exposure to these eurozone risks, the fund should evaluate its existing prospectus and statement of additional information ("SAI") disclosure to determine if relevant risks are adequately addressed. In general, the content of the disclosure, the placement of any additional risk disclosure (*i.e.,* summary prospectus, statutory prospectus or SAI), and the timing of any revised disclosure (*i.e.,* filing an immediate supplement versus enhancing existing disclosure during the next regular update of the registration statement)

36 For UCITS, the dedicated person responsible for risk oversight should lead the implementation of risk procedures and contingency plans, subject to the directions of the UCITS' board.

37 A UCITS is subject to a similar standard of liability for an untrue statement contained in its prospectus. Accordingly, the comments in this section have general application to UCITS.

will depend on the adequacy of existing disclosure and an evaluation of the level of risk.

Shareholder Reports

While including disclosure regarding potential Euro risks in a shareholder report will not defeat possible Section 11 liability, it may be required (in the management discussion of fund performance, or "MDFP"), if the risks impacted fund performance during the period. In addition, even if not strictly required, fund management may wish to discuss eurozone developments and risks and their possible impact on the fund, in the MDFP (or elsewhere), as a matter of shareholder relations. Further, the fund's auditors should be asked for their views on whether changes to the presentation of the fund's financial statements are called for or whether there are notes that should be added to the financial statements on this topic. The content of any such changes may well differ across funds, based on the composition of each fund's portfolio.

Other Communications

In addition to the registration statement and shareholder reports, a fund with significant eurozone exposure may wish to consider communicating to shareholders some discussion of the potential eurozone crisis and the steps that the fund has taken, or will be taking, to protect itself in a letter to investors, white paper, notice on its website or other communication. As with any type of fund or adviser communication, it is critical for such a piece to be fair and balanced and subject to the appropriate procedures for the review of marketing materials.

Furthermore, fund marketing pieces should be reviewed to make sure that they include adequate risk disclosure regarding any material direct or indirect exposure to eurozone risks. Personnel involved in reviewing marketing materials for funds should be sensitive to inconsistent messaging between marketing pieces and the fund's registration statement. Such personnel should guard against overstatements in marketing materials regarding the degree to which a fund has been insulated from eurozone risks. During the last financial crisis, the SEC Staff took a close look at fund marketing materials and focused on divergence between the risk disclosure in these materials and the risk disclosure in the registration statement.

While the SEC Staff has provided mutual funds with specific guidance with respect to certain areas, such as derivatives disclosure,[38] it has not done so with respect to eurozone risk disclosure. The Division of Corporate Finance recently provided guidance to non-investment companies for the MD&A disclosure of such registrants' exposure to certain European countries.[39] This guidance, by its terms, is not a rule, regulation or statement of the Commission itself and is not applicable to mutual funds. Nevertheless, it is worth noting the level of detail and analysis that is expected. While this type of approach would not seem to be workable for mutual funds, the guidance highlights the importance of taking a close look at exposure to the eurozone and related disclosure. Based on the recent past, if the situation in the eurozone deteriorates and funds face the types of losses that occurred during the 2007-08 financial crisis, plaintiffs' lawyers and the SEC will be focusing on affected fund disclosures, and there is a risk that someone may cite to the Division of Corporate Finance guidance, arguing that funds provided insufficient disclosure.

Conclusion

The unfolding events in the eurozone present numerous risks for many mutual funds and will require a coordinated risk management effort involving the fund's service providers, legal counsel and compliance personnel, as well as an active board to monitor and oversee this process. In addition to heightened investment risk, further negative developments in this region, including potential currency redenomination, could implicate fund valuation and liquidity, present operational risks and create numerous contractual uncertainties involving derivatives and other agreements. Finally, without timely, accurate and consistent disclosures to investors, the benefits of a comprehensive and proactive risk management program will not be fully realized and funds could still face legal and reputational risks.

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38 Letter to Karrie McMillan, General Counsel to the Investment Company Institute from Barry Miller, Associate Director, SEC Division of Investment Management, Office of Legal and Disclosure, regarding Derivatives Disclosure by Investment Companies (July 30, 2010).

39 *CF Disclosure Guidance: Topic No. 4* (January 6, 2012).

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