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Reed Smith Financial Industry Group — ReedSmith Client Alert

# Generic Guidance on 'Generic' Derivatives Disclosure—Recent Comments From the Staff on Derivatives Disclosure

## Part I—Prospectus Disclosure

We had hopes for some progress toward consistent, if not sensible, regulation when the SEC announced that the Division of Investment Management was reevaluating the use of derivatives by investment companies. ("SEC Staff Evaluating the Use of Derivatives by Funds," SEC Press Release 2010-45 (Mar. 25, 2010)). However, we were disappointed with the first peek at that progress. In a letter to the ICI dated July 30, 2010, the Division's Office of Legal and Disclosure provided "some observations" regarding "current derivatives-related disclosure by investment companies ...." The observations continue to treat derivatives as unfathomable mysteries requiring specialized disclosure, suggesting that the staff has not yet come to grips with the nature of derivatives and their use by investment companies.

The staff's "primary observation" is that derivatives disclosures are too generic to allow investors to assess "how the fund's investment adviser actually intends to manage the fund's portfolio and the consequent risks." No examples are given—the guidance itself is generic—so we cannot know what the generic disclosures actually say. For example, the staff identifies the following boundaries for ineffective disclosure: "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." In other words, disclosure must be neither too brief nor too lengthy, neither too abbreviated nor too technical. The letter gives no indication of what disclosures Goldilocks or the staff would consider "just right."

For example, it is not uncommon for the investment strategy section of a prospectus to include a statement to the effect that: "The fund may use derivative contracts to implement its investment strategy," followed by a specific statement as to how the fund intends for that to happen and a description of the typical derivative contracts (e.g., futures, forward, swaps and options). Additional risk factors are added to the disclosure for the risks inherent in these contracts (e.g., counterparty, leverage, correlation, liquidity and valuation). These disclosures are nearly identical across different funds in the same complex because the derivatives are used as tools to implement aspects of each fund's investment strategy, rather than as an independent investment strategy. Just as gears can be used to run all types of engines, from watch drives to jet turbines, without changing the essential nature of a gear, so derivative contracts can be used to implement all sorts of investment strategies, without varying the essential nature of the contracts. Nevertheless, the letter cites the use of common disclosures by different funds as a sign of being too "generic," which suggests the staff may have doubts regarding this approach to derivatives disclosure.

The staff's letter expresses concern that this generic disclosure "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." This comment fails to reflect that funds typically use derivatives as substitutes for or hedges against direct investments, and that the extent of the substitution or hedging depends on ever-changing market conditions. This makes it impossible to predict when derivatives contracts will be used and for which purpose, much less which types will be used and to what extent.

The July 30 letter also does not reflect a complete grasp of the risks posed by derivative contracts. Any derivative contract shares the risks of the underlying security or asset. The main difference is that derivative contracts allow the investor to be long or short the risk, depending on which side of the contract is taken. When a fund is long the underlying security or asset, the contract operates as a substitute for direct investment. When the fund is short a risk that is already present in the portfolio, the contract acts as a hedge; otherwise it operates as a short position. This is why prospectuses commonly note that derivative contracts "may be used for 'hedging and non-hedging purposes' ...." Another difference is that some derivative contracts unbundle the risks of the underlying security or assets, allowing the fund to take or hedge against just interest rate, credit or currency risks.

The other risks of derivative contracts are largely a result of their being *contracts*. A contract: (i) may not exactly replicate direct ownership of the underlying security or asset, (ii) creates leverage by allowing the fund to take a larger notional position than the amount of its investment, (iii) depends on the other party's ability to perform and (iv) cannot be freely transferred in the same manner as a security. These risks are common to all forms of derivative contracts, and the relative degree of risk depends mostly on whether the contract is traded on a commodities exchange or over the counter, rather than on the particular type of contract. The reforms imposed by the Dodd-Frank Act are intended to make these risks even more uniform by requiring, among other things, standardization of terms and central clearing. In other words, these risks of derivative contracts are principally "off the rack," and do not need to "be tailored to the types of derivatives used by the fund."

The fact that funds utilizing summary prospectuses no longer have to mail prospectus supplements may make the staff's new guidance less problematic for funds. One could imagine a prospectus disclosing that a bond fund uses exchange-traded Treasury futures to manage its duration, and then stickering the prospectus to disclose that it had switched to using over-the-counter LIBOR swaps. So long as this does not affect the disclosure in the summary prospectus, the fund will merely need to file the supplement and update its website. It is hard to see what this is supposed to accomplish, however, as most investors would not be aware of the change, and those that became aware would probably not understand its significance.

In a first-year contracts course, it is a standard ploy for a student to suggest that the outcome of a case was because of the poor wording of the contract. One professor had a standard response to this—he would say, "Oh, you mean they should have written . . . ," then he would read the clause in question from the case, and then add "*and we really mean it*." Our reaction to the staff's observations is also to add "*and we really mean it*" to the disclosures made about derivatives contracts in describing an investment strategy. Anyone who has worked with the standard ISDA Master Agreement and supporting documents understands that forwards, swaps and options have far more in common than most obligations generically classified as "bonds."[1] Disclosure is therefore generic because derivative contracts are so similar and, in many cases, may be freely substituted for direct investments, not because funds are withholding more specific information that would be material to investors.

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[1] Here again, implementation of the Dodd-Frank reforms by the SEC and the Commodity Futures Trading Commission will only reduce the distinctions among various types of derivative contracts. The reforms mandate that the SEC and CFTC must regulate "security-based swaps" and "swaps," and defines the terms broadly to mean forwards, swaps, and options, as well as any combination of the three types of derivatives.

Andrean P. Cross* *Partner*
*Pittsburgh*
+1 412 288 2614

Stephen A. Keen* *Partner*
*Pittsburgh*
+1 412 288 1567

* These are the authors' personal comments and observations, and do not represent the views of Reed Smith LLP or any of its clients.

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