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Reed Smith Financial Industry Group Client Alert Reed Smith

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

## Part II—Shareholder Reports

Able, Baker and Charlie are three bond fund portfolio managers. Each believes that a substantial increase in interest rates is imminent and decides to sharply reduce the portfolio's duration in order to reduce the impact of a rate increase. Able's fund is not set up to execute derivative contracts, so she reduces the fund's duration by selling longer-dated bonds and reinvesting in short-term obligations. Baker has her fund sell CME Futures on the Two-Year Treasury Note to reduce her fund's duration. Charlie reduces his fund's duration by entering into a standard interest rate swap in which the fund will receive three-month US$ LIBOR and pay a fixed rate. All three funds' durations are reduced by exactly the same amount as a result of these trades.

The portfolio managers make the right call—interest rates rise and their funds' net asset values fall much less than their benchmark index and peers'. In fact, a performance attribution system ascribes 80 percent of the funds' outperformance of the benchmark to their shortened durations. At the end of the fiscal year in which this occurs, each portfolio manager writes the mandatory discussion of his or her fund's performance (known as the Management Discussion of Fund Performance, or MDFP), which includes the following paragraph:

> Bond prices fell substantially during the period, because of a significant increase in interest rates. The fall in prices adversely affected the fund's total return during the period. On a relative basis, however, during the period, the fund outperformed its benchmark and most of the bond funds in its category because the fund's duration (which measures the portfolio's sensitivity to interest rate changes) was substantially less than the benchmark's duration.

Do the portfolio managers need to write anything more about their duration call in the MDFP? According to a July 30, 2010, letter from the staff of the SEC to the ICI, Baker and Charlie may need to, because "a fund whose performance was materially affected by derivatives should discuss that fact ...." The staff's conclusion is based on observations that:

> ... some funds ... 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.

What should Baker and Charlie say about their use of derivatives? Is it enough to say that:

> The increase in interest rates caused certain of the fund's derivative contracts to appreciate in value, which partially offset the overall decline in the value of the fund's bond portfolio.

Or do they also need to identify whether they used futures or swaps? Must they refer to the derivatives exposure shown in the financial statements, and what if the exposure changed during the period? And most importantly, why would a shareholder, having been told of the fund's short duration and its positive impact on relative performance, care how the portfolio manager shortened the duration?

Ironically, Able's failure to use the derivative contracts will probably have a more significant impact on future fund performance. Taking the direct investment route forced Able to substantially restructure the portfolio, shortening the credit as well as interest rate duration, and probably changing the representation of issuers and sectors. The transaction costs of executing these trades would almost certainly be higher than the costs of selling exchange-traded futures or entering into a vanilla interest rate swap. Able will also incur additional transaction costs replacing maturing portfolio securities or re-extending the duration when market conditions change.

The staff's position in the letter basically assumes that any use of derivatives is significant to shareholders. Our example demonstrates why this is not always the case, and that the failure to employ derivative contracts may be more significant than their use. Just to be clear, we have no objection to the staff interpreting Form N 1A to require disclosure in the MDFP of how investment strategies were implemented during the relevant period. We think the staff should apply this interpretation consistently, however, and not just when the strategy happens to be implemented with derivative contracts. In other words, if Baker and Charlie must add a sentence about the appreciation of their derivative contracts, Able also should be required to add something to the effect that:

> During the period, the fund sold bonds with longer maturities and reinvested in shorter term bonds. As a result, the increase in interest rates caused the prices of the fund's bond portfolio to decline less, on average, than the prices of the bonds represented in the benchmark and held by many other bond funds.

Another reason for the absence of any discussion of derivatives in an MDFP is that a fund may implement its investment strategy during a fiscal period without using derivatives. We do not think this means that a fund should remove disclosures regarding derivative contracts from its prospectus. The fact that a fund does not employ every aspect of its principal investment strategies in a given year does not mean that the particular strategy will not be used in a subsequent year—in other words, "principal" should be defined in terms of how the fund is intended to be managed, rather than how the fund happened to be managed during the last fiscal year.

Our example can also be used to illustrate the difficulty of explaining the "extent" to which derivatives will be used. Two-Year Treasury Note futures have a shorter duration that the typical five-year LIBOR swap. So Baker would have to sell a larger notional amount of futures to shorten her fund's duration than the notional amount of swaps used by Charlie to have the same effect. Baker's fund will also have to post margin for the futures, while Charlie's fund may or may not have to post collateral, depending on the overall value[1] of all of its derivatives contracts with the swap counterparty. Thus, by most measures, Baker might appear to be using derivative contracts to a greater extent than Charlie, while, in actuality, the contracts will have identical effects on fund performance and will entail largely the same risks.

We believe that "extent" is better understood in terms of potential impact on fund performance than by any other metric. If the staff accepted this approach, they would find that general investment limitations also serve to limit the extent to which a fund uses derivatives. Thus, if the funds in our example had an investment limitation requiring the fund to maintain a duration of between two and five years, this would also limit the extent to which the funds could use derivative contracts to manage duration, even though it does not explicitly refer to derivatives. Requiring these funds to describe how much of the portfolio may consist of derivative contracts would be, in our view, equivalent to requiring the funds to describe how much of the portfolio will consist of obligations maturing in five years. It is impossible to manage a portfolio effectively if it is subject to such arbitrary limitations.

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[1] We have assumed that the interest rate swap is a bi-lateral contract between the fund and the dealer, rather than a centrally cleared swap with the margin requirements fixed by the central counterparty; although, we expect that the recently enacted derivatives reform legislation (Title VII of the Dodd-Frank Act) will mandate that plain vanilla interest rate swaps be subject to clearing and margin requirements analogous to the approach taken with respect to exchange-traded futures contracts.

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* 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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