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SEC's Division of Investment Management Releases Guidance on Risk Disclosures Related to Current Market Conditions

By The Investment Management Practice

In a recently published Guidance Update, the staff of the SEC's Division of Investment Management (the "Staff") reminds fund advisers of their ongoing obligation to maintain, update, and provide risk disclosures to their investors that reflect the current market conditions. The full text of this release can be found here.

In the Guidance Update, the Staff notes that clear and accurate disclosure of risks associated with fund investments is important for investor protection. The Staff further states that the "degree of risk is dynamic in nature rather than static," that it changes in response to market conditions, and that "different risks may be heightened or lessened at different points in time."

With this perspective, the Staff outlines several steps that fund advisers should take on an ongoing basis in order to provide risk disclosures to investors that remain robust in changing market conditions.

- Monitor market conditions on an ongoing basis to assess the impact of changing conditions on funds and the risks associated with fund investments;
- Assess whether fund risks have been adequately communicated to investors in light of current market conditions; and
- If changes in current market conditions warrant (*i.e.*, if the changes have resulted in changes to fund risks that are material to investors), provide updated communications to investors disclosing such risks in a manner required by federal securities laws and as otherwise appropriate (including through fund prospectus supplements or amendments, shareholder reports, website disclosures, and letters to shareholders).

The Staff also notes that many fund boards request that the fund's adviser report to the board on its process for preparing (or updating) the fund's disclosure materials. As part of this process, the Staff suggests that fund advisers consider providing information to the fund board on steps taken to evaluate the adequacy of fund risk disclosures and consider whether changes are appropriate.

The Guidance Update highlights two circumstances in which the Staff has observed the tendency of funds to update their risk disclosures in order to address current market conditions.

- Fixed Income Funds: The Staff provided examples of specific risk disclosures provided by fixed-income funds to investors to address changes in market conditions relating to interest rate risk, liquidity risk, and duration risk. The Staff believes these updated disclosures have the benefit of alerting investors of the potential impact of higher interest rates, which could result in a decline in the value of fixed-income investments held by these funds, depress returns, reduce liquidity, and disproportionately impact investments in longer-term fixed income securities.

- Puerto Rico Debt: The Staff also highlighted examples of risk disclosures provided by funds with investments in, or exposure to, Puerto Rico debt. For example, the Staff noted that some "single-state" tax-exempt funds have included express disclosure in their prospectuses that they may invest in Puerto Rico debt. The Staff also notes that some funds have communicated risks relating to the recent downgrades in ratings of Puerto Rico debt, and how such downgrades may adversely affect market values and liquidity of the fund's securities. The Staff's view is that any fund investing in Puerto Rico debt should consider, based on the nature and significance of its investments, whether such disclosure is appropriate.

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