

## Accounting and Disclosure Information

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# ADI 2019-08 - Improving Principal Risks Disclosure

The mutual fund summary prospectus is designed to help promote informed investment decisions by providing investors with information that is easy to use and readily accessible.<sup>[1]</sup> This includes principal risks of investing in a fund. Principal risks include those risks that are reasonably likely to adversely affect the fund's net asset value, yield, and total return.<sup>[2]</sup> A fund's principal risks will, for example, depend on the fund's investment objective(s), holdings, investment strategies, and structure.

The staff has observed that while some funds provide clear and concise principal risk disclosures in plain English,<sup>[3]</sup> others provide risk disclosures that are overly lengthy and technical. This can make it difficult for investors to identify and understand the key risks of an investment. The staff has observed the following approaches that may improve principal risk disclosures for investors.

### Ordering Risks by Importance

Some funds appear to list their principal risks in order of importance, with the most significant risks appearing first. We strongly encourage all funds to consider this approach to better highlight for investors the risks that they should consider most carefully. Funds that list their principal risks in alphabetical order could obscure the importance of key risks, especially when a fund includes many principal risks. For example, a real-estate fund that lists risks alphabetically may describe a number of less relevant risks before describing the key risks of real-estate investments. In some extreme cases, this presentation format could result in a fund's key risks being obscured to such an extent that it could render the disclosure potentially misleading.

The staff recognizes that ordering risks based on importance requires subjective determinations. For example, funds may reasonably consider different factors in determining which risks are most important or weigh factors differently. The relative importance of a risk can change with market conditions or with changes to a fund's investments. The staff believes that funds are best positioned to make these judgments of relative importance, and we would not generally expect to comment on a fund's ordering of risks by importance.

### Tailoring Risk Disclosures

The staff has observed several fund groups that tailor their risk disclosure for each fund in the fund group rather than rely on generic, standardized, risk disclosures across funds. While standardized disclosures across funds may be appropriate for certain risks, the staff encourages funds to tailor other risk disclosures to how the particular fund operates.

The staff also has observed principal risk disclosures that describe investments that are not discussed in the funds' principal investment strategies. For example, some funds include credit risk disclosure that discusses the heightened risks associated with below-investment-grade or distressed securities even when the fund does not hold, or expect to hold, these types of investments.<sup>[4]</sup> In order to provide investors with meaningful information, the staff encourages funds to tailor risk disclosures to more closely describe the principal risks associated with an investment in that particular fund.

## Disclosing that a Fund is Not Appropriate for Certain Investors

In its principal risks disclosure, a fund may describe the types of investors the fund is intended for or the types of investment goals that may be consistent with an investment in the fund.<sup>[5]</sup> The staff encourages funds to consider disclosing that a fund *is not* appropriate for certain investors given the fund's characteristics. For example, a fund seeking to provide a defined return over a specific time period generally may not be appropriate for an investor that does not intend to hold the fund for the specified period. Highlighting this information may assist investors in making better informed investment decisions in line with their investment goals.

## Other Disclosure Considerations

Finally, the staff wishes to remind funds of measures they can take to improve their risk disclosure so as to provide investors clear, concise, relevant, and timely information:

- The intent of the summary prospectus is to provide investors a concise summary of key information.<sup>[6]</sup> Funds should present more detailed information about their principal risks elsewhere in the prospectus.
- The staff encourages funds to disclose non-principal risks (and non-principal investment strategies) in the fund's statement of additional information rather than in the fund's prospectus. The staff believes that including this disclosure in the prospectus may overwhelm other important information.<sup>[7]</sup>
- The staff encourages funds to periodically review their risk disclosures, including the order of their risks, and consider whether the disclosures remain adequate in light of the fund's characteristics and market conditions.

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ADIs are recurring publications that summarize the staff's views regarding various requirements of the federal securities laws.

The statements in this ADI represent the views of the Division of Investment Management. This update is not a rule, regulation or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content. Future changes in rules, regulations, and/or staff no-action and interpretive positions may supersede some or all of the information in a particular ADI.

We hope that this ADI will assist registrants in preparing their filings. We also welcome feedback on this ADI and on any disclosure matters. If you have any questions or feedback, please contact:

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<sup>[1]</sup> See *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-end Management Investment Companies*, Investment Company Act Release No. 28584 (Jan. 13, 2009) [74 FR 4546 (Jan. 26, 2009)] ("Fund Summary Prospectus Adopting Release"), available at: <http://www.sec.gov/rules/final/2009/33-8998.pdf>.

<sup>[2]</sup> See Item 4(b)(1)(i) of Form N-1A.

<sup>[3]</sup> Form N-1A provides that the Summary Section must be provided in plain English under Rule 421(d) under the Securities Act. See General Instruction B.4.(c) of Form N-1A. In addition, the prospectus, in its entirety, is subject to the requirement that the information is presented in a clear, concise, and understandable manner. See Rule 421(b) of the Securities Act. Similarly, Form N-1A also provides that the prospectus disclosure requirements "are

intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters.” General Instruction 3.C.1.(b) of Form N-1A.

[4] We note that these are risks that are not reasonably likely to adversely affect the fund’s net asset value, yield, and total return.

[5] See Instruction to Item 4(b)(1)(i) of Form N-1A.

[6] See Fund Summary Prospectus Adopting Release, *supra* n. 1.

[7] Form N-1A provides that a fund should describe any investment strategies and risks that are not principal in the Statement of Additional Information. See Item 16(b) of Form N-1A. Form N-1A, however, also provides that a fund may include (except in the summary section) information in the prospectus that is not otherwise required, but only so long as 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 information that is required to be included. See General Instruction C.3.(b) of Form N-1A.

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