Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

Client Alert

Current Issues Relevant to Our Clients

January 16, 2014

Fixed Income Advisers—SEC Guidance on Fund Risk Management and Disclosure

With fixed income markets already in decline in May 2013, speculation regarding Federal Reserve action reached a pinnacle in the last half of June, sparking a bond market selloff of historic proportions. The prospect of the Federal Open Markets Committee tapering "quantitative easing" and a rise in interest rates combined with concerns regarding Detroit and Puerto Rico made 2013 rather unpleasant for many fixed income investors. With this backdrop, the staff of the Securities and Exchange Commission's Division of Investment Management recently published guidance for advisers to registered investment companies with respect to risk management and disclosure matters in light of the recent volatility in the fixed income market. This Client Alert summarizes the staff recommendations for fund advisers to consider relating to changing fixed income market conditions. You can obtain a copy of the staff's guidance here.

The staff guidance first reviews recent developments in the fixed income market, paying particular attention to the impact on bond funds. The staff notes that, in addition to market losses, the June selloff led to bond funds experiencing net outflows of nearly $70 billion or approximately 1.8% of assets. The staff notes that while outflows from bond funds during periods of rising interest rates are not new, the recent outflows could contribute to greater volatility because the market for bond funds is much greater and dealer inventories of bonds are substantially smaller relative to the overall bond market size than they were in previous periods of rising interest rates. While bond fund investments stand at record highs, fixed income dealer capacity has not kept pace and remains at 2001 levels. The current level of dealer market-making capacity is also not likely to rise given increased regulatory capital requirements and fewer proprietary trading desks at broker-dealers, along with other structural changes affecting many market participants. The staff warns that the combination of record bond fund investments with lower relative dealer capacity in a rising interest rate environment has the potential to decrease liquidity and increase volatility in fixed income markets.

In light of the potential fixed income market volatility, the staff recommends several steps that bond fund advisers might consider:

- ***Assess and Stress Test Liquidity***—The staff recommends that advisers consider assessing fund liquidity needs in both normal and stressed environments. Advisers might also consider their sources of liquidity that would mitigate the need to sell assets into a declining market. Advisers should assess their ability to meet redemption demands over a variety of time periods.

- ***Conduct More General Stress Tests/Scenario Analyses***—The staff suggests that advisers should consider other potential threats, including interest rate hikes, widening spreads, price shocks to fixed income products, increased volatility and reduced liquidity.

- ***Risk Management Evaluation***—The staff suggests that advisers might consider what risk management strategies are most appropriate during periods of fixed income market volatility given the results of their stress tests and analyses, which may include decisions regarding portfolio composition, concentrations, diversification and liquidity.

- ***Communication with Fund Boards***—The staff suggests that advisers might consider what information should be provided to fund directors in order to keep them informed of risk exposures, liquidity positions and the fund's ability to manage through a changing interest rate environment and a period of fixed income market volatility.

- ***Shareholder Communications***—The staff recommends that advisers assess whether their current disclosures are adequate given recent events in the fixed income markets and the potential impact of shifting monetary policy or rising interest rates. If a fund determines that its current disclosures are inadequate, the staff indicates that the fund should consider the appropriate method of communicating the additional risks to shareholders, such as through prospectuses or shareholder reports.

For More Information

To discuss any topic covered in this alert, please contact a member of the Investment Management Group or visit us online at chapman.com.