SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 270, and 274

[Release Nos. 33–7153; 34–35546; IC–20974; File No. S7–10–95]

RIN 3235–AG43

Improving Descriptions of Risk by Mutual Funds and Other Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comments.

SUMMARY: The Securities and Exchange Commission (the ''SEC'' or ''Commission'') is seeking comments and suggestions on how to improve the descriptions of risk provided to investors by mutual funds and other management investment companies (''funds'' or ''investment companies''). In order to encourage individual investor comments and suggestions, the SEC is including in the Release an appendix directed to investors, which the SEC intends to reprint separately and distribute to investors.

DATES: The SEC requests comments on or before July 7, 1995.

ADDRESSES: Three copies of your comments should be submitted to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, D.C. 20549. All comment letters should refer to File No. S7–10–95. All comments received will be available for public inspection and copying in the SEC's Public Reference Room, 450 Fifth Street NW., Washington, D.C. 20549. If you are an individual investor and do not have access to a copier machine, you may send in one copy of your comments.

FOR FURTHER INFORMATION CONTACT: Susan Nash, Senior Special Counsel, (202) 942–0697, Paul B. Goldman, Chief Financial Analyst, (202) 942–0510, Roseanne Harford, Senior Counsel, (202) 942–0689, Martha H. Platt, Senior Counsel, (202) 942–0725, in the Division of Investment Management, or Craig McCann, Professional Fellow, (202) 942–8032, Office of Economic Analysis.

SUPPLEMENTARY INFORMATION:

Executive Summary

Today the SEC is continuing its efforts to enhance the information that investors in funds receive to assist them in making an informed investment decision. In recent years, the SEC has taken significant steps designed to improve the understandability and comparability of fund disclosure of performance and expenses.[1] The SEC is now requesting comment on how to improve risk disclosure for investment companies, including ways to increase the comparability of disclosure about funds' risk levels through quantitative measures or other means.[2]

Under existing SEC rules, a fund is required to discuss in its prospectus the principal risk factors associated with investing in the fund.[3] Funds typically describe the risks of investing in the fund by describing the risks of particular investment policies that the fund may use and investments that the fund may make.[4] Lengthy and highly technical descriptions of permissible policies and investments that are often used in meeting existing requirements may make it difficult for investors to understand the total risk level of a fund. The SEC staff has found that funds typically provide only the most general information on the risk level of the fund taken as a whole and has encouraged funds to modify their existing disclosure to enhance investor understanding of risks.[5] The SEC believes that it is now appropriate to explore whether SEC disclosure requirements should be revised in order to improve the communication of fund risks to investors and increase the likelihood that investors will readily grasp the risks of investing in a particular fund before they invest.

Several factors make it important that the SEC explore better ways of explaining fund risks to investors. First, average Americans are placing increasing reliance on funds to meet important financial needs, such as retirement and college expenses.[6] Understanding the risks of various investment products is one of the most important ingredients in creating an overall investment strategy or portfolio to meet these financial needs.[7] Second,

[1] See, *e.g.*, Disclosure of Mutual Fund Performance and Portfolio Managers, Investment Company Act of 1940 (''Investment Company Act'') Rel. No. 19382 (Apr. 6, 1993) [58 FR 19050 (Apr. 12, 1993)] (requiring mutual fund prospectuses or annual reports to discuss performance and provide line graph comparing fund performance to that of an appropriate market index over the last ten fiscal years; financial highlights table of prospectus revised to include total return information and generally to provide investors with information showing the performance of funds on a per share basis); Registration Form for Closed-End Management Investment Companies, Investment Company Act Rel. No. 19115 (Nov. 20, 1992) [57 FR 56826, 56829 (Dec. 1, 1992)] (improvements to financial highlights table for closed-end funds; fee table providing standard format for expense information required in closed-end fund prospectuses); Advertising by Investment Companies, Investment Company Act Rel. No. 16245 (Feb. 2, 1988) [53 FR 3868 (Feb. 10, 1988)] [hereinafter ''Rel. 16245''] (mutual fund advertisements and sales literature containing performance data required to include uniformly computed performance data); Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Rel. No. 16244 (Feb. 1, 1988) [53 FR 3192 (Feb. 4, 1988)] (fee table required in mutual fund prospectuses).

[2] The SEC requested comment on methods for disclosing risk in 1993 when it proposed rule amendments that would have given investors the option of purchasing mutual fund shares based on a short form prospectus. Off-the-Page Prospectuses for Open-End Management Investment Companies, Investment Company Act Rel. No. 19342 (Mar. 19, 1993) [58 FR 16141, 16145 (Mar. 25, 1993)] [hereinafter ''Rel. 19342'']. In particular, the SEC asked whether the short form prospectus should be required to contain a standardized presentation of the degree and kind of risk presented by a mutual fund relative to other mutual funds. A limited number of comments were received on this topic, with the comments being almost evenly divided whether standardized risk disclosure should be required. See Summary of Comment Letters Relating to Proposed Rule 482(g) Made in Response to Investment Company Act Release No. 19342, File No. S7–11–93, Jan. 27, 1994, at 17–18 [hereinafter ''Summary of Comments: Rel. 19342''].

[3] Risk factors include those peculiar to the fund and those that apply generally to funds with similar investment policies and objectives or, in the case of closed-end funds, similar capital structures or trading markets. Item 4(c), Form N–1A, & Guide 21, Disclosure of Risk Factors, Guidelines for Form N–1A [17 CFR 239.15A & 274.11A] (mutual funds); Item 8.3.a., Form N–2 [17 CFR 239.14 & 274.11a-1] (closed-end funds).

[4] See Form N–1A, Item 4(a)(ii) (requires concise description of mutual fund investment objectives and policies and brief discussion of how the fund proposes to achieve such objectives, including description of the securities in which the fund will invest and special investment practices or techniques that will be employed); Form N–1A, Item 4(b) (requires discussion of types of investments, policies, and practices that will not constitute the ''principal portfolio emphasis'' of a mutual fund, but which place more than 5% of the fund's net assets at risk); Form N–2, Item 8.2. & 8.4. (similar requirements for closed-end funds).

[5] See Memorandum dated Sept. 26, 1994, from Division of Investment Management to Chairman Levitt regarding Mutual Funds and Derivative Instruments 11 [hereinafter ''Derivatives Report'']; Letter to Registrants from Carolyn B. Lewis, Assistant Director, Division of Investment Management 7 (Feb. 25, 1994) (both documents on file with the SEC's Public Reference Room).

[6] According to a June 1994 survey sponsored by the Investment Company Institute, 31% of United States households owned shares in a mutual fund, up from 6% of households in 1980. Investment Company Institute, Fundamentals (Sept. 1994); Investment Company Institute, 1994 Mutual Fund Fact Book 85 (34th ed. 1994) [hereinafter ''1994 ICI Fact Book'']. Mutual funds held 14.9% of all household discretionary assets as of June 30, 1994, up from 7.0% at the end of 1982. Source: Investment Company Institute. Total mutual fund assets have grown from $292.9 billion at the end of 1983 to $2.16 trillion at the end of December 1994. 1994 ICI Fact Book, *supra*, at 26; Investment Company Institute Press Release, ''December Mutual Fund Sales Total $39.9 Billion,'' Jan. 26, 1995, at 4.

By the end of 1993, retirement assets accounted for 23% of mutual fund assets (excluding variable annuities), and mutual funds held almost $284 billion of the approximately $857 billion invested in individual retirement accounts (''IRAs'')—about 33% of total IRA assets. 1994 ICI Fact Book, *supra*, at 69.

[7] See, e.g., Burton G. Malkiel, A Random Walk Down Wall Street ch. 13 (1990) [hereinafter

new ways of describing risks may improve investor understanding of the risks associated with the use by some funds of increasingly complex instruments, such as derivatives.[8] Third, the number and types of funds have proliferated, increasing fund investors' need for information that will help them to compare and contrast alternatives.[9]

The importance of risk disclosure was underscored last year when some short-term government bond funds experienced losses as interest rates increased sharply.[10] Shareholders in these funds expressed surprise at the losses, and several shareholder lawsuits were filed.[11] Whatever the legal merits of the shareholder complaints may be, the SEC believes that these events highlight the importance of clear, concise disclosure of risks.

In this Release, the SEC requests that those submitting comments discuss the specific goals of, and various alternatives for, improving risk disclosure. Comments are requested on the relative merits of written and other presentations of risk, including quantitative or numerical measures, graphs, tables, and other pictorial representations.

The Release describes and requests comment on several specific quantitative measures of risk and risk-adjusted performance, including standard deviation, semi-variance, beta, duration, the Sharpe Ratio, the Treynor Ratio, and Jensen's Alpha. These measures of risk are potentially useful because they may give investors a tool for balancing the potential returns of a fund against the risks of the fund. For instance, if a fund has historical annual returns which are 2% above a market index, historical risk measures may provide some indication of the risks that were taken to produce the increased returns. Quantitative risk measurements may provide investors with tools to measure how funds have fared historically in the relationship between risk and return.

The Release also asks for comments addressing a number of general topics related to quantitative risk measures. These include:

• The benefits to be derived from quantitative measures versus the costs and burdens to the fund that must produce such information;

• Quantitative measures currently used by fund managers to assess risk, and whether such internally used measures should be disclosed to investors;

• Investor understanding of quantitative measures, and means to increase that understanding;

• Standardizing the ways in which funds calculate quantitative measures to assure comparability and the validity of any underlying assumptions; and

• Availability of quantitative risk information from third party providers (e.g., the financial press and rating services).

Comments are also requested on whether funds should be required to disclose a self-assessment of their risk level, using an SEC-created standard scale or some other method. In addition, comments are requested on whether funds should describe to investors the ways or strategies that fund managers use to manage, understand, and monitor the risks of their funds.

The SEC requests comments that address the specific questions posed in this Release as well as alternative risk disclosure methods and related matters. Where possible, please provide actual rule language that you believe would best express your recommendation.

To encourage individual investor comments and suggestions on this Release, the SEC for the first time has prepared a short summary specifically directed to individual investors. The summary, which appears as an appendix to the Release, will be reprinted in a format that leaves space for individual investors to tell the SEC about their concerns and ideas and distributed through investor groups and other means designed to reach individual investors.

I. The Goals of Risk Disclosure

The SEC's goal is to improve disclosure of fund risks so that investors will have the information they need to understand the risk of any particular fund investment. The best means for achieving this aim may depend, in part, on the specific goals of risk disclosure. The SEC therefore requests comment on the specific goals of risk disclosure, including the matters raised below.

The SEC asks persons submitting comments to define, as precisely as possible, what ''risks'' should be disclosed to investors. To what extent are investors concerned with the likelihood that they will lose principal, that their return will not exceed a specified benchmark (such as the Standard & Poor's (''S&P'') 500), or with the variability of their returns (or the volatility of the value of their investment) over time? How should the relationship between risk and an investor's time horizon shape the disclosure that is provided to investors? For example, is the same risk information useful to an investor with an investment time horizon of less than one year and to an investor with an investment time horizon of twenty years? [12] How can the disclosure of risk help investors answer the fundamental questions—Is this investment suitable for me? If I have diversified my investments, how does this particular fund fit into my diversification strategy?

Comments are requested on the nature of risk comparisons that are useful to investors. For example, should risk disclosure facilitate comparison among a broad range of investment options, such as between funds and other investment products? Or is it sufficient to facilitate comparisons among all funds and fund types, both equity and fixed income? Or among all equity funds, on the one hand, and all fixed income funds, on the other? Or only within groups of funds with similar investment objectives and policies, such as short-term government bond funds?

Is improved disclosure of risks equally important for equity, fixed income, and balanced or asset allocation funds? Do recent derivatives-related losses by some fixed income funds, and the apparently greater use of derivatives by fixed income funds, suggest that the need for improved disclosure of risks is greater for fixed income funds? [13] In

''Random Walk'']; Susan E. Kuhn, ''What it Takes to Retire Today,'' Fortune, Dec. 26, 1994, at 113; Joshua Shapiro, ''The Discipline of Saving for College,'' New York Times, Sept. 10, 1994, at 34.

[8] See Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Issues Affecting the Mutual Fund Industry, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives 18–19 (Sept. 27, 1994); Derivatives Report, supra note 5, at 11–12.

[9] See, e.g., 1994 ICI Fact Book, *supra* note 6, at 30–31 (increase from 564 mutual funds at the end of 1980 to 4,558 at the end of 1993; mutual funds classified according to 21 investment objectives).

[10] See, e.g., Leslie Eaton, ''Paine Webber to Bail Out Fund Battered by Complex Investments,'' New York Times, July 23, 1994, at A1; Robert McGough, ''Piper Jaffray Acts to Boost Battered Fund,'' Wall Street Journal, May 23, 1994, at C1.

[11] See, e.g., Karen Donovan, ''Derivatives Slump; Losers Go to Court,'' National Law Journal, Nov. 7, 1994, at A1; G. Bruce Knecht, ''Minneapolis Investors Are Hurt By Local Firm They Knew As Cautious,'' Wall Street Journal, Aug. 26, 1994, at A1; John Waggoner, ''Mutual Fund Losses Anger Novice Investors,'' USA Today, June 16, 1994, at 1B.

[12] See Letter to Barry P. Barbash, Director, Division of Investment Management, from Paul Schott Stevens, General Counsel, Investment Company Institute 3–4 (Jan. 19, 1995) [hereinafter ''ICI Letter''] (on file with the SEC's Public Reference Room) (discussing different concepts of risk); Paul A. Samuelson, ''The Long-Term Case for Equities and How it Can be Oversold,'' Journal of Portfolio Management 15–24 (Fall 1994) (raising questions about common wisdom that, for long-term investor, stocks will outperform bonds or cash).

[13] See *supra* notes 10 and 11 and accompanying text. A recent industry survey of non-money market funds indicated that the level of derivatives use varied by fund type, with fixed income funds

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light of the substantive limits on permitted money market fund investments,[14] should risk disclosure requirements for money market funds be different from those applicable to other funds?[15]

Comments are also requested on the degree of detail regarding fund risk that ideally would be communicated to investors. In meeting existing disclosure requirements, funds often describe the purposes of using particular types of instruments and the risks associated with each type, but typically provide only the most general information on the risk level of the fund taken as a whole.[16] Should disclosure convey the risks of each particular type of instrument held by a fund, the risks of broader classes of instruments (for instance, derivatives as a group), the risks of the fund's portfolio as a whole, or some combination of the foregoing? Should the focus of disclosure be shifted from the characteristics of particular securities to the nature of the investment management services offered, including the objectives of a fund manager and the associated risks and rewards? Do investors need to understand separately the different types of risk, such as market, credit, legal, and operational risks, or is it the aggregate effect of different types of risk that is important to an investment decision?

II. Narrative and Non-Narrative Risk Disclosure Options

The SEC currently requires fund prospectuses to include narrative descriptions of risk,[17] and the SEC is interested in the potential for improving risk disclosure through changes to the narrative disclosure requirements and the use of non-narrative forms of disclosure. The SEC therefore asks persons submitting comments to discuss the contributions that both narrative and non-narrative forms of disclosure can make to investor understanding of risk and to provide the SEC with the findings of any relevant market research on the effective communication of risk.

At present, a number of funds voluntarily supplement narrative descriptions of risk through means such as quantitative measures, graphs, tables, and other pictorial representations. For example, some funds provide quantitative risk measures like those described in section III.A. of this Release. Another method used is a line graph that shows relative risk and return levels for the fund and some benchmark, such as Treasury bills or a market index such as the S&P 500. Another method is a bar graph that shows consistency of returns for the fund and a market index (as measured by monthly rates of return over the life of the fund). Finally, some fund families use pictures to show the relative risks of the various funds within the family.

The SEC believes that quantitative measures, graphs, tables, and other pictorial representations may assist investors in understanding and comparing funds. The SEC currently requires disclosure of quantitative information in tabular form in the areas of fund performance and expenses.[18] Recently, the SEC adopted rules that require graphic depictions of information to facilitate investor understanding of fund performance.[19] The SEC now requests comment on the relative merits and usefulness of various formats for investment company risk disclosure, including quantitative measures, graphs, tables, and other pictorial representations. To what extent should these methods be used to supplement, or replace, current narrative risk disclosure?

III. Quantitative Measures of Risk

A. Specific Historical Quantitative Measures of Risk and Risk-Adjusted Performance

This section of the Release discusses several historical quantitative measures of risk and risk-adjusted performance that could be used for fund disclosure, and the following section raises a number of general questions about quantitative measures. Comments are requested regarding whether the SEC should require fund disclosure of any one or a combination of the enumerated measures or any other measures. Persons submitting comments are also asked to consider each of the enumerated quantitative measures, and any other measures they may wish to suggest, in the context of the general questions raised in the following section.

Historical measures of risk and risk-adjusted performance are generally calculated from past portfolio returns and, in some cases, past market returns. There are two broad classes of historical risk measures, referred to in this Release as total risk measures and market risk measures. In addition, there is a third class of measures, risk-adjusted measures of performance. (Unless the context indicates otherwise, risk-adjusted measures of performance are included in ''quantitative risk measures'' and similar terms and phrases used in this Release.) These three classes of measures are described below, and examples of each are provided. Comments are requested on the relative advantages and disadvantages of the three classes of measures and of specific measures within each class.

1. Measures of Total Risk

Total risk measures, including standard deviation and semi-variance, quantify the total variability of a portfolio's returns around, or below, its average return.

• *Standard Deviation of Total Return*. The risk associated with a portfolio can be viewed as the volatility of its returns, measured by the standard deviation of those returns.[20] For example, a fund's

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accounting for 84% of the total market value of all derivatives held by reporting funds and 62% of the total national amount. Investment Company Institute, Derivative Securities Survey 6 (Feb. 1994). Survey respondents included 52 fund complexes with 1,728 non-money market funds holding aggregate net assets of $958 billion (76% of industry assets in non-money market funds). *Id.* at 4.

[14] Mutual funds are prohibited from calling themselves money market funds unless they comply with the risk-limiting provisions of rule 2a–7 under the Investment Company Act. These provisions are designed to limit a fund's exposure to credit, interest rate, and currency risks. 17 CFR 270.2a–7(b), (c)(2)–(4), & (d).

[15] Losses in the value of certain adjustable rate notes held by some money market funds recently resulted in the funds' advisers electing to take actions designed to prevent the funds' per share net asset values from falling below $1.00; and one small, institutional money market fund liquidated and redeemed its shares at less than $1.00 as a result of such losses. See, e.g., ''A History of Stepping up to the Plate,'' Fund Action, Sept. 12, 1994, at 9; Brett D. Fromson, ''Losses on Derivatives Lead Money Fund to Liquidate,'' Washington Post, Sept. 28, 1994, at F1. These losses, however, raise concerns about the appropriateness of the funds' investments in some types of adjustable rate securities and not merely risk disclosure concerns. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Rel. No. 19959, § II.D.2.d. (Dec. 17, 1993) [58 FR 68585, 68601–02 (Dec. 28, 1993)] [hereinafter ''Rel. 19959''] (certain types of adjustable rate notes not appropriate investments for money market funds). See also Letter from Barry P. Barbash, Director, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (June 30, 1994) (on file with the SEC's Public Reference Room).

[16] See Derivatives Report, *supra* note 5, at 11.

[17] See *supra* notes 3 and 4 and accompanying text.

[18] For mutual funds, see Form N–1A, Items 2 (Synopsis), 3 (Condensed Financial Information), and 5A (Management's Discussion of Fund Performance). For closed-end funds, see Form N–2, Items 3 (Fee Table and Synopsis) and 4 (Financial Highlights). See also *supra* note 1 and accompanying text. A closed-end fund is also required to include in its prospectus a table quantifying the effects of leverage on returns to investors. Form N–2, Item 8.3.b.(3) (General Description of the Registrant, Risk Factors, Effects of Leverage).

[19] See *supra* note 1. The SEC also recently adopted rules requiring graphic depictions of issuer performance by public companies that are not investment companies. Executive Compensation Disclosure, Securities Exchange Act Rel. No. 31327 (Oct. 16, 1992) [57 FR 48126 (Oct. 21, 1992)].

[20] William F. Sharpe, Gordon J. Alexander, and Jeffery V. Bailey, Investments 178 (5th ed. 1995)

historical risk could be measured by computing the standard deviation of its monthly total returns over some prior period, such as the past three years. The larger the standard deviation of monthly total returns, the more volatile, *i.e.*, spread out around the fund's average monthly total return, the fund's monthly total returns have been over the prior period. Standard deviation of total return can be calculated for funds with different objectives, ranging from equity funds to fixed income funds to balanced funds, and can be measured over different time frames. For example, a fund could calculate standard deviation of monthly returns over the prior three years or yearly returns over the prior ten years.

• *Semi-variance.* Standard deviation measures both ''good'' and ''bad'' outcomes, *i.e.*, the variability of returns both above and below the average return. To the individual investor, however, risk may be synonymous with ''bad'' outcomes.[21] Semi-variance, which can be used to measure the variability of returns below the average return, reflects this view of risk.[22] A fund with a larger semi-variance has returns that are more spread out below the average return.

2. Measures of Market Risk

Individual securities, and portfolios of securities, are generally subject to two sources of risk: (i) Risk attributable to firm-specific factors, including research and development, marketing, and quality of management; and (ii) risk attributable to general economic conditions, including the inflation rate, interest rates, and exchange rates.[23] According to academic literature in Finance, firm-specific risk can be reduced or eliminated through portfolio diversification, but the risk attributable to general economic conditions, so-called ''market risk,'' cannot be eliminated through diversification.[24] Unlike standard deviation and variance, which measure portfolio risk from both sources, the measures described in this section are measures of market risk. The SEC requests comment on whether, given that most fund portfolios are diversified, it is appropriate to focus on market risk when measuring fund risks.

• *Beta.* Beta measures the sensitivity of a security's, or portfolio's, return to the market's return. The market's beta is by definition equal to 1. Portfolios with betas greater than 1 are more volatile than the market, and portfolios with betas less than 1 are less volatile than the market. For example, if a portfolio has a beta of 2, a 10% market return would result in a 20% portfolio return, and a 10% market loss would result in a 20% portfolio loss (excluding the effects of any firm-specific risk that has not been eliminated through diversification).[25]

The calculation of a fund's historical beta requires the selection of a benchmark market index, and persons supporting the use of beta are asked to address how the benchmark should be selected and whether a single benchmark should be used for all funds. If a single benchmark should be selected, what should it be? If a single benchmark is not used, how should the lack of comparability of betas for funds using different benchmarks be addressed? Beta is generally used in connection with equity securities, and persons submitting comments are asked to address whether or not the use of beta should be limited to equity funds.

• *Duration.*[26] Duration is a measure of the price sensitivity of a bond, or bond portfolio, to interest rate changes.[27] There are different types of duration,[28] and persons supporting the use of duration are asked to be specific regarding the duration measure that they support. Would so-called ''modified duration,'' which can be interpreted as the percentage change in the price of a bond, or bond portfolio, for a 100 basis point change in yield, be particularly useful?[29]

The use of duration has several limitations, and persons submitting comments are asked to address each of these. First, duration is only meaningful for bonds and portfolios of bonds and therefore cannot be used to measure the risk of equity funds and has limited applicability to balanced funds. Second, duration measures interest rate risk only and not other risks to which bonds are subject, *e.g.*, credit risks and, in the case of non-dollar denominated bonds, currency risks. Third, duration is difficult to calculate precisely for bonds with prepayment options, *e.g.*, mortgage-backed securities, because the calculation requires assumptions about prepayment rates.[30] Fourth, bond value changes resulting from interest rate changes are sometimes poorly predicted by duration.[31]

The SEC staff takes the position that, for a fund with a name or investment objective that refers to the maturity of the fund's portfolio, such as ''short-term'' or ''long-term,'' the dollar-weighted average portfolio maturity of the portfolio must reflect that characterization.[32] The SEC requests

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[hereinafter ''Sharpe, Alexander, & Bailey'']. If the returns earned by a portfolio are ''normally'' distributed, that is, in the shape of a bell curve, approximately 95% of the actual returns will fall within two standard deviations of the average return. Random Walk, *supra* note 7, at 219. For example, for a fund with an average monthly return of 1% and a standard deviation of 4%, 95% of the fund's monthly returns would fall between −7% (1%−(2×4%)) and 9% (1%+(2×4%)) if the returns were ''normally'' distributed. See Sharpe, Alexander, & Bailey, *supra*, at 177.

[21] See Sharpe, Alexander, & Bailey, *supra* note 20, at 178; Allan Flader, ''Deviating from the Standard,'' Financial Planning, June 1994, at 148.

[22] Funds' risk levels would be ranked in the same order using semi-variance and standard deviation if the distribution of fund returns were symmetric. Sharpe, Alexander, & Bailey, *supra* note 20, at 178.

[23] Zvi Bodie, Alex Kane, and Alan J. Marcus, Investments 197 (2d ed. 1993) [hereinafter ''Bodie, Kane, & Marcus''].

[24] Bodie, Kane, & Marcus, *supra* note 23, at 197–99; Sharpe, Alexander, & Bailey, *supra* note 20, at 212–17.

[25] Sharpe, Alexander, & Bailey, *supra* note 20, at 211; Frank J. Fabozzi and Franco Modigliani, Capital Markets: Institutions and Instruments 136–40 (1992) [hereinafter ''Fabozzi & Modigliani''].

[26] The SEC previously requested comment on duration as a measure of interest rate risk for securities held by money market funds. See Rel. 19959, *supra* note 15, § II.D.2.d., 58 FR at 68602. In response to that request, several persons submitting comments expressed support for the use of duration or other price volatility tests; one person specifically opposed a duration requirement on the grounds that the costs funds would incur would outweigh benefits to investors. See Summary of Comment Letters on Proposed Amendments to Rules Regulating Money Market Funds Made in Response to Investment Company Act Rel. 19959, File No. S7–34–93, Nov. 10, 1994, at 63–64.

[27] Bodie, Kane, & Marcus, *supra* note 23, at 473–74. Duration measures the weighted average maturity of a bond's, or bond portfolio's, cash flows, *i.e.*, principal and interest payments. A zero-coupon bond's duration, for example, is the same as its maturity because its sole cash flow is the payment made at maturity. By contrast, a bond bearing interest payable periodically has a duration that is shorter than its maturity because the periodic interest payments reduce the weighted average maturity of the bond's cash flows below the final maturity of the bond. *Id.*

[28] For a discussion of the computation and interpretation of so-called ''Macaulay duration'' and ''modified duration,'' see Bodie, Kane, & Marcus, *supra* note 23, at 473–75, and Fabozzi & Modigliani, *supra* note 25, at 393–98.

[29] Fabozzi & Modigliani, *supra* note 25, at 397. For example, if a bond portfolio has a modified duration of 7 and yield increases by 100 basis points, the estimated decrease in the value of the portfolio would be 7%.

[30] See James Hom and Gary Arne, Standard & Poor's, ''Prepayments and Model Error in Fund Risk Ratings,'' CreditReview, Jan. 16, 1995, at 17–18; John Rekenthaler, Commentary: ''Duration Arrives,'' Morningstar Mutual Funds, Jan. 21, 1994, at 1–2.

[31] Duration is less useful as a measure of interest rate risk when the following conditions are not met: (1) the yield curve is flat (*i.e.*, interest rates for all maturities of bonds are the same), (2) changes in yield are small, and (3) yield shifts are parallel (*i.e.*, the Treasury yields of all maturities change by equal numbers of basis points). See Fabozzi & Modigliani, *supra* note 25, at 396–401.

[32] See, *e.g.*, Form N–7 for Registration of Unit Investment Trusts Under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Rel. No. 15612 (Mar. 9, 1987) [52 FR 8268, 8301 (Mar. 17, 1987)] (guide to proposed registration form for unit investment trusts publishing staff position on portfolio maturity).

comment on whether, separate and apart from duration's potential use as a quantitative risk measure, a fund's name or investment objective that refers to the maturity of its portfolio should be required to be consistent with the fund's duration.

3. Risk-Adjusted Measures of Performance [33]

Risk-adjusted measures of performance were developed in the 1960s to compare the quality of investment management. Three widely-used risk-adjusted measures are:

- *Sharpe Ratio.*[34] Also known as the Reward-to-Variability Ratio, this is the ratio of a fund's average return in excess of the risk-free rate of return (''average excess return'') [35] to the standard deviation of the fund's excess returns. It measures the returns earned in excess of those that could have been earned on a riskless investment per unit of total risk assumed.
- *Treynor Ratio.*[36] Also known as the Reward-to-Volatility Ratio, this is the ratio of a fund's average excess return to the fund's beta. It measures the returns earned in excess of those that could have been earned on a riskless investment per unit of market risk assumed. Unlike the Sharpe Ratio, the Treynor Ratio uses market risk (beta), rather than total risk (standard deviation), as the measure of risk.
- *Jensen's Alpha.*[37] This is the difference between a fund's actual returns and those that could have been earned on a benchmark portfolio with the same amount of market risk, *i.e.*, the same beta, as the portfolio.[38] Jensen's Alpha measures the ability of active management to increase returns above those that are purely a reward for bearing market risk.

B. General Issues

This section of the Release raises a number of general questions about quantitative risk measures. Persons submitting comments are asked to address these questions, particularly in the context of specific quantitative measures.

1. Benefits of Quantitative Risk Measures

The SEC asks for comments on the potential benefits that could be derived from fund disclosure of quantitative risk measures. Comments are also requested on associated costs and burdens.

Would quantitative risk measures, including risk-adjusted measures of performance, help investors to evaluate historical performance and investment management expertise? The SEC requires that fund prospectuses include standardized return information,[39] even though past returns are not necessarily indicative of future returns. Persons submitting comments are asked to address whether quantitative disclosure of the risk level incurred to produce stated returns may provide investors with a better tool to understand past fund performance and management.[40] Historical data could, for example, help investors distinguish among funds that have achieved comparable rates of return with significantly different levels of risk. Would it be helpful to investors for funds to present one or more risk measures together with fund performance data in the financial highlights table? [41] Would a risk measure that covers the same periods currently required for reporting total returns in the financial highlights table in fund prospectuses or in mutual fund advertisements be useful to investors? [42]

Would quantitative risk measures be useful to investors as indicators or guides to future fund risk levels, enhancing investors' ability to compare risks assumed by investing in different funds? The SEC requests any research related to the degree of correlation between historical measures of a fund's risk and expected future levels of risk.

2. Risk Measures Currently Used by Investment Companies

The SEC requests comment on whether quantitative risk measures that are currently used by investment companies for internal purposes, such as portfolio management, evaluation or compensation of portfolio managers, and reports by management to the board of directors, could be adapted for disclosure purposes. This approach could have two potential advantages: first, the measures currently used by investment companies presumably have been determined to be the most useful by fund managers, who are in the best position to understand and analyze fund risk; and, second, use of these measures for disclosure purposes should impose relatively small additional costs on funds. The SEC therefore requests that persons submitting comments identify which quantitative risk measures funds use internally and for what purposes.

The SEC also asks persons submitting comments to discuss the extent to which quantitative risk measures used by investment companies for internal purposes would be useful to investors. If such measures would not be useful to investors, why not? How might internal measures be adapted to avoid or overcome these problems?

3. Investor Understanding of Quantitative Risk Measures

Persons submitting comments are asked to discuss the difficulties that

[33] The SEC has solicited comment on risk-adjusted measures of performance on two prior occasions. In 1990, the SEC requested comment on whether mutual funds should be required to adjust performance figures to reflect risk for purposes of Item 5A of Form N–1A. See Disclosure and Analysis of Mutual Fund Performance Information; Portfolio Manager Disclosure, Investment Company Act Rel. No. 17294 (Jan. 8, 1990) [55 FR 1460, 1464 (Jan. 16, 1990)]. See also Summary of Comments on Proposed Amendments to Form N–1A, File S7–1–90, at 23–24 (summarizing views of the nine persons submitting comments who addressed risk adjustment of performance, all of whom opposed it).

In 1986, the SEC requested comment on how mutual funds could present risk-adjusted performance information in advertisements prepared in accordance with rule 482 under the Securities Act of 1933 [17 CFR 230.482]. See Advertising by Investment Companies; Proposed Rules and Amendments to Rules, Forms, and Guidelines, Investment Company Act Rel. No. 15315 (Sept. 17, 1986) [51 FR 34384, 34390 (Sept. 26, 1986)]. See also Summary of Comments on Mutual Fund Advertising Proposals, File No. S7–23–86, Mar. 31, 1987, at 69–70 (summarizing views of the thirteen persons submitting comments who addressed the issue, including nine who supported it and one who opposed it).

[34] See William F. Sharpe, ''The Sharpe Ratio,'' 21 Journal of Portfolio Management 49–58 (Fall 1994); William F. Sharpe, ''Mutual Fund Performance,'' 39 Journal of Business 119–38 (Jan. 1966); Sharpe, Alexander, & Bailey, *supra* note 20, at 935–37; Edwin J. Elton & Martin J. Gruber, Modern Portfolio Theory and Investment Analysis 648–52 (4th ed. 1991) [hereinafter ''Elton & Gruber''].

[35] The yield on 90-day Treasury bills is often used as a proxy for the risk-free rate of return.

[36] See Jack L. Treynor, ''How to Rate Management of Investment Funds,'' 43 Harvard Business Review 63–75 (Jan.-Feb. 1965); Sharpe, Alexander, & Bailey, *supra* note 20, at 934–35; Elton & Gruber, *supra* note 34, at 657–58.

[37] Michael C. Jensen, ''The Performance of Mutual Funds in the Period 1945–1964,'' 23 Journal of Finance 389–416 (May 1968); Michael C. Jensen, ''Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios,'' Journal of Business (Apr. 1969); Sharpe, Alexander, & Bailey, *supra* note 20, at 927–34.

[38] For an equity fund, the benchmark portfolio could be comprised of a market index, *e.g.*, the S&P 500, and a risk-free asset, *e.g.*, 90-day Treasury bills. Sharpe, Alexander, & Bailey, *supra* note 20, at 798.

[39] Form N–1A, Item 3; Form N–2, Item 4.

[40] For discussions of the importance of risk as a component of performance evaluation, see Sharpe, Alexander, & Bailey, *supra* note 20, at 917–49, and Bodie, Kane, & Marcus, *supra* note 23, at 796–826.

Funds are currently required to disclose historical returns for each of the last ten fiscal years (or, if less, the life of the fund). See Form N–1A, Item 3. This data shows variability of past annual returns and therefore provides some guidance regarding past risk.

[41] See Form N–1A, Item 3; Form N–2, Item 4 (financial highlights table).

[42] See Form N–1A, Item 3 & Form N–2, Item 4 (fund financial highlights tables cover each of last ten fiscal years); rule 34b–1 under the Investment Company Act [17 CFR 270.34b–1] & rule 482(e)(3) under the Securities Act [17 CFR 230.482(e)(3)] (non-money market mutual fund advertisements and sales literature containing performance information required to contain average annual total return for one, five, and ten years).

investors would face in properly interpreting various quantitative risk measures, such as understanding what aspects of risk are measured, the limits on predictive utility of risk measures, and the importance of investment time horizon in determining how much risk to assume. Are the difficulties significantly greater than those associated with the proper interpretation of yield and return figures? Is there a potential problem of investor over-reliance on quantitative risk measures, and, if so, what could be done to protect against such over-reliance?

Comments are also requested regarding which quantitative risk measures would be easiest for investors to use properly and how quantitative measures can be made more understandable to investors. One possibility is to provide some form of interpretation of raw numbers. For example, standard deviations could be divided by the standard deviation for some benchmark such as the S&P 500. Another possibility is to convert raw numbers into a classification scale, such as one to ten or ''very low'' to ''very high'' risk. Another possibility would be to represent the level of fund volatility graphically, rather than through computation of standard deviation. Would it be helpful, for example, if funds were required to include a bar graph showing total returns for each of the last 10 years to provide investors a picture of the extent to which annual returns varied over that period and the frequency with which the returns were negative or below some benchmark? Would a chart like the following be helpful?

Using historical numbers, the following illustrates the fund's estimated variability of quarterly returns over the noted periods (*i.e.*, approximately 95% of the time, the fund's quarterly returns fell within these ranges).

10 year	5-year	3-year
−5% to 9%	−4% to 8%	−5% to 8%.

Are there narrative disclosures that can help investors to understand risk measures? Persons submitting comments are asked to report the results of any experience with, or research on, the relative effectiveness of alternative means of presenting quantitative information.

4. Historical Measures v. Portfolio-Based Measures v. Risk Objectives or Targets

There are three approaches to the use of quantitative risk measures: historical, portfolio-based, and risk objectives or targets. The SEC asks for comments on the relative merits and limitations of these three approaches.

The simple historical approach to quantitative risk measures is outlined in section III.A., above. This method generally uses actual past returns of a fund to compute a measure of risk for the fund. An alternative is a portfolio-based computation, which calculates a portfolio risk measure based on the particular securities in the portfolio as of a specified measurement date.[43] This method, too, is historical in that the computation (i) uses the portfolio composition as of a specified measurement date, and (ii) the computation is based on historical behavior of the securities in the portfolio.

There are at least two important limitations of using portfolio-based measures for fund disclosure: first, a fund may be invested in newly introduced financial instruments that have little or no history, and for which historical behavior must be estimated, and, second, portfolio-based measures, which are derived from portfolio composition on one particular date, may be less representative of the risk of a managed portfolio over time than a simple historical measure derived from fund returns over a period of time.

The SEC seeks comment on whether the SEC should require funds generally to disclose portfolio-based risk measures.[44] The SEC also asks for comments on whether such measures could be useful for new funds that do not have sufficient operating history to make use of a simple historical measure meaningful, funds that change their investment objectives or policies, funds that change investment advisers or portfolio managers, or merged funds comprised of different funds with different operating histories and different past risk levels.[45]

Another approach to risk measures is requiring funds to announce risk objectives or targets. Any of the risk and risk-adjusted performance measures could be used by funds in this manner. For example, a fund could announce its intention to follow a strategy that would yield a standard deviation of 10%–12% per year, a beta of 1.50–1.75 with respect to the S&P 500, or a duration of 7–9 years. Comments are requested regarding the relative merits of this approach as compared to the simple historical and portfolio-based approaches. Persons submitting comments are asked to address specifically the relative merits for funds with significant operating histories, new funds, funds that change their investment objectives or policies, funds that change investment advisers or portfolio managers, or merged funds comprised of different funds with different operating histories and different past risk levels. Persons supporting the use of simple historical measures by relatively new funds, funds that change their investment objectives or policies or their investment advisers or portfolio managers, or merged funds are also asked to address whether narrative disclosure should be required to explain the limits on the usefulness of the disclosure resulting from the funds' circumstances.

5. Computation Issues

Comments are requested on the following issues related to computation of quantitative risk measures and on any other relevant computation issues. What length of fund operating history is required to make particular historical risk measures useful? What requirements should be imposed on funds without this operating history? For example, if 18 months of operations are required to calculate a meaningful standard deviation figure, should funds that have been operating for less than 18 months be required to disclose the standard deviation of an appropriate market index or peer group of funds and explain any differences they expect between the fund's standard deviation and that of the index or peer group?

[43] See, *e.g.*, Comptroller of the Currency, Risk Management of Financial Derivatives 49–53 (Oct. 1994); J.P. Morgan, Introduction to RiskMetrics™ (2d ed.) (Oct. 25, 1994); Group of Thirty, Derivatives: Practices and Principles 10–11 (July 1993).

[44] The Investment Company Institute has suggested that portfolio-based measures would be of limited relevance at best in an actively managed portfolio, would ignore the role of portfolio management, and would be burdensome to compute. *ICI Letter, supra* note 12, at 8 n.10.

[45] Issues have arisen with respect to fund advertisement of performance information in similar circumstances. See IDS Financial Corp. (pub. avail. Dec. 19, 1994) (acquisition of other funds' assets); North American Security Trust (pub. avail. Aug. 5, 1994) (combination of two funds); The Managers Core Trust (pub. avail. Jan. 28, 1993) (newly formed hub fund); Unified Funds (pub. avail. Apr. 23, 1991) (changed investment adviser); John Hancock Asset Allocation Trust (pub. avail. Jan. 3, 1991) (change from money market fund to asset allocation fund); Founders Funds, Inc. (pub. avail. Oct. 15, 1990) (change from unit investment trust to mutual fund); Zweig Series Trust (pub. avail. Jan. 10, 1990) (changed investment adviser); Philadelphia Fund, Inc. (pub. avail. Oct. 17, 1989) (changed investment adviser); Commonwealth Funds (pub. avail. June 14, 1989) (combination of two funds); Investment Trust of Boston Funds (pub. avail. Apr. 13, 1989) (changed investment adviser); The Fairmont Fund Trust (pub. avail. Dec. 9, 1988) (changed investment objective); and Growth Stock Outlook Trust, Inc. (pub. avail. Apr. 15, 1986) (new fund).

For risk measures that require the use of a benchmark market index, what issues, if any, are associated with the selection of an appropriate benchmark? How should the SEC address the need to use assumptions to calculate certain risk measures, such as the prepayment assumptions that may be required to calculate duration? Can various quantitative risk measures be manipulated and how do the various measures differ in their susceptibility to manipulation? How can the potential for such manipulation be reduced or eliminated? For instance, is there some combination of risk measures the SEC could require that would not be susceptible to simultaneous manipulation?

Persons submitting comments are also asked to describe as specifically as possible the computation method they would recommend for any quantitative risk measure they favor. For example, persons favoring standard deviation should specify whether monthly returns, quarterly returns, or returns over some other periods should be used. As another example, persons favoring beta should describe the benchmark or benchmarks that should be used. Persons submitting comments are also asked to discuss the benefits and limitations associated with their recommended method of computation.

6. Effects on Portfolio Management

The SEC recognizes that requiring disclosure of a quantitative risk measure may affect portfolio management, *e.g.*, causing fund managers to adopt more conservative investment strategies. Comments are requested regarding whether, and how, disclosure of a quantitative risk measure might influence portfolio management and evaluating the associated benefits and detriments.

7. Third Party Providers of Quantitative Risk Information

The financial press and other third parties currently disseminate some quantitative information regarding fund risks. The available information includes measures such as those described in section III.A., including standard deviation, beta, and duration.[46] In addition, some organizations disseminate fund performance ratings that take risk into account[47] or fund risk ratings.[48] This data is made available either through reports and other documents published by the organizations that collect and calculate the measures or through periodicals and newspapers covering financial issues.

The SEC asks persons submitting comments to address the SEC's role with respect to disclosure of quantitative risk information in light of the availability of fund risk information from the financial press and other third parties. Is there, for example, helpful risk information that third party providers do not make available? Would SEC-required disclosure be important to ensure that all investors have access to some quantitative risk information and to help educate investors about the importance of such information? Would SEC-required disclosure be important to facilitate comparability among funds by ensuring that standardized quantitative risk information will be available for all funds? Would SEC-required disclosure of a quantitative risk measure be helpful wherever historic returns are reported to indicate to investors the risks incurred to generate those returns?

Persons submitting comments are also asked to address whether the SEC should take any steps to facilitate the provision of fund risk information by the financial press and other third parties. For example, should the SEC require more frequent disclosure of fund portfolio holdings or more detailed descriptions of fund portfolio holdings to facilitate third party risk analyses? If so, what information should the SEC require funds to make available and with what frequency? The SEC is currently authorized to require funds to file with the SEC ''such information * * * as the SEC may require, on a semi-annual or quarterly basis, to keep reasonably current the information and documents contained in the [funds' Investment Company Act of 1940] registration statement[s] * * *.''[49] Persons submitting comments are asked to address whether statutory amendments would be required to implement any recommendations they make in response to this paragraph.

Last year, the SEC requested comment regarding whether it should encourage or require disclosure of third party fund risk ratings in prospectuses, sales literature, and advertisements.[50] Persons who wish to address that issue in the context of today's broad inquiry into improved risk disclosure are invited to do so.

IV. Narrative Disclosure Options

The SEC asks for comment on the usefulness to investors of narrative risk disclosure currently found in prospectuses.[51] The SEC also asks persons submitting comments to describe ways of improving narrative risk disclosure that will not increase, and may reduce, technical information that may be of limited utility to investors. For example, should prospectus disclosure focus on the broad investment strategies of a fund rather than the particular investments used to implement the strategy?

Can disclosure of fund risks be improved through increased focus on the policies and investments actually used by a fund as opposed to all permissible policies and investments? For example, should a fund describe the policies and investments that have been used during some prior period, such as the preceding year, or that the fund intends to use during some future period, such as the following year, and simply list the other permitted policies and investments? Or should funds be required to provide a table or grid that indicates whether, and the extent to which, the policies and investments authorized to be used were used during some prior period, such as the preceding year? If a fund intends to alter the mix of policies and investments, should it be required to describe the projected change? In addressing the questions of this paragraph, persons submitting comments should consider the possibilities of placing various information in the prospectus,[52] annual

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[46] See, *e.g.*, CDA/Wiesenberger, Mutual Funds Update, Dec. 31, 1994; Morningstar Mutual Funds, Dec. 9, 1994; The Value Line Mutual Fund Survey, Part 2, Ratings & Reports, Feb. 21, 1995. Value Line also ranks mutual funds in five risk categories, based on historical standard deviation. How to Use The Value Line Mutual Fund Survey, A Subscriber's Guide (1994), at 4–5.

[47] See, *e.g.*, Business Week, Feb. 14, 1994, at 78–79; Forbes, Aug. 29, 1994, at 174; CDA/Wiesenberger, Investment Companies Yearbook 1994 441 (1994); Morningstar Mutual Fund Performance Report, Jan. 1995, at 3; How to Use The Value Line Mutual Fund Survey, A Subscriber's Guide (1994), at 4–5.

[48] These ratings are based on an analysis of factors such as currency, interest rate, liquidity, and mortgage prepayment risks; hedging; leverage; and the use of derivatives. *See* ''Bond Fund Risks Revealed,'' Fitch Research Special Report, Oct. 17, 1994, at 1; Gary Arne, Standard & Poor's, CreditReview, Jan. 16, 1995, at 12.

[49] Investment Company Act § 30(b) [15 U.S.C. 80a–29(b)].

[50] Nationally Recognized Statistical Rating Organizations, Securities Act Rel. No. 7085 (Aug. 31, 1994) [59 FR 46314 (Sept. 7, 1994)]. The SEC is currently studying the comment letters received.

[51] See discussion *supra* notes 3–5 and accompanying text.

[52] Mutual funds generally offer their shares on a continuous basis and, as a result, are required to file periodic ''post-effective'' amendments to their registration statements in order to maintain a ''current'' prospectus required by section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)]. Post-effective amendments also satisfy the requirement that mutual funds amend their Investment Company Act registration statements annually [17 CFR 270.8b–16]. Because closed-end funds do not generally offer their shares to the public on a

report, and statement of additional information. For example, should the prospectus focus on the policies and investments the fund has actually made and that it may make in the reasonably foreseeable future, with the complete list of permissible investments and policies to be disclosed in the statement of additional information? As another example, should periodic reports be enhanced to include more information about what policies and investments the fund has, in fact, pursued and what risks were actually taken?

Can risks be accurately depicted through narrative disclosure apart from technical descriptions of particular types of investments? Would investors find it useful for funds to provide in their prospectuses a summary of the risk characteristics of the portfolio as a whole either in lieu of or in addition to disclosure of the characteristics of particular types of permissible investments? If a risk summary would be useful, what risks should it address? For example, should the SEC require a fund that invests a specified level, *e.g.*, 5% or 10% or 25%, of its net assets in a particular manner, *e.g.*, securities of non-U.S. companies, to discuss the related risks, *e.g.*, exchange rate fluctuations?[53]

A mutual fund's Management's Discussion of Fund Performance (''Management's Discussion''), contained in the prospectus or annual report, is currently required to discuss the factors, including the market conditions and the investment techniques and strategies, that materially affected the fund's performance during the previous fiscal year.[54] The SEC requests comments regarding whether narrative risk disclosure can be improved through amendments to the requirements for the Management's Discussion. Should the SEC, for example, explicitly require the Management's Discussion to address the risks assumed during the previous fiscal year and the effects of those risks on fund performance? Should the requirement for the Management's Discussion be extended to money market funds? If the Management's Discussion is a useful vehicle for risk disclosure, how should disclosure be accomplished for closed-end funds, which are not subject to the Management's Discussion requirements?

V. Self-Assessment of Risk

Another alternative upon which the SEC seeks comment is self-assessment by funds of their aggregate risk level. One approach might be to describe where the fund fits on a risk scale from low risk, for instance, a money market fund, to moderate risk, for instance, a growth and income fund investing in S&P 500 stocks and high quality bonds, to high risk, for instance, an emerging market fund.[55] Some fund complexes currently place various funds within the complex on a risk scale, and the SEC requests comment on whether such an approach would be useful for comparing funds from different complexes. If risk self-assessment is used, should the SEC create a standard scale? Persons supporting an SEC-created scale are asked to describe specifically what that scale should be, with particular attention to designing the scale to promote a high degree of uniformity in funds' self-assessments. Persons who favor a self-assessment approach but not an SEC-created scale are asked to address how the approach will foster meaningful investor comparisons among funds.

Comments are also requested on whether funds should be required to provide self-assessments of their exposures to various types of risk, with the results presented in chart or table format. Bond funds, for example, might rate their interest rate risk, credit risk, prepayment risk, and currency risk on a scale of low to medium to high.

VI. Risk Management Procedures

The disclosure options described in this Release have focused on improved disclosure of the level of risk incurred by a fund. Persons submitting comments are also asked to consider whether disclosure of fund risk management procedures should be required. Such disclosure could be narrative. For example, should funds be required to disclose the extent and nature of involvement by the board of directors in the risk management process? As another example, should funds describe the ''stress-testing'' they do to determine how the portfolio will behave in various market conditions? Alternately, such disclosure could be quantitative in format. For example, if the SEC requires disclosure of a quantitative risk objective or target, funds could be required to disclose the funds' actual risk level in subsequent periods and compare it with the previously-provided objective or target and explain the reasons for divergence.

VII. Liability Issues

Persons submitting comments are asked to address the appropriate scope of, and limits on, the liability of funds, investment advisers, and others for various risk disclosures. Persons submitting comments should specify any forms of risk disclosure that they believe raise particularly significant liability concerns, explain the concerns, and suggest means for mitigating the concerns.

VIII. Regulatory Flexibility Act

According to the SEC's rules and unless otherwise defined for a particular rulemaking proceeding, an investment company with net assets of $50 million or less at the end of its most recent fiscal year is a ''small entity'' for purposes of the Regulatory Flexibility Act.[56] The SEC requests persons submitting comments to describe and project fund costs to provide the various disclosures described in this Release, and any other disclosure that persons submitting comments may wish to discuss, and address whether requiring the disclosure would have a significant economic impact on small entities. If so, the SEC asks persons submitting comments to describe that impact specifically. Persons submitting comments also are asked to suggest methods for improving disclosure of fund risks without imposing significant costs on funds, specifically without having a significant economic impact on funds that are small entities.

IX. Conclusion

The SEC is seeking comments and suggestions on a number of specific issues related to fund disclosure of risks. Persons submitting comments are encouraged, however, to address any other matters that they believe merit examination.

Dated: March 29, 1995.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

Appendix—SEC Request for Investor Suggestions on How To Improve the Descriptions of Risk in Mutual Funds

The U.S. Securities and Exchange Commission (''the SEC''), the federal government agency that oversees mutual funds, wants to hear from investors on

continuous basis, they generally do not update their prospectuses periodically.

[53] *Cf.* Form N–1A, Item 4(b)(ii) (greater prospectus disclosure required for investment practices that place more than 5% of a fund's net assets at risk).

[54] Form N–1A, Item 5A.

[55] In Rel. 19342, *supra* note 2, the SEC requested comment on this approach and other formats for disclosing risk, including numerical scales and other visual or symbolic representations. A limited number of persons submitting comments addressed these specific methods for standardizing risk disclosure. Summary of Comments: Rel. 19342, *supra,* note 2, at 17–18.

[56] Investment Company Act rule 0–10 [17 CFR 270.0–10].

how the descriptions of risk in mutual funds may be improved. When investors choose a mutual fund, they should understand the risks of the fund before they invest and not be surprised if the value of their investment rises and falls significantly.

The risks and potential rewards of investing in any mutual fund are explained in a written document provided by the mutual fund called a ''prospectus.'' The prospectus contains information that is important to making an informed decision when choosing a mutual fund.

The SEC is concerned that the descriptions of risk in mutual fund prospectuses are not as helpful or as clear as they could be. The SEC is seeking ideas and suggestions on how these descriptions of risk may be improved. Your ideas and suggestions may shape how risks are explained in the future and help investors make better investment choices.

Here are a series of questions and examples on how the descriptions of risk may be improved. We urge you to respond, whether you answer one question or all, or just have general comments. Feel free to use this form or write a separate letter marked ''File No. S7–10–95.''

Please mail your comments to the SEC no later than July 7, 1995. Directions for sending your comments to the SEC are provided at the end of this document. The SEC will make your comments and other comments received by the SEC available to the public.

How do you learn about mutual fund risks? The SEC would like to know how you learn about the risks of a mutual fund before you invest in the fund.

• Do you learn about mutual fund risks from the fund prospectus, a broker or bank representative, an investment adviser, a family member or friend, magazines, newspapers, or other publications? If you use more than one of these sources, please list all of the sources that you use.

• What information do you find most useful in evaluating mutual fund risks? What can the SEC do to provide information about the risks of investing in mutual funds that other sources of information do not do?

How well do mutual fund prospectuses describe the risks of investing? The SEC would like to know if you find the way mutual fund prospectuses describe the risks of investing to be helpful.

• Do mutual fund prospectuses give you a good idea of the risks of investing? What do you like about the way mutual funds describe risk in their prospectuses and what would you like funds to do differently?

• Would you like all mutual fund prospectuses to contain a summary of the risks of investing in the fund? If so, what would you like to see in the summary?

• Provide copies of any mutual fund descriptions of risk that you believe are very helpful or unhelpful. Tell the SEC what you like or don't like about the descriptions.

What do you want to know about risk? Risk means different things to different people. The SEC would like to know how you define risk.

• Do you define risk as:

(1) the chance that you will lose part of your investment;

(2) the chance that your investment will earn less than a certain amount, for example, a fixed percentage, such as 5% per year, or the return on a no-risk investment, such as a bank CD or U.S. treasury bill, or the return on a stock or bond index, such as the Standard & Poor's 500 stock index; or

(3) the variability in your fund's return, that is, the month-to-month or year-to-year ups and downs in your fund's share price or its distributions?

Or do you define risk in some other way?

• In choosing a mutual fund, are you most interested in comparing the risks of investing in the fund to the risks of putting your money in:

(1) investments that are not mutual funds, for example, bank CDs or individual stocks and bonds;

(2) other mutual funds of all types;

(3) mutual funds of the same broad type, for example, stock funds or bond funds; or

(4) mutual funds with the same investment objective, for example, short-term bond funds?

• Is your need for information about the risks of investing in mutual funds greater for stock funds or bond funds, or is your need for information about risk the same in both cases? Explain.

Would you like risk to be described with numbers, graphs, or tables? The SEC is looking at a variety of ways that mutual funds could tell investors about risk in addition to, or instead of, descriptions in words. The SEC would like your ideas and suggestions about which of those ways would be most helpful to you.

• Do you find information most helpful when it is in the form of written descriptions, numbers, graphs, tables, charts, pictures, or some other form?

Mutual funds today are required to provide investors with their annual returns for each of the past 10 years. By looking at these returns, investors can get an idea of how variable a fund's returns have been. This variability could be illustrated with a bar graph like the following.

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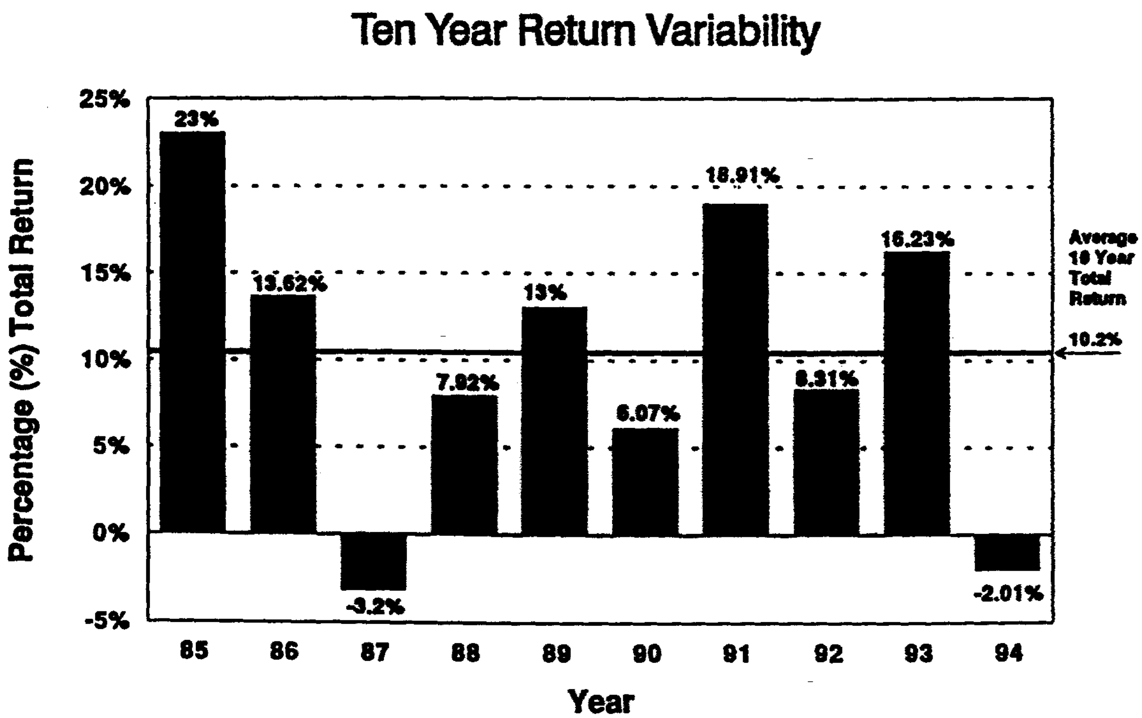

BILLING CODE 8010–01–C

• Would you find a bar graph like the above helpful in understanding the ups and downs in a mutual fund's annual returns? Would it increase your understanding of a fund's risk if the fund also provided you a bar graph of the returns of a market index, such as the Standard & Poor's 500 stock index?

The SEC is looking at the possibility of requiring mutual funds to use numbers to tell investors about the risks of investing. Examples of the numbers that the SEC is considering as required risk measures are:

• Standard Deviation of Total Return. This number measures how variable a fund's total returns have been, that is, how much they have gone up and down. The larger the standard deviation, the more variable a fund's total returns have been.

• Duration. This number measures how sensitive a bond fund's value is to changes in interest rates.

If you have ideas about what risk measurement numbers the SEC should ask mutual funds to give to investors, the SEC would like to hear those ideas.

• Should the SEC require funds to disclose standard deviation or duration or any other specific risk measures? Why or why not?

Should mutual funds rank their risk levels? The SEC is considering whether it would be useful and practical for mutual funds to rank various aspects of risk. For example, bond funds could be required to tell investors whether their exposures to interest rate changes, default risks, and currency fluctuations are low, medium, or high. This could be done in the form of a chart like the following.

RISK SUMMARY

Portfolio	Interest rate risk	Default risk	Currency risk
High-Yield Fund.	Medium	High	Low.
Global Bond Fund.	Medium	Medium	High.
Mortgage-Backed Security Fund.	High	Low	Low.

• Would it be useful for funds to rank various aspects of risk? Do you find the above chart helpful? Do you understand the types of risk referred to in the chart and the significance of those risks?

How to mail your ideas and suggestions to the SEC:

• This form can be mailed to the SEC by folding it in half, with the return address showing. Please staple or tape this form closed. No postage is necessary.

• If you do not wish to use this form, you can write a letter directly to the SEC. Mark your letter ''File No. S7–10–95,'' and send it to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

• Remember to send your ideas and suggestions by July 7, 1995.

Do you want further information about what the SEC is considering?

• If you would like a copy of the complete SEC release that describes what the SEC is considering, write to Office of Consumer Affairs, Securities and Exchange Commission, Attn: Michael Strupp, Mail Stop 2–6, 450 Fifth Street, N.W., Washington, D.C. 20549.

Thank you for responding.

Your Name ____________________

Street Address ____________________

City ____________________

State ____________________

Zip ____________________

[FR Doc. 95–8143 Filed 4–3–95; 8:45 am]

BILLING CODE 8010–10–P