

MEMO# 22001

November 30, 2007

SEC Proposes Enhanced Disclosure And New Delivery Option For Mutual Funds; Two Conference Calls Scheduled

[22001]

November 30, 2007

TO: SEC RULES COMMITTEE No. 91-07
SMALL FUNDS COMMITTEE No. 39-07
OPERATIONS COMMITTEE No. 32-07
ETF ADVISORY COMMITTEE No. 35-07
TECHNOLOGY COMMITTEE No. 30-07 RE: SEC PROPOSES ENHANCED DISCLOSURE AND
NEW DELIVERY OPTION FOR MUTUAL FUNDS; TWO CONFERENCE CALLS SCHEDULED

The Securities and Exchange Commission has proposed amendments to the rules and forms used by mutual funds to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act of 1933. [\[1\]](#) The proposed amendments would require key information to appear in plain English, in a standardized order, at the front of every mutual fund's statutory prospectus, in place of the current risk/return summary. Additionally, the proposed amendments would permit a fund to satisfy its prospectus delivery obligation under Section 5(b)(2) of the Securities Act by providing investors with a summary prospectus containing the same key information, and making additional information, including the statutory prospectus, available on the Internet and in paper upon request. The proposed amendments are summarized below.

Comments on the proposed amendments are due no later than February 28, 2008. We will hold two conference calls to discuss the amendments. The first call will be on Tuesday, December 11 from 2:00 – 4:00 p.m. EST, and will focus on the content and legal aspects of the proposal. The second call will be on Thursday, December 13 from 2:00 – 4:00 p.m. EST, and will focus on cost, operational, and technology issues associated with the proposal. If you plan to participate on either call, please send an email to Pat Dickerson at pdickerson@ici.org. Be sure to identify the call(s) you wish to join. Dial-in information and

agendas will be provided prior to the calls. If you are unable to participate on the calls, you may provide your comments directly to Mara Shreck at 202/326.5923 or mshreck@ici.org.

Background

As explained in the Proposing Release, investor advocates, fund industry representatives and others agree that mutual fund prospectuses are long and complicated, and difficult for investors to use. There is widespread agreement that certain key information should be provided to investors in a streamlined document, with more details provided elsewhere. The current proposal is intended to provide investors with information that is easier to use and more readily accessible, while retaining the comprehensive information that is currently available for those who desire it.

There are two components to the proposal. First, the Commission is proposing amendments to Form N-1A to require that every fund prospectus contain a summary section at the beginning, consisting of specified key information about the fund, including investment objectives and strategies, risks, costs, and performance. Second, the Commission is proposing a new option for funds to satisfy their prospectus delivery obligations. Under this proposed option, a fund would be permitted to send or give investors a document containing only this key information (a “summary prospectus”), provided that the full prospectus (the “statutory prospectus”) and other information is made available on the Internet, and in paper upon request. [\[2\]](#) Each of these components is described more fully below.

Proposed Amendments to Form N-1A

The proposed amendments to Form N-1A would require the statutory prospectus of every mutual fund to include a summary section at the front of the prospectus containing specified key information, presented in plain English, in a prescribed order. As the Proposing Release acknowledges, this concept is similar to the current risk/return summary. The proposal contains modifications to the format, as well as the content and specified order of information included in the front of the prospectus.

Format

The proposed amendments would require the summary information in the front of a statutory prospectus to be presented separately for each fund covered by a multiple fund prospectus; information for multiple funds could not be integrated, as is currently permitted in the risk/return summary. Information for multiple share classes of the same fund, however, could be integrated. The Proposing Release suggests that this information should be presented in three to four pages per fund, but the proposed rules do not impose any specific page limit.

Content

The proposed amendments would require that the summary section of the statutory prospectus contain specified information in a prescribed order, as set forth below. This information is largely drawn from the current risk/return summary, as well as the existing fund profile permitted by Rule 498 under the Securities Act (the “profile”).

Investment objectives and goals: The proposed summary section would begin with a fund’s investment objectives or goals, exactly as currently contained in a fund’s risk/return

summary.

Costs (fee table): The second item in the proposed summary section would be a fee table and example. These would be similar to the current fee table, with several modifications in addition to its new location. First, mutual funds that offer discounts on front-end sales charges for volume purchases (breakpoint discounts) would be required to include a brief narrative disclosure alerting investors to the availability of these discounts. Second, the parenthetical following the heading “Annual Fund Operating Expenses” would be revised. Instead of “expenses that are deducted from fund assets,” it would read “ongoing expenses that you pay each year as a percentage of the value of your investment.” Third, funds other than money market funds would be required to include, immediately following the fee table example, their portfolio turnover rate for the most recent fiscal year, as a percentage of the average value of the portfolio, accompanied by a brief explanation of the effect of portfolio turnover on transaction costs and fund performance.

Finally, the amendments would modify the requirement that a fund disclose gross operating expenses that do not reflect the effect of expense reimbursement or fee waiver arrangements. Under the proposal, if the fund has an arrangement that reduces its operating expenses, and that will continue to reduce them for no less than one year from the effective date of the fund’s registration statement, the fund would be permitted to place two additional captions below the “Total Annual Fund Operating Expenses” caption. One caption would show the amount of the reimbursement or waiver, and the second would show the fund’s total expenses net of the reimbursement or waiver. Funds disclosing these arrangements would also be required to disclose the period for which the reimbursement or waiver arrangement is expected to continue, and briefly describe the circumstances under which such arrangements could be terminated. These arrangements could also be reflected in the fee table example, but only for periods for which the arrangement is expected to continue.

Investments, risks, and performance: The next item in the proposed summary section would be principal investment strategies and risks. The required disclosure would be the same as that currently required in the risk/return summary, including the risk/return bar chart and table illustrating the variability of returns and past performance.

Portfolio holdings: The proposed summary section would next include a list of the 10 largest issues contained in the fund’s portfolio, in descending order, with the percentage of net assets represented by each, as of the end of the most recent calendar quarter. [\[3\]](#)

Management: The next item would be the name of each investment adviser and sub-adviser of the fund, followed by the name, title, and length of service of each of the fund’s portfolio managers, similar to the requirements in the profile as well as Item 5 of Form N-1A. As in the profile, certain limitations would apply to this disclosure. [\[4\]](#)

Purchase and sale of fund shares: The proposed summary section would state the fund’s minimum initial and subsequent investment requirements and that the fund’s shares are redeemable, and identify the procedures for redeeming shares. This disclosure is similar to the required disclosure in the profile, except that disclosures that would be provided in the fee table (sales loads, breakpoints, and charges upon redemption) would not be included in this section.

Tax information: Next, the summary section would be required to state, as applicable, that the fund intends to make distributions that may be taxed as ordinary income or capital

gains, or that the fund intends to distribute tax-exempt income. A fund holding itself out as investing in securities generating tax-exempt income would be required to provide, as applicable, a general statement that a portion of the fund's distributions may be subject to federal income tax. This item is a streamlined version of the required tax disclosure in the profile.

Financial Intermediary Compensation: Finally, the summary section would be required to include the following – or similar – statement:

Payments to Broker-Dealers and Other Financial Intermediaries: If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may influence the broker-dealer or other intermediary and your sales person to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information.

Other Amendments to Form N-1A

As proposed, the amendments would eliminate the existing provisions in Form N-1A that permit a fund to omit detailed information about purchase and redemption procedures from the statutory prospectus and provide this information in a separate document that is incorporated into and delivered with the statutory prospectus. [\[5\]](#) A similar provision in the requirements for the SAI would also be eliminated.

Request for Comment

The Proposing Release requests comment on numerous issues relating to the proposed amendments to Form N-1A, including:

- Is it helpful to have a separate summary section in a statutory prospectus?
- Are the requirements with respect to multiple fund and multiple class prospectuses appropriate (i.e., permitting multiple fund prospectuses but requiring that each fund be addressed separately in the summary section)? Should more flexibility be permitted? If so, how can this be done consistent with the goal of achieving concise, readable summaries?
- Should the Commission impose any formatting requirements on the summary section of the statutory prospectus, such as page limitations, required fonts, or layouts?
- Are each of the requirements for the content and order of information appropriate? Are the revisions to the fee table appropriate? Should additional information be included?
- Is it appropriate to prohibit a fund from including information in the summary section that is not required?
- Should the optional separate purchase and redemption document be eliminated or otherwise modified?

New Delivery Option for Mutual Funds

The Commission is proposing to replace Rule 498, the voluntary profile rule, with a new rule that would permit a fund to satisfy its prospectus delivery obligation under Section 5(b)(2) of the Securities Act by providing a summary prospectus to investors, and making additional information, including the statutory prospectus, available on the Internet and in

paper upon request. The proposed new Rule 498 specifies the criteria for satisfying statutory prospectus delivery requirements, the content of the summary prospectus, updating requirements for the summary prospectus, and requirements for the provision of additional information on the Internet.

Use of the Summary Prospectus to Satisfy Statutory Prospectus Delivery Requirements

The proposed new rule would provide that any obligation under Section 5(b)(2) of the Securities Act to have a statutory prospectus precede or accompany the carrying or delivery of a mutual fund security (in an offering registered on Form N-1A) would be satisfied if: 1) a summary prospectus is provided no later than the time of the carrying or delivery of the fund security; [\[6\]](#) and, if any other materials accompany the summary prospectus, the summary prospectus is given greater prominence than those materials and is not bound together with them; 2) the summary prospectus that is provided satisfies the rule's requirements; and 3) the conditions set forth in the rule requiring the statutory prospectus and other information to be provided on the Internet are satisfied.

The proposed rule would also require a fund to send a paper or email copy of the statutory prospectus or other information upon request. This requirement is not a condition to reliance on the rule, however. Thus, failure to send the statutory prospectus would not be a violation of Section 5(b)(2), but would be a violation of the rule.

The proposed rule also contains a provision that is similar to Section 2(a)(10)(a) of the Securities Act, which excludes from the definition of prospectus communications that accompany or are preceded by a statutory prospectus. Under the proposed rule, a communication relating to an offering registered on Form N-1A provided after the effective date of the fund's registration statement (other than a prospectus permitted or required under Section 10 of the Securities Act) would not be deemed a prospectus if a summary prospectus were provided prior to or at the same time as such communication and the conditions of the rule relating to the provision of additional information are satisfied. As noted above, if such communications are provided at the same time as a summary prospectus, the summary prospectus must be given greater prominence and not bound together with the other communications. As a result of this provision, such communications would not be subject to liability under Section 12(a)(2) of the Securities Act. [\[7\]](#)

Content of the Summary Prospectus[\[8\]](#)

The proposal would require the summary prospectus to include the same information as the summary section of the statutory prospectus described above, in the same order. Like the summary section, a summary prospectus would be permitted to describe only a single fund, but could describe multiple share classes of the fund. The summary prospectus would not be permitted to omit any of the required information or to include additional information, except that it would be required to contain certain information on a cover page or at the beginning of the summary prospectus.

As proposed, the first page of a summary prospectus would include: the fund's name and the share classes to which the summary prospectus relates; a statement identifying the document as a "summary prospectus"; and the approximate date of the summary prospectus's first use. It would also be required to include a prescribed legend informing the reader that additional information is available online or by making a request by email or by telephone. [\[9\]](#) The legend would be required to include an Internet address, toll-free or collect telephone number, and email address that investors can use to obtain the statutory

prospectus and other information. [\[10\]](#) The Internet address at which the information is available could not be the Commission's EDGAR system, and the address would be required to be specific enough to lead investors directly to the statutory prospectus and other required information, rather than to a home page or other section of a Web site on which the materials are posted. The Web site could be a central site with prominent links to each required document.

Updating Requirements

Similar to the existing profile rule, the new rule would require that average annual total returns and yield be provided as of the end of the most recent calendar quarter prior to the summary prospectus's first use, and updated at the end of each succeeding calendar quarter, not later than one month after the completion of the quarter.

The proposed rule would also require the top 10 portfolio holdings information to be provided as of the end of the most recent calendar quarter prior to the summary prospectus's first use, or the immediately prior calendar quarter if the most recent calendar quarter ended less than one month prior to the summary prospectus's first use. The portfolio holdings information would be required to be updated on the same schedule as the performance information. [\[11\]](#) Information could be updated by affixing a label or sticker, or by other reasonable means.

The proposal does not require performance and portfolio holdings information to be updated on a quarterly basis for the statutory prospectus. The rule would provide that the failure to include in the statutory prospectus or registration statement the quarterly updated information would not, solely by virtue of its inclusion in a summary prospectus, be considered an omission of material information required to be included in the statutory prospectus or registration statement.

Notwithstanding the quarterly updating requirements, the rule would provide that, for purposes of satisfying a fund's delivery obligations, a summary prospectus that satisfies the requirements of the rule at the time it is provided shall be deemed to continue to satisfy them until the earlier of the date on which 1) the information in the summary prospectus is required to be updated for purposes other than the required quarterly update, or 2) the fund is required to file an annual updating amendment to its registration statement to update its statutory prospectus. The Proposing Release notes that today, many funds send an updated statutory prospectus to existing shareholders once a year to meet their prospectus delivery obligations for those shareholders who purchase additional shares during the year. This provision would allow such funds to send instead an updated summary prospectus to shareholders once each year.

Provision of the Statutory Prospectus, SAI and Shareholder Reports

To rely on the proposed new rule to satisfy prospectus delivery requirements under the Securities Act, a fund must meet certain conditions with respect to the availability of additional information.

Availability of Information on the Internet

As proposed, the summary prospectus, statutory prospectus, SAI, and most recent annual and semi-annual reports to shareholders must be accessible, free of charge, at the Internet address specified on the cover page or at the beginning of the summary prospectus. The documents must be accessible on or before the time that the summary prospectus is

provided. To satisfy the requirement that a statutory prospectus precede or accompany the carrying or delivery of a mutual fund security, the summary prospectus must remain available for at least 90 days after the security is delivered. To rely upon the proposed rule to deem a communication not a prospectus under Section 2(a)(10) of the Securities Act, the summary prospectus must remain available for at least 90 days after the communication is sent or given.

The proposal would require information made available on the Internet to be presented in a format that: 1) is convenient for both reading online and printing in paper; 2) permits a person accessing the statutory prospectus or SAI to move directly back and forth between the table of contents of the document and the sections of the document that are referenced in the table of contents; and 3) permits a person accessing the summary prospectus to move directly back and forth between each section of the summary prospectus and a) any section of the statutory prospectus or SAI that provides additional detail concerning information provided in the summary prospectus, or b) the tables of contents in the statutory prospectus and SAI that prominently display the sections within those documents providing additional detail about information contained in the summary prospectus. [\[12\]](#)

The proposed rule would further require that a person accessing the Web site be able to permanently retain, free of charge, an electronic version of each of the documents made available, in a format that is convenient for both reading online and printing on paper. The retained versions of the statutory prospectus and SAI must also permit a reader to move back and forth between a table of contents and each section of the same document referenced in the table of contents.

Compliance with these conditions would be required in order to meet the prospectus delivery obligations of Section 5(b)(2) of the Securities Act. The Commission recognizes, however, that occasionally a fund may be out of compliance with these requirements despite its best efforts, due to system outages or other technological issues. The proposed rule contains a safe harbor provision stating that the conditions regarding Internet availability of the required materials would be deemed to be met, notwithstanding that they are unavailable for a time in the manner required, provided that 1) the fund has reasonable procedures in place to ensure that the materials are available in the required manner, and 2) in the event of a problem, the fund takes prompt action to ensure that the materials become available as soon as practicable following the time at which the fund knows or reasonably should have known that the materials are not available.

Provision of Information in Paper and by Email

The proposed rule would also require that a fund (or financial intermediary through which the fund may be purchased or sold) send, by U.S. first class mail or other reasonably prompt means, a paper copy of the fund's statutory prospectus, SAI, and most recent annual and semi-annual shareholder report to any person requesting such a copy, at no cost to such person, within three business days after receiving the request. The fund or financial intermediary would also be required to send an electronic copy of any such material by email, within three days of receiving a request for an electronic copy.

Incorporation by Reference

The proposed rule would permit the summary prospectus to incorporate by reference information contained in the fund's statutory prospectus, SAI, and the most recent shareholder report. The rule would provide that information incorporated by reference into a summary prospectus would be deemed to be conveyed to a person not later than the

time the person receives the summary prospectus, for purposes of Sections 12(a)(2) and 17(a)(2) of the Securities Act.

The following conditions apply to incorporation by reference. First, information must be incorporated only by reference to the specific document in which it is contained, and not by reference to another document that incorporates the information by reference. Second, incorporation by reference is only permitted if a fund satisfies the conditions described above regarding the provision of the incorporated information to investors upon request. Third, a legend in the summary prospectus would need to identify clearly the document from which the information is incorporated, including the date of the document, and explain how that information may be obtained.

Filing Requirements for the Summary Prospectus

The proposed rule would require that each summary prospectus be filed with the Commission on EDGAR no later than the fifth business day after the date that it is first used. The summary prospectus would be filed as part of the registration statement, but would not be deemed a part of the registration statement for purposes of Section 11 of the Securities Act.

Request for Comment

The Proposing Release requests comment on numerous issues relating to proposed new Rule 498, including:

- Should funds be permitted to meet their prospectus delivery obligations in this way?
- Should investors have the ability to opt out of the rule permanently and thereafter receive a paper copy of any statutory prospectus? How could a permanent opt-out provision be implemented?
- Should the summary prospectus be required to be given greater prominence than other materials accompanying it, and not bound together with them? Are any clarifications of these requirements needed?
- Should the summary prospectus be required to contain the same information as the summary section of the statutory prospectus, in the same order?
- Should the number of funds or share classes that may be included in a summary prospectus be restricted? Are there groups of funds that should be permitted to be included in a single summary prospectus even if multiple fund summary prospectuses are generally prohibited?
- Should page limits be imposed on summary prospectuses?
- Should the performance and portfolio holdings information be required to be updated quarterly? What concerns or burdens would this involve? Would semi-annual or only annual updating be more appropriate?
- Should the rule require funds to provide quarterly updated performance and portfolio holdings information on the Internet and/or via a toll-free number instead of updating the summary prospectus quarterly?
- If quarterly updating is required, should there be additional safe harbors or a cure provision in cases where a summary prospectus that lacks the required quarterly update has been inadvertently distributed?
- Are the requirements for Internet and paper availability of the required information reasonable and practical?
- Is the requirement that a user be able to permanently retain a copy of the required information appropriate? Is it reasonable to require that a saved version retain

internal links? Would it be feasible to require that the saved version also retain links to other documents?

- Is the safe harbor provision for inadvertent technological outages sufficient? Should funds having technological problems be required to disclose on the Web site that the information was not available for a period of time, and explain the reason for the failure? Should funds that are not able to comply for a certain period, perhaps a week or more, or that experience repeated outages, be required to notify the Commission and/or investors?

Compliance Date and Transition Period

According to the Proposing Release, if the proposed amendments to Form N-1A are adopted, the Commission expects to provide a transition period after the effective date to give funds sufficient time to prepare their registration statements. All initial registration statements on Form N-1A and all post-effective amendments that are annual updates to effective registration statements on Form N-1A filed six months or more after the effective date would be required to comply with the proposed amendments to Form N-1A. A fund would not be permitted to rely on the new Rule 498 to satisfy its delivery obligations unless the fund was also in compliance with the amendments to Form N-1A.

Mara Shreck
Assistant Counsel

endnotes

[1] See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Release Nos. 33-8861 and IC-28064 (Nov. 21, 2007) ("Proposing Release"), available at <http://www.sec.gov/rules/proposed/2007/33-8861.pdf>.

[2] A summary prospectus meeting the requirements of the rule would be deemed a prospectus authorized under Section 10(b) of the Securities Act and Section 24(g) of the Investment Company Act of 1940.

[3] The proposal includes a provision similar to the exclusion in the current requirements for quarterly disclosure of a fund's complete portfolio holdings, pursuant to which a fund may, in certain circumstances, list an amount not exceeding five percent of the total value of portfolio holdings as "miscellaneous securities," to guard against the premature release of positions that could lead to front-running or other predatory trading practices.

[4] In particular, a fund would generally not be required to identify a sub-adviser whose sole responsibility is day-to-day management of the fund's cash instruments, and a fund with three or more sub-advisers would not be required to identify each sub-adviser, but only those advisers responsible for the management of a significant portion of the fund's net assets (generally 30% or more).

[5] The Proposing Release indicates that this option is infrequently used, and that it seems unnecessary because under the proposed amendments, a fund could provide a summary prospectus, along with any additional sales materials, including a document describing purchase and redemption procedures. See *infra*.

[6] A fund may rely on existing Commission guidance, which typically requires affirmative consent, to provide the summary prospectus by electronic means.

[7] The communications would, however, be subject to the general antifraud provisions of the federal securities laws – Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934, and Section 34(b) of the Investment Company Act.

[8] A sample summary prospectus is available at <http://www.sec.gov/investor/hypotheticalprospectus.pdf>.

[9] Where applicable, the legend could also include a statement that the summary prospectus is intended for use in connection with a defined contribution plan that meets the requirements of certain provisions of the Internal Revenue Code, and is not intended for use by other investors.

[10] The legend would also be permitted to indicate that this information is available from a financial intermediary through which shares of the fund may be purchased or sold.

[11] The one-month lag is intended to eliminate potential predatory trading practices such as “front-running.”

[12] The Proposing Release explains that this is intended to allow an investor to move between related sections of the summary prospectus, statutory prospectus, and SAI with a maximum of two mouse clicks.