

**MEMO# 16879**

December 15, 2003

# **SEC PROPOSES DISCLOSURE REQUIREMENTS RELATING TO MARKET TIMING, FAIR VALUE PRICING, AND SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS**

[16879] December 15, 2003 TO: COMPLIANCE ADVISORY COMMITTEE No. 110-03 SEC RULES COMMITTEE No. 103-03 SMALL FUNDS COMMITTEE No. 34-03 RE: SEC PROPOSES DISCLOSURE REQUIREMENTS RELATING TO MARKET TIMING, FAIR VALUE PRICING, AND SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS The Securities and Exchange Commission has proposed amendments to Form N-1A under the Investment Company Act of 1940 that would require each mutual fund to disclose: (1) the risks to shareholders from the frequent purchase and redemption of the fund's shares, and the fund's policies and procedures with respect to such frequent purchases and redemptions; (2) the circumstances under which the fund will use fair value pricing and the effects of such use; and (3) the fund's policies and procedures regarding disclosure of its portfolio securities, as well as any ongoing arrangements providing for such disclosure.<sup>1</sup> The proposed requirements are summarized below. Comments on the proposal must be filed with the SEC by Friday, February 6, 2004. The Institute will hold a conference call on Monday, Dec. 22nd at 3:00 p.m. EST to discuss the proposed amendments. The dial-in number for the call is 888-769-8515, and the pass code is 58622. If you plan to participate in the call, please send an e-mail to Monica Carter-Johnson at [mcarter@ici.org](mailto:mcarter@ici.org). If you are unable to participate in the call, please provide your comments before the call, if possible, to Rachel Graham by phone (202-326-5819), fax (202-326-5827) or e-mail ([rgraham@ici.org](mailto:rgraham@ici.org)).

**I. FREQUENT PURCHASE AND REDEMPTION OF FUND SHARES** Proposed Item 7(e) of Form N-1A would require a mutual fund to disclose in its prospectus: (1) the risks, if any, that frequent purchases and redemptions of fund shares by fund shareholders may present for other shareholders of the fund;<sup>2</sup> and (2) whether or not the

<sup>1</sup> See SEC Release Nos. 33-8343, IC-26287 (Dec. 11, 2003) (the "Release"). A copy of the Release is available on the SEC's website at <http://www.sec.gov/rules/proposed/33-8343.htm>.

<sup>2</sup> The Release states that these risks may include, among other things: (1) dilution in the value of fund shares held by long-term shareholders; (2) interference with the efficient management of the fund's portfolio; and (3) increased brokerage and administrative costs. The Release emphasizes that the disclosure should be specific to the fund, taking into account the fund's investment objectives, policies, and strategies.

<sup>3</sup> fund's board of directors has adopted policies and procedures with respect to such frequent purchases and redemptions. The prospectus would have to describe any such policies and procedures, including: • whether or not the

fund discourages frequent purchases and redemptions of its shares; • whether or not the fund accommodates such purchases and redemptions; • a specific discussion of any policies and procedures for deterring frequent purchases and redemptions of the fund's shares, including: (1) any restrictions that the fund imposes to prevent such purchases and redemptions;<sup>4</sup> (2) a statement as to whether each such restriction applies uniformly in all cases, and (3) a specific description of the circumstances, if any, under which any such restriction will not be imposed;<sup>5</sup> and • any policies and procedures for detecting frequent purchases and redemptions of the fund's shares, including any arrangements for detecting such activity through intermediaries, such as investment advisers, broker-dealers, transfer agents, and third party administrators. Proposed Item 7(e) also would require prospectus disclosure of any arrangement that the fund has with any person to permit frequent purchases and redemptions of its shares, including: (1) the identity of such person; and (2) any compensation or other consideration received by the fund, its investment adviser, or any other party pursuant to such arrangement.<sup>6</sup> The Release notes that any such arrangement must be consistent with the antifraud provisions of the federal securities laws and with the fiduciary duties of the fund and its adviser to fund shareholders. The SEC requests comment on, among other things: (1) whether the prospectus is the appropriate location for each of the proposed disclosures, or whether all or part of the disclosure would be more 3 If the fund's board of directors has not adopted such policies and procedures, the fund would be required to state in its prospectus the specific basis for the board's view that it is appropriate for the fund not to have such policies and procedures. 4 The prospectus would have to describe the following restrictions, if applicable: (1) restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period; (2) any exchange fee or redemption fee; (3) any costs or administrative or other fees or charges that are imposed on shareholders deemed to be engaged in frequent purchases and redemptions of fund shares, together with a description of the circumstances under which such costs, fees, or charges will be imposed; (4) any minimum holding period that is imposed before an investor may make exchanges into another fund; (5) any restrictions imposed on exchange or purchase requests submitted by overnight delivery, electronically, or via facsimile or telephone; and (6) any right of the fund to reject, limit, delay, or impose other conditions on exchanges or purchases or to terminate or otherwise limit accounts based on a history of frequent purchases and redemptions of fund shares, including the circumstances under which such right will be exercised. 5 The Release notes that a fund would not be required to repeat this disclosure to the extent that it is provided in the fund's prospectus in response to other Items of Form N-1A, including Item 3 (redemption and exchange fees), Item 7(c) (restrictions on redemptions and redemption charges), and Item 8(a)(2) (exchange privileges). 6 An instruction to proposed Item 7(e) would clarify that such consideration includes any agreement to maintain assets in the fund or in other investment companies or accounts managed by the adviser or its affiliate. 3 appropriately located in the SAI, shareholder reports, Form N-CSR, the fund's website, or another location; (2) whether exchange-traded funds, which do not sell or redeem their individual shares at net asset value, should be expressly excluded from the proposed disclosure requirements; and (3) whether the SEC should modify related disclosure items in Form N-1A or alter the proposed requirements to ensure better coordination among the various disclosures. II. DISCLOSURES RELATING TO FAIR VALUE PRICING Item 7(a)(1) of Form N-1A requires a mutual fund to describe in its prospectus the procedures for pricing the fund's shares, including the method used to value fund shares (market price, fair value, or amortized cost). The proposal would amend the instruction to Item 7(a)(1) to require that a mutual fund provide a brief explanation of: (1) the circumstances under which the fund will use fair value pricing; and (2) the effects of using fair value pricing.<sup>7</sup> The Release notes that the proposed disclosure should be specific

to the fund. According to the Release, the SEC proposed this amendment to “clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable).” The Release states that fair valuation of a fund’s portfolio securities can serve to foreclose arbitrage opportunities available to market timers. The proposed disclosure would not apply to money market funds, which the Release notes are subject to the pricing requirements of Rule 2a-7 under the Investment Company Act. The SEC requests comment on, among other things: (1) whether the proposed disclosure is necessary in light of the fact that all funds are required to use fair value pricing if market quotations for a portfolio security are not readily available (including when they are not reliable); (2) whether money market funds or any other types of funds should be excluded from the proposed disclosure requirement; (3) whether the prospectus is the appropriate location for the proposed disclosure, or whether the SAI would provide investors with adequate access to the information; (4) whether other locations (e.g., shareholder reports, Form N-CSR, or the fund’s website) would be more appropriate for the proposed disclosure; and (5) whether there are cases in which the proposed disclosure would assist market timers and, if so, how the proposal should be modified to address those cases.

III. DISCLOSURE OF PORTFOLIO HOLDINGS Proposed Item 12 of Form N-1A would require a mutual fund to describe in its SAI the fund’s policies and procedures (including any policies and procedures of the fund’s adviser, or any other third party, that the fund uses or that are used on the fund’s behalf) with respect to disclosure of the fund’s portfolio securities to any person. The description would have to include the following:

7 The current instruction states: “If a fund has a policy that contemplates using fair value pricing under special circumstances (e.g., when an event occurs after the close of the exchange on which the fund’s portfolio securities are principally traded that is likely to have changed the value of the securities), provide a brief explanation of the circumstances and the effects of this policy. If the fund’s policy is to use fair value pricing only when market prices are unavailable, it need not explain the circumstances and the effects of the policy.”

4 • how the policies and procedures apply to disclosure to different categories of persons, including individual investors, institutional investors, intermediaries that distribute the fund’s shares, third-party service providers, rating and ranking organizations, and affiliated persons of the fund; • any conditions or restrictions placed on the use of disclosed information, including any requirement that the information be kept confidential or any prohibition on trading based on the information, and any procedures to monitor the use of the information; • the frequency with which information about portfolio securities is disclosed, and the lag, if any, between the date of the information and the date on which it is disclosed; • any policies and procedures with respect to the receipt of compensation or other consideration by the fund, its investment adviser, or any other party in connection with the disclosure of information about portfolio securities; • the persons who may authorize disclosure of the fund’s portfolio securities; • the procedures that the fund uses to ensure that disclosure of information about portfolio securities is in the best interests of fund shareholders, including procedures to address conflicts between the interests of fund shareholders, on the one hand, and the interests of the fund’s adviser, principal underwriter, or any affiliate of the fund or its adviser or principal underwriter, on the other; and • the manner in which the fund’s board of directors exercises oversight of disclosure of the fund’s portfolio securities. A mutual fund also would have to describe in its SAI any ongoing arrangements to make available information about the fund’s portfolio securities to any person, including: • the identity of the persons who receive information pursuant to such arrangements; • any compensation or other consideration received by the fund, its adviser, or any other party in connection with such arrangements;

8 • any conditions or restrictions placed on the use of disclosed information, including any requirement that the information be kept confidential or any prohibition on trading based on the information, and

any procedures to monitor the use of the information; • the frequency with which information about portfolio securities is disclosed, and the lag, if any, between the date of the information and the date on which it is disclosed; and 8 An instruction to proposed Item 12 would clarify that such consideration includes any agreement to maintain assets in the fund or in other investment companies or accounts managed by the adviser or its affiliate. The Release notes that disclosing portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so and that legitimate business purposes generally would not include the receipt of consideration by the fund's adviser or its affiliates. 5 • the persons who may authorize disclosure of the fund's portfolio securities. The Release emphasizes that a mutual fund or adviser that discloses the fund's portfolio securities may only do so consistent with the antifraud provisions of the federal securities laws and its fiduciary duties to fund shareholders. According to the Release, disclosure of portfolio holdings information to selected third parties is permissible only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality. The Release offers examples of instances in which selective disclosure may be appropriate, subject to confidentiality agreements and trading restrictions.<sup>9</sup> A mutual fund would be required to state in its prospectus that a description of the fund's policies and procedures with respect to the disclosure of its portfolio securities is available in the fund's SAI and, if applicable, on the fund's website. The SEC requests comment on, among other things: (1) whether there are types of ongoing arrangements that should be excluded from the proposed disclosure requirements (e.g., arrangements where the disclosed information is subject to a confidentiality requirement or there are prohibitions on trading based on the information); (2) the appropriate location for the proposed disclosure (e.g., prospectus, SAI, Form N-CSR, Form 8-K, shareholder reports, website); (3) whether, in addition to ongoing arrangements, mutual funds should be required to disclose all instances of selective disclosure of portfolio securities (including, for example, whether a fund should have to disclose whether its board of directors approved each instance of selective disclosure); and (4) whether Regulation FD should apply to mutual funds with respect to their disclosure of portfolio holdings or other information. Rachel H. Graham Assistant Counsel 9 Those examples are: (1) disclosure for due diligence purposes to an investment adviser that is in merger or acquisition talks with the fund's current adviser; (2) disclosure to a newly hired adviser or subadviser prior to commencing its duties; or (3) disclosure to a rating agency for use in developing a rating.