

**MEMO# 16986**

January 16, 2004

# **DRAFT INSTITUTE COMMENT LETTER ON DISCLOSURE PROPOSAL ON MARKET TIMING, FAIR VALUE PRICING, AND PORTFOLIO HOLDINGS**

[16986] January 16, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 6-04 SEC RULES COMMITTEE No. 7-04 SMALL FUNDS COMMITTEE No. 5-04 RE: DRAFT INSTITUTE COMMENT LETTER ON DISCLOSURE PROPOSAL ON MARKET TIMING, FAIR VALUE PRICING, AND PORTFOLIO HOLDINGS As we previously advised you, the Securities and Exchange Commission has proposed for comment 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> Attached is a draft of the Institute's comment letter on the proposal. The draft letter expresses support for the proposal but recommends several refinements, which are summarized below. Comments on the proposal must be filed with the SEC by Friday, February 6th. Please provide comments on the draft letter to the undersigned no later than Wednesday, January 28th by phone (202-326-5819), fax (202-326-5827), or e-mail (rgraham@ici.org). Specificity of Market Timing Disclosures. Under the proposal, a fund would have to describe, with specificity, its policies and procedures for deterring frequent purchases and redemptions of fund shares. The draft letter expresses concern that too much specificity could provide a "roadmap" to timers and asks the SEC to confirm that funds do not have to disclose in detail the precise ways in which they seek to deter timing activity. Discretion to Impose Greater Restrictions on Suspected Timers. Under the proposal, a fund must disclose any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period. The draft letter states that 1 See Institute Memorandum to Compliance Advisory Committee No. 110-03, SEC Rules Committee No. 103-03, and Small Funds Committee No. 34-03 [16879], dated December 15, 2003 relating to SEC Release Nos. 33-8343, IC-26287 (Dec. 11, 2003), which release is available on the SEC's website at <http://www.sec.gov/rules/proposed/33-8343.htm>. no set of policies and procedures to deter market timing is foolproof and recommends that funds be able to retain limited discretion to impose greater restrictions on suspected timers than those in its stated policies, but only if there is board oversight. Explaining Use and Effects of Fair Value Pricing. Under the proposal, a fund would have to explain briefly in its prospectus the circumstances in which it will use fair value pricing and the effects of such pricing. The

draft letter states that funds cannot anticipate every circumstance that may require them to fair value portfolio securities and that too much specificity could help arbitrageurs to take unfair advantage of the fund. It seeks clarification that funds should discuss generally the types of situations in which they may be likely to use fair value pricing. The draft letter also recommends that the SEC revise the proposed disclosure requirement to require discussion of the objectives, rather than the effects, of using fair value pricing.

**Disclosure of Portfolio Holdings to Service Providers.** Under the proposal, a fund would be required to describe how its policies and procedures with respect to disclosure of portfolio securities apply to different categories of persons, including third-party service providers and affiliated persons of the fund. The draft letter seeks clarification that funds may discuss briefly, in general terms, how their policies and procedures apply to disclosures of portfolio holdings information to service providers.

**Identifying Persons Authorizing or Receiving Disclosure of Portfolio Holdings.** Under the proposal, a fund would have to identify: (1) any person who may authorize disclosure of its portfolio securities; and (2) any person who receives such information pursuant to an ongoing arrangement. The draft letter seeks clarification that funds may identify such persons by category rather than by name.

**Applying Regulation Fair Disclosure to Mutual Funds.** The proposing release requests comment on whether the SEC should apply Regulation FD to mutual funds with respect to their disclosure of portfolio holdings or other information. The draft letter asserts that applying Regulation FD in this manner could harm a fund's long-term shareholders. It states that the better approach is to require funds to have systems to prevent disclosure, in the first instance, of portfolio holdings information that is not in the best interests of fund shareholders. The draft letter expresses the Institute's view that this proposal, together with new Rule 38a-1 under the Investment Company Act of 1940, would achieve that goal.

**Compliance Date.** Under the proposal, funds would have to comply with the proposed disclosure requirements in registration statements and post-effective amendments filed on or after the effective date of the requirements. The draft letter asks that the proposal be modified to require compliance in filings made on or after November 5, 2004, which is one month following the compliance date for new Rule 38a-1. It states that this would give funds sufficient time to obtain board approval for their policies and procedures, as required by Rule 38a-1, and file registration statements that contain disclosures based on those policies and procedures.

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