The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC ISSUES MAJOR DISCLOSURE INITIATIVES

1 Investment Company Act Release No. 22528 (February 27, 1997). March 3, 1997 TO: SEC RULES COMMITTEE No. 24-97 RE: SEC ISSUES MAJOR DISCLOSURE INITIATIVES _____ The Securities and Exchange Commission has issued three releases proposing significant changes to the disclosure requirements applicable to mutual funds. The proposals would (1) substantially revise Form N-1A, the registration form for mutual funds, (2) allow funds to use a simplified "fund profile," which would provide investors with the option of purchasing shares or requesting the full prospectus, and (3) revise the "name test" currently applicable only to mutual funds by requiring any investment company whose name suggests that it focuses on a particular type of investment to have a fundamental policy requiring it to invest at least 80% of its assets accordingly. Comments on all three proposals are due 90 days after publication in the Federal Register. Summaries of each of the proposals are set forth below. Copies of the proposals are attached. A meeting has been scheduled for Tuesday, April 1, 1997 at 10:00 a.m. at the Institutes offices to discuss the proposals. Please contact Melissa Magruder at 202/326-5823 by Monday, March 24 to let her know if you will be attending the meeting. If you can not attend the meeting please provide any comments by March 30, 1997 to Dorothy Donohue by phone at 202/326-5821 or e-mail at donohue@ici.org or Amy Lancellotta by phone at 202/326-5824 or by e-mail at amy@ici.org. You can reach either of us by fax at 202/326-5827. I. FORM N-1A AMENDMENTS Under the proposed amendments to Form N-1A,1 the current two part disclosure format (i.e., the prospectus and the Statement of Additional Information or "SAI") would be retained. The SAI could continue to be incorporated by reference into the prospectus. The Commission has proposed, however, a series of changes intended to focus the prospectus on essential information about the fund. The Institute is pleased to report that as part of these sweeping changes, the Commission is not proposing to require funds to use quantitative risk measures. 2A. Part A - Information In The Prospectus 1. Front and Back Cover Pages The front cover page of a funds prospectus would be required to include the funds name and a simplified disclaimer stating that the Commission has not approved these securities or the prospectus. (The disclaimer would no longer be required to appear in large capital letters and in bold-faced type). The back cover page would include disclosure about the availability and date of the SAI, including a telephone number that investors could use to obtain the SAI. To ensure prompt delivery of the SAI, the proposal would require funds to send the SAI within three days of the receipt of a request. The back cover page also would be required to include disclosure regarding incorporation by reference (if applicable) and about how a shareholder can make inquiries about the fund. 2. Risk/Return Summary The proposals would require a new risk/return summary at the beginning of all

fund prospectuses. The summary would be required to be set forth in a standardized, question-and- answer format and would cover disclosure about the funds investments, risks, performance and fees. First, the fund would be required to disclose its investment objectives and its principal investment strategies. This would include disclosure of the availability of additional information about the funds investments in its shareholder reports. (Reports would be required to be sent to investors within three business days of a request.) Second, the fund would be required to summarize the principal risks of investing in the fund. The disclosure would focus on risks to which the funds portfolio as a whole is subject, rather than the risks of individual securities. This narrative disclosure also would (1) include general information about the risk of losing money, (2) identify the types of investors for whom the fund may be an appropriate or inappropriate investment and (3) include certain special risk disclosures applicable to money market funds, single state money market funds and funds advised by or sold through banks. Third, funds would be required to include a bar chart showing the funds annual returns for each of the last ten calendar years and a table showing the funds average annual returns for the last one, five and ten fiscal years, along with those of a broad-based securities market index. (Funds would be permitted but not required to include returns of more than one index or of a peer group of comparable funds.) The bar chart would not reflect sales loads; however, disclosure of this fact would be required. The bar chart could show returns for more than one fund. In the case of multiple class funds, the chart would show the returns of the class that has had returns for the longest period over the last ten years. If more than one class had returns for at least ten years, or for the same period, the chart would reflect the returns of the class with the greatest net assets. Fourth, funds would have to include the fee table. The fee table would be revised in several respects, including (1) changing the amount used in the example from $1,000 to $10,000, (2) adding a new line item for shareholder account fees, (3) simplifying the narrative disclosure, 3(4) changing the captions of certain line items and (5) prohibiting disclosure of the range of possible deferred sales loads to be made in a tabular format. If the Commissions recently proposed "Plain English" initiative is adopted, the Commission intends to make clear that the plain English disclosure principles apply to the risk/return summary. 3. Information Moved from the Prospectus to the SAI The proposed amendments would move certain disclosure about legal, technical, and operational matters from the prospectus to the SAI. Information moved from the prospectus to the SAI would include disclosure about a funds legal status as an open-end investment company, a funds policies regarding borrowing money and issuing securities, information about a funds board of directors, controlling persons, affiliated brokers, a funds form of organization and state of incorporation (except in the case of funds organized outside the United States), a funds qualification under Subchapter M of the Internal Revenue Code, how performance data is calculated, and disclosure about shareholder voting rights, senior securities, other classes, principal underwriters, and service providers. 4. Consolidation of Information about Sales Loads and Marketing Fees The proposal would require information about a funds rule 12b-1 fees and sales loads to appear in one place rather than being located throughout the prospectus. In addition, the proposed amendments would revise disclosure requirements for rule 12b-1 plans to focus on the fees paid under these plans rather than on technical, legal matters relating to the plan. In particular, funds would have to disclose that the ongoing nature of rule 12b-1 fees will increase investment costs and may exceed other types of sales loads. Certain information about rule 12b-1 plans and sales loads now required to be in the prospectus (including disclosure of dealer reallowances, certain information about waivers and breakpoints, and third party fees) would be moved to the SAI or eliminated. 5. Financial Highlights Table The proposed amendments would retain the financial highlights table but no longer require the information to appear in the front of the prospectus. The proposed amendments also would make certain technical and conforming

changes to the table. The release states that the Commission intends to revisit this disclosure more comprehensively in a future rulemaking initiative. 6. Other Changes The proposed amendments would eliminate the current instruction that limits disclosure concerning investment practices to those that place no more than 5% of a funds assets at risk. The standard would be replaced by a more general one requiring disclosure of principal investment strategies. The release indicates that the reason for the change is to discourage the practice of funds disclosing "an inventory of various investments" they may 4make. Funds also would be required to explain in general terms how an adviser decides which securities to buy and sell. Funds would be required to disclose the percentage of assets that may be committed to temporary defensive positions. Funds also would be required to disclose their anticipated turnover rates, and tax consequences and the effects of trading costs in the case of funds with high (over 100%) turnover rates. Tax disclosure would be revised to require specific disclosure about the anticipated tax consequences of distributions and when shareholders can expect to receive specific information about distributions of ordinary income and capital gains during the prior calendar year. Disclosure of the tax consequences of reinvested dividends and exchanges also would be required. There also would be special disclosures required of tax-exempt funds. B. Part B - Statement Of Additional Information The proposed amendments would make a number of technical and conforming changes to the SAI disclosure requirements to reflect the changes made to the prospectus disclosure requirements. The release states that after completion of the prospectus reform initiative, the Commission intends to review the SAI requirements and propose amendments to simplify and update SAI disclosure. A new instruction to Form N-1A would instruct funds to avoid cross- references to the SAI (or to shareholder reports) in the prospectus, unless specifically required. C. Part C - Other Information The proposed amendments would no longer require a fund to file model retirement plans that are used to offer the funds shares or a schedule showing how it calculates performance data. It also would codify current standards for when funds must file updated financial information. D. Prospectus For Pension Plan Participants The proposed amendments would permit a fund that is offered as an investment alternative in a participant-directed defined contribution plan to modify its prospectus for use by plan participants, recognizing that certain prospectus disclosure is unnecessary for plan participants because of the way these plans are structured and regulated under the Employment Retirement Income Security Act and the Internal Revenue Code. E. New Investment Company Registration Package Information in the Guides to Form N-1A and generic comment letters about legal requirements, interpretive positions, and descriptions of filing procedures would be updated and reorganized in a new Investment Company Registration Package. Because the registration package would provide guidance on the preparation of Form N-1A, the guides to N-1A would not be republished with Form N-1A and the generic comment letters would no longer apply. Information traditionally addressed in the generic comment letters generally would be 2 Investment Company Act Release No. 22529 (February 27, 1997). 5 considered when the registration package is updated. In addition, the proposed amendments would incorporate in Form N-1A certain disclosure requirements from the guides and the generic comment letters. F. General Funds would be granted flexibility to structure prospectuses for more than one fund or class in an effort to avoid repetitive disclosures. The proposed amendments would permit funds to include typed, duplicated, or faxed signatures on paper filings if a manual signature is retained by the registrant for five years. If the amendments are adopted, a fund filing a new registration statement would be required to comply with the amendments 6 months after their effective date. A fund with an effective registration statement would be required to comply with the amendments at the time of the next annual update of its registration statement, but no later than 16 months after the effective date of the amendments, if adopted. II. PROFILE PROSPECTUS The Institute is pleased to

report that the Commission has proposed a new rule 498 under the Securities Act that would permit mutual funds to provide investors with a "fund profile" that would provide a summary of key information about a fund. 2 The proposed form of the profile is similar in many respects to that developed by the Institute and its members that participated in the pilot program for the profile. Unlike the pilot program, however, investors who receive the fund profile would have the option of purchasing fund shares or requesting and reviewing the fund*s prospectus. Investors deciding to purchase fund shares based on a profile would receive the fund*s prospectus with their purchase confirmation. Funds would be required to send the prospectus within three business days of a request. (Funds also would be required to mail shareholder reports within three business days of a request.) Rule 498 would limit the contents of the profile to only the information specified by the rule. Profiles could not incorporate information by reference. The profile would be required to include concise disclosure of key information in a specific order and in a question-and-answer format. These items would include the same risk/return summary that is proposed to be required to be included at the beginning of a fund*s prospectus which would, as explained above, summarize the fund*s investment objectives, strategies, risks, performance and fees. Thus, disclosure about a fund*s risks would include a bar chart of the fund*s returns and a table that would compare the average annual returns of the fund to those of a broad-based securities market index. Performance information would be required to be current to the most recent calendar quarter. Updates would have to be made as soon as reasonably practicable following completion of the quarter; they could be made by sticker or stamp. A fund also would be required to identify its investment adviser and the person or persons primarily responsible for the day-to-day management of the fund*s portfolio. This item would require information about the length of time the portfolio manager has managed the fund and a summary of the portfolio manager*s business experience for the last five years. A fund generally would have to identify subadvisers as well. For both portfolio managers and subadvisers, specific disclosure would not be required if there are three or more that manage a portion of the fund*s portfolio, except that disclosure would be required regarding any portfolio manager or subadviser that manages at least 40% of the portfolio. Other items would require a fund to describe how to purchase and sell its shares, how frequently it intends to make distributions, what reinvestment options are available, and what other services are available to investors (e.g., exchange privileges). The rule would permit a profile to omit certain information and to include a plan*s enrollment form in profiles tailored for use by retirement plan participants. Fund profiles could be made available through direct mail and mass print, broadcast and electronic media. (The release notes that electronic media may be particularly well-suited for the delivery of profiles to investors.) Funds would be required to file profiles with the Commission at least 30 days prior to first use. The same filing requirement would apply to profiles containing substantive changes to previously filed profiles. No filing, however, would be required for profiles that only contain updated return information. Filings would be made on EDGAR; for a two year period, however, funds also would be required to file with the SEC two copies of the profile in the primary form intended to be distributed. A fund would not be able to use the profile when material information relating to its particular circumstances is not addressed by the required disclosure. Unlike the profiles used in the pilot program, profiles could include information about more than one fund. If the Commission*s plain English disclosure requirements are adopted, they would apply to the profile. 3 Investment Company Act Release No. 22530 (February 27, 1997). 6 III. INVESTMENT COMPANY NAMES The Commission has proposed for comment a new rule 35d-1 under the Investment Company Act that would require any registered investment company (including open-end funds, closed-end funds and unit investment trusts) with a name that suggests that the fund focuses on a particular type of investment to have a fundamental policy requiring it to

invest at least 80% of its net assets in the type of investment suggested by its name.3 This would include any name that suggests that the fund focuses its investments in a particular type of security (e.g., the ABC Stock Fund) or in securities of issuers in a particular industry (e.g., the ABC Health Care Fund). In addition, the 80% rule would apply to funds with names that suggest the fund focuses its investments in a particular country (e.g., the ABC Japan Fund) or geographic region (e.g., the ABC Latin America Fund). (The release sets forth proposed criteria for ascertaining whether a security would satisfy the 80% test for funds that focus their investments in particular countries or geographic regions.) It also would apply to funds whose names indicate their distributions are exempt from federal income tax (e.g., the XYZ Tax-Exempt Fund) or from both federal and state income tax (e.g., the XYZ New York Tax-Exempt Fund). Such funds could meet either an asset or income test. Funds with names that do not suggest a particular investment emphasis would not be bound by the 80% rule. The Commission proposes to allow funds up to one year from the effective date of the rule, if adopted, to comply with the rule*s requirements. The proposed 80% requirement would apply at the time a fund invests its assets and would require a fund that no longer meets the 80% requirement to make future investments in a manner that would bring the company into compliance with the 80% requirement. The rule would provide an exception for funds that take a temporary defensive position to avoid losses in response to adverse market, economic, political, or other conditions. The proposed 80% requirement would be based on a fund*s net assets plus any borrowings that are senior securities under the Investment Company Act. Cash and cash equivalents would be included in a fund*s net assets for purposes of the 80% test. The staff of the Division of Investment Management would continue to evaluate, and give interpretive advice regarding, investment company names that are not covered by the proposed rule (e.g., fund names that include the words global or international). In determining whether a name is misleading, the Division would consider whether the name would lead a reasonable investor to conclude that the company invests in a manner that is inconsistent with the fund*s intended investments or the risks of those investments. The proposed rule would prohibit a fund from using a name that suggests that the fund is guaranteed or approved by the U.S. government. The proposed rule also would codify a staff position that prohibits a fund from using a name that includes the words "guaranteed" or "insured" or similar terms in conjunction with "United States" or "U.S. government." The staff no longer intends to require funds that have names that suggest that their investments have certain maturities (e.g., short-term) to have average weighted portfolio maturities of specified lengths because it believes that a reasonable investor would not necessarily expect funds with these names to be limited in this manner. Because of the shortcomings associated with the use of average weighted maturity and the increasing use by investment professionals of duration to evaluate bond portfolios, the Division is developing recommendations relating to duration and the maturity of a fund*s investments. Craig S. Tyle Vice President and Senior Counsel Attachments (in .pdf format)
