

SEC PROPOSES AMENDMENTS TO MUTUAL FUND DISCLOSURE AND PROSPECTUS DELIVERY REQUIREMENTS

Just in time for the holidays, the Securities and Exchange Commission announced its latest proposal for disclosure reform.¹ Using the current risk/reward summary and fund profile as a starting point, the SEC's new proposal would require additional information and further standardization of presentation in the prospectus summary and would rely on a rule change and the internet availability of the statutory prospectus to encourage more widespread use of the proposed short-form "Summary Prospectus" than was achieved through use of the fund profile.

The proposal, which the SEC issued on November 21, 2007, would

- require a mutual fund to include at the front of its statutory prospectus a three or four page summary with standardized elements and order of presentation; and
- allow a mutual fund to satisfy its prospectus delivery obligations by using a Summary Prospectus that is a stand-alone version of the proposed new summary section of the fund's statutory prospectus, so long as the fund's statutory prospectus is available via the internet and certain other conditions are met.

The proposal relates only to Form N-1A (relating to open-end management investment companies), Form N-4 (relating to insurance company separate accounts offering variable annuity contracts), and Form N-14 (relating to business combinations), and not, for example, to Form N-2 (relating to closed-end management investment companies). The deadline for receipt of comments on the proposal is February 28, 2008.

Background

The proposed prospectus summary requirement builds on the current requirement for a risk/return summary in a mutual fund prospectus. Like the current risk/return summary, the proposed summary is intended to promote better understanding by investors of material fund information and to facilitate comparisons across funds through the use of standardized disclosures and presentation. The proposal adds certain elements to the summary that are not in the current risk/return summary and requires additional standardization of the presentation.

The proposed optional use of a Summary Prospectus as a sales document builds on the current provision for use of a fund profile under Rule 498 under the Securities Act of 1933 as a sales document and adds a requirement for internet access to the statutory prospectus. This addition

¹ See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28064 (Nov. 21, 2007), available at <http://www.sec.gov/rules/proposed/2007/33-8861.pdf>.

continues a recent SEC trend of permitting, under certain circumstances, internet access to materials to serve as an important part of meeting delivery obligations with respect to required disclosure materials.² Given that the failure of the fund profile to achieve widespread use is largely ascribed to concerns over potential liability for failure to deliver a statutory prospectus, it remains to be seen whether the SEC's proposal to rely on internet access will be sufficient to allay those concerns.

Summary Section of Statutory Prospectus (Mandatory)

Content. The proposal would require, at the front of each mutual fund's statutory prospectus, a three or four page summary setting out concise, plain English information about the fund. The summary would contain several items not now required in the risk/return summary of a statutory prospectus, and the items included in the summary would have to be presented in a specified order, as follows:

- Investment objectives and goals;
- Fee table and example (*new placement at front part of summary*), narrative disclosure about breakpoint discounts at the beginning of the fee table (*new item*), and portfolio turnover rate (*new item*);
- Principal investment strategies;
- Principal risks;
- Performance information;
- Top ten portfolio holdings (*new item*);
- Investment adviser, sub-advisers (if any) and portfolio managers (*new item*);
- Brief purchase and sale information (*new item*);
- Brief tax information (*new item*); and
- Brief statement concerning financial intermediary compensation (*new item*).

As is the case with the risk/return summary, a fund could not include information in the proposed new summary that is not required or expressly permitted. Certain of the above items, although not required in the current risk/return summary, are current requirements of the fund profile

² See, e.g., Shareholder Choice Regarding Proxy Materials, Securities Exchange Act Release No. 56135 (Jul. 26, 2007) (revising "notice and access" model pertaining to proxy materials); Internet Availability of Proxy Materials, Securities Exchange Act Release No. 55146 (Jan. 22, 2007) (adopting "notice and access" model under which an issuer may satisfy its obligations under the SEC's proxy rules by posting proxy materials on a web site and informing shareholders of how to access the materials); Securities Offering Reform, Securities Act Release No. 8591 (Jul. 19, 2005) (adopting "access equals delivery" model under certain circumstances for final prospectus delivery).

under Rule 498. For example, a fund profile, unlike a risk/return summary, is required to include information about the fund's investment adviser, sub-advisers (if any) and portfolio managers, and certain purchase, sale and tax information.

Significant proposed changes

- A requirement for a separate, self-contained summary section for each fund covered by a multiple fund prospectus. Information for multiple funds could not be integrated in a single summary. (The information for multiple classes of a single fund could be integrated or presented separately.)
- The inclusion of a list of the top ten portfolio holdings as of the end of the most recent calendar quarter.
- A requirement to place the fee table at the beginning of the summary, immediately after the statement of investment objectives and goals, and before principal investment strategies, risks and performance information.
- Permission to show voluntary fee reductions or waivers as a line item in the fee table (rather than in a footnote), so long as there is a commitment to continue them for at least one year from the effective date of the fund's registration statement, and permission to use the after-waiver information in the fee table examples.

The inclusion of additional items in the summary is intended to make the summary essentially identical in content to the proposed stand-alone Summary Prospectus, discussed below. The use of the same document for both purposes serves to eliminate the need to have the Summary Prospectus filed prior to its first use. (A summary section in the statutory prospectus meeting the proposed content requirements of Form N-1A would automatically meet the content requirements applicable to the Summary Prospectus.)

Using a Summary Prospectus as a Sales Document (Optional)

Prospectus delivery obligations (avoidance of liability for failure to deliver a full prospectus). Under the proposal, paragraph (c) of a new Rule 498 would permit, though not require, a person to satisfy mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act by providing the new Summary Prospectus so long as certain conditions are met. The principal condition is the public availability of the statutory prospectus on a web site (other than the SEC's EDGAR web site). A mutual fund relying on this option would also be required to send its statutory prospectus in paper or by e-mail to an investor upon request. The SEC states in the proposing release that the failure to send the requested statutory prospectus would violate the rule permitting the use of a Summary Prospectus, but would not result in a violation of the prospectus delivery requirements of Section 5(b)(2).

Incorporation by reference. The proposal would permit the Summary Prospectus to incorporate by reference information from the statutory prospectus, the Statement of Additional Information and the most recent shareholder report. Presumably, this provision is intended to lower a registrant's risk of liability for failure to deliver a prospectus.

Multiple series and multiple class funds. As with the summary section of the statutory prospectus, a separate Summary Prospectus would be required for each fund covered by a multiple fund prospectus, but information about multiple classes could be integrated or presented separately. The fund profile under current Rule 498, by contrast, may describe more than one fund.

Updating. The proposed Summary Prospectus would have to be current with respect to top ten portfolio holdings³ and average annual total returns and yield as of the most recent calendar quarter. Such updating could be done by affixing a label or sticker or by other reasonable means, but would not be required in the statutory prospectus.⁴ If a fund used its Summary Prospectus for the single purpose of satisfying the fund's annual updating requirement, quarterly updating would not be needed. The current requirement that a fund profile be updated on a quarterly basis with respect to average annual total returns and yield is generally acknowledged as one of the reasons that more mutual funds have not opted to make fund profiles available to investors.

Profile. Under the proposal, the current Rule 498--and the current fund profile--would be eliminated and replaced by a new Rule 498--and the new Summary Prospectus.

Filing the Summary Prospectus. A Summary Prospectus would be filed with the SEC under a simplified Rule 497(k). The rule would require that each definitive form of the Summary Prospectus be filed no later than the fifth business day after the date it is first used.

Prototype Summary Prospectus. The proposal includes, as an appendix, a three-page "hypothetical Summary Prospectus" that is an example prepared by the SEC staff for illustrative purposes. If the SEC mandates the standardized prospectus summary section described above, the prototype will be a useful reference for preparing that summary. Given that the proposed Summary Prospectus presents the same two key concerns--liability and quarterly updating--as does the fund profile, it remains an open question whether funds will use the proposed voluntary stand-alone Summary Prospectus more widely than they have used the fund profile.

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³ The proposal would allow portfolio holdings to be disclosed with at least a one-month lag and, with respect to certain securities, would permit the withholding of their names by use of a category called "miscellaneous securities."

⁴ Paragraph (e)(1) of proposed new Rule 498 would provide that information updated on a quarterly basis would not be considered an omission of material information from a statutory prospectus solely because the updated information is included in a Summary Prospectus.

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