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Proposed Amendments to Form N-1A Concerning Disclosure on Market Timing and Selective Disclosure of Portfolio Holdings

The Securities and Exchange Commission (the "SEC") has proposed amendments to Form N-1A: "Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings" (the "Proposal").[1] Comments must be submitted to the SEC by February 6, 2004. This memorandum outlines the requirements of the Proposal.[2]

A. Introduction

In the past few months, federal and state regulators have uncovered widespread misconduct in the mutual fund industry. To date, dozens of individuals and almost forty institutions face or may face civil or criminal actions by regulators for involvement in such misconduct. Among the many areas of concern are three in particular: market timing, late trading and selective disclosure of fund portfolio holdings.[3] The Investment Company Act of 1940, as amended (the "1940 Act"), is the principal foundation for federal regulation of the mutual fund industry. The principal mandates that govern practices such as market timing, late trading and selective disclosure of portfolio holdings are encompassed within the

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1 Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 17 CFR Parts 239 and 274; Release Nos. 33-8343, IC-26287, File No. S7-26-03: RIN 3235-AI99 (December 11, 2003).

2 Several sections of the Proposal offer similar new rules for insurance company separate accounts that issue variable annuities and variable life insurance policies. This memorandum only focuses on the potential impact of the Proposal for mutual funds.

3 Proposed Rule, Release Nos. 33-8343, IC-26287 at Sections I.A - I.C.

Securities Act and the 1940 Act, and the rules and regulations promulgated thereunder by the SEC.[4]

The 1940 Act requires registered open-end management investment companies ("mutual funds"), their principal underwriters and dealers to sell and redeem mutual fund shares at prices based on the mutual fund's net asset value ("NAV") next computed after receipt of an order to buy or redeem shares. This requirement is known as "forward-pricing."[5] The 1940 Act also requires mutual funds to calculate their NAV at least once a day, and most perform this obligation as of 4:00 P.M. when the main U.S. stock exchanges close.[6] When market prices for mutual funds' portfolio securities are not reliable or readily available, mutual funds are required to fair value portfolio securities, in good faith, taking into account all relevant facts and circumstances.[7]

If a mutual fund misprices or fails to fair value its portfolio securities, an investor may have an arbitrage opportunity. The opportunity is available principally when NAVs do not account for recent events, allowing an investor that makes quick trades in fund shares to exploit the stale or inaccurate portfolio price information embedded in a mutual fund's NAV. This trading practice is known as market timing and often involves investors that make frequent purchases, exchanges and redemptions of mutual fund shares. While market timing is not illegal by itself, the SEC maintains that the practice dilutes gains and amplifies losses for long-term shareholders.[8] Moreover, mutual funds that selectively permit certain investors to

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4 The Securities Exchange Act of 1934, as amended, and the Investment Advisers Act of 1940, as amended, and the rules and regulations promulgated thereunder, also regulate these practices.

5 Forward-pricing is required under Rule 22c-1 of the 1940 Act.

6 All times herein are eastern standard.

7 Section 2(a)(41) of the 1940 Act.

8 *Id.* The harm is purportedly dilutive because market timers gain a disproportionate share of fund portfolio gains and avoid a disproportionate share of fund portfolio losses by swiftly trading in advance of the funds incorporating new information into NAVs. *See* Eric Zitzewitz, "Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds", Research Paper No. 1749, Stanford

market time fund shares, in breach of stated policies in the fund's prospectus or Statement of Additional Information ("SAI"), may violate both the federal securities laws and their fiduciary obligations.

Late trading occurs when investors place orders to buy or redeem fund shares after 4:00 P.M. – the time for calculating most funds' NAVs – but still receive a price based on the 4:00 P.M. NAV of that day rather than the following day, as required by the forward-pricing rule. As such, late trading represents another method by which certain investors exploit an arbitrage opportunity in fund shares based on information delays. Late trading violates the 1940 Act and, unlike market timing, is illegal.

Finally, late trading and market timing activities are often facilitated by fund managers who selectively disclose information on the funds' portfolio holdings so that the arbitrage opportunities can be more precisely exploited by certain investors. Fund managers that are complicit with investors' market timing or late trading practices may violate both the federal securities laws and their fiduciary obligations to the funds' other shareholders.

To combat these abuses, the SEC's Proposal focuses on enhanced disclosure by mutual funds to shareholders, particularly with respect to mutual funds' policies and procedures designed to prevent market timing and selective disclosure of portfolio holdings.[9] The SEC is also seeking to educate shareholders about the economic risks surrounding these practices. With respect to late trading, the SEC has issued a companion release proposing new rules that are not addressed in this memorandum.[10]

Graduate School of Business Research Paper Series (Oct. 2002), available at http://faculty-gsb.stanford.edu/zitzewitz/Research/arbitrage1002.pdf.

9 *Id.* at Section I.C.

10 Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, 17 CFR Part 270; Release No. IC-26288, File No. S7-27-03: RIN: 3235-AJ01 (December 17, 2003). Paul, Weiss, Rifkind, Wharton & Garrison LLP has written a memorandum on these new rules. Please contact us for a copy of the memorandum.

B. Market Timing

The Proposal aims to enhance disclosure on market timing principally in the mutual funds' prospectuses.[11] However, as noted earlier, market timing is often only discernible when investors engage in frequent trading of fund shares. Therefore, while the SEC is seeking only to prevent market timing activity, its Proposal actually addresses all frequent purchases and redemptions of fund shares.[12]

First, the Proposal would require mutual fund prospectuses to describe the risks that frequent trading of fund shares creates for shareholders and their long-term economic interests.[13] While the SEC cautions that the disclosure of risks should be specific for each fund, its Proposal states that the disclosures may include the following important risks for shareholders:[14]

- dilution of the value of fund shares owned by long-term shareholders;
- interference with the efficient management of the fund's portfolio; and
- increased brokerage and administrative costs.

Second, the Proposal would require mutual fund prospectuses to specifically describe the fund's policies and procedures regarding frequent trading.[15] With respect to these policies and procedures, the prospectus would be required to describe:[16]

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11 Proposed Rule, Release Nos. 33-8343, IC-26287 at Section I.A.

12 *Id.* at Section II.A.

13 *Id.*

14 *Id.*

15 *Id.* If a mutual fund's board of directors does not adopt policies and procedures designed to address market timing or frequent trading of fund shares, the Proposal would require that mutual fund's prospectus to state the specific rationale for why such policies and procedures would be inappropriate for the fund. *Id.*

- whether the fund discourages or accommodates frequent trading of fund shares;
- the fund's policies and procedures for deterring frequent trading; and
- the fund's policies for detecting frequent trading of fund shares, particularly with respect to any arrangements involving third-party financial intermediaries.

Third, the Proposal would require mutual fund prospectuses to disclose, with specificity, any restrictions imposed on investors to prevent or curtail frequent trading. Under the Proposal, mutual funds would be required to disclose the following types of restrictions:[17]

- any volume limitations on shareholder trading activity in fund shares within any given time period;
- any redemption or exchange fees;
- any costs or penalties imposed on shareholders that the mutual fund concludes are engaged in frequent trading of fund shares, along with a description of when the costs or penalties will be imposed;
- any minimum holding periods before exchanging fund shares;
- any restrictions on the means of shareholder order placement; and
- any rights the mutual fund reserves to restrict trade activity in accounts the fund concludes are engaged in frequent trading of fund shares.

Fourth, the Proposal would require mutual fund prospectuses to state whether the restrictions on frequent trading apply consistently to all investors, or whether the fund suspends the restrictions in certain situations or for certain investors.[18] If a mutual fund does

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16 Proposed Rule, Release Nos. 33-8343, IC-26287 at Section II.A.

17 *Id.*

18 *Id.*

suspend the restrictions in certain circumstances or arrange to permit frequent trading of fund shares for certain investors, the Proposal would require that fund's prospectus to specifically describe the circumstances and conditions surrounding the accommodation.[19] The Proposal would require that the description include the identity of any investors permitted to engage in frequent trading and any consideration received by the fund, its investment adviser or any other party pursuant to such arrangement.[20]

Fifth, the Proposal would require these new disclosures be included in mutual fund prospectuses.[21] Currently, the SEC permits certain similar disclosures to be removed from the prospectus and delivered to investors in a separate document, known as the purchase and redemption document.[22] The Proposal would amend this practice in part and require the disclosures regarding frequent trading of fund shares to be placed in the prospectus.

Finally, the SEC states that compliance with the aforementioned disclosure requirements would not absolve the mutual fund or its service providers from liability under the antifraud provisions of the federal securities laws.[23] As such, the SEC's release emphasizes that these disclosures would not legalize otherwise illegal conduct.

C. <u>Fair Value Pricing</u>

The Proposal would amend the registration form for mutual funds so that funds are required to explain in their prospectuses the conditions under which fair value pricing will be implemented for portfolio securities.[24] In addition, mutual funds would be required to

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19 *Id.*

20 *Id.*

21 *Id.*

22 Item 7(f) to Form N-1A.

23 Proposed Rule, Release Nos. 33-8343, IC-26287 at Section II.A.

24 *Id.* at Section II.B.

explain in their prospectus the economic and financial effect of fair value pricing for portfolio securities.[25]

The SEC notes that these explanations should be tailored for each fund. For example, mutual funds that invest in overseas securities, and therefore are more prone to a form of market timing known as time-zone arbitrage, would be required to provide a more detailed discussion on how the fund expects to address possible international events that may affect the fund's portfolio holdings. A mutual fund that invests only in domestic securities would be able to provide a much less detailed discussion.[26]

D. Selective Disclosure of Fund Portfolio Holdings

The Proposal would require all mutual funds' SAIs to describe the fund's policies and procedures, as well as the policies and procedures of the fund's services providers, regarding the disclosure of information on portfolio securities.[27] Mutual fund prospectuses also would be required to state that the fund's SAI and, if applicable, the fund's website contain descriptions of these policies and procedures.[28]

While the SEC notes that such disclosures would not absolve the fund from liability under the antifraud provisions of the federal securities laws, the Proposal release also notes that mutual funds would be able to disclose information on portfolio securities to third-parties when both a legitimate business purpose and a duty of confidentiality is extant.[29] The SEC states that the following items would be required in the description of the fund's policies and procedures regarding disclosure of information on portfolio holdings:[30]

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25 *Id.*

26 *Id.*

27 *Id.* at Section II.C.

28 *Id.*

29 *Id.*

30 *Id.*

- how, if at all, the policies and procedures apply to different categories of persons and entities;
- any conditions or restrictions placed on the use of disclosed information regarding portfolio holdings;
- any procedures used to monitor the use of disclosed information on portfolio holdings;
- the frequency with which portfolio information is disclosed;
- the length of time between the date of the information and its disclosure;
- any policies and procedures regarding receipt of any compensation by the fund, its investment adviser or any other party in connection with disclosure of portfolio information;
- the persons who can approve disclosure of portfolio information;
- the procedures used by the mutual fund to ensure that disclosure of portfolio information is in the best interests of shareholders, as well as to ensure that any conflicts of interests are adequately addressed; and
- the method by which the fund's board of directors oversees the disclosure process.

Second, the Proposal would require mutual funds to describe in their SAIs all arrangements to disclose information on portfolio securities to third-parties.[31] The SEC states that the following items would be required in the mutual funds' disclosures: [32]

- the identity of persons that receive the disclosed information;

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[31] *Id.*

[32] *Id.*

- any consideration received by the fund, its investment adviser or any other party in connection with the arrangements;
- any conditions or restrictions placed on the use of disclosed information;
- any procedures to monitor the use of disclosed information;
- the frequency with which information is disclosed;
- the length of time between the date of the information and its disclosure; and
- the persons who can approve the disclosure of information.

Finally, it should be noted that, in its release, the SEC requested comments on whether Regulation FD should apply to mutual funds when considering their disclosure of portfolio holdings.[33] Regulation FD regulates the selective disclosure of material non-public information and, according to the SEC's release, currently applies only to investment funds that are closed-end.[34]

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If you have any questions concerning the Proposal or would like to consider submitting a comment on any part of the Proposal to the SEC, please do not hesitate to contact us.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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33 *Id.*

34 Regulation FD, 17 CFR 243.101(b).