Chapter 28

The Regulatory Response to the Mutual Fund Scandals

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(Chapter 28 reflects regulatory activity through August 24, 2006.)

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§ 28:1  Introduction  

The fallout from the market timing and other regulatory enforcement cases in the mutual fund industry over the past three years has rocked the mutual fund industry, which previously had prided itself on operating for six decades without scandal. Nearly half of all U.S. households have a stake.\(^1\) New York State Attorney General Eliot Spitzer (NYAG) attributes the current fund-trading scandal to the democratization of investing over the past twenty years, the

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1. The latest annual survey conducted in June 2005 by the Investment Company Institute (ICI), the fund industry’s largest trade group, found that 53.7 million households, or 47.5% of all U.S. households, or 91.3 million individuals, own mutual funds, 35.6 million of whom owned mutual funds inside employer-sponsored retirement plans. *U.S. Household Own-
emergence of massive financial outfits following a spate of mergers, and those financial outfits’ inability to be satisfied with the profits they earned from individual investors.2 Other commentators have suggested that pressure to generate good fund performance, higher management fees and new assets in light of a declining stock market was a factor,3 while others propose that greed and lax oversight by regulators and the funds themselves were the root causes.4 The initial round of cases involved fund advisers, executives and intermediaries giving favorable treatment to market timers.5 While market timing per se is not illegal, the advisers and their executives charged in those cases were alleged to have violated their fiduciary


5. For example, joint investigations by the U.S. Securities and Exchange Commission (“SEC”) and the NYAG’s Office found that senior executives at Alliance Capital Management had authorized complex market timing arrangements with 18 broker dealers and hedge fund operators in return for infusions of assets that generated greater management fees. The market timing arrangements contrasted with publicly issued policies discouraging rapid trading of Alliance funds. See Press Release, Office of New York State Attorney General Eliot Spitzer, Alliance Agreement Includes New Form of Relief for Shareholders (Dec. 18, 2003), available at www.oag.state.ny.us/press/2003/dec/dec18c_03.html.

The SEC filed a civil injunctive action against Gary L. Pilgrim (the President, Chief Investment Office and Director of Pilgrim Baxter, and the President of the PBHG Funds), Harold J. Baxter (the CEO and Chairman of Pilgrim Baxter, and the Chairman and trustee of the PBHG Funds and the PBHG Insurance Series Fund), and Pilgrim Baxter, a registered investment adviser, charging them with fraud and breach of fiduciary duty in connection with market timing of the PBHG Funds. The SEC’s complaint alleges that Pilgrim had a substantial interest in a hedge fund whose trading strategy involved rapid trading of mutual fund shares and that, in March 2000, with the consent of both Pilgrim and Baxter, the hedge fund began market timing several PBHG funds, including a fund managed by Pilgrim. The complaint further alleges that neither Pilgrim nor Baxter disclosed to the

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(Mutual Fund Reg., Rel. #2, 11/06) 28–5
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obligations to the funds and their shareholders by failing to disclose the conflicts of interest in the arrangements at issue in those cases and to have defrauded fund shareholders by failing to disclose that they permitted trading in excess of or contrary to the policies disclosed in their prospectuses and other disclosure documents. In some cases, brokers and other fund intermediaries were charged with defrauding the funds by assisting their customers in concealing their trading activity from the funds. Other cases charged that brokers and fund executives permitted favored investors to engage

board of Pilgrim Baxter, the fund board, or fund shareholders, that Pilgrim had a financial interest in the hedge fund and that the hedge fund had been permitted to market time PBHG funds. The complaint alleges that over the next twenty months, the hedge fund engaged in far more short-term exchange transactions than were permitted under the limit set forth in the PBHG funds’ prospectuses. In 2000 and 2001, the hedge fund is alleged to have profited by more than $13 million from its trading. $3.9 million of which is alleged to have been Pilgrim’s share. Both Pilgrim and Baxter resigned from each of these positions on November 13, 2003. See SEC v. Pilgrim, Civil Action No. 03-CV-6341 [E.D. Pa.] [filed Nov. 20, 2003], available at www.sec.gov/litigation/complaints/comp18474.htm. Pilgrim Baxter settled the charges by consenting to a censure and an administrative cease and desist order under which it agreed to:

(1) use its best efforts to cause the PBHG funds to adopt certain corporate governance policies;
(2) cooperate with the SEC in ongoing investigations and litigation such as SEC v. Pilgrim, including waiver of any evidentiary privilege relating to allegations of the complaint in that case or any internal investigation of those matters;
(3) establish an internal compliance structure having certain characteristics;
(4) retain an independent compliance consultant; and
(5) pay $90 million in disgorgement and penalties.


6. See, e.g., SEC v. Mutuals.com, Inc., Civil Action No. 303 CV 2912D (N.D. Tex.) [filed Dec. 4, 2003] (“Mutuals.com Complaint”), available at www.sec.gov/litigation/complaints/comp18489.htm. According to the SEC’s complaint, the defendants fraudulently helped institutional brokerage customers and advisory clients carry out and conceal thousands of market timing trades and illegal late trades in shares of hundreds of mutual funds. Specifically, the SEC alleged that, whenever a fund tried to restrict timing activities, Mutuals.com and its principals used means such as: [1] formation and registration of two affiliated broker-dealers through which they could continue to market time undetected, [2] changing account numbers for blocked customer accounts; [3] using alternative registered representative numbers for registered representatives who were blocked from trading by mutual funds; [4] using different branch identifi-
in “late trading” by accepting fund share orders after the daily deadline set forth in the fund prospectuses.\(^7\)

The initial cases triggered industry-wide regulatory inquiries into whether similar practices existed at other firms as well as inquiries into other fund practices that presented potential conflicts of interest. These inquiries have resulted in many other market timing and late trading cases involving other mutual fund complexes as well as a variable annuity issuer.\(^8\) In addition, regulators have investigated and brought cases against brokers and fund advisers relating to undisclosed conflicts of interest and other violations in the fund distribution process.\(^9\) Prompted by regulators’ inquiries, funds, their advisers, brokerages and banks, among others, have also discovered possible improper market timing of fund shares by employees through their own internal probes.\(^10\)

In response, under Congress’ eye, the SEC adopted extensive reform of the regulatory structure for mutual funds. The reforms were not limited just to the practices at issue in the recent enforcement cases. Rather, seeking to provide stronger oversight of and safeguards against the potential conflicts of interest inherent in the fund business, the SEC has sought to enact corporate governance changes that would fundamentally affect how mutual fund complexes are run, and has required funds to adopt detailed written compliance programs and appoint a chief compliance officer to oversee implementation of the program.

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7. Id.
9. A partial listing of the regulatory enforcement cases involving market timing, late trading, and certain fund distribution violations is included as Appendix 28A.
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Some of the SEC’s proposed reforms have run into opposition and, as the urgency prompted by the initial disclosures of wrongdoing has waned, are being modified or withdrawn. As discussed later in this chapter, two of them, the SEC’s fund governance rule and its hedge fund adviser registration rule, recently were overturned by the courts.\footnote{10.1} While the SEC apparently intends to push forward on both fronts, both proposals may be changed significantly. The SEC’s proposal for point-of-sale disclosure, as initially proposed, was criticized as being duplicative and confusing, and while the SEC reposed a simplified disclosure form, this proposal has been pending for over two years.\footnote{10.2} Finally, the proposed “hard close” rule, which was proposed as a specific preventative against late trading, apparently is highly unlikely to be enacted.\footnote{10.3}

Congress also has considered enacting legislative reforms of the mutual fund industry. Legislative action, however, now appears unlikely.

These enforcement cases and the resulting regulatory reforms are causing dramatic, long-term changes in the mutual fund business. In the wake of these cases, shareholders have filed hundreds of fund-related class action suits against fund advisers. Investors and institutions have withdrawn billions of dollars from scandal-tainted funds complexes.\footnote{10.4} In addition, firms that have settled enforcement cases are paying hundreds of millions in disgorgement and fines. Moreover, fund firms generally are restructuring their corporate governance, tightening their internal compliance controls, and reducing advisory fees and sales charges. A new wave of activism has sprung up among fund independent directors. Organizations such as the Mutual Fund Directors Forum publish best practices guidelines to assist independent directors in fulfilling their fiduciary duties. Firms also are still digesting other effects of the regulatory changes on their business operations.

Some commentators have suggested that these changes and the cost of implementing them, taken together, will discourage new entrants and lead to a wave of consolidation in the fund advisory

In this chapter, we first provide an overview of the violations charged in the regulatory enforcement cases, and we then discuss the regulatory actions taken in response to these scandals, focusing primarily on the SEC’s regulatory initiatives.

§ 28:2 Background—What Are the Abuses?

Though market timing in the fund industry is not a recent phenomenon, it was thrust into the public eye on September 3, 2003, when the NYAG’s Office filed a complaint involving abusive mutual fund trading practices by a hedge fund, Canary Capital Partners, LLC.¹² That action and many subsequent actions revolved primarily around two problematic practices—late trading and market timing of mutual fund shares.¹³ Other enforcement cases have focused on abuses in the fund distribution process involving “revenue sharing” and “directed brokerage.”

§ 28:2.1 Late Trading

“Late trading” involves violation of the SEC’s “forward pricing” rule, which is set forth in Rule 22c-1 under the Investment Company Act of 1940 (the “1940 Act”). Under this Rule, a purchase or redemption order must be priced based on the fund’s NAV next computed after receipt of the order. The SEC adopted Rule 22c-1 in 1968 to eliminate or reduce so far as reasonably practicable any dilution of the value of outstanding redeemable securities of registered investment companies such as mutual funds through [i] the sale of


¹³ See Appendix 28A.
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fund shares at a price below their NAV or (ii) the redemption or repurchase of fund shares at a price above their NAV.\(^{14}\) Dilution through the sale of fund shares at a price below NAV might occur if these securities were sold for a certain period of time at a price based upon a previously established NAV, allowing speculators to take advantage of an upswing in the market prior to an accompanying increase in the NAV of the shares by purchasing the fund shares at a price which does not reflect the increase and redeeming them at large profits.\(^{15}\)

The SEC intended Rule 22c-1 to eliminate or reduce so far as reasonably practicable “other results,” aside from dilution, arising from the sale, redemption or repurchase of fund shares that are “unfair to the holders of such outstanding securities.”\(^{16}\) The SEC, in its Rule 22c-1 Adopting Release, stated that backward pricing of fund shares caused unfair results to other shareholders not only because the speculators could gain unfair advantage at the expense of other shareholders, but also because fund managers might (i) hesitate in investing what they believe to be speculators’ money and (ii) be forced to make untimely liquidations when speculators redeem their securities.\(^{17}\)

Mutual (open-end) funds, unlike individual stocks, generally are valued once daily, usually at 4:00 P.M. EST, when the New York Stock Exchange (NYSE) usually closes.\(^{18}\) The price, or net asset value (NAV), generally reflects the closing prices of the securities owned by the fund, plus the value of any uninvested cash held by the fund less liabilities. Accordingly, under Rule 22c-1, orders placed at any time during the trading day up to the 4:00 P.M. deadline receive that day’s NAV, but an order placed at 4:01 P.M. or afterwards receives the next day’s NAV.

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15. Id.
16. Id.
18. Rule 22c-1 under the 1940 Act requires that the current net asset value of a fund’s shares be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day as set by the board of directors of the fund. Exceptions are made for: (1) days on which changes in the value of the fund’s portfolio securities will not materially affect the current net asset value of the fund’s shares; (2) days during which no such shares are tendered for redemption and no order to purchase or sell such shares is received by the fund; and (3) customary national business holidays described or listed in the prospectus, and local and regional business holidays listed in the prospectus.
Late trading refers to the practice of placing orders to buy or sell mutual fund shares after 4:00 P.M., EST, but receiving the price based on the prior NAV already determined at 4:00 P.M. that same day, a practice that is illegal and violates Rule 22c-1 under the 1940 Act. Late trading allows the trader to profit from knowledge of market-moving events that occur after 4:00 P.M. but are not reflected in that day’s fund share price, essentially “betting today on yesterday’s horse races.”

The opportunity for “late trading” arose in some instances because certain fund intermediaries abused current SEC interpretations permitting fund share orders to be transmitted to the complexes after 4 P.M. as long as the order was received by the intermediary before 4 P.M. Investors place their orders both indirectly through intermediaries such as broker-dealers, insurance company separate accounts and retirement plans and directly with the fund via telephone or computer to the fund’s primary transfer agent. Under current SEC rules and staff interpretations, funds may treat the time of receipt of an investor’s order by a person designated by the fund [such as a dealer] as the time for determining the price the order will receive. Accordingly, where broker-dealers, pension administrators, insurance company separate accounts and other intermediaries receive customer orders before 4:00 P.M. EST or other established order deadline, but are administratively unable to transfer

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19. Investment Company Act Rel. No. 26,288 [Dec. 11, 2003] (“22c-1 Amending Release”) (proposing amendments to Rule 22c-1). In the Mutuals.com Complaint under the Fourth Claim for Relief, the SEC alleges that Mutuals.com, as a registered broker-dealer, violated Rule 22c-1 by routinely executing customer orders received after 4:00 P.M. EST as if the orders were placed before 4:00 P.M.

20. Canary Complaint, at 3. In some cases, the late traders are alleged to have found ways to persuade clearinghouse workers to put a 4:00 p.m. time stamp on orders submitted after 4:00 P.M. Jon D. Markman, How Mutual Funds Stole Your Money, MSN Online, Nov. 18, 2003, available at http://moneycentral.msn.com/content/P64776.asp.


22. See Charles Schwab & Co., Inc., SEC No-Action Letter [pub. avail. July 7, 1997] (“Schwab Letter”) [allowing customer orders placed directly with Schwab or a designated entity of Schwab to be deemed to have been received by the fund for purposes of Rule 22c-1 at the time that Schwab or its designee receives the orders]. See also American Express Travel Related Services, SEC No-Action Letter [pub. avail. Nov. 24, 2000] permitting TRS to collect and promptly remit American Express customers’ purchase orders for fund shares and variable insurance products to affiliated broker-
mit the orders to the fund until after 4:00 P.M. EST, which is often the case, the “time stamp” on the order for pricing purposes would be before 4:00 P.M. and would thus qualify for that day’s NAV, even though the fund receives the order after 4:00 P.M. This practice is permitted by the SEC on the condition that orders received by the fund after 4:00 P.M. EST were received by the intermediary before that time.

In some cases, financial intermediaries are alleged to have participated in concealing late trading for favored customers. In some instances, favored customers were permitted to place conditional trades before 4:00 P.M. with the option of canceling or confirming the trades after 4:00 P.M. In other instances, traders are alleged to

dealers without triggering the pricing provisions of Rule 22c-1 because such collection of orders by a “processing agent” would not be deemed receipt of an order by a fund, the fund’s broker-dealer or underwriter, or other fund designee as required under Rule 22c-1; Investment Company Act Rel. No. 5,569 (Dec. 27, 1968) [relating to SEC staff interpretive positions on Rule 22c-1 under the 1940 Act].

23. For instance, the SEC alleged in its complaint in SEC v. Sec. Trust Co., N.A., Civil Action No. CV 03-2323 PHX JWS (D. Ariz.) [Nov. 24, 2003] (“STC Complaint”) that “mutual funds expected that retirement plans and their TPAs [third party administrators] required several hours after the market closed to process trades submitted by plan participants before market close. In contrast, the hedge funds had no such business purpose for submitting their own trades as late as five hours after market close.” STC Complaint at 2.

Although purchase and redemption orders must be submitted to retail dealers and other intermediaries by 4:00 P.M. in order to receive that day’s price, SEC rules permit those intermediaries to forward the order information to Fund/SERV or fund primary transfer agents at a later time. These intermediaries, including broker-dealers, banks, and administrators of retirement plans, typically process orders received before 4:00 P.M. in the early evening hours before submitting them to Fund/SERV or fund primary transfer agents. The process is typically completed in the middle of the night. 22c-1 Amending Release at 2.


25. The SEC alleged in the STC Complaint that STC, a financial intermediary not registered with the SEC, allowed its client hedge funds to effect mutual fund trades at STC after 4:00 P.M. EST but still receive that day’s price. STC Complaint, at 8. The hedge funds allegedly prepared proposed trade orders during the day, and then made adjustments to the orders at around 4:30 P.M. EST and again at 6:30 P.M. EST based on after-hours trading data. Id. In addition, the STC Complaint charges that the hedge funds would occasionally wait to finalize and send their trade file to STC until the last minute (that is, just before 9:00 P.M. EST) in case any additionally potentially market-moving news came out. Id. Two days after the STC Complaint was filed, the NYAG’s Office brought criminal charges.
have been permitted routinely to submit two orders for a single fund before the order deadline (one to buy and one to sell) and then to cancel one after hours. Fund intermediaries also are alleged to have altered records to conceal that such orders were confirmed or canceled after the order deadline. In a recent case, a brokerage firm and its affiliate also provided financing for their customers’ late-trading and market timing transactions.

§ 28:2.2 Market Timing

Market timing may take many forms, including the practice of frequent buying and selling of mutual fund shares in order to exploit any lags between changes in the value of the fund’s portfolio securities and the reflection of that change in the fund’s share price. Because mutual funds calculate their NAV per share once at the end of the business day, the most recent transaction price at

against three former executives of STC, all of whom ultimately pleaded guilty to facilitating late trading, admitting to placing mutual fund trades from two hedge funds after the 4:00 P.M. EST order deadline. STC was not charged with crimes, but under an agreement with the Treasury Department and the Office of the Comptroller of Currency it has closed. See also NASD News Release, NASD Charges A.B. Watley and Former Brokers with Facilitating Mutual Fund Late Trading and Market Timing for Hedge Funds (Apr. 6, 2006), available at www.nasd.com/PressRoom/2006NewsRelease/NASDW_016340.

26. For example, in the STC Complaint, the SEC alleged that from May 2000 to July 2003, STC facilitated hundreds of mutual fund trades in nearly 400 different mutual funds by several hedge funds, including the Canary Capital funds. The SEC further alleged that approximately 99% of these trades were transmitted to STC after the 4:00 P.M. EST market close; 82% of the trades were sent to STC between 6:00 P.M. and 9:00 P.M. EST and the hedge funds’ late trading was effected by STC through its electronic trading platform, which was designed primarily for processing trades by administrators for retirement plans. The SEC further alleged that STC knowingly and repeatedly misrepresented to mutual funds that the hedge funds were a retirement plan account because mutual funds expected that retirement plans and their administrators required several hours after the market closed to process trades submitted by plan participants before the market close. STC Complaint at 2–3.

27. Id.


28. See Pilgrim Baxter Order, at § 9 (“Market timing includes [a] frequent buying and selling of shares of the same mutual fund or [b] buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing.”) See also Investment Company Act Rel. No. 26287 at note 10 (Dec. 11, 2003) (proposing amendments to Forms N-1A, N-3, N-4 and N-6 relating to disclosure of market timing and selective disclosure of portfolio holdings) (“Form Amendments Proposing Release”), Rule 22c-2 Adopting Release (adopting Rule 22c-1 and describing market timing).
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4:00 P.M. EST for some securities does not fully reflect all available market information, resulting in “stale” prices.29

The example most often cited is international funds. Certain international funds provided market timers with an opportunity for “time zone arbitrage,” because the funds used the closing prices in foreign markets to price shares of foreign companies, notwithstanding that the foreign markets closed many hours before the 4:00 P.M. closing of the NYSE. As a result, the foreign share prices used in determining the fund’s NAV did not reflect events or information that first became known after the close of the foreign market, for example, an announcement affecting a particular foreign company or broader market moving economic data. Market timers sought to profit from this potential pricing gap by investing in the foreign funds on days when it appeared that the foreign shares held by a fund might be undervalued.30


30. One recent study indicates that the potential returns to even a very simple timing strategy can be quite high. According to a study by Eric Zitzewitz, an assistant professor of economics at Stanford University’s Graduate School of Business, timers who buy international funds on days the S&P 500 Index has risen and sell them on days it has declined can earn uncompounded excess returns of 35% per year; refinements to the trading strategy purportedly can double these returns. He concluded that these excess returns come at the expense of long-term shareholders, whose returns are diluted by disadvantageously timed inflows and outflows. He also concluded that dilution is concentrated in international equity funds, where the arbitrage opportunities are largest. Zitzewitz estimates that in 2001, dilution caused by market timing averaged 1.1% and 2.3% of assets per year in general and regionally focused international funds, respectively. Eric Zitzewitz, Who Cares about Shareholders? Arbitrage-Proofing Mutual Funds, 19 J.L. Econ. & Org. 245, 246-47 [Oct. 2003] (“Zitzewitz”).
Market timing is not, however, limited to international funds. The recent fund enforcement cases have charged alleged market timing activity in domestic equity funds and junk bond funds. Although market timing is not per se illegal, it can be disruptive to portfolio management, increase trading and administrative costs, and cause other detrimental effects to shareholders. Accordingly, even prior to the Canary case, funds often employed methods to

31. Some small company stocks trade infrequently. Because mutual funds use the stock’s last traded price for valuation purposes, the end-of-day NAV of a small-cap fund may be stale relative to the market information available near the end of the trading day simply because its portfolio holdings are priced less frequently than that of a large-cap fund. The more concentrated a mutual fund is in stocks that trade infrequently and thus are priced infrequently, the potentially “staler” the NAV. According to Ciccotello, market timing thus has great profit potential among domestic funds that hold small company stocks. See Ciccotello, et al., supra note 29, citing Andrew Lo & A. Craig MacKinley, An Econometric Analysis of Nonsynchronous Trading, 45 J. ECONOMETRICS 181 [1990].

32. See Zitzewitz, supra note 30, at 246 (estimating potential arbitrage returns in domestic small-cap equity funds and convertible and high-yield and convertible bond funds at 20%–25% and 10%–25%, respectively).

33. A January 2003 memorandum to Invesco CEO Cunningham describes the harm that market timing causes ordinary mutual fund investors, listing, among other things:
   [1] “Arguably Invesco has increased its business risk by granting large numbers of exceptions to its prospectus policy (effectively changing the policy) without notice to shareholders.”
   [2] Allowing market timing “may not be . . . in the best interests of the fund and its shareholders” and Invesco certainly has not informed investors of a de facto change.”
   [3] Ordinary mutual fund investors are harmed by market timers because market timing increases the cash needs of funds, the amount of borrowing a fund must undertake, costs due to increased trading transactions, and the necessity to undertake cash hedging strategies by a fund all of which cause an impact on fund performance.
   [4] Market timing creates negative income tax consequences for ordinary long term mutual fund investors and “[t]his adds insult to injury for long-term shareholders, since they suffer potentially lower returns and an extra tax burden.”
   [5] A large amount of timing activity involved Invesco money market funds and the portfolio managers of those funds have “been forced to adopt a highly liquid investment strategy . . . which lowers performance.”
   [6] Market timing has caused fluctuation of fund assets as much as twelve percent within a single day and this causes “artificially high accruals [of expenses] charged to long term investors who are not market timers.”
   [7] “By causing frequent inflows and outflows, market-timing investors impact the investment style of a fund . . . . Virtually every portfolio manager at Invesco would concede that he or she has had to manage funds differently to accommodate market timers.”
   [8] “High volumes of market timing activity increases the risk that portfolio managers will make errors. . . .”
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deter market timing and disclosed these methods in their registration statements.34

Over the past three years, regulators brought charges against many mutual fund advisers alleging that they breached their fiduciary duties under section 36(b) of the 1940 Act to treat all shareholders fairly by allowing select investors to engage in market timing of their funds in order to increase fund assets and collect greater management fees.35 Regulators also have brought charges relating to fraud and false statements in registration statements where a fund is alleged to have knowingly permitted certain market

34. Typical restrictions on market timing activities include (1) prohibiting frequent movement between money market funds, on the one hand, and equity or bond funds, on the other; (2) limiting switches between funds in a family to two or four per year; (3) placing a fifteen or thirty day prohibition on the movement of funds after the first purchase; (4) limiting the privilege of redeeming or exchanging by telephone, and requiring transactions to be made by mail; (5) charging a one or two percent redemption fee to those who sell their shares in a fund within one year of purchase; (6) honoring redemption requests by short-term shareholders only with “payment in kind” [a proportional amount of every stock in the fund’s portfolio, rather than cash]; or (7) simply telling market timers to take their business elsewhere. In re Michael Flanagan, Ronald Kindschi, and Spectrum Admin., Inc., SEC Rel. No. ID-160, Admin. Pro. File No. 3-9784 (Jan. 31, 2000), citing Pre-Hearing Transcript at 158-59, 498–99, 507-08, 583–84.

35. For example, William Francis Galvin, Secretary of the Commonwealth of Massachusetts, in investigating market timing allegations at Putnam, stated that “in effect, two classes of investors existed at Putnam. The first class were the connected investors—those privileged insiders who were able to skim the funds through a legal trading activity known as ‘market-timing.’ The second class were the average investors who placed their trust in Putnam to follow its own policies, including the policy against market timing.” Testimony of William Francis Galvin before the Subcommittee on Financial Management, the Budget, and International Security U.S. Senate Committee on Governmental Affairs, Mutual Funds: Trading Practices and Abuses that Harm Investors, November 3, 2003, at 3. See also In re Federated Inv. Mgmt. Co., Admin. Pro. File No. 3-12111, Securities Exchange Act Rel. No. 52,839 [Nov. 28, 2005]; In re Banc of Am. Capital Mgmt., LLC, Admin. Pro. File No. 3-11818, Securities Act Rel. No. 8,538 [Feb. 9, 2005] [fund advisers breached their fiduciary duties by entering into undisclosed agreements permitting favored large investors to engage in market timing at the expense of the long term investors].
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timing activity contrary to the fund’s prospectus disclosure restricting such activity.36

The fund enforcement cases also described various methods that brokers and other intermediaries are alleged to have used to assist their customers to conceal market timing activities from mutual funds and avoid the funds’ market timing restrictions, including:

- Concealing customers’ identity through the use of various identification numbers, some of which were specifically created to avoid fund market timing detection systems;
- Establishing multiple accounts for a single client;
- Transferring fund shares from detected accounts into newly opened accounts; and
- Avoiding detection by trading in fund shares through wrap and omnibus accounts.37

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36. In the Invesco Complaint, the SEC alleged that from at least 1997 through October 2003, the Invesco funds’ prospectuses uniformly disclosed that Invesco would limit shareholders to only “four exchanges out of each fund per twelve-month period.” The complaint alleges that in practice Invesco made exceptions to its exchange policy, permitting more than sixty separate broker-dealers, hedge funds, and investment advisers to trade in excess of the prospectus restrictions. Invesco Complaint at 6. Based on these and other representations, the SEC brought charges under section 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”) and Rule 10b-5 thereunder [prohibiting the use of manipulative and deceptive devices in connection with the purchase or sale of a security], section 17(a)(1)–(3) of the Securities Act of 1933 (“1933 Act”) [prohibiting fraudulent interstate transactions in the offer or sale of any securities], section 206(1)–(2) of the Investment Advisers Act of 1940 (“Advisers Act”) [prohibiting transactions by investment advisers that would defraud any client or prospective client], and section 34(b) of the 1940 Act [prohibiting false statements in registration statements and other documents filed with the SEC under this title]. See also In re Waddell & Reed, Inc., Admin. Pro. File No. 3-12372, Securities Exchange Act Rel. No. 54,173 [July 24, 2006]; In re Am. Express Fin. Corp., Admin. Pro. File No. 3-12114, Investment Advisers Act Rel. No. 2,451 [Dec. 1, 2005]; In re Columbia Mgmt. Advisors Inc., Admin. Pro. File No. 3-11814, Securities Act Rel. No. 8,534 [Feb. 9, 2005]; In re RS Mgmt., Inc., Admin. Pro. File No. 3-11696, Investment Advisers Act Rel. No. 2,310 [Oct. 6, 2004].

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In some cases, these abuses are alleged to have been furthered by employees of the brokerage firm in failing reasonably to supervise the brokers, enforce market timing policies and procedures, and implement and enforce controls to ensure that the brokers did not engage in improper market timing practices. 38

Regulators also have brought enforcement cases against hedge funds and their managers that engaged in market timing. 38.1 These cases have included charges that the hedge funds and their advisory personnel defrauded the mutual funds by taking steps to avoid detection and to circumvent the funds’ market timing restrictions.

§ 28:2.3 Revenue Sharing and Directed Brokerage

Regulators have brought many enforcement cases involving failures to disclose fund marketing payments and undisclosed conflicts of interest. Some payments were made in hard dollars; in other instances, the payments were made by directing fund portfolio transactions to brokers selling fund shares. The latter practice was deemed to present such intractable conflicts of interests that the SEC has adopted a rule banning that practice. 39

Some hedge funds are alleged to have employed similar practices. For example, in the STC Complaint, the SEC alleges that STC and the other defendants employed similar methods, from the “omnibus” method (where STC opened five omnibus accounts for the Canary hedge funds at STC through which the hedge funds’ trades were rotated in an attempt to evade detection by the mutual funds) to the “taxpayer ID” method (where STC opened mirror accounts for the five omnibus accounts using STC’s taxpayer identification number in order to impede efforts by mutual funds to detect market timers by their tax ID numbers). See also In re Canadian Imperial Holdings Inc., Admin. Pro. File No. 3-11987, Securities Act Rel. No. 8,592 [July 20, 2005].

Omnibus accounts are a common form of holding mutual fund shares. They are accounts opened by a brokerage firm or other financial intermediary for the benefit of its customers. The fund shares are held and orders are placed in the intermediary’s name, and orders may be batched so that a single order aggregating all customer orders is placed. As a result, the identities of the specific shareholders are not known to the fund. 38.


38.1. See, e.g., In re Millenium Partners, L.P., Admin. Pro. File No. 3-12116, Securities Act Rel. No. 8,639 [Dec. 1, 2005] (adviser created over 100 legal entities, opened over 1,000 trading accounts, and used trading through omnibus accounts and variable annuities to disguise market timing trading); see also In re Veras Capital Master Fund, Admin. Pro. File No. 3-12133, Securities Act Rel. No. 8,646 [Dec. 22, 2005].

Generally, brokers are compensated for selling fund shares through sales loads and asset-based trail fees paid by the fund pursuant to plans adopted under Rule 12b-1 under the 1940 Act. In addition, it is permissible for a fund adviser or other service provider to pay additional amounts out of its “legitimate profits” to defray distribution expenses.\footnote{40}

In several enforcement cases, the SEC found that brokerage firms operated programs to specially promote a select group of mutual funds, and that these programs created an undisclosed conflict of interest because the brokerage firms received additional compensation for selling the select funds and because the brokerage firms paid a higher commission rate to their brokers for selling the select funds.\footnote{41} The SEC further concluded that these brokerage firms misled their customers by failing to disclose the existence of the programs, the payments or the conflicts, and that disclosures in the funds’ prospectuses were not sufficiently specific to enable the brokerage firms’ customers to understand the conflicts.\footnote{41.1} In related cases, NASD concluded that some of these programs violated NASD Conduct Rule 2830[k], which prohibits member brokerage firms from favoring the sale of mutual fund shares based on the receipt of brokerage commissions.\footnote{42}

\footnote{40. \textit{See}, e.g., Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 11,414 (Oct. 28, 1980) (adopting Rule 12b-1 under the 1940 Act).


41.1. \textit{Id.}

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The SEC also has charged fund advisers for directing fund brokerage in connection with fund promotional programs. Under the 1940 Act, fund brokerage is considered an asset of the fund, and therefore allocation of fund brokerage must benefit the fund.\(^{43}\) In recent enforcement cases, the SEC found that the fund adviser had agreed to pay specified amounts to brokerage firms to sell fund shares; by directing fund brokerage to the brokerage firms to satisfy those obligations, the fund adviser had a conflict of interest with the fund, because it was using a fund asset (that is, the brokerage commissions) to satisfy obligations of the adviser.\(^{44}\) The SEC concluded that since the adviser had not disclosed that conflict to the fund shareholders or the board, it had violated the antifraud provisions of the Advisers Act, and the disclosure requirements of the 1940 Act.\(^{44.1}\)

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44.1. Id.
§ 28:2.4 Other Abuses

Some cases also involved selective disclosure of portfolio holdings by fund managers to curry favor with large investors. Specifically, certain funds are alleged to have given frequent updates of their portfolio holdings to select shareholders, enabling these shareholders to use such information to short the fund’s holdings in the same or similar proportions to the fund’s established positions.\(^45\)

§ 28:3 The Regulatory Response

§ 28:3.1 Corporate Governance Changes

[A] Overview

In 2001, the SEC adopted rules to improve corporate governance of mutual funds by enhancing director independence and improving disclosure of information that investors could use to assess director independence.\(^46\) These rules were the result of a lengthy assessment prompted by the growth in mutual funds and the SEC’s growing reliance on independent directors in protecting fund investors.\(^47\) The amendments adopted at that time required that funds relying on certain exemptive rules must meet the following requirements: a majority of the directors must be independent directors; the independent directors must select and nominate independent directors; and when independent directors hire counsel, counsel to the independent directors must be independent of the fund managers.

The recent enforcement cases suggested to the SEC a need for additional rulemaking to enhance director independence. The 1940 Act relies heavily on fund boards to manage conflicts of interest


\(^{47}\) Id. at ¶ 1.
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between the fund’s adviser and the fund. The SEC has stated that the recent enforcement cases suggested, in many cases, “a serious breakdown in management controls.”49 In the SEC’s view, in some cases the fund was used to benefit the fund’s investment manager or other fund insiders.

However, the new fund governance rules also reflect more general concerns on the SEC’s part as to the adequacy of fund governance structures. In proposing the new fund governance rules, the SEC stated that it was concerned that in many cases, including some of the fund complexes involved in the SEC’s enforcement cases, fund management dominated the board. The SEC identified the following problems with that situation:

- The adviser has a monopoly of information concerning the fund;
- The adviser is in a position to control the board agenda;
- The adviser is in a position to impede board oversight;
- Some boards may have abdicated their oversight responsibility, or failed to ask tough questions; and
- Some boards may have lacked the information or structure to play their oversight role.50

In the SEC’s view, management-dominated boards were less likely to effectively fulfill their oversight role. The SEC broadly questioned whether fund boards, as currently constituted, could effectively oversee funds. The SEC noted that in addition to violations charged in its recent enforcement cases, deficient board oversight could lead to “excessive fees and brokerage commissions, less than forthright disclosure, mispricing of securities, and inferior performance.”51

48. Investment Company Governance, 1940 Act Release No. 26,520 (July 27, 2004) (“Investment Company Act Rel. No. 26,520”), at § I. But see K. Damato, D. Reilly, and K. Richardson, “Do Mutual Funds Really Need Directors,” Wall Street Journal Online (June 7, 2004), http://online.wsj.com/article_print/o,SBI108656923845230242,00.html, noting that mutual funds in many countries are governed using a “contract” approach, rather than the “corporate” approach used in the United States. Under the contract approach, the fund is treated as a product of the investment manager, and oversight typically is provided by an outside entity such as a bank responsible for safeguarding fund assets and overseeing the manager’s activities.

49. Investment Company Act Rel. No. 26,520, at § I.


51. Id. § I.

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Further, in the proposing release for the new fund governance rules, the SEC described the proper role of a fund board as follows:

We believe that a fund board must be “an independent force in [fund] affairs rather than a passive affiliate of management.” Its independent directors must bring to the boardroom “a high degree of rigor and skeptical objectivity to the evaluation of [fund] management and its plans and proposals,” particularly when evaluating conflicts of interest. To empower independent directors to better serve as an effective check on fund management, we are proposing to require funds to adopt better governance practices.52

In July 2004, the SEC addressed its concerns by adopting fund governance rule amendments.53 As discussed below, two of the principal new requirements were that for funds relying on certain exemptive rules, the board chair be an independent director and 75% of the directors be independent, up from the current requirement of a majority of independent directors. The SEC also noted that these amendments would complement the SEC’s new rule requiring funds to appoint a chief compliance officer, who would report directly to the board on compliance matters.54 The SEC stated that these new corporate governance rules would put fund boards in a better position to require the highest compliance standards.55

While many industry participants and commentators supported these amendments, they were and continue to be very controversial. When they were proposed, some fund industry participants and commentators criticized the proposals—in particular the requirements for an independent board chairman and the 75% supermajority requirement56—on several grounds. They questioned the absence of empirical evidence of a connection between the problems alleged in the regulatory cases and inadequacies in the corporate governance rules.

52. Id. (footnotes omitted).
53. Investment Company Act Rel. No. 26,520, at § I.
54. This rule is discussed in section 28.3.2 below.
55. Investment Company Act Rel. No. 26,520, at § I.
56. See, e.g., Letter from Craig Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC (Mar. 10, 2004), File No. S7-03-04; Letter from Eric Roiter, Senior Vice President and General Counsel, Fidelity Management and Research Company, to Jonathan G. Katz, Secretary, SEC (Mar. 10, 2004), File No. S7-03-04. With this letter, Fidelity also submitted a study commissioned by it that “strongly indicates that neither superior investment performance nor lower expenses for shareholders is advanced by having independent directors serve as fund board chairs.” Contrary analysis is described in Investment Company Act Rel. No. 26,520, at note 52.
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governance of the fund complexes charged in those cases. Some also questioned whether the proposed changes would have been able to prevent the practices charged in the regulatory cases, noting that most funds already were subject to a variety of requirements intended to assure board independence and that in several enforcement cases the fund companies charged had an independent board chairman and a majority of independent directors. Another criticism was that the proposed changes would deprive fund boards of the knowledge and experience provided by members affiliated with the fund advisers. Another criticism leveled at the proposal was that it took power away from fund boards to decide on the best corporate governance structure for their fund.57 Others expressed concern that the proposed amendments were expanding the board’s role beyond its proper oversight function.

Some of these criticisms also were raised from within the Commission. Two of the five Commissioners (Commissioners Glassman and Atkins) dissented from the adoption of the proposal.58 While the dissenting Commissioners supported the amendments’ objective of strengthening investor protection, in their view the new corporate governance rules might weaken investor protection at a substantial cost. One of their criticisms was that neither the need for the new rules nor the cost of implementing them was supported by empirical evidence. The dissenter also objected that existing majority independence requirements were sufficient, because they enabled independent directors to control the board’s agenda and the outcome of board votes. The dissenters also criticized the 75% independent director requirement by noting that a 66% requirement would be consistent with industry best practices and would be much less expensive for funds to implement.59 They also questioned the benefits of requiring an independent chairman, not-

59. The SEC staff estimated that nearly 60% of all funds already meet the 75% independence requirement. See Investment Company Act Rel. No. 26,520, at note 78. The dissenters cited an ICI estimate that at least half of fund boards would need to change their composition to comply with the 75% requirement. See Dissent, at note 22, citing Tyle Comment Letter.
ing for example that an inside chairman with access to information concerning the day-to-day operations of the fund might have been more likely to discover the violative conduct charged in the recent enforcement cases. They also expressed a concern that the SEC’s focus on the duties of the independent directors was shifting attention away from the fiduciary obligations of the fund adviser and even weakening those obligations.

A lawsuit was filed by the U.S. Chamber of Commerce seeking to prevent the rules from going into effect. The primary grounds for the lawsuit were that the SEC exceeded its authority by seeking to impose these requirements, when the 1940 Act itself only requires that 40% of fund board directors to be independent; the SEC’s action was arbitrary and capricious, because there was no empirical evidence supporting the need for the amendments; and the SEC did not take into consideration the costs of implementing these proposals.

On June 21, 2005, the U.S. Court of Appeals for the D.C. Circuit issued its decision regarding the Chamber’s lawsuit. The court held that the SEC did not exceed its statutory authority in adopting provisions that require a board to have [1] no less than 75% independent directors, and [2] an independent chairman. The court also held that the SEC’s rationales for the provisions satisfied the requirements of the Administrative Procedure Act (APA), 5 U.S.C. § 551, et seq. However, the court further held that the SEC violated the APA when it failed to consider the costs that mutual funds would incur in order to comply with the conditions, and failed to adequately consider a proposed alternative to the independent chairman condition. Therefore, the court granted the Chamber’s petition in part and remanded the matter to the SEC to address the above-noted deficiencies.

On June 30, 2005, the SEC issued a response to the court’s remand. As a threshold matter, the SEC decided that it need not

60. [Reserved.]
60.1 Chamber of Commerce v. SEC, 412 F.3d 133 (per curiam) (D.C. Cir. 2005).
60.2 Id. at 2.
60.3 Id.
60.4 Id. at 17 (“[U]ncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure.”); Id. at 18, 19 [noting that if an alternative is facially reasonably and neither frivolous nor out of bounds, the Commission has an obligation to consider such alternative].
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conduct any additional fact-finding in order to address the remanded issues. As to the costs that a fund would incur by changing its board’s composition, the SEC concluded that it had adequately considered the various costs and that such costs were minimal compared to the expected benefit of compliance with the amendment. With regard to the cost of appointing an independent chairman, the SEC also concluded that it had a reliable basis for estimating such costs. The SEC concluded that the fund integrity and investor confidence engendered by independent chairmen would far outweigh any potential costs. In response to the court’s instruction to consider an alternate proposal that each fund be required prominently to disclose whether it has an inside or an independent chairman and thereby allow investors to make an informed choice, the SEC concluded that, in light of the nature of investment companies and the purpose of the amendments, this proposal would not adequately protect fund investors from potential abuses. The SEC concluded that “the benefits of the 75 percent independent director condition and the independent chairman condition far outweigh their costs, and that the disclosure alternative does not afford adequate protection to fund investors.” Thus, the SEC decided, by a 3-2 vote, to reenact its proposal unaltered.

Commissioners Glassman and Atkins both opposed the new rules as well as the Commission’s response to the court’s remand. In their dissenting statements, Commissioners Glassman and

60.6. Id. at 4 (noting that the existing record was developed through full notice and comment procedures and that, therefore, the information in the existing record, together with publicly available information, is a sufficient base upon which to address the remanded issues).

60.7. Id. at 10–16 (giving a detailed discussion of the costs associated with increasing or decreasing the number of directors on a board); id. at 20 (“We expect that the minimal added expense of compliance with these conditions will have little, if any, adverse effect on efficiency, competition and capital formation. Indeed, we anticipate that compliance . . . will help increase investor confidence, which may lead to increased efficiency and competitiveness of the U.S. capital markets. We also anticipate that this increased market efficiency and investor confidence may encourage more efficient capital formation.”).

60.8. Id. at 16–20 (giving a detailed discussion of the costs associated with hiring an independent chairman and additional staff).

60.9. Id. at 24 (“We believe that a more robust system of checks and balances on fund boards should raise investors’ expectations regarding the governance of these funds. By promoting investor confidence in the fairness and integrity of the individuals that monitor investment companies, we promote investor confidence in the fairness and integrity of our markets.” (citations omitted)).

60.10. Id. at 25–29.

60.11. Id. at 31.

60.12. Id.
Atkins articulated their objections to the SEC’s actions. Their main objections were that (1) the response to the court’s remand was rushed; (2) the SEC responded quickly in order to take advantage of the SEC’s political composition; (3) the procedures followed by the SEC were abnormal; and (4) the SEC’s conclusions lacked factual support.

On April 7, 2006, the U.S. Court of Appeals for the D.C. Circuit vacated the readopted rule. The Court of Appeals held that the SEC had violated the Administrative Procedures Act by relying on information outside the rulemaking record as primary evidence in support of the proposed rulemaking, without providing an opportunity for public comment. The court set aside the independent chair and director independence requirements, and gave the SEC ninety days to reopen the rulemaking for public comment.

Accordingly, on June 13, 2006, the SEC requested additional public comment on the proposed rule. The SEC requested comment and data on the costs of compliance with the two requirements, and “suggestions for additional provisions designed to achieve the underlying purpose of the amendments, which is the protection of funds and fund shareholders.” The SEC also requested comment on whether the rule amendments will promote efficiency, competition and capital formation, as required by section 2(c) of the 1940 Act. The comment period closed on August 21, 2006.

[B] The Amendments: General

The proposed corporate governance rules, which would be set forth in Rule 0-1(a)(7) under the 1940 Act, would be applicable to any investment company that relies on any of ten specified exemp-


60.14. Id. (providing more detail of Commissioner Glassman’s objections); see also Judith Burns, Independence Rules for Mutual Funds Faces New Protest, WALL ST. J., Jul. 8, 2005, at C3 [noting that Commissioners Atkins and Glassman expressed concern over the rapid pace of the readoption of the rules].

60.15. Chamber of Commerce v. SEC, 443 F.3d 890 [D.C. Cir. 2006].


60.17. Id.
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tive rules.61 Most mutual funds would need to comply with the corporate governance requirements, because most fund complexes rely on one or more of these rules.

The mandated fund governance requirements are the following: at least 75% of the directors of the fund must be independent directors or, if the fund board has only three directors, all but one of the directors must be independent directors:

- the chairman of the board must be an independent director;

61. The ten exemptive rules are:
   1. Rule 10f-3 [permitting a fund to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate, if the fund directors, including a majority of the independent directors, approve procedures governing the purchases and review quarterly reports on purchases];
   2. Rule 12b-1 [permitting use of fund assets to pay distribution expenses pursuant to a plan approved by the fund directors, including a majority of the independent directors];
   3. Rule 15a-4(b)(2) [permitting a fund board to approve an interim advisory contract without shareholder approval when the adviser or a controlling person receives a benefit in connection with the assignment of the contract, if the fund directors, including a majority of the independent directors, review and approve the contract];
   4. Rule 17a-7 [permitting securities transactions between a fund and another client of the fund investment adviser, if the fund directors, including a majority of the independent directors, approve procedures governing the transactions and review quarterly reports on transactions];
   5. Rule 17a-8 [permitting mergers between certain affiliated funds if the fund directors, including a majority of the independent directors, request and evaluate information about the merger and determine that the merger is in the best interests of the fund and its shareholders];
   6. Rule 17d-1(d)(7) [permitting a fund and its affiliates to purchase joint liability insurance policies if the fund directors, including a majority of the independent directors, annually determine that the policies are in the best interests of the fund and its shareholders];
   7. Rule 17e-1 [specifying conditions under which a fund may pay commissions to affiliated brokers in connection with the sale of securities on an exchange, including a requirement that the fund directors, including a majority of the independent directors, adopt procedures for the payment of the commissions and review quarterly reports of any commissions paid];
   8. Rule 17g-1 [permitting a fund to maintain joint insured bonds and requiring fund independent directors to annually approve the bond];
   9. Rule 18f-3 [permitting a fund to issue multiple classes of voting stock, if the fund board of directors, including a majority of the independent directors, approves a plan for allocating expenses to each class]; and
   10. Rule 23c-3 [permitting the operation of an interval fund by enabling a closed-end fund to repurchase shares from investors, if the directors adopt a repurchase policy for the fund and review fund operations and portfolio management in order to assure adequate liquidity of investments to satisfy repurchase payments].
the board must perform a self-assessment at least once annually;
the independent directors must meet separately at least once a quarter;
the independent directors must be affirmatively authorized to hire their own staff; and
a fund must retain copies of written materials that the board considers when approving the fund’s investment advisory contract.

These requirements are described in more detail below.

[C] The Amendments: Supermajority of Independent Directors

The purpose of this requirement is to strengthen the independent directors’ control of the fund board and its agenda, and thereby assure that the interests of fund shareholders are controlling. The SEC believes that this requirement will help the independent directors to carry out their fiduciary obligations. The SEC noted that because of fund management’s knowledge concerning the daily operations of the fund, they have an information advantage in setting the board’s agenda and potentially dominating board deliberations. This requirement is intended to redress that imbalance and assure that the independent directors have control of the board and its agenda.62 The exception for three director boards was included to address concerns as to the expense for small funds to implement this proposal.

An independent director is one who is not an “interested person” of the fund as defined in section 2(a)(19) of the 1940 Act. However, in the release adopting these amendments, the SEC urged that independent directors apply a higher standard in selecting candidates to become new independent directors, and select candidates who have “real” independence rather than “legal” independence:

We urge independent directors to look beyond those requirements and examine whether a candidate’s personal or business relationships suggest that the candidate will not aggressively represent the interests of fund investors. Persons who have served as executives of the fund adviser or who are close family members of employees of the fund, its adviser or principal underwriter would,
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in our view, be poor choices for candidates, although they may meet the minimum statutory requirements.\(^{63}\)

[D] **The Amendments: Independent Board Chair**

As noted above, this is the most controversial of the new requirements. The SEC justified this amendment on the grounds that the board could better protect the fund's interests and perform its oversight function if the board chair did not have conflicts of interests arising from a dual role as executive of the adviser.

The adopting release for the amendments indicates that the chair’s role, in the SEC’s view, should at least include the following responsibilities:

- Setting the agenda for board meetings;
- Promoting meaningful dialogue between fund management and the board;
- Playing a significant role in determining the information provided to the board;
- Providing a check on the adviser;
- Playing a significant role in negotiating the investment advisory contract; and
- Providing leadership to the board focusing on the best interests of the shareholders.\(^{64}\)

The adopting release also indicates that the SEC does not expect the chair to become involved in the day-to-day management of the fund.

The SEC indicated that it expects fund management to continue to play a significant role on the board, even though they no longer will be permitted to serve as board chair. The adopting release states that the independent chair "undoubtedly" will continue to consult with fund management concerning the board's activities, although the independent chair will make final decisions concerning the board agenda.\(^{65}\) The SEC also indicated that it fully expects that executives of fund management will continue to serve on fund boards and that fund executives who are not fund directors also would continue to participate in appropriate circumstances in board deliberations.

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63. *Id.* § II.C.
64. *Id.* § III.B.
65. *Id.*
The SEC summarized its view of the relationship between the fund board and fund management, and of its goal in adopting independent chair requirement, as follows:

If a board is to provide effective oversight of the management company, there may be times when it must be prepared to say “no” to the manager’s chief executive officer. We do not mean to suggest that the relationship between the board and the management company need be adversarial. Indeed, we believe that a crucial challenge to every fund board involves establishing an appropriate balance between cooperation with the management company and oversight of the management company. Our primary concern, and the one that has led us to adopt this amendment, is that too often the proper balance has not been achieved, particularly where an executive of the adviser has exerted a dominant influence over the board. While having an independent chairman should not disadvantage a board that is properly balanced, it may significantly benefit one that is not.66

[E] The Amendments: Annual Self-Assessment

Fund directors are required at least annually to evaluate the performance of the board and its committees. The purpose of this amendment is strengthen directors’ understanding of their role, fostering better communications and greater cohesiveness, identifying potential weaknesses, and providing the directors with an opportunity to consider changes to their corporate governance structure and practices.67 While the self-assessment is not required to be in writing, the SEC stated that it expects that board minutes will reflect the substance of the matters discussed in the annual self-assessment.

The amendment and the adopting release do not specify what the self-assessment must include, except that it should include the effectiveness of the board’s committee structure and the number of funds on whose board each director serves.68 The first requirement is intended to focus the directors on the effectiveness of the board’s committee structure, and whether committees need to be created, consolidated, or revised. The latter requirement addresses whether the directors are overseeing too many funds. In the proposing release, the SEC noted that while directors often serve on many fund boards in a single fund complex, this practice has been criticized on the grounds that the directors are unable to pay adequate

66. Id. (citations omitted).
67. Investment Company Act Rel. No. 26,520, at § III.C.
68. Id.; Investment Company Act Rel. No. 26,323, at § III.C.
attention to their obligations to specific funds. Acknowledging the
effects that may derive from this practice, the SEC stated that it
nevertheless was sufficiently concerned about this practice to
require the directors to evaluate it annually.69

[F] The Amendments: Quarterly Executive
Sessions

Independent fund directors are required to meet at least quarter-
ly in separate sessions without the presence of fund management or
interested directors. The purpose of this requirement is to provide
the independent directors with “the opportunity for a frank and can-
did discussion among themselves regarding the management of the
fund, including its strengths and weaknesses.”70 This requirement
also is intended to improve collegiality and communication among
the independent directors. While this provision does not specify
what the independent directors should discuss, the SEC has stated
that it expects they will use this opportunity to discuss the perform-
ance of the investment adviser and other service providers, as well
as the fund’s activities pursuant to the exemptive rules on which it
relies.71

Independent Director Staff

This amendment requires funds to explicitly authorize indepen-
dent directors to hire employees, experts and other consultants that
they deem necessary to carry out their duties. This provision is de-
signed to enable independent directors to obtain assistance in mat-
ters beyond their expertise as well as to understand the practices of
other funds.72

[H] The Amendments: Record-Keeping
Requirements

This provision requires funds to retain written materials that the
board considers in approving advisory contracts under section 15 of
the 1940 Act. The purpose of this amendment is to assist the SEC’s
examination staff in determining whether fund boards are properly

69. Investment Company Act Rel. No. 26,323, at § III.C.
70. Investment Company Act Rel. No. 26,520, at § III.D.
71. Id. at n.65 and accompanying text.
72. Id. § III.E.
performing their fiduciary duties in approving advisory contracts.\textsuperscript{73} The SEC noted that its examination staff had found a wide variation in the nature and quality of the materials presented to fund boards on this subject, and that in some instances the materials were inadequate.\textsuperscript{74} The SEC also stated that this amendment may encourage independent directors to request more information, addressing the SEC’s concern as to information imbalance between fund board and the investment adviser.\textsuperscript{75}

\section*{I] Best Practices Proposals}

In November 2003, SEC Chairman Donaldson asked the Mutual Fund Directors Forum to develop practical guidance and best practice recommendations for independent fund directors.\textsuperscript{76} The Mutual Fund Directors Forum is a non-profit organization for independent directors “dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors.”\textsuperscript{77}

In response, in July 2004 the Mutual Fund Directors Forum published a report on best practices for independent fund directors.\textsuperscript{78} The Report includes best practice recommendations on the following subjects: independence of independent directors; oversight of soft dollar, directed brokerage and revenue sharing arrangements; review of management agreements and management fees; valuation and pricing; and effectiveness of independent directors as to conflicts of interest.

\footnotesize{\textsuperscript{73} Id. § III.F. \\
\textsuperscript{74} Investment Company Act Rel. No. 26,323, at II.F, citing \textit{In re Heart of Am. Inv. Servs.}, Investment Company Act Rel. No. 11,975 (Oct. 6, 1981) (settling an administrative proceeding based in part on a fund board’s failure to request and evaluate proper information in connection with advisory contract approval). \\
\textsuperscript{75} Investment Company Act Rel. No. 26,520, at § III.F. \\
\textsuperscript{76} Letter from William H. Donaldson, Chairman, SEC, to David S. Ruder, Chairman, Mutual Fund Directors Forum [Nov. 17, 2003]. \\
\textsuperscript{77} Mutual Fund Directors Forum website, \textit{available at www.mfdf.com}. \\
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§ 28:3.2 Requirement for Compliance Programs for Investment Advisers and Investment Companies

[A] Introduction

On December 3, 2003, the SEC adopted new rules requiring each registered investment company and investment adviser to adopt and implement written procedures designed to prevent violations of the federal securities laws, as defined in those rules. They also are required to review annually the implementation and effectiveness of the compliance program and to appoint a chief compliance officer (CCO) responsible for administering the compliance program. Fund CCOs will report directly to the fund board. The stated purpose of these rules is to ensure that all funds and advisers have “internal programs to enhance compliance with the federal securities laws.”

In the Compliance Rules Adopting Release, the SEC stated that the need for these rules was confirmed by the recent enforcement cases involving market timing and other violations. The SEC noted that fund advisory or distribution personnel had participated in or assisted others in the illegal conduct charged in those cases. Accordingly, the SEC was adopting the compliance rules as a first step in its regulatory response to “curb the abusive practices recently uncovered and prevent their recurrence.”

[B] The New Compliance Program Rules

The SEC adopted two compliance program rules (the “Compliance Rules”). Rule 206(4)-7 under the Advisers Act requires investment advisory firms to “adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by [the adviser] and [its] supervised persons. . . .” Rule 38a-1 under the 1940 Act requires every registered investment company [a “fund”] to approve and implement “written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund.”

80. Id. § 1.
81. Id.
82. Id.
83. Rule 206(4)-7[a].
84. Rule 38a-1(a)[1]. Investment advisers, principal underwriters, administrators and transfer agents are referred to herein as “service providers.”
rules also include requirements for appointment of a CCO, and for annual review of the compliance program. While Rule 206(4)-7 does not specify how the compliance program is to be adopted, Rule 38a-1 contains detailed requirements for the appointment of the CCO and approval of the program. Rule 38a-1 also contains special provisions addressing its application to unit investment trusts (including insurance company separate accounts), which do not have a board of directors.

The compliance date for Rule 38a-1 is October 5, 2004. Funds and advisers must complete their first annual review of the compliance policies and procedures no later than 18 months after their adoption or approval. The CCO of a fund must submit the first annual report to the fund board within sixty days after completion of the annual review.

[C] Scope of the Compliance Program

The Compliance Rules Adopting Release states that the compliance policies and procedures should be reasonably designed to prevent violations from occurring, detect violations that have occurred, and promptly correct any violations that have occurred. The Compliance Rules Adopting Release discusses the application of Rule 38a-1 to certain important compliance areas, and provides a non-exclusive list of critical areas that policies and procedures should cover.

The SEC has made clear that compliance programs under these rules should be tailored to the nature of the firm and its operations. The SEC stated that in designing the compliance program, the firm should “first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks.” This risk assessment process is at the heart of the design and maintenance process for compliance programs subject to the Compliance Rules. The SEC envisions that funds will

85. Rule 206(4)-7(c); Rule 38a-1(a)(4).
86. Rule 206(4)-7(b); Rule 38a-1(a)(3).
87. Rule 38a-1(a)(2) and (4).
88. Rule 38a-1(b).
89. Compliance Rules Adopting Release, at § III.
90. Id. § II.A.1.
91. Id.
92. The adequacy of this risk assessment process also can be expected to affect the scope and nature of subsequent SEC inspections. The SEC inspection staff uses a risk-based approach to determine the frequency of inspection and depth of the procedures they apply to particular areas. The SEC inspection staff believes that registrants with a strong “culture of compliance” are likely to have more effective compliance controls and less

(Mutual Fund Reg., Rel. #2, 11/06) 28–35
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implement compliance programs that will change over time to identify new and unusual patterns that point to compliance problems and deficiencies.\textsuperscript{92.1} The SEC also noted that it expected smaller firms without conflicting business interests to have simpler programs than larger firms with multiple lines of business or affiliations with other financial service firms.\textsuperscript{93}

\textbf{[C][1] Investment Advisers}

While Rule 206(4)-7 does not require that specific procedures be included in investment adviser compliance programs, in the Compliance Rules Adopting Release, the SEC stated that it would expect an adviser’s compliance program to address at a minimum, the following issues, to the extent that they are relevant to the adviser:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients’ investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses fund brokerage to obtain research and other services (that is, “soft dollar arrangements”), and allocates aggregated trades among clients;

likely to have compliance problems than those that do not. See Lori A. Richards, Director, Office of Compliance Inspections and Examinations (OCIE), Speech by SEC Staff: The New Compliance Rule: An Opportunity for Change, presented at ICI/Independent Directors Council Mutual Funds Compliance Programs Conference [June 28, 2004] (“Richards Speech”), available at www.sec.gov/news/speech/spch063004lar.htm. The SEC inspection staff believes that a good culture of compliance has at least five elements: strategic vision, identification of specific risks within each strategic area, control points for each of these risks, good documentation, and assignment of responsibility to specific people. See Lori A. Richards, Director, OCIE, Speech by SEC Staff: The Culture of Compliance, presented at NRS Spring Compliance Conference [Apr. 23, 2003], available at www.sec.gov/news/speech/spch042303lar.htm. Funds and advisers should keep these elements in mind in designing and maintaining their compliance programs.

92.1. See William H. Donaldson, Chairman, Remarks before the Mutual Fund and Investment Management Conference [Mar. 14, 2005], Lori A. Richards, Director, OCIE, Remarks before the Investment Adviser Compliance Best Practices Summit: Compliance Programs: Our Shared Mission [Feb. 28, 2005]. Richards stated, “an effective compliance program must continue to evolve and, to do so, the program must be able to identify, meet, and incorporate changes in your business and changes in your customers, to continue to identify conflicts of interest, to be responsive to changes in the statutory and regulatory regime, and to continually strive to find the best technology and the best people.”


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- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

**[C][2] Investment Companies**

Fund compliance programs must cover oversight of service providers, as well as the fund. Most fund operations are carried out by the investment adviser, distributor, or other service providers, which have their own compliance policies and procedures. Rule 38a-1 neither requires a fund to adopt, as its own, the policies and procedures of its service providers, nor allows the fund simply to rely on its service providers’ policies and procedures. Instead, Rule 38a-1 requires the fund board to approve the policies and procedures of service providers, and requires the fund’s policies and procedures to include provisions to oversee compliance by its service providers. Rule 38a-1 provides flexibility so that each fund may apply Rule 38a-1 in a manner best suited to its organization.

In the Compliance Rules Adopting Release, the SEC stated that funds’ or their advisers’ policies and procedures should address the issues listed above. In addition, in light of the enforcement cases, the SEC stated that it expected fund compliance programs to address the following areas:

- **Pricing of portfolio securities and fund shares.** The 1940 Act requires funds to sell and redeem their shares at prices based on their current NAV, and to pay redemption proceeds.
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promptly. Funds also are required to calculate their NAVs using the market value of their portfolio securities when market quotations for those securities are “readily available,” and, when market quotations are not readily available, by using the fair value of those securities, as determined in good faith by the fund’s board. These pricing requirements are designed to ensure that fund shares are purchased and redeemed at fair prices and to prevent dilution of shareholder interests.

The SEC believes that “funds that fail to fair value their portfolio securities under such circumstances may violate rule 22c-1 under the Investment Company Act. Fund directors who countenance such practices fail to comply with their statutory valuation obligations and fail to fulfill their fiduciary obligation to protect fund shareholders.” Accordingly, the SEC believes that Rule 38a-1 requires funds to:

• Adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices;
• Establish criteria for determining when market quotations are no longer reliable for a particular portfolio security;
• Provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and
• Regularly review the appropriateness and accuracy of the method used in valuing securities and make any necessary adjustments.

• Processing of transactions. Under the SEC’s “forward pricing” rules, an investor submitting a purchase order or redemption request must receive the price next calculated after receipt of the purchase order or redemption request. The SEC believes that Rule 38a-1 requires that a fund have in place procedures to segregate investor orders received be-

96. 1940 Act § 2(a)(41).
97. When fund shares are mispriced, short-term traders have an arbitrage opportunity they can use to exploit a fund and disadvantage the fund’s long-term investors by extracting value from the fund without assuming any significant investment risk.
98. Compliance Rules Adopting Release, at § II.B.2 [citations omitted].
99. The SEC has adopted amendments to fund disclosure requirements with respect to the use and the effects of fair value pricing. See section 28:3.6.[b], infra.
fore it determines its share price (which will receive that day’s price) from those that were received after it determines its share price (which will receive the following day’s price). In this regard, the SEC stated that funds may not rely on contractual provisions with transfer agents and other intermediaries to comply with these requirements. Rather, “[f]unds should not only approve and periodically review the policies and procedures of transfer agents, as required by the rule, but should also take affirmative steps to protect themselves and their shareholders against late trading by obtaining assurances that those policies and procedures are effectively administered.”

- **Identification of affiliated persons.** To prevent self-dealing and overreaching by persons in a position to take advantage, the 1940 Act prohibits a fund from entering into certain transactions with affiliated persons. Rule 38a-1 requires policies and procedures to be in place that identify affiliated persons and are reasonably designed to prevent unlawful transactions with them.

- **Protection of nonpublic information.** The federal securities laws prohibit insider trading. Section 204A of the Advisers Act, in particular, requires investment advisers (including adviser to funds) to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the adviser or any of its associated persons from misusing material, nonpublic information. The SEC believes that fund advisers should incorporate their section 204A policies into the policies required by Rule 38a-1. These policies typically include prohibitions against trading portfolio securities on the basis of information acquired by analysts or portfolio managers employed by the investment adviser. The SEC believes that a fund’s compliance policies and procedures should also address other potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund’s portfolio, its trading strategies, or pending transactions, and the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund’s portfolio.

- **Compliance with fund governance requirements.** Fund boards play an important role in overseeing fund activities to ensure that they are being conducted for the benefit of the fund and its shareholders. They must, among other things:

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things, approve the fund’s advisory contracts, underwriting agreements, and distribution plans. The 1940 Act requires that fund directors be elected by fund shareholders, and that a certain percentage be “independent directors.” Moreover, in order for a fund to rely on many of the SEC’s exemptive rules, independent directors must constitute a majority of the board, must be selected and nominated by other independent directors, and if they hire legal counsel, that counsel must be an independent legal counsel.101

The consequences of failing to meet the 1940 Act’s governance requirements are severe. Therefore, the SEC believes that a fund’s policies and procedures should be designed to guard against, among other things, an improperly constituted board,102 the failure of the board to properly consider matters entrusted to it, and the failure of the board to request and consider information required by the 1940 Act from the fund adviser and other service providers.

• Market timing. The SEC has adopted amendments to its registration forms requiring funds to disclose their policies on “market timing,” that is, excessive short-term trading. Failure to follow those policies may violate the antifraud provisions of the federal securities laws. Moreover, a fund adviser that waives or disregards those policies for its own benefit or the benefit of a third party may breach its fiduciary responsibilities to the fund. Thus, the SEC believes that under Rule 38a-1, a fund must have procedures reasonably designed to ensure compliance with its prospectus (and other) disclosure regarding market timing. These procedures should “provide for monitoring of shareholder trades or flows of money in and out of the fund in order to detect market timing activity, and for consistent enforcement of the fund’s policies regarding market timing.”103 In addition, if the fund permits waivers of the market timing policies, the procedures should be reasonably designed to prevent

101. See, e.g., Rule 12b-1 under the 1940 Act.
102. For example, a board lacking a sufficient number of disinterested directors would be improperly constituted.
103. The Compliance Rules Adopting Release notes that if an investment company permits waivers of its market timing policies, the market timing procedures should be reasonably designed to prevent waivers that would harm investors or subordinate investor interests to those of any affiliated person. In the Compliance Rules Adopting Release, the SEC “strongly urges” that persons authorized to waive market timing policies report at least quarterly all waivers granted, so the depositor can evaluate whether the waivers were proper.
 waivers that would harm investors or subordinate their interests to those of any affiliated person.

[D] Approval Requirements of Fund Compliance Program

Rule 38a-1 requires that the fund board approve the compliance policies and procedures of the fund and each of its service providers. The approval must be based on a finding that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund and its service providers.  

The board is only required to approve policies and procedures of service providers that could affect the fund. Separate approval by the board is not required if the policies and procedures of a service provider are included within the policies and procedures adopted for the fund.

The board may satisfy its obligations under Rule 38a-1 in connection with the adoption of a compliance program by reviewing summaries of the compliance programs of the service providers prepared by the CCO, legal counsel or other persons familiar with the compliance programs. The summaries should describe the important features of the programs (including programs of service providers) to provide the board with a good understanding of how the compliance programs address particular compliance risks.

In considering whether to approve a fund’s or service provider’s compliance policies and procedures, the SEC believes the board should consider:

- The nature of the fund’s exposure to compliance failures; and
- The adequacy of the policies and procedures in light of recent compliance experiences, which may demonstrate weaknesses in the compliance programs.

The SEC has also suggested that boards consider best practices used by other fund complexes and consult with counsel and other experts and specialists familiar with compliance practices successfully employed by similar funds or service providers.

As a practical matter, the boards of funds that use the services of an unaffiliated service provider may not be able to review all of the documentation for the service provider’s compliance program. This problem also may arise where a fund has a large number of service providers, for example, in the context of a multi-manager fund. In

104. Rule 38a-1[a][2]
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this circumstance, the SEC and its staff have stated that the fund board may rely on reports prepared by third parties or summaries prepared by the service provider itself.\textsuperscript{106} The report or summary must:

- Describe the service provider’s compliance program as it relates to services provided to the fund;
- Discuss the compliance risks material to the fund; and
- Assess the adequacy of the service provider’s compliance controls.

The SEC staff has indicated that summaries prepared by service providers may be relied upon where the service provider presents limited risk exposure, as for example where a sub-adviser manages a limited amount of the fund's assets or where, based on the fund’s long-standing relationship with the sub-adviser and the sub-adviser’s experience, the CCO has confidence that the sub-adviser’s procedures are reasonably designed to prevent violations of the Federal Securities Laws.\textsuperscript{107} The staff has noted that in this circumstance, the CCO must reasonably believe that the information concerning the service provider’s policies and procedures is sufficient to enable the fund’s board to determine that those policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws.

Where a fund board relies on such reports for its approval of the service provider’s compliance program, the fund must also gather and take into account other relevant information, such as its experience with the service provider.\textsuperscript{108}

Rule 38a-1 does not require the board to approve amendments to compliance policies and procedures of the fund or its service providers on an ongoing basis. Instead, Rule 38a-1 requires the CCO to discuss material changes to the compliance policies and procedures in his or her annual report to the board.

**[E] Annual Review**

The Compliance Rules require an annual review of the adequacy of the compliance policies and procedures adopted pursuant to the relevant Compliance Rule and the effectiveness of their implementation. A fund’s annual review must also cover the compliance

\textsuperscript{106} Id.

\textsuperscript{107} ICI Memorandum re: SEC Staff Affirms Ability to Rely on Summaries of Service Providers’ Policies and Procedures under Rule 38a-1 [July 23, 2004].

\textsuperscript{108} Compliance Rules Adopting Release, at n.35.
The annual review should take into consideration any compliance issues that arose in the prior year, changes in the firms’ or its affiliates’ business activities, or changes in applicable laws or regulations. The fund board need not conduct the review. Instead, the board would have the benefit of the review in the report submitted by the CCO, which it will evaluate.

While the Compliance Rules require annual review only, the SEC has suggested that entities consider interim reviews in response to significant compliance, business or regulatory developments. The SEC has stated that it expects “all funds will begin reviewing their compliance policies and procedures currently, not only in light of the adoption of these rules, but also in light of the recent revelations of unlawful practices involving fund market timing, late trading, and improper disclosures and use of non-public portfolio information.”

**[F] Duties of the CCO**

**[F][1] Designation and Qualifications of CCO**

The Compliance Rules require each fund and adviser to designate one individual as CCO responsible for administering the entity’s compliance program. The CCO should be competent and knowledgeable regarding the Federal Securities Laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures. The CCO should also have sufficient seniority and authority to compel others to adhere to the compliance policies and procedures.

In order to assure the independence of a fund CCO, Rule 38a-1 requires that the CCO’s appointment and compensation be approved by the fund’s board of directors, including a majority of the disinterested directors. Moreover, the CCO may not be dismissed except with the approval of the fund’s board of directors, including a majority of the disinterested directors.

The SEC expects that often the fund CCO will be employed by the fund’s investment adviser or administrator. Moreover, he or she “is likely to be the CCO of that organization inasmuch as the duties of the positions will have significant overlap. Alternatively, the CCO of the fund may be another member of the adviser or administrator’s legal or compliance departments.”

109. Rule 38a-1[a][3].
111. Id. at § II.B.2.
112. Rule 38a-1[a][4][i].
113. Rule 38a-1[a][4][ii].
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The SEC recognizes that a fund CCO who is employed by the fund’s adviser might be conflicted in his or her duties, and that the adviser’s business interests might discourage the adviser from making forthright disclosure to fund directors of its compliance failures. Rule 38a-1, however, is designed to address these concerns by including provisions designed to promote the independence of the CCO from fund management, as described above.

[F][2] Fund CCO Responsibilities

The CCO is responsible for administering the fund’s policies and procedures adopted under Rule 38a-1.114 As part of those responsibilities, the CCO must provide a written report at least annually to the fund board addressing at least the following subjects:

1. the operation of the compliance policies and procedures under Rule 38a-1 of the fund, and any service providers;
2. any material changes in those policies and procedures since the date of the last report;
3. any material changes in those policies and procedures recommended as a result of the required annual review; and
4. any Material Compliance Matter that occurred since the last report.115

“Material Compliance Matter” is defined in Rule 38a-1(e)(1) as any compliance matter about which the board would need to know to oversee the fund’s compliance with the Federal Securities Laws, including:

1. a violation of the Federal Securities Laws by the fund, a service provider, or any officer, director, employee or agent thereof;
2. a violation of the compliance policies and procedures under Rule 38a-1 of the fund or its service providers; or
3. a weakness in the design or implementation of the compliance policies and procedures under Rule 38a-1 of the fund or its service providers.

The SEC has asked for comment on whether its definition of “material compliance matter” that must be reported to the board adequately addresses the SEC’s concern that fund boards receive

114.1. For an SEC staff member’s views of the CCO’s duties, see G. Gohlke, Associate Director, OCIE, Speech at the Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC’s New Regulatory Framework (May 5, 2005).
compliance information they reasonably need to know in order to oversee fund compliance.\footnote{116}{Compliance Rules Adopting Release, at § II.F.} As of this writing, the SEC has not taken action in response to the comments received.

The CCO also is required to meet in executive session with the disinterested directors at least once each year, without anyone else, such as fund management or inside directors, present.\footnote{117}{Rule 38a-1(a)(4)(iv).} The executive session is intended to provide an opportunity for the CCO and the disinterested directors to speak freely about any sensitive compliance matter or concern, including any reservation as to the cooperativeness of fund management.\footnote{118}{Compliance Rules Adopting Release, at § II.C.2.}

The CCO has responsibility for overseeing the compliance programs of the service providers. The SEC has described that role as follows:

The chief compliance officer, in exercising her responsibilities under the rule, will oversee the fund’s service providers, which will have their own compliance officials. A chief compliance officer should diligently administer this oversight responsibility by taking steps to assure herself that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The chief compliance officer should be familiar with each service provider’s operations and understand those aspects of their operations that expose the fund to compliance risks. She should maintain an active working relationship with each service provider’s compliance personnel. Arrangements with the service provider should provide the fund’s chief compliance officer with direct access to these personnel, and should provide the compliance officer with periodic reports and special reports in the event of compliance problems. In addition, the fund’s contracts with its service providers might also require service providers to certify periodically that they are in compliance with applicable federal securities laws, or could provide for third-party audits arranged by the fund to evaluate the effectiveness of the service provider’s compliance controls. The chief compliance officer could conduct (or hire third parties to conduct) statistical analyses of a service provider’s performance of its duties to detect potential compliance failures.\footnote{119}{Compliance Rules Adopting Release, § II.C.2. [footnotes omitted].}
The CCO also should expect to be a primary contact with the SEC staff. The SEC staff views the CCO as a valuable resource for the inspection program. As the head of OCIE has stated:

As regulators, we will look to the Chief Compliance Officer as our ally, just as we do the independent auditors and the Board of Directors, particularly the independent directors. As examiners, we will develop that alliance—we will speak often to the Chief Compliance Officer, utilizing her knowledge to more completely understand the fund’s compliance program, to hear concerns, and to understand emerging issues and the ways in which they are being handled. We expect the Chief Compliance Officer to be open, honest and candid with us about issues that arise.\textsuperscript{120}

Thus, the SEC clearly expects that the CCO will play a leading role in handling an SEC inspection. As CCO is a new position, however, his or her role undoubtedly will evolve as registrants and the inspection staff gain more experience with its requirements.\textsuperscript{120.1}

\textbf{[G] Protection of Fund CCO from Undue Influence}

Rule 38a-1 includes a provision to protect a fund’s CCO from undue influence by persons seeking to conceal their or others’ non-compliance with the Federal Securities Laws. In particular, Rule 38a-1 prohibits any officer, director or employee of the fund, its investment adviser, its principal underwriter, or any person acting under its direction, from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the CCO in the performance of his or her responsibilities under Rule 38a-1.\textsuperscript{121}

\begin{itemize}
  \item \textsuperscript{120}. Richards Speech, supra note 92, at § 1.
  \item \textsuperscript{120.1}. The SEC has established a “CCO Outreach” program to foster communication between CCOs and the SEC staff. It consists of three elements: (1) regional seminars for CCOs to learn the “nuts and bolts” of the examination process; (2) annual national seminars featuring presentations by SEC staff members responding to concerns raised by the CCOs; and (3) a newsletter, the “CCO Observer,” which will allow the SEC to communicate directly with CCOs about emerging issues such as new rules, interpretive releases, recent examination findings, and relevant enforcement actions. See William Donaldson, Remarks before the Mutual Fund and Investment Management Conference (Mar. 14, 2005).
  \item \textsuperscript{121}. Rule 38a-1(c).
\end{itemize}
[H] Unit Investment Trusts

In recognition that unit investment trusts (UITs) do not have a board of directors, Rule 38a-1 modifies certain of its provisions for UITs’ compliance programs. Under these provisions, the UIT’s depositor or principal underwriter must approve its CCO, receive all annual reports, and approve the removal of the CCO from his or her responsibilities. Rule 38a-1 does not specifically require that the entity’s board of directors perform these functions. Accordingly, it appears that UIT sponsors may perform these functions by action of their boards, or a designated committee or person, in light of their particular organization and good corporate governance standards.

[I] Record Keeping

Rule 38a-1 includes record-keeping requirements applicable to fund compliance records. The Compliance Rules Adopting Release makes clear that all records and reports required by this Rule (and any other SEC rule) are meant to be made available to the SEC and the SEC staff, and thus are not subject to attorney-client privilege, the work-product doctrine, or other similar protections. Rule 38a-1 requires each fund to maintain copies, which may be kept electronically, of the following documents:

- **Written compliance policies and procedures.** All policies and procedures that are in effect or were in effect at any time during the last five years in an easily accessible place.

- **Materials presented to the board.** All materials provided to the board in connection with its approval of the board’s and its service providers’ policies and procedures and the annual written reports of its CCO, for at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place.

- **Documentation of annual review.** All records documenting its annual compliance review for at least five years after the end of the fiscal year in which the review was conducted, the first two years in an easily accessible place.

In connection with the adoption of Rule 206(4)-7, the SEC also amended Rule 204-2 under the Advisers Act to require advisers to keep copies of their written compliance policies and procedures and documentation of the CCO’s annual review of those policies and procedures.

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122. Rule 38a-1(b).
123. Compliance Rules Adopting Release, at n.94.
124. Rule 204-2(a)(17).
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§ 28.3.3 Investment Adviser Codes of Ethics

In July 2004, the SEC adopted Rule 204A-1 under the Advisers Act requiring each registered investment adviser to adopt a code of ethics. The code of ethics must set forth the standards of conduct expected of all advisory personnel and address conflicts that arise from personal trading by advisory personnel, including transactions involving any mutual fund managed by the adviser. The SEC also adopted conforming amendments to personal securities reporting requirements of Rule 17j-1 under the 1940 Act.

[A] Standards of Conduct

The Rule requires each code of ethics to set forth a standard of business conduct that the adviser requires of all its supervised persons. The standard must reflect the adviser’s fiduciary obligations and those of its supervised persons and must require compliance with the federal securities laws. In the Rule 204A-1 Adopting Release, the SEC stated that the code of ethics should embody “ideals for ethical conduct premised on fundamental principles of openness, integrity, honesty and trust.” Advisers may set higher standards for their employees, such as those established by trade or professional groups.

[B] Protection of Material Non-public Information

In a change from the initial rule proposal, the Rule does not require that each code of ethics include provisions reasonably designed to prevent access to material nonpublic information about the adviser’s securities recommendations and client securities holdings and transactions. However, the SEC reminded advisers that they are required by law to maintain and enforce policies and procedures to prevent the misuse of material nonpublic information. The SEC also noted its belief that this requirement prohibited misuse of material nonpublic information about the adviser’s securities.

126. Investment Advisers Act Rel. No. 2,256, at § II.A.
127. For example, the Investment Counsel Association of America has released a best practices guide to help investment advisers to comply with the Rule.
recommendations, and client securities holdings and transactions. The Adopting Release notes that this requirement would not prohibit the adviser from providing necessary information to persons providing services to the adviser or its accounts (for example, brokers, accountants, custodians and fund transfer agents).\footnote{130}

[C] Personal Securities Trading

The code of ethics must call for the adviser’s access persons to periodically report their personal securities transactions and holdings to the adviser’s CCO or other designated persons.\footnote{131} The code of ethics must also require the adviser to review those reports.\footnote{132} In addition, the code of ethics must require access persons to obtain the adviser’s approval before investing in an initial public offering or private placement.\footnote{133}

- **Personal Trading Procedures.** The Rule does not require codes of ethics to include specific provisions regarding personal trading, other than requiring pre-clearance of investments in an initial public offering or private placement. However, in the Adopting Release, the SEC noted that advisory firm codes of ethics commonly included the following elements, which the SEC suggested all advisers should consider in crafting their own employee trading procedures:
  - Prior written approval before access persons can place a personal securities transaction;
  - Maintenance of lists of issuers of securities that the advisory firm is analyzing or recommending for client transactions, and prohibitions on personal trading in securities of those issuers;
  - Maintenance of “restricted lists” of issuers about which the advisory firm has inside information, and prohibitions on any trading (personal or for clients) in securities of those issuers;
  - “Blackout periods” when client securities trades are being placed or recommendations are being made and access persons are not permitted to place personal securities transactions;

\begin{footnotes}
\item[130] Investment Advisers Act Rel. No. 2,256, at note 12.
\item[131] Rule 204A-1(a)[3].
\item[132] \textit{Id.}
\item[133] Rule 204A-1(d). Firms with only one access person need not include this provision.
\end{footnotes}
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- Reminders that investment opportunities must be offered first to clients before the adviser or its employees may act on them, and procedures to implement this principle;
- Prohibitions or restrictions on short-swing trading and market timing;
- Requirements to trade only through certain brokers, or limitations on the number of brokerage accounts permitted;
- Requirements to provide the adviser with duplicate trade confirmations and account statements; and
- Procedures for assigning new securities analyses to employees whose personal holding do not present apparent conflicts of interest.\(^ {134}\)

- **Persons Subject to the Reporting Requirement.** The Rule requires the adviser’s “access persons” to report their personal securities holdings and transactions. It defines an “access person” as a supervised person who has access to nonpublic information regarding clients’ securities transactions, is involved in making securities recommendations to clients, who has access to such recommendations that are nonpublic, or who has access to nonpublic information regarding the portfolio holdings of affiliated mutual funds.\(^ {135}\) The Rule creates a legal presumption that, if the advisory firm’s primary business is providing investment advice, then all of its directors, officers, and partners are access persons.\(^ {136}\)

- **Reportable Securities and Beneficial Ownership.** Rule 204A-1 treats all securities as reportable securities, except: money market instruments, direct obligations of the U.S. government, money market fund shares, shares of other mutual funds (unless the adviser or a control affiliate acts as the investment adviser or principal underwriter for the fund), and shares in UITs if the UIT is invested exclusively in unaffiliated mutual funds.\(^ {137}\)

- **Reporting of Investment Company Shares.** The Rule requires all advisers’ codes of ethics to call for reporting of holdings and transactions in affiliated mutual funds. By requiring reporting of transactions involving affiliated mutual

135. Rule 204A-1(e)(1).
137. Rule 204A-1(e)(10).
fund shares, the Rule is intended to help advisers identify abusive trading, such as market timing, by persons with access to information about the fund’s portfolio.\textsuperscript{138}

- **Initial and Periodic Holdings and Transactions Reports.** The Rule requires access persons to report their securities holdings at the time the person becomes an access person and at least annually thereafter. The Rule also requires access persons to make quarterly reports of all personal securities transactions. No report is necessary if an access person had no transactions during the quarter.

[D] **Other Requirements**

The Rule requires that any violation of the code of ethics be reported promptly to the adviser’s CCO or other designated person.\textsuperscript{139} The SEC encouraged advisers to create an environment that encourages and protects people who report violations.\textsuperscript{140} The Rule requires the adviser to provide each supervised person with a copy of the code of ethics and any amendments to it, and each supervised person to acknowledge, in writing, receipt of those copies.\textsuperscript{141} The SEC further noted that while it was not requiring firms to educate employees about their codes of ethics, it expected that most firms would provide adequate training on the procedures and practices under their codes.\textsuperscript{142} The Rule requires advisers to maintain and enforce their codes of ethics by reviewing their access persons’ securities holdings and transactions.\textsuperscript{143} While the SEC did not require that the records be maintained on an electronic database, the SEC questioned whether large advisory firms would be able adequately to review the personal trading of their employees through manual review of the transaction and holdings report.\textsuperscript{144} The SEC provided the following guidance as to its expectations as to the scope of the review:

Review of personal securities holding and transaction reports should include not only an assessment of whether the access person followed any required internal procedures, such as pre-clearance, but should also compare the personal trading to any restricted lists; assess whether the access person is trading for his own account in the same securities he is trading for clients,

\begin{itemize}
\item \textsuperscript{138} Investment Advisers Act Rel. No. 2,256, at § II.C.6.
\item \textsuperscript{139} Rule 204A-1(a)(4).
\item \textsuperscript{140} Investment Advisers Act Rel. No. 2,256, at § II.E.
\item \textsuperscript{141} Rule 204A-1(a)(5). The acknowledgements may be made electronically.
\item \textsuperscript{142} Investment Advisers Act Rel. No. 2,256, at § II.F.
\item \textsuperscript{143} Rule 204A-1(a)(3).
\item \textsuperscript{144} Investment Advisers Act Rel. No. 2,256, at § II.G.
\end{itemize}
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and if so whether the clients are receiving terms as favorable as the access person takes for himself; periodically analyze the access person’s trading for patterns that may indicate abuse, including market timing; investigate any substantial disparities between the quality of performance the access person achieves for his own account and that he achieves for clients; and investigate any substantial disparities between the percentage of trades that are profitable when the access person trades for his own account and the percentage that are profitable when he places trades for clients.\(^\text{145}\)

**[E] Effective Date**

The effective date of the new rule and related rule amendments is August 31, 2004. The date by which advisers must comply with the new requirements is January 7, 2005.

§ 28:3.4 Mutual Fund Redemption Fees

In March 2005, the SEC adopted new Rule 22c-2 under the 1940 Act that would require mutual funds’ board of directors (with certain limited exceptions) to consider approving a redemption fee of up to two percent of the amount redeemed when it determines that such fee is in their fund’s best interest.\(^\text{146}\) Rule 22c-2 would supplement other measures the SEC has taken (for example, requiring advisers and funds to adopt compliance policies and procedures discussed in section 28:3.2 above to prevent violation of the Federal Securities Laws, including establishing fair value pricing in certain circumstances, and requiring disclosure of funds’ market timing policies and procedures). Prior to adoption of the rule, many funds already had implemented redemption fees to curb excessive trading that may dilute the value of fund shares held by long-term shareholders, disrupt portfolio management and raise a fund’s transaction costs. However, the SEC was concerned that many funds were unable to effectively impose redemption fees on the accounts of investors who purchase fund shares through intermediaries because their share holdings were frequently identified in the intermediary’s name, rather than the shareholder’s name (so-called “omnibus accounts”). Accordingly, Rule 22c-2 was adopted to implement redemption fees as a means to stem, or possibly eliminate, market timing, but also to provide funds with an effective way of imposing

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\(^{145}\) Id.

redemption fees on shareholders who hold their shares through intermediaries.147

[A] Redemption Fees

Rule 22c-2 requires that each fund's board of directors (including a majority of independent directors) either (i) approve a redemption fee on shares redeemed within seven or more calendar days after the shares were purchased that, in its judgment, is necessary or appropriate to recoup costs the fund may incur as a result of redemptions, or to otherwise eliminate or reduce dilution of the fund's outstanding securities, or (ii) determine that imposition of a redemption fee is not necessary or appropriate.148 The proceeds of the redemption fee, in all cases, must be paid to the fund itself. Directors may impose the fee to offset the costs of short-term trading in fund shares, and/or to discourage market timing and other types of short-term trading strategies.

The redemption fee may not exceed two percent of the amount redeemed. The two percent limit is designed to be a compromise between two goals of the SEC—preserving the redeemability of mutual fund shares while reducing or eliminating the ability of shareholders who rapidly trade their shares to profit at the expense of their fellow shareholders. Under the new rule, however, directors may approve a redemption fee of less than two percent. By adopting Rule 22c-2, the SEC is now permitting redemption fees to be based on the judgment of the fund and its board rather than tying such fees to the administrative and processing costs associated with redeeming fund shares.

[B] Shareholder Information

Rule 22c-2 also addresses the findings of the market timing investigations that abusive market timing practices were concealed through omnibus accounts.149 The rule requires funds to enter into written agreements with their intermediaries under which the intermediaries must, upon request, provide funds with certain shareholder identity and transaction information, and carry out instructions from the fund to restrict or prohibit further purchases or exchanges by a shareholder (identified by the fund) that has violated the fund's market timing policies.

147. As a result of the SEC's adoption of this rule, the staff no-action positions concerning redemption fees have terminated. See, e.g., John P. Reilly & Associates, SEC Staff No-Action Letter [Jul. 12, 1979]; Neuberger & Berman Genesis Fund, Inc., SEC Staff No-Action Letter [Sept. 27, 1988].
149. See supra note 37 and accompanying text.
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[B][1] Fund Responsibilities

Rule 22c-2 requires that each fund (or its principal underwriter), regardless of whether it imposes a redemption fee, enter into a written agreement with each of its financial intermediaries under which each intermediary must provide the fund, upon request, information about the identity of shareholders and about their transactions in fund shares. Funds may request information periodically, or when circumstances suggest that a financial intermediary is not assessing redemption fees or that abusive market timing activity is occurring.

[B][2] Financial Intermediaries

Rule 22c-2 also requires the agreement with financial intermediaries to provide that the intermediary agrees to execute the fund’s instructions to restrict or prohibit further purchases or exchanges by a specific shareholder (as identified by the fund) who has engaged in trading that violates the fund’s market timing policies. Under the rule, a “financial intermediary” includes: (i) a broker, dealer, bank or any other entity that holds securities in nominee name; (ii) an insurance company that sponsors a registered separate account organized as a unit investment trust, master-feeder funds, and certain fund of fund arrangements not specifically excepted from the rule; and (iii) in the case of an employee benefit plan, the plan administrator or plan recordkeeper.

In February 2006, the SEC proposed several amendments to the rule relating to financial intermediaries in response to public comments. First, the SEC proposed to revise the rule to exclude from the definition of “financial intermediary” any intermediary that the fund treats as an individual investor for purposes of fund policies intended to eliminate or reduce dilution of the value of fund shares. Such policies would include restrictions on frequent purchases and redemptions, as well as a fund’s redemption fee policy.

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149.2. Rule 22c-2(a)(2)(ii).
149.3. See Rule 22c-2(c)(1).
149.5. Proposed Rule 22c-2(c)(1)(iv). So, if a fund applies a redemption fee/exchange restrictions to transactions by a retirement plan (an intermediary) rather than transactions of the employees in the plan, then the plan would not be deemed a “financial intermediary” under the rule and the fund would not be required to enter into an agreement with that plan.
Second, to clarify how the rule would apply to “chains of intermediaries,” the SEC proposed to revise the rule so that a fund must enter into a written agreement only with those financial intermediaries that submit purchase or redemption orders directly to the fund, its principal underwriter or transfer agent, or a registered clearing agency (“first-tier intermediary”). The SEC proposed to define this written agreement as a “shareholder information agreement.” (The shareholder information agreement may be part of another contract or agreement, such as a distribution agreement.) In addition, the proposal would include transfer agents and registered clearing agencies among the entities that may enter into shareholder information agreements with financial intermediaries on a fund’s behalf.

The shareholder information agreement must obligate the first-tier intermediary to provide, promptly upon the fund’s request, identification and transaction information for any shareholder accounts held directly with it. If such shareholder account is another financial intermediary, the agreement must obligate the first-tier intermediary to use its best efforts to identify, upon request by the fund, those account holders who are themselves intermediaries, and obtain and forward (or have forwarded) the underlying shareholder information from those indirect intermediaries. If an indirect intermediary refuses to honor the request, the agreement must obligate the first-tier intermediary to prohibit, upon the fund’s request, such indirect intermediary from purchasing additional shares of the fund through the first-tier intermediary. The proposed amendments do not require first-tier intermediaries to enter into formal information-sharing agreements with indirect intermediaries, although they would not prohibit such agreements.

149.6. Chains of intermediaries refer to arrangements where an intermediary (i.e., a broker-dealer) may hold its shares of a fund on behalf of not only individual investors, but also on behalf of other intermediaries (“second, third-tier intermediaries” or “indirect intermediaries”) [i.e., a pension plan]. Commenters had pointed out that the rule did not explain how it would apply to any second tier [or additional tiers] of financial intermediaries. Amending Release at 12.

149.7. Proposed amendment to Rule 22c-2(a)(2).

149.8. If a transfer agent or clearing agency enters into an agreement on behalf of the fund, the agreement must require the financial intermediary to provide the requested information to the fund upon the fund’s request, as provided in the definition of shareholder information agreement. Amending Release at n.37.
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The SEC also confirmed that financial intermediaries could rely on certain exceptions in applicable privacy laws to privacy notice and opt-out requirements in providing shareholder information to funds under the written agreements.  

Third, the SEC proposed to revise the rule to provide that, if a fund does not have an agreement with a particular intermediary, the fund must thereafter prohibit the intermediary from purchasing, on behalf of itself or other persons, securities issued by the fund.  

As such, a fund in this situation could continue to redeem securities within seven calendar days, but must prohibit the financial intermediary from purchasing fund shares on behalf of itself or any other person. This proposal stemmed from concerns that a fund’s inability to obtain agreements with all of its intermediaries could be interpreted, under the rule, to mean that the fund would be precluded from redeeming the shares of any of its shareholders within seven days of purchase.

[C] Exceptions

Rule 22c-2 does not apply to the following funds, unless they elect to impose a redemption fee pursuant to Rule 22c-2(a)(1):

1. money market funds;
2. any fund that issues securities that are listed on a national securities exchange; and
3. any fund that affirmatively permits short-term trading of its securities, if its prospectus clearly and prominently discloses that the fund permits short-term trading of its shares and that such trading may result in additional costs for the fund. In contrast to the proposed rule, the fund need not adopt a fundamental policy to such effect.

[D] Compliance Date

The new rule was effective May 23, 2005 and the compliance date of the rule is October 16, 2006.

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149.9. Amending Release at n.16.
149.10. Proposed Rule 22c-2[a][2][ii].
149.11. The SEC did not change the compliance date of the rule despite its proposed amendments to Rule 22c-2, but said that it would consider doing so when adopting final rule amendments.
§ 28:3.5 Proposed Amendments to the “Forward-Pricing” Rule: The 4:00 P.M. “Hard Close”

The SEC has proposed amendments to Rule 22c-1 under the 1940 Act to prevent further unlawful late trading in the fund industry. Currently, Rule 22c-1 allows transaction orders that are received by retail dealers and other intermediaries by 4:00 P.M. Eastern Standard Time to receive that day’s price, even though the intermediaries forward the order information to Fund/SERV (a national clearing agency) or the fund’s primary transfer agent after 4:00 P.M., when that day’s NAV has already been determined. Under the proposed amendments, an order would be deemed received only upon receipt by

1. the fund itself,
2. the fund’s designated transfer agent, or
3. a clearing agency registered with the SEC (for example, NSCC’s Fund/SERV system).

As a consequence, fund intermediaries, such as broker-dealers, banks, and administrators of retirement plans, would have to submit orders to the fund, the fund’s designated transfer agent, or a registered clearing agency before 4:00 P.M. Eastern Standard Time in order for their customers to receive that day’s 4:00 P.M. price. Orders received after the 4:00 P.M. “hard close” by those entities would receive the following day’s price.

[A] Purchase and Sale Orders; Exchanges

With respect to purchase and sale orders, the SEC proposed to define the term “order” in the rule to clarify when an order is complete (and therefore has been received) for purposes of obtaining the appropriate day’s price. An “order” under the proposed amendments will mean the direction to purchase or sell either (1) a specific number of shares of a fund (for example, all the shares held in an account), or (2) an indeterminate number of shares of a specific value (for example, $10,000 of shares of the fund). The definition also will state that each order will be deemed irrevocable as of the next day.


151. The proposed amendment would use the phrase “based on the current net asset value established as of the next pricing time” instead of the current phrase “based on the current net asset value which is next computed.” This amendment is intended to clarify the current requirement that orders received after the pricing time, but before calculation of the NAV is complete, do not receive same-day pricing.
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pricing time after receipt by the fund, its designated transfer agent, or registered clearing agency. This provision is intended to prevent the canceling or modifying of orders after the pricing time for the order. The SEC also proposed to define “order” to include an exchange.

[B] Exceptions

The proposed amendments would preserve the current exceptions in Rule 22c-1 and would add two others. The first new exception would permit investor orders to receive same-day treatment if, as a result of an emergency, a dealer (or its agent) or other intermediary was unable to transmit the orders, or NSCC or the fund’s designated transfer agent was unable to receive the orders. This “emergency” exception would be available to dealers only if the chief executive officer of the dealer or intermediary certifies to the fund (1) the nature, existence, and duration of the emergency (that is, power failure, hurricane), and (2) that the dealer or intermediary received the orders before the applicable pricing time. In addition, a fund would be required to keep a record of each certification it received for six years. The second new exception would permit a “conduit fund,” such as a master-feeder fund or an insurance company separate account, to submit its orders based on the NAV established by the other fund on the same day.

[C] Status

The SEC has not adopted the proposed amendments to Rule 22c-1, for which the comment period expired on February 6, 2004. In the meantime, the proposed amendments have received much criticism. One widely-shared criticism is that customers that transact fund shares through intermediaries will be disadvantaged, because financial intermediaries will need to stop accepting transaction orders from their customers (for example, 401(k) plan participants or broker-dealer customers) much earlier in the trading day to ensure that the fund, its designated transfer agent or Fund/SERV receives the order by the 4:00 P.M. hard close.

152. Three existing exceptions in Rule 22c-1 would be preserved. The first allows sales of unit investment trust shares in the secondary market involving backward pricing under conditions that do not dilute existing shareholders’ interest in the trust. The second permits insurance company separate accounts to price initial purchase payments up to two days after receipt of a complete contract application and up to five days while obtaining additional information to complete the application. The third allows a fund to adjust the price of its redeemable securities sold pursuant to a sale, merger, consolidation, or purchase of substantially all the assets of certain companies.
The SEC apparently is abandoning its plan to enact the 4:00 P.M. hard close rule in light of, among other things, its inaction on the rule proposal and comments by Robert Plaze, an associate director in the SEC’s Division of Investment Management, expressing his thoughts that the SEC staff would not currently recommend that a hard 4:00 P.M. rule be used to combat late trading.\textsuperscript{152.1}

\section*{§ 28:3.6 Disclosure of Market Timing Policies, Fair Value Pricing Policies, and Selective Disclosure of Portfolio Holdings}

The SEC has adopted amendments to Forms N-1A, N-3, N-4 and N-6, substantially as proposed, to require prospectus disclosure of both the risks to shareholders of frequent purchases and redemptions of investment company shares, and the investment company’s policies and procedures with respect to such frequent purchases and redemptions.\textsuperscript{153} The SEC also has adopted amendments to Forms N-1A and N-3 requiring mutual funds and insurance company managed separate accounts that offer variable annuities (other than money market funds) to explain both the situations in which they will use fair value pricing and the effects of fair value pricing. Finally, the adopted amendments will require mutual funds and insurance company managed separate accounts that offer variable annuities to disclose both their policies and procedures relating to the disclosure of their portfolio holdings, and any ongoing arrangements to make available information about their portfolio holdings.

\subsection*{[A] Disclosure Relating to Frequent Purchases and Redemptions of Fund Shares}

First, the proposed amendments will require a fund’s prospectus to describe the risks, if any, of frequent trading in fund shares for other fund shareholders. The SEC suggests that these risks may include dilution of the value of fund shares held by long-term shareholders, disruption of portfolio management, and increased brokerage and administrative costs. The disclosure should be fund-


\textsuperscript{153} Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Rel. No. 26,418 (Apr. 23, 2004). The SEC removed the proposed requirement that a fund describe its policies and procedures for detecting frequent purchases and redemptions of fund shares in response to many comments that argued that such a requirement would provide potential market timers with a “road map” to avoid detection by the fund.
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specific, taking into account the fund’s investment objectives, policies, and strategies.

Second, a fund’s prospectus will be required to state whether the fund’s board has adopted policies and procedures relating to frequent purchases and redemptions of fund shares by fund shareholders. If not, the fund’s prospectus will be required to include a statement of the board’s specific basis for the view that the fund need not have such policies and procedures.

Third, the amendments will require the fund’s prospectus to describe, with specificity, the policies and procedures adopted by the board, including:

- Whether or not the fund discourages frequent purchases and redemptions of fund shares by fund shareholders;
- Whether or not the fund accommodates frequent buying and selling of fund shares by fund shareholders;
- Any policies and procedures the fund has for deterring such frequent buying and selling of fund shares, including:
  1. any limits on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period;
  2. any exchange or redemption fee;
  3. any other fees or charges that are imposed on shareholders deemed to be engaged in frequent buying and selling of fund shares, along with the circumstances under which such 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 transaction requests submitted by overnight delivery, electronically, facsimile or telephone; and
  6. any right of the fund to reject, limit, delay, or impose other conditions on exchanges or purchases or to close or otherwise limit accounts based on transaction history, including a description of when such right will be exercised; and
- a statement on the application of each of the above policies and procedures for deterring frequent trading to trades through omnibus accounts at intermediaries, such as advisers, broker-dealers, transfer agents, third party administrators, and insurance companies.
Fourth, the amendments clarify that the new disclosure that will be required within the prospectus may not be omitted from the prospectus in reliance on Item 6(g), formerly Item 6(f). Item 6(g) permits funds to omit from the prospectus certain information concerning purchase and redemption procedures if, among other things, such information is included in a separate document that is incorporated by reference into, and filed and delivered with, the prospectus.

Fifth, under the proposed amendments, a fund will be required to disclose any arrangements with any person to permit frequent purchases and redemptions of fund shares in its Statement of Additional Information (SAI). Funds will be required to disclose the identity of such persons as well as any consideration received by the fund, its adviser, or any other party pursuant to the arrangement. Any fund that includes this information in its SAI will need to include a cross-reference to this disclosure in its prospectus.

Sixth, the proposed amendments will apply to all mutual funds, including exchange-traded funds (ETFs), despite numerous comments that argued that ETFs are not as susceptible to market timing because, among other things, they trade on stock exchanges at market prices throughout the day. The SEC noted that, where an ETF buys and sells its shares in cash rather than “in kind,” frequent buying and selling of ETF shares may present risks for long-term ETF shareholders that are similar to the risks of frequent buying and selling of fund shares for long-term shareholders of mutual funds.

Last, the SEC adopted parallel disclosure requirements for insurance company separate accounts that issue variable annuity and variable life contracts relating to the risks of frequent transfers of contract value among sub-accounts, and the separate account’s policies and procedures with respect to such frequent transfers. The requirements have been modified to address the different structure of these issuers.

[B] Disclosure of Circumstances under which Funds Will Use Fair Value Pricing and the Effects of Such Use

The SEC adopted, substantially as proposed, amendments to Forms N-1A and N-3 to require all mutual funds and managed separate accounts that offer variable annuities, other than money market funds, to explain briefly in their prospectuses both the circumstances under which they will use fair value pricing and the effects of such use. The SEC’s intent in adopting these amendments was to clarify 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).
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Such brief disclosure should be specific to the fund. In addition, the SEC clarified that disclosure of the specific methodologies and formulas used to determine fair value pricing is not required. A fund’s disclosure also need not be so specific that it may not adjust the triggering events from time to time in response to market events or other causes. For fund-of-funds arrangements, or any other portion of a fund’s assets that may hold other fund shares, the fund may briefly explain that the fund’s NAV is calculated based upon the NAVs of the mutual funds in which the fund invests and that the prospectuses for those funds explain the circumstances under which they will use fair value pricing and any effects.

[C] **Selective Disclosure of Fund Portfolio Holdings**

In response to the abuses discussed in section 28:2.4 above, the SEC adopted, substantially as proposed, amendments to Form N-1A (and parallel amendments to Form N-3 for managed separate accounts that issue variable annuities) that will require mutual funds to disclose both their policies and procedures with respect to the disclosure of their portfolio holdings and any ongoing arrangements to make available information about their portfolio holdings. The SEC’s intent in adopting these amendments was to provide greater transparency of fund practices relating to disclosure of a fund’s portfolio holdings, and to reinforce funds’ and advisers’ obligations to prevent the misuse of material, nonpublic information.154

First, a fund will be required to describe its policies and procedures relating to the disclosure of its portfolio holdings in its SAI, and provide in its prospectus a cross-reference statement that such information is available in its SAI and, if applicable, its website. Such disclosure must include:

- how the policies and procedures apply 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 imposed on the use of information about portfolio holdings that is disclosed, including confidentiality requirements or prohibitions on trading, and any procedures to monitor the use of this information;

[154. The SEC clarified in the Adopting Release that a fund’s portfolio holdings may be disclosed only consistent with the antifraud provisions of the federal securities laws and the fund’s or adviser’s fiduciary duties and that compliance with these amendments will not make unlawful disclosure lawful.]

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the frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date such information is disclosed;

• any policies and procedures relating to receipt of compensation or other consideration by the fund, its adviser, or any other party in connection with the disclosure of information about portfolio holdings;

• the individuals or categories of individuals who may authorize disclosure of the fund’s portfolio securities;

• the procedures that the fund uses to ensure that disclosing information about the fund’s portfolio holdings is in the best interests of fund shareholders, including procedures to address conflicts of interest between fund shareholders and the fund’s adviser, principal underwriter, or any affiliated person of the fund, its adviser, or its principal underwriter; and

• the manner in which the board of directors of the fund oversees disclosure of the fund’s portfolio securities.

Second, a fund will be required to describe in its SAI any ongoing arrangements to disclose information about the fund’s portfolio securities to any person, including the identity of such persons and any compensation or other consideration received by the fund, its adviser, or any other party in connection with each such arrangement. Although divulging portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so, the SEC clarified that general legitimate business purposes will not include the receipt of consideration by the fund’s adviser or its affiliates. With respect to these arrangements, a fund would also have to describe:

• any conditions or limits placed on the use of information about portfolio securities that is disclosed, including confidentiality requirements or prohibitions on trading based on the information, and any procedures to monitor the use of this information;

• the frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date on which the information is disclosed; and

• the individuals or categories of individuals who may authorize disclosure of the fund’s portfolio holdings.
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The SEC adopted two exceptions from the requirement to describe ongoing arrangements to make available information about the fund’s portfolio holdings. First, a fund will not be required to describe such ongoing arrangement if, not later than the time that the fund makes available the portfolio securities information to any person pursuant to the arrangement, the fund discloses the information in a publicly available filing with the SEC that is required to include the information. A fund may not rely on this exception by voluntarily filing its portfolio holdings information with the SEC (for example, a filing on Form N-Q to disclose month-end holdings).

Second, a fund will not be required to describe any ongoing arrangement if it (i) makes that information available on its website, and (ii) discloses in its prospectus that the information is available on its website. Specifically, to rely on this exception, a fund will need to disclose in its prospectus:

(i) the nature of the information that will be available, including both the date as of which the information will be current (for example, month-end) and the scope of the information (for example, twenty largest holdings);

(ii) the date when the information will first become available and how long such information will remain available, which must be at least until the date on which the fund files a Form N-CSR or Form N-Q for the period that includes the date as of which the website information is current; and

(iii) the location on the fund’s website where either the information or a prominent hyperlink to the information will be available.

[D] Compliance Date

All initial registration statements and post-effective amendments to effective registration statements on Forms N-1A, N-3, N-4, and N-6 filed on or after December 5, 2004, must include the required disclosure. In addition, any fund that files a post-effective amendment to comply with the new disclosure should file a post-effective amendment pursuant to Rule 485(a) under the 1933 Act.
§ 28:3.7 Prohibition on Use of Brokerage Commissions to Finance Distribution

[A] Reasons for the Amendments

In response to the directed brokerage enforcement cases discussed under section 1.2.3 above and the SEC’s review of current brokerage practices, the SEC has adopted amendments to Rule 12b-1 under the 1940 Act that prohibits funds from paying for the distribution of their shares with brokerage commissions. Specifically, the SEC staff found that the directed brokerage practices in those cases were inconsistent with the rationale of a decision in 1981 to allow advisers to consider “sales of shares that the fund issues as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution.” In some instances, advisers and brokers had made arrangements whereby the broker would promote fund shares for an agreed-upon level of brokerage commissions from the adviser. Then if the broker’s compensation fell below these agreed-upon levels, the broker could reduce its selling efforts for the funds. In some cases transactions were directed to selling brokers (broker-dealers that promote fund shares). In other cases where the selling broker lacked the capacity to execute fund securities transactions, the adviser might select another broker to execute the transactions and have the executing broker “step out” a portion of its commission to pay the selling broker. Alternatively, the executing broker might retain a portion of the commission as compensation for its execution services and set the remainder aside pending the adviser’s designation of the selling brokers to which the remainder would be directed.

In adopting the amendments to Rule 12b-1, the SEC concluded that the practice of directing portfolio brokerage as compensation for sales of fund shares could harm fund investors in the following ways:

- It may adversely affect best execution of fund transactions by creating a conflict of interest in the adviser’s brokerage allocation decision process. Because fund advisers’ compensation is based on the amount of assets in the fund, advisers may have an incentive to promote the sale of fund shares to increase their advisory fees. Advisers also may have an incentive to avoid paying brokers out of their own pockets for

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selling fund shares (revenue sharing). These incentives create conflicts of interest that can adversely affect the adviser’s decisions on where to effect portfolio securities transactions, or how frequently to trade portfolio securities.

- By using directed brokerage arrangements, fund advisers and broker-dealers can avoid NASD Conduct Rule 2830(d) that prohibits NASD members (that is, broker-dealers) from selling shares of funds that impose excessive sales loads and other distribution costs directly or indirectly on shareholders.

- The practice of trading brokerage for sales efforts involves costs that are built into brokerage commissions, but are not reflected in the fee table to shareholders in every fund prospectus, which identifies the amount of sales load, as well as 12b-1 fees that are deducted from fund assets. Rather, these costs are treated as capital items rather than expenses. Consequently, this treatment reduces the transparency of fund distribution costs and the ability of an investor to understand those costs.

- Lastly, a broker-dealer’s receiving brokerage commissions in exchange for selling fund shares may corrupt the relationship between broker-dealers and their customers, because the broker has an incentive to recommend funds that best compensate the broker rather than focusing on the customer’s needs.

[B] Rule 12b-1 Amendments

Rule 12b-1(h)(1) prohibits funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker, and applies both to directing transactions to selling brokers, and to indirectly compensating selling brokers by participating in step-out and similar arrangements. The ban extends to any payment, including any commission, mark-up, mark-down, or other fee (or portion of another fee) received or to be received from the fund’s portfolio transactions effected through any broker or dealer.

Rule 12b-1(h)(2) does permit a fund to use its selling broker to execute transactions in portfolio securities only if the fund or its adviser has implemented policies and procedures designed to ensure that its selection of selling brokers for portfolio securities transactions is not influenced by considerations about the sale of fund shares. These procedures must be approved by the fund’s board of directors, including a majority of the independent directors, and must be reasonably designed to prevent: (i) the persons responsible
for selecting broker-dealers to effect transactions in fund portfolio securities transactions from taking into account, in making those decisions, broker-dealers' promotional or sales efforts, and (ii) the fund, its adviser and principal underwriter from entering into any agreement or other understanding under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund shares. These procedures should be incorporated into each fund’s compliance policies and procedures pursuant to Rule 38a-1 of the 1940 Act.

[C] Compliance Date

Funds must be in compliance with the ban and have policies and procedures in place pursuant to the amendments by December 13, 2004.

§ 28:3.8 Confirmation Requirements and Point of Sale Disclosure Requirements

The SEC proposed new Rules 15c2-2 and 15c2-3 under the 1934 Act and amendments to Rule 10b-10 under the 1934 Act and to Form N-1A to respond to concerns that investors in mutual fund shares, UIT interests, and municipal fund securities used for education savings (“529 plans”) lack adequate information about distribution-related costs, as well as certain distribution arrangements that create conflicts of interest for broker-dealers, municipal securities dealers, and their associated persons, such as revenue sharing. The comment period on the proposed rules and amendments expired on April 12, 2004, but in February 2005, in response to the comments received on the proposed new rules, the SEC determined that the proposed point of sale and confirmation disclosure requirements may need to be revised, reopened the comment period on the original proposed rules and published a supplemental request for comment. Such comments included disclosing comprehensive costs and not just distribution-related fees (that is, management fees and other expenses of the covered security) in point of sale and


157.1 Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26,778 (Feb. 28, 2005).
confirmation disclosure, requiring broker-dealers to use the Internet as a disclosure medium to supplement point of sale and confirmation disclosure, oral point of sale disclosure, and the definition of “point of sale.” The comment period expired April 4, 2005.

[A] Proposed Rule 15c2-2: Confirmation of Transactions in Mutual Fund Shares, UIT Interests, and Municipal Fund Securities Used for Education Savings

Proposed Rule 15c2-2 would require brokers, dealers and municipal securities dealers to provide their customers with certain information in connection with certain transactions in mutual fund shares, UIT interests, and 529 plan shares. Because these securities have special distribution and compensation practices, the SEC proposed a new rule, rather than amend Rule 10b-10, which provides current confirmation disclosure requirements for other transactions. Proposed Rule 15c2-2 would retain much of the disclosure framework of Rule 10b-10, while also providing customers of brokers, dealers and municipal securities dealers with targeted cost and conflict information relevant to transactions in those securities.

[A][1] Proposed Rule 15c2-2: No Safe Harbor from Antifraud Provisions or Other Legal Requirements

Proposed Rule 15c2-2, like Rule 10b-10, would not function as a safe harbor for non-disclosure that constitutes deception or that otherwise violates a securities firm’s legal obligations. Rather, the SEC’s intention is for proposed Rule 15c2-2 to be a minimal benchmark for disclosing certain distribution-related costs and conflicts of these securities, in an accessible manner to investors and that could

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158. Rule 10b-10 under the 1934 Act requires broker-dealers to disclose specific information to their customers about securities transactions at or before the completion of each securities transaction, although broker-dealers may also disclose the information monthly or quarterly in limited situations, such as in a periodic plan for purchasing fund shares. Information required in the confirmation includes, among other things, the identity of the security, the number of shares purchased or sold, and the price at which the transaction was effected. Where the broker-dealer acts as the customer’s agent, the amount of remuneration it received from the customer also has to be disclosed. However, the SEC and its staff have taken the position that a broker-dealer may satisfy its Rule 10b-10 obligations without providing customers with a transaction-specific document that discloses information about loads and third party remuneration, so long as the customer receives a fund prospectus that adequately discloses that information. See Exchange Act Rel. No. 13,508, at n.41 (May 5, 1977) [42 Fed. Reg. 25,318 (May 17, 1977)] (adopting Rule 10b-10).
fit on one piece of paper. To clarify this intent, the preliminary note
to proposed Rule 15c2-2 would state that the confirmation disclosure
requirements are not determinative of, and do not exhaust, a
broker’s, dealer’s or municipal securities dealer’s disclosure obligations
under the antifraud provisions of the federal securities laws or
under any other legal requirements.

[A][2] Proposed Rule 15c2-2: Transactions in
Covered Securities

Proposed Rule 15c2-2 would apply to transactions by brokers,
dealers and municipal securities dealers on behalf of customers in
“covered securities.” Proposed Rule 15c2-2(f)(6) would define
“covered security” as:

i. Any security issued by an “open-end company,” as defined
   by section 5(a)(1) of the 1940 Act, that is not traded on a
   national securities exchange;

ii. Any security issued by a “unit investment trust,” as defined
    by section 4(2) of the 1940 Act, other than an exchange-
    traded fund that is traded on a national securities exchange
    or facility of a national securities association, or a UIT that
    is the subject of a secondary market transaction; and

iii. Any “municipal fund security.”

[A][3] Proposed Rule 15c2-2: Schedule 15C and
the Form of Disclosure

Proposed Rule 15c2-2(a) would require a broker, dealer or munic-
ipal securities dealer to make the required disclosures in a manner
that is “consistent with Schedule 15C.” Proposed Schedule 15C has
six main parts:

A: general information;
B: distribution-cost information;
C: broker-dealer compensation information;

159. The preliminary note to the rule would clarify that municipal securities
   brokers would be subject to the proposed rule because they are a type of
   “broker.” See Exchange Act § 3(a)(31) (definition of “municipal securities
   broker”).

160. Proposed Rule 15c2-2(f)(12) would define a “municipal fund security” as
    any municipal security that is issued pursuant to a qualified state tuition
    program as defined by section 529 of the Internal Revenue Code [26
    U.S.C. § 529], and that is issued by an issuer that, but for the application
    of section 2(b) of the 1940 Act, would constitute an investment company
    within the meaning of section 3 of the 1940 Act. Section 2(b) of the 1940
    Act excludes the United States, states and certain other government-
    related instrumentalities and corporations from the scope of that Act.

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D: differential compensation information;
E: breakpoint discount information; and
F: explanations and definitions.

“Consistent with Schedule 15C” means using Schedule 15C, or using a similar layout so long as:

- All information specified in Schedule 15C is set forth in the confirmation;
- Information specified in Parts B through F of Schedule 15C (if applicable) is included with no change, including to the typeset or order of the items;
- Information specified in Part A of Schedule 15C is displayed prominently.

In response to comments on the proposed rules, the SEC solicited further comment on the format of confirmation disclosure, including whether broker-dealers should use their own format for confirmation or, alternatively, whether the SEC should prescribe a format for confirmation disclosures, such as the revised forms set out in Appendix 28C.


Proposed Rule 15c2-2(b)[1]–[2] would require disclosure of the transaction date, the issuer and class of the covered security. Proposed Rule 15c2-2(b)[3] would require disclosure of both the NAV of the shares or units and, if different, their public offering price. Proposed Rule 15c2-2(b)[4] would require disclosure of the number of shares of a covered security purchased or sold by the customer, along with the total dollar amount paid or received in the transaction and the net amount of the investment bought or sold in the transaction (the number of shares or units bought of sold multiplied by the NAV of those shares or units). Proposed Rule 15c2-2(b)[5] would require disclosure of any commission, mark-up, or other compensation the broker, dealer or municipal securities dealer will receive from the customer in connection with the transaction. Proposed Rule 15c2-2(b)[6] would require disclosure of the amount of any deferred sales loads incurred by a customer in a sale of a covered security. Proposed Rule 15c2-2(b)[7] would require, where

161. For instance, fund share classes that charge front-end sales load have a public offering price that exceeds the NAV by the size of the load. The SEC’s intent is to provide customers with more transparent information about both price and NAV and to help them verify eligibility for any breakpoints.
applicable, a statement that a broker, dealer or municipal securities dealer is not a member of the Securities Investor Protection Corporation (SIPC), or that the broker, dealer or municipal securities dealer clearing or carrying the customer account is not a SIPC member.  


Proposed Rule 15c2-2(c)(1) would require disclosure of the amount of any sales load incurred or to be incurred at the time of purchase, expressed in both dollars and as a percentage of the net amount invested, together with information about the potential relevance of breakpoint discounts (including the sales load that should be charged based on the availability of breakpoint discounts). Proposed Rule 15c2-2(c)(2) would require disclosure of the potential amount of deferred sales loads [other than a deferred sales load of no more than one percent that expires no later than one year after purchase, when no other sales load would be incurred]. Proposed paragraph (c)(2) would also require disclosure of the maximum deferred sales load as a percentage of NAV at the time of purchase or sale, as applicable. Proposed Rule 15c2-2(c)(3) would require disclosure of any asset-based sales charges and service fees paid in connection with a customer’s purchase of covered securities. As with the comments to the proposed point of sale disclosure requirements, however, many investors favored confirmation disclosure of comprehensive ownership costs beyond distribution costs, including fund management fees and other expenses.

162. SIPC is a private-sector, nonprofit membership corporation that Congress created under the Securities Investor Protection Act of 1970 to protect customers of failed broker-dealers. Generally, all broker-dealers registered with the SEC must be SIPC members. Where a broker-dealer fails and cannot meet its obligations to customers, SIPC returns cash and securities to customers within certain limits and to the extent possible. Broker-dealers selling only mutual fund shares are exempt from the SIPC member requirement.

163. Deferred sales loads include surrender charges on variable contracts.

164. Proposed Rule 15c2-2(f)(1) would define “asset-based sales charges” as all asset-based charges incurred in connection with the distribution of a covered security, paid by the issuer or paid out of assets of covered securities owned by the issuer. Proposed Rule 15c2-2(f)(2) would define “asset-based service fee” as all asset-based amounts paid for personal service and/or the maintenance of shareholder accounts by the issuer, or paid out of assets of covered securities owned by the issuer. Those terms would encompass Rule 12b-1 fees and similar distribution or service fees incurred by issuers.
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Proposed Rule 15c2-2(c)(4) would require disclosure of any dealer concession that the broker, dealer or municipal securities dealer earns in connection with the transaction, expressed both in dollars and as a percentage of the net amount invested.\(^{165}\)


Proposed Rule 15c2-2(c)(5) would require disclosure of information about two types of arrangements:

- Revenue sharing\(^ {166}\) payments from persons within the fund complex, and
- Commissions, including riskless principal compensation, associated with portfolio securities transactions on behalf of the issuer of the covered security, or other covered securities within the fund complex.\(^ {167}\)

The information would be disclosed based on the firm’s sales on behalf of the fund complex, rather than a fund-by-fund basis. For both revenue sharing and portfolio brokerage commissions, the above disclosure would be required for amounts directly or indirectly earned from the fund complex by:

(A) the broker, dealer or municipal securities dealer;

(B) any of their associated persons (as defined in sections 3(a)(18) and 3(a)(22) of the 1934 Act); and

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165. Proposed Rule 15c2-2(f)(8) would define “dealer concession” as fees that the broker, dealer or municipal securities dealer will earn at the time of the sale, in connection with the transaction, from the issuer of the covered security, an agent of the issuer, the primary distributor, or any other broker, dealer or municipal securities dealer.

166. Proposed Rule 15c2-2(f)(16) would define “revenue sharing” as any arrangement or understanding by which a person within a fund complex, other than the issuer of the covered security, pays a broker, dealer or municipal securities dealer, or any of their associated persons, apart from dealer concessions or other sales fees that would be disclosed pursuant to Proposed Rule 15c2-2(b)(4).

167. The required disclosure of commissions associated with portfolio transactions would include any commissions received by a broker, dealer or municipal securities dealer as part of a “soft dollar” arrangement.
if the covered security is not a proprietary covered security, any other associated person.

Those amounts should be disclosed as a percentage of the total NAV represented by such broker’s, dealer’s, or municipal securities dealer’s total sales of covered securities [as measured by cumulative NAV] on behalf of the fund complex over the four most recent calendar quarters, updated each calendar quarter. The total dollar amount of revenue sharing or portfolio brokerage commissions that the broker, dealer or municipal securities dealer may expect to receive for the transaction, calculated by multiplying that percentage by the net amount invested in the transaction, must also be disclosed. Firms would have thirty days to update the information following the end of the calendar quarter.

Results of the SEC’s in-depth investor interviews and focus group testing suggested that investors are more interested in seeing the total amounts they pay for investments in covered securities than in seeing the broker-dealer’s precise compensation. As a result, the SEC solicited comment on all aspects of the proposed disclosure of broker-dealer compensation, including whether broker-dealers should be required to show quantified details of their compensation practices via website and disclose only the existence of the conflict of interest arising from such practices on point of sale and confirmation disclosure documents.

Proposed Rule 15c2-2: Additional Disclosures for Purchases: Differential Compensation Disclosure

Proposed Rule 15c2-2(c)(6) would require disclosure of an affirmative, negative, or “not applicable” response to whether a broker, dealer or municipal securities dealer pays differential compensation to associated persons related to purchases of the following securities:

- Covered securities that carry a deferred sales load [other than a load of no more than one percent that expires no later than one year after purchase, when no other sales load would be incurred]; and

168. Proposed Rule 15c2-2(f)(15) would define “proprietary covered security” as any covered security as to which the broker, dealer, or municipal securities dealer is an affiliated person, as defined by section 2(a)(3) of the 1940 Act, of the issuer, or is an associated person of the issuer’s adviser or principal underwriter, or, for a UIT interest that is a covered security, an associated person of a sponsor, depositor or trustee of the covered security.
Shares of proprietary covered securities that are issued by an affiliate of the broker, dealer or municipal securities dealer.169

“Differential compensation” would be defined differently depending on which security described above the customer purchased. For covered securities with deferred sales loads, Proposed Rule 15c2-2(f)(9)(i) would define “differential compensation” as any form of higher compensation (including total commissions, reimbursement or avoidance of charges or expenses, or other cash/non-cash compensation) that a broker, dealer or municipal securities dealer can expect to pay to any associated person in connection with the sale of a stated dollar amount of that class of covered security over the next year, based on its current practices and assuming no change in the shares’ NAV if applicable, compared with the compensation that the associated person would have been paid over the next year for the sale of the same dollar amount of another class of the same security that has a front-end sales load. For purchases of proprietary covered securities, Proposed Rule 15c2-2(f)(9)(ii) would define “differential compensation” as: (A) any practice by which a broker, dealer or municipal securities dealer pays an associated person a higher percentage of the firm’s gross dealer concession in connection with selling the same dollar amount of any non-proprietary covered security offered by the firm; and (B) other practices of a broker, dealer or municipal securities dealer that cause an associated person to earn a higher rate of compensation for selling a proprietary covered security, such as additional cash compensation or the imposition, allocation, or waiver of expenses, overhead costs, or ticket charges.

Results of the SEC’s in-depth investor interviews and focus group testing suggested that investors are more interested in seeing the total amounts they pay for investments in covered securities than in seeing the broker-dealer’s precise compensation. As a result, the SEC solicited comment on all aspects of the proposed disclosure of broker-dealer compensation, including whether broker-dealers should be required to show quantified details of their compensation practices via website and disclose only the existence of the conflict of interest arising from such practices on point of sale and confirmation disclosure documents.

169. If a customer purchased a proprietary covered security that had a deferred sales load, both disclosures would be required.
Proposed Rule 15c2-2: Provisions Not Included in General and Purchase-Specific Requirements

The SEC did not include several provisions of Rule 10b-10 in proposed Rule 15c2-2, including required disclosure of whether the broker, dealer or municipal securities dealer is acting as agent or principal, and required disclosure of information specific to transactions in debt securities.

Proposed Rule 15c2-2: Periodic Disclosure Alternative

Proposed Rule 15c2-2(d) would permit brokers, dealers and municipal securities dealers to disclose the required information quarterly for transactions in a “covered securities plan,” and monthly for transactions in no-load open-end money market funds, rather than per each transaction. Generally, the required disclosure would be that discussed above under Rule 15c2-2(b) and (c), but some information would be disclosed in summary form that reflects all transactions within the applicable period. Proposed Rule 15c2-2(d)(3) would require a broker, dealer or municipal securities dealer to provide the customer with written notification before using the periodic disclosure alternative.

Proposed Rule 15c2-2: Exemptive Provision

Proposed Rule 15c2-2(g) would permit the SEC to exempt any broker, dealer or municipal securities dealer from the provisions of the rule with respect to any transactions or class of transactions, when the SEC finds that the firm will provide alternative procedures to effect the purposes of the rule.

Proposed Rule 15c2-2: Comparison Range Disclosure

Proposed Rule 15c2-2(c) would require brokers, dealers and municipal securities dealers to provide comparison information:

- In the case of disclosures of loads, asset-based sales charges and service fees, and dealer concessions, based on the median of, and the ranges associated with, 95% of the transactions involving the same type of covered security (that is, mutual fund, UIT or 529 plan).

170. Proposed Rule 15c2-2(f)(5) would define “covered securities plan” as any plan for direct purchase or sale of a covered security pursuant to certain retirement or pension plans or other agreements or arrangements. This would include plans for automatic reinvestment of dividends or other distributions paid by the issuer of a covered security.

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- In the case of disclosures of revenue sharing and portfolio brokerage, based on the median of, and the ranges associated with, 95% of the brokers, dealers or municipal securities dealers that distribute the same type of covered security. The SEC would publish the medians and comparison ranges from time to time (annually) in the Federal Register in percentage form, and firms would need to update median and percentage range information on their confirmations within ninety days of their publication.

[A][13] Proposed Rule 15c2-2: Disclosures About Transactions Effected by Multiple Firms

There are instances where more than one broker, dealer or municipal securities dealer is involved in a transaction, but only one confirmation is provided to a customer, such as in a transaction effected under an introducing-clearing arrangement. Although a customer may receive a single confirmation for such a transaction, proposed Rule 15c2-2 would require specific disclosure of sales fees, revenue sharing and portfolio brokerage commissions received by any broker, dealer or municipal securities dealer that effects a transaction. As a result, a single confirmation would separately disclose such information for each firm.

[A][14] Proposed Rule 15c2-2: Amendments to Rule 10b-10

Because proposed Rule 15c2-2 would govern confirmation disclosure of purchases and sales in investment company securities, Rule 10b-10 would be amended to exclude those securities. In addition, Rule 10b-10(a)(9) would be amended to eliminate an exception for certain transactions in open-end investment companies and UITs, and references to “investment company plan” and no-load money market funds would be deleted in Rule 10b-10(b). Finally, the preliminary note to Rule 10b-10 would be conformed to that of proposed Rule 15c2-2.

171. In an introducing-clearing relationship, both the introducing firm and the clearing firm are subject to confirmation requirements. The agreement between the two firms would be provided to customers upon establishing of the account or the introducing-clearing arrangement, and the customers thereafter have a reasonable expectation of the responsibilities of both the introducing and clearing broker-dealers with respect to their accounts. See NASD Rule 3230.

Proposed Rule 15c2-3 would require brokers, dealers and municipal securities dealers to provide customers with specified information at the point of sale—before they purchase mutual fund shares, UIT interests and 529 plan securities. The rule was intended to improve investment decisionmaking by providing investors at the point of sale with information about costs and conflicts of interest associated with purchases of covered securities. Investors would then have this information before they finalize their investment decision to purchase a covered security, whether the transaction is solicited or not. A broker, dealer or municipal securities dealer that misstates information in a point of sale disclosure with intent to mislead may be subject to liability under the antifraud provisions of section 10(b) and Rule 10b-5 of the 1934 Act.


The point of sale disclosure requirements would govern purchase transactions in the same securities that are subject to the confirmation requirements of proposed Rule 15c2-2. Accordingly, proposed Rule 15c2-3 would apply to transactions in “covered securities” as defined in proposed Rule 15c2-2.


Proposed Rule 15c2-3 would require the broker, dealer, or municipal securities dealer to provide the disclosure at the point of sale. Proposed Rule 15c2-3[f][1] would define “point of sale” differently depending on the relationship between the broker, dealer, or municipal securities dealer and the customer it solicits. Generally, the point of sale would be immediately prior to the time when broker, dealer or municipal securities dealer accepts the order from the customer. Where the customer has not opened an account with the firm, or the firm does not accept the order from the customer, the point of sale would be the time when the firm first communicates with the customer about the covered security, specifically or in connection with other potential investments.


Proposed Rule 15c2-3[a][1] would require the broker, dealer or municipal securities dealer to inform its customer about the distri-
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bution-related costs that the customer might expect to incur in the transaction, with separate disclosure of:

The amount of sales loads to be incurred at the time of purchase;

- Estimated asset-based sales charges and asset-based service fees paid out of fund assets in the year following the purchase, if NAV remains unchanged;

- The maximum amount of any deferred sales load for the purchase if those shares are sold within one year (other than deferred sales loads of no more than one percent that expire no later than one year after purchase, when no other sales load would be incurred on that transaction), along with a statement about how many years a deferred sales load may be in effect; and

- The dealer concession or other sales fees it would expect to receive for the transactions. These amounts would be referenced against the value of the purchase, or if that value is not reasonably estimable at the time of the disclosure, by reference to a model investment of $10,000.

Proposed Rule 15c2-3(a)(2)(i)–(ii) would require the broker, dealer or municipal securities dealer to state whether it receives revenue sharing or portfolio brokerage commissions from the fund complex. Proposed Rule 15c2-3(a)(2)(iii) would require the broker, dealer or municipal securities dealer to state whether it pays differential compensations in connection with transactions in the covered security, if the covered security charged a deferred sales load or is a proprietary covered security. The definitions used for these provisions would be the same as those terms in proposed Rule 15c2-2.


Proposed Rule 15c2-3(b) would provide that an order made before the point of sale disclosure be treated as an indication of interest until the point of sale information is disclosed, and customers have received an opportunity to terminate any order following disclosure of the information. Further, the broker, dealer or municipal securities dealer must disclose this right to the customer at the time it discloses the point of sale information.


Proposed Rule 15c2-3(c) would require generally that the broker, dealer or municipal securities dealer give or send the information to the customer in writing using Schedule 15D, supplemented by oral disclosure if the point of sale occurs at an in-person meeting. If the
point of sale occurs through oral communication other than at an in-person meeting, however, then the information may be disclosed to the customer orally at the point of sale. A written disclosure document that provides information consistent with the confirmation disclosure requirements of proposed Rule 15c2-2 would also satisfy this requirement.

In response to comments to the proposed rules, however, the SEC has developed revised forms that it is considering adopting. Appendix 28D shows proposed new “models” of required point of sale disclosure forms filled in for a hypothetical mutual fund and 529 savings plan, the differences among the forms reflecting differences in share class fees and other attributes. Appendix 28D also includes a model form for a variable annuity for which the SEC had solicited comment. Broker-dealers would be required to deliver these forms, in the same format, font size and layout of the forms in Appendix 28D, at the point of sale before a customer purchases a covered security. Consistent with investors’ views that disclosure should be targeted and should exclude irrelevant information, broker-dealers would not use a “one size fits all” form to provide written point of sale disclosure, but rather would disclose and omit specific categories of information in a required format to the extent applicable or inapplicable to the particular purchase and further delineate the forms by share class. Broker-dealers would be required to:

- identify the security subject to disclosure more clearly in the forms [for example, for a fund, the disclosure of the fund’s ticker symbol];
- show costs associated with investing in the covered security using standard $1,000, $50,000 and $100,000 purchase amounts, but at customer request, use “fill in the blank” boxes to disclose the customer’s anticipated payment amount;
- disclose sales fees in dollars and as a percentage of the amount invested;
- disclose comprehensive cost information for owning the securities subject to disclosure, including investment company costs such as “management fees” and “other expenses” that are disclosed in the prospectus;
- tailor point of sale disclosures to reflect particular share classes or other pricing structures that are applicable to a contemplated purchase;
- provide point of sale information for all share classes that are under consideration at the point of sale, including share classes other than the typical Class A, Class B and Class C shares;

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- disclose the existence of revenue-sharing payments they receive for promoting covered securities as a conflict of interest and a website address and a toll-free telephone number customers can use to find more detailed information about disclosures of those payments, including the amounts of, and sources of, the payments;
- disclose, if true, that they pay their personnel proportionately more for selling the covered security than for others (that is, whether they pay for differential compensation) or for selling certain share classes over others;
- include a statement that customers should consider all costs, goals and risks before purchasing a covered security, direct customers to the security’s prospectus or official statement for more information, and inform customers that the broker-dealer can provide those documents, including the disclosure regarding special incentives.

Broker-dealers may permissively omit any categories of information that are not applicable.


Proposed Rule 15c2-3(d) would require brokers, dealers or municipal securities dealers to make records of communications and their disclosure sufficient to demonstrate compliance with the delivery requirements of paragraphs [a] and [b]. The brokers, dealers or municipal securities dealers would have to preserve those records for the period specified in Rule 17a-4(b) of the 1934 Act or, for oral communications and their disclosures, pursuant to Rule 17a-4(f) of the 1934 Act and for the period specified in Rule 17a-4(b) of the 1934 Act. For disclosure solely by means of oral communications, this provision would require the broker, dealer or municipal securities dealer to have compliance procedures in place that are sufficient to demonstrate that it provided the required disclosure.


Proposed Rule 15c2-3(e) establishes two exceptions to the rule:

- Transactions resulting from orders that a customer placed via U.S. mail, messenger delivery or a similar third party delivery service. The broker, dealer or municipal securities dealer must have provided the customer, within the prior six months, with information about the maximum potential sales loads, asset-based sales charges and service fees associated with covered securities sold by that firm, as well as the required disclosure on revenue sharing, portfolio brokerage commissions and differential compensation. In addition,
this exception would only be available to brokers, dealers or municipal securities dealers that are not compensated for effecting transactions for customers that do not have accounts with that broker, dealer, or municipal securities dealer. The SEC has solicited comment on this limited exception in response to comments that it could allow broker-dealers to evade disclosure by recommending a fund and then having customers mail in orders.

- Transactions where the clearing firm or the primary distributor did not communicate with the customer about the transaction other than to accept the customer’s order, and where that clearing or distributing firm reasonably believed that another broker, dealer or municipal securities dealer [such as an introducing or a selling firm] has delivered the information to the customer required by the proposed rule. “Reasonable belief” could be demonstrated through a written agreement with the other broker, dealer or municipal securities dealer, supplemented with appropriate auditing practices.

- Transactions effected as part of a covered securities plan, as defined under proposed Rule 15c2-2, so long as the broker, dealer or municipal securities dealer provides the required point of sale disclosure before the first purchase of any covered security as part of the plan.

- Reinvestments of dividends earned.

- Transactions in which the broker, dealer or municipal securities dealer exercises investment discretion.

Comments received to the proposed rule urged the SEC to implement a point of sale exception that covers an investor’s non-periodic purchases of a covered security following his or her initial purchase. Another outstanding exception being aired for comment is whether to include an exception for purchases by institutional investors.

[C] Supplemental Internet-Based Disclosure

Some commenters recommended permitting the proposed point of sale disclosures to be made on a broker-dealer’s website. Although the SEC did not agree that Internet-based disclosure would be an adequate substitute for point of sale and improved confirmation disclosure, it solicited comment on requiring supplemental information relating to broker-dealer compensation arrangements to be disclosed on the Internet inasmuch as such information would be helpful to customers who wish to evaluate how these arrangements can affect broker-dealers’ recommendations and presentation.
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of investment options. If the SEC were to require Internet-based disclosure of compensation arrangements as a supplement to the information disclosed on point of sale and confirmation documents, such disclosure could include information about:

- revenue sharing payments;
- certain other payments out of issuer assets that may provide incentives for broker-dealers to distribute covered securities;
- special compensation-related conditions that broker-dealers place on fund distribution (that is, broker-dealers may have a practice of restricting recommendations of securities to the funds of complexes that make revenue sharing payments);
- broker compensation (that is, any transaction-based and/or annual asset-based payments, including payments denoted as compensation for providing shareholder services, or any payments made in connection with underlying securities purchased via two-tiered products); and
- brokers’ differential compensation practices.

To promote clear disclosure, the SEC also would propose such information to be highly visible, depicted in a tabular format by share class (as applicable) and be accessible (that is, that the website not have password protection or require entry of identifying information or otherwise restrict access). Appendix 28E illustrates how such Internet-based disclosure could appear in practice were the SEC to adopt a rule requiring such disclosure.

For customers who have no access to the Internet or prefer to receive the disclosure by other means, the SEC is considering requiring broker-dealers to maintain a toll-free telephone number that investors could call to request a copy of the Internet-based disclosure.

[D]  Prospectus Disclosure

The SEC is proposing to amend Form N-1A to enhance disclosures of sales loads, including the following:

- Amending the fee table to require the maximum front-end sales load to be shown as a percentage of NAV rather than as of offering price;
- Instructions to the fee table would be amended to clarify that if a fund imposes more than one type of sales load (for example, deferred sales load and a front-end sales load), the aggregate load should be shown in the fee table as a percentage of NAV;
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- Requiring footnote disclosure to the fee table, if applicable, that the actual maximum sales load as a percentage of the net amount invested may be higher than the maximum sales load shown as a percentage of NAV in the fee table. The footnote would be required to explain briefly the reason for this variation and disclose the maximum sales load as a percentage of the net amount invested. Parallel disclosure would be required for the table of front-end sales loads that is required elsewhere in the prospectus, if applicable, that the actual front-end sales load as a percentage of the net amount invested at any breakpoint may be higher or lower than the applicable load in the table of front-end sales loads; and

- Requiring brief disclosure in a fund’s prospectus to direct investors to the disclosure regarding revenue sharing under proposed Rules 15c2-2 and 15c2-3. If any person within a fund complex makes revenue sharing payments, a fund would have to disclose that fact in its prospectus. If any such revenue sharing payments are made, the fund would also be required to disclose that specific information about revenue sharing payments to an investor’s financial intermediary is included in the confirmation or periodic statement disclosure pursuant to proposed Rule 15c2-2, and the point of sale disclosure required under proposed Rule 15c2-3.

§ 28:3.9 Disclosure of Breakpoint Discounts

The SEC has adopted amendments to Form N-1A that will require enhanced disclosure regarding breakpoint discounts on front-end sales loads. The SEC adopted these amendments in response to SEC and NASD findings that mutual fund investors were not receiving breakpoint discounts. “Breakpoint discounts” are reductions in the front-end sales load on a purchase of fund shares, for customers who attain specified levels of investment.

Under the amendments, a fund would be required to provide a brief description in its prospectus or SAI of arrangements that result in sales load breakpoints, including a summary of shareholder eli-

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bility requirements. This summary will be required to include a description or list of the types of accounts (for example, retirement accounts, accounts held at other financial intermediaries), account holders (for example, immediate family members) and fund holdings (for example, funds held within the same fund complex) that may be aggregated to determine eligibility for breakpoints.

The amendments also require a fund to describe in its prospectus the methods used to value accounts in determining whether a shareholder has met sales load breakpoints, including the circumstances in which and the classes of individuals to whom each method applies. The methods required to be disclosed, if applicable, will include historical cost, net amount invested, and offering price.

The amendments will also require fund prospectus disclosure, if applicable, that in order to obtain a breakpoint discount, a shareholder may need to inform the fund or financial intermediary at the time of purchase of the existence of other accounts in which there are eligible holdings to be aggregated to meet sales load breakpoints. A fund will need to describe any information or records, such as account statements, that a shareholder may need to provide to the fund or intermediary to verify eligibility for a breakpoint discount including, if applicable, the following:

- Information or records regarding shares of the fund or other funds held in all accounts (for example, retirement accounts) of the shareholder at the intermediary;
- Information or records regarding shares of the fund or other funds held in an account of the shareholder at another intermediary; and
- Information or records regarding shares of the fund or other funds held at any intermediary by related parties of the shareholder, such as family members.

The amendments also require that a fund state in its prospectus whether it makes available free of charge, on its website at a specified Internet address, this information regarding sales loads and breakpoints in the prospectus and SAI, including whether the website includes hyperlinks that direct the shareholder to the breakpoint information. A fund that does not make such information available on its website must disclose the reasons why it does not do so.

All initial registration statements, and all post-effective amendments to effective registration statements filed on Form N-1A on or after September 1, 2004, must include the disclosure required by the amendments.
§ 28:3.10 Disclosure Relating to Approval of Investment Advisory Contracts

[A] Disclosure Requirement in Shareholder Reports

The SEC has adopted amendments to Forms N-1A, N-2, and N-3 that require fund shareholder reports to discuss, in reasonable detail, the material factors and conclusions that formed the basis for the board of directors’ approval of any investment advisory contract, including sub-advisory contracts. This requirement applies to shareholder reports of open- and closed-end management investment companies and insurance company managed separate accounts that offer variable annuities.

The disclosure requirement in fund shareholder reports will apply to any new investment advisory contract or contract renewal, including sub-advisory contracts and contracts that were approved by shareholders, approved by the board during the most recent fiscal half-year. Because fund shareholder reports will now contain disclosure relating to all advisory contracts approved by the board, the SEC is removing the existing requirement for disclosure in the SAI of Forms N-1A, N-2, and N-3 relating to the board’s approval of any existing investment advisory contract. However, the amendments will require a fund’s prospectus to state that a discussion regarding the board of directors’ basis for approving any advisory contract is available in the fund’s annual or semi-annual report to shareholders, as applicable. This disclosure must indicate the dates covered by the relevant shareholder report.

[B] Disclosure Enhancements

The SEC has adopted several enhancements to the existing proxy statement disclosure requirements and is including these same enhancements in the new shareholder reports disclosure requirement. The amendments clarify that the fund’s discussion must include factors relating to both the board’s selection of the adviser, and its approval of the advisory fee and any other amounts to be paid under the advisory contract.

The amendments will require a fund to discuss certain factors, including but not limited to, the following:

- The nature, extent, and quality of the services to be provided by the adviser;

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- The investment performance of the fund and the adviser;
- The costs of the services to be provided and profits to be realized by the adviser and its affiliates from the relationship with the fund;
- The extent to which economies of scale would be realized as the fund grows; and
- Whether fee levels reflect these economies of scale for the benefit of fund investors.

An instruction clarifies that if any of these factors is not relevant to the board’s evaluation of an advisory contract, the discussion must note this and explain the reasons why that factor is not relevant. The SEC notes that the amendments are not intended to require disclosure of an unaffiliated sub-adviser’s fees if that information would not otherwise be required to be disclosed.

The fund’s discussion must also indicate whether the board relied upon comparisons of the services to be provided and the amounts to be paid under the contract with those under other advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (for example, pension funds).

[C] Evaluating Factors

With respect to the SAI and proxy statement requirements, the SEC is requiring that the fund’s discussion state how the board evaluated each factor, in addition to the existing requirements that a fund’s discussion relate the factors to the specific circumstances of the fund and the advisory contract. For example, it will not be sufficient to state that the board considered the amount of the advisory fee without stating what the board concluded about the amount of the fee and how that affected its determination that the contract should be approved.

[D] Compliance Date

All shareholder reports for periods ending on or after March 31, 2005, and all proxy statements filed on or after October 31, 2004, will be required to comply with the amendments.

§ 28:3.11 Disclosure Regarding Portfolio Managers

The SEC has adopted certain amendments to Forms N-1A, N-2, N-3, and Form N-CSR [the form used by registered management investment companies to file certified shareholder reports with the SEC] requiring disclosure relating to portfolio managers of registered management investment companies in response to the SEC’s
concerns relating to portfolio managers. Specifically, these concerns included a lack of disclosure about the individual members of portfolio management teams, the compensation of portfolio managers, and portfolio managers’ holdings in the funds that they manage; and potential conflicts of interest between the interests of shareholders in a fund that a portfolio manager oversees, and the interests of other clients and investment vehicles, such as hedge funds and pension funds, that a portfolio manager may also oversee.

[A] Identification of Portfolio Management Team Members

The amendments to Forms N-1A and N-2 will require those funds to identify in their prospectuses each member of a committee, team, or other group of persons associated with the fund or its investment adviser who is jointly and primarily responsible for the day-to-day management of the fund’s portfolio. Funds will have to state the name, title, length of service, and business experience of each member of a portfolio management team. If more than five persons are jointly and primarily responsible for the day-to-day management of a fund’s portfolio, the fund need only provide the required information for the five persons with the most significant responsibility. The SEC adopted parallel requirements for Form N-3, which currently does not require disclosure about portfolio managers.

The amendments also require a fund to provide a brief description of each member’s role on the management team (for example, lead member), including a description of any limitations on the person’s role and the relationship between the person’s role and the roles of other persons who have responsibility for the day-to-day management of the fund’s portfolio.

[B] Disclosure of Other Accounts Managed and Potential Conflicts of Interest

The amendments to Forms N-1A, N-2, and N-3 require a fund to provide SAI disclosure of other accounts for which the fund’s portfolio manager is primarily responsible for the day-to-day portfolio management, namely:


176. The amendment is intended to provide investors with a better understanding of what an identified portfolio manager does and does not do in day-to-day managing of the fund, and any relationship of any identified portfolio manager’s responsibilities to those of other members of a portfolio management team, including members who may not be identified in the prospectus.
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- The number of other accounts managed by the portfolio manager;
- The total assets in the accounts, within each of the following categories: (1) registered investment companies; (2) other pooled investment vehicles; and (3) other accounts; and
- For each category, the fund also must disclose the number of accounts and the total assets in the accounts upon which the advisory fee is based on account performance.

If a committee, team, or other group that includes the portfolio manager is jointly and primarily responsible for the day-to-day management of an account, the fund must include that account in its SAI disclosure. This disclosure requirement applies to any portfolio manager who is identified in the fund’s prospectus.

The amendments also require a fund to describe any material conflicts of interest that may arise in connection with the portfolio manager’s management of both the fund and the other accounts, including for example, material conflicts between the investment strategies of the fund and of other accounts that would result in material conflicts in allocating investment opportunities between the fund and other accounts. The SEC considers a conflict “material” if there is a substantial likelihood that a reasonable investor would view disclosure of the conflict as significantly altering the “total mix” of information available about the fund. In the SEC’s view, this would include, for example, a conflict that a reasonable investor would consider likely to affect the manager’s professional judgment in managing the fund.

[C] Disclosure of Portfolio Manager Compensation Structure

The amendments to Forms N-1A, N-2, and N-3 will require SAI disclosure of the structure of, and the method used to determine, the compensation of the fund’s portfolio managers from the fund, its investment adviser, or any other source that relates to management of the fund and the other accounts required to be identified as discussed in section 28:3.11[B] above. The value of the compensation received by a portfolio manager need not be disclosed. This disclosure requirement applies to any portfolio manager who is required to be identified in the fund’s prospectus.

Compensation includes, without limitation, salary, bonus, deferred compensation, and pension and retirement plans and arrangements, whether the compensation is cash or non-cash, but does not include disclosure of group life, health, hospitalization, medical reimbursement, relocation, and pension and retirement plans and arrangements, provided that they are available generally.
to all salaried employees and are not operated in favor of portfolio managers or a group of employees that includes the portfolio managers. For each type of compensation, a fund must describe with specificity:

- the criteria on which that type of compensation is based, and
- how compensation is based on this criteria (that is, whether compensation is fixed, whether and how compensation is based on the fund’s pre- or after-tax performance over a certain period, and whether and how compensation is based on the value of assets held in the fund’s portfolio).

[D] Disclosure of Securities Ownership of Portfolio Managers

The amendments to Forms N-1A, N-2, and N-3 will require a fund to disclose in its SAI the dollar range of the total fund shares owned by each portfolio manager who is required to be identified in the fund’s prospectus. The disclosure is limited to the fund itself and will not require disclosure with respect to other accounts managed by the portfolio manager or the fund’s adviser. Further, the disclosure is limited to “beneficial ownership” as determined in accordance with Rule 16a-1(a)(2) under the 1934 Act.

[E] Date of Disclosure

The disclosure of other accounts managed by a portfolio manager, compensation structure, and ownership of fund securities is required to be provided as of the end of the fund’s most recently completed fiscal year. In the case of an initial registration statement or an update to a fund’s registration statement that discloses a new portfolio manager, information with respect to any newly identified portfolio manager can be as of the most recent practicable date.\(^1\) The date as of which the information is provided must be disclosed. In effect, this means that a fund is required to disclose changes to this information for a previously identified portfolio manager once a year as part of its annual update to its registration statement.

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\(^{177}\) This includes an update to a fund’s registration statement that adds a new series to the fund.
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[F] Index Funds Are Covered

The amendments will remove the current provision in Form N-1A that excludes an index fund from the requirement to identify and provide disclosure regarding its portfolio managers. The SEC removed this provision to shed light on any conflicts of interest for the benefit of index fund investors, such as conflicts in determining trading execution priorities where a portfolio manager for an index fund also manages an actively managed fund.

[G] Disclosure of Availability of Information

The amendments to Forms N-1A, N-2, and N-3 will require a fund to state in its prospectus adjacent to the disclosure identifying the portfolio managers that the above-discussed information relating to portfolio managers is provided in the SAI. In addition, the amendments require that the back cover page of a mutual fund’s prospectus states whether the fund makes available its SAI and annual and semi-annual reports, free of charge, on or through its website at a specified Internet address, and if not, discloses the reasons why it does not do so.

[H] Amendment of Form N-CSR

Because closed-end funds do not offer their shares continuously and thus generally are not required to update their SAIs to meet their obligations under the 1933 Act, the amendments will require closed-end funds to provide the above-discussed disclosure relating to portfolio managers in their annual reports on Form N-CSR. A closed-end fund must disclose any change in its portfolio managers, and provide all of the required information for any newly identified portfolio manager, in its semi-annual reports on Form N-CSR.

The disclosure relating to the name, title, length of service, and business experience of a portfolio manager must be current as of the date of filing of the report, and the disclosure regarding other accounts managed, compensation structure, and fund securities ownership should be as of the end of the fund’s most recently completed fiscal year. Disclosure for a newly identified portfolio manager in an annual or semi-annual report, however, can be as of the most recent practicable date.

178. Instruction 1 to Item 5[a](2) of current Form N-1A. An index fund refers to a fund that has as its investment objective replication of the performance of an index.
[I] Compliance Date

All initial registration statements on Forms N-1A, N-2, and N-3, and all post-effective amendments that are annual updates to effective registration statements on these forms, or that add a new series, filed on or after February 28, 2005, must include the disclosure required by these amendments. Every annual report by a closed-end fund on Form N-CSR filed for a fiscal year ending on or after December 31, 2005, and every semi-annual report on Form N-CSR filed by a closed-end fund after such an annual report, must include this disclosure.

§ 28:3.12 Registration of Certain Hedge Fund Advisers

The SEC’s adoption of a rule and rule amendments under the Investment Advisers Act of 1940 (the “Advisers Act”) requiring investment advisers to certain private investment pools (“hedge funds”) to register with the SEC under the Advisers Act (the “Hedge Fund Rule”\footnote{178.1. Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Rel. No. 2,333 [Dec. 2, 2004] [the Hedge Fund Release].}) was vacated by the D.C. Circuit Court of Appeals’ decision in \textit{Goldstein v. Securities and Exchange Commission} (“\textit{Goldstein}”).\footnote{178.2. No. 04-1434, 2006 [D.C. Cir. June 23, 2006].} As adopted, the Hedge Fund Rule required investment advisers to consider and count each owner (for example, each shareholder, limited partner, member or beneficiary of the private fund) of a “private fund,” as defined in the rule, as a client towards the threshold of 14 clients for purposes of determining the availability of the private adviser exemption of section 203(b)(3) of the Advisers Act.\footnote{178.3. Rule 203(b)(3)-2(a). The Advisers Act exempts an adviser from registration if it: [i] has had fewer than 15 clients during the preceding 12 months; [ii] does not hold itself out generally to the public as an investment adviser; and [iii] is not an adviser to any registered investment company.} The SEC also adopted conforming amendments to existing rules. Advisers would have needed to comply with the requirements of the Hedge Fund Rule, including registering with the SEC if necessary, by February 1, 2006.

[A] \textit{Goldstein v. Securities and Exchange Commission}

On June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the Hedge Fund Rule. The court in \textit{Goldstein} held that the SEC did not have the authority to require hedge fund advisers to consider investors in private funds as “clients” for
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purposes of section 203(b)(3) of the Advisers Act and found the SEC’s interpretation of the word “client” in the Hedge Fund Rule to be arbitrary and “counterintuitive” at best.\(^{178}\)

The court disagreed with the SEC’s argument that, because the Advisers Act did not expressly define “client,” the statute was “ambiguous as to a method for counting clients.”\(^{179}\) Following precedent that the “words of the statute should be read in context, the statute’s place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account”\(^{180}\) to determine whether Congress had foreclosed the agency’s interpretation, the court pointed to a 1970 amendment to section 203\(^{181}\) and another section of the Advisers Act\(^{182}\) that suggested Congress’ understanding that investment company entities, and not their shareholders, were the advisers’ clients. The court also noted that this had been the SEC’s view until it issued the new rule.\(^{183}\)

\(^{178}\) Goldstein at 14.

\(^{179}\) Goldstein at 8.

\(^{180}\) Goldstein at 9 (citing PDK Labs. Inc. v. DEA, 362 F.3d 786, 796 [D.C. Cir. 2004] (internal quotation marks omitted)).

\(^{181}\) In the amendment, Congress eliminated a separate exemption from registration for advisers who advised only investment companies and explicitly made the fewer-than-15 clients exemption unavailable to such advisers. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 24, 84 Stat. 1413, 1430 (1970). The court expressed that the latter prohibition would have been unnecessary if the shareholders of investment companies could be counted as “clients.” Goldstein at 11.

\(^{182}\) The Advisers Act defines “investment adviser” as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.” 15 U.S.C. § 80b-2(11) (emphasis added). The court stated that an investor in a private fund may be affected by the adviser’s advice, but does not receive the advice directly. Goldstein at 11.

\(^{183}\) The court pointed to language in an SEC release in 1985 establishing a “safe harbor,” allowing advisers to count certain limited partnerships as single clients in order to provide “greater certainty” about the meaning of the term. Definition of “Client” of Investment Adviser for Certain Purposes relating to Limited Partnerships, 50 Fed. Reg. 8740, 8740 [Mar. 5, 1985]. Specifically, in proposing the rule, the SEC wrote when “an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of the participants as a group, it appears appropriate to view the pool—rather than each participant—as a client of the adviser.” Id. at 8741.
The court also pointed to various case law and the SEC’s own arguments in \textit{Goldstein} and language in the Hedge Fund Rule in concluding that “the [SEC’s] interpretation of the word ‘client’ comes close to violating the plain language of [the Advisers Act] and “falls outside the bounds of reasonableness.”

\textbf{[B] Implications of \textit{Goldstein}}

Although hedge fund advisers no longer need to comply with the Hedge Fund Rule, \textit{Goldstein} raises practical and interpretive issues for those hedge fund advisers that wish to remain registered and those who wish to withdraw their registration.

The Chair and Vice Chair of the American Bar Association’s Subcommittee on Private Investment Entities submitted a letter to the SEC’s Investment Management Division requesting that the SEC staff address such issues. The letter seeks clarification of requirements relating to offshore advisers, records supporting per-

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184. At best it is counterintuitive to characterize the investors in a hedge fund as the “clients” of the adviser. \textit{See Am. Bar Ass’n v. FTC}, 430 F.3d 457, 471 (D.C. Cir. 2005). The adviser owes fiduciary duties only to the fund, not to the fund’s investors. Section 206 of the Advisers Act. \textit{In SEC v. Capital Gains Research Bureau, Inc.}, 375 U.S. 180 (1963), the Supreme Court held that this provision created a fiduciary duty of loyalty between an adviser and his client. \textit{See id. at 191–92; id. at 201}.

185. The SEC argued that the Hedge Fund Rule amends only the method for counting clients under section 203(b)(3), and that it does not “alter the duties or obligations owed by an investment adviser to its clients.” 69 Fed. Reg. at 72,070. The court stated that the SEC could not explain why “client” has one interpretation in the context of fiduciary duty, but has another meaning entirely when determining registration under the Advisers Act. \textit{Goldstein} at 15–16.

186. \textit{Id.} at 13, 14.

187. Letter from the Chair and Vice Chair of the Subcommittee on Private Investment Entities of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association to Robert E. Plaze, Associate Director, Division of Investment Management, Securities and Exchange Commission (July 31, 2006) (on file with the American Bar Association) (the “Letter”).

188. In the Hedge Fund Release, the SEC clarified that an adviser having a principal office and place of business outside the U.S. (an “offshore adviser”) and advising a private fund organized or incorporated under the laws of a country other than the U.S. (an “offshore fund”) would not be subject to the substantive provisions of the Advisers Act with respect to the offshore fund, but only to its client-counting and antifraud provisions. Hedge Fund Release at 45184. In light of \textit{Goldstein}, the Letter asked the SEC staff to reconfirm this position for those advisers that wish to remain registered with the SEC.
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formance information, performance-based compensation arrangements and the custody rule for hedge fund advisers that remain registered, and seeks clarification of the effect of existing regulations and the Form ADV-W balance sheet requirements for hedge fund advisers that withdraw their registrations.

189. The Hedge Fund Release created a limited “transition” exception for investment advisers to private funds so that such advisers would not be required to maintain books and records that form the basis for or demonstrate the calculation of performance information used by the adviser in advertising and similar materials of any private fund or other account for any period ended prior to February 10, 2005. The Letter asked that the SEC staff continue to make this transition available, stating that not permitting hedge fund advisers this transitional relief would create an incentive for them to withdraw their registrations.

190. The Hedge Fund Release amended Rule 205-3 under the Advisers Act to “grandfather” existing advisory arrangements of hedge fund advisers that were required to register, effectively allowing them to continue receiving performance-based compensation from persons that are not qualified clients, such compensation otherwise generally being prohibited under section 205(a)(1). (Rule 205-3 provides an exemption from this prohibition for performance-based compensation from a person that is a qualified client.) The Letter requested that the SEC staff interpret Rule 205-3 as inapplicable to an adviser of a private fund that receives performance-based compensation from a person that is not a “qualified client,” as defined in the Rule, provided that the arrangements with such person were in effect prior to February 10, 2005, and the adviser was exempt from registration pursuant to section 203(b)(3) of the Advisers Act prior to February 1, 2006. The Letter stated that, without such an interpretation, hedge fund advisers would have an incentive to withdraw their registrations to avoid revising or terminating their advisory contracts involving performance-based compensation.

191. The Letter requested the SEC staff to interpret Rule 206(4)-2 under the Advisers Act to permit an adviser to a “fund of funds” to distribute audited annual financial statements to investors within 180 days following the end of the fund of fund’s fiscal year.

192. The Letter requested the SEC staff to confirm that: (i) an adviser to a private fund that withdraws its registration will not have violated the Advisers Act or rules thereunder (other than those that are applicable to unregistered advisers) provided it files its Form ADV-W by a specified date and (ii) an adviser to a private fund that withdraws by the specified date (Feb. 1, 2007) will not be precluded from again relying on the section 203(b)(3) exemption from registration as an investment adviser if, during the period it was registered as an adviser, it held itself out generally to the public as an investment adviser or had more than fourteen clients.

193. The Letter requested the SEC staff to interpret the requirements of Form ADV-W requiring the filing of a balance sheet as inapplicable to hedge fund advisers that withdraw from registration on or before a specified date (Feb. 1, 2007).
The SEC’s Investment Management Division sent a written response on August 10, 2006, generally agreeing with the positions in the letter and stating that it would not recommend enforcement action to the SEC under any of the situations raised in the letter. The response also clarified the Investment Management Division’s position on two other issues not raised in the letter relating to Form ADV and access by SEC staff to records of a private fund.

[C] SEC Response to Goldstein

On August 7, 2006, SEC Chairman Christopher Cox announced that the agency would not appeal Goldstein. Rather, Chairman Cox announced that the SEC would move quickly and “aggressively” on rulemaking and staff guidance addressing the legal consequences of the court decision, and stated that one of the rule proposals would be a new antifraud rule under the Advisers Act that “would have the effect of ‘looking through’ a hedge fund to its investors” and would effectively “reverse the side-effect of [Goldstein] that the anti-fraud provisions of the Act apply only to ‘clients’ as the court interpreted that term, and not to investors in the hedge fund.” The chairman added that the SEC would consider the issue of raising minimum asset and income requirements for hedge fund investors. The chairman further noted that the guidance would address the transitional and exemptive rules vacated by Goldstein to help eliminate disincentives for voluntary

193.1. Letter from Robert E. Plaze, Associate Director, Division of Investment Management, Securities and Exchange Commission to the Chair and Vice Chair of the Subcommittee on Private Investment Entities of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association [Aug. 10, 2006] [on file with the Division of Investment Management].

193.2. The SEC made several changes to Part 1A of Form ADV and Schedule D, which require advisers to identify and provide certain information on the “private funds” they advise, in adopting the Hedge Fund Rule. In light of Goldstein, the SEC has begun the process of reversing these changes to the Form and Schedule, but until the process is completed, the SEC has posted guidance on its website on how SEC-registered advisers should complete Form ADV at http://www.sec.gov/divisions/investment/ iard.html. The SEC’s response letter also clarified that a registered adviser must make available its records for examination by the SEC staff under section 204 of the Advisers Act and that “it could not evade this requirement” by holding records by or through any other person, including a related person or private fund.

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registration and help hedge fund advisers who are already registered under those rules to remain registered.

§ 28:4 Legislative Proposals

In addition, Congress initially proposed wide ranging legislative reforms to the Investment Company Act in response to the market timing scandals. On November 19, 2003, by a 418-2 vote, the U.S. House of Representatives approved H.R. 2420, entitled the “Mutual Funds Integrity and Fee Transparency Act of 2003,”195 proposing to enact legislative changes paralleling many of the regulatory reforms the SEC subsequently proposed or enacted to address these concerns. A summary of the main provisions of H.R. 2420 is included in Appendix II to this Chapter. A parallel bill also was introduced in the Senate.196 Other statutory reforms also have been proposed. However, it appears as of this writing (August 2006) that Congress is unlikely to take action in the near future.

196. In the Senate, Daniel K. Akaka [S-HI], Peter Fitzgerald [R-IL], and Joe Lieberman [D-CT], introduced S. 1822, the “Mutual Fund Transparency Act” on Nov. 5, 2003 available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s1822is.txt.pdf. Under S. 1822, funds would, among other things, be required to disclose broker compensation directly to investors, instead of simply providing a prospectus. Further, brokerage commissions would be counted as an expense so that investors could compare expense ratios, 75% of mutual fund board members would have to be independent, and portfolio managers would have to disclose their compensation. Other legislative proposals include S. 1971 (“Mutual Fund Investor Confidence Restoration Act of 2003”), which was introduced by Senators Corzine and Dodd, S. 1958 (“Mutual Fund Investor Protection Act of 2003”), which was introduced by Senators Kerry and Kennedy, and S. 2059 (“Mutual Fund Reform Act of 2004”), which was introduced by Senator Fitzgerald.