

REGULATORY UPDATE: CURRENT SEC
AND NASD INITIATIVES AFFECTING
MUTUAL FUNDS

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Marketing and Sale of Mutual Fund Shares

Performance Advertising

- The most common issue in 2000 has been advertising extraordinary performance resulting from non-recurring events
 - Unusually good (above 100%) 1999 performance of technology stocks and funds that concentrate in them
 - Disproportionate allocation of hot IPOs to small funds

Advertising: SEC Action

- Enforcement action against fund adviser involved failure to disclose:
 - That the portfolio manager for the advertised fund and three funds with similar investment strategies had disproportionately allocated hot IPOs to the advertised fund
 - That a large percentage of the fund's performance was attributable to these hot IPOs

Advertising: SEC Action

- Sanctions against adviser
 - \$950,000 fine to SEC
 - \$1.6 million contribution to investor education programs
 - \$400,000 payment to New York
 - Undertaking to engage and follow recommendations of compliance consultant
 - Adverse publicity

Advertising: NASDR Action

- Notice to Members 00-21: advertising of performance attributable to 1999 market conditions or hot IPO investments should disclose:
 - That the performance was due to unusually favorable and unsustainable conditions
 - The nature of these conditions
 - That the favorable conditions and the advertised performance are unlikely to recur

Advertising: NASDR Action

- Enforcement proceeding against mutual fund distributor for advertisements containing line graphs depicting the performance of a \$10,000 investment
 - Line sloped diagonally upwards without any dips, implying no risk of loss
 - Bottom of line said “you are here” while top of line said “your future is here”
 - Dollar values on vertical axis overstated performance

Advertising: Bond Ratings

- SEC approved a temporary NASDR rule allowing the inclusion of bond fund volatility ratings in sales literature that is preceded or accompanied by the fund's prospectus
- The rule contains strict conditions and requires ratings to be accompanied by detailed disclosure

Advertising: Other SEC Action

- Interim Final Rule 160 under the Securities Act of 1933
 - Confirms that investor consent is not needed to deliver fund prospectuses on web sites to accompany sales literature
 - Doesn't apply to other prospectus delivery requirements
 - Responds to Electronic Signatures in Global and National Commerce Act

Advertising: Other SEC Action

- *Janus* no-action letter (8/28/00)
 - Allowed advertising for a fund that was formed by spinning off an entire class to show the pre-spin-off performance of that class
 - The new fund would operate as a continuation of the class, with the same adviser, investment policies and portfolio composition
 - The relief would not apply to a fund formed by carving out part of a class

Sales Practices: Suitability

- NASD Regulation's regulatory and compliance alert warned members against recommending higher expense back-end or level load fund classes to:
 - Investors investing large enough amounts to qualify for discounts on front-end sales charges
 - Investors planning a long term investment in a fund

Sales Practices: Suitability

- The NASDR compliance alert recommended that:
 - Registered representatives ask investors about their goals and time horizons
 - Registered representatives disclose the higher long term expenses of back-end and level load classes
 - Brokerage firms maintain records of these discussions

Sales Practices: Switching

- SEC recently sanctioned a brokerage firm for failing to prevent improper switching between mutual funds
 - Branch office representative generated \$157,000 in unnecessary sales commissions
 - Brokerage firm had written supervisory procedures but didn't effectively implement them
 - Firm had to reimburse customers and pay \$200,000 fine

Sales Practices: Switching

- SEC administrative law judge found that two broker representatives misled market timing clients by:
 - Not disclosing that using back-end load share classes of mutual funds would be more expensive than using front-end load classes in market timing strategy
 - Not disclosing representatives' scheme to avoid detection by funds that reject market timers

Sales Practices: Switching

- SEC administrative law judge rejected:
 - Representatives' defense that they had delivered fund prospectuses disclosing sales charges
 - SEC's contention that the representatives had a duty under the Investment Company Act to disclose that they received larger commission credits for selling back-end load shares
- Representatives were suspended and fined

Sales Practices: Switching

- In a different case, an SEC administrative law judge dismissed an SEC proceeding against a broker representative because:
 - Representative's customers held shares of a particular fund for periods ranging from 16 months to several years
 - Although customers later purchased shares of a riskier fund, the representative fully informed them about the costs and risks

NASDR Sales Charge Limits

- Effective 4/1/00, NASD conduct rule 2830 was amended to:
 - Apply sales charge limits to funds of funds
 - Allow funds to charge installment loads
 - Prohibit sales charges on reinvested dividends
 - Regulate the order of redeeming shares subject to back-end sales charges
 - Eliminate duplicative prospectus disclosure requirement

Non-Cash Compensation

- NASD Regulation clarified training and education exception to prohibition of non-cash compensation to other NASD members' representatives
 - Training meetings should occupy substantially all of the work day
 - Payment or reimbursement for meals, lodging and transportation of representatives (not guests) is okay
 - Payment or reimbursement for golf, tours and entertainment is not okay

Interval Funds: NASD Action

- Effective 6/20/00, NASDR amended conduct rules 2710 and 2830 to exempt interval funds from requirements that apply to other closed end funds:
 - Prospectus will no longer have to be filed with NASDR
 - Limits on underwriting compensation will no longer apply
 - Sales charge limits of rule 2830 will apply to interval funds

Disclosure to and Communications With Fund Investors

Electronic Communications

- SEC interpretive release issued 4/28/00 clarified required procedures for obtaining consent to electronic delivery of required disclosure documents
 - It is acceptable to obtain consent by telephone, with procedures to verify authenticity and detailed record keeping
 - Prospectuses and other documents may be delivered in Portable Document Format if disclosure and access to necessary software are provided

Electronic Communications

- SEC interpretive release clarified that investors may provide “global” consent to the electronic delivery of all documents if:
 - The global consent feature, the media used to deliver documents and investors’ ability to revoke consent are prominently disclosed
 - Brokers, other than online brokers, do not condition the opening of an account on providing global consent

Electronic Communications

- SEC interpretive release generated confusion and controversy about when a fund adopts content of third party web sites hyperlinked from a fund's site
 - Hyperlinks imbedded in web site documents required to be filed with the SEC are presumed to be adopted--this would literally include all fund advertising and sales literature
 - The release created a subjective facts and circumstances test for hyperlinks imbedded in other web site documents

Electronic Communications

- SEC's 7/27/00 release clarified that imbedding hyperlinks in mutual fund advertising and sales literature does not automatically lead to adoption of hyperlinked site's content
- SEC release didn't eliminate ambiguity inherent in facts and circumstances test
- Test is still less objective than NASDR exemptions for links to educational sites and ongoing hyperlinks

Electronic Communications

- Effective 10/1/00: Electronic Signatures in Global and National Commerce Act
 - Authorizes the use of electronic authentication technology as a substitute for manual signatures
 - Creates consumer consent procedures for the electronic delivery of any legally required disclosure document

Electronic Communications

- Electronic Signatures Act consumer consent procedures differ from SEC procedures by:
 - Requiring consent in an electronic format that demonstrates consumer's access to electronic delivery technology
 - Allowing businesses to avoid or terminate relationships with non-consenting consumers

Disclosing After-Tax Returns

- On 3/15/00, the SEC proposed to require tabular disclosure of 1, 5 and 10 year after tax returns in:
 - Prospectus risk/return summaries
 - Management's discussion of fund performance in annual reports
- Both pre-liquidation and post-liquidation figures would be shown

Disclosing After-Tax Returns

- The returns would reflect the highest federal marginal tax rate
- After-tax returns could be excluded from documents:
 - Offering shares exclusively to tax deferred or tax exempt accounts
 - For money market funds
- The proposal hasn't been adopted yet

Disclosure in Confirmations

- SEC filed an *amicus* brief in a lawsuit challenging the omission of rule 12b-1 payments to broker from rule 10b-10 confirmations
 - SEC agreed that rule 10b-10 requires disclosure of asset based fees
 - SEC stated that required prospectus and SAI disclosure about 12b-1 and adviser payments could be used to satisfy rule 10b-10 requirement

New Privacy Rule

- Regulation S-P requires a mutual fund, broker-dealer or registered adviser to:
 - Disclose to individuals its policies about protecting non-public personal information and how individuals can opt out of sharing this information with non-exempt unaffiliated persons
 - Establish procedures to protect the security, confidentiality and integrity of customer records and information

New Privacy Rule

- Notices can be included in other documents but must be conspicuous
- After 7/1/2001, notices must be provided to new customers at the time the relationship is established
- The deadline for sending out the initial notices to existing customers and consumers is 7/1/2001
- It's okay to household privacy notices

New Privacy Rules

- There are opt out exemptions for disclosures to unaffiliated service providers and marketing partners
- Funds should add confidentiality clauses to contracts with service providers (deadline for existing contracts is 7/1/2002)
- Mutual fund advisers and transfer agents aren't deemed to have customer relationships with fund shareholders

Fund Investment Operations

Portfolio Transactions

- SEC inspection staff has been focusing on:
 - Process for determining whether adviser is obtaining best execution for fund transactions--the staff wants to see evidence of periodic review of existing brokerage relationships and practices
 - Allocation of scarce investment opportunities, such as hot IPOs

Regulation FD

- Effective 10/23/00, Regulation FD will
 - Prohibit public companies from knowingly disclosing nonpublic information to securities market professionals, including fund portfolio managers, without simultaneous public disclosure
 - Require companies to promptly follow unintentional disclosure with public disclosure

Foreign Custodians

- SEC adopted new rule 17f-7 and amendments to rule 17f-5
 - They were effective 6/12/00 but final compliance deadline is 7/2/2001
 - They establish conditions for the use of foreign securities depositories to hold mutual fund assets
 - Fund or adviser, not custodian, must decide whether to use a depository

Foreign Custodians

- A fund may use an eligible securities depository regulated by a foreign financial regulator if the depository:
 - Holds the fund's assets under safekeeping conditions at least as good as those for other participants
 - Maintains records to identify participants' assets and segregates them from its own assets

Foreign Custodians

- A fund may use an eligible securities depository regulated by a foreign financial regulator if the depository:
 - Provides periodic reports to participants
 - Undergoes periodic examinations by regulatory authorities or independent accountants

Foreign Custodians

- Custody contract must
 - Require custodian to provide to fund or adviser an analysis of the custody risks of using an eligible depository
 - Require custodian to monitor these risks on an ongoing basis and promptly notify fund or adviser of material changes
 - Impose a duty on custodian to exercise at least reasonable care

Internal Controls

- Office of Compliance, Inspections and Examinations issued a 5/1/00 letter focusing on adviser issues and identifying these weaknesses
 - Allowing portfolio managers to value securities or override values supplied by custodians without supervision
 - Having written procedures but not monitoring for compliance with them
 - Not monitoring risks assumed by portfolio managers against clients' risk tolerance

Transactions With Affiliates and Other Conflicts of Interest

Aggregating Orders for Private Placements

- A 6/7/00 no-action letter allowed an adviser to aggregate private placement purchases by multiple funds, clients and proprietary accounts under the following conditions:
 - The only negotiable term would be the purchase price
 - The adviser's board or investment committee would approve a trade aggregation policy statement

Aggregating Orders for Private Placements

- Conditions of no-action relief:
 - The adviser would establish an aggregation committee to develop written aggregation procedures
 - These procedures would be disclosed in Form ADV and separately to all affected funds and clients
 - Each account's portfolio manager would initially evaluate the suitability of the investment for that account

Aggregating Orders for Private Placements

- Conditions of no-action relief:
 - The adviser would aggregate purchases only to the extent consistent with best execution and the applicable advisory agreement
 - At or before the time of the transaction, the adviser would write a report showing how each aggregated private placement transaction would be allocated

Aggregating Orders for Private Placements

- Conditions of no-action relief:
 - The adviser would review the aggregation procedures annually
 - All accounts would participate at the same unit price
 - The adviser would receive no extra compensation for the transaction
 - Assets of the accounts would be commingled only to the extent needed to settle the trade

Hot IPO Allocation to Fund Directors

- An SEC administrative law judge censured and imposed civil penalties on an adviser and 3 directors of a fund for anti-fraud violations
 - The adviser had allocated hot IPO stock to the directors, who sold the stock for a profit of over \$100,000
 - None of them disclosed this conflict of interest to the fund's shareholders

Personal Trading

- Rule 17j-1 was amended in 1999
- As of 3/1/00, fund advisers should have:
 - Identified and listed access persons and notified them of their reporting obligations
 - Started using the expanded form of quarterly transaction report (reflecting new brokerage accounts)

Personal Trading

- As of 3/1/00, advisers should have:
 - Started obtaining initial holdings reports from newly employed access persons
 - Started requiring portfolio managers to preclear IPO and private placement investments
 - Adopted procedures to review reports

Personal Trading

- As of 9/1/00, fund boards should have:
 - Approved new codes for funds, advisers and distributors that comply with amended rule 17j-1
 - Determined that the codes contain provisions reasonably necessary to prevent violations
 - Obtained supporting certifications from fund officers, the adviser and the principal underwriter

Personal Trading

- If codes were amended after this year's annual amendment to the fund's registration statement, remember to file them as exhibits to the next amendment
- Also remember to obtain annual holdings reports from all access persons

Personal Trading

- MacKenzie obtained an 8/10/00 no-action letter allowing independent directors of a fund adviser to use the same reporting exemptions as independent fund trustees provided that
 - The directors would not be interested persons of the adviser if not for their directorships and owning stock of the adviser
 - The directors are not involved in the day to day operations of the adviser

Redemptions in Kind

- *Signature* no-action letter dated 12/28/99 authorized redemptions in kind by affiliates under the following conditions:
 - Redeeming shareholder must receive a proportionate share of the fund's portfolio securities
 - Securities must be valued according to the fund's regular procedures

Redemptions in Kind

- Conditions for redeeming affiliates' shares in kind
 - Redemptions must be consistent with prospectus and SAI disclosure
 - Neither the redeeming shareholder nor any other person with a pecuniary interest may influence the selection of the distributed securities

Redemptions in Kind

- Conditions for redeeming affiliates' shares in kind
 - The redemption in kind must either
 - Be specifically approved by fund board or
 - Be effected under procedures adopted by the board
 - The fund must create and keep a record for each redemption in kind

Mutual Fund Governance

Fund Governance Proposals

- Under SEC rule proposal, to rely on various commonly used exemptive rules:
 - Independent directors must be a majority of fund's board of directors
 - Independent directors must select and nominate other independent directors

Fund Governance Proposals

- Under SEC rule proposals
 - The minimum percentage requirement for independent directors would be temporarily suspended if the shortfall were caused by an independent director's death or resignation
 - Joint errors and omissions policies would have to cover lawsuits between independent directors and fund advisers

Fund Governance Proposals

- Under SEC rule proposals
 - Any legal counsel for the fund's independent directors must be independent--controversial, but appears likely to be adopted
 - Fund shareholders would no longer have to ratify or reject the directors' selection of an independent public accountant if audit committee conditions are met

Fund Governance Proposals

- Under SEC rule proposals
 - A new exemption would prevent qualified independent director candidates investing in index funds that hold adviser stock from being disqualified
 - Funds would be required to keep records of their assessments of director independence

Fund Governance Proposals

- Fund SAIs would be required to disclose
 - The board's role in governing the fund's operations
 - Basic information about the identity and business experience of directors
 - Ownership of fund shares by directors--they may not have to disclose exact amount
 - Information about directors' potential conflicts of interest

Interim Advisory Contracts

- Amended rule 15a-4 authorizes fund boards, after acquisition of an adviser, to approve an interim advisory contract without immediately obtaining shareholder approval
 - Board must approve interim contract before previous contract terminates
 - Board must find that the scope and quality of services under the interim contract are the same as under previous contract

Interim Advisory Contracts

- Rule 15a-4 conditions
 - Fees under interim contract can't exceed fees under previous contract
 - Differences in interim contract can't be material
 - Term of interim contract can't exceed 150 days
 - Fees must be held in escrow pending shareholder approval of new contract
 - If new contract is not approved, the adviser is only reimbursed for costs