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RECENT REGULATORY DEVELOPMENTS IN THE INVESTMENT COMPANY INDUSTRY

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SIMPSON THACHER & BARTLETT LLP

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RECENT REGULATORY DEVELOPMENTS IN THE INVESTMENT COMPANY INDUSTRY

MAY 3, 2004

Since February 2004, the Securities and Exchange Commission (the "SEC") has continued to adopt several rules and propose additional rules governing investment companies registered under the Investment Company Act of 1940, as amended (the "1940 Act"). The bulk of these rules relate to enhancing disclosure to potential and existing investors and preventing abusive practices by investment companies and their service providers. In addition, the Senate is considering new legislation to address the similar issues. This memorandum provides a summary of the recent regulatory developments.[1]

FINAL RULES

SHAREHOLDER REPORTS AND QUARTERLY PORTFOLIO DISCLOSURE OF REGISTERED MANAGEMENT INVESTMENT COMPANIES

On February 27, 2004, the SEC adopted a new Rule 30b1-5 and Form N-Q and amendments to Rules 30a-2, 30a-3 and 30d-1 and Form N-CSR under the 1940 Act, as well as amendments to Articles 6 and 12 of Regulation S-X. The new rule and form amendments are designed to improve periodic disclosure provided by investment companies about their costs, portfolio investments, and past performance.[2] The amendments

- require disclosure in reports to shareholders of fund expenses borne by shareholders during the reporting period;

- permit a summary portfolio schedule in reports to shareholders, provided that the complete portfolio schedule is filed with the SEC on Form N-CSR semi-annually and is provided to shareholders upon request, free of charge;

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[1] The regulatory developments addressed in this memorandum are those subsequent to, or not previously discussed in, our March 3, 2004 memorandum entitled "*Regulatory Developments in the Investment Company Industry*" (the "March 3, 2004 Memorandum").

[2] "Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies" was issued on February 27, 2004 in Release Nos. 33-8393, 34-49333 and IC-26372.

- exempt money market funds from including a portfolio schedule in reports to shareholders, provided that this information is filed with the SEC on Form N-CSR and is provided to shareholders upon request, free of charge;

- require reports to shareholders to include a tabular or graphic presentation of a fund's portfolio holdings by identifiable categories;

- require a complete portfolio schedule as of the end of the first and third fiscal quarters to be filed on new Form N-Q, which will be filed under the 1940 Act and the Securities Exchange Act of 1934, as amended (the "Exchange Act") and certified by the fund's principal executive and financial officers; and

- require Management's Discussion of Fund Performance be included in the annual report to shareholders.

Disclosure of Fund Expenses

The amendments will require shareholder reports to include costs in dollars borne by shareholders during the reporting period associated with an investment of $1,000:

- based on the actual expenses and return for the period covered by the report; and

- based on the actual expenses and an assumed return of 5% per year.

In addition, the figures for the beginning and ending account value and expenses paid must be provided in tabular form for the period covered by the report.

Disclosure of Portfolio Holdings

Currently, investment companies are required to provide shareholder reports twice a year which include their complete portfolio holdings. The amendments will require funds to file a complete portfolio schedule as of the end of its first and third fiscal quarters on the new Form N-Q. The amendments also permit funds to include a summary portfolio schedule in the reports to shareholders, provided that the complete schedule is filed with the SEC and is provided to shareholders upon request, free of charge.

Summary Portfolio Schedule.

The amendments will permit investment companies to provide summary portfolio schedules, in lieu of complete portfolio schedules[3]. A summary portfolio schedule must include the 50 largest holdings in unaffiliated issuers and each investment in unaffiliated issuers that

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[3] Complete portfolio schedules must be available, free of charge, upon an investor's request.

exceeds one percent of the investment company's net asset value. For each of these, the schedule must show (1) the name of the issuer and title of issue; (2) the balance held at the close of the period (i.e., the number of shares or the principal amount of bonds and notes); (3) the value of the issue at the close of the period; and (4) the percentage value of the issue compared to net assets.

Exemption of Money Market Funds from Portfolio Schedule Requirements in Shareholders Reports.

The amendments will permit money market funds to omit the schedule of investments in securities of unaffiliated issuers from their shareholder reports, provided that they make this schedule available to shareholders, free of charge, upon request, and disclose the availability of the schedule in the shareholder reports. The amendments will also require money market funds to file their complete portfolio holdings schedules semi-annually on Form N-CSR.

Tabular or Graphic Presentation of Portfolio Holdings.

The amendments also will require that a presentation using tables, charts or graphs depicting the investment company's portfolio holdings[4] be included in the annual and semi-annual shareholder reports. The original proposal suggested that the presentation should provide the "most useful information" to investors. The SEC determined, in its final rule, that it was not necessary to prescribe a standardized format for the tabular or graphic presentation, as it allows sufficient flexibility, while encouraging the clear depiction of the types of investments made by the investment company.

Quarterly Filing of Complete Portfolio Schedule.

The amendments will require that investment companies file complete portfolio holdings schedules on the new Form N-Q within 60 days of the end of the first and third fiscal quarters.[5]

An investment company's annual and semi-annual shareholder reports must state that (i) the investment company files its complete portfolio schedule with the SEC for the first and third fiscal quarters on Form N-Q, (ii) Form N-Q is available at the SEC website, (iii) Form N-Q may be reviewed at the SEC's Public Reference Room and how information on operation of the Public Reference Room may be obtained and (iv) if the information on Form N-Q is available to shareholders on the investment company's website or upon request, then how such information may be obtained.

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[4] The presentation must be divided into reasonably identifiable categories, such as industry sector, geographic region, credit quality, maturity, etc.

[5] Form N-Q requires the same schedules of investments that are currently required in the annual and semi-annual shareholder reports. Form N-Q is filed under the 1940 Act and the Exchange Act. The filing is not required to be delivered to shareholders.

The new Form N-Q must also be signed and certified by the principal executive and financial officers, in a manner consistent with Section 302 of the Sarbanes-Oxley Act of 2002. The amendment also broadens the definition of disclosure controls and procedures under Rule 30a-3 of the 1940 Act to include controls and procedures designed to ensure that the information required to be disclosed on Form N-Q is recorded, processed, summarized and reported within the time periods required by the SEC.

As is required with Form N-CSR, an investment company must evaluate, with its principal executive and financial officers, the effectiveness of the disclosure controls and procedures within the 90-day period prior to the filing of a report on Form N-Q. The certification will be similar to that required for Form N-CSR, except that Form N-Q will only contain the schedules of investments and not complete financial statements.

Management's Discussion of Fund Performance

The SEC adopted, as proposed, a requirement that investment companies (except money market funds) include a Management's Discussion of Fund Performance ("MDFP") in their annual shareholder reports. The SEC believes that this information will help investors in assessing an investment company's performance over the past year, as well as complement other "backward looking" information required in the annual report, such as financial statements. By requiring that the MDFP be included in the annual report, the information is included in the certifications by the principal executive and financial officers of the investment company, as required by Section 302 of the Sarbanes-Oxley Act and Rule 30a-2 under the 1940 Act.

Compliance Date

The SEC will require all shareholder reports for periods ending on or after July 9, 2004 to comply with the amendments. Also, investment companies must file a Form N-Q for any fiscal quarter that ends on or after July 9, 2004.

DISCLOSURE REGARDING MARKET TIMING AND SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS

On April 11, 2004, the SEC adopted amendments to the registration statement form used by open-end funds that are designed to enhance disclosure in the areas of market timing, fair value pricing and selective disclosure of portfolio holdings.[6]

[6] "Final Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings" was issued on April 11, 2004 in Release Nos. 33-8408 and IC-26418.

Disclosure Regarding Market Timing Policies

The form amendments will require improved disclosure by a fund in its prospectus in the following areas:

- The risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders;
- Whether or not its board has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares and, if the board has not adopted any, the basis for its view that it is appropriate for the fund not to have such policies and procedures; and
- A description of its policies and procedures for deterring frequent purchases and redemptions of fund shares[7], and in its Statement of Additional Information ("SAI"), arrangements to permit frequent purchases and redemptions of fund shares.

The amendments are intended to enable investors to assess the risks, policies and procedures of the investment company in this area and determine whether they are in line with their expectations.

Disclosure Regarding Use of Fair Value Pricing

The amendments will require all investment companies to explain both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. Money market funds, which are subject to Rule 2a-7 under the 1940 Act containing detailed pricing requirements, would not be subject to this proposed disclosure requirement. This amendment is intended to clearly reflect that investment companies are required to use fair value pricing any time that market quotations for portfolio securities are not readily available (including when they are unreliable).

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[7] The policies and procedures must be described with specificity and must include any restrictions imposed by the investment company to prevent such behavior (e.g. restrictions on the volume or number of purchases, redemptions or exchanges by a shareholder during a given time period; exchange or redemption fees; additional costs, fees or charges imposed on shareholders engaging in frequent purchases or redemptions; minimum holding periods; restrictions imposed on exchange or purchase requests submitted by overnight delivery, electronically or via facsimile or telephone; and rights of the investment company to reject, limit, delay or impose other conditions on exchanges or purchases or to close or otherwise limit accounts). The investment company must describe with specificity the circumstances under which such restrictions will not be imposed.

Disclosure Regarding Selective Portfolio Holding Disclosure

The amendments will require investment companies to disclose their policies regarding disclosure of portfolio holdings information in the following manner:

- A description in its SAI of any policies and procedures with respect to the disclosure of its portfolio securities to any person[8] and any ongoing arrangements to make available information about its portfolio securities to any person; and

- A statement in its prospectus that the policies and procedures are available in its SAI, and on its website, if applicable.

Compliance Date

All registration statements and post-effective amendments filed on or after December 5, 2004 must comply with these requirements.

PROPOSED RULES

DISCLOSURE REGARDING APPROVAL OF INVESTMENT ADVISORY CONTRACTS BY DIRECTORS OF INVESTMENT COMPANIES

The SEC has proposed amendments to improve the disclosure provided by an investment company about how the board of directors evaluates and approves, and recommends shareholder approval of, investment advisory contracts.[9] The proposal would require that shareholder reports discuss, in reasonable detail, the material factors and the conclusions that formed the basis for the board of directors' approval of any investment advisory contract. Such disclosure would be similar to that currently required in the SAI and the proxy statements about the basis for the approval of an existing advisory contract and any recommendation of shareholders approval of an advisory contract. The shareholder reports would provide such information regarding any board approval of an investment advisory contract during the period covered by the report, unless such contract was approved by the shareholders.

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[8] The disclosure would be required to include disclosure of any policies and procedures of the fund's adviser, or any other third party, that the investment company uses or that are used on the fund's behalf.

[9] "Proposed Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies" was issued on February 11, 2004 in Release Nos. 33-8364; 34-49219; and IC-26350.

The proposal would require an enhancement of the existing disclosure in the SAI and proxy statement and similar enhancements will be included in the shareholder reports disclosure. These include:

Selection of Adviser and Approval of Advisory Fee

The proposed amendments would require that the investment company's discussion should include factors relating to both the board's selection of the investment adviser, and its approval of the advisory fee and any other amounts to be paid under the advisory contract.

Specific Factors

An investment company must discuss certain factors, including, but not limited to, the following:

- the nature, extent and quality of the services to be provided by the investment adviser;
- the investment performance of the investment company and the investment adviser;
- the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the investment company;
- the extent to which economies of scale would be realized as the investment company grows; and
- whether fee levels reflect these economies of scale for the benefit of the investment company's investors.

Comparison of Fees and Services Provided by Adviser

The discussion must also indicate whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other investment companies or other types of clients, such as pension funds or other institutional investors. If such comparisons were relied upon, then the disclosure must describe the comparisons and how it assisted in the approval process.

Evaluation of Factors

The disclosure must include how the board evaluated each factor. In other words, it is not sufficient to state that the board considered the amount of the investment 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.

MANDATORY REDEMPTION FEES FOR OPEN-END INVESTMENT COMPANIES

The SEC has proposed a new Rule 22c-2 under the 1940 Act that would require investment companies (with certain limited exceptions) to impose a two percent redemption fee on the redemption of shares purchased within the previous five days.[10] The redemption fee would be retained by the investment company.[11]

Two Percent Redemption Fee and Five-Day Holding Period

The proposed rule would require the imposition of a fee of two percent of the proceeds from shares redeemed within five business days of their purchase. Such fee would be mandatory and uniform, as no investment company would be permitted to impose a higher or lower fee than two percent.

In addition, the proposed rule would require a minimum five-day holding period before an investor could redeem its shares without triggering the redemption fee. The rule would not preclude an investment company from instituting a longer holding period.

Smaller Investors

There are three provisions in the proposed rule that would limit the effect of the redemption fee on the accounts of smaller investors. These include:

- First In, First Out (FIFO) method: The shares held the longest will be treated as being redeemed first and those held the shortest time as being redeemed last.

- *De minimus* provision: An investment company will be *permitted*, but not required, to waive the redemption fee if the amount of shares redeemed is $2,500 or less. The SEC also has proposed *requiring* a waiver of the fee if the value is $2,500 or less.

- Financial emergency: An investment company will be *required* to waive the fee on redemptions of $10,000 or less, upon written request due to an unanticipated financial emergency. The investment company would also

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[10] "Proposed Rule: Mandatory Redemption Fees for Redeemable Fund Securities" was issued on March 5, 2004 in Release No. IC-26375A.

[11] The purpose of the proposed new rule is to reduce or eliminate the opportunity of short-term traders to exploit other investors in the investment company by (i) requiring them to reimburse the investment company for the approximate redemption-related costs incurred as a result of the trades, and (ii) discouraging short-term trading of shares of the investment company by reducing the profitability of the trades.

be *permitted* to waive the fee on redemptions greater than $10,000 in such emergency situations.

Shareholder Accounts and Intermediaries

The SEC has proposed three methods of preventing abusive market timing trades through omnibus accounts., which have often been beyond the reach of the board's efforts to protect the investment company and its shareholders from the harmful effects of short-term trading. Each investment company would be allowed to determine which method to use.

- Option one: An account number used by the intermediary must be provided to permit the investment company to match the current transaction with previous transactions by the same account and assess a redemption fee, if applicable.

- Option two: The intermediary would enter into an agreement with the investment company requiring the intermediary to identify redemptions of account holders that would trigger the redemption fee and transmit holdings and transaction information sufficient to allow the assessment of the redemption fee.

- Option three: The investment company would enter into an agreement with a financial intermediary requiring the intermediary to impose the redemption fees and remit the proceeds to the investment company. This would require the intermediary to determine which transactions are subject to the fee.

Exceptions

There are four proposed exceptions to the mandatory redemption fee.

1. The small investor exemptions discussed above (i.e., $2,500 threshold and financial emergencies).

2. An exception for money market funds, as these are designed to accommodate frequent purchases and redemptions.

3. The rule would not apply to exchange-traded funds, which are traded on stock exchanges and at negotiated prices.

4. The rule would not apply to any investment company that (i) adopts a fundamental policy to affirmatively permit short-term trading in all of its redeemable securities and (ii) discloses in its prospectus that it permits short-term trading of its shares, which might result in additional costs.

PROHIBITION ON THE USE OF BROKERAGE COMMISSIONS TO FINANCE DISTRIBUTION

The SEC has proposed amending Rule 12b-1 under the 1940 Act to prohibit investment companies from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker.[12] The rule would also prohibit "step-out" trades[13] and similar arrangements. The SEC has also proposed a different option that requires investment companies to provide more complete disclosure to shareholders on the use of brokerage commissions to pay brokers for selling its shares or otherwise modify. The SEC is seeking comments as to whether their concerns are justified and if increased or revised disclosure requirements would alleviate the problem.

The SEC is also proposing to require that an investment company that directs any portfolio securities to a broker-dealer must implement policies and procedures reasonably designed to prevent: (i) the persons responsible for selecting the broker-dealers from considering the broker-dealers' promotional or sales efforts and (ii) any agreements under which the investment company directs brokerage transactions or revenue to a broker-dealer for distribution of its shares.

The SEC is also seeking comments on whether additional changes to Rule 12b-1 are necessary to address other issues that have arisen under the rule, or a rescission of the rule is necessary.

DISCLOSURE REGARDING PORTFOLIO MANAGERS OF REGISTERED MANAGEMENT INVESTMENT COMPANIES

On March 11, 2004, the SEC proposed amendments to certain forms to increase disclosure regarding portfolio managers.[14] Currently, investment companies are required to disclose in their prospectuses certain information concerning their portfolio managers, such as name, title, length of service and business experience of those primarily responsible for day-to-day management. If a committee, team or other group is jointly responsible, the investment company must provide disclosure to the effect that the investments are managed by that group, but need not provide the names of the members of the group. The proposed amendments are

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[12] "Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution" was issued February 24, 2004 in Release No. IC-26356.

[13] If a broker selling fund shares lacks the capacity to execute the fund's securities transactions, the adviser may select another broker to execute the transaction and require the executing broker to "step out" a portion of its commission to pay the selling broker. Alternatively, the executing broker may 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 will be directed.

[14] "Proposed Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies" was issued on March 11, 2004 in Release Nos. 33-8396; 34-49398; and IC-26383.

intended to provide greater transparency regarding portfolio managers, their incentives, and the potential conflicts of interest that might arise.

Identification of Portfolio Management Team Members

The proposed amendments would require that investment companies identify in their prospectuses each member of a committee, team or other group of persons associated with the investment adviser that is jointly and primarily responsible for the day-to-day management of the investment company's portfolio. In addition, the amendments would require a brief description of each member's role on the team.

Disclosure Regarding Other Accounts Managed, Potential Conflicts of Interest, and Policies and Procedures to Address Conflicts

The proposed amendments also would require disclosure in the SAI regarding other accounts for which the portfolio manager is primarily responsible for the day-to-day portfolio management. The proposal would also require a description of any conflicts of interest that may arise in connection with the portfolio manager's management of the investment company's investments, on the one hand, and the investments of other accounts, on the other.[15]

Disclosure of Portfolio Manager Compensation Structure

The proposed amendments would require disclosure in the SAI regarding the structure of, and the method used to determine, the compensation of the portfolio managers.[16] The proposal would not require disclosure of the amount of compensation paid to a portfolio manager. Currently, only the advisory fee paid by the investment company to its investment adviser is required to be disclosed.

Disclosure of Securities Ownership of Portfolio Managers

The proposed amendments would require disclosure in the SAI of the ownership of securities by each of the portfolio managers in the investment company and in other accounts, including other investment companies, managed by the investment adviser or portfolio manager. The disclosure would be required to be in tabular format and stated in general dollar ranges.

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[15] The description would include any conflicts between the investment strategy of the investment company and the investment strategy of any other accounts. In addition, the investment company must describe any policies and procedures used to address any such conflicts.

[16] The disclosure would include a discussion of the components of the portfolio manager's compensation, including, without limitation, salary, bonus, deferred compensation and pension and retirement plans and arrangements and whether the compensation is cash or non-cash. For each type of compensation, a description of the criteria on which that type of compensation is based would be required.

Removal of Exclusion for Index Funds

The proposals would remove the current provisions that exclude an investment company that has as its investment objective replication of the performance of an index from the requirement to identify and provide disclosure on its portfolio managers.

Disclosure of Availability of Information

The proposed amendments would require that the investment company's prospectus state that the SAI provides additional information about the portfolio managers' compensation, other accounts managed by the portfolio managers, and the portfolio managers' ownership of securities in the investment company and other accounts managed by the investment adviser or portfolio managers.

LEGISLATIVE DEVELOPMENTS

On February 10, 2004, Senators Peter Fitzgerald, Carl Levin and Susan Collins introduced S. 2059, the "Mutual Fund Reform Act of 2004" ("S. 2059"), in the Senate. The Senate Committee on Banking, Housing and Urban Affairs received the bill for discussion. S. 2059 would, among other things:

- require that 75% of an investment company's board be independent, as well as the board's chairman. In addition, it would set additional requirements for independence[17];
- require the SEC to issue rules on compensation paid to directors and the effect on a director's independence when the director serves on multiple investment companies or receives substantial compensation from the investment adviser of any such investment company;
- establish a fiduciary duty for directors to act with loyalty and care, in the best interests of shareholders, as well as a fiduciary duty for investment advisers;
- allow independent directors to terminate the services of the investment advisers;

[17] To maintain independence, a director must be approved or elected by shareholders at least once every five years and must be determined, on an annual basis, by a majority of the independent directors, not to have any material business or familial relationship with the investment company, a significant service provider to the investment company, or any entity controlling, controlled by, or under common control with such service provider, that is likely to impair the independence of the director.

- apply the standards of Section 301 of the Sarbanes-Oxley Act and Rule 10A-3 under the Exchange Act to audit committees of investment companies;
- expand Section 17(j) of the 1940 Act to prohibit fraud, deception and manipulation;
- require the SEC to standardize how to calculate (i) transaction cost ratio and (ii) expense ratio, as well as define all specific, allowable categories of expenses;
- require the SEC to issue rules requiring disclosure of the investment adviser's compensation and ownership interest in the investment company, as well as amount and source of compensation to brokers;
- require disclosure by an investment company, in any quarterly or periodic report, of any discounts on front-end sales loads for which shareholders may be eligible;
- require the SEC to issue a rule requiring the disclosure of the portfolio turnover ratio of the investment company;
- require disclosure of proxy votes and the proxy voting policies of the investment company;
- require the SEC to issue a rule requiring that each account intermediary must provide such information as is necessary for the investment company to enforce its investment, trading and fee policies;
- require the SEC to issue rules for advertising by investment companies;
- repeal Rule 12b-1 under the 1940 Act and amend Section 12 of the 1940 Act to prohibit payment of asset-based fees to any broker or dealer in connection with the offer or sale of securities;
- add new Section 12A to the 1940 Act, prohibiting revenue sharing arrangements, directed brokerage arrangements or soft-dollar arrangements with any broker or dealer;
- require the SEC to issue rules requiring the disclosure in the registration statement of the market timing policies of the investment company and that the investment company declines to adopt restrictions on market timing;

- require the SEC to issue rules requiring the application and use of fair value method of determining net asset value when market quotations are unavailable;

- prohibit any officer, director, partner or employee of an investment company from engaging in any short-term transaction, in any securities issued by such investment company;

- permit an investment company to charge redemption fees in excess of two percent;

- prohibit (subject to certain exceptions) joint management of both a registered open-end investment company and an unregistered investment company;

- require the SEC to issue rules it deems necessary to prevent the selective disclosure of information by an investment company; and

- require the SEC to study the consequences of conflicts of interest of investment advisers and how to minimize such conflicts of interest.

Many of the issues dealt with in the legislation have already been addressed by the SEC in the final and proposed rules recently announced. For a discussion of previously introduced legislation, please refer to the March 3, 2004 Memorandum.

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If you have any questions regarding the recent regulatory developments in the investment company industry, please contact Sarah E. Cogan (scogan@stblaw.com, 212-455-3575), Cynthia G. Cobden (ccobden@stblaw.com, 212-455-7744), Brynn D. Peltz (bpeltz@stblaw.com, 212-455-2210) or David E. Wohl (dwohl@stblaw.com, 212-455-7937).

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