SIMPSON
THACHER

REGULATORY DEVELOPMENTS IN THE INVESTMENT COMPANY INDUSTRY

March 3, 2004

SIMPSON THACHER & BARTLETT LLP

TABLE OF CONTENTS

Page

SIMPSON THACHER

REGULATORY DEVELOPMENTS IN THE INVESTMENT COMPANY INDUSTRY

MARCH 3, 2004

Since mid-2003, the Securities and Exchange Commission (the "SEC") has adopted several rules and proposed 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, both the House of Representatives and the Senate have considered new legislation to address the same issues. This memorandum summarizes these regulatory developments.[1]

FINAL RULES

COMPLIANCE PROGRAMS OF INVESTMENT COMPANIES

Compliance programs

Investment companies are required under Rule 38a-1[2] to adopt written policies and procedures reasonably designed to prevent the investment company from violating the federal securities laws.[3] In addition, the policies and procedures must include the provision of oversight of compliance by each of the investment company's advisers, principal underwriters,

---

[1] The regulatory developments addressed in this memorandum are those subsequent to, or not previously discussed in, our June 30, 2003 memorandum entitled "*Memorandum to Directors and Trustees of Registered Investment Companies*" (the "June 30, 2003 Memorandum").

[2] "Final Rule: Compliance Programs of Investment Companies and Investment Advisers" was issued on December 17, 2003 in Release Nos. IA-2204 and IC-26299. The amendments were proposed on February 5, 2003 in Release Nos. IA-2107 and IC-25925.

[3] As used in Rule 38a-1, "federal securities laws" is the collective reference to the Securities Act, the Exchange Act, the Sarbanes-Oxley Act of 2002, the 1940 Act, the Investment Advisers Act of 1940, as amended, Title V of the Gramm-Leach-Bliley Act, any rules adopted by the SEC under the foregoing statutes, the Bank Secrecy Act as it applies to investment companies, and any rules adopted thereunder by the SEC or the Department of the Treasury. Rule 38a-1(e)(1) under the 1940 Act.

administrators and transfer agents (collectively, "service providers") with their respective compliance policies and procedures.[4]

Rule 38a-1 also requires an investment company's board, including a majority of its independent directors,[5] to approve the compliance policies and procedures of the investment company and of each of its service providers. In both cases, approval requires a finding by the board that such compliance policies and procedures are reasonably designed to prevent violation of the federal securities laws by the investment company and its service providers. Directors may satisfy their obligations under this rule with respect to investment companies and affiliated service providers by reviewing summaries of compliance programs prepared by the chief compliance officer, legal counsel or other persons familiar with the compliance programs. The summaries should familiarize directors with the salient features of the programs and provide them with a good understanding of how the compliance programs address particularly significant compliance risks. Board approval of amendments to compliance programs is not required.

Board evaluation of the investment company's non-affiliated service providers may be satisfied if the investment company uses a third-party report on the service provider's policies and procedures instead of the policies and procedures themselves. The third-party report must describe the service provider's compliance program as it relates to the types of services provided to the investment company, discuss the types of compliance risks material to the investment company, and assess the adequacy of the service provider's compliance controls.

Rule 38a-1 requires an investment company to review on an annual basis the adequacy of the compliance policies and procedures of the investment company and of each service provider and the effectiveness of their implementation. The review does not need to be conducted by the board, but the review would be required to be addressed in the report submitted by the chief compliance officer to the board. [6]

The SEC release promulgating new Rule 38a-1 describes a number of "critical areas" and other issues that it expects to be addressed by the compliance program of an investment company or service providers. These include:

---

[4] References to "compliance programs" in this memorandum refer to "compliance policies and procedures." Both terms are used interchangeably throughout this memorandum.

[5] "Independent directors" are directors who are not "interested persons" of the company as defined in Section 2(a)(19) of the 1940 Act.

[6] Release Nos. IA-2204 and IC-26299. The requirement for an annual review of an investment company's service providers' compliance programs may also be satisfied by using third-party reports provided to the investment company at least annually, so long as the investment company also obtains and takes into account other relevant information, such as its experience with the service provider.

- Pricing of portfolio securities and investment company shares, including monitoring of circumstances that may necessitate the use of fair value prices, criteria for determining when market quotations are no longer reliable for a particular portfolio security, a methodology to determine the current fair value of the portfolio security, and the regular review of the appropriateness and accuracy of the method used in valuing securities;

- Processing of investment company shares, including segregation of investor orders received before the investment company prices its shares (which will receive that day's price) from those received after the investment company prices its shares (which will receive the next day's price);[7]

- Identification of affiliated persons, including prevention of unlawful transactions by such persons;

- Protection of nonpublic information against potential misuse, including the disclosure to third parties of material information about its portfolio, trading strategies or pending transactions and the purchase or sale of investment company shares by advisers based on material, nonpublic information about the investment company's portfolio;

- Compliance with investment company governance requirements, including issues of an improperly constituted board, failure of the board to properly consider matters entrusted to it, and failure of the board to request and consider information required by the 1940 Act from the adviser and other service providers;

- Market timing, including compliance with disclosed policies regarding market timing, monitoring of shareholder trades or investment company share flows, consistent enforcement of market timing policies and a quarterly report to the board of all waivers of market timing policies;

- Portfolio management process, including allocation of investment opportunities, consistency of portfolios with clients' investment objectives, disclosures by the adviser, voting of proxies relating to portfolio securities and applicable regulatory restrictions;

- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other

---

[7] The SEC also recommends obtaining assurances that the policies and procedures of the investment company's transfer agents against late trading are effectively administered. Release Nos. IA-2204 and IC-26299.

services (soft dollar arrangements) and allocates aggregated trades among clients;

- Proprietary trading of the adviser and personal trading activities of supervised persons;
- Accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisers;
- The accurate creation of required records and their secure maintenance;
- 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.

Chief compliance officer

Each investment company must appoint a chief compliance officer responsible for administering the investment company's compliance program. This person should be competent and knowledgeable regarding the federal securities laws and should have sufficient seniority and authority to develop and enforce the compliance program.

In order to maintain the chief compliance officer's independence from management:[8]

1. The chief compliance officer's designation and compensation must be approved by the board, including a majority of independent directors;
2. The chief compliance officer may be removed from the position only by action of, or with the approval of, the board, including a majority of independent directors;
3. The chief compliance officer must meet separately with the investment company's independent directors at least annually; and

[8] In Release Nos. IA-2204 and IC-26299, the SEC requests further comment on whether additional measures should be required to further enhance the independence and effectiveness of the chief compliance officer.

4. The investment company's officers, directors, employees, investment advisers, principal underwriters and anyone acting under the direction of these persons, are prohibited from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the investment company's chief compliance officer in the performance of his or her duties under Rule 38a-1.

The chief compliance officer must annually furnish the board with a written report on the operation of the compliance program of the investment company and each of its service providers. The report must address, at a minimum:[9]

- The operation of the compliance program since the last report;
- Any material changes[10] to the compliance program since the last report;
- Any recommendations for material changes to the compliance program as a result of the annual review; and
- Any material compliance matters[11] since the date of the last report.

The chief compliance officer is responsible for overseeing the investment company's service providers, which will have their own compliance officers. The chief compliance officer from the investment company may be the chief compliance officer or other employee of one of the service providers, although its responsibilities in each role must remain distinct.[12]

---

[9] The report on a service provider's compliance program may use third-party reports provided to the investment company at least annually, so long as the investment company also obtains and takes into account other relevant information, such as its experience with the service provider.

[10] A change is material if it is a change that an investment company director would reasonably need to know about in order to oversee investment company compliance. Release Nos. IA-2204 and IC-26299, note 81.

[11] Rule 38a-1(e)(2) defines "material compliance matter" to mean any compliance matter that an investment company director would reasonably need to know about in order to oversee investment company compliance and that involves, without limitation:

a. A violation of the federal securities laws by the investment company or its service providers (or officers, directors, employees or agents thereof),

b. A violation of the compliance program of the investment company or its service providers, or

c. A weakness in the design or implementation of the compliance program of the investment company or its service providers.

In Release Nos. IA-2204 and IC-26299, the SEC requests further comment on whether this definition adequately ensures that boards receive information they reasonably need to know to oversee compliance.

[12] Release Nos. IA-2204 and IC-26299.

Recordkeeping

Rule 38a-1(d) requires an investment company to retain, whether in print or electronic format, the following documents:

1. Copies of all of its compliance policies and procedures that are in effect or were in effect at any time during the last five years;

2. Materials provided to the board in connection with its approval of the investment company's and its service providers' compliance programs, and any annual written reports by its chief compliance officer provided to the board for at least five years; and

3. Any records documenting its annual review for at least five years.

Effective and compliance dates

The effective date of this final rule is February 5, 2004, including new Rule 38a-1 under the 1940 Act. The compliance date of the new rule is October 5, 2004.

On or before October 5, 2004, investment companies must designate a chief compliance officer and adopt a compliance program satisfying the requirements of Rule 38a-1 and investment company boards must approve the chief compliance officer and compliance program.

Investment companies must complete their first annual review of compliance programs no later than 18 months after their adoption or approval. The chief compliance officer must submit the first annual report to the board within 60 calendar days of the completion of the annual review.

DISCLOSURE REGARDING NOMINATING COMMITTEE FUNCTIONS AND COMMUNICATIONS BETWEEN SECURITY HOLDERS AND BOARDS OF DIRECTORS

This final rule adopts new disclosure requirements and amendments to existing disclosure requirements to increase the transparency of the operations of investment company boards of directors.[13] These new disclosure standards focus on two areas: (1) the operations of board nominating committees and (2) the means by which security holders may communicate with directors.

[13] "Final Rule: Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors" was issued on November 24, 2003 in Release Nos. 33-8340, 34-48825 and IC-26262. The amendments were proposed on August 8, 2003 in Release Nos. 34-48301 and IC-26145.

The amendments are made predominantly with respect to information required to be disclosed in proxy statements by Schedule 14A of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), and in Form N-CSR.[14]

Disclosure regarding nominating committee processes

An investment company's proxy statement is required to include a statement as to whether the investment company has a nominating committee or a committee performing similar functions (a "nominating committee") and, if it does not have one, (i) the basis for the board's view that a nominating committee is not appropriate for the investment company and (ii) the identification of each director that participates in the consideration of director nominees.

Furthermore, the information described below regarding the investment company's director nomination process must also be included.

1. Nominating committee charter.

If the nominating committee has a charter, the investment company's proxy statement must include either (a) the investment company's website address where a current copy of the charter is available; (b) if (a) is not applicable, a copy of the charter as an appendix to the proxy statement at least once every 3 fiscal years; or (c) if neither (a) nor (b) are applicable, identification of the prior fiscal year in which the charter was included as an appendix to the proxy statement. If the nominating committee does not have a charter, the proxy statement must state that fact.

2. Independence of nominating committee.

The proxy statement must disclose whether or not the members of the investment company's nominating committee are "interested persons" of the investment company as defined in Section 2(a)(19) of the 1940 Act.

3. Security holder nominations.

If the nominating committee has a policy regarding consideration of director candidates recommended by security holders, the proxy statement must include a description of the material elements of that policy, which shall include, but need not be limited to, a statement as to whether the nominating committee will consider director candidates recommended by

---

[14] Because certain exemptive rules under the 1940 Act require that an investment company relying on them have a majority of independent directors on its board and that those independent directors select and nominate any other independent directors, many open-end funds adopt nominating committee charters. Nonetheless, since the majority of the new disclosure requirements apply only to proxy statements, in the absence of a special circumstance in which an open-end investment company would need to proxy shareholders, the new disclosure requirements will generally only affect closed-end investment companies.

security holders. If the nominating committee does not have such a policy, the proxy statement must state that fact and the basis for the board's view that such a policy is not appropriate for the investment company.

If the nominating committee will consider director candidates recommended by security holders, the proxy statement must include a description of the procedures to be followed by security holders in submitting such recommendations. Where material changes to these procedures are implemented (including the adoption of procedures when none were previously in place), the changes must be described in Form N-CSR.[15]

4. *Director qualifications.*

The proxy statement must include a description of:

a. Any specific, minimum qualifications that the nominating committee believes must be met by a person to be nominated to the board of directors by the nominating committee; and

b. Any specific qualities or skills that the nominating committee believes are necessary for one or more of the directors to possess.

5. *Nomination process.*

The proxy statement must include a description of the nominating committee's process for identifying and evaluating nominees, including nominees recommended by security holders, and any differences in the manner in which the nominating committee evaluates nominees for directorships based on whether the nominee is recommended by a security holder.

6. *Sources of nominees.*

For each nominee approved by the nominating committee for inclusion on the proxy card (other than nominees who are executive officers or who are directors standing for re-election), the proxy statement must include a statement as to which of the following categories of persons or entities recommended the nominee: security holder, director, chief executive officer, other executive officer, or employee of the adviser, principal underwriter, or any affiliated person of the adviser or principal underwriter. If there are multiple sources, all should be identified.

If the investment company pays a fee to any third party or parties to identify or evaluate or assist in identifying or evaluating potential nominees, the proxy statement must disclose the function performed by each third party.

---

[15] Material changes need to be disclosed under new Item 9 in Form N-CSR only where implemented after the disclosure regarding procedures was last made as required in the proxy statement, or disclosure regarding previous changes was last made as required in Form N-CSR.

7. Additional disclosure for large, long-term security holders.

If the nominating committee received, by a date not later than the 120th calendar day before the date of the proxy statement released to security holders in connection with the previous year's annual meeting, a recommended nominee from (a) a security holder that beneficially owned more than 5% of the investment company's voting common stock for at least one year as of the date the recommendation was made or (b) a group of security holders that beneficially owned, in the aggregate, more than 5% of the investment company's voting common stock, with each of the securities used to calculate such ownership held for at least one year as of the date the recommendation was made, the proxy statement must identify the candidate and the security holder or security holder group that recommended the candidate and disclose whether the nominating committee chose to nominate the candidate. [16] However, the foregoing disclosure is only required if the written consent of both the security holder or security holder group and the candidate is provided at the time of the recommendation.[17]

Disclosure regarding the ability of security holders to communicate with boards of directors

An investment company's proxy statement will be required to include information regarding its processes for security holder communications[18] with board members, as described below.

1. Process for communicating with board members.

The proxy statement must state whether the board provides a process for security holders to send communications to the board. If the board does not have such a process, the proxy statement must state the basis for the board's view that it is appropriate for the investment company not to have such a process.

---

[16] Instruction 1 to Item 7(d)(2)(ii)(L) of Schedule 14A of the Exchange Act provides that the percentage of securities held by a nominating security holder or security holder group may be determined using information in the investment company's most recent report on Form N-CSR filed with the SEC, unless the party relying on the report knows or has reason to believe that the information contained therein is inaccurate.

[17] Instruction 4 to Item 7(d)(2)(ii)(L) of Schedule 14A of the Exchange Act.

[18] Communications from an officer or director will not be considered "security holder communications." However, communications from an employee or agent of the company will be viewed as "security holder communications" if such communications are made solely in its capacity as a security holder. Instruction 1 to Item 7(h) of Schedule 14A of the Exchange Act. Further, security holder proposals submitted pursuant to Rule 14a-8 under the Exchange Act, and communications made in connection with such proposals, will not be viewed as "security holder communications." Instruction 2 to Item 7(h) of Schedule 14A of the Exchange Act.

If the board does have such a process, the proxy statement must also include:

- A description of the manner in which security holders can send communications to the board and, if applicable, to specified directors; and

- If all security holder communications are not sent directly to board members, a description of the investment company's process for determining which communications will be relayed to board members.[19]

In lieu of the foregoing descriptions, a proxy statement may provide the investment company's website address where such information appears.

2. *Director attendance at board meetings.*

The proxy statement must include either (a) a description of the investment company's policy, if any, with regard to board members' attendance at annual meetings and a statement of the number of board members who attended the prior year's annual meeting or (b) the investment company's website address where such information appears.

Effective and compliance dates

The effective date of this final rule is January 1, 2004. Investment companies must comply with the disclosure requirements in proxy or information statements that are first sent or given to security holders on or after January 1, 2004, and on Form N-CSR for the first reporting period ending after January 1, 2004. Investment companies may comply voluntarily with these disclosure requirements before the compliance date.

AMENDMENTS TO INVESTMENT COMPANY ADVERTISING RULES

The amendments in this final rule are designed to encourage investment company advertisements that convey more balanced information to prospective investors, particularly with respect to past performance.[20] The SEC stated that it had two objectives in amending the advertising regulations for investment companies: (1) to simplify and clarify the rules governing investment company advertising and (2) to enhance the disclosure required in Rule 482 advertising.

---

[19] A registered investment company's process for collecting and organizing security holder communications, as well as similar or related activities, need not be disclosed if the process was approved by a majority of independent directors.

[20] "Final Rule: Amendments to Investment Company Advertising Rules" was issued on September 29, 2003 in Release Nos. 33-8294, 34-48558 and IC-26195. The amendments were proposed on May 17, 2002 in Release Nos. 33-8101, 34-45953 and IC-25575.

In addition to reorganizing Rule 482 under the Securities Act of 1933, as amended (the "Securities Act"), the final rule also implements a number of substantive amendments as described below.

Elimination of "substance of which" requirements

Rule 482 permits the advertisement of investment performance data, as well as other information, regarding the securities of a registered investment company that is selling or proposing to sell its securities pursuant to a registration statement that has been filed under the Securities Act. Such Rule 482 advertisements are "prospectuses" under Section 10(b) of the Securities Act and, historically, could only include information the "substance of which" is included in the statutory prospectus (the full prospectus required by Section 10(a) of the Securities Act). The final rule eliminates the requirement that a Rule 482 advertisement contain only information "the substance of which" is included in the statutory prospectus. Amendments to Form N-1A reflect the elimination of this requirement as well. It should be noted, however, that Rule 482 advertisements, (1) as "prospectuses," remain subject to liability under Section 12(a)(2) of the Securities Act and the antifraud provisions of the federal securities laws; and (2) as Section 10(b) prospectuses under the Securities Act, remain subject to the summary suspension provisions of Section 10(b), which permit the SEC to suspend the use of a materially false or misleading prospectus. In addition, investment company advertising materials must continue to be filed with NASD Regulation, Inc. ("NASDR") or the SEC,[21] and NASDR rules relating to investment company advertising will continue to apply.

The final rule also excludes registered investment companies from relying on Rule 134 under the Securities Act and removes provisions of Rule 134 that applied specifically to investment companies. Rule 134 permits advertisements based on the content of the advertisement. Thus, investment company advertisements that could have been Rule 134 advertisements will be regulated instead by Rule 482.

Applicability of antifraud regulation

In order to emphasize the applicability of antifraud provisions in federal securities laws to investment company advertising, the SEC added a note to new paragraph (a) of Rule 482 stating that the fact that an advertisement is in compliance with Rule 482 does not relieve the investment company, underwriter or dealer of any obligations with respect to the advertisement under the antifraud provisions of the federal securities laws. A similar note was added to Rule 34b-1 under the 1940 Act with respect to supplemental sales literature. Such notes contain cross-references to Rule 156 under the Securities Act, which provides guidance regarding factors to be weighed in considering whether a statement involving a material fact in

---

[21] Closed-end funds are not required to file advertising materials with the SEC. Under Rule 24b-3 under the 1940 Act, open-end funds are not required to file advertising materials with the SEC if they are filed with NASDR.

an investment company's sales materials is or might be misleading. Rule 156 was also amended to state more explicitly that portrayals of past income, gain or growth of assets may be misleading if they convey an impression of investment results that would not be justified under the circumstances, including portrayals that omit explanations, qualifications, limitations or other statements necessary or appropriate to make them not misleading.

Enhanced disclosure

1. Month-End Performance Information

Rule 482 requires that performance information be as of the most recent practicable date. Amended Rule 482 provides that an advertisement containing total return quotations will be considered to have complied with this requirement if:

a. (i) The total return quotations are current as to the most recent calendar quarter ended prior to the submission of the advertisement for publication and (ii) total return quotations current to the most recent month ended seven business days before the date of use of the advertisement by the investor are provided at a toll-free or collect telephone number or on a website (whether of the investment company itself or a third-party intermediary where applicable); or

b. The total return quotations are current as to the most recent month ended seven business days before the date of use of the advertisement by the investor.

As used herein, the "date of use" refers to the entire period of use by the investor, not only the first date of use nor the date of publication.

However, month-end information obtained through a telephone call or website would not be considered part of the advertisement itself and would not cure any materially misleading statement or omission in the advertisement.

2. Narrative Disclosure

In addition to existing disclosure requirements, Rule 482 advertisements that contain performance data of an investment company will now be required to disclose the following information:[22]

- A statement that past performance does not guarantee future results;

---

[22] Existing requirements include (a) a statement that the performance data quoted represents past performance; and (b) a statement that the investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. However, an advertisement for a money market fund may omit the disclosure regarding principal value fluctuation.

- A statement that current performance may be lower or higher than the performance data quoted; and

- A toll-free or collect telephone number or a website where an investor may obtain performance data current to the most recent month-end, unless the advertisement includes total return quotations current to the most recent month ended seven business days prior to the date of use of the advertisement by the investor.

Furthermore, Rule 482 advertisements will also be required to direct a prospective investor's attention to an investment company's charges and expenses by including a statement that:

- Advises an investor to consider the investment company's investment objectives, risks and charges and expenses carefully before investing;

- Explains that the prospectus contains this and other information about the investment company;

- Identifies a source from which an investor may obtain a prospectus; and

- States that the prospectus should be read carefully before investing.

3. Presentation of Explanatory Information

Several changes have been adopted to ensure that certain information in Rule 482 advertisements be made more prominent. Print advertisements will now be required to present required narrative disclosures in a type size at least as large as and of a style different from, but at least as prominent as, that used in the major portion of the advertisement. For print advertisements that include performance data in a type size smaller that that of the major portion of the advertisement, the required narrative disclosure regarding such performance data may appear in a type size no smaller that of the performance data itself.

Advertisements delivered through electronic mediums may satisfy these legibility requirements for narrative disclosure by presenting the statements in any manner reasonably calculated to draw investor attention to them. Radio and television advertisements must give such statements emphasis equal to that used in the major portion of the advertisement.

For all forms of advertisements, narrative disclosure regarding performance data must be presented in close proximity to the performance data. In the case of print advertisements, the disclosure must be included in the body of the advertisement rather than in a footnote. For spoken advertisements, the SEC suggests that the disclosures appear immediately after, immediately before, or briefly separated from the performance data.[23] With respect to print

[23] Release Nos. 33-8294, 34-48558 and IC-26195.

advertisements containing lists of investment company performance information longer than one page in length, the required performance data disclosure may appear once at the beginning of the list, provided that the other prominence requirements of the rule are met. However, for website advertisements, performance-related disclosure must appear on every webpage on which performance data appears and in close proximity to that data.

The prominence and proximity requirements described above will also apply to supplemental sales literature through amendments to Rule 34b-1 under the 1940 Act.

Effective and compliance dates

The effective date of this final rule was November 15, 2003, including the elimination of the "substance of which" requirement from Rule 482. Investment company advertisements submitted for publication after March 31, 2004 should comply with all other amendments proposed by this final rule.

PROPOSED RULES

DISCLOSURE REGARDING MARKET TIMING AND SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS

The SEC recently proposed form amendments to enhance disclosure in the areas of late trading, market timing and selective disclosure of portfolio holdings.[24]

Disclosure regarding market timing policies

The proposed form amendments would require improved disclosure by an investment company in its prospectus in the following areas:

- The risks, if any, that frequent purchases and redemptions of investment company shares may present for other shareholders;
- Whether or not its board has adopted policies and procedures with respect to frequent purchases and redemptions of investment company shares and, if the board has not adopted any, the basis for its view that it is appropriate for the investment company not to have such policies and procedures; and

[24] "Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings" was issued on December 11, 2003 in Release Nos. 33-8343 and IC-26287.

- A description of its policies and procedures for deterring frequent purchases and redemptions of investment company shares,[25] and arrangements to permit frequent purchases and redemptions of investment company shares.

The proposed 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 proposed form amendments would 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 proposed 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 or are unreliable.

Disclosure regarding selective portfolio holding disclosure

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

- A description in its statement of additional information ("SAI") of any policies and procedures with respect to the disclosure of its portfolio securities to any person[26] and any ongoing arrangements to make available information about its portfolio securities to any person; and

- A description in its prospectus of the policies and procedures available in its SAI, and on its website, if applicable.

---

[25] 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; minimum holding periods; 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.

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

These proposed amendments are intended to provide greater transparency of investment company practices with respect to the disclosure of portfolio holdings and to reinforce investment companies' obligations to prevent the misuse of material, non-public information.[27]

AMENDMENTS TO RULES GOVERNING PRICING OF INVESTMENT COMPANY SHARES

The SEC recently proposed amendments to Rule 22c-1 under the 1940 Act, which requires forward pricing of redeemable securities issued by registered investment companies.[28] The amendments are designed to prevent unlawful late trading in investment company shares.

Proposed pricing requirements

The proposed amendments would require that an order to purchase or redeem investment company shares would receive the current day's price only if the order is received before the time that the investment company establishes for calculating its net asset value ("NAV") by (1) the investment company, (2) its designated transfer agent[29] or (3) a securities clearing agency registered with the SEC (e.g. NSCC's Fund/SERV system). The transfer agents would be required to record the date and time the order information is received and thus, only transfer agents with the ability to time-stamp order information and maintain a record of that information could be designated by the investment company.

Purchase and sale orders; exchanges

In order to clarify when an order is complete, and thus received for purposes of determining the appropriate day's price, the proposed amendments would also define the term "order" as the direction to purchase or sell either (a) a specific number of shares of an investment company (e.g. 100 shares held in the account) or (b) an indeterminate number of shares of a specific value (e.g. $10,000 of shares of the investment company). Furthermore, the definition would also state that an order is deemed to be irrevocable as of the next pricing time after its receipt by the investment company, the designated transfer agent or a registered clearing agency.

---

[27] The SEC is also seeking comment regarding (a) whether disclosure of all instances of selective disclosure of portfolio securities should be required and (b) whether Regulation FD, which governs the selective disclosure of material, non-public information and currently applies to closed-end investment companies but not open-end investment companies, should apply to open-end investment companies or managed separate accounts.

[28] "Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares" was issued on December 11, 2003 in Release No. IC-26288.

[29] A "designated transfer agent" would mean the single registered transfer agent (as defined in Section 4(a)(25) of the Exchange Act) that is designated in the investment company's registration statement and is required by written contract to receive order information and maintain a record of the date and time it receives the order information.

In the case of exchange orders, an order will also include a direction to purchase redeemable securities of the investment company using proceeds of a contemporaneous order to redeem a specific number of shares of another investment company. Thus, the first investment company may deem the order received despite the fact that the amount or number of shares of the first investment company to be purchased will not be known until after the NAV of the second investment company is determined.

Exceptions

The proposed amendments would add two new exceptions to the forward pricing requirements of Rule 22c-1.

Under the first new exception, orders would receive same-day treatment if, as a result of an emergency (such as a power failure or hurricane):

1. A dealer or its agent was unable to transmit the investors' orders, and the dealer's chief executive officer certifies to the investment company (a) the nature, existence and duration of the emergency and (b) that the dealer received the orders before the applicable pricing time;[30] or

2. The investment company's designated transfer agent or the registered clearing agency was unable to receive the orders, and the chief executive officer of the designated transfer agent or the registered clearing agency notifies the investment company as to the nature, existence and duration of the emergency.

The second new exception would allow "conduit" investment companies,[31] which invest all their assets in another investment company and thus calculate their NAV based on the other investment company's NAV, to submit orders based on the NAV established by the other investment company on the same day. Thus, an investment company may deem orders from "conduit" investment companies to have been received immediately before its applicable pricing time.

Additional comments requested

The SEC is also seeking comments regarding a suggested approach that would require investment company intermediaries to adopt certain protections to prevent late trading in order to be eligible to submit orders to an investment company's designated transfer agent or a registered clearing agency after the applicable pricing time. Such protections could include:

---

[30] An investment company, or its designated agent, would be required to keep a record of each such certification received for 6 years.

[31] Conduit investment companies rely on Section 12(d)(1)(E) of the 1940 Act, and include most insurance company separate accounts and "master-feeder funds."

- Electronic or physical time-stamping of orders in a manner that cannot be altered or discarded once the order is entered into the trading system;

- Annual certification to the investment company that the intermediary has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the investment company or its designated transfer agent during the period; and

- Submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit its report to the investment company's chief compliance officer.

DISCLOSURE OF BREAKPOINT DISCOUNTS BY INVESTMENT COMPANIES

The SEC recently proposed form amendments that would require investment companies to provide enhanced disclosures regarding any arrangements that result in breakpoints in sales loads and shareholder eligibility requirements.[32] The proposed amendments are intended to help investors understand the breakpoint opportunities available to them, and to alert investors as to the information they may need to provide to investment companies and broker-dealers to take full advantage of all available breakpoint discounts. They should also assist broker-dealers to access information about available breakpoint discounts.

The proposed form amendments would require an investment company to provide enhanced disclosure in its prospectus in the following areas:

1. A brief description of any arrangements that result in breakpoints in, or elimination of, sale loads, including a summary of shareholder eligibility requirements (including the types of accounts, account holders and investment company holdings that may be aggregated for purposes of determining eligibility);[33]

2. A description of the methods used to value accounts in order to determine whether a shareholder has met sales load breakpoints, including the circumstances in which and the classes of individuals to whom each method applies (including historical cost, net amount invested and offering price);

3. If applicable, (a) a statement that in order to obtain a breakpoint discount, it may be necessary for a shareholder to provide information and records to an investment

---

[32] "Proposed Rule: Disclosure of Breakpoint Discounts by Mutual Funds" was issued on December 17, 2003 in Release Nos. 33-8347, 34-48939 and IC-26298.

[33] Any information regarding breakpoint arrangements not included in the prospectus would be required to be included in the SAI, and the prospectus would be required to state that such information is available in the SAI.

company or financial intermediary, such as statements for accounts with holdings eligible to be aggregated to meet sales load breakpoints, (b) a description of such information and records that a shareholder may need to provide and (c) if breakpoints are permitted to be determined based on historical cost, a statement that a shareholder should retain any records necessary to substantiate historical costs; and

4. Whether it makes available free of charge on or through its website information regarding its sales loads and breakpoints that the investment company would be required to include in its prospectus and SAI, including whether the information is in a clear and prominent format and whether it includes hyperlinks that facilitate access to the information.[34]

The disclosure required above, and all other sales load disclosure, would be required to be adjacent to the table of sales loads and breakpoints currently required by Item 8(a)(1) of Form N-1A.

INVESTMENT COMPANY GOVERNANCE

The SEC recently proposed rule amendments to require certain registered investment companies to adopt certain governance practices in order to enhance the independence and effectiveness of their boards and to improve their ability to protect the interests of the investment companies and the shareholders they serve.[35] The proposed governance requirements would apply to any investment company that relies on certain rules that provide an exemption from a provision of the 1940 Act, and which rules have as a condition the approval or oversight of independent directors (each such rule, an "exemptive rule").[36]

The proposed amendments would require that:

1. Independent directors constitute at least 75% of the board, as compared to the current majority requirement;

---

[34] If an investment company does not make such information available in this manner, it would be required to disclose its reasons for not doing so.

[35] "Proposed Rule: Investment Company Governance" was issued on January 15, 2004 in Release No. IC-26323.

[36] The SEC expects that almost all investment companies would rely on one of these exemptive rules at some point and thus, that the rule amendments would apply to most investment companies. These exemptive rules are: Rule 10f-3, Rule 12b-1, Rule 15a-4(b)(2), Rule 17a-7, Rule 17a-8, Rule 17d-1(d)(7), Rule 17e-1, Rule 17g-1(j), Rule 18f-3, Rule 23c-3 and proposed rule 15a-5 (if adopted).

2. The chairman of the board (or if no chairman has been designated, the person who has substantially the same responsibilities as a chairman of a board) be an independent director;

3. The board of directors perform an annual evaluation of the effectiveness of the board and its committees, focusing on both substantive and procedural aspects, and including consideration of (a) the effectiveness of the board's committee structure and (b) whether the directors have taken on the responsibility for overseeing too many investment companies;

4. The independent directors meet at least once quarterly in a separate session at which no interested persons of the investment company are present;

5. The independent directors be explicitly authorized to hire employees and others to help them fulfill their fiduciary duties;[37] and

6. Copies of the written materials that directors consider in approving an advisory contract under Section 15 of the 1940 Act be retained for at least six years.

FURTHER DEVELOPMENTS

DISCLOSURE REGARDING TRANSACTION COSTS

In a recent concept release, the SEC has requested comment on a number of issues related to enhanced disclosure of investment company transaction costs.[38] In general, the SEC is considering whether investment companies should be required to quantify and disclose the amount of transaction costs they incur, include transaction costs in their expense ratios and fee tables, record some or all of their transaction costs as an expense in their financial statements or provide additional quantitative or narrative disclosure about their transaction costs.

[37] The SEC is also seeking comment as to whether independent directors should be required to have independent legal counsel.

[38] "Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs" was issued on December 19, 2003 in Release Nos. 33-8349, 34-48952 and IC-26313.

Quantifying transaction costs

The SEC is seeking comments regarding:

- Whether investment companies should quantify and disclose only their commission costs (commissions paid to effect transactions in portfolio securities);

- Whether investment companies should quantify and disclose all transaction costs that they incur, including commissions, spreads (the difference between the price an investment company pays or receives for a security and the value of the security), market impact costs (the price concessions required to find a buyer or seller for a security) and opportunity costs (the costs of missed trades);

- Whether investment companies should disclose the annual average daily difference between the actual value of the portfolio as of the close of each trading day and the hypothetical value of the portfolio if no trades had been made that day (i.e. the annual average daily total mark-to-market profits or losses on the security purchases and sales made by an investment company);[39] and

- Whether markets or broker-dealers should disclose statistics that compare the prices at which their orders are executed with the price quotes for a security at the time they received the order.

Accounting of transaction costs

The SEC is seeking comments regarding:

- Whether some or all transaction costs should be included in expense ratios and fee tables in an investment company's prospectus;

- Whether some or all transaction costs should be included as expenses in an investment company's financial statements;[40] and

---

[39] This would inform investors about the combined effect of transaction costs and gains and losses from short-term trading in securities.

[40] The reasoning behind this proposal is that some transaction costs relate to costs for research and other services and are therefore operating expenses, as compared to transaction costs that are execution and clearing costs which should be included in the cost basis of securities purchased or in the net proceeds from securities sold.

- How research and other non-execution costs should be allocated among investment companies and among portfolio transactions.

Disclosure related to the level of transaction costs

The SEC is seeking comments regarding:

- Whether transaction costs should be disclosed in terms of rated categories (e.g. very high, high, average, low or very low) comparing them to an industry standard, rather than as part of the expense ratio or as a stand-alone ratio;

- Whether greater prominence should be given to the portfolio turnover ratio, which investment companies (except money market funds) are already required to disclose;

- Whether the average level of net flows into and out of investment companies, measured as a fraction of total assets, should be disclosed;

- Whether investment companies should include in their prospectuses a discussion of the impact that their management style and investment strategy would have on portfolio turnover and transaction costs;

- Whether the information on brokerage costs currently included in the SAI should be moved instead to the prospectus and prominently displayed with portfolio turnover information, and whether the previously eliminated disclosure regarding average commission rate per share should be reinstated; and

- Whether investment companies should report the gross returns on their investment (prior to deduction of loads, fees, expenses and other charges) along with standardized returns (after deduction), instead of the more specific disclosure of transaction costs discussed above.

Review of transaction costs by directors

The SEC is seeking comments regarding:

- Whether existing requirements for board review of transaction costs (currently conducted as part of the board's evaluation of the advisory contract between the adviser and the investment company) are adequate;

- Whether boards should be required to receive reports with mandated information regarding soft dollars and directed brokerage payments and whether investors should receive periodic summaries of these reports;

- Whether the SEC or another independent body should collect statistics regarding execution cost measurements and make aggregated statistics available for comparison purposes for investment company boards; and

- Whether investment company advisers should be required to provide boards with an internal allocation of their uses of brokerage commissions.

REVENUE SHARING

The SEC has also recently commenced an investigation into "revenue sharing," whereby an investment company, its advisers and/or its distributor make payments in return for the distribution of investment company shares. The SEC is scrutinizing the activities of several broker-dealers and investment companies to determine whether they adequately informed investors of the conflicts of interests. Disclosure that the SEC previously considered sufficient may now be deemed inadequate.

ICI PROPOSALS REGARDING SOFT DOLLARS AND DIRECTED BROKERAGE

The Investment Company Institute (the "ICI") has recently called on the SEC to make substantial reforms regarding the use of soft dollars and directed brokerage.[41] With respect to soft dollars, the ICI urged the SEC to amend the definition of permitted research such that soft dollars could no longer be used to pay for virtually any products and services that are otherwise available in the marketplace, including expenses for computers, software and investment publications. Furthermore, the ICI has called on the SEC to limit the use of soft dollars by all investment advisers, including investment company managers, to acquiring only "proprietary research that reflects unique intellectual content."[42] Therefore, the majority of research products and services from third parties would be paid for directly by investment managers from their management fees, and not by investors. Finally, the ICI urged the SEC to abolish the practice of directed brokerage altogether in order to eliminate any possibility of potential conflict of interest. The SEC has not yet responded to the recommendations of the ICI.

---

41 Press Release, Investment Company Institute, ICI Asks SEC to Dramatically Curtail Soft Dollars and Ban Directed Brokerage (December 15, 2003) (available at www.ici.org/statements/nr/2003/03_news_soft.html).

42 *Id*.

LEGISLATIVE DEVELOPMENTS

We stated in our June 30, 2003 Memorandum[43] that the House of Representatives was considering H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003 ("H.R. 2420"), and described the key provisions thereof. On November 19, 2003, the House of Representatives passed a revised version of H.R. 2420. As passed, H.R. 2420 would, among other things:

- Require investment companies to provide enhanced disclosure regarding transaction costs and fees in the prospectus and/or the SAI and other reports to shareholders in addition thereto;
- Require the SEC to issue rules prohibiting the sale of investment company securities by a broker or dealer without disclosure of incentive compensation received by the broker or dealer;
- Require investment advisers to provide annual reports to investment company boards regarding revenue sharing, directed brokerage and soft dollar arrangements, and require boards to have a fiduciary duty to review such arrangements to determine whether they are in the best interest of shareholders;
- Strengthen the independence of boards and the independence and authority of audit committees of boards;
- Prohibit joint management of investment companies and hedge funds by the same portfolio manager or investment adviser;
- Prohibit short term trading by interested persons;
- Require the SEC to issue rules addressing stale prices, late trading and internal compliance policies and procedures of investment companies; and
- Require the SEC to conduct a study on the use of soft dollar arrangements and to submit a report to Congress on market timing and late trading.

On November 5, 2003, Senators Akaka, Fitzgerald and Lieberman introduced S. 1822, the Mutual Fund Transparency Act of 2003 ("S. 1822"), in the Senate. S. 1822 would, among other things, enhance disclosure regarding brokerage commissions, strengthen the independence of

[43] The June 30, 2003 Memorandum is available upon request or at our website: *www.simpsonthacher.com*.

boards and require the SEC to conduct studies on the creation of a Mutual Fund Oversight Board, financial literacy among investors and investment company advertising.

On November 25, 2003, Senators Daschle, Kerry and Kennedy introduced S. 1958, the Mutual Fund Investor Protection Act of 2003 ("S. 1958"), in the Senate. S. 1958 would provide for the establishment of a Mutual Fund Oversight Board, which the SEC would have oversight and enforcement authority over and which would be funded by investment companies. The Mutual Fund Oversight Board would oversee the conduct of investment companies and would have the power to set standards for, conduct inspections of and bring disciplinary proceedings against investment companies. In addition, S. 1958 would require boards to have a fiduciary duty to demonstrate that negotiated fees for advisory, management, marketing and investment services are reasonable and in the best interest of shareholders. Furthermore, S. 1958 would, among other things, address late trading and market timing; prohibit short-term trading by interested persons; provide stiffer criminal and civil penalties for various willful violations of the 1940 Act (including RICO enforcement); strengthen board independence; and enhance disclosure of transaction costs and other related information in the prospectus and/or the SAI and other reports to shareholders in addition thereto.

Also on November 25, 2003, Senators Corzine and Dodd introduced S. 1971, the Mutual Fund Investor Confidence Restoration Act ("S. 1971"), in the Senate. Of the three bills introduced in the Senate, S. 1971 most closely resembles H.R. 2420 and would include many of the same requirements. In addition, S. 1971 would, among other things:

- Require the SEC to issue rules requiring that investment companies establish formal policies and procedures related to market timing;

- Require the SEC to issue rules requiring disclosure by any senior executive officer of an investment company of any intended sale or purchase of securities of any investment company that employs the same investment adviser as the investment company with which such officer is employed, prior to the actual time of purchase; and

- Require the SEC to conduct studies on the creation of a Mutual Fund Oversight Board, the use of soft dollar arrangements, financial literacy among investors and investment company advertising and to submit a report to Congress on market timing and late trading.

Provisions of these bills go further, in some respects, than SEC action. The legislature is not expected to act on these bills for several months.

SIMPSON THACHER & BARTLETT LLP