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RECENT REGULATORY DEVELOPMENTS IN THE INVESTMENT COMPANY INDUSTRY

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Since May 2004, the Securities and Exchange Commission (the "SEC") has continued to adopt rule and form amendments for investment companies registered under the Investment Company Act of 1940, as amended (the "1940 Act"). The bulk of these amendments relate to enhancing disclosure to potential and existing investors and enhancing fund governance requirements. This memorandum provides a summary of the recent regulatory developments.[1]

DISCLOSURE OF BREAKPOINT DISCOUNTS BY OPEN-END INVESTMENT COMPANIES

On June 14, 2004, the SEC adopted form amendments that require open-end investment companies to provide enhanced disclosure regarding breakpoint discounts on front-end sales loads. Under the amendments, an open-end investment company will be required to describe in its prospectus any arrangements that result in breakpoints in sales loads and to provide a brief summary of shareholder eligibility requirements. The 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.

Disclosure of Arrangements that Result in Breakpoints in Sales Loads

The amendments require an investment company to provide a brief description in its prospectus of any arrangements that result in breakpoints in, or elimination of, sale loads, including letters of intent and rights of accumulation. Each class of individuals or transactions to which the arrangements apply must be identified and each different breakpoint must be stated as a percentage of both the offering price and the amount invested.

The amendments direct that prospectus disclosure regarding breakpoints be brief in order to avoid overwhelming investors with excessively detailed information. The prospectus does not have to include the information currently required in the SAI regarding breakpoints for affiliated persons of the fund and breakpoints in connection with a reorganization. This information will continue to be required in the SAI, and the prospectus will be required to state, if applicable, that additional information concerning sales load breakpoints is available in the SAI.

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

The description of arrangements resulting in breakpoints must include a brief summary of shareholder eligibility requirements, describing or listing the types of accounts (e.g., retirement accounts, accounts held at other financial intermediaries), account holders (e.g., immediate family members, family trust accounts, solely-controlled business accounts) and fund holdings (e.g., funds held within the same fund complex) that may be aggregated for purposes of determining eligibility for sales load breakpoints.

Disclosure of Methods Used to Value Accounts

The amendments also require a mutual fund to include in its prospectus 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. The methods required to be disclosed, if applicable, include historical cost, net amount invested, and offering price.

Disclosure Regarding Information and Records Necessary to Aggregate Holdings

The amendments require a mutual fund to state in its prospectus, if applicable, that, in order to obtain a breakpoint discount, it may be necessary at the time of purchase for a shareholder to inform the fund or his or her financial intermediary of the existence of other accounts in which there are holdings eligible to be aggregated to meet sales load breakpoints.

In addition, a mutual fund will be required to describe any information or records, such as account statements, that may be necessary for a shareholder to provide to the fund or his or her financial intermediary in order to verify his or her eligibility for a breakpoint discount. The description will be required to include, if applicable, information or records regarding shares of the fund or other funds held (a) in all accounts (e.g., retirement accounts) of the shareholder at the financial intermediary; (b) in any account of the shareholder at another financial intermediary; and (c) at any financial intermediary by related parties of the shareholder, such as members of the same family or household.

If a mutual fund permits breakpoints to be determined based on historical cost, it will be required to state in its prospectus that a shareholder should retain any records necessary to substantiate historical costs because the fund, its transfer agent, and financial intermediaries may not maintain this information.

Disclosure of Availability of Sales Load and Breakpoint Information on Fund's Web Site

The amendments require that a mutual fund state in its prospectus whether it makes available free of charge, on or through its Web site, information regarding its sales loads and breakpoints that the investment company would be required to include in its prospectus and SAI. The prospectus must also state whether the Web site includes hyperlinks that facilitate access to the information.

A mutual fund that does not make the sales load and breakpoint information available on its Web site is required to disclose the reasons why it does not do so (including, where applicable, that the fund does not have an Internet Web site).

Presentation Requirements

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 Form N-1A. This information must be presented in a clear, concise, and understandable manner, and include tables, schedules, and charts where doing so would facilitate understanding.

Compliance Date

The effective date for these amendments was July 23, 2004, and the SEC is requiring all initial registration statements, and all post-effective amendments that are either annual updates to effective registration statements or that add a new series, filed on Form N-1A on or after September 1, 2004, to include the disclosure required by the amendments.

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

On June 30, 2004, the SEC adopted amendments to forms used under the Securities Act of 1933 (the "Act"), the Securities Exchange Act of 1934 (the "Exchange Act") and the 1940 Act to improve the disclosure provided by registered management investment companies about how their boards of directors evaluate and approve, and recommend shareholder approval of, investment advisory contracts. The amendments 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. This disclosure requirement applies to any new investment advisory contract or contract renewal, including subadvisory contracts and contracts approved by shareholders, approved by the board during the most recent fiscal half-year.[2] Because such disclosure is similar to that currently required in the SAI, the amendments remove the existing requirement for disclosure in the SAI of Forms N-1A, N-2, and N-3 with respect to the board's approval of any existing investment advisory contract. However, the amendments do require that a fund prospectus state that a discussion regarding the board of directors' basis for approving any investment advisory contract is available in the fund's annual or semi-annual report to shareholders, as applicable. This disclosure must indicate the dates

[2] Because a fund is required to provide shareholder reports disclosure only regarding board approval during the fund's most recent fiscal half-year, if the board approves a contract during the first half of a fiscal year, the disclosure would be required in the semi-annual report for that period, but need not be repeated in the annual report.

covered by the relevant shareholder report so that a shareholder may easily request the appropriate report.

The amendments adopt several enhancements to the existing proxy statement disclosure requirement regarding advisory agreements and the same enhancements apply in the new shareholder reports disclosure requirement. These enhancements include:

Selection of Adviser and Approval of Advisory Fee

The amendments 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.[3]

If any of the above factors is not relevant to the board's evaluation of a particular contract, the discussion must note this and explain the reasons why that factor is not relevant.

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

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[3] Courts have used similar factors in determining whether investment advisers have met their fiduciary obligations under section 36(b) of the 1940 Act. *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 929 (2nd Cir. 1982).

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 they 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.

Compliance Date

The SEC will require all shareholder reports for periods ending on or after March 31, 2005, and all proxy statements filed on or after October 31, 2004 to comply with the amendments. The effective date for the amendments that remove the current SAI disclosure requirement with respect to the board's approval of any existing investment advisory contract is January 31, 2006. Prior to January 31, 2006, a fund may omit disclosure in its SAI with respect to any board approval of an investment advisory contract if it has previously provided the required disclosure with respect to that board approval in a shareholder report.

INVESTMENT COMPANY GOVERNANCE

On August 2, 2004, the SEC adopted rule amendments to require certain registered investment companies to adopt 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. The governance requirements apply to any investment company that relies on certain rules that provide an exemption from a provision of the 1940 Act, which rules have as a condition the approval or oversight of independent directors (each such rule, an "exemptive rule").[4]

Board Composition

The amendments require that at least 75% of the directors of the fund be independent directors, as compared to the current majority requirement. If the fund board has only three directors, all but one of the directors must be independent directors.

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[4] 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 and Rule 23c-3.

Independent Chairman of the Board

The chairman of the board must be an independent director. If no chairman has been designated, the person who has substantially the same responsibilities as a chairman of a board must be an independent director.

Annual Self-Assessment

The board of directors must 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.

Separate Sessions

The independent directors must meet at least once quarterly in a separate session at which no interested persons of the investment company are present. The rule does not specify the matters that should be discussed by the independent directors at the separate executive sessions, although the SEC states that it expects the independent directors would use this forum to discuss, among other things, their views on the performance of the fund adviser and other service providers.

Independent Director Staff

The independent directors must be explicitly authorized to hire employees and others to help them fulfill their fiduciary duties. Although the SEC is not requiring independent directors to have their own counsel, it recommends such counsel to independent directors. If independent directors do hire their own counsel, such counsel must be an "independent" counsel.

Recordkeeping for Approval of Advisory Contracts

Copies of the written materials that directors consider in approving an advisory contract under Section 15 of the 1940 Act must be retained for at least six years, the first two years in an easily accessible place.

Compliance Date

After January 15, 2006, (i) persons may rely upon any of the amended rules only if they meet the foregoing governance standards and (ii) funds must begin to comply with the recordkeeping requirements.

DISCLOSURE REGARDING PORTFOLIO MANAGERS OF INVESTMENT COMPANIES

On August 23, 2004, the SEC adopted form amendments to improve the disclosure provided by registered management investment companies regarding their portfolio managers. These

amendments extend the existing requirement that a registered management investment company provide basic information in its prospectus regarding its portfolio managers to include the members of management teams. The amendments also require a registered management investment company to disclose additional information about its portfolio managers, including other accounts that they manage, compensation structure, and ownership of securities in the investment company.

Identification of Portfolio Management Team Members

The amendments adopted by the SEC require mutual funds and closed-end funds to identify in their prospectuses each member of a committee, team, or other group of persons associated with the fund or its investment adviser that is "jointly and primarily responsible" for the day-to-day management of the fund's portfolio.[5] This identification must include the name, title, length of service, and business experience of each member of the portfolio management team.

If more than five persons are jointly and primarily responsible for the day-to-day management of a fund's portfolio, the fund need only provide the required information for the five persons with the most significant responsibility.

The amendments also require a fund to provide a brief description of each member's role on the management team (e.g., lead member). A fund's description of a member's role on a committee, team, or group must include a description of any limitations on the person's role and the relationship between the person's role and the roles of other persons who have responsibility for the day-to-day management of the fund's portfolio.

Disclosure Regarding Other Accounts Managed and Potential Conflicts of Interest

The amendments require a fund to provide disclosure in its SAI regarding other accounts for which the fund's portfolio manager is primarily responsible for the day-to-day portfolio management. If a committee, team, or other group that includes the portfolio manager is jointly and primarily responsible for the day-to-day management of an account, the fund is required to include that account in responding to the disclosure requirement.

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[5] If a fund has a management team that includes (i) additional members who are not jointly and primarily responsible for day-to-day management, or (ii) analysts who make securities recommendations with respect to the portfolio, but do not have decision-making authority, identification of these individuals is not required.

This disclosure requirement, as well as the disclosure requirements discussed below regarding compensation structure and ownership of fund securities, applies to any portfolio manager who is required to be identified in the prospectus.[6]

As adopted, the amendments require a fund to disclose the number of other accounts managed by a portfolio manager, and the total assets in the accounts, within each of the following categories: registered investment companies; other pooled investment vehicles; and other accounts. For each such category, a fund is also required to disclose the number of accounts and the total assets in the accounts with respect to which the advisory fee is based on account performance.

The amendments also require a fund to describe any material conflicts of interest that may arise in connection with the portfolio manager's management of the fund's investments, on the one hand, and the investments of the other accounts, on the other. This description would include, for example, material conflicts between the investment strategy of the fund and the investment strategy of the other accounts managed by the portfolio manager and material conflicts in allocation of investment opportunities between the fund and such other accounts.

Disclosure of Portfolio Manager Compensation Structure

The SEC has adopted a requirement that a fund provide disclosure in its SAI regarding the structure of, and the method used to determine, the compensation of any portfolio manager who is required to be identified in the prospectus.

The amendments require a description of the structure of, and the method used to determine, the compensation received by a fund's portfolio manager from the fund, its investment adviser, or any other source with respect to management of the fund and any other account included by the fund in response to the disclosure requirement described above regarding other accounts managed by the portfolio manager.[7] The amendments do not require disclosure of the value of compensation received by a portfolio manager.

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[6] If a fund identifies more than five persons as portfolio managers in its prospectus, it need only provide the required disclosure regarding other accounts managed, compensation, and securities ownership for the five persons with the most significant responsibility for the day-to-day management of the fund's portfolio.

[7] For purposes of the disclosure requirement, compensation includes, without limitation, salary, bonus, deferred compensation, and pension and retirement plans and arrangements, whether the compensation in cash or non-cash. The amendments permit funds to omit disclosure regarding group life, health, hospitalization, medical reimbursement, relocation, and pension and retirement plans and arrangements, provided that they do not discriminate in scope, terms, or operation in favor of the portfolio manager or a group of employees that includes the portfolio manager and are available generally to all salaried employees.

For each type of compensation (*e.g.*, salary, bonus, deferred compensation, retirement plans and arrangements), a fund is required to describe with specificity the criteria on which that type of compensation is based. For example, the following must be described: whether compensation is fixed, whether (and, if so, how) compensation is based on the fund's pre- or after-tax performance over a certain period, and whether (and, if so, how) compensation is based on the value of assets held in the fund's portfolio.

Disclosure of Securities Ownership of Portfolio Managers

The amendments require that a fund disclose in its SAI the securities ownership in the fund of each portfolio manager who is required to be identified in the fund's prospectus. This disclosure requirement is limited to a portfolio manager's ownership of equity securities in the fund itself.

This disclosure requirement applies to fund securities beneficially owned by a portfolio manager. [8] These amendments require that funds disclose portfolio managers' ownership of securities in the fund using the following dollar ranges: none, $1-$10,000, $10,001-$50,000, $50,001-$100,000, $100,001-$500,000, $500,001-$1,000,000 or over $1,000,000.

Date of Disclosure

The required information regarding other accounts managed by a portfolio manager, compensation structure, and ownership of fund securities must be provided as of the end of the fund's most recently completed fiscal year. However, in the case of an initial registration statement or an update to a fund's registration statement that discloses a new portfolio manager, information with respect to any newly identified portfolio manager is required to be provided as of the most recent practicable date. The date as of which the information is provided must be disclosed.

Removal of Exclusion for Index Funds

The amendments remove the current provision in Form N-1A that excludes a fund that has as its investment objective replication of the performance of an index from the requirement to identify and provide disclosure regarding its portfolio managers.

Disclosure of Availability of Information

In order to assist investors in finding the additional information about portfolio managers that is required in the SAI, the amendments require a fund to state in its prospectus that the SAI

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[8] For purposes of the requirement to disclose a portfolio manager's beneficial ownership of fund securities, "beneficial ownership" will be determined in accordance with rule 16a-1(a)(2) under the Exchange Act.

provides this information. This disclosure is required to appear adjacent to the disclosure identifying the portfolio managers.

In addition, the back cover page of a mutual fund's prospectus must state whether the fund makes available its SAI and annual and semi-annual reports, free of charge, on or through its Web site at a specified Internet address. If a mutual fund does not make its SAI and shareholder reports available in this manner, the fund is required to disclose the reasons why it does not do so (including, where applicable, that the fund does not have an Internet Web site). Amendments to Forms N-2 and N-3 require similar disclosure on the front cover page of the prospectus for closed-end funds and insurance company managed separate accounts that issue variable annuity contracts. In addition, the amendments to Forms N-2 and N-3 require that the front cover page of the prospectus include a statement explaining how to obtain the fund's shareholder reports and a toll-free (or collect) telephone number for investors to call to request the fund's SAI, annual and semi-annual reports, and other information, and to make shareholder inquiries. They also change from optional to mandatory disclosure of the Commission's Internet Web site address. These requirements are similar to existing requirements of Form N-1A.

Amendment of Form N-CSR

The amendments also require that closed-end funds provide disclosure regarding their portfolio managers in their annual reports on Form N-CSR. This disclosure must include the basic information (name, title, length of service, and business experience), as well as the information regarding other accounts managed by a portfolio manager, compensation structure, and ownership of fund securities.

This disclosure in Form N-CSR with respect to the name, title, length of service, and business experience of a portfolio manager is required to be current as of the date of filing of the report, and the disclosure regarding other accounts managed, compensation structure, and fund securities ownership generally is required to be current as of the end of the fund's most recently completed fiscal year.[9]

Compliance Date

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

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[9] In the case of a newly identified portfolio manager in an annual or semi-annual report, however, this disclosure is required to be current as of the most recent practicable date.

2005, and every semi-annual report by a closed-end fund on Form N-CSR filed after the first such annual report, must include the disclosure required by the amendments.

PROHIBITION ON THE USE OF BROKERAGE COMMISSIONS TO FINANCE DISTRIBUTION

On August 18, 2004, the SEC adopted an amendment to Rule 12b-1 under the 1940 Act that prohibits open-end investment companies from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. The rule would also prohibit "step-out" and similar arrangements designed to compensate brokers for selling fund shares. The SEC noted that fund advisers often use directed brokerage arrangements to gain shelf space for their funds, and that currently, fund advisers are required to obtain best execution for all security transactions. However, as increasing fund assets increases an adviser's management fees, there is a natural incentive for advisers to direct portfolio transactions to a selling broker to increase assets it manages, even though such broker might not provide best execution.

Under the amendment, a fund can still use a broker that sells fund shares to execute portfolio transactions when doing so is in the best interests of shareholders. However, the fund must implement policies and procedures that are designed so that the selection of the broker is not influenced by considerations regarding the sale of fund shares. These procedures must be reasonably designed to prevent: (i) the persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities (e.g., trading desk personnel) from taking broker-dealers' promotional or sales efforts into account in making those decisions; and (ii) the fund, its adviser or principal underwriter from entering into any agreement under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund's shares. The fund's board of directors, including a majority of its independent directors, must approve the policies and procedures.

The compliance date for the amendment is 90 days from publication of the amendment in the Federal Register.

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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) or David E. Wohl (dwohl@stblaw.com, 212-455-7937).

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