

portfolio schedules on a quarterly basis.²⁰ A significant majority of funds already make their full portfolio schedules publicly available at least quarterly.²¹

Recent allegations, however, have highlighted instances where some mutual fund managers may be selectively disclosing their portfolios in order to reward large investors. Specifically, allegations have been made that certain funds gave frequent updates of their portfolio holdings to favored shareholders, enabling these shareholders to use a fund's portfolio information to short the fund's holdings in the same or similar proportions to the fund's established positions.²² In addition, more than 30% of mutual fund complexes that responded to a recent Commission examination request for information sent to 88 of the largest such complexes appear to have disclosed portfolio information in circumstances that may have provided certain fund shareholders with the ability to make advantageous decisions to place orders for fund shares. This selective disclosure can facilitate fraud and have severely adverse ramifications for a fund's investors if someone uses that portfolio information to trade against the fund, or otherwise uses the information in a way that would harm the fund.

We are concerned about the misuse of material, nonpublic information that may occur when a mutual fund's portfolio holdings are selectively disclosed and professional traders are given the opportunity to use this information to their advantage to the detriment of fund shareholders. For

many issuers, Regulation FD generally requires that when an issuer discloses material information, it do so through public disclosure, not through selective disclosure.²³ Regulation FD does not, however, apply to mutual funds.²⁴ We have concluded that the recent allegations regarding selective disclosure of portfolio holdings by some mutual fund managers suggest that we need to take steps to reinforce funds' and advisers' obligations to prevent the misuse of portfolio holdings information that is selectively disclosed.

C. Disclosure Proposals

The Commission is proposing form amendments to require better disclosure with respect to the tools that mutual funds use to combat market timing activity. First, in order to enable investors to assess a mutual fund's practices regarding frequent purchases and redemptions of fund shares to determine if they are in line with their expectations, the Commission is proposing to require improved disclosure in fund prospectuses of a mutual fund's risks, policies, and procedures in this area. The proposals would:

- Require a mutual fund to describe in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders;
 - Require a mutual fund to state in its prospectus whether or not the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares and, if the board has not adopted any such policies and procedures, state the specific basis for the view of the board that it is appropriate for the fund not to have such policies and procedures;
 - Require a mutual fund to describe any policies and procedures for deterring frequent purchases and redemptions of fund shares, and any arrangements to permit frequent purchases and redemptions of fund shares; and
 - Require similar disclosure in prospectuses for insurance company separate accounts offering variable insurance contracts, with respect to frequent transfers among sub-accounts.
- Second, we are proposing to clarify instructions to our registration forms to require all mutual funds (other than money market funds) and insurance

company managed separate accounts that offer variable annuities to explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. As described above, fair valuation of a fund's portfolio securities, which is required under certain circumstances, can serve to foreclose arbitrage opportunities available to market timers.

In addition, in order to provide greater transparency of fund practices with respect to the disclosure of the fund's portfolio holdings, and to reinforce funds' and advisers' obligations to prevent the misuse of material, non-public information, the Commission is proposing to require mutual funds and insurance company managed separate accounts that offer variable annuities to disclose their policies with respect to disclosure of portfolio holdings information. The proposals would:

- Require a fund to describe in its SAI any policies and procedures with respect to the disclosure of the fund's portfolio securities to any person and any ongoing arrangements to make available information about the fund's portfolio securities to any person; and
- Require a fund to state in its prospectus that a description of the policies and procedures is available in the fund's SAI, and on the fund's Web site, if applicable.

II. Discussion

A. Disclosure Concerning Frequent Purchases and Redemptions of Fund Shares

The Commission is proposing amendments to Form N-1A, the registration form used by mutual funds, that would require disclosure of both the risks to fund shareholders of the frequent purchase and redemption of fund shares, and a fund's policies and procedures with respect to such frequent purchases and redemptions.²⁵ As discussed above, market timing strategies often involve such frequent purchases and redemptions of fund shares. These proposals are intended to require mutual funds to describe with specificity the restrictions they place on frequent purchases and redemptions, if any, and the circumstances under which any such restriction will not apply. This additional disclosure would enable investors to assess mutual funds' risks, policies, and procedures in this area and determine if a fund's policies and procedures are in line with their

²⁰ Investment Company Act Release No. 25870 (Dec. 18, 2002) [68 FR 160 (Jan. 2, 2003)].

²¹ See Scott Cooley, *Tell Investors What They Own*, Morningstar Online, Feb. 6, 2002 (more than 70% of funds currently provide monthly or quarterly portfolio disclosure to Morningstar). See also Tom Lauricella and Aaron Lucchetti, *To Industry, Silence is Golden—Mutual Funds Embrace Disclosure Rules—As Long as it Doesn't Involve Them*, Wall Street Journal Europe, Aug. 1, 2002, at M1 (roughly 200 fund firms and 17 of the top 20 largest funds provide quarterly or monthly holdings updates to investors); *Survey of Fund Groups' Portfolio Disclosure Policies Summary of Results*, Investment Company Institute (2001), available at: http://www.ici.org/port_holdings_appdxa.html.

²² See *State of New York v. Canary Capital Partners, LLC, et. al.*, at 25 and 41, (N.Y. Sup. Ct., filed Sept. 3, 2003) available at: http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf (alleging that fund group regularly provided investor with detailed breakdowns of the portfolios of the target funds, allowing the investor to sell short the stocks that the portfolios contained); Ian McDonald, *Will Funds Disclose More—Publicly?*, The Wall Street Journal, Sept. 9, 2003, at C1 (describing allegations that fund groups provided hedge fund with more frequent reports on their fund holdings than were available to other investors).

²³ Regulation FD [17 CFR 243.100 *et seq.*]; Investment Company Act Release No. 24599 (Aug. 15, 2000) [65 FR 51716 (Aug. 24, 2000)] (adopting Regulation FD).

²⁴ Rule 101(b) of Regulation FD [17 CFR 243.101(b)].

²⁵ Proposed Item 7(e) of Form N-1A.