

expectations.²⁶ We are also proposing similar amendments to the registration forms for insurance company separate accounts that issue variable annuities and variable life insurance policies.²⁷

The amendments that we are proposing to Form N-1A would require that a mutual fund's prospectus describe the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders of the fund.²⁸ These risks may include, among other things, dilution in the value of fund shares held by long-term shareholders, interference with the efficient management of the fund's portfolio, and increased brokerage and administrative costs. The disclosure should be specific to the fund, taking into account its investment objectives, policies, and strategies. For example, we would generally expect a fund that invests in overseas markets to describe the risks of time-zone arbitrage.

The proposed amendments would also require a mutual fund's prospectus to state whether the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares by fund shareholders.²⁹ If the fund's board of directors has not adopted any such policies and procedures, the fund's prospectus would be required to include a statement of the specific basis for the view of the board that it is appropriate for the fund not to have such policies and procedures.³⁰ On the other hand, if the fund's board of directors has adopted such policies and procedures, the fund's prospectus would be required to include a description of those policies and procedures, including:

- Whether or not the fund discourages frequent purchases and redemptions of fund shares by fund shareholders;
- Whether or not the fund accommodates frequent purchases and redemptions of fund shares by fund shareholders;
- Any policies and procedures of the fund for deterring frequent purchases and redemptions of fund shares by fund shareholders; and
- Any policies and procedures of the fund for detecting frequent purchases

and redemptions of fund shares, including any arrangements for detecting frequent purchases and redemptions of fund shares through intermediaries, such as investment advisers, broker-dealers, transfer agents, and third party administrators.³¹

The description of the mutual fund's policies and procedures, if any, for deterring frequent purchases and redemptions of fund shares by fund shareholders would be required to include any restrictions imposed by the fund to prevent or minimize such frequent purchases and redemptions, including:

- Any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period;
- Any exchange fee or redemption fee;
- Any costs or administrative or other fees or charges that are imposed on shareholders deemed to be engaged in frequent purchases and redemptions of fund shares, together with a description of the circumstances under which such costs, fees, or charges will be imposed;
- Any minimum holding period that is imposed before an investor may make exchanges into another fund;
- Any restrictions imposed on exchange or purchase requests submitted by overnight delivery, electronically, or via facsimile or telephone; and
- Any right of the fund to reject, limit, delay, or impose other conditions on exchanges or purchases or to close or otherwise limit accounts based on a history of frequent purchases and redemptions of fund shares, including the circumstances under which such right will be exercised.

The proposals would require that the policies and procedures for deterring frequent purchases and redemptions, including any restrictions imposed to prevent or minimize such frequent purchases and redemptions, be described with specificity.³² For

example, a fund might state that a 2% redemption fee will be applied to all redemptions within 60 days after purchase or, in describing any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period, a fund might state that it prohibits more than 3 exchanges per year.

A fund would also be required to indicate whether each restriction applies uniformly in all cases or whether the restriction will not be imposed under certain circumstances. If any restriction will not be imposed under certain circumstances, the fund would be required to describe with specificity the circumstances under which the restriction will not be imposed.³³

We are also proposing to require a mutual fund to describe in its prospectus any arrangements with any person to permit frequent purchases and redemptions of fund shares.³⁴ This description would include the identity of the persons permitted to engage in frequent purchases and redemptions and any compensation or other consideration received by the fund, its investment adviser, or any other party pursuant to such arrangements. A proposed instruction would clarify that the consideration required to be disclosed includes any agreement to maintain assets in the fund or in other investment companies or accounts managed by the investment adviser or by any affiliated person of the investment adviser.³⁵

We emphasize that a mutual fund that enters into an arrangement with any person to permit frequent purchases and redemptions of fund shares may only do so consistent with the antifraud provisions of the federal securities laws and the fiduciary duties of the fund and its investment adviser to fund shareholders. Disclosure provided pursuant to these proposed amendments would not make lawful conduct that is otherwise unlawful. For example, disclosure would not render lawful an arrangement whereby an investment adviser permits frequent purchases and redemptions of a mutual fund's shares in return for consideration that benefits the adviser, such as an agreement to

it is provided in the prospectus in response to other Items of Form N-1A, including Items 3 (redemption and exchange fees), 7(c) (restrictions on redemptions, and redemption charges), and 8(a)(2) (exchange privileges).

³³ Proposed Item 7(e)(4)(iii) of Form N-1A.

³⁴ Proposed Item 7(e)(5) of Form N-1A.

³⁵ Proposed Instruction to Item 7(e)(5) of Form N-1A.

²⁶ In our release adopting rule 38a-1 under the Investment Company Act, we state that a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing.

²⁷ Proposed Item 8(e) of Form N-3; proposed Item 7(e) of Form N-4; proposed Item 6(f) of Form N-6.

²⁸ Proposed Item 7(e)(1) of Form N-1A.

²⁹ Proposed Item 7(e)(2) of Form N-1A.

³⁰ Proposed Item 7(e)(3) of Form N-1A.

³¹ Proposed Item 7(e)(4) of Form N-1A.

Persons that are not registered as broker-dealers need to consider whether the securities activities that they are undertaking are brokerage activities that require them to register as broker-dealers. Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act") defines a broker as a person engaged in the business of effecting transactions in securities. It includes several exceptions for certain bank activities. Section 15 of the Exchange Act essentially makes it unlawful for a broker or dealer "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills)" unless the broker or dealer is registered with the Commission.

³² Proposed Item 7(e)(4)(iii) of Form N-1A. A fund need not repeat this disclosure to the extent