

in any way to better coordinate the disclosure requirements of these Items?

- Exchange traded funds ("ETFs") are investment companies that are registered under the Investment Company Act as open-end management investment companies or unit investment trusts. However, unlike typical open-end funds or unit investment trusts, ETFs do not sell or redeem their individual shares at NAV. Instead, ETFs sell and redeem their shares at NAV only in large blocks, generally in exchange for a basket of securities that mirrors the composition of the ETF's portfolio, plus a small amount of cash. Shares of ETFs are listed on national securities exchanges for trading, which allows investors to purchase and sell individual ETF shares among themselves at market prices throughout the day. Should ETFs be expressly excluded from the proposed disclosure requirements?

B. Disclosure of Circumstances Under Which Funds Will Use Fair Value Pricing

The Commission is proposing to amend the Instruction to Item 7(a)(1) of Form N-1A, and to add a corresponding Instruction to Form N-3, to clarify that all mutual funds and managed separate accounts that offer variable annuities, other than money market funds, are required to explain briefly in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing.⁴⁹ We are proposing to amend this instruction to clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable). Money market funds would not be subject to the proposed requirement to disclose the circumstances under which they would use fair value pricing and the effects of such use, because such funds are subject to rule 2a-7 under the Investment Company Act, which contains its own detailed pricing requirements.⁵⁰

We note that the disclosure regarding the circumstances under which a fund

would use fair value pricing and the effects of such use should be specific to the fund. For example, if a fund invests exclusively in frequently traded exchange listed securities of large capitalization domestic issuers and calculates its NAV as of the time the exchange typically closes, there may be very limited circumstances in which it would use fair value pricing (e.g., if the exchange on which a portfolio security is principally traded closes early or if trading in a particular portfolio security was halted during the day and did not resume prior to the fund's NAV calculation). By contrast, if a fund invests primarily in securities that are traded on overseas markets, we would expect a fuller discussion of the circumstances under which the fund would use fair value pricing, such as specific events occurring after the close of the overseas exchange that would cause the fund to use fair value pricing. Similarly, we would expect that the description of the effects of using fair value pricing would be fund specific, e.g., minimizing the possibilities for time-zone arbitrage, in the case of a fund investing in overseas markets.⁵¹

We request comment generally on the proposed disclosure regarding fair value pricing and specifically on the following issues:

- Is the proposed Instruction requiring funds to explain briefly the circumstances under which they will use fair value pricing and the effects of using fair value pricing appropriate? Is this proposed disclosure necessary in light of the fact that all funds are required to use fair value pricing if market quotations for a portfolio security are not readily available (including when they are not reliable)? Will the disclosure provide useful information to investors about the particular circumstances under which a fund will use fair value pricing and the effects on that fund of using fair value pricing? Should money market funds or any other types of funds not be required to provide the disclosure?

- Is the fund prospectus the appropriate location for the proposed disclosure, or would the SAI provide investors with adequate access to this

information? Are there any other locations, such as Form N-CSR, reports to shareholders, or the fund's Web site, that would be more appropriate for this disclosure?

- Are there cases where disclosure of the circumstances under which a mutual fund will use fair value pricing and the effect on the fund of using fair value pricing may assist investors who intend to engage in market timing strategies? If so, how should we modify the proposed Instruction to address these cases?

C. Selective Disclosure of Fund Portfolio Holdings

We are proposing amendments to Form N-1A that would require mutual funds to disclose their policies and procedures with respect to the disclosure of their portfolio securities and any ongoing arrangements to make available information about their portfolio securities.⁵² We are also proposing parallel amendments to Form N-3 for managed separate accounts that issue variable annuities.⁵³ These amendments are intended 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.

We emphasize that a mutual fund or investment adviser that discloses the fund's portfolio securities may only do so consistent with the antifraud provisions of the federal securities laws and the fund's or adviser's fiduciary duties to fund shareholders. Disclosure provided pursuant to these proposed amendments would not make lawful conduct that is otherwise unlawful. Divulging portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality. Examples of instances in which selective disclosure of a fund's portfolio securities may be appropriate, subject to confidentiality agreements and trading restrictions, include disclosure for due diligence purposes to an investment

⁴⁹ Proposed Instruction to Item 7(a)(1) of Form N-1A; proposed Instruction to Item 11(c) of Form N-3. We are not proposing to amend Forms N-4 and N-6 because these forms are used by insurance company separate accounts that are organized as unit investment trusts and typically hold only securities issued by underlying mutual funds. These underlying mutual funds are responsible for valuing their own portfolio securities, including, as required, through fair valuation.

⁵⁰ Rule 2a-7(c) (describing the requirements for calculating the share price of money market funds using the amortized cost and penny-rounding methods).

⁵¹ We also note that the Commission is issuing a release adopting new rule 38a-1 under the Investment Company Act, which requires funds to adopt policies and procedures that require a fund to monitor for circumstances that may necessitate the use of fair value prices, establish criteria for determining when market quotations are no longer reliable for a particular portfolio security, provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security, and regularly review the appropriateness and accuracy of the method used in valuing securities and make any necessary adjustments.

⁵² Proposed Items 4(d) and 12(f) of Form N-1A. In the release adopting rule 38a-1 under the Investment Company Act, we state that a fund's compliance policies and procedures should address misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio, its trading strategies, or pending transactions.

⁵³ Proposed Items 5(f) and 19(e) of Form N-3. We are not proposing to amend Forms N-4 and N-6 because these forms are used by insurance company separate accounts that are organized as unit investment trusts, which typically hold only securities issued by underlying mutual funds.