

SEC Adopts Amendments on Breakpoint Disclosure

On May 26, 2004, the Securities and Exchange Commission ("SEC") adopted amendments to Form N-1A under the Investment Company Act of 1940 ("1940 Act"), which will require a mutual fund to provide enhanced disclosure regarding breakpoint discounts on front-end sales loads.¹

"Breakpoint" refers to the level of dollar investment in a mutual fund at which an investor may obtain a reduced sales load. The amendments are meant to ensure that investors more easily understand how breakpoints work and that they receive the breakpoint discounts to which they are entitled.

The breakpoint amendments grew out of SEC and National Association of Securities Dealers ("NASD") concerns that investors were infrequently receiving breakpoint discounts. Regulators from both agencies, in conjunction with the New York Stock Exchange, conducted an examination sweep of 43 broker-dealers selling front-end sales load mutual funds, beginning in late 2002. The SEC and NASD brought enforcement actions against 15 brokerage firms for failure to deliver mutual fund breakpoint discounts. The firms have agreed to compensate customers for overcharges, to pay fines totaling more than \$21.5 million, and to undertake other corrective measures.² The SEC also asked the NASD, along with the Securities Industry Association and the Investment Company Institute, to form a joint task force to study ways to prevent breakpoint problems. The adopted

amendments implement two of the task force's recommendations.³

Specifically, the amendments require a mutual fund to:

- provide in its prospectus a brief description of arrangements resulting in sales load breakpoints, including a summary of eligibility requirements;
- describe in its prospectus the methods used to value accounts to determine whether a shareholder has met sales load breakpoints;
- state in its prospectus, if applicable, that to obtain a breakpoint, it may be necessary for shareholders to provide information and records such as account statements to a mutual fund or financial intermediary; and
- state in its prospectus whether it makes information regarding breakpoints available on its Web site.

The SEC did not make online disclosure of breakpoint discounts mandatory, but Commissioners Goldschmid and Campos both suggested that Web-based breakpoint information could be useful. Paul Roye, director of the SEC's Division of Investment Management, noted that Chairman Donaldson recently assembled an SEC

¹ Rel. No. 33-8427 (June 7, 2004).

² Press Release: Fifteen Firms to Pay Over \$21.5 Million in Penalties to Settle SEC and NASD Breakpoint Charges.

³ The SEC staff noted that industry participants are continuing to work on a central breakpoint schedule that would consolidate information from all funds on breakpoint requirements.

staff task force to examine ways of using technology to improve disclosure. This same task force is drafting the outlines of a new surveillance program for mutual funds by examining the mutual fund reporting regime, looking at both the frequency of reporting to the Commission and the categories of information to be reported.

Funds must provide the breakpoint disclosure required by the amendments starting September 1, 2004.

Still pending are two proposed rules requiring broker-dealers to provide enhanced disclosure—at the point of sale and in transaction confirmations—regarding the costs and conflicts of interest associated with the distribution of mutual fund shares and other securities.⁴

⁴ *SEC Proposes New Confirmation and Point of Sale Disclosures*, Financial Services Update No. 6 (Feb. 20, 2004).

Practice group contacts

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