

## SEC Proposes Use of Summary Prospectus and Other Changes Designed to Enhance Prospectus Disclosure

Mutual funds may soon be permitted to provide key information directly to investors in a "summary prospectus" and make the statutory prospectus and certain other information available on an Internet web site in satisfaction of their prospectus delivery obligations under the Securities Act of 1933, as amended (the "Securities Act"). On November 21, 2007, the U.S. Securities and Exchange Commission (the "SEC") issued a release<sup>1</sup> (the "Proposing Release") proposing rule and form amendments ("Proposed Rules") that would permit these changes. The Proposed Rules would also require each fund to provide key investment information in plain English in a standardized order at the front of the statutory prospectus, using the same format as the summary prospectus.

### Background

Since 1978, the statutory prospectus for mutual funds has undergone numerous modifications designed principally to make the prospectus less complex and easier for the average investor to understand, and to assure that the prospectus contains information that the SEC believes is necessary for an investor to make an informed investment decision. In 1978, the SEC adopted a unified form for mutual funds, Form N-1, which included two parts: (i) the prospectus; and (ii) a list of exhibits, financial state-

ments, and other information required in the registration statement but not in the prospectus.

Soon after Form N-1's adoption, the SEC staff began considering a more simplified prospectus for mutual funds. These efforts culminated with the adoption of Form N-1A, which was designed to provide investors with a prospectus that is substantially shorter and simpler, so that the prospectus clearly disclosed the fundamental characteristics of the particular investment company. One reason for Form N-1A's success was that more detailed information could be provided in a Statement of Additional Information ("SAI") that did not need to be delivered to investors with the prospectus, but that could be incorporated into the prospectus to assuage liability concerns.

Many mutual funds subsequently took steps to substantially revise and simplify prospectus disclosures in response to the SEC's "Plain English" initiative, launched in the late 1990s. In 1998, the SEC again tried to simplify and improve fund prospectuses by adopting rule amendments to permit funds to provide investors with a "profile prospectus" that includes key summary information about the mutual fund, including:

- the fund's investment objectives, strategies, and risks;
- investment performance results;
- fees and expenses;
- the fund's investment adviser and portfolio manager(s);

<sup>1</sup> Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Release No. 33-8861 (Nov. 21, 2007), available at <http://www.sec.gov/rules/proposed/2007/33-8861.pdf>.

- purchase and redemption procedures; and
- fund distribution and services available to investors.

A significant drawback with the profile, however, was that SEC rules did not allow a fund to incorporate by reference the full statutory prospectus or SAI into the profile—in part because the SEC recognized that limitations existed on the ability of investors to easily access additional information not provided in the profile. In the end, this inability to incorporate the full statutory prospectus and SAI into the profile meant that very few fund groups have used the profile, principally due to significant concerns regarding potential liability for material omissions.

In recent years, the SEC has taken steps to consider how the Internet could be used to facilitate investor access to information about issuers, while simplifying the written disclosure documents delivered to investors. As investors have gained increased access to the Internet, the SEC began to consider the possibility of allowing a fund to deliver a short, summary prospectus to investors—similar to the profile—that directed investors to the fund’s statutory prospectus or SAI on an accessible web site, and allow the fund to incorporate by reference the prospectus or SAI into the summary prospectus. These efforts have culminated with the Commission’s action on the Proposed Rules.

### Proposed Summary Section to Statutory Prospectus

The Proposed Rules would require every mutual fund to include a summary section, in plain English, at the front of the fund’s statutory prospectus under the Securities Act. This summary section would be required to include only the following information, presented in the following order:

- **Investment Objective.** The summary section would begin with a statement of the fund’s investment objectives or goals. A fund also could identify its “type” or “category” (e.g., noting that the fund is a “money market” or “balanced” fund).
- **Fee Table.** The Proposed Rules would include a number of changes from the information currently required in a fund’s statutory prospectus:
  - **New Location.** The Proposed Rules would move the fee table and expense example forward from its current location in the statutory prospectus, where they currently follow information about investment strategies, risks, and past performance. The Proposing Release noted that this placement was designed to reflect “the importance of costs to an investment decision.”
  - **New Disclosure about Breakpoint Discounts.** Funds that offer breakpoint discounts would be required to briefly disclose information about the availability of such discounts.
  - **Revised Description of “Annual Fund Operating Expenses.”** The Proposed Rules would revise the parenthetical following this heading to read, “ongoing expenses that you pay each year as a percentage of the value of your investment,” rather than the current “expenses that are deducted from fund assets.”
  - **New Disclosure Regarding Portfolio Turnover.** Mutual funds, other than money market funds, would be required to disclose their portfolio turnover rates along with an explanation about the impact of portfolio turnover on transaction costs and fund investment performance.
  - **Revised Treatment of Expense Reimbursement and Fee Waiver Arrangements.** For funds with expense reimbursements or fee waiver arrangements that reduce fund operating expenses (and that will continue to reduce them for no less than one year from the registration statement’s effective date), the Proposed Rules would permit funds to place two additional captions directly below the “Total Annual Fund Operating Expenses” caption. One Caption would show the amount of any expense reimbursement or fee waiver arrangement, and the other would show the fund’s net expenses after subtracting the expense reimbursement or fee waiver from the fund’s gross annual expenses. Funds that disclose these arrangements would be required to disclose the period for which the expense reimbursement or fee waiver arrangement is expected to continue, and briefly describe who can ter-

minate the arrangement and under what circumstances.

- **Investments, Risks, and Performance.** Immediately following the fee table and expense example, the Proposed Rules would require a fund to disclose its principal investment strategies, risks, and investment performance in the same form as currently required in the fund's statutory prospectus.
- **Portfolio Holdings.** The Proposed Rules next would require a fund to include a list of its ten largest holdings, in descending order, together with the percentage of net assets represented by each holding. To determine a fund's top ten holdings, funds would be required to aggregate and treat as a single issue: (i) all fully collateralized repurchase agreements; and (ii) all securities of any one issuer (other than fully collateralized repurchase agreements). The Proposed Rules would allow a fund to exclude certain securities in a manner similar to that permitted by existing Form N-Q or N-CSR disclosure requirements, which allow a fund to list any securities whose value does not exceed 5% of the total value of a fund's portfolio holdings as "miscellaneous securities," subject to certain conditions.
- **Fund Management.** The summary section next would be required to disclose the name of a fund's investment adviser and sub-adviser, followed by the name, title, and length of service of the fund's portfolio managers. Similar to the current requirements for profile prospectuses, a fund would not be required to identify a sub-adviser whose sole responsibility is limited to day-to-day management of the fund's cash instruments (unless the fund is a money market fund or other fund with a principal investment strategy of regularly holding cash instruments). Similarly, a fund that has three or more sub-advisers – each of which manages a portion of the fund's portfolio – would not be required to identify each sub-adviser unless a sub-adviser is (or is reasonably expected to be) responsible for the management of a "significant portion" of the fund's net assets (deemed to be 30% or more of the fund's net assets).
- **Purchase and Sale of Fund Shares.** The Proposed Rules would require a fund to disclose its

minimum initial and subsequent investment requirements, the fact that its shares are redeemable, and the procedures for redeeming shares, all in the same manner as is currently required for profile prospectuses.

- **Tax Information.** The Proposed Rules next would require a fund to disclose whether it intends to make distributions that may be taxed as ordinary income or capital gains, or whether it intends to distribute tax-exempt income. A fund that holds itself out as investing in securities generating tax-exempt income would be required to include a general statement to the effect that its distributions may still be subject to federal income tax.
- **Financial Intermediary Compensation.** In order to address concerns that investors lack adequate information about certain distribution-related costs that create conflicts for financial intermediaries, the Proposed Rules would require ending the summary section with the following disclosure regarding financial intermediary compensation (which could be modified, provided that the modified disclosure included comparable information):

*Payments to Broker-Dealers and Other Financial Intermediaries*

If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may influence the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's web site for more information.

For a statutory prospectus relating to multiple funds, the Proposed Rules would require that the summary information be presented separately for each fund. The Proposed Rules, however, would permit a fund with multiple share classes to integrate the information about those classes into one summary section.

## The New Summary Prospectus

The Proposed Rules would replace Rule 498 under the Securities Act—the current voluntary profile rule—with a new rule that would allow a fund to satisfy its prospectus delivery obligations under the Securities Act by sending a summary prospectus, and providing the statutory prospectus online. Under the Proposed Rules, any materials provided along with the summary prospectus cannot be given greater prominence than, or be bound together with, the summary prospectus.<sup>2</sup>

The summary section appearing in a fund's statutory prospectus would form the body of the fund's summary prospectus, except that a fund's top ten holdings and investment performance information would be updated in the summary prospectus each quarter, as described below. The summary prospectus also would include a cover page and certain introductory information, and could incorporate by reference information included in the fund's statutory prospectus, statement of additional information and most recent shareholder report.

- **Scope of Summary Prospectus.** Under the Proposed Rules, the summary prospectus would not be permitted to omit any of the required information from the summary section of the fund's statutory prospectus, and could not include any additional information, except as described below. In addition, a summary prospectus could describe only one fund, but could describe multiple classes of a single fund.
- **Cover Page / Beginning of Summary Prospectus.** The Proposed Rules would require certain information to be presented on a cover page or at the beginning of the summary prospectus, including: (i) the fund's name and the share classes to which the summary prospectus relates; and (ii) a statement identifying the document as a "summary prospectus." It also would be required to include the following legend:

Before you invest, you may want to review the Fund's prospectus, which contains more information about the Fund and its risks. You can find the Fund's

prospectus and other information about the Fund online at \_\_\_\_\_. You can also get this information at no cost by calling \_\_\_\_\_ or by sending an e-mail request to \_\_\_\_\_.

The legend could also indicate that the summary prospectus is intended for use in connection with a 401(k), 403(b), or 457 plan, or a variable life insurance or annuity contract, and is not intended for use by other investors. In addition, the legend could indicate that the statutory prospectus and other information are available from a broker-dealer or other financial intermediary.

- **Updating of Certain Information in Summary Prospectus.** The Proposed Rules would require each fund to update the information in its summary prospectus on an annual basis, except for disclosure relating to the fund's investment performance and top ten portfolio holdings, which would need to be updated on a quarterly basis. With respect to holdings information, the Proposed Rules would require each fund to update its top ten portfolio holdings as of the end of the most recent calendar quarter prior to the summary prospectus's first use, or the previous calendar year if the most recent calendar quarter ended less than one month prior to the first use. This requirement is intended to ensure at least a one-month lag between the end of a calendar quarter and the disclosure of the top ten holdings as of the end of that quarter.

A fund would be able to reflect the updated performance and portfolio holdings information in the summary prospectus by affixing a label or sticker (or by other reasonable means) in lieu of reprinting the entire summary prospectus each quarter. Moreover, as long as the only changes to the summary prospectus during the year are the required quarterly updates to the fund's top ten portfolio holdings and investment performance information, a fund would not be required to send an updated summary prospectus to its shareholders more than once annually. Although the holdings and investment performance sections of the summary section would need to be updated on a quarterly basis, this requirement would not apply to the same information in the fund's statutory prospectus. The Proposed Rules specifically provide that the omission of the quarterly updated holdings and

<sup>2</sup> The SEC did not elaborate on what "greater prominence" means. We anticipate comments on the Proposed Rules seeking clarification on this subject in the adopting release.

investment performance information from a fund's statutory prospectus would not constitute, solely by virtue of its use in the summary section, an omission of material information required to be included in the statutory prospectus.

- ***Incorporation by Reference.*** The Proposed Rules would permit a fund to incorporate by reference into the summary prospectus information in the fund's statutory prospectus SAI and most recent shareholder report. A fund would not be permitted to incorporate by reference into the summary prospectus information from any other source. If a fund incorporates information by reference into the summary prospectus, the summary prospectus legend must clearly identify the document from which the information is incorporated, including the date of the document, and explain that any information incorporated from the SAI or shareholder report may be obtained, free of charge, in the same manner as the statutory prospectus.

Significantly, the ability to incorporate by reference a fund's statutory prospectus and SAI represents an attempt by the SEC to address the liability concerns raised by providing only a summary document to fund shareholders. Rule 159 of the Securities Act provides that, in determining a fund's liability under Sections 12(a)(2) and 17(a)(2)<sup>3</sup> of the Securities Act, any information conveyed to the fund purchaser after the purchase is not considered. Rule 159 thus raises the concern that information delivered after the summary prospectus, such as the statutory prospectus and SAI, would not be considered in determining whether a fund is liable under Sections 12(a)(2) and 17(a)(2) of the Securities Act. However, under the Proposed Rules, if a fund's summary prospectus incorporates information from the fund's statutory prospectus and SAI by reference, that information therein will be treated as having been conveyed to a person who received the summary prospectus not later than the time the summary prospectus is received. Thus, an investor will be deemed to have received materials incorporated by reference into the summary prospectus at the time the investor receives the summary prospectus.

<sup>3</sup> Sections 12(a)(2) and 17(a)(2) of the Securities Act impose liability on a fund if the fund offering was carried out by means of a prospectus or oral communication that is materially false or misleading.

The Proposing Release further notes the SEC's belief that a person who provides a summary prospectus in good faith in reliance on the Proposed Rules should be able to rely on Section 19(a) of the Securities Act. This section protects a defendant from liability for actions taken in good faith in conformity with SEC rules, against any claim that the summary prospectus did not include information disclosed in the fund's statutory prospectus—regardless of whether the fund incorporates the statutory prospectus by reference into the summary prospectus.

## Internet Access to Information

A fund that decides to rely on the Proposed Rules to meet its statutory prospectus delivery obligations by delivering a summary prospectus must also make certain information available over the Internet. As described below, the fund's current summary prospectus, statutory prospectus, SAI, and most recent annual and semiannual reports to shareholders would need to be accessible, free of charge, at the web site address specified on the cover page or at the beginning of the summary prospectus.

- ***Timing.*** The above-mentioned documents must be accessible online on or before the time that the summary prospectus is sent or given to investors. Current versions of the documents must remain on the web site through at least 90 days after the fund's securities are carried or delivered, or a communication with respect to a mutual fund's security is sent or given. This requirement is designed to ensure that the public has continuous access to the information from the time the summary prospectus is sent or given until at least 90 days after the date of delivery of a security or communication in reliance on the Proposed Rules.
- ***Format.*** The information must be presented in a format that:
  - is convenient for both reading online and printing on paper;
  - permits persons accessing the statutory prospectus and SAI to move directly back and forth between the table of contents in that document and each section of that document referenced in the table of contents (e.g., through hyperlinking); and

- permits persons accessing the summary prospectus to move directly back and forth between each section of the summary prospectus and any section of the statutory prospectus and SAI that provides additional detail concerning that section of the summary prospectus or, alternatively, tables of contents in the statutory prospectus and SAI that prominently display the sections within those documents that provide additional detail concerning information in the summary prospectus.
- **Safe Harbor.** The Proposed Rules would include a safe harbor to protect funds in cases where there existed an Internet outage or other event that prevented continuous web access to the documents. A fund would be protected from liability provided that: (i) it had reasonable procedures to ensure that Internet access to the documents was available; and (ii) the fund took prompt action to ensure that the necessary Internet access was restored as soon as practicable following the earlier of the time it knew, or reasonably should have known, Internet access was not available.
- **Paper and E-Mail Delivery.** The Proposed Rules would require a fund or intermediary to send, at no cost to the requestor and by first class mail or other reasonably prompt means, a paper copy (or e-mail copy, if so requested) of the fund's statutory prospectus, SAI, and most recent annual and semiannual shareholder report to any person requesting a copy within three business days after receiving the request.

## Observations

The Proposed Rules appear to serve the intended purpose of both enhancing disclosure and giving investors a choice in the format and quantity of information they would like to receive before making an investment decision. By permitting delivery of the summary prospectus on the Internet, and only requiring the delivery of a paper prospectus upon request, the Proposed Rules have the potential to save funds and their shareholders substantial printing and postage expenses. Nonetheless, one SEC Commissioner has observed that the SEC's proposal "may still need some

modifications."<sup>4</sup> Commissioner Paul Atkins has observed that the proposed "quarterly updating requirement" may be unnecessary, and has questioned the usefulness of including information about a fund's top ten holdings in the summary prospectus.<sup>5</sup> Indeed, the SEC's focus on quarterly performance seems somewhat inconsistent with its past statements that investors should not base investment decisions on short-term investment performance, but instead focus on investment performance over the long term.<sup>6</sup>

The Proposed Rules' requirements relating to Internet availability of the summary and statutory prospectus, SAI, and shareholder reports may also pose certain operational challenges for fund firms—particularly insofar as they require "hyperlinking" between the summary prospectus and more detailed disclosure in the statutory prospectus or SAI.

Regardless of whether funds choose to use the summary prospectus, all funds will have to amend their statutory prospectuses under the Proposed Rules. The costs of such action to many fund groups may be significant. The Proposed Rules also may raise particular concerns for funds that currently use a large multi-fund prospectus. The requirement that each summary section of a statutory prospectus address only one fund could lead to significantly larger statutory prospectuses.

The SEC has proposed a compliance date that would require post-effective amendments that are filed within six-months after the effective date of the Proposed Rules to comply with these new requirements. Funds may wish to consider whether this is sufficient time to deal with the many operational issues pre-

<sup>4</sup> Paul S. Atkins, Remarks Before the Independent Directors Council (Nov. 28, 2007), available at [http://www.sec.gov/news/speech/2007/spch112807ps\\_a-2.htm](http://www.sec.gov/news/speech/2007/spch112807ps_a-2.htm).

<sup>5</sup> Paul S. Atkins, Open Meeting Statement on Mutual Fund Prospectus Disclosure and Delivery (Nov. 15, 2007), available at [http://www.sec.gov/news/speech/2007/spch111507ps\\_a.htm](http://www.sec.gov/news/speech/2007/spch111507ps_a.htm).

<sup>6</sup> See, e.g., New SEC Mutual Funds Tips Remind Investors To Look at More Than Short-Term Past Performance (Jan. 24, 2000), available at <http://edgar.sec.gov/news/press/2000-7.txt>.

sented, and if not, provide comment to the SEC on this point. Comments must be received by February 28, 2008.



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