

Summary Versus Profile Prospectus Liability

by Gary O. Cohen

The Securities and Exchange Commission (SEC) has proposed a new Summary Prospectus for mutual funds (proposal).¹ The Summary Prospectus would take the place of the existing profile prospectus (Profile).² The proposal intends, among other things, to overcome concerns that the industry has had with the Profile. The essential concern has been that delivering a Profile might result in liability for delivering less than all of the information contained in a statutory prospectus.³

Old Liability Concerns

A Profile, like other offering documents, is subject to the liability provisions of the Securities Act of 1933 and rules thereunder.⁴ Liability concerns for a Profile could arise based on Section 12(a)(1) and Section 5(b)(2). Section 12(a)(1), in effect, imposes liability on a fund that offers or sells fund shares in violation of Section 5. Section 5(b)(2), in effect, requires that a fund deliver a paper statutory prospectus before or with a confirmation for the purchase of fund shares.

Delivery of a Profile does not relieve an issuer from the requirement of also delivering a paper statutory prospectus. The proposal would change that. The proposal is that delivery of the Summary Prospectus would satisfy the issuer's obligation to deliver a paper statutory prospectus.⁵ In other words, unless an investor requested a paper statutory prospectus, delivery of a Summary Prospectus

would mean that a fund need not deliver a paper statutory prospectus at *any* time, including with the confirmation for the purchase of fund shares.

Liability also could arise based on Section 12(a)(2) and Rule 159. Section 12(a)(2), in effect, imposes liability on a fund for a statutory prospectus or oral communication that contains a material untruth or omission. Rule 159, in effect, provides that a fund cannot avoid that liability for information conveyed to the purchaser at the *time the shares were sold* by relying on information conveyed *only after* the time of sale. In other words, delivery of a paper statutory prospectus only with a confirmation for the sale of fund shares would not appear to cure a material untruth or omission conveyed to the purchaser at an earlier time of sale.⁶

Delivery of a Profile, rather than a paper statutory prospectus, at the time fund shares were sold may not convey information sufficient for a fund to avoid liability for untrue or incomplete statements made to a purchaser at the time the shares were sold. The proposal would change that. The proposal is that delivery of a Summary Prospectus would convey all of the information in a statutory prospectus at the time of sale.⁷ In other words, a fund would not need to deliver a paper statutory prospectus at the time fund shares were sold in order to protect itself against liability for conveying untrue or incomplete information.

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New SEC Approaches

In proposing the changes noted above, the SEC is following conceptual approaches for the Summary Prospectus that it did not follow for the Profile. The SEC is basing the changes on the concept that delivery of the Summary Prospectus delivers or conveys the information in the statutory prospectus. The Summary Prospectus does so through disclosing:

- Electronic access to the statutory prospectus on the fund's Web site; and
- The Summary Prospectus' incorporation by reference of the statutory prospectus.

The proposal is that a fund's delivery of a Summary Prospectus would be optional.⁸ However, a fund that chooses to deliver a Summary Prospectus would have to meet certain conditions relating to liability concerns. The condition requiring electronic access to the statutory prospectus is mandatory.⁹ The authority to incorporate the statutory prospectus into the Summary Prospectus is optional.¹⁰ The SEC does not explain why incorporation by reference is optional rather than mandatory.

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Electronic Access

The SEC, in essence, is saying that a fund could deliver a statutory prospectus by providing it on an Internet Web site rather than delivering a paper copy.¹¹

When the SEC authorized the Profile in 1998, the American public's use of the Internet was not as widespread as it is today. So, delivery based on electronic access was not an approach that the SEC saw fit to follow. But the SEC is currently relying on "technological advances" since 1998.¹² The SEC points to the fact that "[i]n recent years, access to the Internet has greatly expanded, and significant strides have been made in the speed and quality of Internet connections."¹³

The SEC followed a similar approach in 2005 when it adopted so-called securities offering reform rules for non-funds.¹⁴ The SEC relied on increased "Internet usage"¹⁵ as a basis for providing that a final statutory prospectus would be deemed to be delivered by having been posted on a Web site rather than provided in paper. The SEC said that "[u]nder such an 'access equals delivery' model, investors are presumed to have access to the Internet, and issuers and intermediaries can satisfy their [prospectus] delivery requirements if the filing or documents are posted on a Web site."¹⁶

Curiously, there appears to be a difference between what the SEC said about electronic access in 2005 and what the SEC is saying now. In 2005, the SEC referred to electronic access to a statutory prospectus with the expressive phrase "access equals delivery."¹⁷ The SEC used the phrase repeatedly¹⁸ in its 2005 adopting release. However, that phrase does not appear in the proposing release here. Indeed, the SEC appears to have studiously avoided the phrase. It is not clear from the proposing release why the SEC did not use the phrase here. The SEC's thinking could be that the Summary Prospectus, not access to the statutory prospectus, delivers the statutory prospectus.

Incorporation by Reference

The SEC, in effect, is proposing that a fund could deliver a statutory prospectus not only by electronic access, but also by incorporating the statutory prospectus into the Summary Prospectus by reference. More technically, the proposal is that a fund may incorporate by reference into a Summary Prospectus any or all of the *information* contained in the statutory prospectus, statement of additional information or most recent report to shareholders.¹⁹

In authorizing the Profile in 1998, the SEC expressly refused to permit incorporation of the statutory prospectus into the Profile.²⁰ The SEC's rationale was its belief that "allowing this incorporation would be inconsistent with the purpose of the [P]rofile."²¹ The SEC said that "the [P]rofile was designed to provide summary information about a fund in a self-contained format and that permitting incorporation by reference of the statutory prospectus would be inconsistent with the [P]rofile being a self-contained document."²²

The SEC explains that it does not intend the Summary Prospectus to be a self-contained document. Instead, the SEC intends the Summary Prospectus to be "one element in a layered disclosure regime that results in the simultaneous provision of information to investors through multiple means."²³

As with electronic access discussed above, the SEC bases its proposal regarding incorporation by reference on technological advances. The SEC points to the "expansion in Internet access and the strides in the speed and quality of Internet connections since the profile rule was adopted in 1998."²⁴ The SEC explains that "an investor could make use of required links between the Summary Prospectus and the other documents in order to move quickly and easily between the documents to review particular information."²⁵

Effect of Electronic Access and Incorporation by Reference

The proposal is not entirely clear as to the effect of electronic access and incorporation by reference in protecting a fund against liability in connection with delivering and conveying information under Section 5(b)(2) and Rule 159, respectively.

By way of background, the effect of incorporation by reference is usually expressed in terms of whether or not the incorporated document becomes a part of the incorporating document. There is a line of cases involving the Investment Company Act of 1940²⁶ and other federal securities laws²⁷ that support the concept that information incorporated by reference becomes part of the incorporating document as a matter of law. However, there is also judicial authority that, at least in some situations, whether or not information incorporated by reference becomes part of the incorporating document is subject to a facts and circumstances standard.²⁸

The SEC has said that the effect of incorporation by reference is to make the incorporated document part of the incorporating document as

a matter of law.²⁹ At the same time, the SEC at least has suggested that the effect of incorporation by reference requires a facts and circumstances determination.³⁰ So, the proposal seems to raise the following questions.

Is the Effect of Incorporation by Reference Dependent on Facts and Circumstances?

The proposed rule does not provide, at least expressly, that incorporated information becomes a part of the incorporating document. Therefore, it is not entirely clear whether the legal effect of the proposed rule is to provide that statutory prospectus information incorporated by reference into a Summary Prospectus becomes a part of the Summary Prospectus (i) as a matter of law or (ii) depending on all of the facts and circumstances.

At the same time, the proposed rule provides that, for purposes of Rule 159, information in the statutory prospectus that is incorporated by reference into the Summary Prospectus is deemed to be conveyed to an investor not later than the time that the investor receives the Summary Prospectus.³¹ This would appear to mean that the incorporated statutory prospectus information *does* become part of the Summary Prospectus regardless of the facts and circumstances, at least for purposes of Rule 159.

Is the Effect of Electronic Access and Incorporation by Reference Limited, Respectively, to the Purposes of Section 5(b)(2) and Rule 159?

The proposed rule does not provide, at least expressly, that statutory prospectus information incorporated by reference into a Summary Prospectus would help satisfy a fund's obligation to deliver a statutory prospectus under Section 5(b)(2).

Similarly, the proposed rule does not provide, at least expressly, that electronic access would help assure that information is conveyed to an investor at the time of the sale of fund shares under Rule 159.

The proposed rule would *require* electronic access, but not incorporation by reference. So, this difference might explain why the proposed rule would not base satisfaction of Section 5(b)(2) on incorporation by reference. A Summary Prospectus that did not incorporate statutory prospectus information by reference would, nevertheless, be deemed to satisfy the obligation to deliver a statutory prospectus under Section 5(b)(2).

On the other hand, it would seem that electronic access should help assure that information is conveyed to an investor at the time of the sale of fund shares under Rule 159. In other words, it would seem that a fund would not need to incorporate statutory prospectus information by reference in order to help avoid liability under Rule 159. This would be because electronic access would be deemed to convey the statutory prospectus information to an investor at the time of the sale of fund shares. Indeed, the SEC states that a fund would "be able to rely on Section 19(a) of the Securities Act against a claim that the Summary Prospectus did not include information that is disclosed in the fund's statutory prospectus, *whether or not* the fund incorporates the statutory prospectus by reference in the Summary Prospectus."³²

Conclusion

The proposal intends to address industry concerns about liability in connection with the Profile. It goes a long way in doing so. However, the proposal may not be entirely clear in some technical respects. It would be helpful if the SEC addressed these matters either in the proposed rule or any adopting release.

NOTES

1. *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, SEC Securities Act Release No. 8861, Investment Company Act Release No. 28064 (Nov. 21, 2007) (SEC Rel. No. IC-28064).

2. The Profile is authorized by Rule 498, entitled "Profiles for Certain Open-End Management Investment Companies," under the Securities Act of 1933.

3. The NASD's Report of the Mutual Fund Task Force: Mutual Fund Distribution 14 (undated, but released April 5, 2005) stated:

Few firms have used the Rule 498 profile. One issue that has impeded its wider acceptance has been concern over the potential liability exposure that the profile presents. For example, a profile summarizes the risks associated with the fund, which are described in greater detail in the full fund prospectus. By providing two levels of disclosure, the summary at the time of the sale and the more detailed disclosure after the sale has been executed, the profile system presents an opportunity for litigation over the issue of whether the profile omitted material information. The fact that the profile is a voluntarily used document, rather than an SEC-required disclosure document with line item summaries, may exacerbate this litigation risk.

4. All references to Sections and Rules are to Sections of the Securities Act of 1933 and rules thereunder.

5. Proposed Rule 498(c), SEC Rel. No. IC-28064, *supra* n.1.

6. Rule 159 excludes "any information conveyed to the purchaser only after such time of sale (including such contract of sale) will not be taken into account." For a non-fund, the "time of sale" would seem to be a time not prior to the date of the effectiveness of the issuer's registration statement under the Securities Act of 1933. See I Loss, *Securities Regulation*, 223-224 (1961) (Section 5 of the Securities Act of 1933 permits "the making of offers but not sales, contracts of sale or contracts to sell prior to the effective date"). However, in adopting securities offering reform rules for non-funds in 2005, the SEC stated that "[o]ur proposed Rule 159 would also provide that liability under Section 12(a)(2) would be assessed based on the information conveyed at the time of the contract of sale, independent of the contents of the final prospectus filed after the time of sale." *Securities Offering Reform*, Securities Act Release No. 8591, Securities Exchange Act Release No. 52056, Investment Company Act Release No. 26993 (July 19, 2005) at n.347 (emphasis added) (SEC Rel. No. IC-26993). The SEC went on to state that the "market" has access to the final prospectus upon its filing and dissociates the statutory prospectus delivery from the date of the confirmation. Query whether it is necessarily clear that a final fund statutory prospectus that is delivered with a confirmation, but nevertheless "on file" cannot be considered. In any event, for a fund, the "time of sale" would seem to be a date *after* the fund's registration statement under the Securities Act of 1933 had become effective. It follows that, under the proposal, an offeree would seem to have electronic access to the fund's statutory prospectus at the "time of sale" of the fund's shares. This would mean that, for purposes of Rule 159, the information in the fund's statutory prospectus would have been conveyed at "the time of sale" of the fund's shares.

7. Proposed Rule 498(b)(iii), SEC Rel. No. IC-28064, *supra* n.1.

8. "We are proposing a new option for satisfying prospectus delivery obligations with respect to mutual fund securities under the Securities Act." SEC Rel. No. IC-28064, *supra* n.1, at 12.

9. Proposed Rule 498(f), SEC Rel. No. IC-28064, *supra* n.1.

10. Proposed Rule 498(b)(3)(ii), SEC Rel. No. IC-28064, *supra* n.1.

11. SEC Rel. No. IC-28064, *supra* n.1, at 1.

12. *Id.* at 10.

13. *Id.* at 9-10.

14. SEC Rel. No. IC-26993, *supra* n.6.

15. *Id.* at 244.

16. *Id.*

17. *See, e.g., id.* at 244, 246, 247.

18. The author counted at least 14 references to the phrase "access equals delivery."

19. Proposed Rule 498(b)(3)(i), SEC Rel. No. IC-28064, *supra* n.1.

20. *Id.* at 66.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.* at 67.

25. *Id.*

26. *White v. Melton*, 757 F.Supp. 267 (S.D.N.Y. 1991). The court said, at 271 with emphasis added: "The SEC expressly provided that SAIs incorporated by reference are deemed 'a part of the prospectus as a *matter of law*.'" The court also said, at 272 with emphasis added: "[T]he court concludes as a *matter of law* that plaintiff cannot state a claim for fraud under the securities laws based on defendants' placement of the freeze rule in the SAI, as incorporated by reference into the Prospectus, rather than in the Prospectus itself."

27. *Majeski v. Balcov Entertainment Co.*, 393 F.Supp. 1397 (E.D. Wisc. 1994); *Weilgos v. Commonwealth Edison Co.*, 123 F.R.D. 299 (N.D. Ill. 1988); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 122 F.2d 1 (C.A.N.Y. 1983); *In re Airgate PCS, Inc. Securities Litigation*, 389 F.Supp. 2d 1360 (2005); *Lasker v. New York State Electric & Gas Corp.*, 1995 WL 867881 (E.D.N.Y. 1995).

28. The court said in *Kramer v. Time Warner, Inc.*, 937 F.2d 767, 778 (C.A.N.Y. 1991) (emphasis added):

The documents so incorporated may be difficult to obtain and, depending on the nature of the information and other *circumstances*, incorporation by reference may complicate analysis. Indeed, at least where the SEC by regulation or other authoritative act has not approved disclosure through incorporation by

reference ... the practice should be restricted to *circumstances* in which no reasonable shareholder can be misled.

29. The SEC has stated that: "if a mutual fund incorporates the Statement of Additional Information by reference, the Statement would be a *part* of the prospectus as a *matter of law*." *Investment Companies, Mutual Funds, Registration Statements*, Securities Act Release No. 6479; Securities Exchange Act Release No. 20355 (Aug. 12, 1983).

30. The SEC has stated:

For purposes of Section 12(a)(2) and Section 17(a)(2), whether or not information has been conveyed to an investor at or prior to the time of the contract of sale currently is a *facts and circumstances* determination, and our actions today do not affect that determination. Such information could include information in the issuer's registration statement and prospectuses for the offering in question, the issuer's Exchange Act reports *incorporated by reference* therein or information otherwise disseminated by means reasonably designed to convey such information to investors.

SEC Rel. No. IC-26993, *supra* n.6, at 176 (emphasis added).

31. Proposed Rule 498(b)(3)(iii), SEC Rel. No. IC-28064, *supra* n.1.

32. *Id.* at 71 (emphasis added).