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Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239 and 274

[Release Nos. 33–8343; IC–26287; File No. S7–26–03]

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Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing amendments to Form N–1A under the Securities Act of 1933 and the Investment Company Act of 1940 to require open-end management investment companies to disclose in their prospectuses both the risks to shareholders of the frequent purchase and redemption of investment company shares, and the investment company's policies and procedures with respect to such frequent purchases and redemptions. The proposals would also amend Forms N–3, N–4, and N–6 to require similar prospectus disclosure for insurance company separate accounts issuing variable annuity and variable life insurance contracts. The Commission is also proposing to amend Forms N–1A and N–3 to clarify that open-end management investment companies and insurance company managed separate accounts that offer variable annuities, other than money market funds, are required to explain both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. In addition, the Commission is proposing to require open-end management investment companies and insurance company managed separate accounts that offer variable annuities 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.

DATES: Comments must be received on or before February 6, 2004.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by one method only. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–26–03; this file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet Web site *(http://www.sec.gov).*[1]

FOR FURTHER INFORMATION CONTACT: Kieran G. Brown, Attorney, or Sanjay Lamba, Attorney, Office of Disclosure Regulation, Division of Investment Management, (202) 942–0721, at the Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is proposing for comment amendments to Form N–1A [17 CFR 239.15A and 274.11A], Form N–3 [17 CFR 239.17a and 274.11b], Form N–4 [17 CFR 239.17b and 274.11c], and Form N–6 [17 CFR 239.17c and 274.11d], registration forms used by investment companies to register under the Investment Company Act of 1940 ("Investment Company Act") and to offer their securities under the Securities Act of 1933 ("Securities Act").

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I. Introduction and Background

Millions of individual American investors hold shares of open-end management investment companies ("mutual funds"), relying on these funds for their retirements, their children's educations, and their other basic financial needs.[2] The tremendous growth of mutual funds reflects the trust that investors have placed in funds and the regulatory protections provided by the federal securities laws.

Recent allegations regarding late trading and abusive market timing, however, point to instances where it appears that some in the mutual fund industry, and some intermediaries that sell fund shares, have lost sight of their obligations to investors.[3] These allegations relate to abuses in at least three areas:

- "Late trading," the practice of placing orders to buy or redeem mutual fund shares after 4 p.m., Eastern time, as of which most funds calculate their net asset value ("NAV"), but receiving the price based on the 4 p.m. NAV;
- Abuses related to "market timing," including the alleged overriding of stated market timing policies by fund executives to benefit large investors at the expense of small investors, or to benefit the fund's investment adviser; and
- The selective disclosure by some fund managers of their funds' portfolio holdings in order to curry favor with large investors.

The Commission is extremely concerned by the abuses that have surfaced in the mutual fund industry, and we have taken vigorous enforcement action where abuses have been uncovered.[4] We also believe,

[1] We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

[2] A management investment company is an investment company other than a unit investment trust or face-amount certificate company. *See* section 4 of the Investment Company Act [15 U.S.C. 80a–4]. Management investment companies typically issue shares representing an undivided proportionate interest in a changing pool of securities, and include open-end and closed-end companies. *See* T. Lemke, G. Lins, A. Smith III, Regulation of Investment Companies, Vol. I, ch. 4, § 4.04, at 4–5 (2002). An open-end company is a management company that is offering for sale or has outstanding any redeemable securities of which it is the issuer.

[3] *See, e.g.,* Riva D. Atlas, *Another Fund Faces Inquiry Over Trading,* NEW YORK TIMES, October 22, 2003, at C4; Tom Lauricella, *Two-Tier System: For Staid Mutual Fund Industry, Growing Probe Signals Shake Up—Investigators Find Indications of Widespread Abuses Hurting Small Investors—Unfair Pricing for Big Players,* WALL STREET JOURNAL, October 20, 2003, at A1; Brooke A. Masters, *Spitzer Alleges Mutual Fund Improprieties,* WASHINGTON POST, September 4, 2003, at E1.

[4] *See, e.g., In the Matter of Putnam Investment Management, LLC,* Release No. IC–26255 (Nov. 13, 2003) (investment adviser violated antifraud provisions of the federal securities laws by failing to disclose potentially self-dealing short-term

however, that regulatory reforms are necessary to help prevent such abuses from recurring in the future. The Commission is proposing a package of rule amendments intended to address abuses that have surfaced in the areas of late trading, market timing, and selective disclosure. In this release, we are proposing disclosure reforms intended to shed more light on market timing and selective disclosure of portfolio holdings. In a second release, we are proposing amendments that would require that an order to purchase or redeem redeemable securities of a registered investment company be received by the company, its designated transfer agent, or a registered securities clearing agency by the time that the fund establishes for calculating its NAV in order to receive that day's price. In addition, we are publishing a release adopting rules requiring registered investment companies and investment advisers to adopt and implement written compliance policies and procedures, review those policies and procedures annually, and designate a chief compliance officer responsible for their administration.

A. Forward Pricing and Market Timing

Section 22 of the Investment Company Act of 1940 (the ''Investment Company Act'') regulates the pricing, distribution, and redemption of redeemable securities, including mutual fund shares.[5] Paragraph (c) of section 22 gives the Commission broad power to regulate the pricing of redeemable securities, including the power to prescribe by rule methods for computing the price that a shareholder will receive upon redemption. Rule 22c–1(a) under the Investment Company Act requires mutual funds to sell and redeem their shares at a price based on the NAV next computed after receipt of an order. This requirement is referred to as ''forward pricing.'' The purpose of this requirement is to prevent dilution and assure that prices bear an appropriate relation to the current NAV of a mutual fund's shares.[6] Rule 22c–1 generally requires mutual funds to compute their NAVs at least once daily, Monday through Friday, at a specific time or times as determined by their boards.[7] Typically, mutual funds calculate their NAVs once each day at or near the close of the major U.S. securities exchanges and markets (usually 4 p.m., Eastern time).

Mutual funds generally calculate their NAVs by using the closing prices of portfolio securities on the exchange or market on which the securities principally trade. In some cases, however, the closing price of a security held in a mutual fund's portfolio may not reflect its current market value at the time of the fund's NAV calculation, for example, if an event that will affect the value of those securities has occurred since the closing price was established, but before the fund's NAV calculation.[8]

When market quotations for a portfolio security are not readily available (including when market quotations are unreliable), a mutual fund is required to calculate its NAV by using the fair value of that security, as determined in good faith by the fund's board.[9] In a separate release adopting rule 38a–1 under the Investment Company Act, we are reemphasizing the obligation of mutual funds to fair value their securities under certain circumstances. If a mutual fund misprices its shares by failing to use fair value pricing when market quotations for its portfolio securities are unreliable, an investor may take advantage of the disparity between the portfolio securities' last quoted prices and their fair value. When mutual fund shares are mispriced, short-term traders have an arbitrage opportunity that they can use to exploit the fund and disadvantage the fund's long-term investors by extracting value from the fund without assuming any significant investment risk, through market timing.[10] Mutual funds that fair value their portfolio securities consistent with their obligations can effectively reduce or eliminate the profit that market timers seek to exploit.[11]

Mutual funds that invest in overseas securities markets are particularly vulnerable to market timers who may take advantage of time zone differences between the foreign markets on which international funds' portfolio securities trade and the U.S. markets which generally determine the time as of which NAV is calculated (''time-zone arbitrage''). For example, a market timer may purchase shares of a mutual fund that invests in overseas markets based on events occurring after foreign market closing prices are established, but before the fund's NAV calculation, that are likely to result in higher prices in foreign markets the following day. The market timer would redeem the fund's shares the next day when the fund's share price would reflect the increased prices in foreign markets, for a quick profit at the expense of long-term fund shareholders. Market timing opportunities are not limited to international funds. Mutual funds that invest in small-cap securities and other types of investments which are not frequently traded, including high-yield bonds, also can be the targets of market timers.[12]

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trading of mutual fund shares by several of its employees, and by failing to take adequate steps to detect and deter such trading activity through its own internal controls and its supervision of investment management professionals); *In the Matter of James Patrick Connelly, Jr.,* Release No. IC–26209 (Oct. 16, 2003) (vice chairman of investment advisory firm violated antifraud provisions of the federal securities laws by allowing select investors to time mutual funds managed by the firm); *In the Matter of Steven B. Markovitz,* Release No. IC–26201 (Oct. 2, 2003) (hedge fund trader who engaged in late trading of mutual fund shares violated antifraud provisions of the federal securities laws and rule 22c–1(a) under the Investment Company Act).

[5] Both mutual funds and unit investment trusts issue redeemable securities. *See* section 4(2) and 5(a)(1) of the Investment Company Act [15 U.S.C. 80a–4(2) and 80a–5(a)(1)]. For purposes of simplicity, this section of the release only refers to mutual funds.

[6] Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (October 8, 1968) (adopting rule 22c–1) (''Rule 22c–1 Adopting Release'').

[7] Rule 22c–1(b) under the Investment Company Act [17 CFR 270.22c–1(b)].

[8] Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR46558, 46559–46660 n.7 (Nov. 27, 1984)].

[9] *See* Accounting Series Release No. 118 (Dec. 23, 1970) [35 FR 19986 (Dec. 31, 1970)]; Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR46558, 46559–46660 n.7 (Nov. 27, 1984)]. Subsequent to the issuance of these releases, our staff has reminded funds of their fair valuation obligations. In 1999 and 2001, the Division of Investment Management issued interpretive letters elaborating on funds' obligations under sections 2(a)(41) of the Investment Company Act and rule 22c–1 [17 CFR 270.22c–1] thereunder. Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 8, 1999) (*http://www.sec.gov/divisions/investment/guidance/tyle120899.htm*); Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Apr. 30, 2001) (*http://www.sec.gov/divisions/investment/guidance/tyle043001.htm*).

[10] *See* Rule 22c–1 Adopting Release, *supra* note 6 (describing market timing). Market timing may take many forms. In this release, we use the term to refer to arbitrage activity involving the frequent buying and selling of mutual fund shares in order to take advantage of the fact that there may be a lag between a change in the value of a mutual fund's portfolio securities and the reflection of that change in the fund's share price.

[11] ''Fair valuation'' refers to the process of determining the current market value of a security when market quotations are not readily available (such as when there are no market quotations for the security or if the market quotations for the security are unreliable). When market quotations for a security are not readily available, a fund is required to calculate its NAV by using the fair value of that security, as determined in good faith by the fund's board.

[12] *See* Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds,* Research Paper No. 1749, Stanford Graduate School of Business Research Paper Series (Oct. 2002), available at *http://faculty-gsb.stanford.edu/zitzewitz/Research/arbitrage1002.pdf* (''Zitzewitz''), at 2 (estimating arbitrage returns available in domestic small-cap equity funds at 20–25 percent

Continued

Market timing itself is not illegal. However, market timing may dilute the value of long-term shareholders' interests in a mutual fund if the fund calculates NAV using closing prices that are no longer accurate. Dilution may occur, for example, if fund shares are overpriced because redeeming shareholders will receive a windfall at the expense of the shareholders that remain in the fund. Similarly, dilution may occur when a fund sells its shares at a price lower than its NAV.[13]

Market timing also may harm shareholders because it may cause mutual funds to manage their portfolios in a disadvantageous manner. For example, a mutual fund's investment adviser may maintain a larger percentage of its assets in cash or may be forced to liquidate certain portfolio securities prematurely to meet higher levels of redemptions due to market timing. This is particularly true for mutual funds that invest primarily in foreign or emerging market securities, which are often thinly traded. Mutual funds also may incur increased brokerage and administrative costs related to the frequent purchases and redemptions associated with market timing.

In order to discourage market timers, many mutual funds have developed policies and procedures with respect to frequent purchases and redemptions of fund shares. Some mutual funds disclose in their prospectuses that they do not permit market timing, and many mutual funds have taken steps to discourage market timing. These steps may include, for example:

- Imposing redemption or exchange fees on shares that are redeemed or exchanged within a certain time period following their purchase;
- Restricting exchange privileges, for example, by restricting exchange requests submitted through a particular medium, such as telephone or facsimile transmission, or received after a certain time of day, or by delaying both the redemption and purchase sides of an exchange;
- Restricting frequent trading, for example by limiting the total number of exchanges that an investor may make within a certain time period, or by limiting the number of ''round trip'' transactions where an investor purchases shares of a fund, exchanges those shares for shares of a different fund, and then exchanges back into the originally purchased fund;
- Delaying the payment of the proceeds from the redemption of fund shares for up to seven days;[14] and
- Identifying market timers and restricting their trading privileges or expelling them from the fund.

While many mutual funds disclose in their prospectuses that they discourage market timing, many do not identify with specificity the frequency or type of trading that they consider to be problematic, or the specific steps that they will take to ensure that market timing trades are detected and prevented. Other mutual funds disclose specifically the number of trades that they consider to be problematic and the steps that they take to prevent and detect market timing. Item 7(c) of Form N–1A requires mutual funds to disclose in their prospectuses procedures for redeeming the fund's shares, including any restrictions on redemptions; any redemption charges, including how these charges will be collected and under what circumstances the charges will be waived; and the circumstances, if any, under which the fund may delay honoring a request for redemption for a certain time after a shareholder's investment.[15] Item 8(a)(2) of Form N–1A requires a description of exchange privileges, which may be provided in the prospectus or the Statement of Additional Information (''SAI'').[16] Item 3 of Form N–1A requires a mutual fund to include any exchange fee or redemption fee in the fee table of its prospectus.[17]

Other aspects of mutual fund policies and procedures to deter market timing are not explicitly required to be disclosed, however. For example, our registration forms do not explicitly require funds to describe with specificity the circumstances under which restrictions on frequent purchases and redemptions will not be imposed, or the terms of arrangements with particular investors pursuant to which frequent purchases and redemptions are permitted.[18]

We believe that it may be useful to require mutual funds to describe with specificity the restrictions they place on frequent purchases and redemptions and the circumstances and arrangements under which the restrictions are not imposed. These additional disclosure requirements would enable investors to better assess a mutual fund's risks, policies, and procedures in this area, and to determine if a fund's policies and procedures are in line with their expectations.

B. Selective Disclosure of Fund Portfolio Holdings

Currently, mutual funds are required to include their complete portfolio holdings in the reports that are delivered to all shareholders twice a year.[19] In December 2002, we proposed amendments that would require mutual funds to disclose their complete

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and estimating arbitrage returns available in convertible and high-yield and convertible bond funds at 10–25 percent). *See also* William Goetzmann, Zoran Ivkovich, and K. Geert Rouwenhorst, Day Trading International Mutual Funds: Evidence and Policy Solutions, Working Paper No. ICF–00–03, Yale School of Management, Yale University (Oct. 2000), available at: *http://papers.ssrn.com/paper.taf?abstract__id=217168,* at 7–8 (describing opportunities for arbitrage in stale pricing of Russell 2000 index).

[13] By one estimate, dilution resulting from market timing can cost investors in international stock funds that are focused on a particular geographic region as much as 2.3% of their assets each year, and may cost fund shareholders as a whole up to $4.9 billion per year. *See* Zitzewitz, *supra* note 12, at 2 and 16; Jason Greene and Charles Hodges, *The Dilution Impact of Daily Fund Flows on Open-End Mutual Funds: Evidence and Policy Solutions,* 36 Journal of Financial Economics, 131–158 (2002) (estimating annualized dilution from market timing of 0.48% in international funds and nearly 1% for a subsample of funds whose daily flows are particularly large).

[14] Under section 22(e) of the Investment Company Act [15 U.S.C. 80a–22(e)], in general no registered investment company may suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security, for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption.

[15] Items 7(c)(1), (c)(2), and (c)(6) of Form N–1A. Form N–1A is the registration form used by mutual funds to register under the Investment Company Act and to offer their shares under the Securities Act of 1933 [15 U.S.C. 77a].

[16] Item 8(a)(2) of Form N–1A. Similarly, Items in the registration forms for insurance company separate accounts that issue variable annuities and variable life insurance policies require disclosure of provisions and limitations for transfers of contract value among sub-accounts of the separate account. Item 8(b)(ii) of Form N–3; Item 7(b)(ii) of Form N–4; Item 6(b)(2) of Form N–6. The SAI is part of a fund's registration statement and contains information about a fund in addition to that contained in the prospectus. The SAI is required to be delivered to investors upon request and is available on the Commission's Electronic Data Gathering, Analysis, and Retrieval System.

[17] Item 3 and Instructions 2(b) and 2(c) to Item 3 of Form N–1A. Similarly, Item 3(a) and Instruction 10 to Item 3(a) of Form N–3; Item 3(a) and Instruction 11 to Item 3(a) of Form N–4; and Item 3 and Instruction 2(b) to Item 3 of Form N–6 require fee table disclosure of fees charged for transfers of contract value among sub-accounts.

[18] Commission staff sent information requests to 88 of the largest mutual fund complexes, with approximately 90% of the fund industry's total assets and 4,100 individual funds or portfolios under management. Fifty percent of the fund groups that responded to these staff information requests appear to have one or more arrangements with certain shareholders to allow these shareholders to engage in market timing.

[19] Section 30(e) of the Investment Company Act [15 U.S.C. 80a–29(e)] (requiring a registered investment company to transmit to its stockholders, at least semi-annually, reports containing financial statements and other financial information as the Commission may prescribe by rules and regulations); rule 6–10(c)(1) of Regulation S–X [17 CFR 210.6–10(c)(1)] (requiring that a portfolio schedule be filed in support of the balance sheet entry for investments in securities of unaffiliated issuers).

portfolio schedules on a quarterly basis.[20] A significant majority of funds already make their full portfolio schedules publicly available at least quarterly.[21]

Recent allegations, however, have highlighted instances where some mutual fund managers may be selectively disclosing their portfolios in order to reward large investors. Specifically, allegations have been made that certain funds gave frequent updates of their portfolio holdings to favored shareholders, enabling these shareholders to use a fund's portfolio information to short the fund's holdings in the same or similar proportions to the fund's established positions.[22] In addition, more than 30% of mutual fund complexes that responded to a recent Commission examination request for information sent to 88 of the largest such complexes appear to have disclosed portfolio information in circumstances that may have provided certain fund shareholders with the ability to make advantageous decisions to place orders for fund shares. This selective disclosure can facilitate fraud and have severely adverse ramifications for a fund's investors if someone uses that portfolio information to trade against the fund, or otherwise uses the information in a way that would harm the fund.

We are concerned about the misuse of material, nonpublic information that may occur when a mutual fund's portfolio holdings are selectively disclosed and professional traders are given the opportunity to use this information to their advantage to the detriment of fund shareholders. For many issuers, Regulation FD generally requires that when an issuer discloses material information, it do so through public disclosure, not through selective disclosure.[23] Regulation FD does not, however, apply to mutual funds.[24] We have concluded that the recent allegations regarding selective disclosure of portfolio holdings by some mutual fund managers suggest that we need to take steps to reinforce funds' and advisers' obligations to prevent the misuse of portfolio holdings information that is selectively disclosed.

C. Disclosure Proposals

The Commission is proposing form amendments to require better disclosure with respect to the tools that mutual funds use to combat market timing activity. First, in order to enable investors to assess a mutual fund's practices regarding frequent purchases and redemptions of fund shares to determine if they are in line with their expectations, the Commission is proposing to require improved disclosure in fund prospectuses of a mutual fund's risks, policies, and procedures in this area. The proposals would:

- Require a mutual fund to describe in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders;
- Require a mutual fund to state in its prospectus whether or not the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares and, if the board has not adopted any such policies and procedures, state the specific basis for the view of the board that it is appropriate for the fund not to have such policies and procedures;
- Require a mutual fund to describe any policies and procedures for deterring frequent purchases and redemptions of fund shares, and any arrangements to permit frequent purchases and redemptions of fund shares; and
- Require similar disclosure in prospectuses for insurance company separate accounts offering variable insurance contracts, with respect to frequent transfers among sub-accounts.

Second, we are proposing to clarify instructions to our registration forms to require all mutual funds (other than money market funds) and insurance company managed separate accounts that offer variable annuities to explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. As described above, fair valuation of a fund's portfolio securities, which is required under certain circumstances, can serve to foreclose arbitrage opportunities available to market timers.

In addition, in order 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, the Commission is proposing to require mutual funds and insurance company managed separate accounts that offer variable annuities to disclose their policies with respect to disclosure of portfolio holdings information. The proposals would:

- Require a fund to describe in its SAI any policies and procedures with respect to the disclosure of the fund's portfolio securities to any person and any ongoing arrangements to make available information about the fund's portfolio securities to any person; and
- Require a fund to state in its prospectus that a description of the policies and procedures is available in the fund's SAI, and on the fund's Web site, if applicable.

II. Discussion

A. Disclosure Concerning Frequent Purchases and Redemptions of Fund Shares

The Commission is proposing amendments to Form N–1A, the registration form used by mutual funds, that would require disclosure of both the risks to fund shareholders of the frequent purchase and redemption of fund shares, and a fund's policies and procedures with respect to such frequent purchases and redemptions.[25] As discussed above, market timing strategies often involve such frequent purchases and redemptions of fund shares. These proposals are intended to require mutual funds to describe with specificity the restrictions they place on frequent purchases and redemptions, if any, and the circumstances under which any such restriction will not apply. This additional disclosure would enable investors to assess mutual funds' risks, policies, and procedures in this area and determine if a fund's policies and procedures are in line with their

[20] Investment Company Act Release No. 25870 (Dec. 18, 2002) [68 FR 160 (Jan. 2, 2003)].

[21] *See* Scott Cooley, *Tell Investors What They Own,* Morningstar Online, Feb. 6, 2002 (more than 70% of funds currently provide monthly or quarterly portfolio disclosure to Morningstar). *See also* Tom Lauricella and Aaron Lucchetti, *To Industry, Silence is Golden—Mutual Funds Embrace Disclosure Rules—As Long as it Doesn't Involve Them,* Wall Street Journal Europe, Aug. 1, 2002, at M1 (roughly 200 fund firms and 17 of the top 20 largest funds provide quarterly or monthly holdings updates to investors); *Survey of Fund Groups' Portfolio Disclosure Policies Summary of Results,* Investment Company Institute (2001), available at: *http://www.ici.org/port_holdings__appdxa.html.*

[22] *See State of New York* v. *Canary Capital Partners, LLC, et. al.,* at 25 and 41, (N.Y. Sup. Ct., filed Sept. 3, 2003) available at: *http://www.oag.state.ny.us/press/2003/sep/canary__complaint.pdf* (alleging that fund group regularly provided investor with detailed breakdowns of the portfolios of the target funds, allowing the investor to sell short the stocks that the portfolios contained); Ian McDonald, *Will Funds Disclose More—Publicly?,* The Wall Street Journal, Sept. 9, 2003, at C1 (describing allegations that fund groups provided hedge fund with more frequent reports on their fund holdings than were available to other investors).

[23] Regulation FD [17 CFR 243.100 *et seq.*]; Investment Company Act Release No. 24599 (Aug. 15, 2000) [65 FR 51716 (Aug. 24, 2000)] (adopting Regulation FD).

[24] Rule 101(b) of Regulation FD [17 CFR 243.101(b)].

[25] Proposed Item 7(e) of Form N–1A.

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

[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 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.

maintain assets in other accounts managed by the adviser.

The proposed amendments to Form N–1A would also clarify that the new disclosure that would be required regarding frequent purchases and redemptions of fund shares may not be omitted from the prospectus in reliance on current Item 7(f), which would be redesignated as Item 7(g).[36] Current Item 7(f) permits funds to omit from the prospectus certain information concerning purchase and redemption procedures if, among other things, the information is included in a separate document that is incorporated by reference into, and filed and delivered with, the prospectus.[37] We believe that the information required by new Item 7(e) is more appropriately included in the same document as the prospectus.

We are proposing to require similar disclosure in Forms N–3,[38] N–4,[39] and N–6,[40] the registration forms for insurance company separate accounts that issue variable annuity and variable life insurance contracts, with respect to both the risks of frequent transfers of contract value among sub-accounts, and the separate account's policies and procedures with respect to such frequent transfers. However, we are proposing the following modifications to address the different structure of these issuers:

- The proposed amendments to Forms N–3, N–4, and N–6 would require disclosure regarding the risks of, and policies and procedures with respect to, frequent transfers of contract value among sub-accounts of the registrant. A person attempting to engage in market timing of mutual funds through a variable annuity or variable life insurance contract typically would make tax-free transfers of contract value among sub-accounts, each of which invests in a particular underlying mutual fund.[41]
- The proposed amendments to Forms N–4 and N–6 would require disclosure with respect to whether the separate account or its depositor has policies and procedures with respect to frequent transfers of contract value among sub-accounts, rather than whether such policies and procedures have been adopted by the separate account's board of directors. The separate accounts registered on these forms are unit investment trusts, which do not have boards of directors, and the depositor would be responsible for adopting and implementing any policies and procedures.[42] If neither the separate account nor the depositor has any such policies and procedures, the proposals would require that the prospectus include a statement of the specific basis for the view of the depositor that it is appropriate for the separate account and depositor not to have such policies and procedures.[43]
- The proposed amendments to Forms N–3, N–4, and N–6 would require disclosure of the risks that frequent transfers of contract value among sub-accounts may present not only for other contractowners, but also for other persons who have material rights under the contract (including, in the case of Forms N–3 and N–4, participants, annuitants, and beneficiaries, and, in the case of Form N–6, the insured or beneficiary).[44]
- The proposed amendments to Forms N–3, N–4, and N–6 that require disclosure of any arrangements for detecting frequent transfers of contract value among sub-accounts would not explicitly reference arrangements for detecting transfers through intermediaries, such as investment advisers, broker-dealers, transfer agents, and third party administrators.[45] Because the variable annuity and variable life insurance contracts registered on these forms are typically held in the name of the contractowner and not an intermediary, insurance companies generally will not need to enter into any such arrangements with intermediaries in order for the insurance company to be able to detect frequent transfers among sub-accounts. If an insurance company had any such arrangements with intermediaries, however, disclosure of those arrangements would be required.
- The proposed amendments to Forms N–3, N–4, and N–6 would specifically require disclosure concerning any consideration received by the sponsoring insurance company pursuant to any arrangements to permit frequent transfers of contract value.[46]
- A proposed Instruction in Form N–3 clarifies that consideration received pursuant to arrangements to permit frequent transfers of contract value includes any agreement to maintain assets in the registrant or in other investment companies or accounts managed or sponsored by the investment adviser, the insurance company, or any affiliated person of the investment adviser or the insurance company.[47] The parallel proposed Instructions in Forms N–4 and N–6 would include as consideration any agreement to maintain assets in the registrant or in other investment companies or accounts managed or sponsored by any investment adviser of a mutual fund in which a sub-account of the registrant is invested, the sponsoring insurance company, or any affiliated person of such an investment adviser or the insurance company.[48]

We request comment generally on the proposals described above and specifically on the following issues:

- Should we require that mutual funds and insurance company separate accounts make each of the proposed disclosures discussed above? Should we require any additional disclosures?
- Is the prospectus the appropriate location for each of the proposed disclosures? Would all or part of the disclosure be more appropriately located in the SAI, reports to shareholders, Form N–CSR, the registrant's Web site, or another location? Should we permit mutual funds to disclose any of the required information in the separate disclosure document referenced in current Item 7(f) of Form N–1A?
- Several Items of Forms N–1A, N–3, N–4, and N–6 (*e.g.*, Items 3, 7(c), and 8(a)(2) of Form N–1A; Items 3 and 8(b)(ii) of Form N–3; Items 3 and 7(b)(ii) of Form N–4; and Items 3 and 6(b)(2) of Form N–6) call for disclosures that are related to the disclosures called for by the proposals. Should we amend any of these other Items or alter the proposals

[36] Proposed Item 7(g) of Form N–1A.

[37] Item 7(f) of Form N–1A.

[38] Proposed Item 8(e) of Form N–3. Form N–3 is used by all insurance company separate accounts offering variable annuity contracts that are registered under the Investment Company Act as management investment companies.

[39] Proposed Item 7(e) of Form N–4. Form N–4 is used by all insurance company separate accounts offering variable annuity contracts that are registered under the Investment Company Act as unit investment trusts. *See* section 4(2) of the Investment Company Act [15 U.S.C. 80a–4(2)] (defining "unit investment trust").

[40] Proposed Item 6(f) of Form N–6. Form N–6 is used by all insurance company separate accounts offering variable life insurance policies that are registered under the Investment Company Act as unit investment trusts.

[41] Increases in the cash values of variable annuity and variable life insurance contracts—known as the "inside buildup"—are tax-deferred until the contract's surrender or maturity. *See* I.R.C. section 7702(g) (1986).

[42] Proposed Item 7(e)(ii) of Form N–4; proposed Item 6(f)(2) of Form N–6.

[43] Proposed Item 7(e)(iii) of Form N–4; proposed Item 6(f)(3) of Form N–6.

[44] Proposed Item 8(e)(i) of Form N–3; proposed Item 7(e)(i) of Form N–4; proposed Item 6(f)(1) of Form N–6.

[45] Proposed Item 8(e)(iv)(D) of Form N–3; proposed Item 7(e)(iv)(D) of Form N–4; proposed Item 6(f)(4)(iv) of Form N–6.

[46] Proposed Item 8(e)(v) of Form N–3; proposed Item 7(e)(v) of Form N–4; proposed Item 6(f)(5) of Form N–6.

[47] Proposed Instruction to Item 8(e)(v) of Form N–3.

[48] Proposed Instruction to Item 7(e)(v) of Form N–4; proposed Instruction to Item 6(f)(5) of Form N–6.

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.

adviser that is in merger or acquisition talks with the fund's current adviser, disclosure to a newly hired investment adviser or sub-adviser prior to commencing its duties, or disclosure to a rating agency for use in developing a rating.

Our proposals would require a mutual fund's SAI to describe the fund's policies and procedures with respect to the disclosure of its portfolio securities.[54] The mutual fund's prospectus would be required to state that a description of its policies and procedures is available in its SAI and, if applicable, on its Web site.[55] The SAI description of the mutual fund's policies and procedures with respect to the disclosure of its portfolio securities would be required to include:

- How the policies and procedures apply to disclosure to different categories of persons, including individual investors, institutional investors, intermediaries that distribute the fund's shares, third-party service providers, rating and ranking organizations, and affiliated persons of the fund;[56]
- Any conditions or restrictions placed on the use of information about portfolio securities that is disclosed, including any requirement that the information be kept confidential or prohibitions on trading based on the information, and any procedures to monitor the use of this information;[57]
- The frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date on which the information is disclosed;[58]
- Any policies and procedures with respect to the receipt of compensation or other consideration by the fund, its investment adviser, or any other party in connection with the disclosure of information about portfolio securities;[59]
- The persons who may authorize disclosure of the fund's portfolio securities;[60]
- The procedures that the fund uses to ensure that disclosure of information about portfolio securities is in the best interests of fund shareholders, including procedures to address conflicts between the interests of fund shareholders, on the one hand, and those of the fund's investment adviser; principal underwriter; or any affiliated person of the fund, its investment adviser, or its principal underwriter, on the other;[61] and
- The manner in which the board of directors exercises oversight of disclosure of the fund's portfolio securities.[62]

A mutual fund's disclosure of its policies and procedures with respect to the disclosure of its portfolio securities would be required to include any policies and procedures of the fund's investment adviser, or any other third party, that the fund uses or that are used on the fund's behalf.[63]

We are also proposing to require a mutual fund to describe in its SAI any ongoing arrangements to make available information about the fund's portfolio securities to any person, including the identity of the persons who receive information pursuant to such arrangements and any compensation or other consideration received by the fund, its investment adviser, or any other party in connection with such arrangements.[64] A proposed instruction would clarify that the consideration required to be disclosed would include 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.[65] As indicated above, however, divulging portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so, and legitimate business purposes generally would not include the receipt of consideration by the fund's investment adviser or its affiliates. With respect to these ongoing arrangements, funds would also be required to describe:

- Any conditions or restrictions placed on the use of information about portfolio securities that is disclosed, including any requirement that the information be kept confidential or prohibitions on trading based on the information, and any procedures to monitor the use of this information;
- The frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date on which the information is disclosed; and
- The persons who may authorize disclosure of the fund's portfolio securities.[66]

We request comment generally on the proposed disclosure requirements regarding disclosure of a fund's portfolio securities and specifically on the following issues:

- Should we require mutual funds and insurance company managed separate accounts to disclose their policies and procedures with respect to the disclosure of portfolio securities to any person? If so, what information should they be required to disclose?
- Are there any types of arrangements that should be excluded from the requirement to disclose ongoing arrangements to make available information about portfolio securities, such as arrangements where the information that is disclosed is subject to a confidentiality requirement or a prohibition on trading based on the information?
- What is the appropriate location for any disclosure about a mutual fund's or separate account's disclosure of its portfolio securities (*e.g.*, prospectus,

[54] Proposed Item 12(f)(1) of Form N–1A; proposed Item 19(e)(i) of Form N–3.

[55] Proposed Item 4(d) of Form N–1A; proposed Item 5(f) of Form N–3.

[56] Proposed Item 12(f)(1)(i) of Form N–1A. With respect to managed separate accounts issuing variable annuity contracts registered on Form N–3, the categories would include contractowners, participants, annuitants, and beneficiaries. Proposed Item 19(e)(i)(A) of Form N–3.

[57] Proposed Item 12(f)(1)(ii) of Form N–1A; proposed Item 19(e)(i)(B) of Form N–3.

[58] Proposed Item 12(f)(1)(iii) of Form N–1A; proposed Item 19(e)(i)(C) of Form N–3.

[59] Proposed Item 12(f)(1)(iv) of Form N–1A. With respect to managed separate accounts issuing variable annuity contracts registered on Form N–3, this description would also be required to include any policies and procedures with respect to the receipt of compensation or other consideration by the sponsoring insurance company. Proposed Item 19(e)(i)(D) of Form N–3.

[60] Proposed Item 12(f)(1)(v) of Form N–1A; proposed Item 19(e)(i)(E) of Form N–3.

[61] Proposed Item 12(f)(1)(vi) of Form N–1A. With respect to managed separate accounts issuing variable annuity contracts registered on Form N–3, this description would be required to include the procedures that are used to ensure that disclosure of information about portfolio securities is in the best interests of contractowners, participants, annuitants, and beneficiaries, including procedures to address conflicts between the interests of such persons, on the one hand, and those of the separate account's investment adviser or principal underwriter; the sponsoring insurance company; or any affiliated person of the separate account, its investment adviser or principal underwriter, or the sponsoring insurance company, on the other. Proposed Item 19(e)(i)(F) of Form N–3.

[62] Proposed Item 12(f)(1)(vii) of Form N–1A; proposed Item 19(e)(i)(G) of Form N–3.

[63] Proposed Instruction to Item 12(f)(1) of Form N–1A; proposed Instruction to Item 19(e)(i) of Form N–3.

[64] Proposed Item 12(f)(2) of Form N–1A. With respect to managed separate accounts issuing variable annuity contracts registered on Form N–3, disclosure of any compensation or other consideration received by the sponsoring insurance company would also be required. Proposed Item 19(e)(ii) of Form N–3.

[65] Proposed Instruction to Item 12(f)(2) of Form N–1A. With respect to managed separate accounts issuing variable annuity contracts registered on Form N–3, the consideration required to be disclosed would also include any agreement to maintain assets in other investment companies or accounts managed or sponsored by the sponsoring insurance company of the registrant or by an affiliated person of such sponsoring insurance company. Proposed Instruction to Item 19(e)(ii) of Form N–3.

[66] Proposed Item 12(f)(2) of Form N–1A; proposed Item 19(e)(ii) of Form N–3.

SAI, Form N–CSR, Form 8–K, shareholder reports, Web site, etc.)?

- In addition to disclosing ongoing arrangements, should we require mutual funds and insurance company managed separate accounts to disclose all instances of selective disclosure of portfolio securities? If so, when should this disclosure be required to be made? What facts should be required to be disclosed regarding each such instance of selective disclosure (*e.g.*, the names of persons or entities who receive portfolio holdings information; the terms of the disclosure, including any compensation paid for the information; the reasons why the disclosure is in the best interests of fund shareholders; the terms of any confidentiality agreement)? Should funds be required to disclose whether the board of directors has approved each individual instance of selective disclosure?
- Currently, Regulation FD, which governs the selective disclosure of material non-public information, does not apply to funds, other than closed-end funds.[67] Should Regulation FD apply to mutual funds or managed separate accounts with respect to their disclosure of portfolio holdings or other information?
- Are there any other measures that we should consider to reinforce the obligations of funds and their advisers to comply with their fiduciary duties and to prevent the misuse of material, non-public information, including the selective disclosure of portfolio holdings information?

D. Compliance Date

If we adopt the proposed disclosure requirements, we expect to require all new registration statements and all post-effective amendments to effective registration statements filed on or after the effective date of the amendments to comply with the proposed amendments. The Commission requests comment on this proposed compliance date.

III. General Request for Comments

The Commission requests comment on the amendments proposed in this release, whether any further changes to our rules or forms are necessary or appropriate to implement the objectives of our proposed amendments, and on other matters that might have an effect on the proposals contained in this release.

IV. Paperwork Reduction Act

Certain provisions of the proposed amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501, *et seq.*], and the Commission is submitting the proposed collections of information to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: (1) ''Form N–1A under the Investment Company Act of 1940 and Securities Act of 1933, Registration Statement of Open-End Management Investment Companies'; (2) ''Form N–3—Registration Statement of Separate Accounts Organized as Management Investment Companies''; (3) ''Form N–4—Registration Statement of Separate Accounts Organized as Unit Investment Trusts''; and (4) ''Form N–6 under the Investment Company Act of 1940 and the Securities Act of 1933, Registration Statement of Insurance Company Separate Accounts Registered as Unit Investment Trusts that Offer Variable Life Insurance Policies.'' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Form N–1A (OMB Control No. 3235–0307), Form N–3 (OMB Control No. 3235–0316), Form N–4 (OMB Control No. 3235–0318), and Form N–6 (OMB Control No. 3235–0503) were adopted pursuant to section 8(a) of the Investment Company Act [15 U.S.C. 80a–8(a)] and section 5 of the Securities Act [15 U.S.C. 77e].

We are proposing amendments to Form N–1A to require mutual funds to provide improved disclosure regarding their policies and procedures with respect to frequent purchases and redemptions of fund shares. The proposals also would amend Forms N–3, N–4, and N–6 to require similar disclosure in prospectuses for insurance company separate accounts offering variable insurance contracts, with respect to frequent transfers among sub-accounts. In addition, we are proposing amendments to clarify instructions to Forms N–1A and N–3 to require all mutual funds (other than money market funds) and managed separate accounts that issue variable annuities, to explain in their prospectuses the circumstances under which they will use fair value pricing, and the effects of using fair value pricing.

Finally, we are proposing amendments to Form N–1A to require disclosure regarding mutual funds' policies and procedures with respect to the selective disclosure of their portfolio holdings to any person. We are also proposing parallel amendments to Form N–3 for managed separate accounts that issue variable annuities.

Form N–1A

Form N–1A, including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are open-end funds registering with the Commission. Compliance with the disclosure requirements of Form N–1A is mandatory. Responses to the disclosure requirements are not confidential.

The current hour burden for preparing an initial registration statement on Form N–1A is 809 hours per portfolio. The current annual hour burden for preparing post-effective amendments of Form N–1A is 101 hours per portfolio. The Commission estimates that, on an annual basis, registrants file initial registration statements on Form N–1A covering 483 portfolios, and file post-effective amendments on Form N–1A covering 6,542 portfolios. An additional burden of 1,694 hours for the preparation and filing of initial registration statements and 22,897 hours for the filing of post-effective amendments is expected to result from the Commission's recent proposed rulemaking relating to ''fund of funds'' arrangements.[68] Thus, the Commission estimates that the current total annual hour burden for the preparation and filing of Form N–1A is 1,076,080 hours.[69]

We estimate that the proposed amendments would increase the hour burden per portfolio per filing of an initial registration statement by 10 hours and would increase the hour burden per portfolio per filing of a post-effective amendment to a registration statement by 4 hours. Thus, if the proposed amendments to Form N–1A are adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments to Form N–1A would be 1,107,078 hours ((10 hours × 483 portfolios) + (4 hours × 6,542 portfolios) + 1,076,080 hours).

Form N–3

Form N–3, including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are separate accounts, organized as management investment

[67] 17 CFR 243.101(b).

[68] *See* Investment Company Act Release No. 26198 (Oct. 2, 2003) (''Fund of Funds Proposing Release'').

[69] This estimate is based on the following calculation: (809 hours × 483 portfolios) + (101 hours × 6,542 portfolios) = 1,051,489 hours. The additional annual hour burden of 24,591 hours (22,897 + 1,694) resulting from the proposed rules described in the Fund of Funds Proposing Release yield a total annual hour burden of 1,076,080 hours.

companies offering variable annuities, registering with the Commission on Form N–3. Compliance with the disclosure requirements of Form N–3 is mandatory. Responses to the disclosure requirements are not confidential.

The current annual hour burden for preparing an initial registration statement on Form N–3 is 915.2 hours per portfolio. The current annual hour burden for preparing post-effective amendments of Form N–3 is 150.4 hours per portfolio. The Commission estimates that, on an annual basis, 3 initial registration statements will be filed on Form N–3 and 38 post-effective amendments will be filed on Form N–3. We estimate that the average number of portfolios per filing is 4, and therefore that annually there are a total of 12 portfolios covered by initial registration statements on Form N–3 and 152 portfolios covered by post-effective amendments on Form N–3. The Fund of Funds Proposing Release would require additional cumulative burdens of 42 hours and 49 hours, respectively. Thus, we estimate that the current total annual hour burden for the preparation and filing of Form N–3 is 33,934 hours.[70]

We estimate that the proposed amendments would increase the hour burden per portfolio per filing of an initial registration statement on Form N–3 by 10 hours and would increase the hour burden per portfolio per filing of a post-effective amendment to a registration statement on Form N–3 by 4 hours. Thus, if the proposed amendments to Form N–3 are adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments on Form N–3 would be 34,662 hours ((10 hours × 12 portfolios) + (4 hours × 152 portfolios) + 33,934 hours).

Form N–4

Form N–4, including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are separate accounts, organized as unit investment trusts that offer variable annuity contracts, registering with the Commission on Form N–4. Compliance with the disclosure requirements of Form N–4 is mandatory. Responses to the disclosure requirements are not confidential.

The current annual hour burden for preparing an initial registration statement on Form N–4 is 273.2 hours per separate account. The current annual hour burden for preparing a post-effective amendment on Form N–4 is 195 hours per separate account. The Commission estimates that annually, 157 initial registration statements are filed on Form N–4 and 1,242 post-effective amendments are filed on Form N–4. The Fund of Funds Proposing Release would require additional cumulative burdens of 39.5 hours and 310.5 hours, respectively. Thus, we estimate that the current total annual hour burden for the preparation and filing of Form N–4 is 285,432 hours.[71]

We estimate that the proposed amendments would increase the hour burden per filing of an initial registration statement on Form N–4 by 5 hours and would increase the hour burden per filing of a post-effective amendment to a registration statement on Form N–4 by 2 hours. Thus, if the proposed amendments to Form N–4 are adopted, the total annual hour burden for separate accounts for preparation and filing of initial registration statements and post-effective amendments on Form N–4 would be 288,701 hours ((5 hours × 157 portfolios) + (2 hours × 1,242 portfolios) + 285,432 hours).

Form N–6

Form N–6, including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are separate accounts, organized as unit investment trusts that offer variable life insurance policies, registering with the Commission on Form N–6. Compliance with the disclosure requirements of Form N–6 is mandatory. Responses to the disclosure requirements are not confidential.

The current annual hour burden for preparing an initial registration statement on a Form N–6 is 765 hours per separate account. The current annual hour burden for preparing a post-effective amendment filed as an annual update on Form N–6 is 65 hours, and the annual hour burden for preparing a post-effective amendment filed for other purposes is 10 hours. The Commission estimates that annually, 50 initial registration statements, 150 post-effective amendments that are annual updates, and 350 additional post-effective amendments are filed on Form N–6. The Fund of Funds Proposing Release would require additional cumulative burdens of 12.5 hours for initial registration statements, and 37.5 hours for annual update post-effective amendments and additional post-effective amendments. Thus, we estimate that the current total annual hour burden for the preparation and filing of Form N–6 is 51,550 hours.[72]

We estimate that the proposed amendments would increase the hour burden per filing of an initial registration statement on Form N–6 by 5 hours, and would increase the hour burden per filing of a post-effective amendment that is an annual update on Form N–6 by 2 hours. Thus, if the proposed amendments to Form N–6 are adopted, the total annual hour burden for separate accounts for preparation and filing of initial registration statements and post-effective amendments on Form N–6 would be 52,100 hours ((5 hours × 50 portfolios) + (2 hours × 150 portfolios) + 51,550 hours).

Request for Comments

We request your comments on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549–0609, with reference to File No. S7–26–03. OMB is required to make a decision concerning

[70] This estimate is based on the following calculation: (915.2 hours × 12 portfolios) + (150.4 hours × 152 portfolios) + (42 hours + 49 hours) = 33,934.2 hours.

[71] This estimate is based on the following calculation: (273.2 hours × 157 separate accounts) + (195 hours × 1,242 separate accounts) + (39.5 hours + 310.5 hours) = 285,432.4 hours.

[72] This estimate is based on the following calculation: (765 hours × 50 initial registration statements) + (65 hours × 150 annual update post-effective amendments) + (10 hours × 350 additional post-effective amendments) + (12.5 hours + 37.5 hours) = 51,550 hours.

the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release.

V. Cost/Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. Our proposals would require mutual funds to provide enhanced disclosure about their policies and procedures with respect to frequent purchases and redemptions of fund shares. Specifically, the proposals would:

• Require a mutual fund to describe in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders;

• Require a mutual fund to state in its prospectus whether or not the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares and, if the board has not adopted any such policies and procedures, state the specific basis for the view of the board that it is appropriate for the fund not to have such policies and procedures;

• Require a mutual fund to describe any policies and procedures for deterring frequent purchases and redemptions of fund shares, and any arrangements to permit frequent purchases and redemptions of fund shares; and

• Require similar disclosure in prospectuses for insurance company separate accounts offering variable insurance contracts, with respect to frequent transfers among sub-accounts.

The Commission is also proposing amendments to clarify instructions to our registration forms for mutual funds and insurance company managed separate accounts that offer variable annuities to require that all such funds (other than money market funds) explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing.

In addition, our proposals would require mutual funds, and insurance company managed separate accounts that offer variable annuities, to disclose their policies with respect to the disclosure of portfolio holdings information. The proposals would:

• Require a fund to describe in its SAI any policies and procedures with respect to the disclosure of the fund's portfolio securities to any person and any ongoing arrangements to make available information about the fund's portfolio securities to any person; and

• Require a fund to state in its prospectus that a description of the policies and procedures is available in the fund's SAI, and on the fund's Web site, if applicable.

A. Benefits

The proposed form amendments will benefit fund investors by providing them with more detailed information about mutual fund practices relating to frequent purchases and redemptions of fund shares (or, in the case of insurance company separate accounts offering variable insurance products, frequent transfers of contract value among sub-accounts). These proposals are intended to require mutual funds and insurance company separate accounts to describe with specificity the restrictions they place on frequent purchases and redemptions (or frequent transfers among sub-accounts), if any, and the circumstances under which a restriction will not apply. Market timing arbitrage strategies often involve such frequent purchases and redemptions of mutual fund shares or frequent transfers among sub-accounts of insurance company separate accounts. By increasing transparency of funds' policies and procedures in this area, the proposals are designed to help restore investor confidence in the fairness of fund operations and in the practices and procedures of intermediaries selling fund shares. This additional disclosure would enable investors to assess funds' risks, policies, and procedures in this area and determine if a fund's policies and procedures are in line with the investor's expectations. In addition, these proposed amendments may benefit fund shareholders by deterring decisions relating to portfolio management that are motivated by considerations of the interests of the fund or the fund's adviser rather than the interests of fund shareholders.

The proposed amendments to Forms N–1A and N–3 relating to fair value pricing also will benefit investors by clarifying that all mutual funds and managed separate accounts that offer variable annuities, other than money market funds, are required to explain both the circumstances under which they will use fair value pricing and the effects of using such pricing. These amendments would 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). Fair valuation of a fund's portfolio securities, which is required under certain circumstances, can serve to foreclose arbitrage opportunities available to market timers.

Similarly, the proposed amendments to Forms N–1A and N–3 relating to funds' policies and procedures with respect to the selective disclosure of portfolio holdings information may benefit investors by providing greater transparency of fund practices relating to the disclosure of the fund's portfolio holdings, and reinforcing funds' and advisers' obligations to prevent the misuse of material, non-public information. We have no means by which to quantify these benefits, however.

We seek comment on the benefits of the proposed amendments (and any alternatives suggested by commenters) as well as any data quantifying those benefits.

B. Costs

The proposals would impose new requirements on mutual funds to provide disclosure of their policies and procedures with respect to frequent purchases and redemptions of fund shares (or frequent transfers of contract value among sub-accounts, in the case of insurance company separate accounts offering variable insurance contracts), and selective disclosure of portfolio holdings information. We estimate that complying with the proposed new disclosure requirements would entail a relatively small financial burden. The information regarding a fund's policies and procedures in these areas should be readily available to management and the board of directors of a fund. Therefore, we expect that the cost of compiling and reporting this information should be limited.

Our proposals would require additional disclosure by a mutual fund in its prospectus regarding its policies and procedures relating to frequent purchases and redemptions by fund shareholders and additional disclosure by an insurance company separate account that issues variable insurance products in its prospectus regarding its policies and procedures relating to frequent transfers among sub-accounts. In addition, we are proposing to require each mutual fund and insurance company managed separate account to describe in its SAI any policies and procedures regarding the disclosure of the fund's portfolio holdings information, and to state in its prospectus that a description of those policies and procedures is available in the fund's SAI.[73] These costs may include both internal costs (for attorneys

[73] The proposed amendments that would clarify mutual funds' and insurance company managed separate accounts' disclosure requirements with respect to fair value pricing are not expected to result in any significant costs.

and other non-legal staff of a fund, such as computer programmers, to prepare and review the required disclosure) and external costs (for printing and typesetting of the disclosure).[74] For purposes of the Paperwork Reduction Act, we have estimated that the proposed new disclosure requirements would add 35,545 hours to the burden of completing Forms N–1A, N–3, N–4, and N–6.[75] We estimate that this additional burden would equal total internal costs of $1,608,411 annually, or approximately $423 per fund.[76]

The external costs of providing the new prospectus disclosure relating to frequent purchases and redemptions of mutual fund shares and frequent transfers among sub-accounts of insurance company separate accounts may or may not be significant, depending on the complexity of a fund's policies and procedures in these areas, the extent to which restrictions on frequent purchases and redemptions or transfers among sub-accounts apply uniformly in all cases or will not be imposed under certain circumstances, and the extent to which a fund currently provides specific disclosure in this area. We expect that the external costs of providing the new disclosure relating to each mutual fund's and insurance company managed separate account's policies and procedures with respect to disclosure of portfolio holdings information would be minimal, because the required description of a fund's policies and procedures with respect to the disclosure of the fund's portfolio securities to any person and any ongoing arrangements to make available information about the fund's portfolio securities will be required in the fund's SAI, which is delivered to investors upon request.[77]

We request comment on the nature and magnitude of our estimates of the costs of the additional disclosure that would be required if our proposals were adopted.

C. Request for Comments

We request comments on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of, or suggested alternatives to, the proposed amendments. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VI. Consideration of Effects on Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act [15 U.S.C. 80a–2(c)] and section 2(b) of the Securities Act [15 U.S.C. 77(b)] require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

The proposed amendments are intended to provide greater transparency for mutual fund shareholders regarding a fund's policies and procedures with respect to frequent purchases and redemptions of fund shares (or frequent transfers of contract value among sub-accounts, in the case of insurance company separate accounts offering variable insurance contracts), and selective disclosure of portfolio holdings information. These changes may improve efficiency. The enhanced disclosure requirements are intended to enable shareholders to make a more informed assessment as to whether a particular fund is in line with shareholders' investment objectives, which could promote more efficient allocation of investments by investors and more efficient allocation of assets among competing funds. The proposed amendments may also improve competition, as enhanced disclosure may prompt funds to compete to provide investors with policies and procedures that effectively protect long-term investors from harmful market timing, and from the misuse of portfolio holdings information through selective disclosure. Finally, the effects of the proposed amendments on capital formation are unclear.

Although, as noted above, we believe that the proposed amendments would benefit investors, the magnitude of the effect of the proposed amendments on efficiency, competition, and capital formation, and the extent to which they would be offset by the costs of the proposals, are difficult to quantify. We note that, with respect to our proposals regarding funds' policies and procedures with respect to frequent purchases and redemptions (or frequent transfers among sub-accounts), in many cases funds currently provide disclosure in their prospectuses or elsewhere of the limitations that they place on frequent trading in order to discourage market timing.

We request comment on whether the proposed amendments, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

VII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis (''Analysis'') has been prepared in accordance with 5 U.S.C. 603, and relates to the Commission's proposed form amendments under the Securities Act and the Investment Company Act to require funds to provide additional disclosure about their policies and procedures with respect to frequent purchases and redemptions of mutual fund shares (or, with respect to insurance company separate accounts, frequent transfers among sub-accounts) and selective disclosure of fund portfolio holdings to any person. Specifically, the proposals would:

- Require a mutual fund to describe in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders;
- Require a mutual fund to state in its prospectus whether or not the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares and, if the board has not adopted any such policies and procedures, state the specific basis for the view of the board that it is appropriate for the fund not to have such policies and procedures;
- Require a mutual fund to describe any policies and procedures for

[74] We note that, with respect to our proposals regarding mutual funds' policies and procedures with respect to frequent purchases and redemptions and insurance company separate accounts' policies and procedures with respect to frequent transfers among sub-accounts, in many cases funds currently provide disclosure in their prospectuses or elsewhere of the limitations that they place on frequent trading in order to discourage market timing.

[75] This would represent 30,998 additional hours for Form N–1A, 728 additional hours for Form N–3, 3,269 additional hours for Form N–4, and 550 additional hours for Form N–6.

[76] These figures are based on a Commission estimate that approximately 3,800 investment companies would be subject to the proposed amendments and an estimated hourly wage rate of $45.25. The estimate of the number of investment companies is based on data derived from the Commission's EDGAR filing system. The estimated wage figure is based on published compensation for compliance attorneys outside New York City ($37.60) and programmers ($29.44), and the estimate that attorneys and programmers would divide time equally on compliance with the proposed disclosure requirements, yielding a weighted wage rate of $33.52 (($37.60 × .50) + (29.44 × .50)) = $33.52). *See* Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry 2002 (Sept. 2002). This weighted wage rate was then adjusted upward by 35% for overhead, reflecting the costs of supervision, space, and administrative support, to obtain the total per hour internal cost of $45.25 (33.52 × 1.35) = $45.25.

[77] A fund would be required to state in its prospectus that a description of its policies and procedures is available in the fund's SAI, and on the fund's Web site, if applicable.

deterring frequent purchases and redemptions of fund shares, and any arrangements to permit frequent purchases and redemptions of fund shares; and

- Require similar disclosure in prospectuses for insurance company separate accounts offering variable insurance contracts, with respect to frequent transfers among sub-accounts.

The Commission is also proposing amendments to clarify instructions to our registration forms for mutual funds and insurance company managed separate accounts that offer variable annuities to require that all such funds (other than money market funds) explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing.

As noted above, the Commission also is proposing to require mutual funds, and insurance company managed separate accounts that offer variable annuities, to disclose their policies with respect to disclosure of portfolio holdings information. The proposals would:

- Require a fund to describe in its SAI any policies and procedures with respect to the disclosure of the fund's portfolio securities to any person and any ongoing arrangements to make available information about the fund's portfolio securities to any person; and
- Require a fund to state in its prospectus that a description of the policies and procedures is available in the fund's SAI, and on the fund's Web site, if applicable.

A. Reasons for, and Objectives of, Proposed Amendments

Recent allegations regarding late trading, abusive market timing, and other abuses point to instances where it appears that some in the mutual fund industry, and some intermediaries that sell fund shares, have lost sight of their obligations to investors. The proposed amendments include disclosure reforms intended to shed more light on market timing and selective disclosure of portfolio holdings information. The proposals are intended to require mutual funds to describe with specificity the restrictions they place on frequent purchases and redemptions, if any, and the circumstances under which any such restriction will not apply. The proposals would require similar disclosure by insurance company separate accounts that offer variable insurance contracts, with respect to the restrictions, if any, that they place on frequent transfers among sub-accounts. This additional disclosure would enable investors to assess mutual funds' and insurance company separate accounts' risks, policies, and procedures in this area and determine if the policies and procedures are in line with their expectations. The proposed amendments also are intended to provide greater transparency of mutual fund and insurance company managed separate account practices with respect to the disclosure of a fund's portfolio holdings, and to reinforce funds' and advisers' obligations to prevent the misuse of material, non-public information. The proposals are part of a package of rule amendments intended to address abuses that have surfaced in the areas of late trading, market timing, and selective disclosure.

B. Legal Basis

The Commission is proposing amendments to Forms N–1A, N–3, N–4, and N–6 pursuant to authority set forth in sections 5, 6, 7, 10, and 19(a) of the Securities Act [15 U.S.C. 77e, 77f, 77g, 77j, and 77s(a)], and sections 8, 22, 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a–8, 80a–22, 80a–24(a), 80a–29, and 80a–37].

C. Small Entities Subject to the Rule

For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[78] Approximately 145 investment companies registered on Form N–1A meet this definition.[79] We estimate that few, if any, registered separate accounts registered on Form N–3, N–4, or N–6 are small entities.[80]

D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments would require a mutual fund to disclose in its prospectus both the risks to shareholders of the frequent purchase and redemption of fund shares, and the fund's policies and procedures with respect to frequent purchases and redemptions of fund shares. The proposals would require similar prospectus disclosure for insurance company separate accounts issuing variable insurance contracts. The proposed amendments would also clarify that all mutual funds and insurance company managed separate accounts that issue variable annuities, other than money market funds, are required to explain both the circumstances under which they will use fair value pricing, and the effects of using fair value pricing. Finally, the proposals would require mutual funds and insurance company managed separate accounts that issue variable annuities to disclose their policies and procedures with respect to the disclosure of their portfolio securities to any person and any ongoing arrangements to make available information about their portfolio securities.

The Commission estimates some one-time formatting and ongoing costs and burdens that would be imposed on all funds, including funds that are small entities. We note, however, that in many cases funds currently provide disclosure in their prospectuses of the limitations that they place on frequent trading in order to discourage market timing. For purposes of the Paperwork Reduction Act, we have estimated that the proposed new disclosure requirements would increase the hour burden per portfolio per filing of an initial registration statement on Form N–1A by 10 hours and would increase the hour burden per portfolio per filing of a post-effective amendment to a registration statement by 4 hours. We estimate that this additional burden would increase total internal costs of an initial filing by $452.50 per mutual fund portfolio annually, and would increase total costs of filing a post-effective amendment by $181 per mutual fund portfolio annually.[81]

The external costs of providing the new prospectus disclosure relating to frequent purchases and redemptions of mutual fund shares and frequent transfers among sub-accounts of insurance company separate accounts that issue variable insurance contracts may or may not be significant, depending on the complexity of a fund's policies and procedures in these areas, the extent to which restrictions on frequent purchases and redemptions or frequent transfers among sub-accounts apply uniformly in all cases or will not be imposed under certain circumstances, and the extent to which a fund currently provides specific

[78] 17 CFR 270.0–10.

[79] This estimate is based on analysis by the Division of Investment Management staff of information from databases compiled by third-party information providers, including Morningstar, Inc. and Lipper.

[80] This estimate is based on figures compiled by Division of Investment Management staff regarding separate accounts registered on Forms N–3, N–4, and N–6. In determining whether an insurance company separate account is a small entity for purposes of the Regulatory Flexibility Act, the assets of insurance company separate accounts are aggregated with the assets of their sponsoring insurance companies. Rule 0–10(b) under the Investment Company Act [17 CFR 270.0–10(b)].

[81] These figures are based on an estimated hourly wage rate of $45.25. *See supra* note 76.

disclosure in this area. We expect that the external costs of providing the new disclosure relating to a mutual fund's or insurance company managed separate account's policies and procedures with respect to disclosure of portfolio holdings information would be minimal, because the required description of a fund's policies and procedures with respect to the disclosure of the fund's portfolio securities to any person and any ongoing arrangements to make available information about the fund's portfolio securities will be required in the fund's SAI, which is delivered to investors upon request.

The Commission solicits comment on the effect the proposed amendments would have on small entities.

E. Duplicative, Overlapping or Conflicting Federal Rules

There are no rules that duplicate, overlap, or conflict with the proposed amendments.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small issuers. In connection with the proposed amendments, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed amendments for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed amendments, or any part thereof, for small entities.

The Commission believes at the present time that special compliance or reporting requirements for small entities, or an exemption from coverage for small entities, would not be appropriate or consistent with investor protection. The proposed disclosure amendments would provide shareholders with greater transparency of mutual funds' policies and procedures with respect to frequent purchases and redemptions of fund shares (and, with respect to insurance company separate accounts that issue variable insurance contracts, frequent transfers among sub-accounts) and mutual funds' and insurance company managed separate accounts' policies and procedures with respect to selective disclosure of their portfolio holdings. Different disclosure requirements for funds that are small entities may create the risk that the shareholders in these funds would not be as able as investors in larger funds to assess a fund's risks, policies, and procedures with respect to frequent purchases and redemptions of fund shares, as well as a fund's practices with respect to the disclosure of its portfolio holdings. We believe it is important for the disclosure that would be required by the proposed amendments to be provided to shareholders by all funds, not just funds that are not considered small entities.

We have endeavored through the proposed amendments to minimize the regulatory burden on all funds, including small entities, while meeting our regulatory objectives. Small entities should benefit from the Commission's reasoned approach to the proposed amendments to the same degree as other investment companies. Further clarification, consolidation, or simplification of the proposals for funds that are small entities would be inconsistent with the Commission's concern for investor protection. Finally, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection in the present context.

G. Solicitation of Comments

The Commission encourages the submission of written comments with respect to any aspect of this Analysis. Comment is specifically requested on the number of small entities that would be affected by the proposed amendments and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–26–03; this file number should be included on the subject line if e-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549–0102. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (*http://www.sec.gov*).[82]

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Enforcement Fairness Act of 1996,[83] a rule is "major" if it results or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

The Commission requests comment on the potential impact of the proposed amendments on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views.

IX. Statutory Authority

The Commission is proposing amendments to Forms N–1A, N–3, N–4, and N–6 pursuant to authority set forth in sections 5, 6, 7, 10, and 19(a) of the Securities Act [15 U.S.C. 77e, 77f, 77g, 77j, and 77s(a)] and sections 8, 22, 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a–8, 80a–22, 80a–24(a), 80a–29, and 80a–37].

List of Subjects

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

17 CFR Part 274

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule and Form Amendments

For the reasons set out in the preamble, the Commission proposes to amend Title 17, Chapter II, of the Code of Federal Regulations as follows.

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

1. The authority citation for part 239 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u–5, 78w(a), 78*ll*(d), 79e, 79f, 79g, 79j, 79*l*, 79m, 79n, 79q, 79t, 80a–8, 80a–24, 80a–26, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

[82] We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

[83] Pub. L. 104–21, Title II, 110 Stat. 857 (1996).

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

2. The authority citation for part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a–8, 80a–24, 80a–26, and 80a–29, unless otherwise noted.

Note: The text of Forms N–1A, N–3, N–4, and N–6 do not, and these amendments will not, appear in the Code of Federal Regulations.

3. Form N–1A (referenced in §§ 239.15A and 274.11A) is amended by:

a. In Instruction 6 to Item 1(b)(1), revising the reference ''Item 7(f)'' to read ''Item 7(g)'';

b. In Instruction 6 to Item 1(b)(1), revising the reference ''Item 7(f)(3)'' to read ''Item 7(g)(3)'';

c. In Item 4, revising the title and adding new paragraph (d);

d. In Item 7, revising the Instruction to paragraph (a)(1);

e. In Item 7, redesignating paragraphs (e) and (f) as paragraphs (f) and (g), respectively;

f. In Item 7, adding paragraph (e);

g. In newly redesignated Item 7(f)(2)(i), revising the reference ''paragraph (e)(1)'' to read ''paragraph (f)(1)'';

h. In newly redesignated paragraph (g) of Item 7, revising the introductory text;

i. In paragraph (a)(2) of Item 8, revising the reference ''Item 7(f)'' to read ''Item 7(g)''; and

j. In Item 12, adding paragraph (f).

The additions and revisions read as follows:

Form N–1A

* * * * *

Item 4. Investment Objectives, Principal Investment Strategies, Related Risks, and Disclosure of Portfolio Holdings

* * * * *

(d) *Portfolio Holdings.* State that a description of the Fund's policies and procedures with respect to the disclosure of the Fund's portfolio securities is available (i) in the Fund's SAI; and (ii) on the Fund's Web site, if applicable.

* * * * *

Item 7. Shareholder Information

(a) * * *

(1) * * *

Instruction. A Fund (other than a Money Market Fund) must provide a brief explanation of the circumstances under which it will use fair value pricing and the effects of using fair value pricing.

* * * * *

(e) *Frequent Purchases and Redemptions of Fund Shares.*

(1) Describe the risks, if any, that frequent purchases and redemptions of Fund shares by Fund shareholders may present for other shareholders of the Fund.

(2) State whether or not the Fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of Fund shares by Fund shareholders.

(3) If the Fund's board of directors has not adopted any such policies and procedures, provide 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.

(4) If the Fund's board of directors has adopted any such policies and procedures, describe those policies and procedures, including:

(i) Whether or not the Fund discourages frequent purchases and redemptions of Fund shares by Fund shareholders;

(ii) Whether or not the Fund accommodates frequent purchases and redemptions of Fund shares by Fund shareholders;

(iii) Any policies and procedures of the Fund for deterring frequent purchases and redemptions of Fund shares by Fund shareholders, including any restrictions imposed by the Fund to prevent or minimize frequent purchases and redemptions. Describe each of these policies, procedures, and restrictions with specificity. Indicate whether each of these restrictions applies uniformly in all cases or whether the restriction will not be imposed under certain circumstances. Describe with specificity the circumstances under which any restriction will not be imposed. Include a description of the following restrictions, if applicable:

(A) Any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period;

(B) Any exchange fee or redemption fee;

(C) 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;

(D) Any minimum holding period that is imposed before an investor may make exchanges into another Fund;

(E) Any restrictions imposed on exchange or purchase requests submitted by overnight delivery, electronically, or via facsimile or telephone; and

(F) Any right of the Fund to reject, limit, delay, or impose other conditions on exchanges or purchases or to terminate 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; and

(iv) 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.

(5) Describe any arrangements with any person to permit frequent purchases and redemptions of Fund shares, including the identity of the persons permitted to engage in frequent purchases and redemptions pursuant to such arrangements, and any compensation or other consideration received by the Fund, its investment adviser, or any other party pursuant to such arrangements.

Instruction. The consideration required to be disclosed by Item 7(e)(5) 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.

* * * * *

(g) *Separate Disclosure Document.* A Fund may omit from the prospectus information about purchase and redemption procedures required by Items 7(b)–(d) and 8(a)(2), other than information that is also required by Item 7(e), and provide it in a separate document if the Fund:

* * * * *

Item 12. Description of the Fund and Its Investments and Risks

* * * * *

(f) *Disclosure of Portfolio Holdings.*

(1) Describe the Fund's policies and procedures with respect to the disclosure of the Fund's portfolio securities to any person, including:

(i) How the policies and procedures apply to disclosure to different categories of persons, including individual investors, institutional investors, intermediaries that distribute the Fund's shares, third-party service providers, rating and ranking organizations, and affiliated persons of the Fund;

(ii) Any conditions or restrictions placed on the use of information about portfolio securities that is disclosed, including any requirement that the

information be kept confidential or prohibitions on trading based on the information, and any procedures to monitor the use of this information;

(iii) The frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date on which the information is disclosed;

(iv) Any policies and procedures with respect to the receipt of compensation or other consideration by the Fund, its investment adviser, or any other party in connection with the disclosure of information about portfolio securities;

(v) The persons who may authorize disclosure of the Fund's portfolio securities;

(vi) The procedures that the Fund uses to ensure that disclosure of information about portfolio securities is in the best interests of Fund shareholders, including procedures to address conflicts between the interests of Fund shareholders, on the one hand, and those of the Fund's investment adviser; principal underwriter; or any affiliated person of the Fund, its investment adviser, or its principal underwriter, on the other; and

(vii) The manner in which the board of directors exercises oversight of disclosure of the Fund's portfolio securities.

Instruction. Include any policies and procedures of the Fund's investment adviser, or any other third party, that the Fund uses, or that are used on the Fund's behalf, with respect to the disclosure of the Fund's portfolio securities to any person.

(2) Describe any ongoing arrangements to make available information about the Fund's portfolio securities to any person, including the identity of the persons who receive information pursuant to such arrangements. Describe any compensation or other consideration received by the Fund, its investment adviser, or any other party in connection with such arrangements, and provide the information described by paragraphs (f)(1)(ii), (iii), and (v) of Item 12 with respect to such arrangements.

Instruction. The consideration required to be disclosed by Item 12(f)(2) 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.

* * * * *

4. Form N–3 (referenced in §§ 239.17a and 274.11b) is amended by:

a. In Item 5, adding paragraph (f).

b. In Item 8, adding paragraph (e).

c. In Item 11, adding an Instruction to paragraph (c).

d. In Item 19, adding paragraph (e).

The additions read as follows:

Form N–3

* * * * *

Item 5. General Description of Registrant and Insurance Company

* * * * *

(f) State that a description of the Registrant's policies and procedures with respect to the disclosure of the Registrant's portfolio securities is available (A) in the Registrant's Statement of Additional Information; and (B) on the Registrant's Web site, if applicable.

* * * * *

Item 8. General Description of Variable Annuity Contracts

* * * * *

(e)(i) Describe the risks, if any, that frequent transfers of contract value among sub-accounts of the Registrant may present for other contractowners and other persons (*e.g.*, participants, annuitants, or beneficiaries) who have material rights under the variable annuity contracts.

(ii) State whether or not the Registrant's board of managers has adopted policies and procedures with respect to frequent transfers of contract value among sub-accounts of the Registrant.

(iii) If the Registrant's board of managers has not adopted any such policies and procedures, provide a statement of the specific basis for the view of the board that it is appropriate for the Registrant not to have such policies and procedures.

(iv) If the Registrant's board of managers has adopted any such policies and procedures, describe those policies and procedures, including:

(A) Whether or not the Registrant discourages frequent transfers of contract value among sub-accounts of the Registrant;

(B) Whether or not the Registrant accommodates frequent transfers of contract value among sub-accounts of the Registrant;

(C) Any policies and procedures of the Registrant for deterring frequent transfers of contract value among sub-accounts of the Registrant, including any restrictions imposed by the Registrant to prevent or minimize frequent transfers. Describe each of these policies, procedures, and restrictions with specificity. Indicate whether each of these restrictions applies uniformly in all cases or whether the restriction will not be imposed under certain circumstances. Describe with specificity the circumstances under which any restriction will not be imposed. Include a description of the following restrictions, if applicable:

(*1*) Any restrictions on the volume or number of transfers that may be made within a given time period;

(*2*) Any transfer fee;

(*3*) Any costs or administrative or other fees or charges that are imposed on persons deemed to be engaged in frequent transfers of contract value among sub-accounts of the Registrant, together with a description of the circumstances under which such costs, fees, or charges will be imposed;

(*4*) Any minimum holding period that is imposed before a transfer may be made from a sub-account into another sub-account of the Registrant;

(*5*) Any restrictions imposed on transfer requests submitted by overnight delivery, electronically, or via facsimile or telephone; and

(*6*) Any right of the Registrant to reject, limit, delay, or impose other conditions on transfers or to terminate or otherwise limit contracts based on a history of frequent transfers among sub-accounts, including the circumstances under which such right will be exercised; and

(D) Any policies and procedures of the Registrant for detecting frequent transfers of contract value among sub-accounts of the Registrant.

(v) Describe any arrangements with any person to permit frequent transfers of contract value among sub-accounts of the Registrant, including the identity of the persons permitted to engage in frequent transfers pursuant to such arrangements, and any compensation or other consideration received by the Registrant, its investment adviser, the Insurance Company, or any other party pursuant to such arrangements.

Instruction:

The consideration required to be disclosed by Item 8(e)(v) includes any agreement to maintain assets in the Registrant or in other investment companies or accounts managed or sponsored by the investment adviser, the Insurance Company, or any affiliated person of the investment adviser or the Insurance Company.

* * * * *

Item 11. Purchases and Contract Value

* * * * *

(c) * * *

Instruction:

A Registrant (other than a money market fund or sub-account) must provide a brief explanation of the

circumstances under which it will use fair value pricing and the effects of using fair value pricing.

* * * * *

Item 19. Investment Objectives and Policies

* * * * *

(e)(i) Describe the Registrant's policies and procedures with respect to the disclosure of the Registrant's portfolio securities to any person, including:

(A) How the policies and procedures apply to disclosure to different categories of persons, including contractowners, participants, annuitants, beneficiaries, institutional investors, intermediaries that distribute the Registrant's contracts, third-party service providers, rating and ranking organizations, and affiliated persons of the Registrant;

(B) Any conditions or restrictions placed on the use of information about portfolio securities that is disclosed, including any requirement that the information be kept confidential or prohibitions on trading based on the information, and any procedures to monitor the use of this information;

(C) The frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date on which the information is disclosed;

(D) Any policies and procedures with respect to the receipt of compensation or other consideration by the Registrant, its investment adviser, the Insurance Company, or any other party in connection with the disclosure of information about portfolio securities;

(E) The persons who may authorize disclosure of the Registrant's portfolio securities;

(F) The procedures that the Registrant uses to ensure that disclosure of information about portfolio securities is in the best interests of contractowners, participants, annuitants, and beneficiaries, including procedures to address conflicts between the interests of such persons, on the one hand, and those of the Registrant's investment adviser or principal underwriter; the Insurance Company; or any affiliated person of the Registrant, its investment adviser or principal underwriter; or the Insurance Company, on the other; and

(G) The manner in which the board of managers exercises oversight of disclosure of the Registrant's portfolio securities.

Instruction:

Include any policies and procedures of the Registrant's investment adviser, or any other third party, that the Registrant uses, or that are used on the Registrant's behalf, with respect to the disclosure of the Registrant's portfolio securities to any person.

(ii) Describe any ongoing arrangements to make available information about the Registrant's portfolio securities to any person, including the identity of the persons who receive information pursuant to such arrangements. Describe any compensation or other consideration received by the Registrant, its investment adviser, the Insurance Company, or any other party in connection with such arrangements, and provide the information described by paragraphs (e)(i)(B), (C), and (E) of Item 19 with respect to such arrangements.

Instruction:

The consideration required to be disclosed by Item 19(e)(ii) includes any agreement to maintain assets in the Registrant or in other investment companies or accounts managed or sponsored by the investment adviser, the Insurance Company, or any affiliated person of the investment adviser or the Insurance Company.

* * * * *

5. Item 7 of Form N–4 (referenced in §§ 239.17b and 274.11c) is amended by adding paragraph (e), to read as follows:

Form N–4

* * * * *

Item 7. General Description of Variable Annuity Contracts

* * * * *

(e)(i) Describe the risks, if any, that frequent transfers of contract value among sub-accounts of the Registrant may present for other contractowners and other persons (*e.g.*, participants, annuitants, or beneficiaries) who have material rights under the variable annuity contracts.

(ii) State whether or not the Registrant or depositor has policies and procedures with respect to frequent transfers of contract value among sub-accounts of the Registrant.

(iii) If neither the Registrant nor the depositor has any such policies and procedures, provide a statement of the specific basis for the view of the depositor that it is appropriate for the Registrant and depositor not to have such policies and procedures.

(iv) If the Registrant or depositor has any such policies and procedures, describe those policies and procedures, including:

(A) Whether or not the Registrant or depositor discourages frequent transfers of contract value among sub-accounts of the Registrant;

(B) Whether or not the Registrant or depositor accommodates frequent transfers of contract value among sub-accounts of the Registrant;

(C) Any policies and procedures of the Registrant or depositor for deterring frequent transfers of contract value among sub-accounts of the Registrant, including any restrictions imposed by the Registrant or depositor to prevent or minimize frequent transfers. Describe each of these policies, procedures, and restrictions with specificity. Indicate whether each of these restrictions applies uniformly in all cases or whether the restriction will not be imposed under certain circumstances. Describe with specificity the circumstances under which any restriction will not be imposed. Include a description of the following restrictions, if applicable:

(*1*) Any restrictions on the volume or number of transfers that may be made within a given time period;

(*2*) Any transfer fee;

(*3*) Any costs or administrative or other fees or charges that are imposed on persons deemed to be engaged in frequent transfers of contract value among sub-accounts of the Registrant, together with a description of the circumstances under which such costs, fees, or charges will be imposed;

(*4*) Any minimum holding period that is imposed before a transfer may be made from a sub-account into another sub-account of the Registrant;

(*5*) Any restrictions imposed on transfer requests submitted by overnight delivery, electronically, or via facsimile or telephone; and

(*6*) Any right of the Registrant or depositor to reject, limit, delay, or impose other conditions on transfers or to terminate or otherwise limit contracts based on a history of frequent transfers among sub-accounts, including the circumstances under which such right will be exercised; and

(D) Any policies and procedures of the Registrant or depositor for detecting frequent transfers of contract value among sub-accounts of the Registrant.

(v) Describe any arrangements with any person to permit frequent transfers of contract value among sub-accounts of the Registrant, including the identity of the persons permitted to engage in frequent transfers pursuant to such arrangements, and any compensation or other consideration received by the Registrant, the depositor, or any other party pursuant to such arrangements.

Instruction:

The consideration required to be disclosed by Item 7(e)(v) includes any agreement to maintain assets in the Registrant or in other investment companies or accounts managed or sponsored by the depositor, any

investment adviser of a portfolio company, or any affiliated person of the depositor or of any such investment adviser.

* * * * *

6. Item 6 of Form N–6 (referenced in §§ 239.17c and 274.11d) is amended by adding paragraph (f), to read as follows:

Form N–6

* * * * *

Item 6. General Description of Contracts

* * * * *

(f) *Frequent Transfers among Sub-accounts of the Registrant.*

(1) Describe the risks, if any, that frequent transfers of Contract value among sub-accounts of the Registrant may present for other Contractowners and other persons (*e.g.*, the insured or beneficiaries) who have material rights under the Contract.

(2) State whether or not the Registrant or Depositor has policies and procedures with respect to frequent transfers of Contract value among sub-accounts of the Registrant.

(3) If neither the Registrant nor the Depositor has any such policies and procedures, provide a statement of the specific basis for the view of the Depositor that it is appropriate for the Registrant and Depositor not to have such policies and procedures.

(4) If the Registrant or Depositor has any such policies and procedures, describe those policies and procedures, including:

(i) Whether or not the Registrant or Depositor discourages frequent transfers of Contract value among sub-accounts of the Registrant;

(ii) Whether or not the Registrant or Depositor accommodates frequent transfers of Contract value among sub-accounts of the Registrant;

(iii) Any policies and procedures of the Registrant or Depositor for deterring frequent transfers of Contract value among sub-accounts of the Registrant, including any restrictions imposed by the Registrant or Depositor to prevent or minimize frequent transfers. Describe each of these policies, procedures, and restrictions with specificity. Indicate whether each of these restrictions applies uniformly in all cases or whether the restriction will not be imposed under certain circumstances. Describe with specificity the circumstances under which any restriction will not be imposed. Include a description of the following restrictions, if applicable:

(A) Any restrictions on the volume or number of transfers that may be made within a given time period;

(B) Any transfer fee;

(C) Any costs or administrative or other fees or charges that are imposed on persons deemed to be engaged in frequent transfers of Contract value among sub-accounts of the Registrant, together with a description of the circumstances under which such costs, fees, or charges will be imposed;

(D) Any minimum holding period that is imposed before a transfer may be made from a sub-account into another sub-account of the Registrant;

(E) Any restrictions imposed on transfer requests submitted by overnight delivery, electronically, or via facsimile or telephone; and

(F) Any right of the Registrant or Depositor to reject, limit, delay, or impose other conditions on transfers or to terminate or otherwise limit Contracts based on a history of frequent transfers among sub-accounts, including the circumstances under which such right will be exercised; and

(iv) Any policies and procedures of the Registrant or Depositor for detecting frequent transfers of Contract value among sub-accounts of the Registrant.

(5) Describe any arrangements with any person to permit frequent transfers of Contract value among sub-accounts of the Registrant, including the identity of the persons permitted to engage in frequent transfers pursuant to such arrangements, and any compensation or other consideration received by the Registrant, the Depositor, or any other party pursuant to such arrangements.

Instruction. The consideration required to be disclosed by Item 6(f)(5) includes any agreement to maintain assets in the Registrant or in other investment companies or accounts managed or sponsored by the Depositor, any investment adviser of a Portfolio Company, or any affiliated person of the Depositor or of any such investment adviser.

* * * * *

Dated: December 11, 2003.

By the Commission.

J. Lynn Taylor,

Assistant Secretary.

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