



# Federal Register

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**Thursday,  
January 2, 2003**

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**Part II**

## **Securities and Exchange Commission**

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**17 CFR Parts 210, 239, 249, 270, and 274  
Shareholder Reports and Quarterly  
Portfolio Disclosure of Registered  
Management Investment Companies;  
Proposed Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 210, 239, 249, 270, and 274

[Release Nos. 33-8164; 34-47023; IC-25870; File No. S7-51-02]

RIN 3235-AG64

### Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

**SUMMARY:** The Securities and Exchange Commission is proposing rule and form amendments under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 to improve the periodic disclosure provided by registered management investment companies about their portfolio investments, costs, and past performance. The proposed amendments would permit a registered management investment company to include a summary portfolio schedule of investments in its reports to shareholders, provided that the complete schedule is filed with the Commission and is provided to shareholders upon request, free of charge. The proposals also would require a registered management investment company to include a tabular or graphic presentation of its portfolio holdings in its reports to shareholders. In addition, the proposed amendments would require a registered management investment company to disclose its complete portfolio schedule on a quarterly basis in filings with the Commission that would be available on the Commission's Electronic Data Gathering, Analysis, and Retrieval System. The proposed amendments also would require a registered open-end management investment company to include in its shareholder reports disclosure of fund expenses borne by shareholders during the reporting period. Finally, the proposals would require a registered open-end management investment company to include Management's Discussion of Fund Performance in its annual report to shareholders.

**DATES:** Comments must be received on or before February 14, 2003.

**ADDRESSES:** To help us process and review your comments more efficiently, comments should be sent by hard copy or electronic mail, but not by both methods.

Comments sent by hard copy 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](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-51-02; 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>).<sup>1</sup>

**FOR FURTHER INFORMATION CONTACT:** David S. Schwartz, Senior Counsel, or Paul G. Cellupica, Assistant Director, 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 (the "Commission") is proposing for comment new rule 30b1-4 (17 CFR 270.30b1-4) and new Form N-Q (17 CFR 274.129) under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) ("Investment Company Act"); amendments to Forms N-1A (17 CFR 239.15A; 17 CFR 274.11A), N-2 (17 CFR 239.14; 17 CFR 274.11a-1), and N-3 (17 CFR 239.17; 17 CFR 274.11b) under the Investment Company Act and the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) ("Securities Act"); amendments to proposed Form N-CSR (17 CFR 249.33; 17 CFR 274.128) under the Investment Company Act and the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) ("Exchange Act"); and amendments to Article 6 (17 CFR 210.6) and Article 12 (17 CFR 210.12) of Regulation S-X (17 CFR 210).

### Executive Summary

We are proposing rule and form amendments that would:

[sbull] Permit a management investment company registered under the Investment Company Act ("fund") to include a summary portfolio schedule in its reports to shareholders, provided that the complete portfolio schedule is filed with the Commission on proposed Form N-CSR semi-annually and is

<sup>1</sup> 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.

provided to shareholders upon request, free of charge;<sup>2</sup>

[sbull] Exempt money market funds from including a portfolio schedule in reports to shareholders, provided that this information is filed with the Commission on proposed Form N-CSR and is provided to shareholders upon request, free of charge;

[sbull] Require reports to shareholders by funds to include a tabular or graphic presentation of a fund's portfolio holdings by identifiable categories;

[sbull] Require a fund to file its complete portfolio schedule as of the end of its first and third fiscal quarters with the Commission on new proposed Form N-Q;

[sbull] Require open-end management investment companies ("mutual funds") to disclose fund expenses borne by shareholders during the reporting period in reports to shareholders; and

[sbull] Require a mutual fund to include Management's Discussion of Fund Performance in its annual report to shareholders.<sup>3</sup>

These proposed amendments are intended to provide better information to investors about fund investments, costs, and performance.

### I. Background

The Investment Company Act and rules thereunder require each fund to

<sup>2</sup> 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, section 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. A closed-end company is any management company other than an open-end company. See Section 5 of the Investment Company Act (15 U.S.C. 80a-5). Open-end companies ("mutual funds") generally offer and sell new shares to the public on a continuous basis, while closed-end companies generally engage in traditional underwritten offerings of a fixed number of shares and in most cases do not offer their shares to the public on a continuous basis.

Proposed Form N-CSR would be used by registered management investment companies to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002. See Investment Company Act Release No. 25723 (Aug. 30, 2002) (67 FR 57298 (Sept. 9, 2002)); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002). The Commission proposed amendments to Form N-CSR in Investment Company Act Release No. 25739 (Sept. 20, 2002) (67 FR 60828 (Sept. 26, 2002)); Investment Company Act Release No. 25775 (Oct. 22, 2002) (67 FR 66208 (Oct. 30, 2002)); Investment Company Act Release No. 25838 (Dec. 2, 2002) (67 FR 76780 (Dec. 13, 2002)); and Investment Company Act Release No. 25845 (Dec. 10, 2002).

<sup>3</sup> Item 5 of Form N-1A.

transmit a report to its shareholders semi-annually, within 60 days of the end of the period for which the shareholder report is made, and to file the report with the Commission no later than 10 days after it is transmitted to shareholders.<sup>4</sup> Reports to shareholders currently are required to contain financial statements and other financial information,<sup>5</sup> as well as information about the fund's officers and directors.<sup>6</sup> Annual reports to shareholders of mutual funds typically also contain Management's Discussion of Fund Performance ("MDFP"), although they are not required to do so.<sup>7</sup> MDFP includes narrative disclosure of the factors that materially affected the fund's performance during the fiscal year, a line graph comparing the fund's performance over 10 years to that of an appropriate broad-based market index, and a table of the fund's average annual total returns for 1-, 5-, and 10-year periods.

Shareholder reports are one of the principal means by which funds provide periodic information to their investors. Fund shareholder reports historically have served primarily as a vehicle to provide financial statements and other financial information to shareholders.<sup>8</sup> We believe that, with

<sup>4</sup> See Section 30(e) of the Investment Company Act (15 U.S.C. 80a-29(e)); Rule 30e-1 under the Investment Company Act (17 CFR 270.30e-1) (transmission of report to shareholders); Section 30(b)(2) of the Investment Company Act (15 U.S.C. 80a-30(b)(2)); Rule 30b2-1 under the Investment Company Act (17 CFR 270.30b2-1) (filing of shareholder report with the Commission); proposed Form N-CSR (proposed Form to be used by registered management investment companies to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002).

<sup>5</sup> See Item 22(b)(1), (b)(2), (c)(1), and (c)(2) of Form N-1A (registration statement of open-end management investment companies); Instructions 4.a, 4.b, 5.a, and 5.b to Item 23 of Form N-2 (registration statement of closed-end management investment companies); Instructions 4(i), 4(ii), 5(i), and 5(ii) to Item 27(a) of Form N-3 (registration statement of separate accounts organized as management investment companies that offer variable annuity contracts).

<sup>6</sup> Items 13(a)(1) and 22(b)(5) of Form N-1A; Item 18.1 and Instruction 4.e to Item 23 of Form N-2; Item 20(a) and Instruction 4(v) to Item 27(a) of Form N-3.

<sup>7</sup> Item 5 of Form N-1A (MDFP required in prospectus unless included in annual report to shareholders).

<sup>8</sup> Section 30(e) of the Investment Company Act (15 U.S.C. 80a-29(e)) (requiring a fund 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); National Securities Markets Improvement Act of 1996, Pub. L. 104-290, Section 207, 110 Stat. 3416, 3430 (Oct. 11, 1996) (adding Section 30(f) to the Investment Company Act, which allows the Commission to require that semi-annual reports "include such other information as the Commission deems necessary or appropriate in

some modifications, fund shareholder reports could become a more effective vehicle for communicating information to investors. Today's proposals principally address disclosure of fund portfolio holdings and expenses, two significant areas for improvement that have been identified by investor groups, members of the fund industry, and others.

#### A. Disclosure of Fund Portfolio Holdings

Currently, funds are required to include their complete portfolio holdings in the reports that are delivered to all shareholders twice a year.<sup>9</sup> Investor groups, members of the fund industry, and others have suggested ways in which this current disclosure regime could be improved, both by making the portfolio schedule that is required to be delivered to investors more streamlined, useful, and understandable and by increasing the frequency with which funds disclose their entire portfolio holdings.

First, some have argued that permitting funds to include a summary portfolio schedule in lieu of a complete portfolio schedule in their shareholder reports would simplify those reports, enable investors to focus on a fund's principal holdings, and thereby better evaluate the fund's risk profile and investment strategy.<sup>10</sup> At the same time, the fund's full portfolio schedule could remain available, upon request, to those investors who find this information useful. Because of its size or investment strategy, a fund may hold securities in hundreds, or even thousands, of portfolio companies, which may require as many as 35 or 40 pages to list. For

the public interest or for the protection of investors").

<sup>9</sup> Rule 6-10(c)(1) of Regulation S-X (17 CFR 210.6-10(c)(1)) requires that a portfolio schedule be filed in support of the balance sheet entry for investments in securities of unaffiliated issuers. The form of the portfolio schedule is specified in Rule 12-12 of Regulation S-X (17 CFR 210.12-12). This list of portfolio securities also is required to be included with the financial statements in the Statement of Additional Information ("SAI") of a fund, which is part of the registration statement filed with the Commission under both the Securities Act and the Investment Company Act. See Item 22 of Form N-1A; Item 23 of Form N-2; Item 27(a) of Form N-3.

<sup>10</sup> See Letter from Craig S. Tyle, General Counsel, Investment Company Institute ("ICI"), to Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission ("SEC") (Aug. 11, 1998); Letter from Heidi Stam, Principal, Securities Regulation, The Vanguard Group, to Cynthia Fornelli, Deputy Director, Division of Investment Management, SEC (Oct. 13, 1999); Letter from Robert C. Pozen, General Counsel and Managing Director, Fidelity Investments, to The Honorable Steven Wallman, Commissioner, SEC (May 5, 1995). The letters are available for inspection and copying in File No. S7-51-02 in the Commission's public reference room.

many funds, such as index funds, providing a lengthy portfolio schedule may not contribute significantly to investor understanding regarding the fund's primary investment focus. It may, however, result in significant printing and mailing costs, which are ultimately borne by investors. Similarly, because of the high turnover of portfolio holdings by money market funds, and the fact that money market funds' portfolios are circumscribed by the credit quality, maturity, and portfolio diversification requirements of rule 2a-7 under the Investment Company Act, some have also argued that such funds should be exempt from the requirement to list portfolio holdings in their reports to shareholders.<sup>11</sup>

Advocates of this position have asserted that investors would be better served if fund shareholder reports contained a summary portfolio schedule listing a fund's most significant holdings, coupled with a chart, table, graph, or other graphical presentation breaking down a fund's investments by category. For example, a domestic equity fund might provide a graphical presentation that shows its portfolio investments broken down by industry sector, while a corporate or municipal bond fund might present its holdings broken down by credit quality or maturity.

Second, others have argued that investors would benefit if funds were required to disclose their complete portfolio schedules more frequently than semi-annually. The Commission has received six rulemaking petitions in the past several years that advocate more frequent disclosure of funds' portfolio holdings.<sup>12</sup> The petitioners argue that increasing the frequency of portfolio disclosure by funds will allow investors to better monitor the extent to which their funds' portfolios overlap, and hence will enable investors to make

<sup>11</sup> 17 CFR 270.2a-7. See Letter from Craig S. Tyle, General Counsel, ICI, to Barry P. Barbash, Director, Division of Investment Management, SEC (Aug. 11, 1998) at 2.

<sup>12</sup> See Rulemaking Petition by the International Brotherhood of Teamsters (Jan. 18, 2001) (disclose portfolio holdings monthly); Rulemaking Petition by the American Federation of Labor and the Congress of Industrial Organizations (Dec. 20, 2000) (disclose portfolio holdings monthly); Rulemaking Petition by the National Association of Investors Corporation (Oct. 9, 2000) (disclose portfolio holdings monthly); Rulemaking Petition by the Consumer Federation of America, *et al.* (Aug. 8, 2000) (disclose portfolio holdings monthly and on random days throughout year); Rulemaking Petition by the Financial Planning Association (June 28, 2000) (increase frequency of portfolio holdings disclosure); Rulemaking Petition by Fund Democracy, LLC (June 28, 2000) (disclose portfolio holdings monthly). The petitions are available for inspection and copying in File No. S7-51-02 in the Commission's public reference room.

more informed asset allocation decisions. In addition, the petitioners argue that more frequent disclosure would expose "style drift" (when the actual portfolio holdings of a fund deviate from its stated investment objective) and provide investors with greater information about how a fund is complying with its stated investment objective. The petitioners also argue that more frequent disclosure would help to shed light on and prevent several potential forms of portfolio manipulation. These include "window dressing" (buying or selling portfolio securities shortly before the date as of which a fund's holdings are publicly disclosed, in order to convey an impression that the manager has been investing in companies that have had exceptional performance during the reporting period) and "portfolio pumping" (buying shares of stocks the fund already owns on the last day of the reporting period, in order to drive up the price of the stocks and inflate the fund's performance results). Those who seek more frequent portfolio disclosure advocate that this information be made readily available to shareholders, not that the information be separately delivered to each fund shareholder.

### B. Disclosure of Fund Expenses

Potential mutual fund investors receive significant disclosure about fund fees and expenses. Since 1988, the Commission has required the mutual fund prospectus to include a fee table that shows all fees and charges associated with a mutual fund investment as a percentage of net assets.<sup>13</sup> In addition, the Commission has undertaken efforts to educate investors about the significance of the costs that they pay in connection with mutual fund investments. In 1999, for example, the Commission introduced the Mutual Fund Cost Calculator, an Internet-based tool available on the Commission's website that enables investors to compare the costs of owning different funds.<sup>14</sup> In addition, the fund industry has undertaken efforts to educate investors and increase their

awareness and understanding of mutual fund fees.<sup>15</sup>

Despite existing disclosure requirements and educational efforts, the degree to which investors understand mutual fund fees and expenses remains a significant source of concern. Mutual fund fees are of two types, transactional (e.g., sales loads, redemption fees) and ongoing (e.g., asset-based charges such as management fees and 12b-1 fees).<sup>16</sup> While transactional fees are relatively transparent, ongoing fees are less evident because they are deducted from fund assets and are reflected in reduced account balances rather than being separately stated. Significant concerns have been raised regarding the degree to which investors understand the nature and effect of these ongoing fees.<sup>17</sup>

A joint report of the Commission and the Office of the Comptroller of the

<sup>15</sup> See, e.g., ICI, *Frequently Asked Questions About Mutual Fund Fees*, <http://www.ici.org/aboutfunds/bro-mf-fees-faq.htm> (visited Nov. 27, 2002); Fidelity Research & Management, *How to Buy Funds Overview*, <http://www.fidelity.com/products/funds/calculator> (calculator for comparing the impact of fees and expenses from one fund to another) (visited Nov. 29, 2002); The Vanguard Group, *How to Select a Mutual Fund*, <http://www.vanguard.com/VGApp/hnw/FundsCompareCostsIntro?entryPoint=PandA> (calculator showing the impact of mutual fund loads, sales charges, fees, and other expenses on investment returns) (visited Nov. 29, 2002).

<sup>16</sup> A 12b-1 fee is a fee charged by some mutual funds against fund assets to pay for marketing and distribution activities. See Section 12(b) of the Investment Company Act (80 U.S.C. 80a-12(b)); Rule 12b-1 under the Investment Company Act (17 CFR 270.12b-1).

<sup>17</sup> See, e.g., Theo Francis, *Getting the Most From Fund Costs*, Wall Street Journal, Dec. 2, 2002, at R1 (discussing the importance of considering fees and expenses when investing in mutual funds, and explaining how to use the SEC's cost calculator); James Glassman, *A Failing Grade for Mutual Funds*, Washington Post, Dec. 1, 2002, at H1 (discussing importance of differences in expenses to fund returns, and using examples from SEC's cost calculator); Neil Weinberg, *Fund Manager Knows Best; As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs*, Forbes Magazine, Oct. 14, 2002 (84% of investors believe higher expenses result in higher performance); *Investors Need to Bone Up on Bonds and Costs, According to Vanguard/Money Investor Literacy Test*, Press Release, Business Wire, Sept. 25, 2002 (75% of survey respondents could not accurately define fund expense ratio and 64% did not understand the impact of expenses on fund returns); Liz Pulliam Weston, *Fees Making Matters Worse as Funds' Performance Drops*, Chicago Tribune, Jan. 1, 2002, at C5 (some investors are not aware of the impact of fund expenses on returns, while others do not realize that lower-cost alternatives are available); Michelle Singletary, *Are Our Funds Milking Us? Who Can Tell?*, Washington Post, Apr. 4, 1999, at H1 (studies show that a great number of mutual fund investors do not understand what funds are costing them); Charles Gasparino, *Go Figure; Investors Should Take a Close Look at the Fees Their Funds Are Charging*, Chicago Tribune, Sept. 15, 1998, at C1 (investors often do not realize how fees affect their fund's performance).

Currency, for example, found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns.<sup>18</sup> These ongoing fees can have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years.

In an important contribution to the public dialogue on fund fees, the United States General Accounting Office ("GAO") issued a report in 2000, prepared pursuant to a request by Representative Michael G. Oxley, then Chairman of the Subcommittee on Finance and Hazardous Materials, House Committee on Commerce, and Representative John D. Dingell, Ranking Member of the Committee on Commerce, that analyzed mutual fund fees and the market forces that influence those fees.<sup>19</sup> The report's principal conclusion was that additional disclosure could help to increase investor awareness and understanding of mutual fund fees and, thereby, promote additional competition among funds on the basis of fees.<sup>20</sup> The GAO Report asserted that although mutual funds do not provide individual shareholders with information on the specific dollar amount of fees paid on their account statements, most other financial products and services (e.g., bank deposit accounts, stock or bond transactions through a securities broker) are required to make such disclosures, and that these disclosures may be one reason for the apparently vigorous price competition among firms offering these other products and services.<sup>21</sup> The GAO Report therefore recommended that the Commission require funds to provide each investor with an exact dollar figure for fees paid in each quarterly account statement. However, the GAO Report acknowledged the potential costs associated with accounting for, and reporting, costs on an individual basis and encouraged the Commission to consider the cost and burden that various alternative means of making such disclosures would impose on the industry and investors. The GAO specifically discussed less costly alternatives, including providing the dollar amount of fees paid for preset

<sup>18</sup> Securities and Exchange Commission and Office of the Comptroller of the Currency, *Report on the OCC/SEC Survey of Mutual Fund Investors* (June 26, 1996).

<sup>19</sup> GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* (June 7, 2000) ("GAO Report").

<sup>20</sup> *Id.* at 97-98.

<sup>21</sup> *Id.* at 70-72.

<sup>13</sup> Item 3 of Form N-1A; Investment Company Act Release No. 16244 (Feb. 1, 1988) (53 FR 3192 (Feb. 4, 1988)) (release adopting mutual fund fee table); Investment Company Act Release No. 15932 (Aug. 18, 1987) (52 FR 32018 (Aug. 25, 1987)) (release proposing mutual fund fee table).

<sup>14</sup> *Mutual Fund Cost Calculator* (last modified Sept. 6, 2000), <http://www.sec.gov/mfcc-int.htm>. See also *Invest Wisely: An Introduction to Mutual Funds* (last modified Apr. 4, 2001), <http://www.sec.gov/investor/pubs/inwsmf.htm> (investor brochure describing types of mutual fund fees and expenses).

investment amounts, such as \$1,000, which investors could use to estimate the amount that they paid on their own accounts.

In December 2000, the Commission staff issued a report on mutual fund fees and expenses ("Commission Staff Report"), which considered, among other issues, the recommendations in the GAO Report, and concluded that disclosure of the dollar amount of fees paid for a preset investment amount would likely have the most favorable trade-off between costs and benefits.<sup>22</sup> The Commission Staff Report recommended requiring mutual funds to include in shareholder reports the cost in dollars associated with an investment of \$10,000 that earned the fund's actual return for the period and incurred the fund's actual expenses for the period. Coupled with an investor's average account balance over the period, this would permit an individual investor to estimate the dollar costs that he or she incurred during the period. The staff also recommended that mutual funds disclose the cost in dollars, based on the fund's actual expenses, associated with an investment of \$10,000 that earned a standardized return (e.g., 5%) for the period. This would permit investors to compare the relative magnitudes of the ongoing costs of different funds.

Today's proposals address these important issues. They are intended to improve the information disclosed to investors about a fund's investments, by enhancing and streamlining the information provided in reports to shareholders about a fund's portfolio holdings and by requiring funds to disclose their portfolio holdings quarterly rather than semi-annually. In addition, our proposals are targeted at heightening investors' understanding of ongoing fund fees and expenses.

## II. Discussion

### A. Disclosure of Portfolio Holdings

The Commission is proposing rule and form amendments that would: (1) Permit a fund to include a summary portfolio schedule in its reports to shareholders, provided that the complete portfolio schedule is filed with the Commission semi-annually on proposed Form N-CSR and is provided to shareholders upon request, free of charge; (2) exempt money market funds from including a portfolio schedule in reports to shareholders, provided that this information is filed with the Commission on proposed Form N-CSR and is provided to shareholders upon

request, free of charge; (3) require reports to shareholders to include a tabular or graphic presentation of a fund's portfolio holdings by identifiable category; and (4) require a fund to file its complete portfolio schedule as of the end of its first and third fiscal quarters with the Commission on new proposed Form N-Q. Together, these proposals would replace a one-size-fits-all approach to portfolio holdings disclosure, where all funds deliver their full portfolio schedules to all their shareholders twice a year, with a "layered" approach that would make more information available while permitting funds to tailor their shareholder reports to their particular circumstances and investors to tailor the amount of information they receive to meet their particular needs.<sup>23</sup> This "layered" approach is intended to result in the availability of enhanced portfolio information at reduced cost.

#### 1. Summary Portfolio Schedule

We are proposing to permit funds to include in their reports to shareholders a summary portfolio schedule, in lieu of a complete portfolio schedule. The complete portfolio schedule would, however, continue to be available, free of charge, to those investors who are interested in this more detailed information. Our proposal is intended to address concerns that the current requirement for a fund to include in its shareholder reports a schedule that lists all investments held by the fund results, in many cases, in long lists of securities that do not provide meaningful information to most investors, and in substantial printing and mailing costs that are borne by fund investors.<sup>24</sup> Permitting funds to provide a summary portfolio schedule in lieu of a complete portfolio schedule in required reports to shareholders could streamline these reports and help investors to focus on a fund's principal holdings, and thereby

<sup>23</sup> Cf. Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Securities Act Release No. 8144 (Nov. 4, 2002) [67 FR 68054, 68063 (Nov. 8, 2002)] (separate disclosure required in Management's Discussion and Analysis ("MD&A") with respect to off-balance sheet arrangements would layer the MD&A, which would enable investors with varying levels of interest and financial acumen to easily obtain desired information); Chairman Harvey L. Pitt, SEC, Remarks before the Investment Company Institute, 2002 General Membership Meeting (May 24, 2002) (producing and disclosing financial information in layers benefits investors by yielding clear and concise financial statements that allow readers to explore whatever layer of detail they wish).

<sup>24</sup> See text accompanying note 10, *supra*.

better evaluate the fund's risk profile and investment strategy.

Our proposed amendments to Regulation S-X would permit a fund to include in its reports to shareholders a summary portfolio schedule, *Schedule VI—Summary schedule of investments in securities of unaffiliated issuers*, in lieu of the full schedule contained in *Schedule I—Investments in securities of unaffiliated issuers*.<sup>25</sup> The proposed summary portfolio schedule would include—in order of descending value—each of the fund's 50 largest holdings in unaffiliated issuers and each investment that exceeds one percent of the fund's net asset value. For purposes of determining whether the value of a security exceeds one percent of net asset value, a fund would be required to aggregate and treat as a single issue all securities of any one issuer. However, each issue would be required to be listed separately in the schedule, whether or not issued by a single issuer. Restricted securities could not be combined with unrestricted securities of the same issuer.<sup>26</sup> All securities not separately listed in the summary schedule would be required to be listed in a category labeled "Other Securities."<sup>27</sup> Funds would continue to be required to include in their reports to shareholders the other schedules currently required by Regulation S-X.<sup>28</sup>

We are recommending that the summary portfolio schedule include the fund's 50 largest holdings and each investment that exceeds one percent of net assets, because we believe that this would result in inclusion of the most significant portfolio holdings information in shareholder reports.<sup>29</sup>

<sup>25</sup> Schedule I of Regulation S-X (17 CFR 210.12–12); proposed Schedule VI of Regulation S-X (17 CFR 210.12–12C); proposed rule 6–10(c)(2) of Regulation S-X (17 CFR 210.6–10(c)(2)); proposed Instruction 1 to Item 21(b)(1) and Instruction to Item 21(c)(1) of Form N-1A; proposed Instructions 4.a., 5.a., and 7 to Item 23 of Form N-2; proposed Instructions 4.(i), 5.(i), and 7 to Item 27(a) of Form N-3.

<sup>26</sup> Proposed Note 1 to Schedule VI.

<sup>27</sup> Proposed Note 2 to Schedule VI.

<sup>28</sup> In addition to *Schedule I—Instruments in securities of unaffiliated issuers*, Article 6–10(c) of Regulation S-X (17 CFR 210.6–10(c)) requires the following schedules to be filed: *Schedule II—Investments-other than securities* (17 CFR 210.12–13); *Schedule III—Investments in and advances to affiliates* (17 CFR 210.12–14); *Schedule IV—Investments-securities sold short* (17 CFR 210.12–12A); and *Schedule V—Open option contracts written* (17 CFR 210.12–12B).

<sup>29</sup> Cf. The American Institute of Certified Public Accountants ("AICPA") Audit and Accounting Guide, Audits of Investment Companies section 7.10 (Dec. 2000) (requiring funds to disclose each investment whose fair value constitutes more than one percent of net assets, all investments in any one issuer whose fair values aggregate more than one percent of net assets, and the fifty largest investments).

<sup>22</sup> Division of Investment Management, SEC, Report on Mutual Fund Fees and Expenses (Dec. 2000).

However, we note that if funds were required to disclose a somewhat higher number of securities, such as 150, this could result in a significant majority of funds including their complete schedules in their shareholder reports, while still allowing the minority of funds with lengthy portfolio schedules to limit their portfolio disclosure to two or three printed pages. We estimate that as of October 2002, almost 75% of all funds had portfolio holdings exceeding 50 securities, but only 25% of all funds had portfolio holdings exceeding 150 securities, and fewer than 10% of all funds had portfolio holdings exceeding 350 securities.<sup>30</sup>

The format of our proposed summary portfolio schedule would be similar to that of the complete schedule of investments in unaffiliated issuers currently contained in reports to shareholders. Thus, with respect to each issue required to be listed, the schedule would show (1) the name of the issuer and title of the issue; (2) the balance held at the close of the period (*i.e.*, the number of shares or the principal amount of bonds and notes); and (3) the value of each item at the close of the period.<sup>31</sup> Unlike the complete schedule, however, the summary schedule would also show the percentage value of the issue compared to net assets.<sup>32</sup> The summary schedule would also show the total value of all investments in securities of unaffiliated issuers.<sup>33</sup>

Because the proposed summary portfolio schedule would require investments to be listed in order of descending value, the requirement in the complete portfolio schedule that investments be listed separately by type (*e.g.*, common shares, preferred shares, bonds and notes, time deposits, and put and call options purchased) would be inapplicable.<sup>34</sup> However, the proposals would require each type of instrument to be identified by an appropriate symbol or footnote.<sup>35</sup> As with the current requirements for disclosure of the complete portfolio schedule, the summary schedule would require funds to identify by appropriate symbols each issue of securities that is non-income producing, each issue of securities held in connection with open put or call option contracts or loans for short sales,

and each issue of restricted securities.<sup>36</sup> Short-term debt instruments of the same issuer (with disclosure indicating the range of interest rates and maturity dates), and fully collateralized repurchase agreements (with footnote disclosure indicating the range of dates of the repurchase agreements, the total purchase price of the securities, the total amount to be received upon repurchase, the range of repurchase dates, and a description of the securities subject to the repurchase agreements) would be required to be aggregated and treated as a single issue.<sup>37</sup> As in the current complete schedule, a fund also would be required to state in a footnote to the summary schedule the following amounts based on cost for Federal income tax purposes: (i) Aggregate gross unrealized appreciation for all securities in which there is an excess of value over tax cost; (ii) aggregate gross unrealized depreciation for all securities in which there is an excess of tax cost over value; (iii) net unrealized appreciation and depreciation; and (iv) the aggregate cost of securities for Federal income tax purposes.<sup>38</sup>

To ensure that shareholders have continued access to a complete schedule of the fund's portfolio holdings, any fund that uses a summary portfolio schedule would be required to file its complete portfolio schedule with the Commission on proposed Form N-CSR, which would be available on the Commission's Electronic Data Gathering, Analysis, and Retrieval System ("EDGAR").<sup>39</sup> In addition, any fund that uses a summary portfolio schedule would be required to send its complete schedule of investments in securities of unaffiliated issuers to shareholders upon request within three business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery, and to disclose in its reports to shareholders that this complete portfolio schedule is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the fund's

Web site, if applicable; and (iii) on the Commission's Web site.<sup>40</sup>

We believe that permitting the use of a summary portfolio holdings schedule potentially could enable funds to provide more meaningful information in their annual and semi-annual reports to shareholders, and encourage investors to focus on a fund's most significant holdings in evaluating its risk profile and investment strategy. In addition, the costs of printing and mailing of shareholder reports should be reduced. At the same time, the proposals would require that the fund's complete portfolio schedule continue to be readily available, without charge, to shareholders who are interested in this information, and that the fund provide disclosure in its reports to shareholders of how this information may be obtained. This "layered" disclosure approach is intended to enable investors with varying degrees of interest in a fund's portfolio holdings to easily obtain the desired level of information about the fund. Thus, the proposals attempt to strike a balance that would result in maximum availability of information in a useful format and at minimum cost.

*We request comment on our proposal to permit funds to deliver a summary portfolio schedule in their reports to*

<sup>40</sup> Proposed Instruction 1 to Item 21(b)(1) and proposed Instruction to Item 21(c)(1) of Form N-1A; proposed Instruction 7 to Item 23 of Form N-2; proposed Instruction 7 to Item 27(a) of Form N-3.

A fund may incorporate its financial statements by reference into its registration statement. A fund that includes a summary portfolio schedule in its reports to shareholders, and that chooses to incorporate its financial statements in its Statement of Additional Information ("SAI") by reference, would be expected to incorporate by reference its full portfolio schedule from Form N-CSR, along with the other financial statements and supporting schedules in its annual report to shareholders. See General Instruction D.1.(c) to Form N-1A (permitting incorporation by reference into the SAI generally); proposed General Instruction F to Form N-2 (permitting incorporation by reference of information from Form N-CSR in response to Item 23 ("Financial Statements")); proposed General Instruction G to Form N-3 (permitting incorporation by reference of information from Form N-CSR in response to Item 27 ("Financial Statements")). Such a fund would be required to deliver the full portfolio schedule from Form N-CSR, as well as the shareholder report, upon a shareholder request for the SAI. See Instruction to Item 10(a)(2)(iii) of Form N-1A (requiring any information incorporated by reference into the SAI to be delivered with the SAI unless the information has been previously delivered in a shareholder report and the fund states that the shareholder report is available, without charge, upon request); General Instruction F to Form N-2 (requiring any information incorporated by reference into the SAI to be delivered with the SAI unless the person to whom the SAI is sent or given holds securities of the fund and otherwise has received copies of the material, and fund states that the material is available, without charge, upon request); General Instruction G to Form N-3 (same).

<sup>30</sup> This estimate is based on the Commission staff's analysis of data from the *Morningstar Principia Plus* database (Nov. 2002) (data as of Oct. 2002).

<sup>31</sup> Columns A, B, and C of proposed Schedule VI of Regulation S-X.

<sup>32</sup> Column D of proposed Schedule VI.

<sup>33</sup> Proposed Note 4 to proposed Schedule VI.

<sup>34</sup> Note 2 to Schedule I (17 CFR 210.12-12).

<sup>35</sup> Proposed Note 2 to proposed Schedule VI.

<sup>36</sup> Proposed Notes 3, 5 and 6 to proposed Schedule VI; Notes 5, 6, and 7 to Schedule I (17 CFR 210.12-12).

<sup>37</sup> Proposed Note 2 to proposed Schedule VI.

<sup>38</sup> Proposed Note 7 to proposed Schedule VI; note 8 to Schedule I (17 CFR 210.12-12).

<sup>39</sup> Proposed Item 7 of proposed Form N-CSR. Funds that include the complete portfolio schedule in their shareholder reports would also file this schedule on Form N-CSR, as part of the shareholder report. This schedule must be audited, except in the case of a report on Form N-CSR as of the end of a fiscal half-year. Proposed Instruction to Item 7 of proposed Form N-CSR.

shareholders and specifically on the following issues.

[sbull] Are the proposals to require funds to disclose their 50 largest holdings and holdings accounting for one percent (and greater) of net assets appropriate? Should a smaller or larger number of holdings (e.g., 25, 100, 150, etc.) or a higher or lower percentage threshold (e.g., 0.5%, 2%, etc.) be used?

[sbull] As proposed, securities disclosed in the summary schedule would be identified in order of descending value (largest holding to smallest). Should we adopt a different approach (e.g., listing portfolio securities by identifiable category)?

[sbull] Should we require that a fund have a minimum number of securities to utilize a summary portfolio schedule (e.g., 150 or 250 securities)? If so, should we select a number that is intended to ensure that the majority of funds continue to include their complete schedules of portfolio holdings?

[sbull] Should we allow the use of a summary portfolio schedule with respect to other investments in addition to investments in securities of unaffiliated issuers (e.g., investments in securities sold short, open option contracts written, investments other than securities, and investments in and advances to affiliates)?<sup>41</sup> If so, what modifications to the proposed summary portfolio schedule would be necessary?

[sbull] As proposed, the summary portfolio schedule would require short-term debt instruments of the same issuer, and fully collateralized repurchase agreements, to be aggregated and treated as a single issue. Should aggregation be optional or mandatory? If fully collateralized repurchase agreements are permitted or required to be aggregated, what information about aggregate repurchase agreements of a fund should be required in the summary schedule?

[sbull] Are there any modifications in the format of the proposed summary portfolio schedule that would be appropriate, such as eliminating or revising the requirements to indicate by appropriate symbols non-income producing securities and restricted securities?

[sbull] Should we exempt index funds from the requirement to include their portfolio holdings in their reports to shareholders, as long as the holdings are filed with the Commission and made available to investors upon request and free of charge, on the grounds that

delivery of this information to all shareholders is unnecessary as long as an index fund tracks its designated index? If so, how should we determine whether a fund tracks a designated index sufficiently closely to qualify for this exemption?

[sbull] Should we require a shareholder report covering more than one fund to use the same type of portfolio schedule (summary or complete) for all funds included in the report?

[sbull] Is Form N-CSR the appropriate location for funds that include a summary portfolio schedule in their shareholder reports to disclose their complete portfolio schedules? We have proposed, but not yet adopted, Form N-CSR to implement the certification requirement of section 302 of the Sarbanes-Oxley Act of 2002.<sup>42</sup> If we ultimately do not adopt Form N-CSR to implement the Sarbanes-Oxley Act, should we nevertheless adopt Form N-CSR as a vehicle for a fund to disclose its complete portfolio holdings schedule? If not, how should a fund file its complete portfolio holdings schedule with the Commission?

[sbull] Should a fund that uses a summary portfolio schedule be permitted to provide its complete portfolio schedule to investors exclusively through posting this information on its Web site?

## 2. Exemption of Money Market Funds From Portfolio Schedule Requirements in Shareholder Reports

We are proposing to permit money market funds to omit Schedule I, the schedule of investments in securities of unaffiliated issuers, from their reports to shareholders, provided that they make this schedule available to shareholders upon request and free of charge, and disclose the availability of the schedule in their reports to shareholders.<sup>43</sup> Currently, money market funds, like other funds, are required to include their portfolio schedules in the shareholder reports that are delivered to all investors. The investments of money market funds are, however, circumscribed by the credit quality, maturity, and portfolio diversification requirements of rule 2a-7 under the Investment Company Act.<sup>44</sup> Portfolio holdings schedules of money market funds typically contain a list of short-term government and corporate debt securities that may not assist the average

investor in evaluating the money market fund, or in distinguishing one money market fund from another. Moreover, investors generally treat money market funds as cash investments, and therefore may be less interested in the composition of money market fund portfolios than other types of funds.

Our proposals would require money market funds to file their complete portfolio holdings schedules semi-annually with the Commission on proposed Form N-CSR, however, so that complete information about their portfolios would remain available to interested investors.<sup>45</sup> We also are proposing to require any money market fund that does not include its complete portfolio schedule in its reports to shareholders to disclose in its shareholder reports that its complete schedule of investments in unaffiliated issuers is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the fund's Web site, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>.<sup>46</sup> The proposals also would require a money market fund to send its complete schedule of investments in securities of unaffiliated issuers within three business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery.<sup>47</sup>

*We request comment generally on whether money market funds should be permitted to omit their portfolio schedules from reports to shareholders and specifically on the following issues.*

[sbull] Would the proposed exemption be necessary or appropriate if the Commission permits, as also proposed, all funds to use summary portfolio schedules?

[sbull] Is the information with respect to a money market fund in either a complete or the proposed summary portfolio schedule sufficiently important that it should be delivered to all investors in the fund?

[sbull] Should the exemption for money market funds from the requirement to include a portfolio schedule in its reports to shareholders apply to all of the required schedules, or only the schedule of investments in unaffiliated issuers?<sup>48</sup>

<sup>45</sup> Proposed Item 7 of proposed Form N-CSR.

<sup>46</sup> Proposed Instruction 2 to Item 21(b)(1) and proposed Instruction to Item 21(c)(1) of Form N-1A; proposed Instruction 7 to Item 27(a) of Form N-3.

<sup>47</sup> *Id.*

<sup>48</sup> See *Schedule II—Investments-other than securities* (17 CFR 210.12-13); *Schedule III—Investments in and advances to affiliates* (17 CFR 210.12-14); *Schedule IV—Investments-securities sold short* (17 CFR 210.12-12A); and *Schedule V—Open option contracts written* (17 CFR 210.12-12B).

<sup>41</sup> *Schedule II—Investments-other than securities* (17 CFR 210.12-13); *Schedule III—Investments in and advances to affiliates* (17 CFR 210.12-14); *Schedule IV—Investments-securities sold short* (17 CFR 210.12-12A); and *Schedule V—Open option contracts written* (17 CFR 210.12-12B).

<sup>42</sup> Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002).

<sup>43</sup> 17 CFR 210.12-12. See Proposed Instruction 2 to Item 21(b)(1) and proposed Instruction to Item 21(c)(1) of Form N-1A; proposed Instruction 7(ii) to Item 27(a) of Form N-3.

<sup>44</sup> 17 CFR 270.2a-7.

### 3. Tabular or Graphic Presentation of Portfolio Holdings

We also are proposing to require funds to include in their annual and semi-annual reports to shareholders a presentation using tables, charts, or graphs that depicts a fund's portfolio holdings by reasonably identifiable categories (e.g., industry sector, geographic region, credit quality, or maturity).<sup>49</sup> This presentation would show the percentage of net asset value attributable to each category. We believe that such a presentation could illustrate, in a concise and user-friendly format, the allocation of a fund's investments across asset classes. We believe that this presentation, coupled with a summary portfolio schedule, has the potential to effectively convey to investors key information about a fund's investments. Particularly in the case of a fund with a large number of holdings, the combination of a summary portfolio schedule and a tabular or graphic asset allocation presentation could be significantly more useful to many investors than the fund's complete portfolio schedule standing alone.

Under our proposals, a fund would have the flexibility to determine both the categories to be used (e.g., industry sector, geographic region, credit quality, maturity, etc.) and the format (e.g., tables, charts, graphs, etc.) of the presentation. The categories should be selected, and the format of the presentation designed, to provide the most useful information to investors about the types of investments made by the fund, given its investment objectives. For example, a domestic equity fund could choose to categorize its investments by attributes such as industry sector, market capitalization, or price-earnings ratio. A bond fund could choose to categorize its investments by attributes such as credit quality or maturity or government versus non-government securities.<sup>50</sup> Permitting a fund to determine the most useful means of presenting this portfolio information would allow each fund to tailor the presentation in a manner that is appropriate to its holdings. Further, over time, this flexible approach could enable both funds and the Commission

<sup>49</sup> Proposed Item 21(d)(2) of Form N-1A; proposed Instruction 6.a to Item 23 of Form N-2; proposed Instruction 6(i) to Item 27(a) of Form N-3.

<sup>50</sup> Credit quality would be required to be the ratings grade assigned by a nationally recognized statistical rating organization ("NRSRO"), as that term is used in paragraphs (c)(2)(vi)(E), (F), and (H) of Rule 15c3-1 under the Exchange Act (17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H)). The fund could use ratings of only one NRSRO. Proposed Item 21(d)(2) of Form N-1A; proposed Instruction 6.a to Item 23 of Form N-2; proposed Instruction 6(i) to Item 27(a) of Form N-3.

to determine whether certain types of presentations are more effective for different types of funds.

*We request comment generally on the appropriateness of the proposed tabular or graphic presentation of fund holdings.*

[sbull] Would the proposed presentation be useful to shareholders? Should such a presentation be required or optional?

[sbull] Are there any particular types of funds (e.g., money market funds or index funds) that should be exempt from the requirement to provide the tabular or graphic presentation of fund holdings? On what basis should such categories of funds be exempted?

[sbull] Are there any alternative presentations that should be required for certain types of funds? For example, should an index fund be required to show the extent to which it tracks the designated index ("tracking error")?

[sbull] Would a tabular or graphic presentation be useful for a fund with a small number of holdings or should funds with, e.g., less than 25 or 50 or 100 securities (or some other number) be exempt from this requirement?

[sbull] Should a fund that includes its full portfolio schedule, rather than a summary portfolio schedule, in its shareholder reports be exempt from the tabular or graphic presentation requirement since the full portfolio schedule requires classification of securities according to type of business or type of instrument?<sup>51</sup> Is the tabular or graphic presentation necessary in a shareholder report that contains a summary portfolio schedule, where the holdings would be listed in order of descending value, with percentage of net assets identified?

[sbull] What alternative presentations should we permit funds to use to illustrate the percentage and categories of securities they hold?

[sbull] Should we mandate the format of presentation?

[sbull] Should we mandate identifiable categories of holdings for any or all types of funds (e.g., bond funds—credit quality or maturity; international funds—region, etc.)?

### 4. Quarterly Filing of Complete Portfolio Schedule

We propose to require funds to file their complete portfolio holdings schedules with the Commission on a quarterly basis, rather than semi-annually as currently required. As described above, funds would be required to file their complete portfolio schedules for the second and fourth

<sup>51</sup> Note 2 to *Schedule I—Investments in securities of unaffiliated issuers* (17 CFR 210.12-12).

fiscal quarters on proposed Form N-CSR.<sup>52</sup> In addition, funds would be required to file their portfolio schedules for the first and third fiscal quarters on new Form N-Q under the Investment Company Act, within 60 days of the end of the quarter.<sup>53</sup> Form N-Q would require funds to file the same schedules of investments that are currently required in annual and semi-annual reports to shareholders. These schedules could be unaudited.<sup>54</sup> Form N-Q would be a reporting form required under the Investment Company Act only, unlike proposed Form N-CSR, which is a combined Exchange Act and Investment Company Act form.<sup>55</sup> Form N-Q would be required to be signed by the fund, and on behalf of the fund by its principal financial officer or officers.<sup>56</sup>

Our proposals are intended to provide greater transparency of fund portfolio holdings, without imposing significant costs on funds and, ultimately, their shareholders. The proposals would enable interested investors, through more frequent access to portfolio information, to monitor whether, and how, a fund is complying with its stated investment objective. Given the significant interest in more frequent portfolio information that has been expressed in rulemaking petitions to the Commission by investors groups and others,<sup>57</sup> we believe that it is appropriate to propose more frequent portfolio reporting by funds for public comment at this time. We note, however, that the proposals would only require the *filing* of a fund's portfolio schedule on Form N-Q with the Commission on EDGAR and not actual delivery of that information to shareholders. A fund would be required to include in its annual and semi-annual

<sup>52</sup> Proposed Item 7 of proposed Form N-CSR. See note *supra* and accompanying text.

<sup>53</sup> Proposed Form N-Q; proposed rule 30b1-4 under the Investment Company Act. Small business investment companies ("SBICs") registered with the Commission on Form N-5 would not be required to file Form N-Q. General Instruction A to proposed Form N-Q. Although they are management investment companies, SBICs are not currently required to deliver reports to shareholders containing financial statements, and hence are not required to deliver schedules of investments to their shareholders.

<sup>54</sup> See Proposed Item 1 of proposed Form Q; *Schedule I—Investments in securities of unaffiliated issuers* (17 CFR 210.12-12); *Schedule II—Investments-other than securities* (17 CFR 210.12-13); *Schedule III—Investments in and advances to affiliates* (17 CFR 210.12-14); *Schedule IV—Investments-securities sold short* (17 CFR 210.12-12A); and *Schedule V—Open option contracts written* (17 CFR 210.12-12B).

<sup>55</sup> See Investment Company Act Release No. 25723, *supra* note 2 (proposed form N-CSR).

<sup>56</sup> General Instruction F.2.(a) to Form N-Q.

<sup>57</sup> See *supra* note 12.

reports to shareholders a statement that: (i) The fund files its complete schedule of portfolio holdings with the Commission for the first and third quarters of each fiscal year on Form N-Q; (ii) the fund's Forms N-Q are available on the Commission's Web site at <http://www.sec.gov>; (iii) the fund's Forms N-Q may be reviewed and copied at the Commission's Public Reference Room, and how information on the operation of the Public Reference Room may be obtained; and (iv) if the fund makes the information on Form N-Q available to shareholders on its Web site or upon request, a description of how the information may be obtained from the fund.<sup>58</sup> This proposal is intended to strike an appropriate balance between investors' interest in more frequent portfolio information and the costs associated with disclosing and making that information available to investors, which are ultimately borne by investors.

We are cognizant of concerns raised by some members of the fund industry that mandating more frequent portfolio disclosure would harm fund shareholders by expanding the opportunities for professional traders to exploit this information by engaging in predatory trading practices, such as trading ahead of funds, often called "front-running."<sup>59</sup> They assert that more frequent portfolio disclosure would facilitate the ability of outside investors to "free ride" on a mutual fund's investment strategies, by obtaining for free the benefits of fund research and investment strategies that are paid for by fund shareholders.<sup>60</sup>

At this time, we are not persuaded that these concerns are significant enough to prevent our proposal from being put forward for public comment. We have endeavored to address those concerns by proposing a 60-day delay for the filing of the required additional quarterly disclosure. We believe that a 60-day filing delay would limit the ability of professional traders to engage

in these harmful trading practices. In this regard, we note that a significant majority of funds already make their full portfolio schedules publicly available at least quarterly, apparently without concern about predatory trading practices.<sup>61</sup>

We also note that currently, fund managers and other institutional investment managers exercising investment discretion over \$100 million or more in certain equity securities must disclose information about portfolios that they manage on Form 13F within 45 days of the end of each quarter.<sup>62</sup> Reports on Form 13F disclose a fund manager's aggregate holdings in each security required to be reported; the holdings of each individual mutual fund or other account over which an investment manager has discretion are not broken out separately.<sup>63</sup> To the extent that required quarterly disclosure about a fund's portfolio investments raises concerns about predatory trading practices, these concerns are not new, since fund portfolio holdings have been disclosed on Form 13F, aggregated by investment manager, since 1979.<sup>64</sup>

<sup>61</sup> 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—appdx.html>.

<sup>62</sup> See Section 13(f) of the Exchange Act (15 U.S.C. 78m(f)); Rule 13f-1 under the Exchange Act (17 CFR 240.13f-1). Securities required to be reported on Form 13F include, among other securities, all exchange-traded or NASDAQ-quoted securities. Rule 13f-1 under the Exchange Act (17 CFR 240.13f-1); Section 13(d)(1) of the Exchange Act (15 U.S.C. 78m(d)(1)). Congress enacted Section 13(f) in order to create a central depository of historical and current data about the investment activities of institutional investment managers that would be available to individuals, federal and state regulators, and other institutional investment managers. Report of Senate Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 85 (1975). The dissemination of this data was intended to increase confidence among all investors in the integrity of the securities markets. *Id.* at 82.

<sup>63</sup> See Special Instruction 12 to Form 13F (17 CFR 249.325).

<sup>64</sup> Institutional investment managers may request confidential treatment of information in filings on Form 13F pursuant to Section 13(f)(3) of the Exchange Act (15 U.S.C. 78m(f)(3)), on the basis, among others, that the information would reveal an investment manager's ongoing program of acquisition or disposition. See Report of Senate Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 87 (1975) (describing intended exemption). An application for confidential treatment on this basis must, among other requirements: (a) describe the investment

*We request comment generally on whether more frequent portfolio holdings disclosure should be required and specifically on the following issues.*

[sbull] With regard to the proposed Form N-Q filing requirement, we request public comment on feasible alternatives that minimize the reporting burdens on registered management investment companies. In addition, we request comment on the utility to investors of the reports to the Commission in relation to the costs to registered management investment companies of providing those reports.

[sbull] Are there less burdensome alternatives than requiring quarterly disclosure of a fund's full portfolio schedule of investments, as proposed?

[sbull] What, if any, additional costs would funds incur as a result of filing their complete portfolio holdings schedules with the Commission via EDGAR on a quarterly basis with a 60-day delay?

[sbull] How frequently should funds be required to disclose information about their portfolios? Monthly, quarterly, semi-annually, or some other frequency? In addressing this question, commenters should address both the benefits to investors from more frequent disclosure and the detriments to funds, and their shareholders, from predatory trading practices that could accompany more frequent disclosure.

[sbull] Would a 60-day delay sufficiently discourage or impair the ability of third parties to "front-run" and "free ride" or should the period be longer, e.g., 75 days or 90 days? Would a 30- or 45-day or some other delay sufficiently discourage or impair the ability of third parties to engage in predatory trading practices? Is there any evidence that the current quarterly disclosure required by Form 13F either facilitates or does not facilitate predatory trading practices, such as "front-running"?

[sbull] Shareholder reports are currently required to be filed with the Commission within 70 days of the end of each semi-annual reporting period; reports on Form 13F are required to be filed within 45 days of the end of each quarter; and proposed Form N-Q would

strategy being followed with respect to the relevant securities holdings; (b) explain why public disclosure of the securities would, in fact, be likely to reveal the investment strategy; (c) demonstrate that such revelation of an investment strategy would be premature, and indicate whether the manager was engaged in a program of acquisition or disposition of the security both at the end of the quarter and at the time of the filing; and (d) demonstrate that failure to grant the request for confidential treatment would be likely to cause substantial harm to the manager's competitive position. Instructions for Confidential Treatment Requests, Form 13F (17 CFR 249.325).

<sup>58</sup> Proposed Item 21(d)(3) of Form N-1A; proposed Instruction 6.b. to Item 23 of Form N-2; proposed Instruction 6.(ii) to Item 27(a) of Form N-3.

<sup>59</sup> See Letter from Craig S. Tyle, General Counsel, ICI, to Paul F. Roye, Director, Division of Investment Management, SEC (July 17, 2001), available at <http://www.ici.org/port—holdings—com.html>; Russ Wermers, *The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, ICI Perspective (June 2001), available at <http://www.ici.org/pdf/per07-03.pdf>. (increasing the frequency of portfolio holdings disclosure may increase the likelihood of predatory trading practices, such as "front-running"). These materials are available for inspection and copying in File No. S7-51-02 in the Commission's public reference room.

<sup>60</sup> *Id.*

be required to be filed within 60 days of each semi-annual reporting period. Should the filing periods for these three forms be identical? If so, what period is appropriate, 30 days, 45 days, 60 days, 70 days, or some other period? Are concerns about predatory trading practices more or less significant in the context of disclosure about aggregate holdings in equity securities managed by an institutional investment manager (Form 13F), as opposed to disclosure of the securities in each fund (proposed Form N-Q)?

[sbull] If we extended the time period for filing Form 13F to, for example, 60 days, would there continue to be a need for institutional investment managers to be able to request confidential treatment of filings on Form 13F on the basis of a manager's ongoing investment strategy? Are there other changes that should be made to Form 13F, such as, for example, modifying the \$100 million filing threshold?

[sbull] Would quarterly disclosure of portfolio holdings deter portfolio manipulation, such as "window dressing" and "portfolio pumping?" Are there additional ways to inhibit or curb these practices? For example, should we require the proposed summary portfolio schedule and/or the complete portfolio schedule to identify securities acquired within a designated number of days before the end of the reporting period (e.g., 20 days, 10 days, 5 days, 2 days)?

[sbull] Should Form N-Q require disclosure of less than a fund's complete portfolio schedule (e.g., information comparable to that permitted in the proposed summary portfolio schedule, top 25 holdings, top 10 holdings, etc.)?

[sbull] As proposed, Form N-Q would require quarterly disclosure of all of the schedules of investments required for funds by Regulation S-X. Should any of this information be deleted from Form N-Q? Is there additional information that should be required on Form N-Q?

[sbull] As proposed, Form N-Q would be filed under the Investment Company Act only. Should Form N-Q also be a reporting form under sections 13(a) and 15(d) of the Exchange Act, subject to certification under section 302 of the Sarbanes-Oxley Act of 2002?

[sbull] As proposed, Form N-Q would be required to be signed by the fund, and on behalf of the fund by its principal financial officer or officers. Are the principal financial officer(s) the appropriate persons to be required to sign proposed Form N-Q? Should the chief executive officer(s) sign proposed Form N-Q?

### B. Disclosure of Fund Expenses

We are proposing to require mutual funds to disclose in their reports to shareholders fund expenses borne by shareholders during the reporting period. Fund shareholder reports would be required to include: (1) The cost in dollars associated with an investment of \$10,000, based on the fund's actual expenses and return for the period; and (2) the cost in dollars, associated with an investment of \$10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year.<sup>65</sup> The first figure is intended to permit investors to estimate the actual costs, in dollars, that they bore over the reporting period. The second figure is intended to provide investors with a basis for comparing the level of current period expenses at different funds. Together, the two expense figures in the proposed example are designed to increase investor understanding of the fees that they pay on an ongoing basis for investing in a fund.

The proposed disclosure in shareholder reports would supplement the fee disclosure required in the mutual fund prospectus. Funds are currently required to include in their prospectuses a fee table that includes, as a percentage of fund assets, all fees and charges associated with a mutual fund investment.<sup>66</sup> The fee table reflects both (1) charges paid directly by a shareholder out of his or her investment, such as front- and back-end sales loads, and (2) recurring charges deducted from fund assets, such as management and 12b-1 fees.<sup>67</sup> The fee table is accompanied by a numerical example that illustrates the aggregate expenses that an investor could expect to pay over time on a \$10,000 investment if he or she received a 5 percent annual return and remained in the fund for 1-, 3-, 5-, and 10-year periods.

The numbers that we are proposing be disclosed in mutual fund shareholder reports are intended to provide information to investors about actual current period expenses. This disclosure would respond to concerns that have been raised regarding the degree to which investors understand the nature and effect of these ongoing fees.<sup>68</sup> While some have advocated that this information should be provided on an individualized basis in shareholder account statements, our proposals are intended to strike an appropriate

balance between investors' need for this information and the costs and burdens that would be associated with providing this information on an individualized basis.

The methodology for calculation of the proposed fee disclosure would be similar to that required for the expense example in the fee table of the mutual fund prospectus, with modifications to reflect the fact that the example in shareholder reports is intended to reflect actual historical expenses borne by an investor, rather than hypothetical future expenses. In determining its actual operating expenses during the reporting period, a fund would be required to include all expenses that are deducted from its assets or charged to all shareholder accounts, including management fees, distribution (12b-1) fees, and other expenses.<sup>69</sup> The example would not reflect any exchange fees, redemption fees, or sales charges (loads).<sup>70</sup>

Our proposal would require a fund to use its actual operating expenses (after expense reimbursement or fee waiver arrangements that reduced expenses) for the reporting period in calculating the example.<sup>71</sup> Expenses that would be deducted from the fund's assets for the purposes of the required example would be the amounts shown as expenses in the fund's statement of operations.<sup>72</sup> If there were any increases or decreases in fund operating expenses that occurred during the reporting period (or that occurred or would be expected to occur during the current fiscal year) that would have materially affected the information in the example had those changes been in place throughout the reporting period, the fund would be

<sup>69</sup> Proposed Instructions 2(a)(i) and 2(d) to Item 21(d)(1) of Form N-1A. "Other expenses" would include extraordinary expenses as determined under generally accepted accounting principles (see Accounting Principles Board Opinion No. 30). If extraordinary expenses were incurred that materially affected a fund's "other expenses," the fund would be permitted to disclose in a footnote to the required example what "actual operating expenses" would have been had the extraordinary expenses not been included. See proposed Instruction 2(a)(ii) to Item 21(d)(1) of Form N-1A. If the fund is a feeder fund it would be required to reflect the aggregate expenses of the feeder fund and master fund, and to state in a footnote to the example that the example reflects the expenses of both the feeder and master fund. Proposed Instruction 1(c)(i) to Item 21(d)(1) of Form N-1A. If the report covers more than one class of multiple class fund or more than one feeder fund that invests in the same master fund, a separate example would be required for each class or feeder fund. Proposed Instruction 1(c)(ii) to Item 21(d)(1) of Form N-1A.

<sup>70</sup> Proposed Instruction 2(a)(i) to Item 21(d)(1) of Form N-1A.

<sup>71</sup> Proposed Instruction 2(c)(i) to Item 21(d)(1) of Form N-1A.

<sup>72</sup> Proposed Instruction 2(a)(i) to Item 21(d)(1) of Form N-1A.

<sup>65</sup> Proposed Item 21(d)(1) of Form N-1A.

<sup>66</sup> Item 3 of Form N-1A.

<sup>67</sup> *Id.*

<sup>68</sup> See discussion in Section I, "Disclosure of Fund Expenses," *supra*.

required to restate in a footnote to the example the expense information using the current fees as if they had been in effect throughout the entire reporting period.<sup>73</sup> Account fees that are collected by more than one fund would be required to be allocated among the funds in proportion to the relative average net assets.<sup>74</sup> The example would assume the reinvestment of all dividends and distributions.<sup>75</sup>

The proposed numerical expense disclosure would be accompanied by a prescribed narrative explanation.<sup>76</sup> The narrative would explain that mutual funds charge both transaction costs and ongoing costs and that the example is intended to help a shareholder understand his or her ongoing costs and to compare these costs with the ongoing costs of investing in other mutual funds. The narrative also would explain the assumptions used in the example, note that the example does not reflect any transactional costs, and caution that the example is useful in comparing ongoing costs but not total costs of different funds. A fund would be permitted to modify the narrative explanation if the narrative contained comparable information to that prescribed, and a fund could eliminate any part of the narrative that is inapplicable.<sup>77</sup> For example, a fund that did not charge loads could omit the statement that the example does not reflect loads.

As an alternative to our proposed approach, we considered the recommendation of the GAO Report that the Commission require mutual funds to provide each investor with an exact dollar figure for expenses paid in each quarterly account statement that the investor receives.<sup>78</sup> The GAO Report's alternative would have the benefit of providing cost disclosure tailored to each investor. However, we have concerns about the cost and logistical complexity that this requirement might entail.<sup>79</sup> Mutual fund expenses are

<sup>73</sup> See proposed Instruction 2(c)(ii) to Item 21(d)(1) of Form N-1A. A change in actual operating expenses would not include a decrease in operating expenses as a percentage of assets due to economies of scale or breakpoints in a fee arrangement resulting from an increase in the fund's assets.

<sup>74</sup> Proposed Instruction 2(d) to Item 21(d)(1) of Form N-1A.

<sup>75</sup> Proposed Instruction 2(b) to Item 21(d)(1) of Form N-1A.

<sup>76</sup> Proposed Item 21(d)(1) and proposed Instruction 1(b) to Item 21(d)(1) of Form N-1A.

<sup>77</sup> *Id.*

<sup>78</sup> See GAO Report, *supra* note 19.

<sup>79</sup> See Letter from Colette D. Kimbrough, Chair, Investment Committee, Securities Industry Association, to Paul F. Roye, Director, Division of Investment Management, SEC (Dec. 7, 2000); Letter from Paul G. Haaga, Jr., Executive Vice President, Capital Research, to The Honorable Arthur Levitt,

charged against fund assets and are not currently accounted for on an individual account basis. Moreover, in many cases fund shares are held by broker-dealers, financial advisers, and other third-party financial intermediaries, which must prepare accurate and timely customer account statements by integrating data supplied by many unrelated fund groups. In addition to the systems changes necessary for the fund itself, these financial intermediaries would need to implement new systems in order to calculate and report personalized expense information for each fund held in an account each quarter. Because we believe that the costs of requiring this expense disclosure in quarterly account statements may outweigh the benefits, we determined that it would be more appropriate to propose including additional expense information in shareholder reports.<sup>80</sup>

*We request comment generally on our proposal to require mutual funds to include in reports to shareholders the dollar cost associated with a \$10,000 investment and specifically on the following issues.*

[sbull] Is the disclosure of actual costs paid over the current period useful to investors? If so, is there a better approach to providing this disclosure than that proposed?

[sbull] Are there better vehicles than annual and semi-annual reports to shareholders in which to include additional disclosure about fund expenses? In particular, would requiring disclosure of the actual costs paid by an individual investor in his or her account statements be preferable? If so, what benefits would individualized cost disclosure in account statements provide to investors that disclosure in shareholder reports of the fees paid on an initial \$10,000 investment would not?

[sbull] What would be the costs of requiring expense disclosure in

Jr., Chairman, SEC (Oct. 27, 2000); Letter from John J. Brennan, Chairman and Chief Executive Officer, Vanguard, to The Honorable Arthur Levitt, Jr., Chairman, SEC (Oct. 13, 2000); Letter from David S. Pottruck, President and Co-CEO, The Charles Schwab Corporation, to The Honorable Arthur Levitt, Jr., Chairman, SEC (Sept. 7, 2000). The letters are available for inspection and copying in File No. S7-51-02 in the Commission's public reference room.

<sup>80</sup> The GAO Report estimated that the costs of personalized disclosure in account statements "might be a few dollars or less per investor" in one-time and annual costs. GAO Report, *supra* note 19, at 97. As of year-end 2001, there were approximately 248 million shareholder accounts invested in funds. Investment Company Institute, Mutual Fund Fact Book 63 (42nd ed. 2002). At a cost of \$1 per shareholder account, this would be a cost of approximately \$248 million.

quarterly account statements, compared to the costs of the proposed expense disclosure requirement in shareholder reports? How would these costs be different for funds sold through and held by third-party intermediaries, such as broker-dealers? Would there be any ways to reduce these costs?

[sbull] Does the proposed example provide useful information as to current period costs? Does the first number required in the example, showing the cost in dollars associated with a \$10,000 investment that earned the fund's actual return for the period and incurred the fund's actual expenses, appropriately convey to investors the actual fees that they have paid? Will investors understand how to estimate their own actual costs by using this number and the average assets they invested in the fund over the reporting period?

[sbull] Does the second required number, showing the cost in dollars associated with a \$10,000 investment that earned a standardized 5% return for the period, provide an appropriate means for investors to compare the ongoing costs of different funds? Would the fact that this number does not reflect certain costs (e.g., exchange fees, sales charges (loads), redemption fees) cause shareholders to draw inappropriate conclusions about the relative costs of various funds? For example, would the proposed requirement to show the ongoing cost in dollars using a standardized return present funds with a front-end load in an unduly favorable light as compared to funds that impose distribution costs through asset-based 12b-1 fees? Is it useful to investors to compare current period costs, as opposed to total costs of fund ownership? If so, how should this number be presented and explained so that investors will understand that it does not reflect total costs?

[sbull] Will our proposed disclosure lead to better cost comparisons among funds and between funds and other investment vehicles? How would our proposed disclosure affect the cost competition among mutual funds and between mutual funds and other savings and investment vehicles, such as bank certificates of deposit? Will mutual fund investors understand that the ongoing costs shown have already been deducted from returns shown by a fund?<sup>81</sup>

<sup>81</sup> See Instruction 3 to Item 21(b)(1); Instruction 5 to Item 21(b)(2); and Instruction 5 to Item 21(b)(3) of Form N-1A (calculation of average annual total return requires deduction of all recurring fees); Rule 482(e)(3)(i) and (e)(4)(i) under the Securities Act (17 CFR 230.482(e)) (requiring calculation of average annual total return in a performance advertisement

[sbull] Will the proposed computation methodology help us to achieve the objective of permitting investors to estimate the actual costs, in dollars, that they bore over the reporting period and also provide them with a basis for comparing the level of current period expenses at different funds? What, if any, modifications to the proposed computation methodology are appropriate?

### C. Management's Discussion of Fund Performance ("MDFP")

We are proposing to require that MDFP, which is currently required for all mutual funds other than money market funds, be included in annual reports to shareholders.<sup>82</sup> Currently, a mutual fund is required to include MDFP in its prospectus unless the information is included in the fund's latest annual report to shareholders.<sup>83</sup> At the time we adopted MDFP, our authority to directly require information in annual reports was circumscribed.<sup>84</sup> Mutual funds, however, typically include MDFP in their annual reports, and we believe that requiring MDFP to be included in the annual report would aid investors in assessing the fund's performance over the prior year, and would fit naturally with other "backward looking" information contained in the annual report, such as

by a mutual fund to be based on methods of computation prescribed in Form N-1A).

<sup>82</sup> Proposed Item 21(b)(7) of Form N-1A.

<sup>83</sup> Item 5 of Form N-1A. A fund that includes MDFP in its annual report must disclose in its prospectus that its annual report contains a discussion of the market conditions and investment strategies that significantly affected the fund's performance during its last fiscal year and that this discussion will be made available upon request and without charge. Item 1(b)(1) of Form N-1A. Because we are proposing to require MDFP in a fund's annual report, we are proposing to amend Instruction 5 to Item 1(b)(1) to require all funds except money market funds, which are not required to provide MDFP, to include this disclosure.

<sup>84</sup> See 15 U.S.C. 80a-29(d) (1988) (permitting the Commission to require that investment companies transmit to shareholders, at least semi-annually, reports containing the following information and financial statements: (1) A balance sheet accompanied by a statement of the aggregate value of investments; (2) a list showing the amount and value of securities owned; (3) a statement of income; (4) a statement of surplus; (5) a statement of aggregate remuneration paid by the company during the period to officers, directors, and certain affiliated persons; and (6) a statement of the aggregate dollar amounts of purchase and sales of investment securities, other than government securities, made during the period covered by the report); Investment Company Act Release No. 19382 (Apr. 6, 1993) (58 FR 19050, 19052 (Apr. 12, 1993)) (permitting a fund to include MDFP in its prospectus or annual report to shareholders, but requiring a fund that placed MDFP in an annual report to disclose in its prospectus that its annual report contained additional performance information that would be made available upon request and without charge).

the fund's financial statements. We now have broad authority to prescribe the content of shareholder reports, and we propose to require MDFP in annual reports to shareholders.<sup>85</sup>

We wish to remind funds of their obligation to use MDFP to provide a complete and accurate discussion of the factors that affected fund performance over the past year. In its integrated reviews of mutual fund prospectuses and shareholder reports, the staff has identified instances where MDFP has provided insufficient substantive discussion of the factors that affected the fund's performance during the most recent fiscal year.<sup>86</sup> The Commission has asked the staff, in its review of a fund's disclosure documents, to continue to focus on areas where funds' MDFP disclosure has been deficient. We expect that our proposed revisions to shareholder reports, coupled with improved MDFP disclosure by funds, should enhance the usefulness of shareholder reports and result in improved disclosure by funds about their operations.

*We request comment generally on our proposal to require mutual funds to include MDFP in their annual reports to shareholders.*

[sbull] Should we require MDFP in annual reports to shareholders?

[sbull] Are there changes that we should make to the content of MDFP?

### D. Compliance Date

If we adopt the proposed amendments, we would expect to require all fund reports to shareholders filed for periods ending on or after the effective date of the amendments to comply with the proposed amendments. In addition, we would expect to require funds to file quarterly reports on Form N-Q with respect to any fiscal quarter ending on or after the effective date. The Commission requests comment on these proposed compliance dates.

<sup>85</sup> The National Securities Markets Improvement Act of 1996 ("NSMIA") added Section 30(f) to the Investment Company Act, authorizing the Commission to require that reports to shareholders include information that "the Commission deems necessary or appropriate in the public interest or for the protection of investors." National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 207, 110 Stat. 3416 (Oct. 11, 1996); 15 U.S.C. 80a-29(f).

<sup>86</sup> See *In the Matter of Davis Selected Advisers-NY, Inc.*, Investment Advisers Act Release No. 2055 (Sept. 4, 2002) (fund violated Section 34(b) of the Investment Company Act (15 U.S.C. 80a-34(b)) by failing to disclose the material impact that investments in initial public offerings had on its performance during its previous fiscal year in its MDFP); Tom Lauricella and Aaron Lucchetti, *What's Your Fund Doing? Some Managers Don't Say*, *The Wall Street Journal*, Oct. 7, 2002, at R23 (describing inadequate discussions in funds' MDFP).

### 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-2—Registration Statement of Closed-End Management Investment Companies"; (3) "Form N-3—Registration Statement of Separate Accounts Organized as Management Investment Companies"; (4) "Form N-CSR—Certified Shareholder Report of Registered Management Investment Companies"; (5) "Rule 30e-1 under the Investment Company Act of 1940, Reports to Stockholders of Management Companies"; and (6) "Form N-Q—Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company." 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-2 (OMB Control No. 3235-0026), and Form N-3 (OMB Control No. 3235-0316) were adopted pursuant to Section 8(a) of the Investment Company Act (15 U.S.C. 80a-8) and Section 5 of the Securities Act (15 U.S.C. 77e). We issued a release proposing Form N-CSR on August 30, 2002 (67 FR 57298 (Sept. 9, 2002)), pursuant to Section 30 of the Investment Company Act (15 U.S.C. 80a-8) and Sections 13 and 15(d) of the Exchange Act (15 U.S.C. 78m and 78o(d)). We proposed amendments to Form N-CSR on September 20, 2002 (Investment Company Act Release No. 25739) (67 FR 60828 (Sept. 26, 2002)); October 22, 2002 (Investment Company Act Release No. 25775) (67 FR 66208 (Oct. 30, 2002)); December 2, 2002 (Investment

Company Act Release No. 25838); and December 10, 2002 (Investment Company Act Release No. 25845). Rule 30e-1 (OMB Control No. 3235-0025) was promulgated under section 30(e) of the Investment Company Act (15 U.S.C. 80a-29(e)). New Form N-Q is being proposed under Section 30 of the Investment Company Act (15 U.S.C. 80a-29(e)).

We are proposing a new rule and form, and rule and form amendments, that are intended to improve the periodic disclosure provided by registered management investment companies ("funds") to their investors about fund investments, costs, and performance. The proposed amendments would:

[sbull] Permit a fund to include a summary portfolio schedule in its reports to shareholders, and exempt a money market fund from the requirement to include a portfolio schedule of investments in securities of unaffiliated issuers in its reports to shareholders, provided that the complete portfolio schedule is filed with the Commission on proposed Form N-CSR semi-annually and is provided to shareholders upon request, free of charge;

[sbull] Require reports to shareholders by funds to include a tabular or graphic presentation of a fund's portfolio holdings by identifiable categories;

[sbull] Require a fund to file its complete portfolio schedule as of the end of its first and third fiscal quarters with the Commission on new proposed Form N-Q;

[sbull] Require open-end management investment companies ("mutual funds") to disclose fund expenses borne by shareholders during the reporting period in reports to shareholders; and

[sbull] Require a mutual fund to include Management's Discussion of Fund Performance in its annual report to shareholders.

These proposed amendments are intended to significantly improve the periodic disclosure that fund investors receive, particularly with respect to portfolio holdings and expenses, while reducing the costs of producing and delivering funds' annual and semi-annual reports to shareholders.

#### *Form N-1A*

Form N-1A contains collection of information requirements. The likely respondents to this information collection are open-end funds registering with the Commission on Form N-1A. Compliance with the disclosure requirements of Form N-1A is mandatory. Responses to the

disclosure requirements are not confidential.

We estimate that the proposed amendments to Form N-1A would have no impact on the hour burden for filing registration statements on Form N-1A. The amendments to Form N-1A relate solely to the contents of shareholder reports for funds registered on Form N-1A, and the additional burden hours imposed by these amendments are reflected in the collection of information requirements for shareholder reports required by rule 30e-1 under the Investment Company Act.

#### *Form N-2*

Form N-2 contains collection of information requirements. The likely respondents to this information collection are closed-end funds registering with the Commission on Form N-2. Compliance with the disclosure requirements of Form N-2 is mandatory. Responses to the disclosure requirements are not confidential.

We estimate that the proposed amendments to Form N-2 would have no impact on the hour burden for filing registration statements on Form N-2. The amendments to Form N-2 relate solely to the contents of shareholder reports for funds registered on Form N-2, and the additional burden hours imposed by these amendments are reflected in the collection of information requirements for shareholder reports required by rule 30e-1 under the Investment Company Act.

#### *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 companies and 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.

We estimate that the proposed amendments to Form N-3 would have no impact on the hour burden for filing registration statements on Form N-3. The amendments to Form N-3 relate solely to the contents of shareholder reports for funds registered on Form N-3, and the additional burden hours imposed by these amendments are reflected in the collection of information requirements for shareholder reports required by rule 30e-1 under the Investment Company Act.

#### *Form N-CSR*

Proposed Form N-CSR, including the proposed amendments, contains collection of information requirements. The respondents to this information collection would be management investment companies subject to rule 30e-1 under the Investment Company Act of 1940 registering with the Commission on Form N-1A, N-2, or N-3. Compliance with the disclosure requirements of Form N-CSR is proposed to be mandatory. Responses to the disclosure requirements are not confidential.

We previously estimated that the weighted average hour burden for preparing a proposed Form N-CSR would be 16.38 hours per filing. We also estimated that 3,700 funds would file Form N-CSR on a semi-annual basis for a total of 7,400 filings. Thus, we estimated that the total annual hour burden for the preparation and filing of Form N-CSR would be 121,195 hours.<sup>87</sup> We estimate that the 3,700 funds filing reports on Form N-CSR include 9,850 portfolios, including 9,100 portfolios of mutual funds registered on Form N-1A, 630 closed-end funds registered on Form N-2, and 120 sub-accounts of managed separate accounts registered on Form N-3.<sup>88</sup>

The proposed amendments would require a fund that has used a summary portfolio schedule in its reports to shareholders in lieu of including a complete schedule of investments in securities of unaffiliated issuers, or a money market fund that has omitted its schedule of investments in securities of unaffiliated issuers from its reports to

<sup>87</sup> See Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms, Investment Company Act Release No. 25723 (Aug. 30, 2002) (67 FR 57298 (Sept. 9, 2002)); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 25739 (Sept. 20, 2002) (67 FR 60828 (Sept. 26, 2002)); Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Investment Company Act Release No. 25775 (October 22, 2002) (67 FR 66208 (Oct. 30, 2002)); Strengthening the Commission's Requirements Regarding Auditor Independence, Investment Company Act Release No. 25838 (Dec. 2, 2002) (67 FR 76780 (Dec. 13, 2002)); Rule 10b-18 and Purchases of Certain Equity Securities by the Issuer and Others, Investment Company Act Release No. 25845 (Dec. 10, 2002).

<sup>88</sup> The estimates of the number of mutual fund portfolios registered on Form N-1A and the number of closed-end funds registered on Form N-2 are based on the Commission staff's analysis of reports filed on Form N-SAR in 2002. The estimate of the number of sub-accounts of managed separate accounts registered on Form N-3 is based on the staff's analysis of reports filed on Form N-SAR in 2002, and the staff's estimate, based on its experience with Form N-3, of four sub-accounts per managed separate account.

shareholders, to file its complete schedule of investments in securities of unaffiliated issuers pursuant to Item 7 of Form N-CSR. We estimate that 7,195 fund portfolios, including 1,000 money market fund portfolios that would be exempt from including a portfolio schedule in their shareholder reports, and 6,195 portfolios (or 70% of the fund portfolios remaining) would take advantage of one of these provisions, and hence would be required to file a complete portfolio schedule on Item 7 of Form N-CSR.<sup>89</sup> We estimate that the requirements of Item 7 of Form N-CSR would increase the hour burden for filing Form N-CSR by 5 hours per portfolio per filing, or 71,950 hours (7,195 portfolios x 5 hours per portfolio x 2 filings per year). Thus, if the proposed amendments to Form N-CSR are adopted, the total annual hour burden for all funds for preparation and filing of Form N-CSR would be 193,145 hours (121,195 hours + 71,950 hours). The weighted average burden per filing on Form N-CSR would be 26.1 hours.

#### Shareholder Reports

Rule 30e-1, including the proposed amendments to Forms N-1A, N-2, and N-3, contains collection of information requirements.<sup>90</sup> The respondents to this collection of information requirement are funds registered on Forms N-1A, N-2, and N-3. Compliance with the disclosure requirements of rule 30e-1 is mandatory. Responses to the disclosure requirements will not be kept confidential.

There are approximately 3,700 funds subject to rule 30e-1. We estimate that the current hour burden for preparing and filing semi-annual and annual shareholder reports in compliance with rule 30e-1 is 212.5 hours per fund, for a total annual burden to the industry of 786,250 hours. We estimate that the 3,700 funds filing annual and semi-annual shareholder reports pursuant to rule 30e-1 include 9,850 portfolios, including 9,100 portfolios of mutual funds registered on Form N-1A, 630 closed-end funds registered on Form N-2, and 120 sub-accounts of managed

separate accounts registered on Form N-3.<sup>91</sup>

We estimate that there are 1,000 money market fund portfolios that would take advantage of the provision permitting a money market fund to omit its schedule of investments in securities of unaffiliated issuers from its shareholder reports. This would decrease the hour burden of complying with rule 30e-1 for these funds by 5 hours per portfolio per filing, or 10,000 hours (1,000 portfolios x 5 hours x 2 filings per year).

We estimate that of the remaining 8,850 portfolios of funds filing shareholder reports, 70%, or 7,095 portfolios, would choose to take advantage of the provisions permitting use of a summary portfolio schedule. However, we estimate that use of the summary portfolio schedule provisions would have no net effect on the burden hours of complying with rule 30e-1. The estimated time necessary to prepare a summary portfolio schedule will be equivalent to the time currently required to prepare a complete portfolio schedule, because a fund will still need to evaluate the size of each of its investments in securities of unaffiliated issuers in order to prepare the summary portfolio schedule.

Further, we estimate that the proposed requirement to include a tabular or graphic presentation in shareholder reports, which would apply to all funds, will increase the estimated burden hours for complying with rule 30e-1 by 3 hours per portfolio per filing, or 59,100 hours (9,850 portfolios x 3 hours x 2 filings per year). We estimate that the requirement to disclose in shareholder reports the dollar cost of investing in the fund over the reporting period, which would apply only to mutual funds, will increase the estimated burden hours for complying with rule 30e-1 by 5 hours per portfolio per filing, or 91,000 hours (9,100 mutual fund portfolios x 5 hours x 2 filings per year).<sup>92</sup> Finally, we estimate that the requirement for mutual funds to include MDFP in annual reports to shareholders would have a negligible effect on the estimated burden hours for complying with rule 30e-1, because over 90% of mutual funds, in the staff's experience, already include MDFP in annual reports to shareholders.

Thus, the proposed amendments would have a net increase on the burden

hours of complying with rule 30e-1 of 140,100 hours (-10,000 hours + 59,100 hours + 91,000 hours), for a new total burden of 926,350 hours.

#### Rule 30b1-4

The purpose of proposed Rule 30b1-4 is to improve transparency of information about funds' portfolio holdings. Proposed Rule 30b1-4 would require funds to file a quarterly report via the Commission's EDGAR system on proposed Form N-Q, not more than sixty calendar days after the close of each first and third fiscal quarter, containing their complete portfolio holdings. The likely respondents to Rule 30b1-4 would be registered management investment companies, other than small business investment companies registered with the Commission on Form N-5.

We estimate that there are approximately 3,700 funds that would be affected by the proposed rule. Each of those 3,700 funds would be required by proposed Rule 30b1-4 to file a complete portfolio holdings schedule via EDGAR on proposed Form N-Q. For purposes of this Paperwork Reduction Act analysis, the burden associated with the requirements of proposed Rule 30b1-4 has been included in the collection of information requirements of proposed Form N-Q, rather than the proposed Rule.

Compliance with rule 30b1-4 is mandatory for every registered fund. Responses to the disclosure requirements will not be kept confidential.

#### Form N-Q

Proposed Form N-Q contains collection of information requirements. The respondents to this information collection would be management investment companies subject to rule 30e-1 under the Investment Company Act of 1940 registering with the Commission on Forms N-1A, N-2, or N-3. Compliance with the disclosure requirements of Form N-Q would be mandatory. Responses to the disclosure requirements would not be kept confidential.

Every registered management investment company, other than a small business investment company registered on Form N-5, would be required to file a quarterly report on Form N-Q disclosing the information required therein, not more than sixty calendar days after the close of the first and third quarters of each fiscal year. We estimate that there are approximately 3,700 funds that would be affected by the proposal, which include 9,850 fund portfolios. We therefore estimate that for each of those

<sup>89</sup> This is based on the Commission staff's estimate that more than 70% of funds had more than 50 securities in their portfolios, according to the staff's analysis of data from the *Morningstar Principia Pro* database.

<sup>90</sup> The proposed amendments are to the shareholder reports requirements in Forms N-1A, N-2, and N-3. Rule 30e-1(a) under the Investment Company Act of 1940 (17 CFR 270.30e-1(a)) requires funds to include in the shareholder reports the information that is required by the fund's registration statement form.

<sup>91</sup> This estimate is based on the Commission staff's analysis of reports filed on Form N-SAR in 2002.

<sup>92</sup> The estimate of the number of mutual funds is based on data derived from the Commission's EDGAR filing system of the number of mutual funds filing shareholder reports pursuant to rule 30e-1.

funds the disclosure of their portfolio holdings schedules in filings on Form N-Q as of the end of each first and third fiscal quarter would require, on average, 10 hours per portfolio per filing,<sup>93</sup> for a total annual hour burden of 197,000 hours (10 hours per filing x 2 filings per year x 9,850 fund portfolios).

#### 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: (1) 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; (2) evaluate the accuracy of the Commission's estimate of burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) 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 3208, 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. S7-51-02. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-51-02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filing and Information Services, 450 Fifth Street NW., Washington, DC 20549. OMB is required to make a decision concerning 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.

<sup>93</sup> This estimate is based on a review of the estimated hour burdens currently associated with other rules and forms under the Investment Company Act that impose similar disclosure requirements.

Our proposed amendments are intended to improve the periodic disclosure provided by registered management investment companies ("funds") about their portfolio investments, costs, and past performance. The proposed amendments would:

[sbull] Permit a fund to include a summary portfolio schedule in its reports to shareholders, and exempt a money market fund from the requirement to include a portfolio schedule of investments in securities of unaffiliated issuers in its reports to shareholders, provided that the complete portfolio schedule is filed with the Commission on proposed Form N-CSR semi-annually and is provided to shareholders upon request, free of charge;

[sbull] Require reports to shareholders by funds to include a tabular or graphic presentation of a fund's portfolio holdings by identifiable categories;

[sbull] Require a fund to file its complete portfolio schedule as of the end of its first and third fiscal quarters with the Commission on new proposed Form N-Q;

[sbull] Require open-end management investment companies ("mutual funds") to disclose fund expenses borne by shareholders during the reporting period in reports to shareholders; and

[sbull] Require a mutual fund to include Management's Discussion of Fund Performance in its annual report to shareholders.

These proposed amendments are intended to significantly improve the periodic disclosure that fund investors receive, particularly with respect to portfolio holdings and expenses, while reducing the costs of producing and delivering funds' annual and semi-annual reports to shareholders.

#### A. Benefits

*Use of Summary Portfolio Schedule and Exemption of Money Market Funds from Portfolio Schedule Requirements in Shareholder Reports.* The Commission estimates that more than 70% of all funds may realize at least some cost savings, through reduced printing and mailing expenses, by use of a summary portfolio holdings schedule in their shareholder reports.<sup>94</sup> Money market funds would realize similar benefits with respect to the proposed exemption from the requirement to include the schedule of investments in unaffiliated issuers in their reports to shareholders. In addition, for purposes of the Paperwork Reduction Act, we

<sup>94</sup> This is based on the Commission staff's estimate that more than 70% of funds had more than 50 securities in their portfolios, according to the staff's analysis of data from the *Morningstar Principia Pro* database.

have estimated that this exemption for money market funds would reduce the burden hours for compliance with shareholder reports requirements by 10,000 hours, translating into a cost savings of \$689,400 annually.<sup>95</sup>

For funds with large numbers of holdings, such as index funds, the cost savings in printing and mailing could be substantial. As of year-end 2001, there were approximately 248 million shareholder accounts invested in funds.<sup>96</sup> For each account, funds are required to provide an annual and semi-annual shareholder report, although our rules allow the delivery of a single shareholder report to investors who share an address ("householding") under certain conditions. We estimate that, as a result, funds may print and deliver approximately 347.2 million and 446.4 million shareholder reports annually.<sup>97</sup> Annually, use of a summary portfolio schedule could therefore impact approximately 243.0 million to 312.5 million shareholder reports.<sup>98</sup> Although we are unable to precisely quantify the overall cost savings, at a minimum, if funds could reduce their printing and distribution expenses by one page per shareholder report, at a cost of 2[cent] per page, shareholders could

<sup>95</sup> See Section IV., *supra* (estimating that 1,000 money market fund portfolios would take advantage of the provision permitting a money market fund to omit its schedule of investments in securities of unaffiliated issuers from its shareholder reports, resulting in an estimated decrease of 5 hours per portfolio per filing). The estimated cost savings is derived from the estimated reduction in burden hours, and an estimated hourly wage rate for professional and non-professional staff of \$68.94. This estimated wage rate is a blended rate, based on published hourly wage rates for compliance attorneys in New York City (\$74.22) and programmers (\$27.91), and the estimate that professional and non-professional staff would divide time equally on compliance with the proposed disclosure requirements, yielding a weighted wage rate of \$68.94 (((\$74.22 x .50) + (\$27.91 x .50)) = \$51.065). See Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2001* (Oct. 2001). 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 \$68.94 (\$51.065 x 1.35) = \$68.94.

<sup>96</sup> Investment Company Institute, *Mutual Fund Fact Book 63* (42nd ed. 2002).

<sup>97</sup> See *Delivery of Disclosure Documents to Households*, Investment Company Act Release No. IC-24123 (64 FR 62540, 62543 (Nov. 16, 1999)) (estimating that householding rules would produce a decline in the number of shareholder reports required to be delivered of between 10 and 30 percent).

<sup>98</sup> This number reflects the estimated 70% of funds that would use a summary portfolio schedule and hence may benefit from reduced printing costs.

save approximately \$4.9 million to \$6.3 million per year.<sup>99</sup> The Commission believes, however, that some funds may be able to reduce the length of their shareholder reports by more than a single printed page and we therefore expect the cost savings to funds may exceed these estimates.<sup>100</sup> These potential savings may be passed on to fund shareholders.<sup>101</sup>

Apart from savings in printing and distribution costs, use of a summary portfolio schedule may benefit investors by helping them focus on a fund's principal holdings, and thereby better evaluate a fund's risk profile and investment strategy. These benefits to investors are difficult to quantify, however. We request comment on the extent and magnitude of the benefits to funds and investors that would result from permitting use of a summary portfolio schedule in shareholder reports, and permitting money market funds to omit a schedule of investments in securities of unaffiliated issuers from shareholder reports.

*Tabular or Graphic Presentation of Portfolio Holdings.* The proposed requirements for funds to provide a tabular or graphic presentation of their portfolio holdings in their annual and semi-annual reports to shareholders should benefit fund investors by illustrating, in a concise and user-friendly format, the allocation of a fund's investments across asset classes. This presentation, coupled with a summary portfolio schedule, may more effectively convey key information about a fund's investments than would the fund's complete portfolio schedule standing alone, particularly in the case of funds with large numbers of holdings.

<sup>99</sup> This is based on an estimate that the typical shareholder report is approximately 25 pages long and costs \$.52 to print and deliver. See *Delivery of Disclosure Documents to Households*, Securities Act Release No. 33-7766 (Nov. 4, 1999) (64 FR 62540, 62543 (Nov. 16, 1999)).

<sup>100</sup> See e.g., Letter from Craig S. Tyle, General Counsel, ICI, to Barry P. Barbash, Director, Division of Investment Management, SEC, *supra* note 10, at 2 (portfolio holdings schedule contained in one large equity fund's March 31, 1998 annual report was nineteen pages long and listed approximately 480 securities); Letter from Heidi Stam, Principal, Securities Regulation, Vanguard, to Cynthia Fornelli, Division of Investment Management, SEC, *supra* note 10, at 1-2 (portfolio holdings schedule in the Vanguard Total Stock Market Index Fund June 30, 1999 semi-annual report was 29 pages long and listed 3,204 securities).

<sup>101</sup> The provision permitting use of a summary portfolio schedule in shareholder reports, and the exemption for money market funds from the requirement to include in shareholder reports a complete schedule of investments in securities of unaffiliated issuers, are not expected to result in any reduction in internal costs for funds, because funds that utilize these provisions would still be required to file their complete portfolio schedules on Item 7 of Form N-CSR.

These benefits to investors resulting from the use of a tabular or graphic presentation are difficult to quantify, however. We request comment on the extent and magnitude of the benefits to funds and investors that would result from use of a summary portfolio schedule in shareholder reports.

*Quarterly Filing of Complete Portfolio Schedule.* The proposal to require the quarterly filing of a fund's complete portfolio schedule via EDGAR, within 60 days after the end of the first and third fiscal quarters, should benefit investors by providing them with greater information about whether, and how, a fund is complying with its stated investment objective. The proposal would allow investors, and their advisers or other investment professionals, to better monitor the extent to which the portfolios of the funds that investors hold overlap, and hence should promote more informed asset allocation decisions. In addition, quarterly disclosure of a fund's portfolio holdings may expose instances of "style drift," when the actual portfolio holdings of a fund deviate from its stated investment objective. The increased transparency resulting from quarterly disclosure may also deter several forms of portfolio manipulation by portfolio managers, including "window dressing" (buying or selling portfolio securities shortly before the date as of which a fund's holdings are publicly disclosed, in order to convey an impression that the manager has been investing in companies that have had exceptional performance during the reporting period) and "portfolio pumping" (buying shares of stocks the fund already owns on the last day of the reporting period, in order to drive up the price of the stocks and inflate the fund's performance results).<sup>102</sup> Any of these forms of portfolio manipulation enhance the apparent composition of the portfolio at the expense of portfolio returns. By increasing the frequency of reporting, engaging in these activities becomes more expensive in terms of returns. Therefore, we would expect fewer funds to engage in these activities. To the extent that portfolio managers currently engage in these activities, shareholders would be better off as a result of the proposed amendments. More broadly, the increased frequency of disclosure will permit investors to

<sup>102</sup> See Rulemaking Petition by the American Federation of Labor and the Congress of Industrial Organizations, *supra* note 12 at 2-3; Rulemaking Petition by the Consumer Federation of America, *et al.*, *supra* note 12 at 2; Rulemaking Petition by Fund Democracy, LLC, *supra* note 12, "Memorandum in Support of Rulemaking Petition" at 7-8, 15-21.

better link the composition of a fund portfolio to fund performance.

*We request comment on the benefits to investors of quarterly portfolio disclosure, and in particular on whether, and to what extent, quarterly portfolio disclosure might deter forms of portfolio manipulation.*

*Disclosure of Fund Expenses in Shareholder Reports.* The proposed requirement for mutual funds to disclose in their reports to shareholders fund expenses borne by shareholders during the reporting period should benefit investors by increasing their awareness and understanding of the fees that they pay on an ongoing basis for investing in a mutual fund. The benefits of the improved transparency of funds' ongoing fees and expenses are difficult to quantify, however. We request comment on the extent and magnitude of these benefits, as well as the benefits of alternative means of disclosure of the ongoing costs of funds.

*Inclusion of MDFP in Annual Reports to Shareholders by Mutual Funds.* The proposals to require funds to include MDFP in their annual reports to shareholders should assist investors in assessing the fund's performance over the prior year. Requiring MDFP in the annual report, as opposed to the fund's prospectus, may benefit shareholders by enabling them to assess information provided in the MDFP together with other "backward looking" information contained in the annual report. We note, however, that to the extent that, based on the staff's experience, over 90% of mutual funds already include this information in their annual reports to shareholders, these benefits are already being realized.

#### B. Costs

The proposed amendments may lead to some additional costs for funds, which could be passed on to fund shareholders. In the case of the additional disclosure requirements being proposed, these costs would include both internal costs (for attorneys 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).

*Use of Summary Portfolio Schedule and Exemption of Money Market Funds from Portfolio Schedule Requirements in Shareholder Reports.* Our proposals to allow funds to include summary portfolio schedules in reports to shareholders, and to exempt money market funds from the requirement to include a portfolio schedule of investments in securities of unaffiliated issuers in their reports to shareholders,

may result in some costs to funds. For purposes of the Paperwork Reduction Act, we estimate that these proposals would not increase the hour burden for completing a shareholder report in compliance with rule 30e-1 under the Investment Company Act. However, we estimate that use of either the provision permitting use of a summary portfolio schedule or the provision permitting a money market fund to omit its schedule of investments in securities of unaffiliated issuers would increase the hour burden for filing Form N-CSR by 5 hours per portfolio per filing, or 71,950 hours (7,195 portfolios x 5 hours per portfolio x 2 filings per year), resulting in an additional cost of filing Form N-CSR of \$4,960,233.<sup>103</sup>

Further, under our proposals, to the extent that investors want to see a complete portfolio schedule, investors would incur search costs to gather this information (*i.e.*, requesting the information from the fund). However, since funds will be required to deliver the complete portfolio schedule within three days and free of charge to all investors who request it, we expect these costs to be very small. We request comment on these estimates.

*Tabular or Graphic Presentation of Portfolio Holdings.* The proposals would require funds to provide one or more tables, charts, or graphs depicting the securities holdings of the fund by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value attributable to each. We estimate that these costs would be limited, however, because a fund could select the most appropriate means by which it would convey information to investors about the types of investments made by the fund, given its investment objectives, and because a majority of funds, according to the staff's estimate, already provide some type of tabular or graphic depiction of their holdings in shareholder reports. For purposes of the Paperwork Reduction Act, we have estimated that the disclosure requirements would add 3 hours per portfolio to the burden of completing each annual and semi-annual report to shareholders, or 59,100 hours total (3 hours per portfolio x 2 reports per year x 9,850 portfolios of funds required to provide reports to shareholders). We estimate that this additional burden would equal total internal costs of

\$4,074,354 annually.<sup>104</sup> Further, because most funds already include a similar type of presentation voluntarily in shareholder reports, we estimate that this new disclosure requirement will not increase printing and mailing costs of shareholder reports for most funds, and hence the external costs to funds of the tabular and graphic disclosure requirement would be minimal. We request comment on these estimates.

*Quarterly Filing of Complete Portfolio Schedule.* Our proposals to require funds to file with the Commission for the first and third fiscal quarters of each fiscal year their complete portfolio holdings schedule on proposed Form N-Q, and to disclose the availability of the filing on the Commission's website, would impose certain costs on funds. We estimate that for purposes of the Paperwork Reduction Act, these disclosure requirements would impose 10 burden hours per portfolio per filing on Form N-Q. We estimate that the total burden would therefore be 197,000 hours, or \$13,581,180 in total internal costs annually, based on an estimate of 3,700 funds filing reports on Form N-Q for 9,850 fund portfolios.<sup>105</sup> Because this quarterly disclosure would only be required to be filed on EDGAR, and not actually delivered to shareholders, we estimate that the external costs per fund, for typesetting, printing, and mailing, of this additional disclosure would be negligible.

Mandating quarterly portfolio disclosure may impose other costs on funds and their shareholders. Arguments have been made that more frequent disclosure of portfolio holdings may expand the opportunities for professional traders to exploit this information by engaging in predatory trading practices, such as trading ahead of funds, often called "front-running."<sup>106</sup> However, in order for "front-running" to significantly decrease investment returns under the proposed quarterly reporting requirements, it appears that the following conditions may have to be present:

1. To accomplish the goals of the trade that might be front run, the fund

manager has limited discretion over the timing of the trade.

2. The trade occurs during a quarter at the end of which the fund otherwise would not have had to report its portfolio holdings.

3. The order is so large that it cannot be reasonably completed within the disclosure window.

4. The market is sufficiently illiquid so that large orders may be reasonably expected to have a substantial impact on price.

5. When the fund's portfolio is revealed, the size of the remaining order is sufficiently large that it is worth front-running.

6. Other traders recognize the front-running opportunity.

7. Other traders are willing to assume the risks of trading on the front-running opportunity.

8. The fund manager cannot delay the trade without a significant effect on performance.

It appears that front running may be a profitable strategy if all of these conditions hold simultaneously. It also appears that these conditions may rarely be met. If this is correct, the resulting costs of front-running under our proposals should be minimal.<sup>107</sup>

Furthermore, there are two additional potential costs that may be associated with these proposals. First, it has been argued that, given public data about aggregate flows of new cash to funds, more frequent disclosure of portfolio holdings would allow traders to effectively identify the securities in which the fund(s) will transact to accommodate this flow. This may, in turn, provide a potentially profitable front-running strategy to these traders.<sup>108</sup> Second, a requirement for more frequent disclosure may disrupt trades that are made for potential tax-

<sup>107</sup> A delay of 60 days in reporting is intended to significantly mitigate the potential costs to funds caused by quarterly portfolio disclosure. The Commission staff estimates that approximately 99% of fund portfolio holdings represent an average of nine days of trading volume or less in the securities held. Thus, even if a fund decided it needed to significantly alter or exit a position at the end of a reporting period, it appears likely that the fund generally could unwind that position in the time between the end of the reporting period and the date of disclosure with only minimal price impact.

<sup>108</sup> See, *e.g.*, Russ Wermers, *Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, ICI Perspective, *supra* note , at 9-10. Some empirical evidence suggests that portfolio holdings are correlated across all funds. See Paul A. Gompers and Andrew Metrick, *Institutional Investors and Equity Prices*, National Bureau of Economic Research Working Paper 6723 (Sept. 1998), available at <http://www.nber.org/papers/w6723>. If this is correct, more frequent disclosure of individual holdings is unlikely to make current trading strategies more profitable, since quarterly aggregate holdings data is currently available through 13F filings.

<sup>103</sup> These figures are based on an estimated hourly wage rate of \$68.94. See *supra* note (explaining calculation of wage rate).

<sup>104</sup> These figures are based on an estimated hourly wage rate of \$68.94. See *supra* note 95 (explaining calculation of wage rate).

<sup>105</sup> This estimate is based on data from the Commission's EDGAR system of the number of registered management investment companies, and an estimated hourly wage rate of \$68.94; see *supra* note 95.

<sup>106</sup> See Letter from Craig S. Tyle, General Counsel, ICI to Paul F. Roye, Director, Division of Investment Management, SEC, *supra* note 59; Russ Wermers, *Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, ICI Perspective, *supra* note 59.

timing advantages.<sup>109</sup> These potential costs are particular cases of front-running, and it appears that they may require the same conditions to hold as those described above, along with additional conditions specific to these strategies.

*We request comment on the analysis above, and on the nature and magnitude of any potential costs of front-running resulting from more frequent disclosure of portfolio holdings.*

Arguments have also been made that more frequent portfolio disclosure may facilitate the ability of outside investors to “free ride” on a mutual fund’s investment strategies, by obtaining for free the benefits of fund research and investment strategies that are paid for by fund shareholders.<sup>110</sup> The extent to which our proposed quarterly disclosure requirement, with a 60 day lag, would result in these types of costs is difficult to quantify, and may depend on a number of assumptions. In general, it appears that the following conditions must be satisfied for free-riding to be a profitable strategy:

1. The market is able to consistently identify skilled fund managers.<sup>111</sup>

2. The trading information of skilled fund managers remains valuable from 2 to 5 months after the trade is initiated.

It appears that a fund may be damaged by free-riding if its trading positions are incomplete when the fund’s portfolio is disclosed and the front-running conditions discussed above are met. In addition, it appears that the market for the securities being traded pursuant to the strategy must be sufficiently illiquid to generate price impacts such that completion of the trading strategy is more costly to the fund manager. It appears that these conditions may not often simultaneously hold, although when they do, funds may be adversely impacted.

We also note, however, that once the fund adviser has completed its trading strategy, it may hope that other traders will follow it because the price impacts of their trading will make the fund’s

trades profitable. The net effect of “free riding” therefore is not necessarily negative.

*We request comment on this analysis and on the nature and magnitude of any potential costs of free-riding that may result from more frequent disclosure of portfolio holdings.*

*We request comment generally on whether, and to what extent, our proposals would impose costs resulting from predatory trading practices, and on any other costs that would be imposed by our proposed quarterly portfolio disclosure requirement.*

*Disclosure of Fund Expenses in Shareholder Reports.* We estimate that in order for mutual funds to comply with the proposed requirement to include in annual and semi-annual reports disclosure of the dollar cost associated with investing a standardized amount in a fund, a typical mutual fund would need to add two additional pages to its annual and semi-annual reports, at a cost of \$0.02 per page.<sup>112</sup> We estimate that a typical fund may have, on average, 30,000 shareholder accounts, and will send out between 42,000 and 54,000 reports to shareholders annually.<sup>113</sup> Therefore, this additional disclosure in shareholder reports would cost approximately \$2,400 ( $(\$0.04 \times 30,000 \text{ shareholder accounts}) \times 2 \text{ reports per year}$ ) in external costs per fund annually. Based on an estimate of 3,100 mutual funds filing annual and semi-annual reports with the Commission pursuant to rule 30e-1, we estimate these external costs would be \$7,440,000 for the industry as a whole. In addition, we estimate for purposes of the Paperwork Reduction Act that these disclosure requirements would add 91,000 burden hours for mutual funds required to transmit shareholder reports, or 10 hours per mutual fund portfolio, equal to internal costs of \$6,273,540 for the industry annually.<sup>114</sup> We request comment on these estimates.

As the Commission considered how to best disclose to investors the fees and

expenses that they incur with investment in a fund, it considered the costs and benefits of various alternatives, including providing fund shareholders with individualized cost information (in dollars) as to the fees and expenses that they paid in quarterly account statements. We estimate that the cost of providing this individualized cost disclosure would greatly exceed the cost of our proposal. According to the GAO Report which recommended requiring individualized cost disclosure in account statements, one broker-dealer with approximately 6.5 million customer accounts estimated that for it to develop the systems necessary to produce such statements might cost as much as \$4 million, with additional annual costs of \$5 million.<sup>115</sup> Given that as of year-end 2001, there were approximately 248 million shareholder accounts invested in funds, estimated industry-wide costs could easily exceed \$100 million annually.<sup>116</sup> We request comment on the costs of alternative methods of increasing investors’ awareness of fund fees and expenses.

*Inclusion of MDFP in Annual Reports to Shareholders by Mutual Funds.* We estimate that the proposed requirement that mutual funds include MDFP in their annual reports to shareholders would not impose any costs on funds or shareholders. The staff estimates that over 90% of mutual funds already include MDFP in their annual reports to shareholders. Further, a fund that does not include MDFP in its annual reports must include MDFP in its prospectus. Thus, this proposed amendment would not impose any new disclosure requirement on funds, but rather would only mandate a change in the location of the required disclosure, for the minority of funds that do not already include MDFP in their annual reports. To the extent, however, that a fund does not already include MDFP in its annual report to shareholders, the fund may incur additional printing and mailing costs. We request comment on this estimate.

### 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.

<sup>115</sup> GAO Report, *supra* note 19, at 79.

<sup>116</sup> See Investment Company Institute, *Mutual Fund Fact Book*, *supra* note 96, at 63.

<sup>109</sup> Russ Wermers, *Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, ICI Perspective, *supra* note 59, at 10-11.

<sup>110</sup> See Letter from Craig S. Tyle, General Counsel, ICI to Paul F. Royce, Director, Division of Investment Management, SEC, *supra* note 59; Russ Wermers, *Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, ICI Perspective, *supra* note 59.

<sup>111</sup> Some empirical studies of mutual fund performance evaluation have suggested that the consistent identification of skilled mutual fund managers is not likely. See Mark Carhart, *On the Persistence of Mutual Fund Performance*, *Journal of Finance*, March 1997, at 57-82.

<sup>112</sup> See *supra* note 99.

<sup>113</sup> The estimate regarding the average number of shareholder accounts per typical fund is derived from data provided in the Mutual Fund Fact Book, *supra* note 96, at 63, 64. The estimates that 42,000 to 54,000 reports to shareholders must be delivered to shareholders annually are derived from the number of shareholder accounts, the requirement that each fund must deliver an annual and a semi-annual report to each account-holder, and an estimated 10 to 30 percent savings in the number of reports that must be delivered to shareholders due to householding rules. See *supra* note 97.

<sup>114</sup> These figures are based on the staff’s estimate, derived from data from the Commission’s EDGAR filing system, that approximately 3,100 mutual funds file shareholder reports with the Commission and hence would be subject to the proposed amendments, and an estimated hourly wage rate of \$68.94. See *supra* note 104.

## VI. Consideration of Burden on Competition; Promotion of Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. Section 23(a)(2) also prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>117</sup> In addition, Section 2(c) of the Investment Company Act, Section 2(b) of the Securities Act, and Section 3(f) of the Exchange Act 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.<sup>118</sup>

The proposed amendments are intended to provide greater transparency for fund shareholders regarding their investments in funds. These proposed amendments may improve efficiency. The enhanced disclosure requirements may provide shareholders with more frequent access to portfolio holdings of the funds in which they invest, which may 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 lead to better-informed investors and may prompt funds to seek to provide better-informed investors with improved products and services. In addition, permitting funds to deliver summary portfolio schedules in shareholder reports may provide a significant reduction in printing and delivery costs ultimately borne by shareholders. 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 is difficult to quantify, particularly given that many funds do not currently provide the type of disclosure contemplated by the proposed amendments.

We request comment on whether the proposed amendments, if adopted, would impose a burden on competition. We also 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 rule and form amendments under the Securities Act, the Exchange Act, and the Investment Company Act to improve the quality of periodic disclosure provided by registered management investment companies ("funds") about their portfolio investments, costs, and past performance. These proposed amendments are intended to enable funds to provide more meaningful information to shareholders while reducing the costs of producing and delivering annual and semi-annual reports to shareholders.

### A. Reasons for, and Objectives of, Proposed Amendments

Shareholder reports are one of the principal means by which funds provide periodic information to their investors. Fund shareholder reports historically have served primarily as a vehicle to provide financial statements and other financial information to shareholders.<sup>119</sup> The Commission believes that, with some modifications, fund shareholder reports could become a more effective vehicle for communicating information to investors. The proposed amendments principally address disclosure of fund portfolio holdings and expenses, two significant areas for improvement that have been identified by investor groups, members of the fund industry, and others.

### B. Legal Basis

The Commission is proposing amendments to Regulation S-X pursuant to authority set forth in sections 5, 6, 7, 8, and 19(a) of the Securities Act (15 U.S.C. 77e, 77f, 77g, 77h, and 77s(a)), sections 12, 13, 15(d) and 23(a) of the Exchange Act (15 U.S.C. 78l, 78m, 78o(d), and 78w(a)) and

<sup>119</sup> Section 30(e) of the Investment Company Act (15 U.S.C. 80a-29(e)) (requiring a fund 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); National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 207, 110 Stat. 3416 (Oct. 11, 1996) (adding Section 30(f) to the Investment Company Act, which allows the Commission to require that semi-annual reports "include such other information as the Commission deems necessary or appropriate in the public interest or for the protection of investors.")

sections 8, 24(a), 30, 31, and 38 of the Investment Company Act (15 U.S.C. 80a-8, 80a-24(a), 80a-29, 80a-30, and 80a-37). The Commission is proposing new rule 30b1-4 and new Form N-Q pursuant to authority set forth in sections 8, 30, 31, and 38 of the Investment Company Act (15 U.S.C. 80a-8, 80a-29, 80a-30, and 80a-37). The Commission is proposing amendments to Forms N-1A, N-2, and N-3 pursuant to authority set forth in sections 5, 6, 7, 10, 19(a), and 28 of the Securities Act (15 U.S.C. 77e, 77f, 77g, 77j, 77s(a), and 77z-3) and sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act (15 U.S.C. 80a-6(c), 80a-8, 80a-24(a), 80a-29, and 80a-37). The Commission is proposing amendments to proposed Form N-CSR pursuant to authority set forth in sections 10(b), 13, 15(d), 23(a), and 36 of the Exchange Act (15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm) and sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act (15 U.S.C. 80a-6(c), 80a-8, 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.<sup>120</sup> Approximately 205 out of 3700 investment companies that would be affected by this rule meet this definition.<sup>121</sup>

### D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments would:

[bull] Permit a fund to include a summary portfolio schedule in its reports to shareholders, and exempt a money market fund from the requirement to include a portfolio schedule of investments in unaffiliated issuers in its reports to shareholders, provided that the complete portfolio schedule is filed with the Commission on proposed Form N-CSR semi-annually and is provided to shareholders upon request, free of charge;

<sup>120</sup> 17 CFR 270.0-10.

<sup>121</sup> This estimate is based on figures compiled by Division of Investment Management staff regarding investment companies registered on Form N-1A, Form N-2, and Form N-3. 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. Investment Company Act rule 0-10(b) (17 CFR 270.0-10(b)).

<sup>117</sup> 15 U.S.C. 78w(a)(2).

<sup>118</sup> 15 U.S.C. 77(b), 78c(f), and 80a-2(c).

[sbull] Require reports to shareholders by funds to include a tabular or graphic presentation of a fund's portfolio holdings by identifiable categories;

[sbull] Require a fund to file its complete portfolio schedule as of the end of its first and third fiscal quarters with the Commission on new proposed Form N-Q;

[sbull] Require open-end management investment companies ("mutual funds") to disclose fund expenses borne by shareholders during the reporting period in reports to shareholders; and

[sbull] Require a mutual fund to include Management's Discussion of Fund Performance in its annual report to shareholders.

The proposed amendments would apply equally to funds that are small entities and to other funds. The Commission estimates that the proposed amendments may result in some one-time formatting and ongoing costs and burdens that would be imposed on all funds, but which may have a relatively greater impact on smaller firms. These include the costs related to disclosing the dollar cost associated with investing a standardized amount in a fund; and the requirement that funds file their complete portfolio schedules with the Commission on a quarterly basis. These costs also could include expenses for computer time, legal and accounting fees, information technology staff, and additional computer and telephone equipment. However, we believe the benefits that will result to shareholders through better information about their funds' investments, costs, and past performance justify these potential costs.

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 regarding a fund's investments, costs, and performance. Different disclosure requirements for small entities, such as reducing the frequency of portfolio holdings reports that small entities would have to file with the Commission, may create the risk that shareholders of those small entities would not have access to sufficient information to make an informed evaluation as to whether the fund is complying with its stated investment objective. We believe it is important that the disclosure that would be required by the proposed amendments be provided to shareholders by all funds, not just funds that are not considered small entities.

We have endeavored throughout these 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](mailto:rule-comments@sec.gov). To help us process and review your comments more efficiently, comments should be sent by hard copy or electronically, but not by both methods. All comment letters should refer to File No. S7-51-02; 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>).<sup>122</sup>

#### **VIII. Consideration of Impact on the Economy**

For purposes of the Small Business Enforcement Fairness Act of 1996,<sup>123</sup> a rule is "major" if it results or is likely to result in:

[sbull] An annual effect on the economy of \$100 million or more;

[sbull] A major increase in costs or prices for consumers or individual industries; or

[sbull] 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 Regulation S-X pursuant to authority set forth in sections 5, 6, 7, 8, and 19(a) of the Securities Act (15 U.S.C. 77e, 77f, 77g, 77h, and 77s(a)); sections 12, 13, 15(d), and 23(a) of the Exchange Act (15 U.S.C. 78l, 78m, 78o(d), and 78w(a)); and sections 8, 24(a), 30, 31, and 38 of the Investment Company Act (15 U.S.C. 80a-8, 80a-24(a), 80a-29, 80a-30, and 80a-37). The Commission is proposing new rule 30b1-4 and new Form N-Q pursuant to authority set forth in sections 8, 30, 31, and 38 of the

<sup>122</sup> 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.

<sup>123</sup> Pub. L. 104-21, Title II, 110 Stat. 857 (1996).

Investment Company Act (15 U.S.C. 80a-8, 80a-29, 80a-30, and 80a-37]. The Commission is proposing amendments to Forms N-1A, N-2, and N-3 pursuant to authority set forth in sections 5, 6, 7, 10, 19(a), and 28 of the Securities Act (15 U.S.C. 77e, 77f, 77g, 77j, 77s(a), and 77z-3] and sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act (15 U.S.C. 80a-6(c), 80a-8, 80a-24(a), 80a-29, and 80a-37]. The Commission is proposing amendments to proposed Form N-CSR pursuant to authority set forth in sections 10(b), 13, 15(d), 23(a), and 36 of the Exchange Act (15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm] and sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act (15 U.S.C. 80a-6(c), 80a-8, 80a-24(a), 80a-29, and 80a-37].

**List of Subjects**

17 CFR Parts 210, 270, and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

17 CFR Parts 239 and 249

Reporting and recordkeeping requirements, Securities.

**Text of Proposed Rule and Form Amendments**

For the reasons set out in the preamble, Title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

**PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975**

1. The authority citation for part 210 continues to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), 80b-3, 80b-11 unless otherwise noted.

2. Paragraph (c) of § 210.6-10 is revised to read as follows:

**§ 210.6-10 What schedules are to be filed.**

\* \* \* \* \*

(c) *Management investment companies.* (1) Except as otherwise provided in the applicable form, the schedules specified in this paragraph shall be filed for management investment companies as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

*Schedule I—Investments in securities of unaffiliated issuers.* The schedule prescribed by § 210.12-12 shall be filed in support of caption 1 of each balance sheet.

*Schedule II—Investments—other than securities.* The schedule prescribed by §

210.12-13 shall be filed in support of caption 3 of each balance sheet. This schedule may be omitted if the investments, other than securities, at both the beginning and end of the period amount to less than one percent of the value of total investments (§ 210.6-04.4).

*Schedule III—Investments in and advances to affiliates.* The schedule prescribed by § 210.12-14 shall be filed in support of caption 2 of each balance sheet.

*Schedule IV—Investments—securities sold short.* The schedule prescribed by § 210.12-12A shall be filed in support of caption 10(a) of each balance sheet.

*Schedule V—Open option contracts written.* The schedule prescribed by § 210.12-12B shall be filed in support of caption 10(b) of each balance sheet.

(2) When permitted by the applicable form, the schedule specified in this paragraph may be filed for management investment companies as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

*Schedule VI—Summary schedule of investments in securities of unaffiliated issuers.* The schedule prescribed by § 210.12-12C may be filed in support of caption 1 of each balance sheet.

\* \* \* \* \*

3. Add § 210.12-12C to read as follows:

**§ 210.12-12C Summary schedule of investments in securities of unaffiliated issuers.**

Column A	Column B	Column C	Column D
Name of issuer and title of issue <sup>1</sup> , <sub>2</sub> .	Balance held at close of period. Number of shares—principal amount of bonds and notes <sup>3</sup> .	Value of each item at close of period <sup>4</sup> , <sup>5</sup> , <sup>6</sup> , <sup>7</sup> .	Percentage value compared to net assets

<sup>1</sup> List the 50 largest issues and any other securities the value of which exceeded one percent of net asset value of the registrant as of the close of the period in order of descending value. For purposes of determining whether the value of a security exceeds one percent of net asset value, aggregate and treat as a single issue all securities of any one issuer. List each issue separately, whether or not issued by a single issuer, except as provided in note 2. Restricted securities shall not be combined with unrestricted securities of the same issuer.

<sup>2</sup> Identify by an appropriate symbol or footnote the type of instrument. For purposes of the list, aggregate and treat as a single issue, respectively, (a) short-term debt instruments of the same issuer (indicating the range of interest rates and maturity dates), and (b) fully collateralized repurchase agreements (indicate in a footnote the range of dates of the repurchase agreements, the total purchase price of the securities, the total amount to be received upon repurchase, the range of repurchase dates, and description of securities subject to the repurchase agreements). Group all securities not separately listed in a category labeled "Other Securities."

<sup>3</sup> Indicate by an appropriate symbol each issue of securities which is non-income producing. Evidences of indebtedness and preferred shares may be deemed to be income producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no cash or in kind dividends declared, the issue shall not be deemed to be income producing. Common shares shall not be deemed to be income producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares.

<sup>4</sup> Total Column C. The total of column C should equal the total shown on the related balance sheet for investments in securities of unaffiliated issuers.

<sup>5</sup> Indicate by an appropriate symbol each issue of restricted securities. State the following in a footnote: (a) as to each such issue: (1) acquisition date, (2) carrying value per unit of investment at date of related balance sheet, e.g., a percentage of current market value of unrestricted securities of the same issuer, etc., and (3) the cost of such securities; (b) as to each issue acquired during the year preceding the date of the related balance sheet, the carrying value per unit of investment of unrestricted securities of the same issuer at: (1) the day the purchase price was agreed to; and (2) the day on which an enforceable right to acquire such securities was obtained; and (c) the aggregate value of all restricted securities and the percentage which the aggregate value bears to net assets.

<sup>6</sup> Indicate by an appropriate symbol each issue of securities held in connection with open put or call option contracts or loans for short sales.

<sup>7</sup> State in a footnote the following amounts based on cost for Federal income tax purposes: (a) Aggregate gross unrealized appreciation for all securities in which there is an excess of value over tax cost, (b) the aggregate gross unrealized depreciation for all securities in which there is an excess of tax cost over value, (c) the net unrealized appreciation or depreciation, and (d) the aggregate cost of securities for Federal income tax purposes.

#### PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

4. 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), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

\* \* \* \* \*

#### PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

5. The authority citation for part 249 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 78a, *et seq.*, unless otherwise noted.

\* \* \* \* \*

#### PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

6. The general authority citation for part 270 is revised to read as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

7. Section 270.30b1-4 is added to read as follows:

##### § 270.30b1-4 Quarterly report.

Every registered management investment company, other than a small business investment company registered on Form N-5 (§§ 239.24 and 274.5 of this chapter), shall file a quarterly report on Form N-Q (§ 274.129 of this chapter) not more than sixty calendar days after the close of the first and third quarters of each fiscal year. A registered management investment company that has filed a registration statement with the Commission registering its securities for the first time under the Securities Act of 1933 is relieved of this reporting obligation with respect to any reporting period or portion thereof prior to the date on which that registration statement becomes effective or is withdrawn.

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

8. The authority citation for part 274 is revised to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, and sections 3(a) and

302, Pub. L. No. 107-204, 116 Stat. 745, unless otherwise noted.

Section 274.128 is also issued under secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745.

8a. Section 274.129 is added to read as follows:

##### § 274.129 Form N-Q, quarterly schedule of portfolio holdings of registered management investment company.

This form shall be used by registered management investment companies, other than small business investment companies registered on Form N-5 (§§ 239.24 and 274.5 of this chapter), for quarterly reports to be filed for the first and third quarters of each fiscal year, pursuant to section 30 of the Investment Company Act of 1940 and § 270.30b1-4 of this chapter.

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

a. Removing Item 5 and redesignating Items 6 through 30 as Items 5 through 29;

b. In paragraph B.2(b) of the General Instructions, revising the phrase “(except Items 1, 2, 3, 5, and 9), B, and C (except Items 23(e) and (i)-(k))” to read “(except Items 1, 2, 3, and 8), B, and C (except Items 22(e) and (i)-(k))”;

c. In paragraph C.3(a) of the General Instructions, revising the reference “Item 8” to read “Item 7”;

d. In paragraph C.3(d)(i), introductory text, of the General Instructions and in newly redesignated Item 6, the introductory text of paragraph (f), revising the reference “Items 7(b)-(d) and 8(a)(2)” to read “Items 6(b)-(d) and 7(a)(2)”;

e. In paragraph (b)(1) of Item 1, removing the phrase “, if required by Item 5”;

f. Removing Instruction 5 to Item 1(b)(1) and redesignating Instruction 6 to Item 1(b)(1) as Instruction 5 to Item 1(b)(1);

g. In newly redesignated Instruction 5 to Item 1(b)(1) and paragraph (a)(2) of newly redesignated Item 7, revising the reference “Item 7(f)” to read “Item 6(f)”;

h. In newly redesignated Instruction 5 to Item 1(b)(1), revising the reference “Item 7(f)(3)” to read “Item 6(f)(3)”;

i. In Item 2(c)(2)(iii), revising the phrase “Instruction 5 to Item 5(b)” to read “Instruction 5 to Item 21(b)(7)”;

j. In Instruction 1(a) to Item 2(c)(2), revising the reference “Item 9(a)” to read “Item 8(a)”;

k. In Instruction 2(a) to Item 2(c)(2), revising the references “Item 21(a)”, “Item 21(b)(1)”, and “Items 21(b)(2) and (3)” to read “Item 20(a)”, “Item 20(b)(1)”, and “Items 20(b)(2) and (3)”, respectively;

l. In Instruction 2(b) to Item 2(c)(2), revising the phrase “Instruction 6 to Item 5(b)” to read “Instruction 6 to Item 21(b)(7)”;

m. In Instruction 2(d) to Item 2(c)(2), revising the references “Item 21(b)(2)” and

“Item 21” to read “Item 20(b)(2)” and “Item 20”, respectively;

n. In Instruction 4 to Item 2(c)(2), revising the phrase “Instruction 11 of Item 5(b)” to read “Instruction 11 to Item 21(b)(7)”;

o. In Instruction 2(a)(i) to Item 3, revising the reference “Item 8(a)” to read “Item 7(a)”;

p. In Instruction 5 to Item 4(b)(1), revising the reference “Item 12(c)(1)” to read “Item 11(c)(1)”;

q. In paragraph (e) of newly redesignated Item 11, revising the reference “Item 9” to read “Item 8”;

r. Revising the reference “Item 13” to read “Item 12” in the following places:

i. Instruction 1 to newly redesignated Item 12;

ii. Paragraph (a)(2) of newly redesignated Item 12;

iii. Paragraph (b)(3) of newly redesignated Item 12;

iv. Paragraph (b)(6) of newly redesignated Item 12;

v. Instructions 6, 8, and 10 to newly redesignated Item 12(b)(7) each time it appears;

vi. Paragraph (b)(8) of newly redesignated Item 12 each time it appears;

vii. Instructions 2, 4, 6, 7, and 8 to newly redesignated Item 12(b)(8) each time it appears; and

viii. Paragraph (b)(9)(iii) of newly redesignated Item 12.

s. In Instruction to paragraph (a) of newly redesignated Item 17, revising the reference “Item 18(a)” to read “Item 17(a)”;

t. In Instruction 4 to paragraph (c) of newly redesignated Item 17 and paragraph (k) of newly redesignated Item 22, revising the reference “Item 22” to read “Item 21”;

u. In Instruction 1 to paragraph (c) of newly redesignated Item 19, revising the references “Item 8(b)(2)”, “Item 15(d)”, and “Item 30” to read “Item 7(b)(2)”, “Item 14(d)”, and “Item 29”, respectively;

v. In paragraph (b) of newly redesignated Item 26, revising the reference “Item 20” to read “Item 19”;

w. In Instruction 2 to paragraph (c) of newly redesignated Item 26, revising the reference “Item 20(c)” to read “Item 19(c)”;

x. In Instruction 1 to newly redesignated Item 28, revising the reference “Item 15” to read “Item 14”;

and

y. Revising Instruction 5 to Item 1(b)(1) and newly redesignated Item 21.

The revisions read as follows.

**Note:** The text of Form N-1A does not and this amendment will not appear in the Code of Federal Regulations.

**Form N-1A**

\* \* \* \* \*

##### Item 1. Front and Back Cover Pages

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

##### Instructions.

\* \* \* \* \*

5. A Money Market Fund may omit the sentence indicating that a reader will find in the Fund's annual report a discussion of the market conditions and investment strategies that significantly affect the Fund's performance during its last fiscal year.

\* \* \* \* \*

#### Item 21. Financial Statements

(a) *Registration Statement.* Include, in a separate section following the responses to the preceding Items, the financial statements and schedules required by Regulation S-X. The specimen price-make-up sheet required by Instruction 4 to Item 17(c) may be provided as a continuation of the balance sheet specified by Regulation S-X.

#### Instructions

1. The statements of any subsidiary that is not a majority-owned subsidiary required by Regulation S-X may be omitted from Part B and included in Part C.

2. In addition to the requirements of rule 3-18 of Regulation S-X (17 CFR 210.3-18), any Fund registered under the Investment Company Act that has not previously had an effective registration statement under the Securities Act must include in its initial registration statement under the Securities Act any additional financial statements and condensed financial information (which need not be audited) necessary to make the financial statements and condensed financial information included in the registration statement current as of a date within 90 days prior to the date of filing.

(b) *Annual Report.* Every annual report to shareholders required by rule 30e-1 must contain the following:

(1) *Financial Statements.* The audited financial statements required, and for the periods specified, by Regulation S-X.

#### Instructions.

1. *Schedule VI—Summary schedule of investments in securities of unaffiliated issuers* (17 CFR 210.12-12C) may be included in the financial statements in lieu of *Schedule I—Investments in securities of unaffiliated issuers* (17 CFR 210.12-12) if: (a) the Fund states in the report that the Fund's complete schedule of investments in securities of unaffiliated issuers is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Fund's Web site, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>; and (b) whenever the Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for the Fund's schedule of investments in securities of unaffiliated issuers, the Fund (or financial intermediary) sends a copy of *Schedule I—Investments in securities of unaffiliated issuers* within 3 business days of receipt by first-class mail or other means designed to ensure equally prompt delivery.

2. In the case of a Money Market Fund, *Schedule I—Investments in securities of unaffiliated issuers* (17 CFR 210.12-12C) may be omitted from its financial statements, provided that: (a) the Fund states in the report that the Fund's complete schedule of

investments in securities of unaffiliated issuers is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Fund's Web site, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>; and (b) whenever the Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for the Fund's schedule of investments in securities of unaffiliated issuers, the Fund (or financial intermediary) sends a copy of *Schedule I—Investments in securities of unaffiliated issuers* within 3 business days of receipt by first-class mail or other means designed to ensure equally prompt delivery.

(2) *Condensed Financial Information.* The condensed financial information required by Item 8(a) with at least the most recent fiscal year audited.

(3) *Remuneration Paid to Directors, Officers, and Others.* Unless shown elsewhere in the report as part of the financial statements required by paragraph (b)(1), the aggregate remuneration paid by the Fund during the period covered by the report to:

(i) All directors and all members of any advisory board for regular compensation;

(ii) Each director and each member of an advisory board for special compensation;

(iii) All officers; and

(iv) Each person of whom any officer or director of the Fund is an affiliated person.

(4) *Changes in and Disagreements with Accountants.* The information concerning changes in and disagreements with accountants and on accounting and financial disclosure required by Item 304 of Regulation S-K (17 CFR 229.304).

(5) *Management Information.* The management information required by Item 12(a)(1).

(6) *Availability of Additional Information about Fund Directors.* A statement that the SAI includes additional information about Fund directors and is available, without charge, upon request, and a toll-free (or collect) telephone number for shareholders to call to request the SAI.

(7) *Management's Discussion of Fund Performance.* Disclose the following information unless the Fund is a Money Market Fund:

(i) Discuss the factors that materially affected the Fund's performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the Fund's investment adviser.

(ii)(A) Provide a line graph comparing the initial and subsequent account values at the end of each of the most recently completed 10 fiscal years of the Fund (or for the life of the Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. Assume a \$10,000 initial investment at the beginning of the first fiscal year in an appropriate broad-based securities market index for the same period.

(B) In a table placed within or next to the graph, provide the Fund's average annual total returns for the 1-, 5-, and 10-year periods as of the end of the last day of the most recent fiscal year (or for the life of the

Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. Average annual total returns should be computed in accordance with Item 20(b)(1). Include a statement accompanying the graph and table to the effect that past performance does not predict future performance and that the graph and table do not reflect the deduction of taxes that a shareholder would pay on fund distributions or the redemption of fund shares.

#### Instructions.

##### 1. Line Graph Computation.

(a) Assume that the initial investment was made at the offering price last calculated on the business day before the first day of the first fiscal year.

(b) Base subsequent account values on the net asset value of the Fund last calculated on the last business day of the first and each subsequent fiscal year.

(c) Calculate the final account value by assuming the account was closed and redemption was at the price last calculated on the last business day of the most recent fiscal year.

(d) Base the line graph on the Fund's required minimum initial investment if that amount exceeds \$10,000.

2. *Sales Load.* Reflect any sales load (or any other fees charged at the time of purchasing shares or opening an account) by beginning the line graph at the amount that actually would be invested (*i.e.*, assume that the maximum sales load, and other charges deducted from payments, is deducted from the initial \$10,000 investment). For a Fund whose shares are subject to a contingent deferred sales load, assume the deduction of the maximum deferred sales load (or other charges) that would apply for a complete redemption that received the price last calculated on the last business day of the most recent fiscal year. For any other deferred sales load, assume that the deduction is in the amount(s) and at the time(s) that the sales load actually would have been deducted.

3. *Dividends and Distributions.* Assume reinvestment of all of the Fund's dividends and distributions on the reinvestment dates during the period, and reflect any sales load imposed upon reinvestment of dividends or distributions or both.

4. *Account Fees.* Reflect recurring fees that are charged to all accounts.

(a) For any account fees that vary with the size of the account, assume a \$10,000 account size.

(b) Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

(c) Reflect an annual account fee that applies to more than one Fund by allocating the fee in the following manner: Divide the total amount of account fees collected during the year by the Funds' total average net assets, multiply the resulting percentage by the average account value for each Fund and reduce the value of each hypothetical account at the end of each fiscal year during which the fee was charged.

5. *Appropriate Index.* For purposes of this Item, an "appropriate broad-based securities

market index" is one that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used. Adjust the index to reflect the reinvestment of dividends on securities in the index, but do not reflect the expenses of the Fund.

6. *Additional Indexes.* A Fund is encouraged to compare its performance not only to the required broad-based index, but also to other more narrowly based indexes that reflect the market sectors in which the Fund invests. A Fund also may compare its performance to an additional broad-based index, or to a non-securities index (e.g., the Consumer Price Index), so long as the comparison is not misleading.

7. *Change in Index.* If the Fund uses an index that is different from the one used for the immediately preceding fiscal year, explain the reason(s) for the change and compare the Fund's annual change in the value of an investment in the hypothetical account with the new and former indexes.

8. *Other Periods.* The line graph may cover earlier fiscal years and may compare the ending values of interim periods (e.g., monthly or quarterly ending values), so long as those periods are after the effective date of the Fund's registration statement.

9. *Scale.* The axis of the graph measuring dollar amounts may use either a linear or a logarithmic scale.

10. *New Funds.* A New Fund (as defined in Instruction 5 to Item 3) is not required to include the information specified by this Item in its prospectus (or annual report), unless Form N-1A (or the annual report) contains audited financial statements covering a period of at least 6 months.

11. *Change in Investment Adviser.* If the Fund has not had the same investment adviser for the previous 10 fiscal years, the Fund may begin the line graph on the date that the current adviser began to provide advisory services to the Fund so long as:

(a) Neither the current adviser nor any affiliate is or has been in "control" of the previous adviser under section 2(a)(9) (15 U.S.C. 80a-2(a)(9));

(b) The current adviser employs no officer(s) of the previous adviser or employees of the previous adviser who were responsible for providing investment advisory or portfolio management services to the Fund; and

(c) The graph is accompanied by a statement explaining that previous periods during which the Fund was advised by another investment adviser are not shown.

(iii) Discuss the effect of any policy or practice of maintaining a specified level of distributions to shareholders on the Fund's investment strategies and per share net asset value during the last fiscal year. Also discuss the extent to which the Fund's distribution policy resulted in distributions of capital.

(c) *Semi-Annual Report.* Every semi-annual report to shareholders required by rule 30e-1 must contain the following (which need not be audited):

(1) *Financial Statements.* The financial statements required by Regulation S-X for the period commencing either with:

(i) The beginning of the Fund's fiscal year (or date of organization, if newly organized); or

(ii) A date not later than the date after the close of the period included in the last report under rule 30e-1 and the most recent preceding fiscal year.

*Instruction.* Instructions 1 and 2 to Item 21(b)(1) also apply to this Item 21(c)(1).

(2) *Condensed Financial Information.* The condensed financial information required by Item 8(a), for the period of the report as specified by paragraph (c)(1), and the most recent preceding fiscal year.

(3) *Remuneration Paid to Directors, Officers, and Others.* Unless shown elsewhere in the report as part of the financial statements required by paragraph (c)(1), the aggregate remuneration paid by the Fund during the period covered by the report to the persons specified under paragraph (b)(3).

(4) *Changes in and Disagreements with Accountants.* The information concerning changes in and disagreements with accountants and on accounting and financial disclosure required by Item 304 of Regulation S-K (17 CFR 229.304).

(d) *Annual and Semi-Annual Reports.* Every annual and semi-annual report to shareholders required by rule 30e-1 must contain the following:

(1) *Expense Example.* The following information regarding expenses for the period:

*Example:*

As a shareholder of the Fund, you incur two types of costs: (1) transaction costs, including sales charges (loads) on purchase payments, reinvested dividends, or other distributions, redemption fees, and exchange fees; and (2) ongoing costs, including management fees, distribution (and/or service) (12b-1) fees, and other Fund expenses. This Example is intended to help you understand your ongoing costs (in dollars) of investing in the Fund and to compare this cost with the ongoing cost of investing in other mutual funds.

The Example assumes that you had a \$10,000 investment in the Fund at the beginning of the reporting period and continued to hold your shares at the end of the reporting period. The Example uses the Fund's actual operating expenses for the period [insert dates], including account fees.

The Example contains two numbers. The first number uses the actual return earned by the Fund during the period from [insert dates] to show the actual ongoing costs incurred on a \$10,000 investment.

The second number uses a hypothetical 5% annual return. You may use this number to compare the ongoing costs of investing in the Fund over the current period with the ongoing costs of investing in other Funds, which appear in their shareholder reports. Please note that the Example does not reflect any transactional costs, such as sales charges (loads), redemption fees, or exchange fees. Therefore, the Example is useful in comparing ongoing costs only, and will not help you determine the relative total costs of owning different funds. In addition, if these transactional costs were included, your costs would have been higher.

Although your actual ongoing costs may have been higher or lower, based on the assumptions described, the costs would have been:

\$— (using the Fund's actual return for the reporting period); and

\$— (using a hypothetical 5% return for the reporting period).

*Instructions.*

1. General.

(a) Round all dollar figures to the nearest dollar.

(b) Include the narrative explanations in the order indicated. A Fund may modify the narrative explanations if the explanation contains comparable information to that shown. A Fund may eliminate any parts of the narrative explanations that are inapplicable. For example, a Fund that does not charge loads need not include the statement that the Example does not reflect loads or that costs would be higher if loads were included.

(c)(i) If the Fund is a Feeder Fund, reflect the aggregate expenses of the Feeder Fund and the Master Fund. In a footnote to the Example, state that the Example reflects the expenses of both the Feeder and Master Funds.

(ii) If the report covers more than one Class of a Multiple Class Fund or more than one Feeder Fund that invests in the same Master Fund, provide a separate Example for each Class or Feeder Fund.

2. Computation

(a)(i) In determining the Fund's "actual operating expenses" for purposes of this example, include all expenses that are deducted from the Fund's assets or charged to all shareholder accounts, including "Management Fees," "Distribution (and/or Service) (12b-1) Fees," and "Other Expenses" as those terms are defined in Instruction 3 to Item 3 of this form as modified by Instructions 2(a)(ii) and (c)(i) to this Item. Reflect recurring and non-recurring fees charged to all investors other than any exchange fees, sales charges (loads), or fees charged upon redemption of the Fund's shares. The amount of expenses deducted from the Fund's assets are the amounts shown as expenses in the Fund's statement of operations (including increases resulting from complying with paragraph 2(g) of rule 6-07 of Regulation S-X (17 CFR 210.6-07)).

(ii) For purposes of this Item 21(d)(1), "Other Expenses" include extraordinary expenses as determined under generally accepted accounting principles (see Accounting Principles Board Opinion No. 30). If extraordinary expenses were incurred that materially affected the Fund's "Other Expenses," the Fund may disclose in a footnote to the Example what "actual operating expenses" would have been had the extraordinary expenses not been included.

(b) Assume reinvestment of all dividends and distributions.

(c)(i) Base the percentages of "actual operating expenses" on amounts incurred during the reporting period. "Actual operating expenses" should reflect actual expenses after expense reimbursement or fee

waiver arrangements that reduced expenses during the reporting period.

(i) If there have been any increases or decreases in Fund operating expenses that occurred during the reporting period (or that have occurred or are expected to occur during the current fiscal year) that would have materially affected the information in the Example had those changes been in place throughout the reporting period, restate in a footnote to the Example the expense information using the current fees as if they had been in effect throughout the entire reporting period. A change in Fund operating expenses does not include a decrease in operating expenses as a percentage of assets due to economies of scale or breakpoints in a fee arrangement resulting from an increase in the Fund's assets.

(d) Reflect any shareholder account fees collected by more than one Fund by allocating the total amount of the fees collected during the reporting period for all such Funds to each Fund in proportion to the relative average net assets of the Fund. A Fund that charges account fees based on a minimum account requirement exceeding \$10,000 may adjust its account fees based on the amount of the fee in relation to the Fund's minimum account requirement.

(2) *Graphical Representation of Holdings.* One or more tables, charts, or graphs depicting the securities holdings of the Fund by reasonably identifiable categories (e.g., type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value attributable to each. The categories should be selected, and the format of the presentation designed, to provide the most useful information to investors about the types of investments made by the Fund, given its investment objectives. Credit quality should be the ratings grade assigned by a nationally recognized statistical rating organization ("NRSRO"), as that term is used in paragraphs (c)(2)(vi)(E), (F), and (H) of Rule 15c3-1 under the Exchange Act (17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H)). The fund should use ratings of only one NRSRO.

(3) *Statement Regarding Availability of Quarterly Portfolio Schedule.* A statement that: (i) the Fund files its complete schedule of portfolio holdings with the Commission for the first and third quarters of each fiscal year on Form N-Q; (ii) the Fund's Forms N-Q are available on the Commission's Website at <http://www.sec.gov>; (iii) the Fund's Forms N-Q may be reviewed and copied at the Commission's Public Reference Room in Washington, DC, and that information on the operation of the Public Reference Room may be obtained by calling 1-800-SEC-0330; and (iv) if the Fund makes the information on Form N-Q available to shareholders on its website or upon request, a description of how the information may be obtained from the Fund.

10. Form N-2 (referenced in §§ 239.14 and 274.11a-1) is amended by:

a. Revising the fourth paragraph and subparagraph 2 of General Instruction F;

b. Revising Instructions 4.a. and 5.a. to Item 23;

c. Redesignating Instruction 6 to Item 23 as Instruction 8; and

d. Adding new Instructions 6 and 7 to Item 23.

The additions and revisions read as follows:

**Note:** The text of Form N-2 does not and this amendment will not appear in the Code of Federal Regulations

**Form N-2**

\* \* \* \* \*

**General Instructions**

\* \* \* \* \*

**F. Incorporation by Reference**

A Registrant may incorporate by reference into the prospectus or the SAI in response to Item 4.1 or 23 of this form the information contained in Form N-CSR (17 CFR 249.331 and 274.128) or any report to shareholders meeting the requirements of section 30(e) of the 1940 Act (15 U.S.C. 80a-29(e)) and Rule 30e-1 (17 CFR 270.30e-1) thereunder (and a Registrant that has elected to be regulated as a business development company may so incorporate into Items 4.2, 8.6.c, or 23 of this form the information contained in its annual report under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) (the "Exchange Act")), provided:

\* \* \* \* \*

2. The Registrant states in the prospectus or the SAI, at the place where the information required by Items 4.1, 4.2, 8.6.c., or 23 of this form would normally appear, that the information is incorporated by reference from a report to shareholders or a report on Form N-CSR. (The Registrant also may describe briefly, in either the prospectus, the SAI, or Part C of the registration statement (in response to Item 24.1) those portions of the report to shareholders or report on Form N-CSR that are not incorporated by reference and are not a part of the registration statement.); and

\* \* \* \* \*

**Item 23. Financial Statements**

\* \* \* \* \*

*Instructions.*

\* \* \* \* \*

4. \* \* \*

a. The audited financial statements required by Regulation S-X for the periods specified by Regulation S-X, modified to permit the omission of the statements and schedules that may be omitted from Part B of the registration statement by Instruction 2 above and as permitted by Instruction 7 below;

\* \* \* \* \*

5. \* \* \*

a. The financial statements required by Regulation S-X for the period commencing either with (1) the beginning of the company's fiscal year (or date of organization, if newly organized); or (2) a date not later than the date after the close of the period included in the last report conforming with the requirements of Rule 30e-1 and the most recent preceding fiscal year, modified to permit the omission of the statements and schedules that may be omitted from part B of the registration

statement by Instruction 2 above and as permitted by Instruction 7 below;

\* \* \* \* \*

6. Every annual and semi-annual report to shareholders required by Section 30(e) of the 1940 Act and Rule 30e-1 thereunder shall contain the following information:

a. One or more tables, charts, or graphs depicting the securities holdings of the Registrant by reasonably identifiable categories (e.g., type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value attributable to each. The categories should be selected, and the format of the presentation designed, to provide the most useful information to investors about the types of investments made by the Registrant, given its investment objectives. Credit quality should be the ratings grade assigned by a nationally recognized statistical rating organization ("NRSRO"), as that term is used in paragraphs (c)(2)(vi)(E), (F) and (H) of Rule 15c3-1 under the Exchange Act (17 CFR 240.15c3-1(c)(2)(vi)(E), (F) and (H)). The Registrant should use ratings of only one NRSRO; and

b. A statement that: (i) The Registrant files its complete schedule of portfolio holdings with the Commission for the first and third quarters of each fiscal year on Form N-Q; (ii) the Registrant's Forms N-Q are available on the Commission's Web site at <http://www.sec.gov>; (iii) the Registrant's Forms N-Q may be reviewed and copied at the Commission's Public Reference Room in Washington, DC, and that information on the operation of the Public Reference Room may be obtained by calling 1-800-SEC-0330; and (iv) if the Registrant makes the information on Form N-Q available to shareholders on its website or upon request, a description of how the information may be obtained from the Registrant.

7. *Schedule VI—Summary schedule of investments in securities of unaffiliated issuers* (17 CFR 210.12-12C) may be included in the financial statements required under Instructions 4.a. and 5.a. of this Item in lieu of *Schedule I—Investments in securities of unaffiliated issuers* (17 CFR 210.12-12) if: (a) The Registrant states in the report that the Registrant's complete schedule of investments in securities of unaffiliated issuers is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Registrant's website, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>; and (b) whenever the Registrant (or financial intermediary through which shares of the Registrant may be purchased or sold) receives a request for the Registrant's schedule of investments in securities of unaffiliated issuers, the Registrant (or financial intermediary) sends a copy of *Schedule I—Investments in securities of unaffiliated issuers* within 3 business days of receipt by first-class mail or other means designed to ensure equally prompt delivery.

\* \* \* \* \*

11. Form N-3 (referenced in §§ 239.17 and 274.11b) is amended by:

a. Revising the fourth paragraph and subparagraph 2 of General Instruction G;

- b. Revising Instructions 4.i. and 5.i. to Item 27(a);
- c. Redesignating Instruction 6 to Item 27(a) as Instruction 8 to Item 27(a);
- d. Adding new Instructions 6 and 7 to Item 27(a); and
- e. Revising newly redesignated Instruction 8 to Item 27(a).

The additions and revisions read as follows.

**Note:** The text of Form N-3 does not and this amendment will not appear in the Code of Federal Regulations.

**Form N-3**

\* \* \* \* \*

**General Instructions**

\* \* \* \* \*

**G. Incorporation by Reference**

Subject to these rules, a Registrant may incorporate by reference into the prospectus or the Statement of Additional Information in response to Items 4(a) or 27 of Form N-3 the information in Form N-CSR (17 CFR 249.331 and 274.128) or any report to contractowners meeting the requirements of Section 30(e) of the 1940 Act (15 U.S.C. 80a-29(e)) and Rule 30e-1 (17 CFR 270.30e-1) provided:

\* \* \* \* \*

2. The Registrant states in the prospectus or the Statement of Additional Information, at the place where the information would normally appear, that the information is incorporated by reference from a report to securityholders or a report on Form N-CSR. The Registrant may also describe, in either the prospectus, the Statement of Additional Information, or Part C of the Registration Statement (in response to Item 28(a)), any parts of the report to securityholders or the report on Form N-CSR that are not incorporated by reference and are not a part of the Registration Statement; and

\* \* \* \* \*

**Item 27. Financial Statements**

(a) \* \* \*

**Instructions:**

\* \* \* \* \*

4. \* \* \*

(i) The audited financial statements required by Regulation S-X for the periods specified by Regulation S-X, as modified by Instruction 2 above and as permitted by Instruction 7 below;

\* \* \* \* \*

5. \* \* \*

(i) The financial statements required by Regulation S-X for the period commencing either with (A) the beginning of the separate account's fiscal year (or date of organization, if newly organized); or (B) a date not later than the date after the close of the period included in the last report conforming with the requirements of Rule 30e-1 and the most recent preceding fiscal year, as modified by Instruction 2 above and as permitted by Instruction 7 below;

\* \* \* \* \*

6. Every report required by Section 30(e) of the 1940 Act and Rule 30e-1 under it (17 CFR 270.30e-1) shall contain the following information:

(i) One or more tables, charts, or graphs depicting the securities holdings of the Registrant by reasonably identifiable categories (e.g., type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value attributable to each. If the Registrant has sub-accounts, provide the information separately for each sub-account. The categories should be selected, and the format of the presentation designed, to provide the most useful information to investors about the types of investments made by the Registrant, given its investment objectives. Credit quality should be the ratings grade assigned by a nationally recognized statistical rating organization ("NRSRO"), as that term is used in paragraphs (c)(2)(vi)(E), (F), and (H) of § 240.15c3-1 of Rule 15c3-1 under the Exchange Act (17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H)). The Registrant should use ratings of only one NRSRO; and

(ii) A statement that: (A) The Registrant files its complete schedule of portfolio holdings with the Commission for the first and third quarters of each fiscal year on Form N-Q; (B) the Registrant's Forms N-Q are available on the Commission's Web site at <http://www.sec.gov>; (C) the Registrant's Forms N-Q may be reviewed and copied at the Commission's Public Reference Room in Washington, DC, and that information on the operation of the Public Reference Room may be obtained by calling 1-800-SEC-0330; and (D) if the Registrant makes the information on Form N-Q available to contractowners on its website or upon request, a description of how the information may be obtained from the Registrant.

7.(i) *Schedule VI—Summary schedule of investments in securities of unaffiliated issuers* (17 CFR 210.12-12C) may be included in the financial statements required under Instructions 4.(i) and 5.(i) of this Item in lieu of *Schedule I—Investments in securities of unaffiliated issuers* (17 CFR 210.12-12) if: (A) the Registrant states in the report that the Registrant's complete schedule of investments in securities of unaffiliated issuers is available (1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (2) on the Registrant's Web site, if applicable; and (3) on the Commission's Web site at <http://www.sec.gov>; and (B) whenever the Registrant (or financial intermediary through which shares of the Registrant may be purchased or sold) receives a request for the Registrant's schedule of investments in securities of unaffiliated issuers, the Registrant (or financial intermediary) sends a copy of *Schedule I—Investments in securities of unaffiliated issuers* within 3 business days of receipt by first-class mail or other means designed to ensure equally prompt delivery.

(ii) In the case of a Registrant or sub-account of a Registrant that holds itself out as a money market account or sub-account and meets the maturity, quality, and diversification requirements of rule 2a-7 (17 CFR 270.2a-7) under the 1940 Act, *Schedule I—Investments in securities of unaffiliated issuers* (17 CFR 210.12-12C) may be omitted from the financial statements required under Instructions 4.(i) and 5.(i) of this Item, provided that: (A) the Registrant states in the

report that the Registrant's complete schedule of investments in securities of unaffiliated issuers is available (1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (2) on the Registrant's website, if applicable; and (3) on the Commission's Web site at <http://www.sec.gov>; and (B) whenever the Registrant (or financial intermediary through which shares of the Registrant may be purchased or sold) receives a request for the Registrant's schedule of investments in securities of unaffiliated issuers, the Registrant (or financial intermediary) sends a copy of *Schedule I—Investments in securities of unaffiliated issuers* within 3 business days of receipt by first-class mail or other means designed to ensure equally prompt delivery.

8. See General Instruction G regarding incorporation by reference.

\* \* \* \* \*

**PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT**

**Company Act of 1940**

12. Form N-CSR (referenced in §§ 249.331 and 274.128) is amended by:

- a. Redesignating Items 7 and 8 as Items 8 and 9; and
- b. Adding new Item 7 to read as follows:

**Note:** The text of Form N-CSR does not and this amendment will not appear in the Code of Federal Regulations.

**Form N-CSR**

\* \* \* \* \*

**Item 7. Schedule of Investments.**

File *Schedule I—Investments in securities of unaffiliated issuers* as of the close of the reporting period as set forth in § 210.12-12 of Regulation S-X (17 CFR 210.12-12), unless the schedule is included as part of the report to shareholders filed under Item 9(a) of this Form.

**Instruction.**

*Schedule I—Investments in securities of unaffiliated issuers* filed under this Item must be audited, except that in the case of a report on this Form N-CSR as of the end of a fiscal half-year *Schedule I—Investments in securities of unaffiliated issuers* need not be audited.

13. Add Form N-Q (referenced in § 274.129) to read as follows:

**Note:** The text of Form N-Q will not appear in the Code of Federal Regulations.

**United States Securities and Exchange Commission, Washington, DC 20549**

**Form N-Q—Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company**

Investment Company Act file number \_\_\_\_\_

(Exact name of registrant as specified in charter)

(Address of principal executive offices)

(Zip code)