SHEARMAN & STERLING LLP

Client Publication

Asset Management | February 20, 2009

New Mutual Fund Summary Prospectus Rules

The Securities and Exchange Commission recently adopted new rules for mutual fund prospectuses, applicable only to open-end registered investment companies. The SEC envisions a "layered" approach to the prospectus in which fund firms have the option of using a "summary prospectus" in a three to four page format, backed up by the availability on request of online and paper copies of the longer full prospectus. Although that aspect of the new rules is optional, the SEC at the same time mandated that the full prospectus be reformatted to include a new summary section at the beginning that is essentially the same as the summary prospectus. The lead time for the new rules means that no fund prospectuses are required to be reformatted until 2010 - although earlier voluntary adoption is possible.

Firms with open-end mutual funds have two tasks ahead:

- They must decide whether and when to begin using the shorter, stand-alone summary prospectuses.
- They must prepare for the mandated reformatting of their current prospectuses that will be required in 2010.

Given that, expect 2009 to see steady back-and-forth among the many constituencies that will need to be involved, including internal marketers and key third-party intermediaries, layout, design and IT specialists (whether in-house or at the financial printers or other vendors), mailing, logistics and other operations teams, and legal and compliance specialists.

Final rule details were released January 13, 2009. A February 18, 2009 webinar hosted by the Investment Company Institute also offered guidance, including commentary by Ms. Susan Nash, the senior SEC official implementing the new rules.

The full SEC rule release is at: http://www.sec.gov/rules/final/2009/33-8998.pdf (Jan. 13, 2009).

Highlights of the New Rules

Brief overview: All mutual funds (again, open-end funds only) are required to use a new summary prospectus format set out in the first few pages of the fund prospectus. Mutual funds also may, but are not required to, use this short summary as a stand-alone selling document outside the regular prospectus. The provisions governing use of the new stand-alone summaries are set out in revisions to Rule 498 under the Securities Act of 1933.

Compliance dates: All initial registration statement and post-effective amendments (e.g., annual updates) filed on or after January 1, 2010 must include the new fund summary section in regular prospectuses. This means that by the end of 2010 all mutual fund prospectuses will include the new summary sections, although some (perhaps many) fund firms may choose never to use the summary prospectus as a stand-alone selling document. The new summary format can be implemented by funds on an optional basis as early as March 31, 2009.

Summary content: The new summary – whether included as the first few pages of a fund's prospectus or used as a stand-alone selling document – must consist only of the following information, presented only in this order:

1. Investment objectives
2. Costs
3. Principle investment strategies, risks, and performance
4. Investment advisers and name, title and length of service of up to five portfolio managers
5. Brief purchase (including minimum purchase amounts) and redemption and tax information
6. Financial intermediary compensation information.

The only items that can precede a summary are the cover page and a table of contents.

Summary length: There is no set requirement, but the SEC expects a summary – again whether included as the first few pages of a fund's prospectus or used as a stand-alone selling document – to be "on the order of three or four pages." For a multi-fund prospectus, this three to four page length guideline applies separately to the new summary section for each fund, so that the listing of summaries across multiple funds actually might run many pages. Trimming the investment description and risk disclosure sections likely will be the most significant editing issues for funds trying to live within a three to four page document.

"Plain English": Plain-English presentation is already required for fund prospectuses, but as a gentle reminder the new rules specify that the summaries, prospectus front and back covers and prospectus risk sections be in plain English. This means straightforward sentence structures, ordinary language, and the use of descriptive headings, bullet point lists, tables, graphs and other visual guideposts.

Other formatting requirements: Standardization extends only to required content and ordering of the summary information. According to the SEC, "Funds have almost complete flexibility with respect to design issues, including layout, graphics and color." While the sample summary prospectus from the SEC's 2007 proposing release was not included in the final rule release, Ms. Nash of the SEC said at the ICI webinar that the sample is still an appropriate precedent as to overall look and feel.

SEC review of filings: Post-effective amendments incorporating the new summary sections will not be immediately effective "B filings" under Rule 485(b). Instead they will be "A filings" under Rule 485(a) and subject to SEC staff review, so that fund firms must build time for that review into their transition plan. That said, "under appropriate circumstances," the review staff will permit automatically-effective B filings; one example of these "appropriate circumstances" is that of a firm that has made A filings for its new summary prospectus format for some of its funds and will follow the same format when updating its remaining prospectuses. Because they are to mirror the corresponding full prospectuses, the stand-alone summary prospectuses will not be subject to any special SEC reviews.

Questions for the SEC?: At the ICI webinar, Ms. Nash offered her department's telephone number for questions. That number is 202-551-6784.

The New Summary as a Stand-Alone Selling Document - Optional

Brief overview: Using the new summary as a stand-alone selling document in lieu of the full prospectus is optional (but, the SEC hints, may be mandated in the future). Using the summary in this manner requires that both the stand-alone summary and the full prospectus be available on the fund's web site at all times and that the full prospectus be sent or e-mailed on request. In addition, the summary truly must be stand-alone; subject to an exception available only for variable annuity funds, it cannot be bound together with any other document and must be given "greater prominence" than any other non-prospectus document used with it. This means, for example, that the summary must be separate from and on top of a package of related advertising material. (A summary prospectus need not be given greater prominence than a full prospectus or another summary prospectus.)

Industry reaction: Both the SEC and the ICI are strongly encouraging funds to adopt the new stand-alone summaries. Representatives of several large fund complexes were speakers at the ICI webinar, and all suggested both that their firms planned to adopt the new format and that the intermediary community is supportive. Despite the overall message of enthusiasm, discussion at the ICI webinar (especially the audience questions) confirmed that not all fund firms will adopt the new stand-alone summaries. Smaller firms are concerned about the cost of the transition, and some firms, especially those with more complex products, are concerned about unduly slimming their disclosures. As with the earlier "profile prospectus," some firms simply will continue to view the potential failings of a short-form selling document as outweighing its convenience.

Cover page of a stand-alone summary: A stand-alone summary must include on its cover the fund's name (and covered share classes), the fund's exchange ticker symbol (for funds with separate ticker symbols for their multiple share classes, ticker symbols will be shown adjacent to the relevant share class listings), the date of the summary and a statement identifying the document as a "Summary Prospectus." There also must be a legend as follows:

> Before you invest, you may want to review the fund's prospectus, which contains more information about the fund and its risks. You can find the fund's prospectus and other information about the fund online at __________. You can also get this information at no cost by calling __________ or by sending an e-mail request to __________.

This legend may indicate that the full prospectus and other information are available from a financial intermediary.

Phone and e-mail availability of the full prospectus: The required telephone number from the stand-alone summary's cover-page legend must be toll-free or state that it allows for a collect call. Delivery of the full prospectus by e-mail may rely on an embedded link as opposed to delivery of a text or PDF file, provided the link remains useable for at least six months and the e-mail specifies when the link will expire.

Internet availability of the full prospectus: The required internet address from the stand-alone summary's cover-page legend may not be the SEC's EDGAR address and must direct the reader to a dedicated web page that in fact has the full prospectus on it or offers a clear one-click link to it. (Including multiple prospectuses or links to multiple prospectuses on a single page is permitted, so long as each fund's information is presented "prominently.") In addition to the full prospectus, a fund company must provide through this web site the stand-alone summary prospectus, the SAI, and the most recent annual and semi-annual reports. This information must be available, in current or updated form, for at least 90 days after delivery of the summary prospectus. ICI webinar participants generally agreed that different web sites could be used by the same fund firm in dealing with different audiences. The example that was offered was that a firm could use a link to its own web site in one set of materials and use a link to an intermediary's web site in materials tailored for use by that intermediary; the same principles should apply in other contexts, such as retail versus institutional audiences.

Internet specifications: All required online information must be "human-readable" on the web site and printable, downloadable and savable in a "human-readable" format. ("Human-readable" is an odd phrase, but apparently the SEC worried that some firms might post information that was only readable by unduly specialized software programs; the agency did not, as a policy matter, want to specify which software applications – e.g., Adobe Acrobat for PDF files – were sufficiently broadly available.) Online documents must be formatted to be "convenient for both reading online and printing on paper." In addition, the full online prospectuses and SAIs must allow one-click linking back and forth from a table of contents to the corresponding information in the document itself – referred to as the "linking within" requirement. Various links also must be available between the online version of the stand-alone summary prospectus on the one hand and the online versions of the full prospectus and SAI on the other hand – referred to as the “linking between” requirement. These requirements, which only apply once a fund uses the new stand-alone summaries, are perceived in the industry as among the most burdensome operational aspects of the new rules. This means that reserving project time with a firm’s IT professionals to establish or review the newly required internet and e-mail features should have an early place on a firm’s transition calendar.

Safe harbor for internet failures: The requirement that information be available on the internet suggests a corollary requirement of a well functioning web site, but the SEC recognizes that failures may occur. Good faith efforts to maintain continuous internet service will be sufficient.

Incorporation by reference: A previous attempt to encourage the fund industry to use a short-form prospectus (then called a “profile prospectus”) failed, in part because of industry concerns that a short-form document would be incomplete and therefore expose firms to failure-to-disclose claims. To address this concern, the stand-alone summary prospectus is allowed to “incorporate by reference” language from the full prospectus, SAI and shareholder reports, provided it clearly identifies and dates the source document and makes the source document available online, by phone or by e-mail in the same manner as the full prospectus is made available. Given that, risk disclosure likely will be incorporated into the stand-alone summaries from the full prospectus and statement of additional information. It will be interesting to see how incorporation-by-reference practices vary as funds begin to adopt the stand-alone summaries.

Filing requirements for the stand-alone summary prospectus: Each stand-alone summary prospectus requires a separate SEC filing upon first use and thereafter at each annual update (annual updating is required on the same cycle as the full prospectus). In addition, if a “sticker” supplement is required that affects both a section of the stand-alone summary prospectus and the full prospectus, two stickers – one for each document – must be prepared and filed. A speaker at the ICI webinar speculated that the practice for supplements is likely to be that traditional “buckslip” supplements (loose supplement or correction pages) will be used for the full prospectus, but that the stand-alone summaries will be reprinted in full when supplemented or corrected.

Adopting the stand-alone summary in mid-year: For the many funds with late-year year-ends (e.g., those with October 31, November 30 or December 31 year-ends), the timing of the new rule raises an interesting question: If the fund proceeds with its regular update, which many are already well along with, and it does not incorporate summary sections into the full prospectus, how can the fund use the stand-alone summaries this year rather than waiting until 2010? The answer is that the fund must do a special mid-year update to the full prospectus to add the new summary sections. This is because the rule requires that a stand-alone summary prospectus and its corresponding full prospectus contain the same information. As to the practical burden of doing a mid-year update to a full prospectus, much of the numeric information in a full prospectus is updated only at year-end, but the prospectus instructions still should be reviewed carefully to identify any special information updates triggered by the new prospectus date. For example, the expense ratio would require updating if expenses year-to-date were materially different from the expense ratio originally shown based on the fiscal year-end. Since the update primarily should involve reordering of existing information, distribution of the updated full prospectus generally should be required only on a “fulfillment basis” (i.e., only to new shareholders). At the ICI webinar, however, Ms. Nash of the SEC encouraged funds to review whether their particular mid-year changes will be sufficiently material to warrant resending prospectuses, or perhaps sending the new stand-alone summaries, to existing shareholders.

More Detail

Ticker symbols: In addition to the ticker symbol requirements outlined above for the stand-alone summary prospectus, all mutual funds now will be required to list their exchange ticker symbol on the cover of the regular prospectus and SAI. For funds with separate ticker symbols for their multiple share classes, the ticker symbol will be shown adjacent to the relevant share class.

Multi-class funds: A fund with multiple share classes, each with its own cost structure, can prepare separate summary information for each class, integrate information about the multiple classes in a single fund summary, or – whatever this means – use another presentation consistent with disclosing the summary information in the standard order at the beginning of the full prospectus. This instruction applies for both the stand-alone summaries and the summary sections of the full prospectus.

Prospectus layout for multi-fund prospectuses: The new summary section of the full prospectus must be separate for each fund – no mixing across funds allowed. Each summary section must be clearly labeled for each fund. Since each summary section must describe only one fund, comparisons among funds will be relocated either outside the summary sections of the full prospectus or to advertising material altogether separate from the prospectus.

Can multi-fund prospectuses integrate anything across the summaries?: Yes, information on purchase and sale of fund shares, tax information and financial intermediary compensation can be presented in a multi-fund prospectus on an integrated basis, assuming it is "identical" for all funds covered by that full prospectus. This integrated information must be presented immediately after the separate summary sections. In addition, each summary section must use a mandated legend directing readers to the heading and page number under which the integrated information is presented. (Remember, however, that even though this limited integration is available as to the summary sections within the full prospectus, no integration is possible between the separate, stand-alone summary prospectuses.)

Special rules for fund purchase and redemption terms: Previously funds were allowed to omit information on the purchase and redemption of shares from the prospectus if the information was provided in a separate document and summarized in the SAI. The option to omit this information is no longer available, except for variable annuity funds. These changes apply for both the stand-alone summaries and the summary sections of the full prospectus.

Changes to the "costs" section of the summary: The traditional fee table and expense examples will continue to be the heart of this section, which also will include specified portfolio turnover information that is being relocated from elsewhere in the prospectus. The costs section also has been moved up, so that it appears even before investment strategies, risks and performance. Trading costs, the biggest cost component not shown in the current fee table, remain unaddressed, because no uniform approach to quantifying and presenting these costs has been identified. 12b-1 fees will continue to be shown under that name – at least for now; the release refers to a future "full reconsideration of sales charges and Rule 12b-1." The costs section of the summary also will have a legend showing the first dollar amount at which breakpoints are available and directing the reader to more detailed breakpoint information available elsewhere. These changes apply for both the stand-alone summaries and the summary sections of the full prospectus.

Fee waivers / expense reimbursements: Fee-waived or expense-reimbursed expense ratios are required to be presented across three lines of the summary's fee table – first the gross ratio, then a line showing the percentage reduction as a result of waivers/reimbursements, and finally the net ratio. Additional information also is required about the expected term of waiver/reimbursement arrangements and when and how the arrangements can be revoked. The expense example is permitted to show the effect of these arrangements only so long as they are expected to remain in place (e.g., if only running year-to-year, the expense example will show the reduced expenses only for the first year). These changes apply for both the stand-alone summaries and the summary sections of the full prospectus.

Changes to the "performance" section of the summary: The traditional performance bar chart will continue to be the heart of this section. Funds that include updated performance data on their web site or toll-free phone line (i.e., nearly all firms) now will include a legend directing the reader to that data. These changes apply for both the stand-alone summaries and the summary sections of the full prospectus.

Financial intermediary compensation: With very few exceptions for no-load funds making no intermediary payments, a new legend is required for both the stand-alone summaries and the summary sections of the full prospectus that must read essentially as follows:

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

Exchange-traded funds: A number of revisions to the prospectus were provided for ETFs. These include the elimination of requirements to disclose information on how to buy and redeem shares directly from the ETF (to be replaced by more limited information tailored to those transacting in ETF "creation units"), a requirement that ETFs disclose that shareholders may pay more than NAV when they buy ETF shares on the market and receive less than NAV when they sell the shares, and a requirement to include specified information about how closely trading of the ETF's shares has tracked its NAV (that NAV tracking information instead may be posted to a free, publicly available web site).

Point-of-sale disclosures: In accord with long-standing prospectus delivery rules, the stand-alone summary need not be delivered at the time of sale, so long as it is delivered at or before the "carrying or delivery" of the purchased shares or, excepting permitted advertisements, at or before delivery of any non-prospectus offering information. The SEC acknowledges that point-of-sale information requirements would be useful, but is deferring that topic for another day.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Robert H. Mundheim
New York
+1.212.848.7738
rmundheim@shearman.com

Richard Metsch
New York
+1.212.848.7518
rmetsch@shearman.com

Amy E. Bohannon
New York
+1.212.848.4347
amy.bohannon@shearman.com

Justin P. Houghton
New York
+1.212.848.4987
justin.houghton@shearman.com