New Disclosure Requirements for Portfolio Managers of Registered Management Investment Companies

From the Investment Management Practice Group

Summary
On August 18, 2004, the Securities and Exchange Commission (“SEC”) adopted amendments to Form N-1A, N-2, N-3 and N-CSR that are designed to improve disclosure provided by mutual funds and closed-end funds about their portfolio managers. Specifically, these amendments will:

- Require a fund to identify in its prospectus each member of a committee, team, or other group of persons that is jointly and primarily responsible for the day-to-day management of the fund’s portfolio (or, in the case of a team with more than five such members, the five members with the most significant responsibility for the day-to-day management of the fund’s portfolio);

- Require a fund to provide information in its Statement of Additional Information (“SAI”) regarding other accounts managed by any of its portfolio managers, including a description of material conflicts of interest that may arise in connection with simultaneously managing the fund and the other accounts;

- Require a fund to disclose in its SAI the structure of, and the method used to determine, the compensation of each portfolio manager;

- Require a fund to disclose in its SAI each portfolio manager’s beneficial ownership of shares of the fund; and

- Require a closed-end fund to provide disclosure regarding its portfolio managers in its reports on Form N-CSR.

The SEC noted that these amendments are adopted in response to concerns that have been raised with respect to the absence of disclosure about: (i) the individual members of portfolio management teams; (ii) the compensation of portfolio managers; (iii) portfolio managers’ holdings in the funds that they manage; and (iv) potential conflicts of interest between the interests of shareholders in a fund that a portfolio manager oversees, and the interests of other clients and investment vehicles, such as hedge funds and pension funds, that a portfolio manager may also oversee.

Below is a brief discussion of the new disclosure requirements.

Identification of Portfolio Management Team Members

Under the changes to Forms N-1A and N-2, the registration forms for mutual funds and closed-end funds, respectively, a fund will now be required to identify in its prospectus each member of a committee, team, or other group of persons that is jointly and primarily responsible for the day-to-day management of the fund’s portfolio;
and the roles of other persons who have responsibility for the day-to-day management of the fund’s portfolio.4

Disclosure Regarding Other Accounts Managed and Potential Conflicts of Interest

A fund will be required to provide disclosure in its SAI regarding other accounts for which the fund’s portfolio manager is primarily responsible for the day-to-day portfolio management.5 Additionally, if a committee, team, or other group that includes the portfolio manager in question is jointly and primarily responsible for the day-to-day management of other accounts, the fund is required to include those other accounts in responding to this disclosure requirement.

A fund must also disclose the number of other accounts managed by a portfolio manager, and the total assets in the accounts within each of the following categories: registered investment companies, other pooled investment vehicles, and other accounts. For each of these categories, a fund is also required to disclose the number of accounts and the total assets in the accounts with respect to which the advisory fee is based on account performance.

If a fund identifies more than five persons as portfolio managers in its prospectus, it need only provide the required disclosure regarding other accounts managed, compensation, and securities ownership for the five persons with the most significant responsibility for the day-to-day management of the fund’s portfolio.

The amendments also require a fund to describe any material conflicts of interest that may arise in connection with the portfolio manager’s management of the fund’s investments, on the one hand, and the investments of the other accounts, on the other.6 This description would include, for example, material conflicts between the investment strategy of the fund and the investment strategy of the other accounts managed by the portfolio manager, and material conflicts in allocation of investment opportunities between the fund and such other accounts.

Disclosure of Portfolio Manager Compensation Structure

A fund will be required to describe in its SAI the structure of, and the method used to determine, the compensation received by the fund’s portfolio manager from the fund, the investment adviser to the fund, or any other source with respect to management of the fund and any other account included by the fund in response to the disclosure requirement described immediately above regarding other accounts managed by the portfolio manager.7

For each type of compensation (e.g., salary, bonus, deferred compensation, retirement plans and arrangements), a fund must now describe with specificity the criteria on which that type of compensation is based—for example, whether compensation is fixed, whether (and, if so, how) compensation is based on the fund’s pre- or after-tax performance over a certain period, and whether (and, if so, how) compensation is based on the value of assets held in the fund’s portfolio. A fund must clearly disclose any differences between the method used to determine the portfolio manager’s compensation with respect to the fund and other accounts. For example, the fund must disclose whether the portfolio manager receives part of an advisory fee that is based on performance with respect to some accounts but not the fund. However, the value of compensation received by a portfolio manager need not be disclosed.

Disclosure of Securities Ownership of Portfolio Managers

A fund must disclose in its SAI the securities ownership in the fund of each portfolio manager who is required to be identified in the fund’s prospectus.8 In its Adopting Release, the SEC explained that this disclosure is intended to help investors assess the extent to which the portfolio manager’s interests are aligned with theirs. The SEC also noted that while a manager could have reasons for not holding shares of a specific fund that are unrelated to the manager’s lack of confidence in the fund, e.g., that its investment objectives do not match the manager’s, a fund is free to include an explanation of these reasons in its disclosure.

A fund is also required to disclose portfolio managers’ ownership of shares of the fund using the following dollar ranges: none, $1-$10,000, $10,001-$50,000, $50,001-$100,000, $100,001-$500,000, $500,001-$1,000,000, or over $1,000,000.

Date of Disclosure

The required information regarding other accounts managed by a portfolio manager, compensation structure, and ownership of fund securities must be provided as of the end of the fund’s most recently completed fiscal year. However, in the case of an initial registration statement or an update to a fund’s registration statement that discloses a new portfolio manager, information with respect to any newly identified portfolio manager is required to be provided as of the most recent practicable date. The date as of which the information is provided must be disclosed. In effect, this means that a fund is required to disclose changes to this information with respect to a previously identified portfolio manager once a year, as part of its post-effective amendment that is an annual update to its registration statement. A fund is not required to update its SAI during the
year for each change in any of the required information regarding a previously identified portfolio manager, such as changes in the fund securities that a portfolio manager owns.

**Removal of Exclusion for Index Funds**

Currently, under Form N-1A, an index fund (i.e., a fund whose investment objective is to replicate the performance of an index) is not required to identify and provide disclosure regarding its portfolio managers. The new amendments have eliminated this exclusion for index funds. In its Adopting Release, the SEC explained that it was removing this exclusion in order to shed light on the alignment of the interests of index fund portfolio managers with the interests of investors in these funds, and on the potential conflicts of interest that may be present in managing these funds.

**Disclosure of Availability of Information**

In order to assist investors in finding the additional information about portfolio managers that is required in the SAI, a fund will now be required to state in its prospectus that the SAI provides this information. This disclosure is required to appear adjacent to the disclosure identifying the portfolio managers.

A fund will also be required to state on the back cover page of the fund’s prospectus whether the fund makes available its SAI and annual and semi-annual reports, free of charge, on or through its web site at a specified Internet address. If a mutual fund does not make its SAI and shareholder reports available in this manner, the fund is required to disclose the reasons why it does not do so (including, where applicable, that the fund does not have an Internet web site).

**Amendment of Form N-CSR (For Closed-End Funds Only)**

Because closed-end funds do not offer their shares continuously and are, therefore, generally not required to maintain an updated SAI to meet their obligations under the Securities Act of 1933, these funds will be required to provide disclosure regarding their portfolio managers in their annual reports on Form N-CSR. A closed-end fund must disclose the basic information about its portfolio managers (name, title, length of service, and business experience), as well as the required disclosure regarding other accounts managed by a portfolio manager, the portfolio managers’ compensation structure, and ownership of fund shares by the portfolio managers. Additionally, a closed-end fund is required to disclose any change in its portfolio managers, and to provide all of the required portfolio manager disclosure for any newly identified portfolio manager, in its semi-annual reports on Form N-CSR.

The disclosure in Form N-CSR with respect to the name, title, length of service, and business experience of a portfolio manager is required to be current as of the date of filing of the report, and the disclosure regarding other accounts managed, compensation structure, and fund securities ownership generally is required to be current as of the end of the fund’s most recently completed fiscal year. In the case of a newly identified portfolio manager in an annual or semi-annual report, however, this disclosure is required to be current as of the most recent practicable date. This will result in basic information about a closed-end fund’s portfolio manager in Form N-CSR that is current on the date of filing, and will make the date with respect to which other disclosure about a portfolio manager is provided consistent with the requirements for the SAI in Forms N-1A, N-2, and N-3.

**Compliance Date**

The effective date of the amendments is October 1, 2004. All initial registration statements on Forms N-1A, N-2, and N-3, and all post-effective amendments that are annual updates to effective registration statements on these forms, filed on or after February 28, 2005, must include the disclosure required by the amendments. Moreover, all post-effective amendments that add a new series, filed on or after February 28, 2005, must comply with the amendments with respect to the new series.

Every annual report by a closed-end fund on Form N-CSR filed for a fiscal year ending on or after December 31, 2005, and every semi-annual report by a closed-end fund on Form N-CSR filed after the first such annual report, must include the disclosure required by the amendments.
Paul Hastings is a leader in providing counseling to investment companies, their boards and their advisers. Our investment management lawyers can help you evaluate the potential effects of the amendments on your business practices and disclosure documents. We can also provide counsel regarding best practices in the investment management industry. If you have any questions concerning these issues, please contact us.

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Notes


2) The SEC also adopted amendments to Form N-3, the registration form for insurance company managed separate accounts that issue variable annuity contracts, to require disclosure regarding portfolio managers, including members of portfolio management teams, similar to the disclosure that will be required by Forms N-1A and N-2. Currently, Form N-3 does not require disclosure about portfolio managers.

3) The SEC noted, however, that under the adopted amendments, disclosure is only required with respect to members of a management team who are jointly and primarily responsible for the day-to-day management of the fund’s portfolio. To the extent that a fund is managed by a committee, team, or other group that includes additional members who are not jointly and primarily responsible for day-to-day management, identification of these individuals is not required. Thus, if a fund has a management team that includes analysts who make securities recommendations with respect to the portfolio, but do not have decision-making authority, these individuals would not have to be identified, unless they are jointly and primarily responsible for day-to-day management of the fund’s portfolio. An analyst owner responsible for day-to-day management of the fund’s portfolio routinely adopts the analyst’s recommendations.

The SEC also noted that the determination of the members of a portfolio management team who are jointly and primarily responsible for the day-to-day management of a fund’s portfolio will depend on the facts and circumstances of the particular fund. For example, in the case of a fund with a large management team, where a single “lead member” is responsible for implementing and monitoring the overall portfolio management of the fund, it may be appropriate to identify this single “lead member” as the portfolio manager.

4) According to the SEC, this requirement is intended to provide investors with a clearer understanding of what an identified portfolio manager does and does not do in the course of day-to-day management of the fund, and the ways in which the responsibilities of any identified portfolio manager relate to those of other members of a portfolio management team, including members who may not be identified in the prospectus as portfolio managers. The new disclosure will also assist investors in funds with large management teams, such as research-driven funds, in understanding how the responsibilities of an identified portfolio manager may differ from those of a manager who manages a fund on his or her own or with a small team of other managers.

5) It should be noted that in the Proposing Release, the SEC sought comments on whether to prohibit portfolio managers of registered funds from managing certain types of accounts, such as hedge funds. However, in the Adopting Release, the SEC determined not to do so. The SEC noted that the disclosure of other accounts managed and material conflicts of interest, together with the requirement in the recently adopted compliance rules for policies and procedures to address conflicts, is a preferable approach to addressing conflicts of interest arising from side-by-side management of multiple accounts.

6) According to the SEC, a conflict would be material if there is a substantial likelihood that disclosure of the conflict would be viewed by a reasonable investor as significantly altering the “total mix” of information available about the fund. In the SEC’s view, this would include, for example, a conflict that a reasonable investor would consider likely to affect the manager’s professional judgment with respect to management of the fund.

7) For purposes of this disclosure requirement, compensation includes, without limitation, salary, bonus, deferred compensation, and pension and retirement plans and arrangements, whether the compensation is cash or non-cash. However, the fund may omit disclosure regarding group life, health, hospitalization, medical reimbursement, relocation, and pension and retirement plans and arrangements, provided that they do not discriminate in scope, terms, or operation in favor of the portfolio manager or a group of employees that includes the portfolio manager and are available generally to all salaried employees.

8) The disclosure requirement applies to fund shares beneficially owned by the portfolio manager(s) in question. For this purpose, “beneficial ownership” will be determined in accordance with rule 16a-1(a)(2) under the Securities Exchange Act of 1934 (the “Exchange Act”). In the Adopting Release, the SEC noted that disclosure of record holdings should not be required and that the focus of “beneficial ownership” should be on whether a manager’s economic interests are tied to the fund shares, rather than his or her ability to exert voting power or to dispose of the shares.

The SEC also noted that under the definition of beneficial ownership in Rule 16a-1(a)(2) under the Exchange Act, a person is presumed to be a beneficial owner of securities that are held by the person’s immediate family members sharing the same household.

9) In the Adopting Release, the SEC also adopted amendments to Forms N-2 and N-3 that require similar disclosure on the front cover page of the prospectus for closed-end funds and insurance company managed separate accounts that issue variable annuity contracts. In addition, the amendments to Forms N-2 and N-3 require that the front cover page of the prospectus include a statement explaining how to obtain the fund’s shareholder reports and a toll-free (or collect) telephone number for investors to call to request the fund's SAI, annual and semi-annual reports, and other information, and to make shareholder inquiries. These amendments also change from optional to mandatory disclosure of the SEC’s Internet web site address. These requirements as adopted are similar to existing requirements of Form N-1A.

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