

January 9, 2004

Proposed Amendments to Form N-1A Concerning Disclosure of Breakpoint Discounts by Mutual Funds

The Securities and Exchange Commission (the “SEC”) has proposed amendments to Form N-1A to require open-end management investment companies (“mutual funds”) to provide enhanced disclosure regarding breakpoint discounts on front-end sales loads and to provide a brief summary of shareholder eligibility requirements: “Disclosure of Breakpoint Discounts by Mutual Funds” (the “Proposal”).¹ Comments on the Proposal must be submitted to the SEC by February 13, 2004. This memorandum outlines the requirements of the Proposal.

A. Introduction

Shares of mutual funds are often sold with a front-end sales load, i.e. a commission paid by an investor to a financial intermediary as compensation for the sale of the shares. The dollar amount of the commission is based on a percentage of the purchase price paid by the investor. Typically, a mutual fund maintains a schedule of front-end sales loads whereby the size of the commission percentage declines as the size of the investment increases (e.g., 5% for sales less than \$50,000, 4% for sales between \$50,000 and \$100,000, 3% for sales greater than \$100,000). The demarcations at which the higher investment amounts reduce the percentage of the front-end sales load are commonly known as “breakpoints” and the reductions of the commissions are commonly known as “breakpoint discounts.” At issue is the degree to which investors are aware of their eligibility for breakpoint discounts.

¹ Proposed Rule: Disclosure of Breakpoint Discounts by Mutual Funds, 17 CFR Parts 239 and 274; Release Nos. 33-8347, 34-48939, IC-26298, File No. S7-28-03; RIN 3235-AI95 (December 17, 2003).

B. Disclosure of Breakpoints in Sales Loads

The SEC is proposing to revise Form N-1A.² The Proposal would require mutual fund prospectuses to include an informative but brief description of any arrangements that result in breakpoint discounts.³ As part of the description, the SEC proposes that the prospectuses identify each class of individuals or transactions to which breakpoints apply and state each different breakpoint as a percentage of both the offering price and the net amount invested.⁴ The Proposal also would require mutual fund prospectuses to detail any eligibility requirements shareholders must satisfy to receive the breakpoint discounts.⁵ Currently, a description of breakpoint discounts and shareholder eligibility is required in the Statement of Additional Information (“SAI”), which is usually delivered to investors only upon request.⁶ Finally, the SEC is proposing a requirement that, when applicable, the prospectus must refer investors and financial intermediaries to the SAI for additional information on breakpoints.⁷

C. Disclosure of Methods Used to Value Accounts

The three principal valuation methods mutual funds currently use in determining whether a shareholder’s aggregated investments qualify for a breakpoint discount are historical cost, net amount invested and the offering price. The SEC is proposing a

² Mutual funds register with the SEC on Form N-1A.

³ Examples of these types of arrangements: letters of intent, accumulation plans, divided reinvestment plans, withdrawal plans, exchange privileges.

⁴ Proposed Rule, Release Nos. 33-8347, 34-48939, IC-26298 at Section II.A. The proposed changes would be under Item 8(a)(2) of the Form N-1A.

⁵ Proposed Rule, Release Nos. 33-8347, 34-48939, IC-26298 at Section II.A.

⁶ The SEC however will continue to permit disclosure of information on breakpoints for affiliated persons of the fund or in connection with a reorganization in the SAI.

⁷ With regard to the SAI, the SEC proposes to amend Item 18(a) of Form N-1A so that information regarding breakpoint discounts not included in the prospectus would be included in the SAI.

requirement that mutual funds disclose in their prospectuses which method is used to value a shareholder's holdings when determining whether that shareholder qualifies for discounts.⁸

D. Disclosure of Necessary Information and Records

The Proposal would require mutual funds to state in their prospectus 1) whether shareholders must notify the fund of accounts eligible to be aggregated in qualifying for breakpoint discounts and 2) whether shareholders must retain records sufficient to verify eligibility for breakpoint discounts.⁹ If a mutual fund requires shareholders to retain certain records in order to qualify for discounts, the SEC proposes requiring that fund's prospectus to state, where applicable, that shareholders need to retain the following:¹⁰

- records regarding shares of the fund or other funds held in all accounts of the shareholder at the fund's financial intermediary;
- records regarding shares of the fund or other funds held in any account of the shareholder at another financial intermediary; and
- records regarding shares of the fund or other funds held at any financial intermediary by related parties of the shareholder.

E. Disclosure of Availability of Breakpoint Discounts on the Fund's Website

The SEC proposes that mutual fund prospectuses state whether the fund makes available on its website, in a clear and prominent format, the information required in the prospectus and SAI on sales loads and breakpoint discounts.¹¹ If the fund does not provide

⁸ Proposed Rule, Release Nos. 33-8347, 34-48939, IC-26298 at Section II.B.

⁹ *Id.* at Section II.C. For example, if a mutual fund gives breakpoint discounts based on aggregations at historical cost, the fund's prospectus should inform shareholders that they must retain records sufficient to verify prior purchases since the fund or its service providers may not preserve this information.

¹⁰ Proposed Rule, Release Nos. 33-8347, 34-48939, IC-26298 at Section II.C.

¹¹ *Id.* at Section II.D. The SEC suggests that the fund's website maintain hyperlinks to the relevant sections of the fund's prospectus or SAI.

this information on its website, the SEC proposes requiring the fund's prospectus to disclose its reasons.¹²

F. Presentation Requirements

The Proposal would require that the description of breakpoint arrangements be located adjacent to the table of sales loads and breakpoint discounts.¹³ While this table is often located in the prospectus, the SEC currently permits mutual funds to provide the table in a separate purchase and redemption document.¹⁴ The SEC proposes to continue to permit this practice so long as the description of breakpoint arrangements would be adjacent to the tables in the separate purchase and redemption document.¹⁵

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If you have any questions concerning the Proposal or would like to consider submitting a comment on any part of the Proposal to the SEC, please do not hesitate to contact us.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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¹² *Id.* at Section II.D.

¹³ *Id.* at Section II.E.

¹⁴ *Id.* The purchase and redemption document is delivered along with the prospectus pursuant to Item 7(f) of Form N-1A.

¹⁵ *Id.* at Section II.E. The purchase and redemption document is delivered along with the prospectus pursuant to Item 7(f) of Form N-1A.