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FORM N-1A LIABILITY ISSUES
"IT'S DÈJÁ VU ALL OVER AGAIN"

David A. Sturms
Vedder, Price, Kaufman & Kammholz
Chicago, Illinois

I. Introduction

It has often been said that "history repeats itself," or, in the words of Yogi Bera: "It's dèjá vu all over again." In March 1998, the Securities and Exchange Commission (the "Commission" or "SEC") adopted broad-based and significant amendments to Form N-1A.[1] These amendments may very well be characterized as the most revolutionary development in mutual fund prospectus disclosure since the proposal and adoption of Form N-1A itself in the early 1980s.[2] Accordingly, they have attracted ample attention and comment. Interestingly enough, the industry reaction and the bar's concerns are eerily parallel to those associated with Form N-1A's initial adoption.

In 1983, the industry applauded the Commission's introduction of the two-part registration statement (which was designed to provide investors with a simplified prospectus containing essential information about a fund and to place more detailed information in a separate document called the "Statement of Additional Information" ("SAI"), which investors could obtain upon request). Industry commentors called the move "revolutionary" and "innovative." Meanwhile, the bar expressed concern about the

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1 Form N-1A is the form of registration statement used by mutual funds under the Investment Company Act of 1940, as amended (the "1940 Act"), and the Securities Act of 1933, as amended (the "1933 Act"). *See* Investment Company Act Release No. 22528 (Feb. 27, 1997) ("Form N-1A Proposing Release"); Investment Company Act Release No. 23064 (Mar. 13, 1998) ("Form N-1A Adopting Release").

2 Investment Company Act Release No. 12927 (Dec. 27, 1982) ("1982 Form N-1A Proposing Release"); Investment Company Act Release No. 13436 (Aug. 12, 1983) ("1983 Form N-1A Adopting Release").

potential liability that a mutual fund faced in omitting information from the prospectus and instead including it in the SAI. Now, with the current amendments, the industry is again showering the Commission with "Goldilocks-type"[3] praise in its efforts to further simplify the prospectus, while the bar is predicting the demise of the "bespeaks caution" defense.

Where are we really? I have to take exception with those who are sounding like "Chicken Little;" the "sky is not falling," it is just raining!

II. Overview of the March 1998 Form N-1A Amendments

The March 1998 Form N-1A amendments are part of a three prong disclosure initiative recently adopted by the SEC.[4] The purpose of these initiatives is to improve disclosure and promote effective communication of information to mutual fund investors. Specifically, the Form N-1A amendments seek to minimize prospectus disclosure about technical, legal, and operational matters that generally are common to all funds and to focus prospectus disclosure on essential information about a particular fund that would assist an investor in making a decision about investing in that fund.

The adoption of the Form N-1A amendments was preceded by an amendment to rule 421, which requires all companies, including investment companies, to use plain English principles in writing the cover pages and risk/return summary section of prospectuses.[5] The plain English rule requires issuers to make their prospectuses clear, concise and understandable by using short sentences, everyday language, active voice, tables and bullet lists, no jargon and no multiple negatives. The plain English rule is intended to create a market in which investors can more easily understand their investments and disclosure under the federal securities laws.

III. Liability Issues Under the Securities Laws and the "Bespeaks Caution" Doctrine

A. General Liability Under the Securities Laws

A mutual fund is unique in that it must register both (i) itself under the 1940 Act and (ii) the securities it issues under the 1933 Act. Form N-1A is the form adopted by the SEC to be used by mutual funds to do so. As with any issuer of securities under the 1933 Act, a mutual fund can be sued civilly for damages if the registration statement is materially misleading or defective, if the fund fails to deliver a prospectus in connection with the sales of its securities, or if the prospectus includes a material misstatement or omission. The fund's underwriter and board of directors are also civilly liable under the 1933 Act for a materially

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[3] Not too bad, not too good; just right!

[4] A second prong of the initiative is the adoption of a new rule 498, which would permit a mutual fund to provide a "profile" summary prospectus to prospective investors. *See* Investment Company Act Release No. 22529 (Feb. 27, 1997) ("Profile Proposing Release"); Investment Company Act Release No. 23065 (Mar. 13, 1998) ("Profile Adopting Release"). The third prong of the initiative, the adoption of a plain English rule, is discussed below.

[5] Rule 421 under the 1933 Act. *See* Securities Act Release No. 7380 (Jan. 14, 1997) ("Plain English Proposing Release"); Securities Act Release No. 7497 (Jan. 28, 1998) ("Plain English Adopting Release").

misleading or defective registration statement. In addition, a shareholder can bring a civil action for fraud under rule 10b-5 of the Securities Act of 1934, as amended (the "1934 Act") in connection with the purchase or sale of a fund's securities. Finally, section 17(a) of the 1933 Act imposes criminal liability for material misrepresentations or omissions.

1. <u>Section 11 Liability</u>

Section 11 of the 1933 Act provides for civil liability for the issuer and associated persons (including, among others, directors of the issuer and underwriters) with respect to material misrepresentations or omissions in the registration statement after such statement becomes effective.

2. <u>Section 12(1) Liability</u>

Section 12(1) of the 1933 Act provides for civil liability for any person who offers or sells a security in violation of section 5 of the 1933 Act. Section 5(a) provides that unless a registration statement is effective for a security, it is unlawful for any person to sell any such security through the use of any prospectus or otherwise or to carry or cause to be carried any such security for the purpose of sale or for delivery after sale. Section 5(b) provides that it is unlawful for any person to deliver any prospectus for any such security for which a registration statement has been filed, unless such prospectus meets the requirements of section 10 of the 1933 Act. Furthermore, it is unlawful for any person to carry or cause to be carried any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of section 10(a) of the 1933 Act. Finally, section 5(c) provides that it is unlawful for any person to offer to sell or offer to buy through the use of any prospectus or otherwise any security, unless a registration statement has been filed as to such security and such registration statement is not subject to a refusal or stop order.

3. <u>Section 12(2) Liability</u>

Section 12(2) of the 1933 Act provides for civil liability, including the purchaser's right of rescission, for any person who offers or sells a security by means of a prospectus or oral communication which includes a material misrepresentation or omission.

4. <u>Rule 10b-5 Liability</u>

Rule 10b-5, which was promulgated under section 10(b) of the 1934 Act, provides for civil liability for any person when such person, in connection with the purchase or sale of any security, (i) employs any device, scheme, or artifice to defraud, or (ii) makes any statement which contains any material misrepresentation or omission, or (iii) engages in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

5. <u>Section 17(a) Liability</u>

Section 17(a) of the 1933 Act provides for criminal liability for any person involved in the offer or sale of any security when such person (i) employs any device, scheme, or artifice to defraud, or (ii) obtains any money or property by means of any material misrepresentation or omission, or (iii) engages in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

B. <u>The "Bespeaks Caution" Doctrine</u>

The "bespeaks caution" doctrine, in essence, protects issuers (including mutual funds) from liability if their prospectuses contain specific, cautionary risk disclosure. Some recent court decisions have suggested that the more specific the discussion of risks, the better. For example, in <u>Sheppard v. TCW/DW Term Trust 2000</u>, 938 F. Supp. 171 (S.D.N.Y. 1996), plaintiffs alleged inadequate disclosure and misleading marketing with respect to the degree to which the funds invested in mortgage-backed derivatives and inverse floaters and the magnitude of interest rate risk. The court granted defendants' motion to dismiss because, in the court's view, "the prospectus clearly 'bespeaks caution' in that the various risks inherent in purchasing shares ... were adequately disclosed." In particular, the <u>Sheppard</u> court noted that the prospectus provided detailed explanations of each type of instrument in which the funds invested, including such instrument's sensitivity to interest rate risk.

Moreover, general statements of risk may not necessarily overcome the omission of specific known risks. In <u>Blatt v. Merrill Lynch</u>, 916 F. Supp. 1343 (D.N.J. 1996) the court stated: "Not just any cautionary language will trigger application of the [bespeaks caution] doctrine. Instead, disclaimers must relate directly to that on which investors claim to have relied." In <u>Blatt</u>, the plaintiffs claimed that the speculative nature of two funds was not disclosed in the funds' prospectuses. The prospectuses were allegedly misleading because they stated that the funds would invest in derivatives only to generate current income or for hedging purposes, when, according to the plaintiffs, the funds would have to speculate in derivatives in order to obtain the higher yields necessary to cover their expenses. Although the prospectuses warned generally about the dangers of net asset value fluctuation, investing in indexed notes and other risks, the court denied defendants' motion to dismiss, finding that the bespeaks caution doctrine could not be invoked because the prospectuses did not alert investors to the speculative nature of the investment strategy.

Similarly, in <u>In Re TCW/DW North American Government Income Trust Securities Litigation</u>, 1997 U.S. Dist. LEXIS 18485 (S.D.N.Y. 1997), a court recently ruled that the bespeaks caution doctrine could not be employed to protect the failure of a mutual fund's prospectus to disclose that a rapid rise in interest rates could dramatically alter the projected average life of the securities in the portfolio. While the prospectus did discuss the negative effect of rising interest rates on a fixed-income based fund, noted the court, the risk that was not described was one apparently limited to the derivative mortgage securities in which the fund was heavily invested. Specifically, the court held that the prospectus failed to adequately disclose the consequences of the risk that rising interest rates could cause prepayments to occur at a slower than expected rate which, in turn, could effectively change a security considered short-term at the time of purchase into a long-term security. It could be a material omission to fail to disclose that a fund expecting to maintain a portfolio of short-term securities could, during a time of rising interest rates, have a portfolio of securities with a much longer life. Although disclosures in the prospectus did accurately depict the type of risk borne by the fund, the court concluded that a reasonable investor could find both that the prospectus failed to disclose the extent of the risk and that this failure significantly altered the total mix of available information.

IV. <u>March 1998 N-1A Amendments — Increased Liability or "Much Ado About Nothing"</u>

A number of commentors have suggested that the March 1998 N-1A amendments materially increase the liability faced by mutual funds and their sponsors. First and foremost, they claim that the amendments contrast with the "bespeaks caution" doctrine. On the other side of the coin, a number of other commentors believe that the bespeaks caution doctrine is relatively unaffected. For example, a few commentors have suggested that a fund could take the Nancy Reagan position (*i.e.*, "just say no" to the Commission's desire to move the detailed, specific risks of individual securities and other factors and circumstances to the SAI). In other words, provide a plain English summary of the principal risks of the fund, but still extoll on for pages regarding individual securities and the like. Other commentors note that a fund might, rather, provide detailed, specific risks of individual securities and other factors and circumstances in the fund's SAI, which may be incorporated by reference into the prospectus. Such commentors point to the fact that the SEC has, in essence, mandated that the level and type of risk disclosure in the prospectus shift from detailed disclosure of individual portfolio securities and their risks to a more general disclosure of the risks of a fund's portfolio as a whole, and that section 19(a) of the 1933 Act provides protection for funds that follow and comply with the requirements of a Commission rule (such as Form N-1A). This commentor believes that, as with most debates with participants that hold views at each end of the spectrum, reality is somewhere in the middle. Simply put, the bespeaks caution doctrine is not dead; it has just been wounded. Under the new world order, mutual funds and their counsel should strive to draft cautionary risk disclosure that, in accordance with the amendments to Form N-1A, adequately and appropriately warns investors of the principal risks of a fund (especially those that go to the fundamental characteristics of the fund and any significant risk factors relating to the principal types of securities in which the fund will invest). The SAI, in turn, may become the repository for the detailed individual security risk disclosure that today permeates many mutual fund prospectuses. Through incorporation by reference and reliance upon section 19(a) of the 1933 Act, this commentor believes that courts should have sufficient authority to dismiss, at the pre-trial stage, spurious lawsuits under the bespeaks caution doctrine. Nevertheless, let the debate begin!

A. The Bespeaks Caution Doctrine: Dead or Alive?

1. Point: It's Dead

One of the primary objectives of the March 1998 amendments to Form N-1A is to shift the focus of the risk disclosure from the risks of individual portfolio securities to the overall risks of a fund. Specifically, as amended, Items 2(c)(1) and 4(c) of Form N-1A both require a Fund to disclose "the principal risks of investing in the Fund, including the risks to which the Fund's portfolio as a whole is subject and the circumstances reasonably likely to affect adversely the Fund's net asset value, yield, and total return."[6]

This shift in disclosure focus, while a laudable concept that may result in more readable, user-friendly prospectuses and mitigate against "disclosure creep," is out of step with the trend toward more detailed, specific disclosure prompted by various court decisions articulating the "bespeaks caution" doctrine. See Sheppard, Blatt and TCW/DW. Case closed!

2. Counterpoint: It's Alive

The concept behind the "bespeaks caution" doctrine is that specific, cautionary risk disclosure may protect a mutual fund from securities law liability. While some recent cases have focused upon the specific disclosure in funds' prospectuses relating to the individual holdings of the funds, the Commission, which is charged with promulgating the form and content of mutual fund disclosure, has amended Form N-1A to "require a fund to disclose the risks to which the fund's particular portfolio as a whole is expected to be subject and to discuss the circumstances that are reasonably likely to affect adversely the fund's net asset value, yield, or total return."[7] The Commission stated as its rationale for this shift in disclosure its view that "disclosing the risks of each possible portfolio investment, rather than the overall risks of investing in a fund, does not help investors evaluate a particular fund or compare the risks of the fund with those of other funds."[8]

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[6] Item 2(c)(1) requires a fund to "summarize" such risks; Item 4(c) requires a fund to "disclose" such risks. Ordinarily, this would lead one to believe that a prospectus must contain both a summary of risks along with a more detailed description of risks. Footnote 27 to the Form N-1A Adopting Release, however, provides that Form N-1A "does not require a fund to include any risk disclosure elsewhere in the prospectus if the requirements of Item 4 of Form N-1A are met by the disclosure in the fund's risk/return summary (i.e., if a fund is able to describe its risks, as required by Item 4, in its risk/return summary, the fund would not need to describe those risks elsewhere in its prospectus)."

[7] Form N-1A Adopting Release, at 54.

[8] Form N-1A Adopting Release, at 54.

As a way of reconciling prospectus simplification and the bespeaks caution doctrine, one commentor suggested that the Commission acknowledge in writing the judicially imposed principles underlying the bespeaks caution doctrine and then expressly mandate in the form itself (or in the specific instructions thereto) the specific risk disclosure that can be included in a prospectus, leaving all other risk disclosure solely in the SAI.[9] That commentor further argued that the Commission should go on to require that any detailed discussion of the risks of specific investments or techniques be contained only in the SAI, not the prospectus. Finally, that commentor (and many others) urged the Commission to explicitly state that funds that comply with the Form N-1A requirements should be permitted to rely upon section 19(a) of the 1933 Act in defending against liability.

In response to these and other comments, the Commission stated in the Form N-1A Adopting Release that: "Section 19(a) of the [1933 Act] and section 38(c) of the [1940 Act] protect a fund from liability under these Acts for actions taken in good faith in conformity with any rule of the Commission" and that "[T]he amendments to Form N-1A are designed to provide better guidance to funds as to what information should be in the prospectus and the SAI to assist funds seeking to act in good faith in conformity with Form N-1A."

The debate on the bespeaks caution doctrine associated with the Form N-1A amendments is very similar to that played out in the Plain English Adopting Release. There, the Commission similarly rejected various commentors' liability concerns. Instead, the Commission argued that plain English does not mean omitting important information. In fact, the Commission cited to the Investment Company Institute's comment letter, dated March 24, 1997, that plain English disclosure should actually reduce potential liability because it decreases the likelihood that an investor will misunderstand the prospectus.

B. Incorporation By Reference: Does It Work?

1. Point: It Works

One of the most significant issues involved in the proposal and adoption of Form N-1A was the potential liability that a mutual fund faced in omitting information from the prospectus and instead including it in the SAI.[10] In the 1982 Form N-1A Proposing Release, the Commission sought to address this concern by reference to section 19(a) of the 1933 Act, which provides that no provision of the 1933 Act "imposing any liability shall

[9] *See* Letter from American Bar Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 12, 1997.

[10] *See* Letter from the American Bar Association to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, dated April 15, 1983 ("1983 ABA Letter").

apply to any act done or omitted in good faith in conformity with any rule of the Commission," and stating that "Form N-1A is intended to provide guidance as to what information the Commission believes should be in the prospectus." The 1982 Form N-1A Proposing Release cautioned, however, that:

> . . . while the Commission believes in light of section 19(a) that, under ordinary circumstances, the registrant's discussion of the various disclosure items of Form N-1A (as designated in Parts A and B) "in good faith in conformity with" the form would not result in liability under section 12(2), the Commission recognizes that there may be concern that a court could impose liability if it found that certain information in Part B constituted a material fact necessary to make the statements required in the prospectus not misleading.

Because of the liability uncertainty,[11] the 1982 Form N-1A Proposing Release sought comment as to whether the Commission should permit incorporation by reference of the SAI into the prospectus. Of the sixteen commentors who responded, thirteen generally supported the concept of incorporation by reference while three commentors specifically disagreed with the notion of permitting incorporation by reference. In light of the comments and the liability concerns, the Commission revised Form N-1A to permit mutual funds to incorporate the SAI into the prospectus by reference.

There is only one reported case construing the ability of a mutual fund to incorporate by reference the SAI into its prospectus (White v. Melton, 757 F.Supp. 267 (S.D.N.Y. 1991)). In that case, the court held that the plaintiff could not state a claim for fraud under the securities laws where a defendant mutual fund placed information regarding a so-called "freeze rule" in the SAI, which was incorporated by reference into the prospectus, rather than the prospectus itself. In so concluding, the court cited the Commission's statements that "SAIs incorporated by reference are deemed 'a part of the prospectus as a matter of law,'" and found that the "freeze rule" was not a fundamental characteristic of the fund and that placement in the SAI rather than the prospectus was consistent with the

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[11] Section 11 of the 1933 Act provides shareholders with a civil remedy for false or misleading statements in a registration statement and for material omissions to state facts required to be stated therein. This provision concerns the registration statement as a whole, so there should be no potential liability for a mutual fund and others in omitting information from Part A (the prospectus) when that information is in Part B (the SAI). Section 12(2) of the 1933 Act, however, provides shareholders with a civil remedy with respect to the use of a prospectus or oral communication that includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading. This provision applies notwithstanding the Commission"s authority under section 10 to prescribe the form and content of prospectuses.

Commission's desire to have the prospectus contain simple and direct information for most investors.

Mutual funds may also look to other precedents for some additional comfort on incorporation by reference. For example, in proposing Forms S-2 and S-3,[12] the Commission noted that incorporation by reference as contemplated in those forms meant that "the prospectus will be deemed to contain full disclosure about both the issuer and the transaction regardless of whether the information is actually presented in the prospectus or is allowed to be incorporated therein by reference from other documents." In particular, the Commission observed that investors would have the benefit of the protection of sections 11 and 12(2) under the 1933 Act with respect not only to the information incorporated by reference into a prospectus, but that it should follow that such information is included in the prospectus for purposes of fulfilling the disclosure requirements.

2. Counterpoint: It Doesn't Work

While White v. Melton is helpful, incorporation by reference does not necessarily cure a prospectus that fails to adequately disclose the risks of the fund. Because the Commission stopped short of mandating the exact language that must be contained in the prospectus, versus what must be shifted to the SAI, a prospectus may have to "stand alone" on the subjective determination of the principal risks of the fund, including the portfolio as a whole and the circumstances reasonably likely to adversely affect the fund. A fund, therefore, cannot necessarily protect itself by extensively disclosing and detailing all appropriate risks in its SAI. As the Commission put it:

> incorporating information by reference from the SAI is not permitted as a response to an item of Form N-1A requiring information to be included in the prospectus. Permitting the SAI to be incorporated by reference into the prospectus was meant to allow funds to *add* material that the Commission determined not to require in the prospectus, not to permit funds to delete *required* information from the prospectus and place it in the SAI. Form N-1A, as amended, provides funds with clearer directions for allocating disclosure between the prospectus and the SAI. Funds can discuss items of information required to appear in the prospectus in greater detail in the SAI, which may be incorporated by reference into the prospectus.[13]

12 Securities Act Release No. 6331 (Aug. 6, 1981).

13 Form N-1A Adopting Release.

Therefore, if a plaintiff can show, for example, that a circumstance (which was disclosed in the SAI, but not in the prospectus) was reasonably likely to occur, then the protection of incorporation by reference to the SAI may not be available. A narrow reading of White v. Melton is shared by a leading commentor,[14] which said:

> The court [in White v. Melton] ultimately disagreed [with the plaintiff that disclosure of the "freeze rule" belonged in the prospectus], but only after treating the motion as one for summary judgment and analyzing at some length the applicable guidelines for determining what information belongs in the prospectus and what belongs in the SAI. In the end, the court cited the plaintiff's failure to allege that the freeze rule affected anything more than "a limited class of investors" in holding that the freeze rule disclosure was appropriately placed. *Id*. at 273 and n.12 In effect, the court relied on a technical pleading omission by the plaintiff to reach a result that it did not feel it could reach on the plain language of the prospectus and SAI alone.

C. Section 19(a) Protection: Real or Illusory?

1. Point: It's Real

The Commission has often cited section 19(a) of the 1933 Act in an effort to allay the liability fears of mutual funds that are charged with following the requirements of Form N-1A in splitting the disclosure between the prospectus and the SAI. Most recently, in the Form N-1A Adopting Release, the Commission stated that: "Section 19(a) of the [1933 Act] and section 38(c) of the [1940 Act] protect a fund from liability under these Acts for actions taken in good faith in conformity with any rule of the Commission" and that "[T]he amendments to Form N-1A are designed to provide better guidance to funds as to what information should be in the prospectus and the SAI to assist funds seeking to act in good faith in conformity with Form N-1A."

The Commission's section 19(a) statements are supported by White v. Melton (discussed earlier). Furthermore, the notion of looking to the interpretation given to a statute (such as section 19(a) of the 1933 Act) by its administering agency as an aid in interpreting Congress's intent is supported by and discussed at length in Wilshire Westwood Associates v.

[14] *See* Letter from Gordon Altman Butowsky Weitzen Shalov & Wein to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 9, 1997 (the letter acknowledged that the firm acted as counsel to the fund in White v. Melton).

Atlantic Richfield Corporation, 881 F.2d 801 (9th Cir. 1989). Citing the Supreme Court in United States v. Shimer, 367 U.S. 374 (1961), the court stated that "... [i]f this choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned."

While, admittedly, the governing precedent is slight and commentators are not in agreement, the better view is that an issuer (as well as directors and others) is protected from liability under the 1933 Act if it reasonably relies on a form[15] adopted by the Commission. An issuer that omits disclosure from its prospectus (Part A of proposed Form N-1A) in reliance upon the items and instructions of the Form is, absent a judicial or other finding that the Form is invalid, almost certainly insulated from liability under sections 10(a)(4) and 19(a) of the 1933 Act. Under section 10(a)(4) "there may be omitted from any prospectus any of the information required [by section 10(a)] which the Commission may by rules or regulations designate as not being necessary or appropriate in the public interest or for the protection of investors." The last sentence of section 19(a) provides:

> No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

While section 10(a)(4) does not state that one relying on the Commission's judgment is protected from liability for omissions under sections 11 or 12(2), the quoted sentence in Section 19(a), which was added in 1934, should accomplish that result. The purpose of that sentence "is to permit the regulations of the Commission, under the powers conferred upon it, adequately to protect persons who rely upon them in good faith." House Committee Report No. 1838 (1934), 73rd Cong. 2d Sess., p. 42. Thus, an issuer which in good faith reliance on Form N-1A omits information from Part A and includes such information in Part B should be protected from liability under sections 11 or 12(2) by virtue of section 19(a).

2. **Counterpoint: It's Illusory**

[15] Rule 100 under the 1933 Act defines "rules and regulations" to include "forms for registration and accompanying instructions thereto."

Mutual funds should not take much comfort in preparing prospectus disclosure from the provisions of section 19(a) of the 1933 Act. Notwithstanding the decision in White v. Melton, at present there is not a sufficient body of case law or jurisprudence under section 19(a) to overcome concerns about its scope and meaning. For example, in Spicer v. Chicago Board Options Exchange, Inc., 1992 U.S. Dist. LEXIS 18796 (N.D. Ill. 1992), the court held that the section 19(a) defense is inapplicable to other potential sources of liability, such as violations of section 10(b) and rule 10b-5 under the 1934 Act. Furthermore, the legislative history of section 19(a) is almost non-existent. The section can, for example, be construed as nothing more than a "savings" clause intended primarily to protect issuers from changes in rule or form.

Importantly, an SEC rule cannot overrule congressional intent. In SEC v. Sloan, 436 U.S. 103 (1978), the SEC argued that its interpretation of the statute was consistent and longstanding, and therefore deserved great deference. Although true as a general principle of law, the Supreme Court disagreed with the SEC in this particular case due to the language of the statute at issue. Quoting NLRB v. Hearst Publications, 322 U.S. 111, 131 (1944), the court stated, "[t]he construction put on a statute by the agency charged with administering it is entitled to deference by the courts, and ordinarily that construction will be affirmed if it has a 'reasonable basis in law.' But the courts are the final authorities on issues of statutory construction, and are not obliged to stand aside and rubber-stamp their affirmance of administrative decisions that they deem inconsistent with a statutory mandate or that frustrate the congressional policy underlying a statute."

V. Conclusion

Although the Form N-1A amendments may produce clearer, more concise prospectus disclosure, they may also increase the opportunity for liability. Of course, funds have always faced liability for materially misleading disclosure documents. However, the Form N-1A amendments, which seek to summarize and reduce the types and amount of risk disclosure, contrast with the evolving "bespeaks caution" doctrine. This is not fatal. It simply means that implementation and compliance with the amendments should be done in a judicious, prudent manner, with appropriate guidance and assistance from counsel and with the full understanding of the issues by the mutual funds' boards and their sponsors' senior management.

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