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Legal Liabilities Arising from the Mutual Fund Disclosure Initiatives Form N-1A Amendments "Profile" "Plain English"

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I. INTRODUCTION

The Securities and Exchange Commission (the "Commission" or "SEC") has recently adopted three new initiatives that seek to improve the quality and usefulness of mutual fund disclosure. Specifically, the SEC has adopted (i) amendments to Form N-1A, (ii) a new rule 498 to permit use of a short-form "profile" and (iii) an amendment to rule 421 requiring that prospectuses (and profiles) be written in "plain English." These initiatives may very well be characterized as the most revolutionary development in mutual fund disclosure since the adoption of Form N-1A itself.

These new SEC initiatives were developed to produce clearer, more concise disclosure. The new initiatives are designed so as not to, in and of themselves, create significant new disclosure-related liability exposures for mutual funds and their sponsors. As with any dramatically new regulatory regime, however, the initiatives leave open legal questions, and there will likely be a period of uncertainty as these questions are tested by the plaintiffs' bar and resolved by the courts.[1] Nevertheless, the most significant increased risk to funds and their sponsors is likely to result from a failure by fund complexes to appreciate and focus adequate resources on implementation of the changes required by the initiatives rather than from the substantive effects of the initiatives themselves.

II. SUMMARY OF THE DISCLOSURE INITIATIVES

In March 1998, the Commission adopted broad-based and significant amendments to Form N-1A.[2] 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"). The amendments are the first major reassessment of Form N-1A since the two-part registration statement (i.e., prospectus and statement of additional information ("SAI")) was initially proposed and adopted in the early 1980s.[3] The 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.

Also in March 1998, the Commission adopted a new rule 498 under the 1933 Act, which would permit, but not require, a mutual fund to provide a "profile" document summarizing key information to

[1] As detailed below, there is a concern that the Form N-1A amendments (which seek to summarize and reduce the types and amount of risk disclosure included in fund prospectuses) can be viewed as at odds with the evolving "bespeaks caution" doctrine (which is a judicial principle that shields issuers and others from liability based upon allegations of misleading disclosure if, and only if, the disclosure addresses the risks specifically and completely). In addition, the profile (which does not contain all information contained in the statutory prospectus, but which can be the sole basis upon which an investor may make an investment decision) may expose funds to a new breed of lawsuits based upon the profile's inherent summary nature.

[2] Investment Company Act Release No. 22528 (Feb. 27, 1997) ("1997 Form N-1A Proposing Release"); Investment Company Act Release No. 23064 (Mar. 13, 1998) ("1998 Form N-1A Adopting Release").

[3] 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").

prospective purchasers.[4] The profile summarizes prospectus disclosure on nine key topics, including a risk/return summary, graphic disclosure of return variability, and information on the fund's investment adviser and manager, purchase and redemption procedures, tax considerations and shareholder services. A fund that opts to use a profile will be able to give investors the choice of investing in the fund based upon the summary information in the profile or requesting additional information about the fund.

The adoption of the Form N-1A amendments and the profile were preceded (in January 1998) by an amendment to rule 421 under the 1933 Act, 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 (and profiles) clear, concise and understandable by using short sentences, everyday language, active voice, tables and bullet lists, no jargon and no multiple negatives.

These three new disclosure initiatives are designed to promote more effective communication of fund information to investors. Overall, the goal of these initiatives is to create disclosure documents that present clear, useful information to the average investor. These changes were effective June 1, 1998. Because the use of a profile is optional, a fund can control when or if it wishes to use a profile. For the Form N-1A amendments and the plain English rule, Form N-1A filings (for either a new fund or the updating of an existing fund) after December 1, 1998 have to comply with the new rules.[6]

III. <u>LIABILITY ISSUES</u>

As stated above, the new initiatives are designed so as not to, in and of themselves, create significant new disclosure-related liability exposures that do not otherwise already exist. However, as discussed below, the initiatives do create some legal uncertainty, and given the significant effects that the new initiatives will have on fund disclosure, it is important that fund complexes devote adequate time and resources to understanding and implementing the changes that the initiatives will require.

<u>A. Liability Issues Associated with the Amendments to Form N-1A</u>

As discussed below, the Form N-1A amendments can be viewed as at odds with the evolving "bespeaks caution" doctrine, the arguable result of which is to reduce the ability of fund complexes to succeed in pre-trial summary disposition of disclosure-related lawsuits. However, the increased risk this presents to fund complexes should be offset by the ability to incorporate by reference into the prospectus more detailed risk disclosure from the SAI and by section 19(a) of the 1933 Act (which protects entities acting in good faith in conformity with SEC rules). Of course, there remains some level of

[4]Investment Company Act Release No. 22529 (Feb. 27, 1997) ("Profile Proposing Release"); Investment Company Act Release No. 23065 (Mar. 13, 1998) ("Profile Adopting Release").

[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").

[6]All new registration statements or post-effective amendments that are annual updates to effective registration statements filed on or after December 1, 1998 must comply with the amendments to Form N-1A and the plain English rule. The final compliance date for filing amendments to effective registration statements to conform with the amendments to Form N-1A and the plain English rule is December 1, 1999.

unpredictability as to how the courts will react when the plaintiffs' bar begins to test the new disclosure regime prompted by the SEC's disclosure initiatives.

1. The Basic Requirements of the Securities Laws. Starting at square one, 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 for damages if the registration statement is materially misleading or defective,[7] if the fund fails to deliver a prospectus in connection with the sales of its securities,[8] or if the prospectus includes a material misstatement or omission.[9] The fund's underwriter and board of directors can also be liable under the 1933 Act for a materially misleading or defective registration statement.[10] In addition, a shareholder can bring an action for fraud under rule 10b-5 of the Securities Exchange Act of 1934, as amended (the "1934 Act"), in connection with the purchase or sale of a fund's securities.[11] Individual states also provide for various state law

[7]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.

[8]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.

[9]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. *See also* section 17(a) of the 1933 Act which provides for criminal liability for any person 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.

[10]Section 11 of the 1933 Act concerns the registration statement as a whole. The registration statement consists of information from Part A (the prospectus) and Part B (the SAI), as well as Part C (other information required to be in the registration statement). Hence, the prospectus actually forms only a part, albeit a very significant part, of the registration statement. Since section 11 concerns the entire registration statement, there should be no potential liability under section 11 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.

[11]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

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claims which may apply to materially misleading or fraudulent statements in a registration statement or prospectus to which issuers, directors, officers, and others may be subject, including breach of fiduciary duty,[12] common law fraud,[13] and common law false advertising[14] claims.

2. The Possible Effect of the Form N-1A Amendments on the "Bespeaks Caution" Doctrine. One of the primary objectives of the March 1998 amendments to Form N-1A is to shift the focus of risk disclosure from the risks of *individual* portfolio securities to the *overall* risks of a fund.[15] This shift in disclosure focus is a laudable concept that may result in more readable, user-friendly prospectuses and mitigate against "disclosure creep." However, as discussed below, the shift is out of step with the trend towards more detailed, specific disclosure, which has been prompted by various court decisions articulating the so-called "bespeaks caution" doctrine.

The bespeaks caution doctrine, as developed by the courts through various decisions, protects issuers (including mutual funds), directors, and officers from claims alleging disclosure-related violations of the securities laws if the prospectus[16] contains specific, cautionary language. Specifically, the doctrine allows courts to rule that claims by investors alleging violations of section 11 and section 12(2) of the 1933 Act, section 10(b) of the 1934 Act and rule 10b-5 thereunder, and/or various state law claims, are not actionable as a matter of law. Although the courts have differed somewhat as to the precise rationale for the dismissal of the claims, the underlying theme in the vast majority of the cases has generally taken one of two forms: (i) that the alleged misstatements or omissions are immaterial as a matter of law because the offsetting bespeaks caution disclosure minimizes the impact of the alleged misstatements or omissions, or (ii) that the investors could not have justifiably relied on the alleged misstatements or omissions because of the presence of the bespeaks caution disclosure. If available, the bespeaks caution

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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.

[12] *See, e.g.*, In re Alliance North American Government Income Trust Securities Litigation, 1996 U.S. Dist. LEXIS 14209 (S.D.N.Y. 1996).

[13] *See, e.g.*, Tabankin v. Kemper Short-Term Global Income Fund, 1994 U.S. Dist. LEXIS 965 (N.D. Ill. 1994) and Okley v. Hyperion 1999 Term Trust, 98 F.3d 2 (2d Cir. 1996).

[14] *See, e.g.*, Taj Mahal Litigation, 793 F. Supp. 543 (D.N.J. 1992).

[15] As amended, Items 2(c)(1) and 4(c) of Form N-1A require a Fund to summarize/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. 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 1998 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)."

[16] The bespeaks caution doctrine has also been applied to registration statements, sales materials and oral statements in and of themselves.

doctrine permits defendants to obtain a dismissal of a lawsuit early in the litigation process, thereby minimizing the likelihood of an expensive judgment or settlement and significantly reducing the overall costs of defense involved.

Because the bespeaks caution doctrine exists only as a creature of case law, its scope is not precise. However, a review of the cases involving the bespeaks caution doctrine indicates that the more specific and detailed the discussion of risks in the prospectus, the more likely it is that the bespeaks caution doctrine will be found applicable by the courts.[17] Moreover, the case law indicates that generalized statements of risk will *not* necessarily support application of the bespeaks caution doctrine, at least where discussion of specific known risks is omitted from the prospectus.[18] Indeed, in one recent case, which has been a subject of much discussion in the mutual fund industry, a federal district court refused to apply the bespeaks caution doctrine to dismiss a disclosure-related lawsuit notwithstanding that the prospectus disclosed the very *type* of specific risk at issue in the lawsuit, on the grounds that the prospectus did not adequately describe the *extent* of the specific risk.[19]

Thus, the bespeaks caution doctrine, as developed and applied by the courts to date, actively promotes the use of specific and detailed prospectus disclosure on virtually every type of risk that might

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[17]For example, in Sheppard v. TCW/DW Term Trust 2000, 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 Sheppard 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.

[18]For example, in Blatt v. Merrill Lynch, 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 Blatt, 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.

[19]In In re TCW/DW North American Government Income Trust Securities Litigation, 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 court noted that the prospectus did discuss the negative effect of rising interest rates on a fixed-income based fund, it also noted that 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 that the prospectus failed to disclose the extent of the risk and that this failure significantly altered the total mix of available information.

conceivably affect the fund or particular portfolio securities. Funds that provide such disclosure may find it significantly easier to invoke the bespeaks caution doctrine in the context of motions to dismiss disclosure-related lawsuits. This, in turn, may decrease the risk that these funds will ultimately be forced into expensive settlements and/or incur significant costs of defense in disclosure-related litigation.

Conversely, funds that *reduce* the length and detail of their prospectus risk disclosure may find it increasingly problematic to rely upon the bespeaks caution doctrine in seeking to dismiss disclosure-related litigation. Yet this reduction is precisely what the Form N-1A amendments appear to be intended to accomplish. The amendments seek to "pare down" prospectus risk disclosure regarding various possible portfolio investments. The SEC presumably intends that the "excess" risk disclosure be eliminated (or at least moved to the SAI). Arguably, then, absent other protections (discussed below), the risk disclosure portions of the N-1A amendments (for those mutual funds choosing to comply with them[20]) could be viewed as *increasing* litigation risk for funds and sponsors in disclosure-related lawsuits.

3. The Protections Afforded by Incorporation by Reference and Section 19(a). At least as a practical matter, any such increased litigation risk should be offset by the effect of two other legal protections. First, a fund that addresses the Form N-1A amendments by shifting all "excess" risk disclosure to the fund's SAI should be able to continue to rely on the bespeaks caution doctrine, on the theory that the SAI disclosure is incorporated by reference into the fund's prospectus. However, the ability to incorporate by reference has not been addressed at all by the courts in connection with the bespeaks caution doctrine.[21] A court could conceivably decide to ignore risk disclosure in an SAI, either

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[20]Form N-1A itself does not provide for any "penalty" or "sanction" for alleged "over disclosure." However, under Rule 461(b) under the 1933 Act, the SEC may deny acceleration when a fund has not made a bona fide effort to make its prospectus reasonably concise, readable and in compliance with the plain English rule. In the Plain English Adopting Release, however, the SEC disclaimed any intention of being "grammar police."

[21]To date, there has been 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 Commission's desire to have the prospectus contain simple and direct information for most investors.

See, however, Letter from Gordon Altman Butowsky Weitzen Shalov & Wein to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 9, 1997, which commented upon the 1997 Form N-1A Proposing Release and the Profile Proposing Release. The letter, which acknowledged that the firm acted as counsel to the fund in White v. Melton, 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

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(1) based upon the rules for incorporation by reference themselves (*i.e.*, incorporation by reference is not permitted for an item, such as "principal" risk disclosure, that is required to be in the prospectus),[22] or (2) under the "buried facts" doctrine (*i.e.*, that the risk disclosure in an SAI cannot be read in the overall context of the prospectus because it is obscured or "buried" in a separate document).[23]

Second, a fund should find another source of protection in section 19(a) of the 1933 Act.[24] In adopting the recent Form N-1A amendments, the Commission explicitly 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." These Commission statements are not unimportant[25] since the courts, in interpreting a statute (such as section 19(a) of the 1933 Act), often look to its administering agency as an aid in such interpretation.[26]

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> 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.

[22]*See* the 1998 Form N-1A Adopting Release, which stated that:

> 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.

[23]*See* Gould v. American Hawaiian Steamship Company, 331 F. Supp. 981 (D.Del. 1971); Kuhn v. American Metal Climax, Inc., 322 F. Supp. 1331 (E.D.Pa. 1970), modified, 458 F.2d 255 (3d Cir. 1972).

[24]Section 19(a) of the 1933 Act provides that no provision of the Act "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."

[25]Warning! Blatant plain English violation!

[26]*See*, *e.g.*, Wilshire Westwood Associates v. 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 in Wilshire stated that: "If 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."

An agency interpretation, however, cannot overrule congressional intent. For example, 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

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Under the SEC's analysis, therefore, a fund should be protected -- at least for 1933 Act and 1940 Act liabilities -- if it omits (or moves to the SAI) disclosure from its prospectus in accordance with the requirements and instructions of Form N-1A.[27] It should be noted that case law interpreting section 19(a) is fairly sparse,[28] and that commentators disagree about the meaning and scope of section 19(a).[29] The

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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.

[27]Such omission is permitted by section 10(a)(4) of the 1933 Act, which provides that: "there may be omitted from any prospectus any of the information required [by section 10(a)] when the Commission may by rule or regulations designate as not being necessary or appropriate in the public interest or for the protections of investors." Rule 100 under the 1933 Act defines "rules and regulations" to include "forms for registration and accompanying instructions thereto." While section 10(a)(4) does not state that one relying upon the Commission's judgment is protected from liability under sections 11 or 12(2) of the 1933 Act, section 19(a) arguably should accomplish that result.

[28]The court in White v. Melton, *supra*, supported the premise of section 19(a) of the 1933 Act: that the Act does not impose any liability upon an act done or omitted in good faith in conformity with any rule of the Commission. *See also, however*, Spicer v. Chicago Board Options Exchange, Inc., 1992 U.S. Dist. LEXIS 18796 (N.D. Ill. 1992), which held that the section 19(a) defense is inapplicable to non-1933 Act sources of liability, such as violations of section 10(b) and rule 10b-5 under the 1934 Act.

[29]*See* Letter from Gaston Snow & Ely Bartlett to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, dated April 21, 1983. In commenting upon the 1982 Form N-1A Proposing Release, the letter stated that:

> 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 the 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, we believe that an issuer which in good faith reliance on Form N-1A, if adopted substantially in its proposed form, omits information from Part A and includes such information in Part B would be protected from liability under sections 11 or 12(2) by virtue of section 19(a).

Compare, however, the 1983 ABA Letter, which argued differently:

> [W]e doubt that registrants will take much comfort in preparing prospectus disclosure from the provisions of [s]ection 19(a) of the [1933] Act . . . . At present there is not a sufficient body of case law or jurisprudence under [s]ection 19(a) to overcome concerns about its scope and meaning. The legislative history of [s]ection 19(a) is almost non-existent. . . . The section can, consistent with its legislative history, be construed as a "savings" clause

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SEC itself has even acknowledged the potential weakness of section 19(a).[30] Moreover, section 19(a) would not afford protection from liabilities arising from violations of rule 10b-5 or other 1934 Act liabilities.[31] Rule 10b-5 actions, of course, are a significant component of disclosure-related lawsuits.

In sum, incorporation by reference and the Commission's embracement of section 19(a) should be viewed positively by the courts. While there can be no absolute assurance that incorporation by reference and section 19(a) alone can fill the gaps created by any diminishing of the bespeaks caution doctrine, particularly for 1934 Act liabilities, any new risks to fund complexes created by the substance of the N-1A amendments should be of lesser import than the risks created by inadequate attention to implementation of the amendments.

4. Implementation of the Risk Shifting Portion of the Form N-1A Amendments. Fund complexes so far have chosen one of two basic paths in the implementation of, and compliance with, the Form N-1A amendments. First, some fund complexes have taken 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 extol on for pages regarding individual securities and the like. Alternatively, many fund complexes have attempted a good faith effort to comply with the spirit of the Form N-1A amendments and seek to capture in the prospectus all reasonably appropriate risks (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), leaving the SAI as the repository for the detailed, specific disclosure regarding individual portfolio holdings. In either event, to reduce the potential liability associated with compliance with the amendments, implementation and compliance with the Form N-1A

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> intended primarily to protect issuers from changes in role or form. The case law under [s]ection 19(a) is not helpful. In no case has a defendant succeeded in escaping liability on the basis of [s]ection 19(a). See, e.g., Byrnes v. Faulkner, Dawkins & Sullivan, 550 F.2d 103 (2d Cir. 1977). While there are a number of cases under [s]ection 23(a) of the [1934 Act] (which is similar to [s]ection 19(a)), they generally stem from essentially the same factual situation, a rule promulgated by the Commission in the 1950's which exempted certain purchases under restricted stock plans from reporting and liability under [s]ection 16, and are quite old. See Green v. Dietz, 143 F. Supp. 464 (S.D.N.Y. 1956).

[30] Specifically, in the 1982 Form N-1A Proposing Release the SEC stated:

> . . . 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.

[31] *See* "Loopholes Seen in Profile's Liability Protection," Fund Action, May 25, 1998; *See also* Spicer v. Chicago Board Options Exchange, Inc., *supra*.

amendments must be done in a judicious, prudent manner, with appropriate input from many areas (*e.g.*, legal, compliance, portfolio managers and senior management).

In effect, every mutual fund complex has had to make a case-by-case assessment of how and what to split between the prospectus and SAI and what risks and circumstances are "reasonably likely to affect adversely the fund's net asset value, yield and total return."[32] This assessment very likely may be judged with the benefit of 20/20 hindsight. Obviously, undisclosed singular circumstances that adversely affect a fund may look reasonably likely once they have occurred. Also, if other fund complexes disclose the risk of similar circumstances, it may appear in hindsight that such a circumstance was reasonably likely and therefore should have been disclosed.

5. Other Form N-1A Liability Issues. The Form N-1A amendments also introduce other lesser issues that may potentially impact on potential liability, including the following:

- Amended Form N-1A indicates that a number of pieces of "non-essential" information, separate and apart from the risk disclosure discussed above, should be moved from various sections of the prospectus to the SAI. With the benefit of hindsight and a given set of unique circumstances, this relocated information may appear to be quite essential, material and properly included in the prospectus.

- Amended Form N-1A permits funds to create and use a separate purchase and sale disclosure document (an "owner's manual") pursuant to one of three "options."[33] In choosing the most efficient of the three options, funds have had to carefully consider the delivery requirements and timing of each type of document as well as the various updating implications.[34]

- Amended Form N-1A requires a fund to send its SAI (and its financial reports) to investors within three business days of a request. The SEC rejected comments requesting "reasonably prompt" delivery of the SAI to build in leeway for unforeseen circumstances. The three business day delivery rule may impose operational and compliance requirements on funds.[35]

[32]Items 2(c)(1) and 4(c) of Form N-1A.

[33]Amended Form N-1A permits funds to use an owner's manual as supplemental sales literature as long as the purchase and sale information in the fund's prospectus is detailed enough to meet the minimum required by Form N-1A (option 1). Amended Form N-1A also allows funds to create a separate section in the SAI for the owner's manual information (for use as part of the SAI or as a stand-alone document) (option 2) or to remove all purchase and sale information from the prospectus and place it only in the owner's manual, which would then be incorporated by reference into, and provided with, the prospectus (option 3).

[34]Each method also presents differing types and levels of opportunities for liability. For example, under so-called "option 1," a fund must decide what the minimum purchase and sale disclosure requirements are under Form N-1A (*e.g.*, Does a fund have to disclose that a signature guarantee is required for redemption requests? Does it have to disclose that purchase checks must be drawn on U.S. banks? Does it have to disclose any check hold policies?). Furthermore, the owner's manual is simply one more disclosure document that must be maintained, updated and delivered.

[35]Funds may now have to build a database of request and mailing dates to (1) monitor their SAI mailings and (2) establish their compliance with the new Form N-1A delivery requirement. The Form N-1A amendments did not

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- Amended Form N-1A expands the legal proceedings disclosure requirement to include those proceedings contemplated by a governmental authority. Again with the benefit of hindsight, this is another area in which a fund could be found to have failed to disclose material information.

B. Liability Issues Associated with Use of the Profile

As discussed below, use of the new profile creates issues as to potential liability exposure arising from the possible omission from the profile of key information that is otherwise disclosed in the associated prospectus. Such exposure should generally be offset by the protection afforded to mutual funds from section 19(a) of the 1933 Act, and from the fact that investors will always receive a fund's prospectus with their purchase confirmations.[36] Of course, there remains a level of unpredictability as to how the courts will react when the plaintiffs' bar begins to test the liabilities associated with the use of the new profile document, and, to date, there has been little to no use of the profile.[37]

1. The Respective Roles of the Statutory Prospectus and the Profile. Section 10 of the 1933 Act contemplates two types of prospectuses: (i) the statutory prospectus under section 10(a) (which is Part A of Form N-1A); and (ii) a summary prospectus under section 10(b) (the profile is a section 10(b) summary prospectus). A profile, as a section 10(b) prospectus, is subject to liability for material misstatements and omissions under sections 12(2) and 17(a) of the 1933 Act, as well as liability for fraudulent statements under section 10(b) of the 1934 Act, and rule 10b-5 under the 1934 Act.[38] A profile is not, however, subject to strict liability for material misstatements and omissions under section 11 of the 1933 Act.[39]

Under section 5(b)(2) of the 1933 Act, a statutory prospectus must precede or accompany any security being sold or delivered after its sale.[40] Typically, for a mutual fund, this would allow the prospectus to be delivered up and until delivery of the confirmation statement (or the security itself).[41]

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mention how the SEC will monitor compliance with this requirement or the ramifications of failing to meet the three business day delivery rule.

[36] Section 5(b)(2) of the 1933 Act. *See* the Profile Adopting Release.

[37] *See* "Top Funds to Sit on Profile Sidelines," Fund Action, May 11, 1998, indicating that a number of mutual fund complexes are "taking a wait-and-see attitude on using profile prospectuses" and that "some industry attorneys fear the condensed missives could cause shareholder lawsuits for lack of disclosure."

[38] Under section 5(b)(1) of the 1933 Act, a summary prospectus may be used to accompany any offer to sell a security.

[39] Although section 11 liability would not apply to the profile, section 11 liability would apply to the sale of a fund's securities if a misleading statement is included in both the profile and the prospectus.

[40] Specifically, section 5(b)(2) provides that it shall be unlawful for any person, directly or indirectly, "to carry or to cause to be carried through the mails or in interstate commerce 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 subsection (a) of section 10." Although the term "prospectus" is defined broadly in section 2(10) to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which *offers* any security for sale or

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2. Potential Liability from the Use of a "Summary" Document. The profile, like any other prospectus, cannot omit material information necessary to make it not misleading. Yet, because a profile is a summary document, such omissions are possible. In essence, the profile may be caught in a "Catch-22"— it cannot contain more information than is required by the nine key points of rule 498, but it may not omit a material fact about the fund in order to avoid liability for material omissions under the 1933 and 1934 Acts. In particular, a fund's use of a profile could result in claims under section 12(2) of the 1933 Act alleging that the profile is misleading because it omits information disclosed in the fund's prospectus.[42]

As with the Form N-1A amendments, the Commission sought to allay the liability concerns by reference to section 19(a) of the 1933 Act.[43] As discussed above, section 19(a) should afford significant protection to fund complexes, at least for 1933 Act and 1940 Act liabilities, provided the profile contains all requisite information under rule 498. The Commission has also disagreed with the concern that the use of profiles will lead to significant potential liabilities under the federal securities laws.[44]

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confirms the sale of any security, [with certain exceptions] . . ." (emphasis added), the form of prospectus contained in the registration statement is the essential disclosure document that must accompany or precede the delivery of the security.

[41]*See* Byrnes v. Faulkner, Dawkins & Sullivan, which is discussed below.

[42]Section 12(2) imposes liability for material misstatements or omissions when the seller cannot demonstrate the exercise of "reasonable care." An action under section 12(2) does not require proof of scienter (*i.e.*, intent to mislead investors, *e.g.*, Wigand v. Flo-Tek, Inc., 609 F.2d 1028 (2d Cir. 1979), or investor reliance on a misleading statement or omission, *e.g.*, MidAmerica Fed. S. & L. Assoc. v. Shearson/American Express, Inc., 886 F.2d 1249 (10th Cir. 1989); Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981). In contrast, claims by private plaintiffs under the antifraud provisions of section 10(b) of the 1934 Act require proof of scienter and investor reliance. Under either type of claim, however, it must be established that the misrepresentation or omission was "material," which generally means that a substantial likelihood exists that a reasonable investor would consider the information important in making an investment decision. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 439 (1976); Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[43]The Commission stated specifically in the Profile Adopting Release that: "a fund that provides investors with a profile in good faith compliance with rule 498 would be able to rely on section 19(a) against a claim that its profile did not include information that is disclosed in the fund's prospectus."

[44]The Profile Adopting Release stated the Commission's view that:

> A fund using a profile generally should not face liability for omitting information included in the fund's prospectus if the profile includes the information required or permitted by rule 498; potential liability would arise only if a profile contains a material misstatement or omits a statement necessary to make the disclosure in the profile not materially misleading. The mere omission of information from the profile that is required or permitted in the prospectus should not, in the Commission's view, give rise to liability under the federal securities laws.

As further support for its view, the Commission argued that:

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The Commission also sought to allay liability concerns on the basis of its prior experience with summary documents, such as advertisements designed to meet the requirements of rule 482 under the 1933 Act.[45] While the Commission's rule 482 analogy may give mutual funds some degree of comfort that the practical risk exposure of using a profile should be comparable to that of a rule 482 advertisement, it should be noted that a profile, unlike a rule 482 ad, is very different and a court will probably distinguish the two.[46]

Perhaps the strongest defense in using a profile is that even if an investor makes the choice of investing in the fund based upon the summary information in the profile, the investor will still receive the fund's statutory prospectus with the purchase confirmation.[47] Thus, a fund complex may argue that to impose section 12 or other liability would be inconsistent with the mechanics of section 5(b)(2), which does not require the delivery of the prospectus until receipt of the purchase confirmation.[48] On the other

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> Like those commenting on the Proposed Profile, commentors on proposed rule 434d argued that a fund using an advertisement under the rule would be subject to potential liability under section 12(a)(2) if the advertisement did not contain all of the information included in the fund's prospectus. In adopting rule 434d, the Commission stated its belief that a fund should not be liable under section 12(a)(2) merely because information included in the fund's section 10(a) prospectus was not included in the advertisement. 44 F.R. at 52817. The Commission is not aware of any lawsuits brought since the adoption of rule 434d in which a fund was found liable for an advertisement meeting the requirements of the rule on the basis that the advertisement failed to include information contained in the fund's prospectus.

[45]In 1979, the Commission adopted rule 434d under the 1933 Act, subsequently redesignated rule 482, which permits investment companies to use advertisements that are designed to be omitting prospectuses under section 10(b) of the 1933 Act. *See* Securities Act Release No. 6116 (Aug. 31, 1979).

[46]Most significantly, a profile, unlike a rule 482 advertisement, may be accompanied by an application to purchase fund shares and it may be the basis for an investment decision. Moreover, under rule 482, an advertisement must conspicuously state "from whom a prospectus containing more information may be obtained and that an investor <u>should</u> read that prospectus carefully before investing" [Rule 482(a)(3) under the 1933 Act] (emphasis added). Under rule 498, on the other hand, the profile must state that "[t]he Fund's prospectus includes additional information . . . that you <u>may</u> want to consider before you invest" [Rule 498(c)(1)(iv) under the 1933 Act] (emphasis added). In fact, the Profile Proposing Release expressly states that "the purpose of the profile . . . is to offer investors the option to make an investment in a fund based <u>solely</u> on the information in the profile" (emphasis added).

[47]Under section 5(b)(2), a statutory prospectus must precede or accompany any security.

[48]This analysis is supported by <u>Byrnes v. Faulkner, Dawkins & Sullivan</u>, 413 F. Supp. 453 (S.D.N.Y. 1976). In that case, the court rejected the argument that a purchaser has a right to cancel and rescind a security purchase upon receipt of the prospectus. The court reasoned that:

> It was clearly within the contemplation of the drafters of the statute that a purchaser might not see the prospectus covering the security he purchased until after the sale had been completed. Yet no provision of the statute either permits recision upon receipt of the prospectus or prevents the parties from binding themselves to the terms of a contract prior to that receipt.

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hand, the plaintiff's bar might argue that because an investor can make an investment based solely upon the information in the profile, a profile should be a stand-alone document, which could not be "cured" by the statutory prospectus. Such an argument might, at least, create a question of fact that could allow a lawsuit to proceed beyond the pleading stage.

At the end of the day, it must be remembered that the use of a profile is optional, not mandatory. Plaintiffs may seek to argue that, for some funds, a profile may not be appropriate.[49] Mutual funds and their sponsors, therefore, will have to balance the advantages of the profile as a new selling document against the potential risks associated with its use. As with any new regulatory development, the profile is untested under the federal securities laws. Creative plaintiffs, and ultimately the courts, may bring, or allow, suits to proceed against funds based upon an allegation that the profile (while complying fully with rule 498) did not adequately disclose a material fact or risk (notwithstanding that the statutory prospectus did). For the reasons discussed above, however, there should a sufficient basis for the courts to reject such suits.

3. Other Profile Liability Issues. In addition to the concern that a profile only contains summary information, there are other practical compliance issues that could potentially impact on potential liability, including the following:

- Rule 498 requires a fund to send the prospectus/SAI/financial reports within three business days of a request. As with the Form N-1A three-day rule, funds need to comply and monitor or document compliance with this requirement.

- Profiles must be updated quarterly. Funds need to build a compliance system to reprint and/or "sticker" profiles to address this requirement.

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> Furthermore, section 12 of the 1933 Act explicitly provides for recision in two specific circumstances: where a person offers or sells securities (a) in violation of section 5 of the [1933] Act or (b) through the use of a material misrepresentation. . . .
>
> Also, the statute makes the time when the shares are delivered the last moment when the prospectus must be made available to the purchaser. If a written confirmation is sent earlier, a prospectus must accompany it. . . . Furthermore, no purchaser is compelled by any provision of the [1933] Act to bind himself to the purchase of any stock until he has had the opportunity to examine a final prospectus.

[49]In the Profile Proposing Release, the Commission suggested that certain funds might not be eligible to use a profile. In particular, the Commission stated that "a fund would not be able to use a profile when material information relating to its particular circumstances is not addressed by the instructions for the 9 items of required disclosure." Several commentors strongly objected to this assertion, arguing that it was inconsistent with the premise underlying the profile initiative. In response to these comments, in the Profile Adopting Release, the Commission stated that it determined to "delete any suggestion that certain funds may be ineligible to use profiles."

- The use of a profile must be coordinated with the Form N-1A amendments. Both the profile and the risk summary (and other sections) of the prospectus should mirror each other since the disclosure obligations are essentially the same. Also, the use of a profile before complying with the N-1A amendments would pose many difficult working issues since the profile, in essence, is tied to the prospectus disclosure.

C. Liability Issues Associated with the Plain English Rule

Rule 421 under the 1933 Act, the plain English rule, is relatively straightforward. It requires all companies, including mutual funds, to use plain English principles in writing the cover pages and risk/return summary section of prospectuses. The plain English rule also applies to the profile.

Commentors have split on whether the plain English rule will result in increased liability. Several commentors have expressed concern that issuers may omit information in the course of simplifying their disclosure language. They also questioned whether it was possible to summarize in plain English complex matters, such as the risk of derivative investments.[50] Other commentors, however, believe plain English will not increase issuer liability. For example, the Investment Company Institute's comment letter argued that plain English disclosure should *reduce* potential liability because it decreases the likelihood that an investor will misunderstand the prospectus.[51] The Commission dismissed the various liability concerns, including a comment urging a safe harbor from liability for the sections of a prospectus that must be in plain English.[52]

As a concept, writing in plain English should have minimal effect on a mutual fund's overall liability exposure. However, implementation of the plain English rule may not be so easy. It may require a long lead time and significant staff resources in order to adequately revamp disclosures. Without such

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[50] *See* Letter from the American Bar Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 31, 1997.

[51] *See* Letter from the Investment Company Institute to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 24, 1997.

[52] In dismissing the various liability concerns, the Commission stated in the Plain English Adopting Release that:

> Using plain English does not mean omitting important information. These rules only require you to disclose information in words investors can understand and in a format that invites them to read the document. For these reasons, we do not believe that a safe harbor rule is necessary or appropriate. . . .
>
> We believe the courts will continue to view the summary section, as its caption indicates, as a highlight of important information in the prospectus. A summary, by its very nature, cannot disclose everything. In determining whether a company has made full disclosure, courts should look at the disclosure in the entire document. . . .
>
> The package of rules we are adopting should lead to clearer documents that are easier for investors to understand. We believe that compliance with these requirements will not increase the risk of litigation.

resources, plain English rewriting, to the extent it leads to inadequate or incorrect disclosure, could result in increased liability exposure.

*   *   *   *