Consumer Federation of America

April 16, 2012

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549–1090

Re: File Number 4-645

Dear Secretary Murphy:

I am writing on behalf of Consumer Federation of America[1] in response to the Commission's request for comment on the subject of methods to improve the effectiveness of disclosures regarding financial intermediaries, investment products, and investment services. This is a subject in which CFA has long had an interest.[2] This study, required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, recognizes that efforts to promote financial literacy and improve financial disclosures must go hand in hand. By promoting financial literacy we seek to ensure that individuals have the knowledge and understanding necessary to make sound financial decisions. Effective financial disclosures are needed to ensure that these same individuals receive the information necessary to put that knowledge to work.

Promoting effective disclosure is particularly important in our securities markets, where full and fair disclosure is at the heart of our system of investor protection. This system can only work if investors receive the key information they need to make a sound decision, in a form that is both accessible and understandable, and at a time when it can be easily incorporated into their decision-making process. However, most financial disclosures fail at least one of these three tests of effective disclosure. Often, investors receive the relevant information, but obscured in a mass of fine print, or conveyed in overly technical language that makes the information all but impenetrable. In other cases, good information is available, but it is not required to be disclosed directly to investors, who must instead take the initiative to seek it out. In other cases, relevant information is not provided until after a product or service is purchased. Without improvements to all three aspects of disclosure – content, format and timing – efforts to improve financial literacy and promote sound financial decision-making are doomed to failure.

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[1] Consumer Federation of America (CFA) is a nonprofit association of approximately 280 national, state and local pro-consumer organizations founded in 1968 to advance the consumer interest through research, advocacy and education.
[2] We have included copies of a number of our previous comment letters in the appendices accompanying this letter.

Vast changes have occurred in our securities markets in recent decades that necessitate a comprehensive review of our disclosure policies and procedures:

- **The Democratization of U.S. Securities Markets:** As recently as the 1980s, stock ownership in America was limited to a minority of mostly wealthy households.[3] By the late 1990s, however, nearly half of all U.S. households held stock either directly or indirectly.[4] And the level of stock ownership, having peaked at 52.2 percent in 2001, has hovered around that 50 percent mark ever since. This democratization of the securities markets has provided U.S. companies with access to a vast pool of capital, but it has also challenged long-held assumptions about the ability of investors to protect their own interests when provided with full and fair disclosure about the companies in which they invest.

- **The Growing Importance of Investment:** Our securities markets have long played a crucial role in providing U.S. companies with access to capital at a reasonable cost. In that environment, disclosures that promote market transparency are central to ensuring the efficient allocation of capital. With the advent of defined contribution pension plans, the securities markets have taken on an additional, increasingly important role in determining the financial well-being and retirement security of growing numbers of middle-income Americans. The financial vulnerability of these middle income investors, and their dependence on personal investments to provide them with income security in retirement, has made it all the more important that we develop disclosure policies that promote sound investment decision-making.

- **The Growing Complexity of Investment Decisions:** At the same time markets have become more important to the financial well-being of a significant portion of the American populous, the investment products available to these investors have proliferated. That diversity delivers significant benefits; it is hard to imagine an investment need for which there is not an appropriate investment product or service. Often, the investor has many suitable options from which to choose. But this abundance of choice also significantly complicates the investment selection process, and the extreme complexity of many of the newer products adds to the difficulty. Faced with this complexity, and despite the availability of a wide array of highly attractive self-directed investment options, most investors continue to rely on investment professionals to help them make investment decisions or, in some cases, to relieve them of that responsibility entirely.

- **A Confusing Market for Investment Services:** But the market for investment service providers is hardly less complex than the market for investment products. Brokers, investment advisers and financial planners who are indistinguishable to the average investor offer a wide array of services under varying business models and subject to different legal and regulatory requirements. Moreover, the information available to investors to help them make these selections is, for much of the profession, grossly inadequate. Disclosure reform is urgently needed to close this gap.

[3] Investment Company Institute and Securities Industry Association, *Equity Ownership in America*, Fall 1999.
[4] Bucks, Brian K., Kennickell, Arthur B., Mach, Traci L., and Moore, Kevin B., "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 95 (February 2009), pp. A1-A55. Available here.

- **The Digital Revolution:** At the same time securities markets were experiencing rapid change, an even more dramatic revolution was underway in the world of computers and communications. The advent of the Internet and widespread use of electronic communications has enormous implications for how we deliver information to investors. Disclosure policies can and should take advantage of this development to improve the quality and accessibility of disclosures while simultaneously reducing the cost of delivery.

In light of these dramatic developments, we encourage the Commission to think big when considering how it could reform disclosure practices in the securities markets to promote better investment decision-making. The resulting changes, if properly conceived and implemented, could benefit not only individual investors, but also those market participants who deliver quality products and services at a reasonable price. That in turn has the potential to promote Americans' retirement preparedness, the efficient allocation of capital, and the overall health of our economy.

Our specific recommendations follow. They are organized as follows: general recommendation regarding disclosure policies; recommendations to improve disclosures with regard to financial intermediaries; recommendations to improve disclosures regarding investment products and services; conclusions. Although our comments cover a wide range of issues, we have not attempted to comment on every conceivable disclosure issue. For example, we have focused primarily on pre-engagement disclosures for financial intermediaries and pre-sale disclosures for products. While there are certainly important issues related to follow-up disclosures that the Commission could pursue, we believe these initial disclosures are most important to improving investors' decision-making. Similarly, our letter focuses on issues related to direct-to-investor disclosures. But it is important to remember that investors may benefit indirectly from disclosures they themselves never read if they rely on intermediaries who help analyze and digest the disclosures for them. These may include brokers and investment advisers, personal finance writers, or information services, such as Morningstar. It is essential that the Commission, as it considers how to improve direct-to-investor disclosures to make them more investor-friendly, maintain easy access for these intermediaries to the full, detailed disclosures they rely on for their more thorough and comprehensive analysis.

General Recommendations Regarding Disclosure Policies

Our approach to disclosure issues is guided by three simple principles. Disclosure policy should be designed to ensure that investors get the information they need, in a form they can use, at a time when it is useful to them in making their investment decision. This has different implications in different contexts, but there are certain themes that apply throughout.

1) When it comes to direct-to-investor disclosure, less is often more.

Our securities laws are premised on the notion that investors should receive full and fair disclosure. As a result, disclosures often take the form of dense legal documents that fulfill the letter of the law, but fail as effective information delivery mechanisms. For many years, we at CFA resisted the notion that investors might benefit more from more abbreviated disclosures. Our concern was that, in promoting summary disclosures, the Commission would be putting its stamp of approval on inadequately informed investment decision-making. After all, as just one example, can an investor really understand a mutual fund's investment strategy or risk based on a one- or two-paragraph discussion of the topic? Probably not.

Over the years, however, we have come to accept that summary disclosures, though imperfect, may in fact be better at conveying information than the more complete disclosures we have traditionally preferred. While our views had been evolving for some time, research we conducted in 2005-2006 on mutual fund purchase practices was decisive in convincing us to drop our opposition to summary disclosure documents. Two factors were particularly influential in changing our views: one was the further evidence provided by our survey that a majority of investors do not view the prospectus as an important source of information; the other was the high quality of the "fund snapshots" produced by many fund companies for display on their websites. Particularly appealing was the way some fund companies took advantage of the flexibility provided by the Internet to both highlight key data and draw the investor in to more complete and detailed discussions of important topics.

In short, there are a variety of at least theoretical benefits to summary disclosure. Summary documents have the potential to be effective in allowing investors to make quick comparisons among a number of options before narrowing down their selection for more careful review. In addition, some investors who might be turned off by a lengthier document may be drawn in by the summary and encouraged to explore further in certain key areas. On the other hand, some investors who never look beyond the summary might still be said to benefit if, absent a summary, they wouldn't have looked at *any* disclosure document. In such cases, while we might consider that the investor is making an inadequately informed investment decision, they would still arguably be better informed than they would otherwise have been without exposure to the summary document.

Further research could offer insights into whether summary disclosures do in fact deliver the expected benefits and what factors contribute to their success. Assuming the research bears out the benefits, we would encourage the Commission to consider how wider use of summary disclosure documents could be incorporated into a layered approach to disclosures in a variety of retail contexts. In developing such documents, the Commission will need to suppress its natural inclination to think like lawyers, and focus instead on how to most effectively convey the truly essential information in a concise and compelling fashion.

2) Summary disclosures should focus on the issues most important to an informed decision.

It requires a significant mental shift to go from designing disclosures to be complete to designing disclosures to focus on essential information. That process of honing in on the essentials needs to be incorporated not just in the selection of key disclosure topics, but also in the presentation of information with regard to each topic.

- A perfect example is disclosure of mutual fund fees, which most experts would agree is essential information that should be included in any summary disclosure document. The current fund fee table provides a fairly detailed break-out of the different components of fund fees, but it is not clear that it actually promotes a good understanding of the key issues relevant to the investment decision. An approach that focuses clearly on two issues – what the investor will pay for the operation of the fund and what the investor will pay for the services of the broker or adviser in selling the fund – might promote a better understanding.

- Similarly, while we are strong supporters of requiring financial intermediaries to disclosure information about their disciplinary record, it is not clear that an undifferentiated listing of every event would be the ideal format for such disclosures. A sharper focus on more serious issues, particularly sales abuse violations like churning or unsuitable recommendations, might reduce information overload.

In both cases, the potential with web-based disclosures for click-through access to more complete information should help to alleviate the concern that investors are being deprived of the full and fair disclosures our laws demand. In arriving at its list of essential information in any given disclosure area, the Commission should consult a broad array of interested parties, including both investor advocates and financial educators.

3) Disclosures should be designed to promote comparability.

Too often, we design disclosures to reflect a particular regulatory requirement, rather than how investors actually make investment decisions. So, for example, we require extensive pre-engagement disclosures by investment advisers, but don't have a comparable requirement for brokers, even though research has shown that investors don't distinguish between these two categories of financial intermediaries. We have specific disclosure requirements for mutual funds, but don't necessarily apply the same disclosure standards to products and services sold in competition with funds. Indeed, past mutual fund industry opposition to pre-sale disclosure proposals was based in large part on the fact that they were being singled out for this heightened disclosure obligation. While we are strong supporters of pre-sale disclosure, we felt their complaint was justified. If pre-sale disclosure is a good idea for mutual funds, and we think it is, it is also a good idea for all other investment products and services.

Ideally, an approach promoting comparability of product and provider disclosures would cut across regulatory regimes to include all financial services, and particularly insurance products and providers. We encourage the Commission to reach out to other regulatory entities to promote that goal. As a first step, however, the Commission could provide significant improvements by tackling the issue within its own jurisdiction. So, for example, the pre-sale disclosure proposal for mutual funds could be reconceived as a pre-sale disclosure document that could be adapted to all investment products and services. Disclosure obligations for brokers and investment advisers could and should be harmonized.

To assist in that process, greater thought should be given to which issues should be addressed through product disclosures, and which are more appropriately dealt with through provider disclosures. As just one example, providing disclosures about revenue sharing payments in mutual fund prospectuses strikes us as a highly ineffective way to convey that information to investors – both because it is unlikely to be read and because it fails to put the information in a context that would highlight its importance for the investor. It would be far more effective to include that information for all product lines in a disclosure regarding limitations on the provider's services (e.g., they only recommend investments that make revenue sharing payments) or conflicts of interest that could bias a provider's recommendations (e.g., they have a financial incentive to recommend funds that make higher revenue sharing payments). This is just one example of an issue that deserves broader consideration – which issues are best addressed through product disclosures and which are best addressed through provider disclosures.

4) Disclosures should be designed to promote sound decision-making.

As the Commission considers how it can improve existing disclosures, one goal should be to ensure that key information is presented in a way that actually promotes understanding and sound investment decision-making. We believe most existing disclosures would fail that test. Going back to the example of mutual fund fees, there is widespread agreement that minimizing the fees paid is one of the most effective steps investors can take to improve their return on investments. Yet, our research on mutual fund purchase practices found that just a third of mutual fund owners considered fund expenses to be very important to their most recent fund purchase decision. This is consistent with other evidence that suggests that current fee disclosure practices are ineffective in promoting cost-conscious choices.

In considering why these disclosures fail, one strong possibility is that disclosing costs as a percentage, rather than as a dollar amount, impedes investor understanding.[5] Another is that current disclosures do not provide sufficient context to enable investors to assess whether costs are reasonable. A more effective approach might be to provide comparative cost information in a way that shows, as a dollar amount, how much more or less an investor would pay over a particular time period relative to category averages. While it would need to be implemented carefully (categories, for example, would have to be appropriately defined) and tested for effectiveness, such an approach would seem to make it much easier both to assess the relative costs of various investment options and the impact those costs would have over time.

Again, this is just one example. The Commission should look for similar examples across the board where there is widespread agreement on sound investment practice, information available to promote that practice, but evidence that the information is being provided in a way that does not appear to motivate investors to adopt the beneficial conduct. While disclosure reform won't be able to eliminate all such discrepancies, we should seek to gain all the advantage we can from well-conceived disclosure requirements.

5) Disclosures should be designed.

We still have a lot to learn about how to convey information visually in a way that promotes investor understanding. In thinking about how to reform disclosure practices, the Commission should seek to incorporate lessons from behavioral economics, graphic design, and disclosure design more generally into its approach. To the degree that other agencies, such as the new Consumer Financial Protection Bureau (CFPB), are looking at similar issues, the Commission should seek to coordinate its efforts with those agencies. This could have the dual benefits of conserving resources and promoting a more uniform approach across jurisdictions. To the degree that the Commission seeks to make greater use of the Internet and more layered disclosures, this offers new opportunities to incorporate user-friendly approaches into disclosure design. Ideally, the result should not be something that looks like a paper document thrown up on the Internet with a few hyperlinks added. Instead, serious thought should be given to how different design approaches can make the disclosures more appealing and the information more accessible.

6) Disclosures should be tested.

While we have our own views, and sometimes strongly held views, about changes that should be made to improve disclosures, the real test is whether the disclosures prove effective when tested with investors. We encourage the Commission to adopt (and Congress to fund) a robust program to

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[5] Although the Commission has taken steps to provide some dollar-amount cost information, it is not prominently displayed in a document widely read by investors in advance of the sale and, in our view, it is not effectively presented.

test the effectiveness of both existing disclosures and possible approaches to improve disclosures. The key criterion should be whether the disclosures are effective in conveying the relevant information in a way that promotes understanding and encourages investors to act on the information. Such a testing program should also help to identify areas where disclosure alone is inadequate to address a particular issue and further policy changes are needed.

7) Disclosures should be in writing whenever possible.

Written disclosures offer enormous advantages over oral disclosures. They allow the investor to study and carefully consider the information presented. They are less easily subject to manipulative presentation and pose less risk of misinterpretation. And they are verifiable in a way that oral disclosures are not, which supports more effective regulatory oversight. Moreover, modern technology has made it possible to provide written disclosures electronically essentially instantaneously and at very little cost. In this way, electronically delivered disclosures eliminate the main argument industry has used in the past to counter pre-sale written disclosure proposals – that it is too costly and too slow. We were very disappointed that, in its recent swaps dealer business conduct rules, the SEC proposed and the CFTC adopted policies that deem oral pre-transaction disclosures as an acceptable alternative to written disclosures, as long as they are subsequently confirmed in writing. This is an approach that we strongly urge the Commission to abandon, particularly in the retail context where investors are especially vulnerable to misleading practices. While there may be some limited circumstances in which written pre-transaction disclosures would not be possible, particularly for investors who do not accept electronic delivery, these should be the rare exception, rather than the rule. Indeed, there would need to be a compelling reason to justify the exception.

8) Disclosures should be delivered.

At various times over the years, industry has argued for an "access equals delivery" approach to disclosure. This puts the burden on the investor to seek out information, with no evidence that the majority of investors are equipped to accept that role. On the contrary, it seems patently obvious to us that, at least in the retail context, access does not equal delivery – delivery equals delivery. That does not have to mean delivery by mail of a paper document. As noted above, technological developments have made it possible to provide electronic delivery of written disclosures virtually instantaneously and at very little cost. That could take the form of delivery of a PDF document or delivery of a link to a web-based document, for example. The basic requirement is simply that disclosures to retail investors include some direct outreach to investors to ensure they receive the relevant information.

Given continuing investor resistance to electronic disclosures, additional study should be given to how to design policies to promote investor acceptance of web-based and electronic disclosures. To do that, the Commission will need to better understand the reasons for investor resistance (e.g., concerns about privacy, about phishing, or record-keeping). Armed with that knowledge, the Commission should be able to develop policies that preserve investor choice of delivery mechanism but encourage adoption of electronic delivery mechanisms. Eventually, a new generation of investors seems likely to accept electronic delivery as the norm.

9) Timing is important.

The best disclosures in the world will do little good if they are delivered too late to be incorporated into the investor's decision-making process or are buried in a document investors don't read. For disclosures about intermediaries, certain disclosures should be provided at or as soon as possible after the first contact and before a business relationship is commenced. This would include general information about the services offered, limitations on those services, the qualifications and background of the provider, how the client pays for services and how the provider is compensated, conflicts of interest, legal obligations of the provider, and disciplinary record, as well as any other information the Commission may deem essential to an informed selection of service provider.

Once the intermediary has been engaged, other information would more appropriately be provided in association with a specific recommendation. This would include any information about fees the provider expects to earn and conflicts the provider may have that could create a bias with regard to the particular product or service being recommended. That information must be provided at or immediately after the point of recommendation if it is to be incorporated into the decision-making process. The same standard should apply to other product-specific (as opposed to provider-specific) disclosures. In this regard, point-of-sale disclosure is marginally better than post-sale disclosure, but it still may be too late to be effective if it comes after the investment decision has already been made. Far better would be a requirement that a summary disclosure document for each alternative recommended be provided at or immediately following the point of recommendation, so that the investor could use the information provided to evaluate the recommendations.

In establishing policies with regard to the timing of disclosures, the primary focus should be on the needs of the investor, not the convenience of the provider, as has too often been the case in the past.

10) Sometimes disclosure is not the answer.

While improved disclosure can promote sound financial decision-making, it can only take us so far. There are limits to what disclosure and investor education can accomplish. For example, disclosure will not be enough to counteract policies that make no sense – such as policies that hold investment advisers but not "financial advisers" to a fiduciary duty when they provide personalized advisory services that are indistinguishable to the average investor or policies that define variable annuities as a security but equity-indexed annuities as an insurance product.

Just as policies that don't make sense can't be resolved through disclosure, complexity is the enemy of clear disclosure. For example, experts would generally agree that an investor considering the purchase of an equity-indexed annuity should understand any penalties they might have to pay to withdraw money early.[6] The following excerpt from a prospectus for an equity-indexed annuity demonstrates, however, the futility of that advice:

> A market value adjustment is applied to withdrawals or surrenders prior to the end of the surrender charge schedule elected … The market value adjustment equals the contract value

[6] We recognize that equity-indexed annuities are not considered securities and thus fall outside the Commission's jurisdiction, but the same issues apply to a greater or lesser extent to disclosures regarding products that are within the Commission's jurisdiction.

withdrawn or surrendered in excess of the free withdrawal amount multiplied by the following:

$$\left[\frac{1+i}{1+j+0.0050}\right]^{(n/12)} - 1$$

where:

i - is the Treasury Constant Maturity yield as published by the Federal Reserve on the business day prior to the contract date for the maturity matching the duration of the surrender charge period;

j - is the Treasury Constant Maturity yield as published by the Federal Reserve on the business day prior to the date of withdrawal or surrender for the maturity matching the remaining years in the surrender charge period (fractional years rounded up to the next full year);

n - is the number of complete months from the time of withdrawal or surrender to the end of the surrender charge period.

If a Treasury Constant Maturity yield for a particular maturity is not published, the yield will be interpolated between the yields for maturities that are published. If the Treasury Constant Maturity yields are no longer published, we will choose a suitable replacement, subject to any regulatory approvals and provide you with notice accordingly.

A positive market value adjustment will increase the amount withdrawn or surrendered. There is no limit on a positive market value adjustment. A negative market value adjustment will decrease the amount withdrawn or surrendered. A negative market value adjustment will not decrease the amount withdrawn or surrendered by more than the interest or index credit earnings proportionately attributable to the withdrawal or surrender amount.

The market value adjustment is waived on the free withdrawal amount, on death, and on annuitization if annuitization occurs after five contract years. The market value adjustment is not waived on the nursing home and terminal illness waivers.

This is model disclosure language in many ways. It presents the relevant information thoroughly and in relatively straightforward language. And yet, few if any consumers who took the time to read the prospectus would walk away with a clear understanding of the market adjustment penalty they might pay for early withdrawal of their funds, and we sincerely doubt that you could design a financial education campaign that would enable a significant percentage of consumers to do so.

You simply cannot, through disclosure and education, get consumers to understand concepts that either make no sense or are so complex that they require the knowledge and sophistication of a highly trained financial professional to understand them. That is why efforts to improve disclosures must be accompanied by policies that protect investor interests, such as imposing a fiduciary duty on brokers when they offer personalized investment advice to retail investors.

Recommendations to Improve Disclosures with Regard to Financial Intermediaries

Reforming disclosures with regard to financial intermediaries should be a top priority for the Commission. For many if not most investors, the decision about whom to rely on for recommendations is the most important investment decision they will make. This is because, as previous CFA survey research indicates, most people who invest through a broker, financial planner, or investment adviser do little or no research about the investments they buy.[7] Instead, they rely virtually without question on the recommendations they receive from that investment professional. For these investors, the decision about whom to rely on for recommendations may be the last true investment "decision" they make. It is of paramount importance, therefore, that they receive good information to assist them in making that all-important selection.

With its recent revisions to Form ADV, the Commission has made great strides in improving the disclosures investors receive from investment advisers. Unfortunately, brokers are not subject to a comparable pre-engagement disclosure requirement, undercutting investors' ability to make an informed choice between these two distinct types of financial intermediaries. As the RAND Study discussed in some detail, and the SEC's 913 Study confirmed, recent years have seen an extensive blurring of the lines between brokers and investment advisers. In a world in which a majority of investors cannot distinguish between a broker and an investment adviser, and cannot tell which regulatory category their own adviser falls into even after the differences have been explained to them, simple logic suggests that they do not shop for an adviser within a single regulatory category. To assist them in making an informed choice among the full range of financial intermediaries available to assist them with investment decisions, disclosure obligations for these two types of financial intermediaries should be harmonized.

In October, 2010, the Financial Industry Regulatory Association (FINRA) put a proposal out for comment that would help to fill this gap.[8] It would require brokers to provide retail customers with a plain English disclosure brochure before or at the time the business relationship commences. The proposed document contains a discussion of a number of important issues, including the accounts and services offered by the firm, its associated conflicts of interest and any limitations on duties owed to the customer. The proposal is a welcome development and, if adopted, would offer a significant improvement over the status quo. We believe, however, that more thought should be given to how this disclosure document would compare to the recently revised Form ADV-Part 2. The goal should be to ensure that investors receive disclosures that are as close to uniform as possible given differences in the two business models. In addition, one glaring omission in the FINRA proposal would need to be corrected, and that is its failure to require disclosure of disciplinary record, a factor that we believe is highly relevant to the selection of a financial intermediary.

Content: In seeking to improve the content of disclosures regarding financial intermediaries, the goal should be to ensure that investors receive easily comparable disclosure

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[7] Roper, Barbara and Brobeck, Stephen, *Mutual Fund Purchase Practices: An Analysis of Survey Results*, Consumer Federation of America, June 12, 2006.

[8] Regulatory Notice 10-54, "FINRA Requests Comment on Concept Proposal to Require a Disclosure Statement for Retail Investors at or Before Commencing a Business Relationship," October 2010, available here.

that covers key information relevant to the selection of a financial intermediary. In our view, this would include:

- the nature of services provided,
- how the investor pays for those services and how the provider is compensated,
- the qualifications of the intermediary to provide those services,
- the nature and extent of any conflicts of interest,
- the legal obligation of the provider to the client and any limitations on that duty,
- investor rights to redress and any limitations on those rights (e.g., forced arbitration agreements), and
- the disciplinary record of the adviser.

Information provided should cover the individual delivering the services as well as information on the firm more generally.

In addition to information about the individual intermediary, investors would benefit from receiving information about the firm employing the intermediary. Firm-level information that would be particularly relevant would include information about firm-level conflicts of interest and the disciplinary record of the firm as a whole. In the latter case, the idea would not be to provide a comprehensive listing of all disciplinary events but a summary of that information. In particular, investors would benefit from receiving information that would help them put that information in context and compare the disciplinary record of the firm to that of other comparable firms.

We know from previous survey research that investors cannot easily distinguish between brokers and advisers and do not understand the different legal obligations they may owe their clients. In addition, a 2011 study by Cerulli Associates and Phoenix Marketing International found that most investors (65 percent) either do not know how their advisers are paid (31 percent) or think the services are provided for free (33 percent).[9] The percentages were even higher (36 percent don't know/40 percent free) among households with $100,000 or less in investable assets. As it seeks to develop improved disclosures for intermediaries, the Commission should test those disclosures to determine whether they effectively convey information, such as this, that is directly relevant to the selection of an intermediary. Where disclosures fail to convey the key information, the Commission should consider whether alternative policies are needed to address the issue.

Format: With the revision of Form ADV, and particularly the requirement that information be presented in a plain English brochure, the Commission made significant progress in making disclosure documents more usable for investors. When we commented in strong support of the SEC's revisions to Form ADV, we expressed some concern that the resulting documents might be too lengthy to be well received and easily digested by investors. (A copy of our comment letter is included in Appendix A.) Before moving forward with a new proposal regarding broker-dealer pre-engagement disclosure, we encourage the Commission to test the effectiveness of the revised Form ADV to ensure that it is fulfilling its intended function. If

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[9] Gleeson, Jerry, "You Charge What?, *Registered Rep*, March 1, 2012, available at http://www.registeredrep.com/advisorland/finance_charge.

Form ADV is well received by investors and appears to be effective in conveying the desired information, the Commission could simply require something comparable for brokers. If on the other hand investors express frustration or confusion as a result of the length and complexity of the Form ADV, the Commission should consider whether a more abbreviated summary form could be adopted for brokers and advisers alike to be offered in conjunction with the fuller disclosures contained in Form ADV (and a similar document for brokers).

Timing: The timing for pre-engagement disclosures for brokers should closely track those for investment advisers. Specifically, they should come as early as possible at or after the point of first contact between the investor and the intermediary if they are to serve their purpose of informing the selection of intermediaries. Follow up disclosures should be provided immediately when there are material changes that might cause an investor to reconsider their selection. Otherwise, annual updates could be provided in a more summary form, as discussed in the Appendix A letter on the Form ADV revisions.

Recommendations to Improve Disclosures with Regard to Investment Products and Services

We believe significant improvements can and should be made to promote greater investor understanding of the products and services they purchase to achieve their investment goals. Toward that end, the top priorities are:

- creating a framework for comparable disclosures for all products and services that focuses on the key issues investors need to understand to make a sound investment decision,

- developing a template for a summary disclosure document based on the framework that presents key information in a way that promotes investor understanding, and

- requiring that summary to be provided prior to the sale of all investment products and services.

Investors would benefit most from such an approach if other financial regulators were to adopt the same or largely similar framework for disclosures under their jurisdiction. Toward that end, the Commission should reach out to the CFPB to explore whether the two agencies could work together to improve the quality and clarity of financial product disclosures. While investors would benefit most if state insurance regulators were also brought on board, recent experience regarding regulation of equity-indexed annuities suggests they may be at best reluctant partners. It is essential that the Commission not water down its own proposals to win their support. Rather, if the Commission and CFPB were to develop a strong framework, that in itself would put pressure on insurance regulators to adopt a similar approach for products under their jurisdiction.

Content: In thinking about how to develop such a disclosure template, the Commission should identify the key questions that investors should be able to answer to determine: 1) whether the type of investment product or service being recommended is generally appropriate given their investment needs, risk tolerance and other factors; and 2) whether the particular product or service being recommended is an attractive option. In refining ideas in this area, the Commission could look to the expertise of both personal finance experts in academia and the media and to leading members of the profession for insight into the factors they consider essential when evaluating investment options. The following are a few areas we believe are critical:[10]

- **The types of investment goals for which a particular investment product is appropriate** (e.g., current income, preservation of capital, long-term growth). This should be presented in a way that is directly relevant to typical investment goals and understandable by average investors. In some cases, it may be appropriate to include information on the types of investors or uses for which the investment is not appropriate (e.g., this is not an appropriate option for investors concerned about capital preservation or this is not appropriate for investors seeking a reliable stream of current income).

  Although it would be appropriate to test this further, we believe it may be appropriate to relegate information on the investment strategy a particular investment product uses to achieve that goal to a more detailed disclosure document available by hyperlink. Our assumption here is that most investors simply aren't equipped to evaluate even summary information regarding investment strategy. However, this is not a firmly held conviction; we are suggesting simply that the issue would merit further study.

- **The risks associated with the investment.** This is an area where our exploration of mutual fund disclosures suggests current practice falls far short of the ideal.[11] To be useful to the investor, information about risk should be presented in a way that is directly relevant not only to the preservation of capital but also, and particularly, to the specific investment goal the investment is designed to meet. For example, an investment that is intended to be used to provide a source of current income should discuss the risks that it will fail to provide that steady income or that income will experience significant fluctuations. In addition, risk disclosures should help the investor to understand how risky a particular investment is in comparison with other investment options recommended for the same purpose. Put simply, risk disclosures should describe what would cause the investor to lose money, what would cause the investment to fail to serve its intended purpose (e.g., provide a steady stream of income), and where the investment falls within a risk spectrum of investment products designed to serve a similar purpose. Our exploration of mutual fund disclosures suggests that this is possible, but rare.

- **The costs of the investment.[12]** Earlier, we discussed the need to improve cost disclosures for service-providers. There is a similar need to improve product cost disclosures. This can be achieved in part by distinguishing product costs from the cost of the services of the financial intermediary selling the product. But another major priority should be to present cost information in a manner that enables the investor to easily assess whether the product costs are relatively high or low and what the long-term impact of that cost differential is likely to be. We believe some form of comparative cost information is essential for this

[10] We explored this issue in greater detail for a report we prepared as part of a project on mutual fund purchase practices. A copy of that report is included in Appendix E. The report was prepared for use with our project advisory committee and not for external publication.

[11] Since mutual fund disclosures generally considered the gold standard, there is every reason to believe that disclosures for other comparable investment products are worse.

[12] We anticipate that information about conflicts of interest would be provided in a product-specific provider disclosure, as discussed above.

purpose, and we would strongly encourage the Commission to analyze and test various different approaches to determine which are most effective.

One issue that arises in this context is the complexity of the fees associated with certain types of products (e.g., variable annuities), which complicates efforts to provide clear, comprehensible disclosures. Industry has sometimes argued against the kind of comprehensive, comparative cost disclosures investors support on the grounds that it is too difficult or costly to provide that information. But, as the creators of the complexity that contributes to the cost and difficulty of disclosure, industry should not be allowed to use that complexity to defend against improved disclosures. If complex fee structures drive up the cost and difficulty of fee disclosures, perhaps an effective fee disclosure requirement would help serve to discourage excess complexity.

Another issue is that certain costs, though paid out of investor assets, remain largely hidden from view (e.g., mutual fund portfolio transaction costs), depriving investors or accurate and complete cost information. Because they are hidden, those portfolio transaction costs may become a vehicle for soft dollar payments for services that at least in some instances ought to be either incorporated in the administrative cost of the fund or paid for directly by the fund manager. In seeking to improve cost disclosures, the Commission should examine how it can best develop cost disclosures that are both complete and clear and whether additional policy changes (such as reform of soft dollar practices) are needed.

- **Past performance.** While there is evidence to suggest that investors place too much emphasis on past performance in selecting investments, past performance nonetheless is or can be important information for investors to consider when selecting an investment. Performance information is perhaps most useful when presented in a fashion that helps illuminate the bumpiness of the ride over a significant time period. Also useful is information that helps investors to assess how a particular investment's past performance has compared to a benchmark or category average. The more the Commission can do to make performance comparable across product lines, the more useful this information would be.

- **Miscellaneous.** There are several other issues that may be considered essential information, either generally or with regard to particular investments. These would include investment minimums for initial and additional investments, tax implications, and certain operational issues (such as the ability to make low- or no-cost exchanges among funds within a particular fund company). While investment minimums would almost certainly belong in a summary disclosure document, and tax implications would belong there at least with regard to investments sold based on their potential tax advantages, it is open to question whether these other operational issues would best be included in the summary or simply linked to in the summary. Further testing and consultation might help to provide an answer to that question.

Format: We believe investors would greatly benefit from development of a template for a summary disclosure document that could be used for all investment products and services. This is most easily accomplished in a web-based format that relies on electronic delivery with click-through access to more detailed information, but there is nothing about this approach that would preclude delivery through a paper document.[13] The real issue is that the document be designed to present the information in a clear, easily comparable, visually appealing format that promotes investor understanding of the disclosed information. The Commission should consult with graphic design and plain English disclosure experts, and rigorous testing should be conducted to determine how best to achieve that goal. As noted above, this summary disclosure should be combined with more detailed disclosures as part of a layered approach to product disclosures.

Timing: For product disclosures to provide meaningful direct benefits to investors, they must be provided far enough in advance of the sale to be incorporated into the investor's decision-making process. Point-of-sale disclosure will typically be too late to maximize their usefulness, and post-sale disclosure is all but useless if the goal is better informed investment decision-making. Ideally, that means providing the disclosure at the point of recommendation for products and services sold through a financial intermediary. For retirement plan investors, the considerations are somewhat different, since investors are responsible for making their own selections. For this purpose, therefore, summary product disclosures should be provided when the employee enrolls in the plan or requests information about enrolling in the plan, whichever comes first, and information on plan options should be continuously available to plan participants either upon request or through direct access on a plan website.

Conclusions

This study can and should serve as the starting point for Commission efforts to improve the disclosures investors receive regarding financial intermediaries, investment products, and investment services. As it considers how to follow up once the study is complete, the Commission should prioritize those areas that are most important to investor well-being, where there are significant gaps in existing disclosure requirements, and where existing disclosures have proven ineffective in conveying the desired information to investors. We believe this will lead the Commission to focus on pre-engagement disclosures to assist investors in choosing a financial intermediary to rely on for investment recommendations, providing generally comparable pre-sale disclosures for all investment products and services, and revising product fee disclosures and risk disclosures to be more meaningful to investors. As it works to revise disclosures in these and other areas, the Commission should take full advantage of existing research on how to present information to make it more attention-grabbing and compelling. And the Commission should carefully test proposed disclosure approaches as they are being developed to ensure that they are effective. Comprehensively improving disclosures is not a goal that will be achieved overnight, but it is one with enormous potential benefits for investors, for the efficient allocation of capital, and for the overall health of our economy. We look forward to working with the Commission as it moves forward on initiatives in this area.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection

[13] Under such an approach we would lose the benefit of easy, click-through access to more detailed disclosures, but information on how to gain access to more detailed disclosures could be included in a paper summary document.

Appendix A:

Consumer Federation of America

July 2, 2008

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-10-00

Dear Ms. Morris:

I am writing on behalf of the Consumer Federation of America[14] to express our strong support for the Commission's proposed revisions to Form ADV and our equally strong opposition to suggestions put forward by various securities industry representatives to weaken that proposal. CFA has long supported the Commission's efforts to make the ADV Form more user-friendly as a disclosure document. We believe the proposed revisions to Form ADV accomplish that, by making it easier for investors to obtain information about key issues they should consider when choosing an investment professional and to understand that information.

As we noted in our June 22, 2000 comment letter on the proposed ADV rewrite, CFA believes investors stand to benefit in particular from the addition of a brochure supplement providing information on the individuals actually providing the investment advice, the higher standards for reporting conflicts of interest, the clarification that a broad range of disciplinary events must be disclosed, and the presentation of that information in the form of a plain English narrative brochure.[15] Having recently read many of the comments submitted regarding this proposal, we were disappointed to see that a number of the aspects of the proposal that are central to its investor benefits are under attack by members of the securities industry. Rather

[14] Consumer Federation of America (CFA) is a non-profit association of approximately 300 national, state, and local pro-consumer organizations. CFA was founded in 1968 to advance the consumer interest the research, advocacy, and education.

[15] Letter from Barbara L. N. Roper, Director of Investor Protection, Consumer Federation of America to Jonathan G. Katz, Secretary, Securities and Exchange Commission regarding Proposed Rule – Electronic Filing by Investment Advisers and Proposed Amendments to Form ADV (File No. S7-10-00), June 22, 2000.

than simply reiterating our support for the proposal, this letter is intended to refute these anti-investor proposals.

1) DO NOT eliminate the brochure supplement.

Several industry commenters suggested eliminating the brochure supplement, which provides information on the individual or individuals who will provide investment advice to the investor. In doing so, they argued that the information contained in the supplement offers little value to investors and is available elsewhere and that preparing the supplements will impose a significant burden on the industry. None of these arguments holds water.

Merrill Lynch suggests, for example, that the brochure supplement provides limited useful information for investors. As far as we can see, Merrill Lynch offers no evidence to support its claim. We respectfully disagree. While some investors may choose their financial professional based on the reputation and qualification of firm principles, we believe many more are likely to be interested in the background, qualifications, and disciplinary record of the individual or individuals who will actually be servicing their account and providing them with investment advice. This is most true in a large firm, such as Merrill Lynch, where many layers will separate the firm principles from the employees actually providing the investment advice. By providing this more relevant information, the proposal to create a brochure supplement closes what has long been a gaping hole in investment adviser disclosure.

In its letter, Sifma makes much of the fact that, at least for those investment advisers who are dually registered as broker-dealer representatives, much of the information proposed to be included in the brochure supplement is already available through Finra's Broker Check system. The fact that an enterprising investor who takes the initiative and knows where to look can find this information does not begin to offer the same investor benefits as providing that information in a plain English brochure at the outset of the engagement. Arguably, those investors who are least sophisticated and therefore most likely to need this information are the very ones who are least likely to seek it out, absent an affirmative delivery obligation. This notion, which we will discuss in greater detail below, that access to information is equivalent to delivery of that information has no place in the retail investor context.

Sifma, Merrill, and others also base their opposition on the significant financial burden they claim this requirement will impose. While we acknowledge that there are likely to be significant start-up costs associated with adopting this proposal, we believe the benefits of providing investors with information directly relevant to their account greatly outweighs the costs. Contrary to the arguments of industry, we believe its greater personal relevance to investors will make the brochure supplement among the most widely read of the disclosure documents they receive, particularly if they receive it in a timely fashion. Moreover, the industry arguments appear to contradict themselves. If brokerage firms are already required to compile and update much of this information when they fill out Form U-4, and if the information is available through Finra's Broker Check, then the costs of formatting that same information in a plain English brochure ought to be minimal, at least once the initial brochure format is developed. In developing their cost estimates, the brokers appear to be either exaggerating or "double-billing" – i.e., attributing costs to the brochure that they already incur to comply with other regulatory obligations.

2) DO NOT shift the burden for obtaining disciplinary information onto investors.

In a similar vein, Sifma and others have urged the Commission to eliminate the requirement that advisers disclose disciplinary information as part of Form ADV. Again, the argument rests on the notion that the availability of the information elsewhere eliminates the need to affirmatively disclose it. The existence of a disciplinary record, particularly a record of abusive sales practices, is highly relevant information that reasonable investors are likely to want when selecting and working with a financial professional. Arming investors with this information is one of the best tools we have to put investors on their guard so that they can protect their own interests. Forcing investors to take the initiative to seek this information out on their own, however, would significantly dilute this benefit. It would guarantee that far fewer investors would actually view this information and take it into account when selecting a financial professional. In addition, advisory firms that are required to disclose disciplinary information, and to constantly update that information, may be quicker to dismiss those practitioners with a tendency to explore the boundaries of what is ethically acceptable. For all these reasons, we believe the requirements to include disciplinary information in the brochure supplement and to require that information to be regulatory updated are absolutely essential and must not be eliminated.

3) DO NOT exempt non-discretionary fee-based accounts from the disclosure requirements.

Absent the complete elimination of the brochure supplement requirement, Sifma urges the Commission to exempt non-discretionary advisory accounts. This would, of course, have the effect of exempting the fee-based accounts the courts recently determined were appropriately regulated as advisory accounts, though its reach would be much further. Sifma offers no justification for exempting one class of advisory accounts from one of the central investor protections contained in the Advisers Act. We strongly oppose any such exemption, which would flout the recent court decision, create a dangerous precedent, and leave vulnerable investors without important protections.

Our previous research suggests a strong tendency of investors to rely heavily on the recommendations they receive from financial professionals and to do little or no additional research of those recommendations, even outside discretionary accounts.[16] Given that tendency, the decision of whom to rely on for investment recommendations is often the most important investment decision most investors will ever make. Unfortunately, it has long been a decision for which we fail to provide useful, timely and understandable disclosures. The proposed revisions to Form ADV begin to redress that disclosure failure. The exemption proposed by Sifma would undo much of the benefit. Moreover, at a time when the recently completed RAND Study tells us investors do not understand the differences between various types of financial professionals and investment services, Sifma's proposed approach would not just perpetuate, but

[16] Roper, Barbara and Brobeck, Stephen, *Mutual Fund Purchase Practices: An Analysis of Survey Results*, Consumer Federation of America, June 12, 2006, pg. 2.

expand a discredited regulatory approach in which services that are indistinguishable to the average investor are subject to different regulatory standards and requirements. Under no circumstances should the Commission increase regulatory inconsistency by applying different disclosure standards to different types of advisory accounts.

4) DO NOT eliminate the requirement that brochures be updated to reflect material events.

Some have urged the Commission to eliminate the requirement to update the brochure to reflect material changes and to provide investors with a summary of those changes. One argument made is that the definition of what constitutes a "material" change is unclear. It is ironic that the same industry representatives that argue for a more principles-based approach to regulation oppose that approach whenever they encounter it. The current standard for materiality, which requires firms to make professional judgments, is as good an example of principles-based regulation as you will find in U.S. securities laws. An appropriate approach to interpreting the standard is clearly articulated in the letter of the Investment Advisers Association and is based on what information a reasonable investor would want to have.[17]

We also believe the requirement to provide a summary of those changes will greatly assist investors who have engaged an investment adviser to focus on the issues that are most likely to be of interest to them. It is not enough, as some have suggested, for the summary simply to identify the sections of the brochure that contain changes. Rather, the summary must provide a brief description of the nature of those changes if it is to serve as a useful guide to investors. We urge the Commission to make this clear when it adopts the final amendments.

On the other hand, we are open to alternatives to the annual delivery requirement. Specifically, we believe an approach that provided investors with a summary of material changes and the option to obtain the complete brochure might provide an acceptable approach. For this to work, the summary of material changes would have to provide enough information for investors to determine whether they need to see the updated brochure. Properly structured, such an approach could improve on the existing system, in which investors are simply notified of their right to obtain an updated brochure, and minimize some of the on-going costs of these proposed amendments without significantly sacrificing investor protections.

5) DO NOT rely on an access equals delivery model for dissemination of the disclosures.

In several cases, commenters have suggested that the fact that investors have access to information should substitute for actual delivery of that information. We believe such an approach has no place in the retail investor context. Furthermore, the analogy that several of these commenters draw to the mutual fund profile is not relevant. In that case, there is a disclosure document, the profile, which is being affirmatively delivered to investors, while the prospectus is made available on-line or in writing upon request. That would not be the case here,

[17] The Morgan Stanley letter, on the other hand, gets this issue backwards. The question isn't whether a brokerage firm of its size would consider a $2,500 SRO fine material. The question is whether an investor would do so. So, the issue of materiality does not vary with the size of firm.

if the Commission were to take the ill-advised recommendation to allow posting on the IARD to substitute for actual delivery of the brochure. Moreover, as we noted above, many investors rely heavily, if not exclusively, on the recommendations they receive from financial professionals. That makes their decision about whom to rely on for recommendations, and the disclosures they receive to help them make that decision, of paramount importance. The Commission should be looking for ways to increase the likelihood that investors will access and use this information, not adopt an approach that would reduce that likelihood.

We also reject the suggestion made by at least one commenter that negative consent and consent through the course of business should satisfy consent obligations for electronic delivery. While the day will certainly come when electronic delivery will be the norm for the vast majority of investors, that day has not yet arrived. There are still significant numbers of investors who do not wish to receive disclosure documents in this manner. CFA's survey on mutual fund purchase practices, for example, asked about respondents' willingness to use the Internet for various purchase-related purposes. Only half (49 percent) were willing to use the Internet to receive periodic reports and disclosure documents, including just six in ten investors 44 and younger.[18] Among older investors the percentages were much lower. This suggests that we still have a ways to go before we can force an Internet-based approach to disclosure.[19]

6) DO require disclosure of disclose arbitration awards or damages in civil proceedings.

Right now, the Commission does not propose to require disclosure of arbitration awards or damages in civil proceedings. Not surprisingly, this decision is supported by many in industry, who have a clear interest in minimizing the information investors receive about disciplinary events. One argument made is that arbitration awards should not be included because there is no finding of facts or conclusions of law in arbitration. It is cynical indeed for the very firms that force investors to adjudicate their disputes through an industry-run arbitration system to then cite the shortcomings of that system as the reason arbitration awards should not be included among the disciplinary events disclosed to investors. We strongly disagree. Investors deserve the most complete information available from which to build a picture of an advisers' integrity. That includes arbitration and civil damages awards, at least as they pertain either to firm practices that are relevant to their account or to the individuals who provide advice to their account. For that reason, we concur with the North American Securities Administrators Association that this information should be included in the brochure.

7) DO consider developing a short-form disclosure document to supplement the revised ADV Form.

Several commenters have suggested that the proposed amendments to Form ADV will result in a brochure that is too long to win wide acceptance among investors. They tend to base this view on the findings of the RAND Study, which found that investors don't read lengthy

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[18] Roper, Brobeck.

[19] The first step in that process should be developing a better understanding of the reasons behind investors' reluctance to rely on the Internet for these purposes.

disclosure documents. While we believe it is premature to conclude that this will be the case, we fear this criticism may have some validity. We reject the suggestion, however, that the proper course is therefore to delay implementation of the amendments until they can be incorporated within the Commission's overall response to the RAND Study. This proposal has already been delayed for far too long. It would be a grave disservice to investors to prolong that delay based on an uncertain timeline for responding to the findings of the RAND Study.

Instead, we would encourage the Commission to proceed with this rule-making, but to also consider developing a short-form disclosure document as a supplement to Form ADV. Such a document should answer at least the following the questions: What services do you offer? How will I be charged? How will you be compensated? What conflicts of interest are present in your business model? And what is your disciplinary record? If an abbreviated disclosure document of this type were developed, then it would be possible to consider a disclosure approach that resembles that now proposed for mutual funds, where investors are provided with the abbreviated document and given the option of receiving the longer disclosure document.

Furthermore, in considering its response to the RAND Study, we would urge the Commission to consider whether all financial professionals should be required to provide this type of tiered disclosure. Given the blurring of lines that has occurred between the different types of financial professionals, and investors' well documented confusion about these differences, we believe these disclosure obligations should be universal for all financial professionals subject to the Commission's jurisdiction who work with retail clients. This would expand on the benefits offered by the current proposal to amend Form ADV by ensuring that investors get plain English information about key issues relevant to selecting a professional for all types of professionals who offer investment recommendations, not just investment advisers.

* * *

CFA has long advocated improved disclosure to assist investors in making the most important investment decision most will ever make – the decision about whom to rely on for investment recommendations. We have given our strong support to the proposed revisions to Form ADV because we believe it furthers that goal by making key information more accessible, more relevant to the individual investor, and more understandable. We are pleased that the Commission finally appears ready to adopt these proposed revisions after years of delay. If the proposal is to retain its promised investor benefits, however, it is essential that the Commission reject the many anti-investor changes being pushed by certain industry representatives. Thank you for your attention to our concerns.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

Appendix B

Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

Consumer @ction

Consumers Union
Publisher of Consumer Reports

April 21, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-06-04

Dear Secretary Katz:

We are writing on behalf of Consumer Federation of America,[20] Fund Democracy,[21] Consumer Action,[22] and Consumers Union[23] with regard to the rule proposal to improve disclosure of certain mutual fund costs and conflicts of interest at the point of sale and on confirmation statements. We applaud the Commission's proposal to correct the longstanding gap in the regulation of fund sales that has deprived mutual fund investors of confirmation statement disclosures, which are standard for other securities, about the compensation brokers receive in connection with the purchase and sale of those securities. We also applaud the

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[20] The Consumer Federation of America (CFA) is a nonprofit association of 300 national, state, and local consumer groups, which in turn represent approximately 50 million Americans. CFA was established in 1968 to advance the consumer interest through research, education, and advocacy.

[21] Fund Democracy is a nonprofit advocacy group for mutual fund shareholders. It was founded in 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments.

[22] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 6,500 community based organizations.

[23] Consumers Union, publisher of *Consumer Reports* magazine, is an independent nonprofit testing, educational and information organization serving only the consumer.

Commission's efforts to address additional regulatory gaps by requiring that brokers provide information on mutual fund distribution costs and conflicts before the sale and by requiring disclosure of some comparative distribution information. Finally, we congratulate the Commission for making a concerted effort to obtain comments on its proposals from typical mutual fund investors.

Although we view this proposal as an improvement over the current woefully inadequate state of mutual fund disclosure, we are nonetheless forced to conclude that it is seriously flawed. As we will discuss in more detail below, the proposed disclosures fail to provide all the information mutual fund investors need about costs and conflicts, they fail to ensure that the information is provided at a time when it is likely to influence the purchase decision, and they fail to ensure that it is provided in a form that average, unsophisticated investor will easily understand. We therefore strongly recommend that the Commission adopt major revisions to the content, timing, and format of its proposed disclosures.

We also believe that there are limits to what disclosure alone should be expected to accomplish, particularly when it comes to combating conflicts of interest. This is especially true when those disclosures are forced to counteract multi-million-dollar advertising campaigns designed to send exactly the opposite message, as is the case with regard to brokerage industry conflicts of interest.

The recent mutual fund sales practice scandals – involving inappropriate sale of B class shares, failure to provide appropriate breakpoint discounts, and use of undisclosed sales competitions to promote the sale of certain funds, as well as a history of recommending funds based on the compensation they offer to the broker rather than the benefits they offer to the client – have, in our view, made it abundantly clear that the Commission must finally act to close the enormous gap between the image brokers promote of themselves as objective financial professionals and the reality of their conflict-laden sales practices. It simply makes no sense to continue to allow brokers to use titles that imply they are objective advisers rather than salespeople and promote their services as if they were primarily advisory in nature without imposing both a fiduciary duty to act in the best interests of their clients and a requirement that they disclose any and all conflicts of interest prior to the engagement. Furthermore, that fiduciary duty must be interpreted to require brokers and investment advisers to include costs as one of the factors they take into account when recommending mutual funds and other investment products.

Even if such an approach were adopted, we believe the complexity of the mutual fund distribution conflicts will inevitably undermine the effectiveness of cost and conflict disclosure. Many of these conflicts are a direct result of the Commission's record of lax interpretation of Section 12(b) of the Investment Company Act. In that provision, Congress wisely prohibited the use of fund assets to sell fund shares. The Commission's past overly permissive positions on 12b-1 fees, revenue sharing arrangements, and directed brokerage arrangements have practically repealed Section 12(b). When these positions are coupled with the Commission's refusal to fulfill its statutory responsibility under Section 36(b) of the Act to take action against fund managers who charge excessive fees, the concept of regulatory limits on the use of shareholders' funds to sell fund shares loses all meaning. We appreciate that the Commission has proposed banning use of directed brokerage to promote distribution and is exploring additional 12b-1 fee reforms. We urge the Commission to take the strongest possible action to end these and similar conflicts of interest.

As part of that review, we encourage the Commission to revisit a recommendation it has made in the past to repeal or amend section 22(d) of the Investment Company Act.[24] By allowing mutual funds to set the compensation brokers receive for the services they provide to investors for selling the fund – a price that logically should be negotiated between the broker and the investor – the provision exempts these costs from the market forces that have dramatically reduced commissions on stock transactions. At the same time, this provision has helped create the system in which funds compete to be sold, by offering financial incentives to the salesperson, rather than competing to be bought, by offering a good product and good service at a reasonable price. If funds were removed from the role of fixing broker compensation, the incentive for brokers to recommend funds that are not in their clients' best interests would be sharply reduced, and investors should reap enormous benefits as a result.

Principles That Should Govern Timing and Content of Disclosure

The proposed confirmation and point-of-sale disclosure serve different, but complementary, purposes. As the Commission noted in its release, the purpose of point-of-sale disclosure is to "allow customers to consider material information when they make their investment decisions."[25] The confirmation disclosure, on the other hand, serves primarily to quantify fund distribution costs, including payments that may have influenced the fund recommendation. While we generally agree with the basic principles for point-of-sale and confirmation disclosure laid out by the Commission in the proposing release, we do not believe the actual proposals live up to these principles.

In revising the content and timing of its proposed disclosures to conform to those principles, we urge the Commission to employ the following logic. Information that is relevant to the selection of the financial professional, including information about practices they engage in that create conflicts of interest, should be required to be provided prior to the engagement, as it is for investment advisers.[26] Information relevant to the purchase of a particular product – including, but by no means limited to, information about distribution related costs and financial incentives that may influence the product selection – should be provided at the point when that purchase is recommended. Confirmation and other post-sale disclosure should quantify the costs

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[24] See *Report on the Public Policy Implications of Investment Company Growth,* Report of the Committee on Interstate and Foreign Commerce, pursuant to Section 136 of the Legislative Reorganization Act of 1946, Public Law 601, 79th Congress, and House Resolution 35, 89th Congress, December 2, 1966. *Protecting Investors: A Half Century of Investment Company Regulation*, SEC, Division of Investment Management, May 1992.

[25] Proposing Release at Part V. B. See also Proposing Release at Part V. D. (The purpose of point-of-sale disclosure is "to enable customers to consider material information prior to a transaction being finalized.")

[26] The SEC's long neglected rule proposal revising ADV form disclosures for investment advisers offers an excellent model for how this disclosure could be provided.

incurred as a result of the transaction, including any costs or payments that may have been estimated in pre-sale disclosures.

Specific Comments on the Point-of-Sale Disclosure Rule Proposal

A. Content of Point-of-sale Disclosures

Under current rules, brokers can sell fund shares without providing any written document to shareholders until days after the investment decision has been made and the purchase has been finalized, when the fund prospectus arrives in the mail with the confirmation. This disclosure gap increases the likelihood that investors will make uninformed investment decisions. The apparent justification for this system is that a broker's suitability obligation substitutes for full pre-sale disclosure. However, the complexity and pervasiveness of conflict-laden sales practices and the failure of the suitability obligation to result in recommendations that are in the client's best interests make clear the folly of perpetuating such a system.

The Commission's point-of-sale proposal is a step in the right direction, but falls far short in addressing this problem. The most significant problems are threefold: the proposed point-of-sale disclosure omits important information, including non-distribution-related expenses; it is not required to be in writing; and it is not required to be delivered far enough in advance of the purchase to allow its use in making an informed investment decision.

<u>Material Information</u>: As the purpose of point-of-sale disclosure articulated by the Commission makes clear, these disclosures should cover all "material" factors relevant to the individual's investment decision. Having taken the bold step of requiring pre-sale disclosure, the Commission should not stop short by requiring only that information about distribution-related costs and conflicts be disclosed. While distribution-related costs are certainly significant, they will generally be less significant to the long-term investor than the fund's operating costs, yet these costs are omitted from the pre-sale disclosure. Similarly, while distribution-related conflicts are important, so are risks associated with the fund, what investment purposes it is suitable for, and its investment strategies. Again, however, these clearly "material" factors are not required to be covered in the pre-sale disclosure. We urge the Commission to rectify this major short-coming in its proposal by requiring that mutual fund investors receive either a full prospectus or a fund profile (as designed in rule 498 under the Securities Act) before the sale.

<u>Fund Operating Expenses</u>: With respect to fund expenses, the pre-sale disclosure should provide investors with a good faith estimate of all the expenses the investor will actually incur if the investment is made. In addition to distribution-related costs, this should include fund operating expenses (which should include portfolio transaction costs, as we have previously proposed), redemption fees, account fees, small account fees (if relevant), and other non-distribution-related fees. As the Commission has stated, fund fees "can have a dramatic effect on an investor's return. A one percent annual fee, for example, will reduce an ending account balance by 18 percent on an investment held for 20 years."[27] Clearly, these costs are a material

[27] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment

factor that fund investors ought to consider when making their purchase decision.

The Commission has also made clear its preference that markets, rather than regulators, discipline fund costs. Pre-sale disclosure is a prerequisite to meaningful cost competition. It is absolutely inexplicable that, having taken the step of requiring pre-sale cost disclosure, the Commission would pass up this opportunity to require pre-sale disclosure of fund operating costs. Until it rectifies this major oversight, the Commission's policy of relying on markets to discipline mutual fund costs will lack all credibility. In fact, failure to include operating costs in the pre-sale disclosures could have the perverse effect of decreasing the likelihood that investors will consider these costs when making a fund purchase, since the clear impression created by their omission will be that they are less important than distribution costs.

Basis for Cost Disclosures: We also believe the basis for providing cost disclosures under the rule must be strengthened. The proposed rule provides that disclosure of covered expenses shall be "by reference to the actual value of the purchase, or, if that value is not reasonably estimable at the time of the disclosure, by reference to a model investment of $10,000." We believe that this will allow too much leeway for a broker to base the disclosure on a $10,000 investment, even when the actual investment amount is likely to be much higher. Given that leeway, we fear that brokers will too often improperly base the disclosure on the $10,000 amount in order to minimize the apparent cost of the investment.

When recommending a mutual fund purchase, a broker will often recommend an amount for that purchase. Where the actual value of the purchase is not known, but where a purchase amount has been recommended, the broker should be required to disclose expenses by reference to the recommended purchase value. Where no such specific recommendation is made, the broker should be required to inquire as to the expected amount or approximate amount of the investment (and keep a record of the response). In such instances, disclosures should be made by reference to this estimated amount of purchase provided by the client. Finally, when neither of these alternatives is available, the broker should be required to make a good faith estimate of the actual amount of the investment and base the disclosure on an amount that is close in value to the estimated value of the investment: e.g., $10,000, $50,000, $100,000, $500,000, etc. Such an approach will reduce the ability of brokers to minimize the costs and will make it possible for regulators to identify brokers that routinely do so.

Comparative Cost Information: The pre-sale disclosure is also the point when comparative cost information should be provided. The proposed rule would relegate this information to the confirmation. But learning, after the sale is completed, that the distribution costs were among the highest in the industry is hardly helpful. Investors need this information while they can still do something about it. While we favor the Commission's suggested approach of comparing cost information to industry norms, we believe the value of this disclosure will be all but lost if it is not provided in advance of the sale.

Consistent with our recommendation that pre-sale disclosure include fund costs as well as distribution costs, we think it is essential that these costs also be placed in the context of industry norms. Ideally, the long-term effect of all costs should also be shown. The prototype disclosures

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Companies, Investment Company Act Release No. 25870 at Part I.B. (Dec. 18, 2002).

submitted to the Commission by Nancy M. Smith, former Director of the SEC's Office of Investor Education and Assistance – and prepared with the assistance of plain English expert, William Lutz, and a design team from The Corporate Agenda – offer an excellent model for how this can be accomplished in a way that average, unsophisticated investors are likely to understand. Showing an investor, for example, that the fees they can expect to pay for buying and owning the fund will cost them an estimated 14 percent of their investment value or $1500 over 10 years when alternatives are available that would cost just 2.75 percent or $300 over the same period would be far more likely than either current disclosures or the newly proposed disclosures to motivate investors to make truly cost-conscious decisions.

Differential Compensation: The point-of-sale disclosure is also the document that should carry the most complete explanation of conflicts of interest that are relevant to the particular fund being recommended. The Commission has made a start, by requiring that qualitative information be disclosed at the point-of-sale about directed brokerage, revenue-sharing payments, and the existence of higher payments for sale of proprietary funds as well as funds that carry a back-end sales load. We are concerned, however, that the proposal does not do nearly enough to highlight all the various types of differential compensation a broker might receive for selling a particular fund.

The purpose of differential compensation disclosure is to direct the investor's attention to the broker's most significant conflict of interest – the incentive to recommend one fund over another, not because it is a better investment for the client, but because the broker will receive a higher fee. It is imperative, therefore, that differential compensation disclosure cover all situations where a broker (including its associated persons) has an incentive to prefer sales of one fund over another or one class of fund shares over another. To aid in the investor's understanding of this concept, disclosures of differential compensation should include a clear statement that the differential payments create an incentive for the broker to recommend a fund in order to increase his or her own compensation regardless of whether it is the best fund for the investor.

The issues to be covered by differential compensation disclosure should start with the fact that some funds charge higher sales loads than others, resulting in a higher commission payment to the broker. Investors need to be able to assess, not just the amount of the commission that they are likely to pay and that the broker is likely to receive, but how that amount compares to those of other funds. For example, if a broker was paid a 4 percent commission for selling Fund A, and would have been paid a 3.5 percent commission for selling Fund B, that differential should have to be disclosed.

That is a key reason why we think it is so important to move comparative cost information from the confirmation statement to the point-of-sale disclosure and to expand the information that is provided. The significance of the incentive to sell a particular fund depends on its size relative to the amounts received for selling other investments. If there is little relative differential, then the broker's bias may be insignificant. If there is a large relative differential, the broker's bias may be substantial. This is clearly material information that ought to be considered as part of the investment decision.

It is ironic that the disclosure proposal would require disclosure of differential payments where the conflict is most obvious – where the fund is an affiliate – but would require no such disclosure of differential payments where the conflict is most insidious – where the fund appears to be independent. In fact, the proposed disclosure with regard to affiliated funds is misleading, since a "No" response to the question of whether the associated person receives more to sell affiliated funds might suggest that he has no extra financial incentive to sell those funds. In fact, the broker always has an extra financial incentive to favor affiliated funds because of the other fees paid by the fund to the broker's affiliates.

We recognize that requiring disclosure of all differential compensation arrangements may require complex and lengthy disclosure, but this is not a problem inherent to disclosure. It is a problem that exists because of a history of non-disclosure and the complex structure of distribution arrangements that archaic Commission positions have allowed to evolve unchecked by competitive forces. It also results from the fact that fund distribution payments are set by the fund and are required to be fixed at the broker level. As long as these structural problems remain unaddressed, adequate disclosure of distribution costs and conflicts may be both difficult and costly to achieve.

Once again, however, the prototype disclosure documents submitted by Nancy Smith offer a good model for how this disclosure could be achieved. Using a heading such as, "Facts you should know about conflicts of interest," and a simple explanations in a question and answer format helps to highlight the significance of the information being provided. All of the information regarding various types of differential compensation should be presented in this format. To the degree that other sales incentives exist, such as sales contests to promote a particular fund family, that fact should also be disclosed here.

Share Class and Breakpoint Disclosures: Two other areas of point-of-sale disclosure content deserve special mention. The disclosure regarding costs associated with different share classes should be provided in dollar amounts and in a comparative format. In other words, regardless of which share class the broker recommends, he or she should have to show what the projected costs to the investor would be over various time periods, so that the investor can make an informed decision up front about which share class is in their best interests. Similarly, on the issue of breakpoint disclosure, the point-of-sale document should indicate the dollar amount at which the next breakpoint discount is available. This would be a helpful supplement to the boilerplate disclosure required by the rule proposal.

Summary of Point-of-Sale Content Recommendations: To sum up, we believe point-of-sale disclosures should include either a full fund prospectus or a fund profile, as well as a plain English document listing the following key information about fund costs and conflicts based on either the recommended amount of the purchase or the estimated amount of the purchase:

- all distribution-related expenses, including commissions, 12b-1 fees, revenue sharing payments, directed brokerage payments, and any other compensation paid or received in connection with the transaction, along with industry norms, presented as both a dollar amount and a percentage of assets, and a clear statement that these payments create an incentive for the broker to recommend a fund based on the payments he receives rather than the best interests of his clients;

- all expenses of owning the fund, including fund operating expenses (with portfolio transaction costs incorporated), redemption fees, account fees, small account fees (as relevant), and any other non-distribution-related expenses, along with industry norms, presented as both a dollar amount and a percentage of assets;

- comparative information on costs associated with different share classes, including a statement of whether the broker gets paid more to sell a certain class of shares; and

- the dollar amount of the next available breakpoint discount.

All cost information would have to be provided cumulatively for each year for the greater of either five years or a period one year longer than the first year in which a deferred commission (if any) is no longer payable.

B. Timing of Point of Sale Disclosures

It does little good to give investors all the material information they need to make an informed investment decision if you don't also require that they receive the information in time to be incorporated in the investment decision. The rule proposal fails this test. The Commission has proposed only that the point-of-sale disclosure must be provided "immediately prior to the time that the broker, dealer or municipal securities dealer accepts the order from the customer." Clearly, this is not enough time to "allow customers to consider material information when they make their investment decisions."[28]

We cannot urge strongly enough that the Commission move this disclosure obligation to a point earlier in the process. At a minimum, the investor should have enough time to evaluate the information and ask questions before making an investment decision. In any instance where the purchase is based on a recommendation from the broker, the broker should have to provide the disclosures either at that time, if the recommendation is made in writing, or immediately following the recommendation, if it is made orally and the investor expresses an interest in following up on the recommendation.

C. Requirement for Written Point-of-Sale Disclosure

The Commission has proposed that brokers be permitted to provide point-of-sale disclosures orally. This is clearly an unworkable arrangement. In light of the complexities of the proposed disclosures, particularly as amended to conform to our recommendations, it is hard to imagine how a broker could provide the disclosures without the assistance of written materials. And, without written documentation, it will be all put impossible to ascertain whether the disclosures have been fully and accurately provided. Furthermore, allowing oral disclosure makes it easier for the broker to rush through or downplay information they don't want to highlight. It also makes it impossible for the investor to carefully "consider" the information,

[28] Proposing Release at Part V.B.

since they will have no thorough and reliable record of that information. For these reasons, we believe it is absolutely necessary for point-of-sale disclosure to be in writing in order for it to have its intended effect.[29] Failure to amend the rule in this regard will render these reforms all but meaningless.

D. Effect of Disclosure on Sale of Mutual Funds

The Commission has requested comment on whether point-of-sale disclosure might "have the effect of directing investors away from mutual funds and related securities." This question seems to be based on an assumption that we reject – that, if full and clear disclosure has the effect of making a particular type of investment less attractive than a competing type of investment, then the disclosure should not be required. Once you embrace that principle – even to protect mutual funds from unfair competition from less well regulated investment products – you inevitably start a regulatory race to the bottom, which each regulator competing to reduce cost and risk disclosure to help the products it regulates compete more effectively. Clearly, that is not in investors' best interests. It also ignores the fact that the purpose of point-of-sale disclosure is in fact to "direct investors away" from certain mutual funds – i.e., those that are not suitable investments – and to direct investors toward investments that are suitable, be they mutual funds or other investment options. If lack of a level playing field is a legitimate concern, however, then the Commission could better help rectify the situation by applying similar principles of full and complete disclosure to all the investment products under its jurisdiction, and it could encourage a similar approach for products outside its jurisdiction.

E. Exception for Certain Transactions

The Commission has proposed to exempt from the point-of-sale disclosure transactions resulting for orders received from the customer via U.S. mail, messenger delivery, or similar third-party delivery service if the broker does not receive compensation from persons who do not have accounts with the broker and has provided at least semiannually generic disclosure regarding certain distribution-related expenses. We believe that this exception is overly broad and needs to be narrowed.

We recognize that if an order arrives by mail unsolicited – and not based on any prior contact with the broker that is related to that transaction where the point-of-sale disclosure could have been provided – it would be unreasonable to effectively prohibit the broker from executing the order without first locating the customer and delivering the point-of-sale disclosure. Under no circumstances, however, should the exception be available where a broker has recommended the purchase, simply because the client has entered the order via mail or other similar third-party delivery service. To ensure that brokers are not able to evade the disclosure requirements simply by having their customers enter their orders by mail, the rule needs to be amended so that it applies only to transactions were there has been no prior contact with the broker related to the transaction where point-of-sale disclosure could have occurred.

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[29] A requirement that the information be provided in writing does not preclude its being provided through electronic means, such as email.

In addition, the disclosure requirement should be strengthened. There is no reason, for example, why the generic disclosure required in paragraphs (e)(1)(i)(A) through (D) of proposed rule 15c2-3 could not include, instead of or in addition to those disclosures, an actual point-of-sale disclosure document based on a $10,000 investment in a representative equity and fixed income fund. Assuming the Commission were to adopt our other strengthening amendments for the point-of-sale disclosure, this approach would ensure that the investor got the comparative information on how costs and compensation amounts compare to industry norms, which we view as key information every investor should have in advance of the sale. We therefore recommend that the Commission amend the exemption to limit it to its intended purpose – the receipt of a blind, impersonal order request from a client with an existing brokerage account – and enhance the required disclosure in this situation.

F. Applicability of the Point-of-Sale Disclosure Rule

The Commission has requested comment on whether the point-of-sale disclosure rule should apply to persons other than brokers, dealers, and municipal securities dealers, such as banks. We believe investors' need for written disclosure of the most important factors affecting the suitability of investments does not depend on the source of the recommendation. We therefore recommend that the rule apply to all mutual fund sales.

The Commission has also requested comment on whether the point-of-sale disclosure rule should apply when an investor is switched to a new investment. Since the switch will generate new costs for the investor and since the new fund may have entirely different characteristics than the one the investor is being switched out of, clearly the disclosures are needed in this instance. In fact, because there is a significant risk that the switch will be recommended by the broker in order to generate additional distribution compensation, the need for point-of-sale disclosure may be even greater in this context.

Specific Comments on the Confirmation Disclosure Rule Proposal

For 25 years, investors in mutual funds have been deprived of the protection afforded by transaction-based disclosure that is provided to purchasers of other types of securities. This is a result of the fact that, in 1979, the Commission effectively exempted mutual fund sales from rule 10b-10, which requires that brokers disclose the compensation they receive in connection with the purchase and sale of securities. We applaud the Commission for acting to correct this longstanding gap in the regulation of fund sales.

A. Purpose of Confirmation Disclosure

The overall purpose of the confirmation disclosure is twofold: to direct investors' attention to total fund distribution costs and to alert investors to brokers' conflicts of interests. As stated by the Commission in the proposing release, "More complete disclosure also may help customers understand the ***costs associated with purchasing fund share*** classes that carry deferred sales loads, as well as the ***potential conflicts of interest*** that broker-dealers and their associated persons have in connection with the sale of those share classes."[30] In this regard, it serves as a supplement to the point-of-sale disclosure and an opportunity to provide actual dollar amount costs where only estimated costs were available pre-sale. The comments we have made above about the appropriate content (except the requirement that all material information be disclosed) and format of disclosures apply equally here.

B. Presentation of Information in the Confirmation[31]

The proposal would require that confirmation disclosures be provided "in a manner that is consistent with Schedule 15C." We are concerned that the "consistent with" requirement will permit the disclosure of information that is unclear. We also believe that Schedule 15C can and must be substantially improved.

First, we believe it is essential that presentation of distribution expenses in the confirmation (and point-of-sale disclosure) be standardized so as to ensure that this information is easy to understand and use. Brokers' record of transparent disclosures is not encouraging. Just as some firms may favor funds that make revenue sharing payments or that make asset-based distribution payments in the form of 12b-1 fees rather than front loads for the very reason that those forms of payments are less transparent, they may also opt for a confirmation (and point-of-sale) disclosure format that is less transparent. This is a particular risk because of the complexity of distribution arrangements in the fund industry. For these reasons, we urge the Commission to adopt a standard format or formats to prevent brokers from using confusing formats that are "consistent with" the informational requirements, but not the spirit, of the confirmation rule.

We also believe that Schedule 15C can be substantially improved in a number of respects. The confirmation should clearly label the nature of the information being disclosed. The approach followed in the prototype submitted by Nancy Smith – with its heading, "Facts you should know about conflicts of interest" and its easy to follow, question and answer format – offers a good model. In addition, we favor dividing the information on costs into two sections. One should be clearly labeled as payments that the investor pays directly or indirectly in connection with the transaction. This should include both distribution-related costs and operating expenses of the fund. Another should be clearly marked as the payments the broker receives directly or indirectly in connection with the transaction. All payments in this category, such as revenue sharing payments and directed brokerage payments should be disclosed in language that makes clear that these payments are designed to encourage the broker to select this fund or class of funds rather than another.

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[30] Proposing Release at Part A.3.

[31] Comments about the appropriate presentation of information in the confirmation apply equally to the point-of-sale disclosure, except where those comments pertain specifically to information that is not required to be disclosed at point-of-sale.

General Comments on Confirmation and Point-of-Sale Disclosure Proposals

A. Designing Standardized Disclosure Forms

The Commission made an obvious effort to develop clear, straightforward sample disclosure documents and to seek comments from average investors. The prototypes submitted by Nancy Smith, however, demonstrate the difference that having the forms written and designed by experts in plain English and information design can make. In keeping with our recommendation that the point-of-sale and confirmation disclosure forms be standardized, we further recommend that they be designed by experts in these fields. Furthermore, we recommend that they be tested for effectiveness in conveying the information with a representative sample of investors. Such an approach should ensure that the cost of implementing the disclosures in not wasted on disclosures that fail to serve their intended purpose.

B. Monitoring of Compliance and Effectiveness

We strongly recommend that the Commission develop and implement a program to monitor compliance with, and the effectiveness of, the new disclosure rules. As part of that program, we recommend that the Commission develop tools to determine whether brokers are evading disclosure requirements by disguising distribution compensation as compensation for non-distribution services, such as payments for transfer agency services. This should include a reminder to fund directors of their responsibility to compare such payments to payments made to non-brokers. To test for effectiveness, the Commission should conduct and/or sponsor research regarding how the new disclosures are being used by investors and their effect on the pricing of distribution services and mutual fund costs, conflicts of interest, and the investment decision-making process.

C. Applicability of Confirmation and Point-of-Sale Disclosure

The Commission has requested comment on whether the confirmation and point-of-sale rules generally should apply to unit investment trusts, exchange-traded funds, variable annuity products, interval funds, and closed-end funds. We strongly recommend that these rules be applied in all situations in which a broker is compensated by someone other than the investor for effecting transactions or where the broker has a financial incentive to recommend one product over another. In each such case, it is important that investors know the costs and conflicts related to distribution payments. This reasoning applies to all of the aforementioned products, and we therefore recommend that the rules apply to all of them.

Comments on Registration Statement Disclosure

The Commission has proposed to amend the registration statement for mutual funds to revise disclosure requirements relating to distribution payments and arrangements. We recommend that registration statement disclosure be improved in two respects, as discussed below.

A. Effects of Investing in Different Share Classes

As the Commission has noted, brokers may recommend a class of fund shares based not on the benefits to the investor but on the amount of compensation the broker receives. To address this problem, we recommend requiring disclosure in the prospectus of the relative costs of investing in each class that is available to the investor. The disclosure should cover a 15-year period and should be accompanied by a narrative disclosure explaining the advantages and disadvantages of investing in each class.

A recent court decision highlights the need for the disclosure. In Benzon v. Morgan Stanley, the court held that, even assuming there was no rational investor for whom Class B shares would be the best investment, the fund had no duty to disclose this fact in the prospectus.[32] It should go without saying that this decision is flatly inconsistent with the requirements of the securities laws, and we encourage the Commission to seek its reversal. But we also believe that additional steps must be taken to clarify the obvious: that an issuer cannot offer securities that it knows cannot be in the best interests of any rational investor.

B. Disclosure of Revenue Sharing Payments

We also recommend that the Commission require meaningful disclosure in fund prospectuses regarding revenue sharing payments, unless of course it adopts our recommendation to ban such payments. As noted by the Commission:

> "Prospectus disclosure does not identify which individual broker-dealers receive revenue sharing, let alone quantify those arrangements. Yet the magnitude of revenue sharing payments – estimated in 2001 to be $2 billion annually – suggests that those arrangements influence the mutual fund choices that broker-dealers and their representatives present to investors."[33]

When a fund knows that brokers may recommend its shares over the shares of other funds because the fund's manager is making additional incentive payments to brokers, and that brokers' recommendations to purchase that fund are therefore biased and may even be unsuitable, the federal securities laws demand the prominent disclosure of such highly material information in the fund prospectus. This obligation exists regardless of whether differential payment disclosure is made by the broker, as the fund is equally responsible for creating, and thus disclosing, the relevant conflict of interest.

Comments on the Costs of the Proposed Disclosures

The brokerage industry has come out in strong opposition to the proposed point-of-sale disclosure rule in particular on the grounds that it imposes potentially enormous costs that are not

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[32] 2004 WL 62747 (M.D. Tenn.).

[33] Proposing Release at Part A.3. (footnote omitted).

justified by the benefits.[34] Clearly, given the complexity of the distribution payment system and the pervasiveness of the conflicts of interest it creates, effective disclosure cannot be accomplished without considerable cost. The answer, however, is not the ersatz disclosure alternative proposed by the SIA, which creates the impression that disclosure is being provided without any assurance that the information is being conveyed to those who need it. The unsophisticated investors who are most likely to place blind trust in their brokers are the very ones who are least likely to seek out the information about costs and conflicts on websites or by calling and requesting it in writing.

The Commission must not weaken disclosure on account of its complexity. Once you adopt that approach, the industry need only build excessive complexity into a system to avoid full disclosure to investors. The current complexity is not the fault of investors, nor was it designed with their interests in mind. It is rather largely the result of decisions by the fund and brokerage industries that have been unrestrained by the disciplining effect of full disclosure over the last 25 years. Had the Commission not exempted transactions in fund shares from the confirmation rule in 1979, had it not allowed rule 12b-1 to be used for purposes for which it clearly was not intended, or had it required full pre-sale disclosure of material information from the outset, many of today's complex distribution arrangements would not have developed. In short, one reason some of these arrangements have developed is precisely because of their weak or nonexistent transparency. The Commission made a similar point in the proposing release, when it stated, "The increase in the number of mutual funds has made broker-dealer 'shelf space' more critical to investment companies, leading to revenue sharing and other distribution arrangements ***that quietly compensate broker-dealers for distribution***."[35] It is imperative that the Commission not weaken the point-of-sale and confirmation disclosure rules to accommodate complexity in the structure of fund distribution payments, any more than the Commission would consider weakening disclosure of investment risks for funds that chose to adopt a more complex, riskier investment strategy.

If conflicts cannot be disclosed in a cost-effective manner that allows all investors an opportunity to carefully consider the relevant information before the sale, the only acceptable alternative is to ban the conduct that creates the conflicts. In fact, as we have noted above, we believe it is long past time for the Commission to revisit the policy that allows mutual funds (and other financial products) to fix the price that investors pay for the services of their broker. If the Commission were to repeal Section 22(d), so that mutual funds no longer determined the rate at which brokers would be compensated for fund sales, repealed section 12(b), so that funds could no longer use shareholder assets to pay for brokers' compensation, and banned directed brokerage and revenue sharing payments,[36] there would be very few conflicts to disclose. This

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[34] Comments of George R. Kramer, Vice President and Acting General Counsel, on behalf of the Securities Industry Association, with regard to File No. S7-0604, April 12, 2004.

[35] Proposing Release at Part A.3. (Emphasis added).

[36] We believe that the Commission should view revenue sharing payments as distribution payments that are made indirectly by the fund in violation of Sections 12(b) and 48(a) of the Act. That revenue sharing constitutes payment by the fund is reflected in the fact that the structure of the advisers' payments to brokers parallels the structure of the funds' payments to the advisers. The Commission's position that revenue sharing payments can be

would simultaneously create a distribution compensation system that minimizes conflicts of interest and allow for a very simple, straightforward disclosure regimen that would be far less expensive to implement.

Conclusion

We commend the Commission for its recognition of longstanding regulatory deficiencies that facilitate abusive sales practices and hinder investors' ability to make informed investment decisions. We hope that this recognition will lead to an informed, critical evaluation not only of specific problems with the present proposal, but also of the need to completely revamp the distribution compensation system to minimize conflicts of interest.

Respectfully submitted,

Mercer Bullard
Founder and President
Fund Democracy, Inc.

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Kenneth McEldowney
Executive Director
Consumer Action

Sally Greenberg
Senior Counsel
Consumers Union

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considered to have been made out of the adviser's profits conflicts with the internal accounting of such costs by the advisers as an expense. The Commission's paid out of profits position also creates an absurd situation in which fund directors must effectively turn a blind eye to revenue sharing payments, because their considering such expenditures would undermine their compliance with the requirements of Section 36(b), as interpreted by the Second Circuit in Gartenberg. (See Remarks of Robert Pozen, President and chief Executive Officer, Fidelity Management & Research, at the Roundtable on the Role of Independent Investment Company Directors, Washington, D.C., Feb. 23, 1999.) This is flatly contrary to investors' best interests.

Appendix C

Consumer Federation of America
AARP
Consumer Action
Consumers Union
Fund Democracy, Inc.

December 6, 2004

The Honorable William Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Chairman Donaldson:

Our organizations would like to congratulate the Commission for testing its proposed point-of-sale mutual fund disclosures with average investors. This testing has provided valuable insights into how the content, format, and timing of these disclosures all affect investors' understanding and use of the information the disclosures are intended to convey. We therefore urge the Commission to adopt the substantial changes the testing indicates are needed to ensure the disclosures fulfill their intended purpose, even if doing so requires re-proposing the rule.

Specifically, we believe the independent consultants' report[37] offers strong support for the following points:

- It is essential to disclose total costs, including fund operating costs, not just distribution costs.
- The costs must be put in context, by providing comparative cost information in dollar amounts, if investors are to understand their importance.
- The disclosures must be provided in writing using standardized format and language.
- The disclosures must be provided early in the process, at the point of recommendation rather than at point of sale.

[37] *Results of In-Depth Investor Interviews Regarding Proposed Mutual Fund Sales Fee and Conflict of Interest Disclosure Forms*, Report to the Securities and Exchange Commission, Siegel & Gale, LLC and Gelb Consulting Group, Inc., November 4, 2004.

If the rule is revised to reflect these findings, it should dramatically improve investors' ability to take fund costs and conflicts of interest into account when making a fund selection. Without these changes, the rule is likely to be ineffective at best and counter-productive at worst.

1. Total costs

As originally proposed, the rule would require disclosure only of those costs associated with distribution of the fund. It would not cover fund operating costs. The consultants who tested the disclosure documents, however, found a "strong investor preference" for including both operating costs and distribution costs in the Point of Sale documents.[38] They also found high levels of frustration associated with having to look for operating cost information in another location.[39] More importantly, they found that failure to provide complete operating cost information led some investors to believe that 12b-1 fees were the only annual expenses they would pay.[40] In other words, the rule as proposed would have the perverse effect of causing some investors to under-estimate and possibly even ignore the operating costs of the funds they purchase. This would be a step backward indeed.

2. Putting fees in context

In one of their more interesting, albeit disturbing, findings, the independent consultants found no evidence that investors understand the impact higher fees have on investment returns.[41] Given the extensive attention this issue has been given in investor education materials, this clearly demonstrates the urgent need to do a better job of communicating this impact. It also helps to explain the persistent lack of effective cost competition among funds in the broker-sold market. The lack of effective competition is further highlighted by the independent consultants' finding that, "[w]ithout comparison ranges, investors assumed the up-front or back-end sales loads and the annual fees were 'reasonable.'"[42]

Including cost comparison ranges on the forms, as the independent consultants recommend, would be a significant improvement. Investors received this suggestion enthusiastically, and several noted that they could use these comparison ranges to better evaluate the fees disclosed on the form.[43] We believe, however, that the prototypes submitted in response to the original rule proposal by Nancy M. Smith, former director of the Office of Investor

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[38] Ibid., p. 6.

[39] Ibid, p. 6.

[40] Ibid., p. 7 and p. 27.

[41] Ibid., p. 12.

[42] Ibid., p. 6.

[43] Ibid., p. 27.

Education and Assistance, offer a superior approach, by clearly illustrating the long-term impact of costs on fund returns in a form investors are likely to understand and to which they are likely to pay attention. By providing the comparative cost information in dollars and over the long-term, this approach makes it significantly more likely that investors would understand the impact of fees on returns. This approach would also help to alleviate the problems investors experienced in distinguishing the higher annual costs associated with B shares.[44] It is unfortunate that this approach was not tested as part of the independent consultants' review.

3. Standardized format and language

The report offers numerous examples throughout of how minor changes in format or wording have a significant impact on investor attention to and understanding of key information. Unless the Commission requires that these disclosures be standardized, we will inevitably see a variety of forms, all in compliance with the rules, that nonetheless vary greatly in their effectiveness. Worse, some brokers may be tempted to use their knowledge of disclosure design to de-emphasize issues they would rather investors ignored. The result could be poor disclosure by those firms with the most to hide. If these concerns are true of written documents – and past experience confirms that they are – they are all the more true of oral disclosures, which will be virtually impossible to police. If the Commission is serious about encouraging investors to take costs and conflicts of interest into account when making fund selections, it must require that these disclosures be provided in writing using standardized format and wording.

4. Timing of disclosures

We have maintained from the outset that investors will only use this information if they receive it early enough to include it in their decision-making process. This view was confirmed by investors in the study, who expressed a preference for receiving the Point of Sale form as "early as possible" in the process so they could use it to evaluate several fund choices.[45] This is exactly how the information can most effectively be used. We therefore urge the Commission to require that the disclosures be provided at the point when the broker recommends a specific fund or funds, not just before the sale is finalized as the original rule proposal would allow.

5. The limits of disclosure

The test results also clearly illustrate the limits of disclosure. Although a major goal of the proposed disclosure documents is to put investors on their guard about conflicts of interest that could cause their broker to recommend funds not in their best interests, the independent consultants found that those investors most likely to rely heavily on the recommendations of their broker were unlikely to change that reliance based on these disclosures.[46] This confirms a view we have long held, that disclosure is better at illuminating costs than at counteracting

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[44] Ibid., p. 13.

[45] Ibid., p. 20.

[46] Ibid., p. 2, 12, 13.

conflicts of interest. Recently, the Commission took the strongly pro-investor step of banning directed brokerage arrangements. We encourage you to continue to explore whether other broker compensation practices should be reformed or eliminated, including the most basic practice of having funds determine the level of payments to the brokerage firm for services provided by the broker to the investor. We believe such reform is long overdue.

These findings further support our view that it is foolish to expect a single disclosure document to overcome multi-million-dollar advertising campaigns designed to send the opposite message. As long as investors are encouraged by the titles brokers use, the services they offer, and the advertisements they display to view their brokers as impartial advisers, they are unlikely to give significant weight to disclosures about conflicts of interest. This is a problem the Commission must attack through more than just disclosure. Rather, it clearly should require brokers who hold out to the public as advisers and offer extensive advisory services to comply with the fiduciary duty and disclosure obligations that accompany that role. Then, it should lend weight to that action by interpreting that fiduciary duty to include an obligation to take costs into account when making recommendations, and it should look for violations when conducting its regulatory and enforcement inspections.

Conclusion

Requiring pre-sale cost and conflict disclosure for mutual funds has the potential to offer enormous benefits to investors. But it will only do so if the requirement is implemented effectively. The Commission is to be congratulated for taking the essential first step toward achieving that goal – testing the proposed disclosures with investors to determine their effectiveness. We now urge the Commission to take the next step, and adopt the changes that the real world tests support. We further urge the Commission to make this approach standard practice both when considering new disclosures and when evaluating existing disclosures.

Respectfully submitted,

Barbara Roper, Director of Investor Protection
Consumer Federation of America

David Certner, Director, Federal Affairs
AARP

Kenneth McEldowney, Executive Director
Consumer Action

Sally Greenberg, Senior Counsel
Consumers Union

Mercer Bullard, President and Founder
Fund Democracy, Inc.

Appendix D

Consumer Federation of America
AARP
Consumer Action
Consumers Union
Fund Democracy, Inc.

December 6, 2004

The Honorable William Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Chairman Donaldson:

Our organizations would like to congratulate the Commission for testing its proposed point-of-sale mutual fund disclosures with average investors. This testing has provided valuable insights into how the content, format, and timing of these disclosures all affect investors' understanding and use of the information the disclosures are intended to convey. We therefore urge the Commission to adopt the substantial changes the testing indicates are needed to ensure the disclosures fulfill their intended purpose, even if doing so requires re-proposing the rule.

Specifically, we believe the independent consultants' report[47] offers strong support for the following points:

- It is essential to disclose total costs, including fund operating costs, not just distribution costs.
- The costs must be put in context, by providing comparative cost information in dollar amounts, if investors are to understand their importance.
- The disclosures must be provided in writing using standardized format and language.
- The disclosures must be provided early in the process, at the point of recommendation rather than at point of sale.

[47] *Results of In-Depth Investor Interviews Regarding Proposed Mutual Fund Sales Fee and Conflict of Interest Disclosure Forms*, Report to the Securities and Exchange Commission, Siegel & Gale, LLC and Gelb Consulting Group, Inc., November 4, 2004.

If the rule is revised to reflect these findings, it should dramatically improve investors' ability to take fund costs and conflicts of interest into account when making a fund selection. Without these changes, the rule is likely to be ineffective at best and counter-productive at worst.

1. Total costs

As originally proposed, the rule would require disclosure only of those costs associated with distribution of the fund. It would not cover fund operating costs. The consultants who tested the disclosure documents, however, found a "strong investor preference" for including both operating costs and distribution costs in the Point of Sale documents.[48] They also found high levels of frustration associated with having to look for operating cost information in another location.[49] More importantly, they found that failure to provide complete operating cost information led some investors to believe that 12b-1 fees were the only annual expenses they would pay.[50] In other words, the rule as proposed would have the perverse effect of causing some investors to under-estimate and possibly even ignore the operating costs of the funds they purchase. This would be a step backward indeed.

2. Putting fees in context

In one of their more interesting, albeit disturbing, findings, the independent consultants found no evidence that investors understand the impact higher fees have on investment returns.[51] Given the extensive attention this issue has been given in investor education materials, this clearly demonstrates the urgent need to do a better job of communicating this impact. It also helps to explain the persistent lack of effective cost competition among funds in the broker-sold market. The lack of effective competition is further highlighted by the independent consultants' finding that, "[w]ithout comparison ranges, investors assumed the up-front or back-end sales loads and the annual fees were 'reasonable.'"[52]

Including cost comparison ranges on the forms, as the independent consultants recommend, would be a significant improvement. Investors received this suggestion enthusiastically, and several noted that they could use these comparison ranges to better evaluate the fees disclosed on the form.[53] We believe, however, that the prototypes submitted in response to the original rule proposal by Nancy M. Smith, former director of the Office of Investor

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[48] Ibid., p. 6.

[49] Ibid, p. 6.

[50] Ibid., p. 7 and p. 27.

[51] Ibid., p. 12.

[52] Ibid., p. 6.

[53] Ibid., p. 27.

Education and Assistance, offer a superior approach, by clearly illustrating the long-term impact of costs on fund returns in a form investors are likely to understand and to which they are likely to pay attention. By providing the comparative cost information in dollars and over the long-term, this approach makes it significantly more likely that investors would understand the impact of fees on returns. This approach would also help to alleviate the problems investors experienced in distinguishing the higher annual costs associated with B shares.[54] It is unfortunate that this approach was not tested as part of the independent consultants' review.

3. Standardized format and language

The report offers numerous examples throughout of how minor changes in format or wording have a significant impact on investor attention to and understanding of key information. Unless the Commission requires that these disclosures be standardized, we will inevitably see a variety of forms, all in compliance with the rules, that nonetheless vary greatly in their effectiveness. Worse, some brokers may be tempted to use their knowledge of disclosure design to de-emphasize issues they would rather investors ignored. The result could be poor disclosure by those firms with the most to hide. If these concerns are true of written documents – and past experience confirms that they are – they are all the more true of oral disclosures, which will be virtually impossible to police. If the Commission is serious about encouraging investors to take costs and conflicts of interest into account when making fund selections, it must require that these disclosures be provided in writing using standardized format and wording.

4. Timing of disclosures

We have maintained from the outset that investors will only use this information if they receive it early enough to include it in their decision-making process. This view was confirmed by investors in the study, who expressed a preference for receiving the Point of Sale form as "early as possible" in the process so they could use it to evaluate several fund choices.[55] This is exactly how the information can most effectively be used. We therefore urge the Commission to require that the disclosures be provided at the point when the broker recommends a specific fund or funds, not just before the sale is finalized as the original rule proposal would allow.

5. The limits of disclosure

The test results also clearly illustrate the limits of disclosure. Although a major goal of the proposed disclosure documents is to put investors on their guard about conflicts of interest that could cause their broker to recommend funds not in their best interests, the independent consultants found that those investors most likely to rely heavily on the recommendations of their broker were unlikely to change that reliance based on these disclosures.[56] This confirms a view we have long held, that disclosure is better at illuminating costs than at counteracting

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[54] Ibid., p. 13.

[55] Ibid., p. 20.

[56] Ibid., p. 2, 12, 13.

conflicts of interest. Recently, the Commission took the strongly pro-investor step of banning directed brokerage arrangements. We encourage you to continue to explore whether other broker compensation practices should be reformed or eliminated, including the most basic practice of having funds determine the level of payments to the brokerage firm for services provided by the broker to the investor. We believe such reform is long overdue.

These findings further support our view that it is foolish to expect a single disclosure document to overcome multi-million-dollar advertising campaigns designed to send the opposite message. As long as investors are encouraged by the titles brokers use, the services they offer, and the advertisements they display to view their brokers as impartial advisers, they are unlikely to give significant weight to disclosures about conflicts of interest. This is a problem the Commission must attack through more than just disclosure. Rather, it clearly should require brokers who hold out to the public as advisers and offer extensive advisory services to comply with the fiduciary duty and disclosure obligations that accompany that role. Then, it should lend weight to that action by interpreting that fiduciary duty to include an obligation to take costs into account when making recommendations, and it should look for violations when conducting its regulatory and enforcement inspections.

Conclusion

Requiring pre-sale cost and conflict disclosure for mutual funds has the potential to offer enormous benefits to investors. But it will only do so if the requirement is implemented effectively. The Commission is to be congratulated for taking the essential first step toward achieving that goal – testing the proposed disclosures with investors to determine their effectiveness. We now urge the Commission to take the next step, and adopt the changes that the real world tests support. We further urge the Commission to make this approach standard practice both when considering new disclosures and when evaluating existing disclosures.

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Appendix E (This report was prepared for use as a discussion document with our mutual fund project advisory committee and was not intended for publication)

Mutual Fund Essential Knowledge: What Do Investors Need to Know and What is the Best Way to Provide that Information?

Prepared by Barbara Roper, CFA Director of Investor Protection

This paper explores whether, or to what extent, a consensus exists on essential knowledge for mutual fund purchasers. To arrive at our assessment, we have reviewed Securities and Exchange Commission regulatory recommendations and comments on those recommendations, research assessing the mutual fund profile developed by the SEC in the mid-1990s, and a number of different types of guides to purchasing mutual funds prepared by regulators, industry members, personal finance writers, and a variety of others. The paper discusses both the general factors investors are advised to consider when purchasing a fund and the more detailed recommendations for how to assess those factors. It also discusses CFA's views on the availability and usability of this information, including ease of access. And it presents CFA's initial analysis of the implications of those findings for both investor education and fund industry information practices. Our goal is to provide a basis for discussion of these topics by the advisory group to our project on mutual fund essential knowledge. As such, it should be viewed, not as a presentation of CFA's final conclusions regarding these topics, but rather as a launching point for discussion.

Background

The question of what mutual fund investors need to know to make an informed purchase, and how best to convey that information to them, is not a new one. The Securities and Exchange Commission has devoted considerable attention to this issue since mutual funds' popularity began to soar in the 1980s. The agency has twice – in 1983 and again in 1997 – attempted to "streamline" the fund prospectus to minimize the amount of technical information provided and focus more on the information investors need to know when selecting funds.[57] These efforts –

[57]The first initiative, in 1983, resulted in the adoption of a two-part disclosure format, with more technical, detailed information moved to the Statement of Additional Information (SAI). The second, in 1997, resulted in the transfer of additional information about fund organization and legal requirements to the SAI, the addition of standardized fund summaries, including a risk/return summary, to the front of the prospectus, and a refocusing of risk disclosures on the overall risk of investing in the fund rather than on the risks associated with specific portfolio securities.

along with related SEC initiatives requiring disclosures to be in plain English and adding a standardized fee table – have made the fund prospectus a far more readable and useful document for fund purchasers.

Yet the move toward clearer, more streamlined disclosure is in constant tension with a countervailing trend to provide more and different information to shareholders. This trend has been particularly pronounced in the past year or so, as the Commission has reacted to the mutual fund trading and sales abuse scandals with a number of new disclosure mandates. For example, information once relegated to the Statement of Additional Information (SAI) on the availability of breakpoint discounts has been moved to the prospectus.[58] Information has also been added to the prospectus regarding portfolio manager compensation.[59] Other disclosures have been added to the annual reports to shareholders, including dollar-amount fund expense disclosure[60] and information on the basis for the fund board's approval of the advisory contract.[61] In addition, a whole new disclosure document has been proposed to provide mutual fund investors who purchase funds from a salesperson with pre-sale information on the costs of brokerage services related to the sale, mutual fund operating costs, and conflicts of interest that may bias the salesperson's recommendations.[62]

While most of these post-scandal disclosure proposals have not been controversial, the proposal to put new cost disclosures in the shareholder report and the proposal to create a new point-of-sale disclosure document have both been hotly debated. In the first instance, the rule was embraced by the fund industry but harshly criticized by investor advocates, who faulted both the placement and content of the disclosures.

In the debate over the point-of-sale disclosure proposal, investor advocates have enthusiastically supported the concept of pre-sale written disclosure. At the same time, they have argued that the timing, content, and format of the disclosures all need improvement. The brokerage firms have opposed the changes sought by investor advocates, particularly those aimed at putting information on costs and conflicts into context. They have also argued in favor of posting the information on the Internet rather than providing it directly to investors. The Investment Company Institute has largely backed the brokerage firms and has also sought to remove the requirement that the forms include fund operating costs. Meanwhile, in response to the SEC's request for comment on this project, the National Association of Securities Dealers (NASD) has proposed a two-page web-based document it calls "Profile Plus" that combines

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[58] SEC File No. S7-28-03.

[59] SEC File No. S7-12-04.

[60] SEC File No. S7-51-02.

[61] SEC File No. S7-08-04.

[62] SEC File No. S7-06-04. This rule proposal also includes enhancements to disclosures on mutual fund transaction confirmations. The re-proposal includes information on mutual fund operating costs that was not included in the original rule proposal.

information from the point-of-sale document about sales-related costs and conflicts with additional summary information about the mutual fund. Clearly, the debate over when to provide disclosures, in what format, and of what information is far from settled.

Even before recent scandals added urgency to efforts to reexamine the best way to provide information to investors, a variety of investor guides had been developed by regulators, members of the fund industry, and others to assist investors in evaluating mutual funds. Most (though not all) adopt the "less is more" approach, proposing to help investors cut through the clutter by identifying a few key items from fund disclosure documents that they should read before purchasing a fund.[63] The SEC itself helped to jumpstart this approach back in the mid-1990s, with its creation of the mutual fund profile. Designed to present key information in a short brochure, the profiles provide summary information in a standardized question-and-answer format on nine key topics.[64] Although originally enthusiastically embraced by fund companies, and well received by investors who were surveyed on their readability and usefulness, the fund profiles do not appear to have gained wide usage.

One reason may be that the fund profile initiative was rapidly overtaken by the development of the Internet, which has dramatically changed investors' access to mutual fund information.[65] On the one hand, the Internet has changed the way fund companies themselves provide information. Investors can readily download prospectuses, other disclosure documents, and sales materials directly from fund websites.[66] Furthermore, because online sales materials are not covered by mandatory rules governing fund profiles, fund companies are free to design their own fund "snapshots" for use on the Internet, and many have done so. In addition, many fund companies, and especially the no-load companies that appeal to self-directed investors, have included extensive investor education materials on their websites designed to aid investors both in developing appropriate investment strategies for particular goals and in finding funds to fit those goals.

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[63] On the other hand, some sources continue to advise investors not only to read the full prospectus carefully before the sale, but also to read the Statement of Additional Information, and the shareholder reports. See, for example, the Massachusetts Securities Division's "Mutual Fund Tips," which advises investors to "Read and understand all information in the fund's prospectus, Statement of Additional Information, and, if available, its annual report. Call the fund company or the Securities Division if you have questions regarding these materials." Others, such as Morningstar, recommend that investors review certain specific information from the SAI and shareholder reports.

[64] These topics were: investment objectives, investment strategies, risks, performance, fees, investment adviser and portfolio manager, purchase and redemption procedures, tax implications, and services available to investors. They will be discussed in more detail below.

[65] Others have suggested that liability concerns related to providing summary information limited the profiles' use.

[66] Some fund companies also enable investors to download the SAI and annual reports.

The growth of the Internet as an information source has also resulted in an explosion of third-party resources for mutual fund investors. At their simplest, these offer basic educational material on how mutual funds operate and how to select an appropriate fund – the online equivalent of materials long available in print media. Others, including the SEC and NASD sites, offer cost calculators that allow investors to estimate the long-term impact of costs on their fund returns. Still others offer screening tools that enable investors to narrow down their fund selections based on a few criteria that can be adjusted to reflect the investor's preferences.[67] Morningstar combines all these features and also provides fund summaries that boil down key information about each fund and include analysis by Morningstar's in-house experts. Yahoo! Finance offers its own variation of the fund summaries.

As a result of these developments, it has never been easier for investors to gain access to information about mutual funds. Yet conventional wisdom continues to suggest that most investors do not, and will not, seek out this information. Investors who purchase their funds through a broker or other financial professional are considered particularly unlikely to educate themselves about the funds they purchase. If these assumptions are true – and it appears to have been some time since they have been adequately tested – that raises serious questions about whether the current approach to fund information practices and investor education needs rethinking.

What do mutual fund investors need to know when purchasing a fund?

Information about mutual funds divides logically into three categories: general information about what mutual funds are and how they operate; specific information about a fund the investor is considering purchasing; and additional information on how to monitor mutual fund investments. The first category includes such topics as: what is a mutual fund, what are the advantages and disadvantages of investing in mutual funds, what are the main types of mutual funds, how do you make (or lose) money in mutual funds, what is NAV, what is total return, what are the fees associated with mutual funds, how do you buy and sell fund shares, and what are the tax implications of owning mutual funds. The second category focuses on issues of how to determine whether a particular fund is appropriate for the investor and whether it is a good choice compared with other similar funds. The third category includes such topics as how to read an account statement, how to assess a fund's performance, what records to maintain for tax purposes, and how to know whether to sell a fund.

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[67] For example, the Mutual Fund Investor's Center on the Mutual Fund Education Alliance website (www.mfea.com) includes a Fund Selector to tool that allows investors to choose: the category of fund they are interested in investing in; either a regular or automatic investing plan account; a minimum total return for either year-to-date, one year, three years, or five years; no-load or low-load; minimum initial investment amount; Morningstar rating; Morningstar risk rating; a maximum expense ratio; a maximum management fee; whether it has a redemption fee; and whether it has a 12b-1 fee. As its name suggests, the fund selector identifies funds that meet the criteria set by the investor. The Forbes website offers a similar tool.

The second category of knowledge will be the primary focus of this study. This is consistent with the project's focus on information needs at the time of purchase. Because of that focus, the third category of knowledge generally falls outside the project's scope. (However, the relative scarcity of information on this topic may suggest the need for further study in the future.) The first category of knowledge may be a prerequisite to an informed mutual fund purchase, but it is not directly tied to the selection of a particular fund. Also, this information is already quite well defined and is available from a variety of sources.[68] While the presentation and amount of detail may vary from source to source, the content tends to be relatively straight-forward, and there is little divergence of message. As a result, we will not examine these general mutual fund overview topics in detail in this study.

That leaves the category of information related to determining whether a particular mutual fund is a good choice for the investor. A review of the guidance available to mutual fund investors – from websites, newspaper and magazine articles, brochures, and books, and from industry, regulatory, and third-party sources – reveals a remarkable degree of consensus.[69] Although the quality and comprehensiveness of the materials vary greatly, there is agreement to the point of near unanimity on the general topics investors are advised to review before purchasing a fund. These topics closely track those included in the SEC's fund profile, although not all the topics included in the profile are included on all lists. At a more detailed level, there is greater variation in recommendations – on the best way to evaluate risk, for example, or the relative importance of fund costs – and many favor at least slightly more detailed information than the fund profiles were designed to provide.

The following discussion identifies the topics investors are commonly advised to consider before buying a fund, presents the range of views on how those topics should be analyzed by investors, and evaluates the availability of that information. It also presents CFA's initial thoughts on the implications of those findings for investor education efforts and industry information practices. In reading this document, advisory group members are asked to consider:

- whether each of these general topics does, in fact, represent essential knowledge;

- whether other topics missing from this list ought also to be added; and

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[68] The three primary sources for mutual fund-related investor education materials – the SEC (*Invest Wisely: An Introduction to Mutual Funds*), the ICI (*A Guide to Understanding Mutual Funds*), and Morningstar (Interactive Classroom, Course 101-109) – all treat the subject similarly. A variety of other websites offer information that also covers these basics, including The Motley Fool (Investing Basics, Mutual Funds), Investopedia (Mutual Fund Basics), and the Canadian Securities Administrators (Mutual Funds – What You Need to Know). For those who are not comfortable using the Internet, the SEC and ICI materials are available in print. Similar information is also available in personal finance books (e.g., *The Consumer Reports Mutual Funds Book* and *Personal Finance for Dummies*) likely to be found at most public libraries.

[69] Sources reviewed included brochures, websites, newspaper and magazine articles, and books prepared by regulators, industry members, and third parties.

- where to draw the line, in evaluating specific content in each area, between desirable knowledge and essential knowledge.

At the same time, advisory group members should consider what questions our survey could include – related to investors' information preferences, for example – that would round out our knowledge of this topic.

I. Investment Objective and Strategies

Recommendations: Most of the investor guides we reviewed started from the assumption that investors should choose funds to serve a specific purpose, whether to fund a particular goal or to fill a particular niche in a portfolio asset allocation plan.[70] Not surprisingly then, the prospectus's statement of investment objectives and its discussion of investment strategies are on every credible list of topics investors should consider when purchasing a fund, as they are seen as key to determining whether a particular fund is appropriate for the investor's intended purpose.

Information Accessibility and Usefulness: The importance of understanding the fund's investment goal and strategy is reflected in the SEC's fund profile requirements. The first two questions fund profiles are required to discuss are: "What are the fund's goals?" and "What are the fund's main investment strategies?" This information also is required to be included in summary form in the risk/return section at the front of every prospectus, with a more detailed explanation of investment strategies in the body of the prospectus. And the information is available from other sources, as well. Typically, for example, funds include this information in the fund "snapshots" many include on their websites.[71] The Yahoo! Finance profiles also

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[70] This is the approach advocated by the following sources we reviewed: the SEC ("Invest Wisely: An Introduction to Mutual Funds" and "Mutual Fund Investing: Look at More Than a Fund's Past Performance"); the Massachusetts Securities Division ("What You Should Know About Mutual Funds"); ICI ("Questions You Should Ask Before You Invest in a Mutual Fund"); Morningstar's Interactive Classroom (Course 302: Building Your Mutual Fund Portfolio); About.com; Fidelity ("How to Buy Funds: Overview"); Vanguard ("How to Select a Mutual Fund: Consider Your Financial Needs); ING Financial Services; Investopedia ("Digging Deeper: The Mutual Fund Prospectus"); Young Money ("How to Choose a Mutual Fund"); Financial Strategies Online ("Financial Guide: Investing in Mutual Funds: Time-Tested Guidelines"); Jane Bryant Quinn; *The Consumer Reports Mutual Funds Book*; *Smart Money: How to be Your Own Financial Manager*, by Ken and Daria Dolan; *The New Century Family Money Book: Your Comprehensive Guide to a Lifetime of Financial Security*, by Jonathan D. Pond; *Personal Finance for Dummies*, by Eric Tyson.

[71] We use the term fund "snapshot" to refer to the online fund descriptions many fund companies include on their websites. These typically include a sampling of key information from the prospectus, and in some cases the shareholder reports and other sources, similar but not identical to the SEC's fund profiles. The amount of material in these snapshots varies among the fund companies, as does the presentation of that material.

include a very brief, plain English explanation of the fund's investment objectives and the primary investment strategies employed to achieve these objectives.[72] The Profile Plus disclosures recently proposed by NASD would include summary information on investment objective and investment strategies and link to more detailed discussion on investment strategies in the full prospectus. Many fund snapshots, Yahoo! Finance profiles, and Morningstar fund reports also include information on the investing style, asset allocation, and key holdings of the fund. Clearly, then, information regarding investment objectives and investment strategies is readily available to any investor willing to seek it out.

While investors have easy access to information on a fund's investment objectives and strategies, it does not follow that most would know how to evaluate this information once they found it. Most of the investor guides we reviewed offered little information to assist investors in determining whether a fund's investment objectives and strategies are consistent with their goals.

Several sources do provide added guidance, however. The Mutual Fund Education Alliance (MFEA) offers a table in the Investor's Center of its website that identifies eight "basic" objectives and, for each objective, lists a type of fund that matches that objective.[73] It also tells what such funds typically invest in, rates the potential for capital appreciation, rates the potential for current income, and rates the potential risk.[74] Among the sources we reviewed, several provided information within their descriptions of different types of funds about the type of investment objectives for which they are and are not suitable.[75] Vanguard's online investor education materials include a section, "Consider Your Financial Needs," that provides a plain English explanation of four basic investment objectives, describes in general terms the typical holdings (e.g., stocks, bonds, cash) of funds designed for each purpose, and explains trade-offs investors should expect when choosing funds to fulfill those objectives. While each approach has its limitations, these materials would seem to indicate that useful information can be provided to help investors determine whether a particular fund matches their goal.

Another factor that could limit the usefulness for average investors of investment objective and investment strategies disclosures is the opacity of some of the disclosures themselves. CFA questions whether unsophisticated investors will understand how investment objectives that are stated in terms such as "to provide shareholders with a high return" or "to maximize yield" relate to their particular financial goal. CFA believes investment objectives stated in simpler terms – "to provide current income" or "to provide long-term growth" or even

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[72] Those we reviewed were quite well written and easy to understand.

[73] The investment objectives identified are maximum capital growth, high capital growth, current income and capital growth, high current income, current income and protection of principal, current income and maximum safety of principal, and tax-exempt income.

[74] Ratings are on a scale from very low to very high. No explanation of the basis for the ratings is provided.

[75] These included the Massachusetts Securities Commission website, *The Consumer Reports Mutual Funds Book*, and *The New Century Money Book*.

"to maximize current income consistent with preservation of principal" – may help less sophisticated investors make the connection between the fund's investment objective and their own. A number of funds also provide supplemental disclosures that CFA believes could help to clarify issues of appropriateness, often in a section headed "Who Should Invest?" In its online fund snapshots as well as its prospectuses, for example, Vanguard takes this approach a step further by also including tips on who should not invest.[76]

Finally, some fund companies present the information visually in a way that CFA believes will make it easier for investors to locate and read.[77] T. Rowe Price, for example, uses a series of tabs at the top of its fund snapshots that both make it easy to find the information and present it in a visually uncluttered style that CFA believes should make it less intimidating to investors. Others – including Fidelity, Vanguard, and Ariel – include a list of links either across the top of the fund snapshots or down the side to assist investors in finding information on a particular topic, such as fees, risks, or performance. Fidelity also provides links to a glossary for key terms throughout its fund snapshots, so investors who want to know what "beta" is, for example, can simply click on the word to see a brief explanation.

Implications for Information Practices and Investor Education: Although we found all the disclosures we reviewed to be reasonably well written, we nonetheless found significant differences in the clarity of the language, the inclusion of additional useful information, and the visual presentation. This suggests to us that, by following the best available examples, fund companies could continue to refine both their disclosure documents and sales materials in order to make it easier for investors to understand how the investment objectives and strategies of the fund relate to the investor's own financial goals. In addition, CFA believes investor educators can use these findings to develop better guidance for investors on how to determine whether a particular fund matches the purpose for which it is being purchased.

II. Risk

Recommendations: Another topic investor guides advise investors to consider when purchasing a mutual fund is the relative risk of the fund being considered. In contrast with the guidance on investment objectives, however, many provide considerable direction on how to do that. Although the detail of those recommendations varies, their overall approach tends to be quite similar. Most equate risk with risk to principal and warn that higher returns are generally accompanied by greater risks. They typically advise the investor to understand the factors that could affect the fund's share price, assess the relative volatility of the fund's past returns, and consider how those risk characteristics fit with the investor's personal investment goals and risk tolerance. In assessing a fund's risks, many also advise investors to consider how the fund

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[76] For example, those considering investing in the Vanguard Dividend Growth Fund are warned that it is not appropriate for "investors unwilling to accept significant fluctuations in share price" or "investors seeking to minimize currently taxable dividend income," by the fund snapshot downloaded from the Vanguard website on March 5, 2005.

[77] This comment applies to all the issues discussed in this report. However, we will not repeat the comment for each section.

contributes to the diversification of their overall portfolio.

The SEC summarizes this approach in its brochure, “Mutual Fund Investing: Look at More Than a Fund’s Past Performance.” Three of the eight topics the SEC advises investors to consider involve risk: the volatility of the fund, the risks it takes to achieve its returns, and how the fund will impact the diversification of the investor’s portfolio. To assess risk generally, it advises investors to read the prospectus and shareholder reports to learn about the fund’s investment strategy and the types of risks associated with that strategy. To assess volatility, it recommends analyzing the fund’s year-to-year performance figures to determine whether it “earned most of its returns in a few small bursts or whether its returns came in a steadier stream.” Finally, it advises that developing a diversified and balanced portfolio among the major asset classes is “key to maintaining an acceptable level of risk.”

Information Accessibility and Usefulness: For each of the categories of information investors are advised to consider in assessing risk, information is available from a number of sources to help them make that assessment. For example, the Investment Company Institute’s publication, “Questions You Should Ask Before You Invest in a Mutual Fund,” explains the major types of risk to which funds typically are subject, including inflation risk, interest-rate risk, credit risk, liquidity risk, currency risk, political risk, and market risk. The SEC’s publication, “Invest Wisely: An Introduction to Mutual Funds,” describes the three main types of funds (money market funds, bond funds, and stock funds) and focuses on the risks associated with each. About.com’s description of different types of funds also includes a narrative discussion of the types of risk associated with each. And a number of personal finance books discuss this issue in some detail.[78] In addition, both the Massachusetts Securities Division and the MFEA provide more basic information, rating the degree of principal risk (e.g, low, medium, high) associated with different categories of funds. Finally, a great deal of guidance is available online and in personal finance books on how to develop a diversified portfolio that balances risks associated with different asset classes, including a sampling of target asset allocation plans on the MFEA website.

Though most investor guides recommend avoiding unnecessary volatility, the guidance on how best to assess volatility is quite varied. At the simplest level, investors are advised to compare year-to-year returns to get a sense of the “roller-coaster” ride associated with investing in a particular fund. A similar suggestion advises investors to consider the fund’s best and worst annual, quarterly, or monthly returns and assess whether they would have been able to resist the temptation to sell under those circumstances. (This is sometimes referred to as the “ulcer index.”) At the other end of the spectrum, a number of sources advise investors to weigh a variety of technical measurements, such as beta, standard deviation, r-squared, and Sharpe ratio.

In its “Five Questions to Ask Before Buying a Fund,” for example, Morningstar advises

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[78] This topic is covered in reasonable depth in all of the following personal finance books, to provide just a sampling: *Smart Money,* by Ken and Daria Dolan, *The New Century Family Money Book*, by Jonathan D. Pond, *The Consumer Reports Mutual Funds Book*, by Greg Daugherty and the editors of Consumer Reports Books, *Bogle on Mutual Funds*, by John C. Bogle, and *Personal Finance For Dummies,* by Eric Tyson.

investors to: 1) check out quarterly and annual returns in different market situations, 2) to consider volatility ratings – including standard deviation, beta, Morningstar Risk Ratings, and Morningstar Bear Market Ratings – and 3) to assess the fund's volatility in conjunction with the returns it produces.[79] Vanguard recommends a similar approach to assessing volatility that combines examining the fund's track record quarter-by-quarter or year-by-year, comparing the best year with the worst year, and looking at beta, (which allows comparisons of the volatility of two funds that have the same benchmark), r-squared (which indicates how much of a fund's past returns can be explained by returns from its benchmark index), and, for bond funds, duration (which is an estimate of how much a bond fund's share price will rise or fall in response to changes in interest rates).

When the SEC revised the prospectus in 1997, one of its goals was to improve risk disclosure. With that in mind, the new rule added a risk/return summary to the front of the prospectus and directed funds to focus their discussion of risks less on risks associated with the individual securities within the portfolio and more on "the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the fund's net asset value and performance." The SEC also directed funds to identify the types of investors for whom the fund may be an appropriate or inappropriate investment (based, for example, on the investor's risk tolerance and time horizon). In addition to the narrative discussion of risk, both the prospectus and the fund profile are required to include a "graphic presentation of risk" in the form of a bar chart showing the fund's returns over a ten-year period and a table comparing the fund's average annual returns to those of a broad-based securities market index.

Despite these improvements, CFA found many of the risk disclosures we reviewed in fund prospectuses and online "snapshots" to be disappointing. Narrative risk descriptions often consisted of boilerplate statements about the fund's exposure to certain categories of risk – market risk or credit risk, for example – with little explanation of the relative riskiness of the fund compared with other similar funds.[80] In addition, because they focus on share price volatility, the narratives often are not focused on the risks most relevant in light of the fund's investment objective. Take, for example, the following risk summary from the online snapshot for a bond fund that lists its objective as providing a high level of current income:

> "The fund's yield, share price, and total return change daily and are based on interest rates, market conditions, other economic and political news, and on the quality and maturity of its investments. In general, bond prices rise when interest rates fall, and vice versa. This effect is usually more pronounced for longer-term securities. You may have a gain or loss when you sell your shares. The ability of an issuer of a debt security to repay principal prior to a security's maturity can

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[79] No fewer than four courses in its Interactive Classroom are specifically devoted to different methods of assessing risk.

[80] The Profile Plus disclosures advocated by NASD also take this approach to narrative risk disclosure, though they would include the 10-year performance bar chart as well.

cause greater price volatility if interest rates change."[81]

CFA questions whether the typical investor would have any better idea of the likely volatility of the fund's income stream after reading that disclosure, or whether they would understand how the risks of this fund compare with those of another similar fund, even though this statement follows the model of discussing the major types of risk to which the portfolio as a whole is subject. Even Vanguard, which has a reputation for candor in its disclosures, provides largely generic risk summaries that give little sense of how a particular fund's investment strategy affects its riskiness in comparison with funds that have a similar investment objective, although it does provide information on the fund's relative "riskiness" within the entire spectrum of fund options.

As a result, CFA questions whether many of the narrative risk disclosures currently provided will provide significant assistance to the investor seeking to understand the nature and extent of the risks associated with the fund and how they compare with those of other similar funds. We are encouraged, however, that better models do exist. The following statement is taken from the online snapshot for the T. Rowe Price Corporate Income Fund:

> "The Corporate Income Fund pursues high current income with some capital appreciation. The fund's emphasis on long-term investment-grade and non-investment grade corporate bonds should offer higher income than what is available from U.S. Treasury securities although with greater risk of loss. The addition of high-yield bonds, convertibles, and foreign securities provides the opportunity for capital growth and higher income, but with greater risk.
>
> "Yield and share price will vary with interest rate changes. Investors should note that if interest rates rise significantly from current levels, bond fund total returns will decline and may even turn negative in the short term. There is also a chance that one of the fund's holdings will have its credit rating downgraded or may default, potentially reducing the fund's income level and share price."

While CFA believes investors seeking income would benefit from slightly more attention to likely income volatility, we believe this nonetheless provides an excellent example of clear, easily understandable risk disclosure that relates directly to the investment strategy of the fund and gives a sense of that fund's riskiness relative to other similar funds.[82]

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[81] As downloaded March 26, 2005. We have chosen this as a model, not because it is particularly bad, but because it is fairly typical.

[82] Risk/Reward summaries for other T. Rowe Price funds we reviewed are of similar quality. The following is another example, taken from the snapshot for T. Rowe Price's Capital Appreciation Fund: "This fund offers investors a conservative "value" approach to long-term capital growth. It combines large-cap stocks with preferred stocks, convertibles, bonds, and money market instruments for capital preservation ... Because of the fund's fixed-income holdings or cash position, it may not keep pace in a rapidly rising market. And its value orientation carries the possibility that the market will not recognize a security's intrinsic worth

The changes to the prospectus adopted by the SEC in 1997 assure that investors who look can easily find the bar chart of annual returns and the table comparing the fund's average returns to those of an appropriate index at the front of the prospectus. The latter table, though generally not the bar chart, is also typically available in the snapshots fund companies provide on their websites. (We found that some fund companies, however, do not include an index for comparison when they include this table of average returns in the fund snapshots, diluting its value.)[83] The NASD's proposed Profile Plus would include the bar chart and an average performance table, but would not include an index for comparison.

Many of the fund snapshots we reviewed also include other volatility measures, such as beta and standard deviation. Fund profiles developed by Morningstar and Yahoo! Finance provide additional information. Morningstar, for example, has two proprietary ratings – their Risk Ratings and their Bear Market Ratings – designed to provide a more well-rounded assessment of risk than that associated with any one particular volatility statistic. Yahoo! Finance profiles list seven risk statistics (alpha, beta, mean annual return, r-squared, standard deviation, Sharpe ratio, and Treynor ratio) for three years, five years, and ten years. They also provide a "risk overview" that includes the Morningstar Risk Rating, the number of up and down years the fund has experienced, and its best and worst 1-year total return. Thus, investors have access to a significant amount of risk-related information to supplement the narrative risk disclosures. Because all these measures equate risk with volatility, however, they relate to only a single element of fund risk.[84]

Implications for Information Practices and Investor Education: CFA believes the degree and nature of fund risk is one of the most important elements for investors to understand when purchasing a fund. As the ICI states in its "Questions You Should Ask" brochure, "Unless you are familiar with the risks involved in an investment, you won't know what to expect from your fund's performance, and you won't know how to properly evaluate it." While investor guides provide a lot of guidance on how to evaluate fund risk, CFA questions whether most investors would be willing or able to do the work involved to assess risk effectively themselves. Furthermore, CFA believes the narrative risk summaries that have the potential to provide a minimum amount of key risk information are often not as useful as they could be.

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for an unexpectedly long time or that a stock judged to be undervalued may actually be appropriately priced." Investor Profile: "Individuals seeking capital appreciation who can accept the price declines inherent in common stock investing but prefer a strategy that focuses on reducing risk as much as maximizing gains."

[83] The NASD's proposed Profile Plus would include the year-by-year performance chart and the table showing average performance for the past one-, five-, and ten-year periods, but it would not provide performance information for an appropriate index to put the numbers in context.

[84] For investors seeking income, this could have the perverse effect of making a fund whose income stream fluctuates more in response to short-term interest rate changes seem "safer" than one with a steadier income stream, if the former has a more stable share price.

CFA believes investors would benefit if funds provided the bar graph of annual returns in their fund snapshots, related their narrative risk descriptions more directly to the investment strategy of the particular fund, and provided more insight into the relative riskiness of the funds compared with other similar funds in the risk/return summary. In addition, CFA believes that, in designing investor education materials, more thought may need to be given to what it is really reasonable to expect average investors to do to familiarize themselves with a fund's risk. We recognize that the notion that there is a limit to what investors should know and understand about risk is likely to be controversial in some quarters. Nonetheless, this strikes us as an area where more thought is needed on where to draw the line between what we would like investors to know and understand and what knowledge is truly essential.

III. Performance

Recommendations: Analyzing the volatility of past performance is one of the key ways investors are advised to assess risk. But many investment guides also contain advice on how to assess performance in its own right. Advice on this topic ranges from warnings not to put too much emphasis on past performance to statements that past performance "is the single most important criterion" for evaluating funds.[85] Typically, however, even those who emphasize the importance of past performance advise investors to put little stock in short-term performance and focus more on performance over five or more years.[86] This reflects a common concern that investors are too likely to select mutual funds based on one or two years of hot returns.

In addition to being warned off the latest "hot" funds, investors are typically advised to compare a fund's performance to that of other funds that have similar investment goals and styles and to an appropriate market index. In this line, investors are often advised to use past performance as a first cut to narrow the list of funds under consideration. For example, investors may be advised to consider only those funds that have consistently out-performed 60 to 65 percent of the funds in their category over the past three and five years.[87] When analyzing performance, investors are almost always advised to focus on total return rather than net asset

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[85] The SEC has an entire publication designed to encourage investors to look beyond performance when selecting mutual funds. *The New Century Family Money Book*, by Jonathan Pond, classifies past performance as the most important factor to consider, although it does emphasize the importance of looking at long-term performance.

[86] For example, About.com says "any track record under five years is noise." http://mutualfunds.about.com/cs/beforeinvesting/bb/before.htm

[87] For example, a *Baltimore Sun* "Money Talks" column from May 9, 2004 advises investors to look at a fund's percentile rank within its fund class over the past five years and for the complete 5-year period and only consider funds ranked among the top third. Similarly, in his annual column identifying actively managed funds which may be worth considering, Jonathan Clements, author of the *Wall Street Journal* "Getting Going" column, eliminates those that have failed to outperform 60 percent of comparable funds over the past three and five years. (See "Getting Going: So how do you pick a stock fund? The answer is right before your eyes," by Jonathan Clements, *Wall Street Journal*, July 11, 1995, pg. C1.)

value (NAV).[88]

Information Accessibility and Usefulness: As noted above in the discussion of risk, the changes to the prospectus adopted by the SEC in 1997 added two performance charts to the prospectus's Risk/Return Summary. As a result, investors who want to review the fund's annual total returns for the past ten years can find that information near the front of the prospectus. Also near the front of the prospectus is the chart showing average annual returns for one, five, and ten years along with the returns of one or more market benchmarks. Fund companies do not consistently include this information in the fund snapshots provided on their websites, however. For example, few of those we reviewed included the bar charts in the fund snapshots. While all the snapshots we reviewed included some information on average annual returns over several time horizons, many did not provide information on this table about returns of a benchmark index.

In contrast to those of many other fund companies, Fidelity's fund snapshots make it extremely easy to find the performance information most guides recommend investors consider when purchasing a fund. Investors who follow the link on Fidelity fund snapshots for additional performance information will find both a table that compares the fund's performance to that of an index and others that compare performance over various time periods to the Morningstar category average. Fidelity also provides the fund's one-, five-, and ten-year Lipper Rankings, which are based on total return. Vanguard also makes it easy for investors to compare a fund's performance to an index, and it allows the investor to choose for themselves an index with which to compare a fund's returns. However, investors must refer to a separate section of the website to find information on the best index to use for various types of funds.[89]

Investors considering funds from companies that provide less complete information can find recommended performance data from third-party sources. Both Morningstar's fund reports and Yahoo! Finance's fund profiles provide extensive information on this topic. The Morningstar reports, for example, lead off with a graph showing growth of a $10,000 investment over the past five years, compared with both the category average and an index (either S&P 500 for stocks or Lehman Brothers Aggregate Bond Index for bonds).[90] Beneath the graph is a chart

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[88] There is another school of thought related to performance. Noting that relatively few actively managed funds consistently beat the market's average returns, proponents of this line of thought argue that investors should stop trying to find a fund that can beat the market and instead invest primarily in index funds. Among those who advocate this approach are financial columnists Jane Bryant Quinn and Jonathan Clements, the Motley Fool, and former Vanguard Chairman John Bogle.

[89] How to Select a Mutual, Examine Investment Returns, as downloaded 3/5/2005.

[90] Many sources warn against using an index that is not appropriate for the fund. While Morningstar's Interactive Classroom includes a course on benchmarks, and identifies benchmarks that are appropriate for different types of funds, it doesn't necessarily include the more appropriate index in the charts in its fund reports. Instead, it uses a combination of a general index and peer groups to provide its benchmark.

showing in numerical terms how the fund performed compared with both the category average and the index. The Yahoo! Finance profiles link to a performance section that includes a chart comparing trailing returns to both the category average and an index for year-to-date, one-month, three-month, one-year, three-year, and five-year periods, last bull market, and last bear market. They include another chart that shows the fund's average annual returns for the past ten years compared with the category average. A third chart shows the fund's rank in its category on both a numerical and percentage basis for the year-to-date, one month, three months, six months, one year, three years, and five years.

Implications for Information Practices and Investor Education: CFA believes investors would benefit if fund companies included in their fund snapshots information comparing the fund's past performance with that of both an appropriate market index and its peers. We also believe investors would benefit if investor education materials directed investors to places (e.g., Morningstar reports and Yahoo! Finance profiles) where they can find the comparative performance numbers they are advised to consider. Here again, however, CFA questions whether more thought shouldn't be given both to where to draw the line between desirable knowledge and essential knowledge and to how best to convey performance information to investors.

IV. Fees and Expenses

Recommendations: Virtually all investor guides encourage investors to understand the fees and expenses associated with any fund they are considering purchasing. The content of the message varies greatly, however, from those who put costs at the top of their list of factors to consider to those who simply encourage investors to decide whether the costs associated with a fund are "acceptable" or "affordable." This is one area where the industry message appears to be markedly different from that of other sources. This difference, however, relates primarily to attitudinal issues (i.e., how investors should factor cost considerations into their purchase decision) rather than informational issues (i.e., what they should know about the costs of the funds they purchase).

On the question of what investors should know, all sources seem to agree that investors should understand what fees the fund they are considering charges and what those charges cover. In particular, they are encouraged to understand the differences between the fees they pay to purchase a fund, which are charged by only some funds, and the fees they pay for the operation of the fund, which are charged by all. Relatively little attention seems to be given to other types of fees, such as small account fees and redemption fees.

Good materials are available to help investors understand these fees, including both the general SEC brochure, "Invest Wisely: An Introduction to Mutual Funds," and a brochure devoted specifically to this topic, "Mutual Fund Fees and Expenses." While investor advocates might disagree with their overall message about the relevance of fund costs to fund selection, the ICI publications – "Understanding Mutual Funds" and "ICI Investor Awareness Series: Frequently Asked Questions About Mutual Fund Fees" – provide useful information not widely available elsewhere on how to read a fee table and how to determine from newspaper listings whether a fund has a sales load or 12b-1 fees and what its expense ratio is.

Most investor guides encourage investors to seek out funds with below average costs.[91] Most explain that costs vary greatly from fund to fund, that fees eat into returns, and that lower-cost funds will therefore tend to perform better over time. A few such guides, including SEC materials, provide a concrete example illustrating the message that seemingly small differences in expenses can translate into large differences in returns over time.

Much of the guidance provided to investors assumes that they will be making their own fund selections without the assistance of a financial professional. Thus, investors are typically advised to avoid load funds, since these charges go to compensate a salesperson for the services they provide. Just over a third of all mutual fund investors, however, purchase funds through a financial professional outside a retirement account.[92] What cost-related advice there is for these investors focuses primarily on the importance of choosing the most appropriate class of fund shares.

Information Accessibility and Usefulness: The fee table included at the front of all prospectuses provides a breakdown of mutual fund fees. Accompanying the general fee table is an example intended to aid investors in comparing costs among funds. Assuming a $10,000 investment in the fund and returns of 5% a year, it shows what the investor's cost would be at the end of one, three, five, and ten years if expenses for the fund remained the same over that period. Cost figures are provided assuming both that the investor sold the shares at the end of the period and that the investor continued to hold the shares. While the fee table shows expenses in percentage terms, the example shows estimated costs in dollar amounts.

The SEC recently adopted an additional requirement that funds include a fee table in the shareholder report showing costs for a $1,000 account based on the fund's actual expenses and performance for the reporting period and on the fund's actual expenses and an assumed return of five percent. The former is intended to allow investors to estimate their actual costs, the latter is intended to allow investors to compare costs among funds. The NASD recently adopted a rule requiring mutual fund ads that give performance figures to also prominently display the fund's expense ratio, which should help give greater prominence to this important information. In addition, the SEC has proposed a new point-of-sale disclosure requirement for funds sold through a financial professional that would cover sales-related costs and conflicts of interest. As re-proposed, the rule would also require disclosure of mutual fund operating costs. The NASD Profile Plus, developed in response to the SEC proposal, would also include this information. Rather than providing a breakdown of the annual expense ratio, the Profile Plus would present just the total expense ratio. This approach is based on the preference investors expressed in one-

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[91] This is the advice of financial columnists Jane Bryant Quinn and Jonathan Clements, the Motley Fool, about.com, Investopedia, CNN Money, Consumer Reports, and Forbes.com. Morningstar has a slightly more nuanced message, emphasizing the importance of choosing funds with low costs for bond funds and large stock funds, where returns don't vary much, and indicating that costs are somewhat less important for small company and foreign stock funds.

[92] According to the ICI *2004 Mutual Fund Fact Book* 37 percent of mutual fund investors purchase their funds through a salesperson.

on-one interviews for getting just the total number.[93]

Cost information is also available from other sources. Online fund snapshots typically include at least the fund's overall expense ratio. In addition, both Morningstar fund reports and Yahoo! Finance fund profiles include clearly labeled expense information. Under the heading Fees & Expenses, the Yahoo! Finance profiles include the total expense ratio, the maximum 12b-1 fee, the maximum front end sales load, the maximum deferred sales load, and the three-year, five-year, and ten-year expense projection per $10,000 invested. In each case, the information for the individual fund is presented side-by-side with the category average.

Despite this widespread availability of expense information, CFA believes several factors limit its usefulness. In the prospectus fee table, for example, CFA questions whether the level of detail may not get in the way of clear presentation of essential information, particularly for funds with a number of different share classes. Because the total annual operating expenses are given no more emphasis than the individual components that contribute to that expense, CFA wonders whether this may not reduce the likelihood that investors will focus on this key number. (That view appears to be upheld by the investor interviews conducted for NASD in testing its Profile Plus proposal.) Also, CFA questions whether the separation of shareholder fees from annual operating expenses – while it makes sense at one level by dividing transaction-based fees from on-going expenses – might not also make it more difficult for investors to put together the information about the combination of load and annual expenses, including 12b-1 fees, associated with different share classes.

Most of the materials we reviewed also provided investors with little information about where a particular fund's costs fall within a range from very low to very high or what the long-term impacts would be. Exceptions exist. The American Funds, for example, include information on category average expenses on their online fund snapshots. Our review indicated, however, that fund companies with higher expenses may be more likely to bury cost information in the fine print of their fund snapshots. As a result, CFA is concerned that investors may be less likely to get clear, useful information on costs from the funds where arguably they need it most.

The SEC and NASD both offer cost calculators on their websites that illustrate the long-term impact of fund costs. Investors can use the cost calculators to compare the cost impacts of various funds based on the amount they expect to invest and the length of time they expect to hold the investment. Because of the complexity of fund costs, however, CFA found the calculators to be somewhat difficult to use.[94] The Personal Fund website offers a cost calculator

[93] Mutual Fund Point of Sale Disclosure: Investor Research Findings, prepared for NASD by Applied Research & Consulting LLC, March 23, 2005.

[94] Investors wanting to analyze costs of B shares in a particular fund, for example, need to know not only the amount of any deferred sales charge, but when it sunsets, whether the shares convert to a different share class, and, if so, when, and what the expense ratio is before and after the conversion. We found the NASD calculator somewhat easier to use, and its side-by-side presentation much more user-friendly, but we frankly question how many investors who invest through a financial professional would be willing or able to complete the process.

that does more of the work for the investor, and thus is, in our view, considerably easier to use.[95] Its cost calculation also includes an estimate of the taxes the investor would pay if the user indicates the fund will be held in a taxable account. If the investor wishes, the website will provide a list of comparable funds with lower costs.[96]

Of the various types of fund summaries we reviewed, CFA found the Yahoo! Finance fund profiles most useful for putting costs in context.[97] The investor education materials we reviewed, however, typically do not direct investors to these profiles for cost information. Some guides to selecting a mutual fund have attempted to offer simple guidelines that investors can use to evaluate expenses. In 1994, for example, the *Wall Street Journal* ran an article on the importance of using yardsticks to evaluate fund expenses.[98] The article included a table, compiled using Morningstar data, that presented average costs for ten types of stock funds and three types of bond funds, with numbers in each category broken out for all funds, no-load funds, and load funds. Morningstar itself also includes some information in its Interactive Classroom on guidelines to use in evaluating fund fees. As a general rule, however, this information does not appear to be widely available.

Information on sales-related costs is less available, although that appears to be about to change. The SEC is putting the finishing touches on a point-of-sale and confirmation statement disclosure requirement that would cover sales-related costs and conflicts of interest and require for the first time that this information be provided before the sale is completed. The Commission appears to have concluded, however, that it is too costly to provide the kind of comparative information that CFA believes is needed to help investors to put these costs into context. CFA is concerned that, without that context, many investors will not know what to make of the information they receive. On the other hand, CFA believes the testing the SEC has conducted of the disclosures has helped to produce a design and language that present key information clearly and in a way that investors are more likely to understand.[99]

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[95] It still requires the user to enter an estimated rate of return and marginal tax rate for income and dividends, as well as the information on the amount being invested, the length of time the investment will be held, and whether the investment will be held in a taxable account. It does link to a table the investor can use to determine these tax rates. The website is found at www.personalfund.com.

[96] The investor has to register to use the site, but registration is free.

[97] The one short-coming we've identified with its system derives from its comparison of index funds to actively managed funds in the same category. This has the effect of making index funds that are extremely expensive for index funds look like reasonably priced funds.

[98] "Mutual funds quarterly review: Use yardsticks to weed through fees," by Robert McGough, *Wall Street Journal*, July 7, 1994.

[99] This is an approach that, if expanded to other disclosure documents, has enormous potential to improve the usefulness of those disclosures.

Investors who purchase funds from a financial professional can use brochures from either the SEC or NASD to help them understand the different classes of fund shares.[100] These documents explain the typical characteristics of each share class and the advantages and disadvantages of each. In addition, investors can use the NASD cost calculator to run a side-by-side comparison of a fund's A, B, and C shares to determine which would be best for them based on how much they plan to invest and how long they expect to hold the fund. (The SEC's cost calculator allows information on only a single fund class to be entered at a time and CFA therefore found it less well suited for this purpose.) Even with the cost calculator, however, we found this to be a fairly labor-intensive process. The NASD also advises investors to ask their financial professional which share class is best for them and to have them put their reasons in writing.

Implications for Information Practices and Investor Education: When the SEC tested its recently proposed point-of-sale disclosures with investors, it found that investors do not make the connection between fees and returns. Previous research reached the same conclusions and found that investors generally do not know the expenses of their funds.[101] In light of these findings, CFA questions whether current disclosures are serving their intended purpose of making investors cost-conscious in their purchase decisions. We believe some of the factors identified above may contribute to this failure. CFA believes the new point-of-sale disclosures have the potential to help, but we also believe more could be done to better educate and inform investors about costs.

Because the format of the prospectus fee table and accompanying example are dictated by the SEC, it would require regulatory action to improve their clarity. As the SEC has done for other disclosures recently, focus group and one-on-one testing with investors could be used to identify changes that would improve the clarity and usefulness of these disclosures. As part of that process, CFA believes it might be beneficial for consideration to be given to a recommendation put forward by the North American Securities Administrators Association in 1998. NASAA recommended that fund prospectuses be required to provide a concrete example of the difference that one percentage point in expenses can have on fund returns over 20 years – the same type of information as is currently provided in SEC educational materials.[102] In addition, CFA believes investors would benefit if fund company snapshots that don't already do so provided headings for cost disclosures in order to make the information stand out visually and

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[100] The NASD offers two publications, "Investor Alert: Understanding Mutual Fund Classes" and "Mutual Fund Breakpoints: A Break Worth Taking."

[101] "Mutual Fund Shareholders: Characteristics, Investor Knowledge, and Sources of Information," by Gordon J. Alexander of the SEC, Jonathan D. Jones of the SEC, and Peter J. Nigro of the Office of the Comptroller of the Currency, June 24, 1996. Fewer than one in five survey respondents could give any estimate of expenses for their largest mutual fund, and even fewer were able to provide a reasonable estimate. Fewer than one in six survey respondents understood that higher expenses can lead to lower returns.

[102] Written Statement of Denise Voigt Crawford, NASAA President, before the House Finance and Hazardous Materials Subcommittee, September 29, 1998.

included comparative information on average fees for the fund category.

CFA also believes investors would benefit if investor educators consistently included in their materials: 1) concrete examples of the long-term impact of seemingly small differences in fund expenses on fund returns and 2) better guidance on how to determine whether a fund has low, average, or high costs for funds in its category. CFA believes more thought should be given to the best way to guide investors through the process of evaluating fund classes, taking into account how much work those who invest through financial professionals are willing to do to make this determination. Finally, CFA believes consideration should be given to providing investors with better access to information comparing sales loads and 12b-1 fees and showing the impact of those costs over the long term.

V. Fund Manager

Recommendations: Some investor guides include information about the fund manager on the list of items investors should know when purchasing a mutual fund. When it designed the fund profile, the SEC included the identity of the investment adviser on its list of key information. The ICI also includes the identity of the fund manager on the list of questions investors should ask when purchasing a fund.[103] Morningstar has a course on its Interactive Classroom on "Why Knowing Your Fund Manager Matters."

Advice on this topic typically relates to two issues – the reputation of the fund family and the tenure and experience of the fund adviser. A number of sources suggest investors need to know how long the current portfolio manager has been managing the fund in order to determine the degree to which that individual is responsible for the fund's past performance.[104] Others have suggested that investors can save themselves time and money by simply choosing a good fund company and buying a handful of funds that produce an appropriate allocation of assets.[105]

Information Availability and Usefulness: Funds are required to include information in the prospectus identifying the investment adviser and portfolio manager of the fund. The SEC recently added a requirement that fund companies identify all members of the management team and provide information on their length of tenure, compensation structure, ownership of fund shares, and management of other accounts. Some fund companies, including American Funds, Fidelity, and Vanguard, also include information on portfolio manager tenure in the fund snapshots they provide on their websites. In addition, the information is available both from Morningstar fund reports and Yahoo! Finance fund profiles. Premium members of Morningstar

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[103] It's publication, "Questions You Should Ask Before You Invest in a Mutual Fund," does not explain why this is important.

[104] *Smart Money*, by Ken and Daria Dolan; *Kiplinger's Practical Guide to Your Money*, by Ted Miller; AARP, "What to Look for in a Mutual Fund;" Investopedia; Forbes.com; Morningstar; and about.com all offer this recommendation.

[105] See, for example, "Instead of Foolishly Chasing Hot Funds, Bet Your Future on a Good, Solid Family," by Jonathan Clements, *Wall Street Journal*, May 29, 2002, p. D. 1.

also get access to reports on fund companies and to its stewardship ratings of the fund companies.

Implications for Information Practices and Investor Education: While information about fund companies and portfolio managers certainly has value, CFA believes the advisory group should consider whether it represents essential information for mutual fund purchasers and, if so, what level of information is essential.

VI Tax Implications

Recommendations: Many investor guides advise investors to keep tax consequences in mind when purchasing a mutual fund. Those who offer concrete suggestions on how to do that typically recommend avoiding funds with high turnover rates, since they will tend to generate more capital gains distributions.[106] Others recommend looking at after-tax returns.[107] Still others recommend investors consider funds that seek to minimize their tax impact.[108] To avoid paying taxes on capital gains they have not benefitted from, investors are also advised to find out when the fund makes its distributions in order to avoid purchasing shares right before a distribution is made.[109]

Information Availability and Usefulness: When the SEC revised the prospectus in 1997, it attempted to refocus these disclosures. The goal was to provide less information on tax treatment of specific securities held by the fund and more on tax treatment of fund distributions and direct tax consequences to investors of investing in the fund. As a result, investors receive information in the prospectus about tax treatment of different types of distributions and any capital gains realized upon selling the fund. In addition, the risk/return summary at the front of the prospectus includes a table showing average annual returns after taxes are paid on distributions and after taxes on distributions and sale of fund shares for one-, five-, and ten-year periods and for the life of the fund. Some, but not all, fund companies provide an estimated schedule of when distributions are likely to be made in the prospectus. When it revised the prospectus, the SEC also required tax-exempt funds to make special disclosures designed to inform investors of certain circumstances in which income from the fund might be taxable. In addition to the information in the prospectus, the financial statements in the annual report show

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[106] For example, Motley Fool recommends looking for funds with turnover no greater than 25 to 50 percent. Morningstar recommends looking for funds with extremely low turn-over, about 10 percent, for taxable accounts and putting tax inefficient funds in tax-advantaged accounts.

[107] Vanguard, "How to Select a Mutual Fund;" MoneySitter.com, "Learn All About Mutual Funds: How to Choose a Mutual Fund," http://www.moneysitter.com/mutualfunds3.htm.

[108] CNN Money recommends investors consider tax efficient funds; Morningstar recommends that individuals in higher tax brackets consider tax-managed funds and, if they want to buy a bond fund, consider buying a municipal bond fund.

[109] SEC, "Invest Wisely;" Morningstar; MoneySitter.com.

turnover rates for the past five years. Information on unrealized or undistributed capital gains can be found in the annual report's Statement of Assets and Liabilities.

Investors also have access to some information outside the fund prospectus. Morningstar reports and Yahoo! Finance profiles both include the annual portfolio turnover rate, as would the NASD's Profile Plus[110]. Yahoo! Finance also provides the category average to put this number in context. Some fund companies, including Fidelity and Vanguard, include after-tax performance figures in their online fund snapshots. Fidelity also includes the portfolio turnover rate. Others, including T. Rowe Price and Morgan Stanley, provide the turnover rate, but not the after-tax performance. American Funds provides portfolio turnover rates for the past five years. The Personal Fund website includes tax costs in its overall assessment of fund costs for investors who indicate they will be investing outside a tax-advantaged account.

Implications for Information Practices and Investor Education: CFA found the guidance on how to evaluate tax considerations to be less consistent than that of other topics considered here. If tax considerations are a key concern, CFA believes investors would benefit from receiving a clearer message from investor education materials on how to factor those considerations into the evaluation of the fund and where to look to find the appropriate information. If agreement can be reached on the key information that investors need, CFA believes investors would also benefit if fund companies who do not already do so were to provide this information in their snapshots.

VII. Operational Issues

Recommendations: A few investor guides advise investors to determine what services they want and find out whether the fund company offers those services.[111] Among the services they are advised to consider are: no- or low-cost exchanges between funds in the same family; automated transaction options; electronic transfers; automatic investment and withdrawal plans; retirement plan options; and check-writing. They are also advised to determine whether the minimum amounts for both initial investments and additional investments fit their needs. Vanguard takes a somewhat different approach, advising investors to determine whether the fund company will keep track of the cost basis of shares over time, has a comprehensive website, and offers programs for investors with substantial assets, brokerage services, access to mutual funds from other companies, and financial planning, asset management, and trust services.[112]

Information Availability and Usefulness: The prospectus includes information on minimum investment amounts and how to buy, sell, and exchange fund shares. Based on those we reviewed, prospectuses for no-load fund companies seem to include far more information on other investor services, such as automatic investment plans, check-writing privileges, and

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[110] NASD's proposed Profile Plus focuses on costs associated with portfolio turnover, rather than discussing its tax implications.

[111] The ICI, SEC, and Canadian Securities Administrators all offer this advice.

[112] Vanguard, How To Select a Mutual Fund, Check a fund's policies.

automatic withdrawal plans. This is presumably because, for broker-sold funds, many of these services would be determined by the broker rather than the fund company and would apply to the brokerage account as a whole rather than to particular fund investments within that account.

When the SEC designed the profile, they required funds to include minimum investment requirements, the existence of breakpoint or fee waivers, and a listing of other available services. Based on our review of online fund snapshots, we found that fund companies take very different approaches to this topic. At least one of those we reviewed did not include the minimum investment amount, although this was not typical. In contrast, some provided considerable information on available account services within the fund snapshots themselves.[113] Still others provide that information on the website, without necessarily including it in each fund snapshot. (Ariel Mutual Funds, for example, includes extensive information in the FAQ section of its website.) In addition, both Morningstar fund reports and Yahoo! Finance fund profiles include the minimum initial investment amount for the fund, with Yahoo! providing somewhat more detail. Yahoo! also provides a listing of brokers through whom investors can purchase the fund. However, neither the Morningstar reports or the Yahoo! Finance profiles we reviewed covered other services offered by the funds.

Implications for Information Practices and Investor Education: Information on minimum investment amounts is, for the most part, relatively easy to find. When it comes to other account services investors are advised to consider, however, we found it far more difficult to locate the desired information. Without knowing how much variation there is among funds with regard to these services, we were unable to assess what information investors truly need in this area. We believe the advisory committee could help to determine what information in this area is essential.

Do different types of investors need different types or amounts of information?

Most of the advice on purchasing mutual funds appears to have been written primarily with those who purchase funds directly from no-load fund companies in mind. It assumes a considerable willingness on the part of the purchaser to research the fund. However, direct purchasers represent a relatively small segment of the mutual fund marketplace, with just 10 percent of mutual fund purchasers buying their funds directly from fund companies and another five percent buying them through discount brokers or fund supermarkets.[114] The largest group, 48 percent, buy their funds through a workplace retirement plan, while another 37 percent buy their funds from a salesperson outside a retirement plan.[115] This raises the question of whether

[113] Vanguard, for example, provides a link at the top of the snapshot to a list of account services available. Fidelity snapshots include a section headed "Features" that lists minimum investment amounts and indicates whether retirement accounts, check writing, direct deposit, and automatic account builder are available, gives the automatic account builder and direct deposit minimums, and indicates how many exchange redemptions are permitted in a year.

[114] ICI's *2004 Mutual Fund Fact Book*, p. 47. A significant percentage of those who purchase through discount brokers may be doing so with advice from a financial planner.

[115] Ibid.

guidance designed for self-directed investors is appropriate for these other groups or whether investors in these groups are likely to need or want different types and amounts of information.

Certain differences are obvious. Investors who purchase funds through salespeople need information about share classes and sales-related costs and conflicts of interest that direct-purchase and retirement plan investors do not. However, other less obvious factors are also likely to affect different types of investors' information needs. A few of those are discussed here. CFA asks advisory group members to consider whether additional factors not discussed here may also result in different information needs for different types of investors.

I. Retirement Plan Investors

Those who invest primarily or exclusively through retirement plans may be significantly less financially sophisticated than typical direct purchasers, and thus may be less willing or able to conduct the kind of research investor guides aimed at direct purchasers expect investors to conduct.[116] In addition, these investors typically choose from a relatively limited menu of investment options.[117] Because of this limited selection, CFA questions whether these investors may have significantly more need for information on what types of funds are appropriate for them than on how to compare individual funds of the same type.[118]

Since most retirement investing decisions start with a choice of an appropriate asset allocation plan, CFA wonders whether these investors' primary information need may involve how to allocate their assets based, for example, on how many years they have until retirement. Similarly, when it comes to selecting funds to implement that plan, we wonder whether their primary need may be for information that helps them put together a combination of funds that provides the desired asset allocation. With this in mind, CFA believes it may be worth considering whether a simple interactive tool that helps investors develop an appropriate asset allocation and then identifies various combinations of funds available through the plan that produce the desired asset allocation might not largely satisfy many of these investors' information needs, or at least their information desires. Absent that sort of tool, CFA believes it

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[116] We expect to learn more about investors information preferences when we conduct our survey. In the meantime, these analysis is based on the assumption that those who invest primarily or exclusively through retirement plans are significantly less willing than direct purchasers to conduct extensive research on their fund options.

[117] "Offering vs. Choice in 401(k) Plans: Equity Exposure and Number of Funds," by Gar Huberman and Wei Jiang, Finance and Economics Division of Columbia Business School. The authors examined more than 600 401(k) plans and found the number of investment options offered ranged from 4 to 59. The median number of choices in the sample was 13, and 96 percent of participants were in plans with seven or more choices.

[118] The more options they have within a plan, the more need they will have for information that allows them to compare comparable options – in other words, the more need they will have for the more comprehensive information needed by the typical direct purchase investor.

may be worth exploring whether very brief documents along the lines of the mutual fund profile developed by the SEC in the 1990s – but with the addition of something along the lines of the Morningstar style box or other simple graphic presentation of the fund's asset allocation – might provide all the information these investors are likely to want or need.

II. Investors Who Purchase Funds Through Salespeople

Investors who purchase funds through salespeople presumably do so at least in part because they are unwilling or unable to make those selections themselves. If this is true, it seems illogical to expect them to conduct the kind of extensive research most investor guides recommend. However, CFA believes recently well-documented problems with broker-dealer sales practices suggest that these investors may have more need for fund information than they realize. If one assumes that investors are likely to rely without significant question on the recommendations of a financial professional, then CFA believes it is logical to conclude that their information needs relate primarily to questions of how to choose an appropriate adviser. As part of this, CFA believes they are likely to need information about how the broker selects investments to recommend and what their conflicts of interest are in making those recommendations.

The SEC appears to have concluded that mutual fund investors need this sort of information, and it has proposed a new disclosure document focusing on sales-related costs and conflicts of interest. The SEC's own research testing those disclosures, however, found that investors who had relied on their broker indicated their dependence would not change based on the disclosures of conflicts.[119] The NASD reached similar conclusions when it tested its Profile Plus disclosure document.[120] CFA does not find this surprising. Once an investor has chosen to rely on a financial professional for recommendations, we believe they are unlikely to want to second-guess those recommendations based on information they receive just as they are preparing to sign the check to make the purchase. This suggests to us that the proper timing of these sorts of disclosures is at the outset of the relationship, so that investors can factor these considerations into their selection of an adviser. In addition, CFA believes such disclosures should apply to all products recommended by brokers and should not be tied exclusively to one class of investments, such as mutual funds.

CFA has long advocated such an approach. In the meantime, however, we believe mutual fund investors who purchase through a salesperson might still benefit from a brief pre-sale disclosure that helps them understand the key characteristics of the funds they are buying, such as how its costs, risks, and performance compare with those of other similar funds. We believe it is possible, for example, that investors who saw clear information showing their fund had significantly above average costs might be somewhat more willing at least to ask why they

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[119] "Results of In-Depth Investor Interviews Regarding Proposed Mutual Fund Sales Fee and Conflict of Interest Disclosure Forms," Report to the Securities and Exchange Commission by Siegel & Gale, LLC and Gelb Consulting Group, Inc., November 4, 2004.

[120] Mutual Fund Point of Sale Disclosure: Investor Research Findings, prepared for NASD by Applied Research & Consulting LLC, March 23, 2005.

were being steered toward a high-cost fund. In addition, CFA believes investors who purchase through a salesperson might benefit from educational materials designed specifically for them and that encourage them to get answers to these few simple questions before purchasing a fund.

CFA anticipates that our survey will tell us more about the information preferences of these investors. That should give us a better sense of the type of information they would be most likely to use. We would appreciate any insight advisory group members can offer on this topic.

Timing and Format of Disclosures

Investor advocates have long argued that, for disclosures to be effective, they need to provide the information investors need, in a form they can understand, and at a time when it is useful to them. CFA believes mutual fund disclosure documents – the prospectus, annual report, and Statement of Additional Information – are fairly comprehensive in the information they provide. However, CFA believes most people would agree that they fail the test of providing that information in a form that is useful to investors. Despite the best efforts of the SEC to streamline the prospectus, we found that it can still take considerable digging, even for someone who is familiar with the documents, to find some of the desired information. Other information, such as the fee table, is presented in a way that CFA believes may make it difficult for investors to pick out the key information. Furthermore, these documents typically lack the kind of comparative information that we believe would be most useful to investors trying to select among different funds of the same type.

We found that other sources of information – including the fund snapshots provided on fund company websites and both the Morningstar fund reports and Yahoo! Finance fund profiles – do a much better job of presenting information in a form that we believe investors would be likely to understand. While they provide significantly less information than official fund disclosure documents, CFA questions whether the best of them actually provide significantly less of the information investors truly need. In fact, many of them do a considerably better job than official fund disclosure documents of providing the comparative information we believe investors are likely to benefit from most.

The Internet also makes it possible to provide information essentially instantly, at least for investors who are comfortable using this tool. There is no longer any need to call an 800-number to have a prospectus sent through the mail. Instead, investors can review any of the various types of summary documents or download a prospectus with a click of the mouse. In testing its Profile Plus, which is designed to be delivered online, the NASD found investors quite receptive to using the Internet for this purpose.[121] Our survey may provide us with some additional information on investors' access to the Internet and willingness to use the Internet for this purpose. In the interim, however, CFA asks advisory group members to consider what the implications of these developments are for disclosure practices. Although CFA believes more in-depth research is needed before significant policy changes can be made based on growing use

[121] March 31, 2005 letter from NASD Chairman and CEO Robert R. Glauber to SEC Secretary Jonathan G. Katz regarding Investment Company Act Release No. 26778 (the "Supplemental Request for Comment").

of the Internet, we believe it would be foolish to ignore the dramatic changes underway in information delivery when developing policy in this area.

(Bibliography omitted here but available upon request)