Via E-mail: rule-comments@sec.gov
Securities and Exchange Commission,
100 F Street NE, Washington, DC 20549-1090.
Attention: Vanessa Countryman, Acting Secretary

September 29, 2020

Re: Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements - File No. S7-09-20

Ladies and Gentlemen:

We are writing to comment on the SEC's proposed amendments ("Proposal") for Improved Fee and Risk Disclosure for Mutual Funds. In this letter, we provide comments and share our research relating to the Proposal on mutual funds and their prospectus disclosures.

The letter makes two broad points, which we detail in the following subsections:

1) Our recent study of S&P 500 index mutual funds (deHaan et al. 2020) finds that:
    a) Retail investors make poor choices when selecting even the simplest of mutual funds. For example, we estimate that retail investors could have saved $358M in 2017 alone by switching from high-fee to low-fee versions of S&P 500 funds that provide nearly identical pre-expense returns.
    b) We find that the high-fee S&P 500 funds have less readable prospectuses and more complex fee structures, consistent with theory that high-fee funds attempt to obfuscate their high fees. We find similar results in a broad sample of funds, indicating that these findings are not unique to S&P 500 funds.

2) We support the current Proposal to improve disclosures but, based on our research findings, think it does not go far enough to help investors understand the fees they must pay. We suggest that the SEC consider requiring standardized language to help investors identify key information. We also suggest other improvements to disclosures and class and fee structures.

Summary of Our Study

Our study seeks to explain why retail investors do not make better choices when purchasing mutual funds. Specifically, we investigate whether unclear disclosures and overly complex fee structures are partially to blame, and whether mutual funds manipulate readability and complexity to obfuscate their fees.

We study S&P 500 index mutual funds from 1994 to 2017. We limit our primary analyses to S&P 500 funds to ensure that the funds are homogeneous in terms of their investment strategies, risks, gross returns, and reporting requirements. All of our analyses are structured so that we only compare S&P 500 funds to each other within the same calendar year.

Despite earning nearly identical pre-expense gross returns, we find that S&P 500 funds charge widely different fees for doing so; e.g., the interquartile range of fees spans 20 to 115 bps.[1] As one example, Schwab's S&P 500 fund charged 2 bps in 2019 while Deutsche's charged up to 506 bps, despite both earning nearly identical pre-expense returns. We estimate that retail investors paid an extra $358M in 2017 alone by holding high-fee versions of S&P 500 index funds. This loss is economically large: over 30 years, these fees compound to $6.9B in lost retirement savings. Moreover, we find that the *cheapest* classes from high-fee funds are still significantly more expensive that the *most expensive* classes from low-fee funds, which is inconsistent with an argument that high-fee funds use classes to benefit certain clientele.

Our first set of tests focuses on the readability of fund prospectuses and summary prospectuses. We measure readability in four ways: 1) document length; 2) writing clarity measured by words per sentence; 3) lack of summarization in the summary prospectus; and 4) the number of individual funds that are included in a single prospectus. These measures stem from prior guidance from the SEC on how to write plain-English disclosures. We find strong evidence that fees and readability are inversely related; i.e., the higher the fund's fees, the less readable its disclosures.

Our second set of tests focuses on the complexity of funds' share classes and fee structures, which we label "structural complexity." We measure structural complexity in five ways: 1) the number of share classes; 2) having a front load; 3) having a 12b-1 fee but no load; 4) the number of front load breaks; and 4) the number of rear load breaks. We again find strong evidence that funds with higher fees have more complex class and fee structures.

The strong positive associations between fees and both complex structures and unreadable disclosures is consistent with academic theory that high-fee funds attempt to obfuscate their fees (e.g., Carlin 2009). We find similar results when looking at the broader mutual fund market. Extensive additional analyses reduce concerns that the complex structures and disclosures are driven by factors beyond funds' control.

Our research informs our comments to the Proposal, summarized below.

Comments on the Proposal

We support the current Proposal, but we believe it does not go far enough in helping investors to understand the fees they must pay. To remedy this problem, we suggest that the SEC consider the following improvements to disclosure readability and structural complexity:

1. Limit the number and types of different fees that funds can charge. The current Proposal does not go far enough to limit the structural complexity of fees. For example, in Table 5 of the Proposal, there are 7 measures of shareholder fees, 6 measures of transaction fees, 5 types of annual operating expenses, a maximum account fee, and an ongoing annual fee. With so much structural

[1] See Table 1 Panel A of our paper.

complexity in fees, retail investors cannot reasonably be expected to understand how much they will be paying in fees. We propose a limit to the number of share classes and the number and types of fees. For example, the SEC should consider whether tiered loads, temporary discounts, and 12b-1 fees should be banned, especially for index funds. Permitting only one type of annual fee (that consolidates all fees) and requiring that funds disclose the fee transparently would help investors identify the total cost of ownership.

2. Improve readability by requiring funds to use standardized language for their benchmarking disclosures. This language should be simple and directly reference the benchmark. For example, all index funds should state in their prospectus, "The fund's goal is to track the total return of the X Index."[2] We propose standardizing the language in the most important disclosures, especially in the summary section of the prospectus.

3. Improve readability by limiting the number of funds that can be included in a single prospectus.

Thank you for your consideration. Please feel free to contact us if you have any questions or would like further information about our study.

Ed deHaan

Yang Song

Chloe Xie

Christina Zhu

Referenced studies

Carlin, B. I. (2009). "Strategic price complexity in retail financial markets." *Journal of Financial Economics* 91: 278-287.

deHaan, E., Song, Y., Xie, C., and Zhu, C. (2020). "Obfuscation in Mutual Funds." Available at SSRN: https://ssrn.com/abstract=3540215.

[2] Our study finds evidence consistent with funds manipulating the readability of even their objective statements. For example, Schwab uses 14 words, "The fund's goal is to track the total return of the S&P 500 Index." In contrast, Deutsche uses 60 words, "The fund seeks to provide investment results that, before expenses, correspond to the total return of common stocks publicly traded in the United States, as represented by the Standard & Poor's 500 Composite Stock Price Index (S&P 500 Index). The fund invests for capital appreciation, not income; any dividend and interest income is incidental to the pursuit of its objective."