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December 30, 2020

Vanessa Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: File No. S7-09-20, *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*

Dear Ms. Countryman:

CFA Institute<sup>1</sup> writes in support of the aforementioned rule proposal (“Proposal”).<sup>2</sup> CFA Institute speaks on behalf of its members and advocates for investor protection and market integrity before standard setters, regulatory authorities, and legislative bodies worldwide. We focus on issues affecting the profession of financial analysis and investment management, education and competencies for investment professionals, and on issues of fairness, transparency, and accountability of global financial markets.

### **Executive Summary**

We believe that retail investors in mutual funds and ETFs will benefit substantially from the Proposal. If adopted, it would achieve a comprehensive and holistic overhaul of the disclosure framework of disclosure rules for open-end mutual funds and ETFs. In addition, the proposed updates to advertising rules would enhance investor protections.

The Proposal—646 pages long—can be distilled into five main themes. First, the Proposal takes a streamlined, layered approach to the annual shareholder report, which the Release estimates would go from more than 100 pages to just 3-4 pages. Importantly, almost all of the information removed from the shareholder report would remain accessible to the public, both online and through filings to the U.S. Securities and Exchange Commission (the “SEC” or the “Commission”). We support this layered approach, which focuses the report on a few topics of most interest to retail investors. By making the report considerably more concise, the Proposal will likely improve the chances that investors actually will read it.

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<sup>1</sup> CFA Institute is a global, not-for-profit professional association of more than 178,000 members, as well as 157 member societies around the world. Members include investment analysts, advisers, portfolio managers, and other investment professionals. CFA Institute administers the Chartered Financial Analyst® (CFA®) Program.

<sup>2</sup> Sec. and Exch. Comm’n, *File No. S7-09-20, 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* (Aug. 5, 2020) [(85 FR 46016 (Nov. 5, 2020))] (“Tailored Shareholder Reports Proposing Release”) available at <https://www.sec.gov/rules/proposed/2020/33-10814.pdf>.

Second, the Proposal would make several changes to required disclosures in the shareholder report, including the expense table, a new section on material changes in the fund, and disclosure of any changes in auditors. We generally support these proposed changes and offer suggestions for further improvements. Among other things, we recommend requiring that the shareholder report provide at least some reference to a fund's risks. In addition, we suggest that the rule require, or at least expressly permit, funds to explain why any material changes occurred. For a synopsis of these and other recommendations, see the table following the Executive Summary.

In both the shareholder report and the prospectus, the Proposal would require all funds to compare their returns against a broad-based market index. In addition, funds would be permitted, but not required, to display supplemental benchmarks that more closely match their investment strategy. We recommend that the rule require both types of disclosure.

Third, the Proposal envisions that the shareholder report would become the central document for existing shareholders. A fund would no longer be required to send annually updated prospectuses to existing shareholders (provided that the fund met certain conditions). This would sharpen the distinction between the prospectus, the document for potential and new investors in the fund, and the shareholder report, the document for existing shareholders. In addition, the Proposal would make the prospectus more understandable to retail investors by modifying the fees and expenses table and disclosure of fund risks. We generally support the proposed changes and offer further suggestions for improvement.

Fourth, the Proposal would revert to mailing of paper shareholder reports as the default option for open-end funds and ETFs. We agree that the revamped shareholder report justifies the return to paper delivery as the default option, as the most likely means of ensuring investors actually read some level of disclosures and reporting about their investment choices on an annual basis.

Fifth, the Proposal would update the rules governing advertising and sales literature of all registered investment companies. We support these changes and applaud the Commission in particular for calling attention to potentially misleading fund advertising claims of "no fee," "zero fee," or low fee accounts.

Finally, we comment on the need for independent investor testing. The Proposal makes good use of previous research, including investor testing, and applies the precepts of effective disclosure design. Nonetheless, the specific proposed changes in disclosures have not been subjected to independent investor testing conducted or overseen by Commission staff. We recommend that the Commission conduct its own investor testing of the proposed changes, either before moving to final adoption of the rule or as part of a post-implementation staff study.

Going forward, we also recommend that the Commission integrate investor testing at an early stage into all future rulemakings on retail investor disclosures. In addition, the Commission should make greater use of the objective investor testing capabilities of the Office of the Investor Advocate.

## Summary of Recommendations

*Recommendations for the annual shareholder report (unless otherwise noted):*

1. **Prescribe the formatting of the expense table in as it appears on page 70 of the Release (with bolded borders, text and numbering applied to the columns “Costs paid” and “Costs paid as a percentage of your investment”).** This particular formatting design is more effective than alternatives in making the two columns stand out.
2. **Consider 1) requiring funds to explain why any material changes occurred or 2) expressly permitting, and perhaps encouraging, an optional explanation.** Investors need to understand not only whether any material changes occurred, but why they occurred.
3. **In both the shareholder report and the prospectus, require, and not merely permit, disclosure of one or more additional benchmarks appropriate to the fund’s investment strategy (unless the fund’s strategy is to mimic the market).** The required disclosure of a broad-based index will help investors to assess the performance of a particular fund against the market as a whole. But to see how well a fund was managed in its specific investment strategy, investors need to see a benchmark that matches the fund’s investment strategy.
4. **The text of any final release of the rule should distinguish between a benchmark and a broad-based market index and should not refer to one as the other.** An appropriate benchmark must reflect the investment mandate, objective, or strategy of the fund; that is not necessarily the same as a broad-based index.
5. **In the prospectus, the term “Distribution [and/or Service] (12b-1) Fees” should be replaced by “marketing fees.”** We agree that the current term “Distribution [and/or Service] (12b-1) Fees” should be replaced, but believe that the proposed alternative, “selling fees,” could be misinterpreted as referring to the fees an investor incurs when redeeming her shares. The term “marketing fees” could avoid this confusion.
6. **1) Require online disclosure of transaction costs, research costs and best execution policies, and 2) establish a standard method of calculation of transaction costs if necessary.** Investors need the enhanced transparency to

understand how much they are paying for trading or research and to assure themselves that they receive the benefits of the research for which they are paying.

7. **Require that the shareholder report include at least a high-level reference to the fund’s risk.** This information is material both to new and existing shareholders. Shareholder reports—as the intended “central source of fund disclosure” for existing investors under this Proposal—should include at least some discussion of fund risks.
8. **Consider requiring the annual shareholder report to present both a line graph of returns in dollar terms and a bar chart of the annual percentage change in returns.** The bar chart is a visually compelling and intuitive way to present volatility, which constitutes one of the key risks of a fund

*General Recommendations:*

9. **Require online disclosure of 1) a fund’s standard deviation of return and (2) correlations of the fund’s returns with those of one or more standard indexes.** These disclosures would enable investors to make more informed investment allocations, especially with respect to more esoteric funds with unclear risks and correlations.
10. **Direct the staff to conduct its own investor testing on the proposed changes – either before moving to final adoption of the rule or in a post-implementation staff study.** Though the Proposing Release draws on previous investor research and makes good use of the precepts of effective disclosure design, the proposed changes have not been subjected to independent investor testing by Commission staff.
11. **Going forward, 1) integrate investor testing at an early stage into all future rulemakings on retail investor disclosures; 2) conduct its own independent investor testing; and 3) deploy the objective research capabilities of the Office of the Investor Advocate in those efforts.** The Commission should not rely on surveys or other research conducted by (or on behalf of) industry participants who have an interest in the outcome of the rulemaking. The Office of the Investor Advocate, an independent voice within the Commission, can provide impartial and professional investor testing capabilities.

## One. Streamlining the Shareholder Report

The Proposal takes a streamlined, layered approach to the annual shareholder report, which the Release estimates would go from more than 100 pages to just 3-4 pages. Importantly, almost none of the excised information would be lost. Instead, it would be moved online and accessible to the public. The changes would enable the shareholder report to focus on key information most relevant to retail shareholders: fund expenses, performance, illustrations of holdings, and material fund changes.

We support this layered approach, which would improve the chances that retail shareholders actually read the document. The length and complexity of current shareholder reports discourage shareholders from reading the document at all.<sup>3</sup> For those who do read the shareholder report, the dense content can make it difficult to find key information within the document.<sup>4</sup>

The Proposal would make three main changes to reduce the length of the report so radically. First, the rule would require each fund in a fund family to send a separate shareholder report, rather than the current practice of bundling shareholder reports for multiple series of a fund family into a single document. This would be a welcome improvement in the readability of the shareholder report, which currently forces readers to sort through dozens of pages to find those sections reporting on their specific fund. Even financially trained readers can find the multi-fund format time-consuming and cumbersome to navigate.<sup>5</sup>

Moreover, requiring a separate shareholder report for each fund in a fund family would be consistent with the rules for the summary prospectus.<sup>6</sup> The Proposal envisions that a revamped shareholder report would replace the annual mailings of the updated prospectus (which, in the overwhelming majority of cases, consists of the summary prospectus).<sup>7</sup> Were the Commission to permit bundled shareholder reports, that would amount to a step backward for investors.

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<sup>3</sup> The Tailored Shareholder Reports Proposing Release cites investor testing, surveys and other forms of feedback portraying retail shareholders as overwhelmed by the volume of fund disclosures. *Id.* at 9. Retail investors find the shareholder reports too long, complicated, and difficult to use. *Id.* at 19 and 22. As a result, many fund shareholders tend to read little if any of the fund disclosures. *Id.* at 23. Testing and surveys also show that retail investors would like concise shareholder reports focusing on certain specific topics, including performance, holdings and fund expenses. *Id.* at 25.

<sup>4</sup> *See Id.* at 425 (“Shareholder reports that include more information than the proposed content may also make it harder for shareholders to find key information within the report.”). *See also* Recommendation of the Investor Advisory Committee on Disclosure Effectiveness (May 21, 2020) (“IAC Disclosure Effectiveness Recommendation”), available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/disclosure-effectiveness.pdf> (“[P]roviding more information, even when that information is accurate and relevant, may actually cause investors to make less use of the information.”).

<sup>5</sup> The following may serve as an illustrative example. While working on this comment letter, the author happened to receive a new shareholder report. The 174-page document combined the reports of 16 funds. Sections relating to the author’s particular fund were interspersed throughout the document, requiring some persistence to scroll through the document in search of particular content. For example, the line graph of performance appeared on p. 16; the shareholder expense example, on p. 157; and so on.

<sup>6</sup> Funds are permitted to bundle multiple series in the statutory prospectus, but are required to present a separate summary prospectus for each individual fund.

<sup>7</sup> *See* Tailored Shareholder Reports Proposing Release, *supra* footnote 2 (noting that an estimated 93% of mutual funds and ETFs use summary prospectuses).

Second, the Proposal would remove certain content—including the schedule of investments and financial statements—from the shareholder report and move it online, both on a website accessible to the public and in filings to the SEC. This layered approach is the most efficient way to satisfy multiple readerships with different interests, needs and levels of financial sophistication. In the words of the SEC Investor Advisory Committee:

Layering of disclosures offers a key way to resolve the tension between the demand for comprehensive information (to inform the market and more sophisticated users, to comply with legal obligations, and to address liability concerns) and the need to communicate clearly to retail investors.<sup>8</sup>

This is a far better approach than simply eliminating the information altogether. While certain information may be of little interest to many retail investors, it may inform investment professionals, other fund companies, and regulators and, through them, may inform the market as a whole. Thus, retail investors can benefit indirectly from disclosures even if they themselves do not read them.<sup>9</sup>

Third, the Proposal would proscribe certain non-essential content, such as the fund president’s letter to shareholders and interviews with portfolio managers. The Proposal generally would prohibit all content unless it is expressly permitted or required. In addition, the Proposal would emphasize that content should be brief and focused on key information.

## **Two. Content Changes in the Shareholder Report**

The Proposal also would make changes to the content that would remain in the shareholder report.

### ***The Expense Table***

Under this Proposal, the expense table would appear prominently near the beginning of the shareholder report. That is a marked improvement over the current placement, which allows for the expense table to be buried deep within a lengthy document.<sup>10</sup> Also, the Proposal would eliminate one of two expense tables. Shareholder reports currently are required to present two expense tables, both in dollar terms: first, a table based on actual returns, and second, a standardized table based on a hypothetical 5% return. The latter allows investors to compare fees (expressed in dollar amounts) across funds, regardless of a fund’s actual returns. The Proposal would eliminate this second, hypothetical table. In its place, the first fee table would add a new column showing expenses in percentage terms. This new figure—also called the expense ratio—would enable investors to compare expenses across different funds, thus obviating the need for a standardized second table based on a hypothetical return.

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<sup>8</sup> See IAC Disclosure Effectiveness Recommendation, *supra* footnote 4.

<sup>9</sup> See Recommendation of the Investor Advisory Committee Regarding Mutual Fund Disclosure (Apr. 14, 2016), (“IAC Recommendation on Mutual Fund Cost Disclosure”), available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-mf-fee-disclosure-041916.pdf> (“Even investors who do not themselves read disclosures can benefit indirectly if improved transparency leads to beneficial market competition.”) See also Stephen J. Choi and A.C. Pritchard, *Securities Regulation: Cases and Analysis*, Fifth Edition (2019), at 546 (explaining how mandatory prospectus disclosures may protect retail investors even if they do not read them).

<sup>10</sup> See *Id.*, IAC Recommendation on Mutual Fund Cost Disclosure, (“Unlike the prospectus disclosures, which come at the start of the document, the shareholder report disclosures may be found at the back of the report at the end of many pages of dense data.”).

**Recommendation One: The Commission should prescribe the formatting of the expense table in the shareholder report as it appears on page 70 of the Release (with bolded borders, text and numbering applied to the columns “Costs paid” and “Costs paid as a percentage of your investment” to make them appear more prominent).**

The Proposal would make two additional changes to clarify the impact of expenses on the shareholder’s investment performance. First, the Proposal would add a new column showing “Total return before costs paid.” Second, funds would be required to display two of the columns – “Costs paid” and “Costs paid as a percentage of your investment”—with greater prominence than the other columns. We support these changes as likely to enhance the salience of key data points for retail investors.

We note, however, that the format of the table in the body of the Release<sup>11</sup> differs from that in the mockup of a hypothetical annual report.<sup>12</sup> We find the formatting of the former far more effective in achieving prominence for those two columns.<sup>13</sup> Greater prescriptiveness in the formatting standard will ensure that the select data points—costs paid in dollar and percentage terms—gain the prominence intended.

### ***Changes in Auditors***

Another content change would streamline the discussion of any changes in and disagreements with the independent auditor. Currently, if the independent auditor has resigned or was dismissed, funds are required to disclose the circumstances surrounding the dismissal or resignation. Funds also must disclose whether in the fund’s two most recent fiscal years there were certain accounting-related disagreements with the former auditor, and other related information. The Proposal would require a high-level summary of this information in the shareholder report, while moving the full disclosure to an SEC filing (on Form N-CSR).<sup>14</sup>

We strongly support the Commission’s decision to retain a disclosure requirement in the annual shareholder report whenever its independent auditor resigns or is dismissed. A change of auditor can serve as a red flag alerting investors to critical risks, ranging from overly aggressive accounting treatment to misleading and fraudulent financial reporting. We share the Commission’s belief “that retaining this

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<sup>11</sup> See Tailored Shareholder Reports Proposing Release, *supra* footnote 2, at 70.

<sup>12</sup> For the hypothetical annual report, *see Id.*, Appendix A, and the free-standing Hypothetical Streamlined Shareholder Report prepared by SEC staff, available at [https://www.sec.gov/files/final\\_2020\\_im\\_annual-shareholder%20report.pdf](https://www.sec.gov/files/final_2020_im_annual-shareholder%20report.pdf).

<sup>13</sup> See Tailored Shareholder Reports Proposing Release, *supra* footnote 2, at 70. In the body of the Tailored Shareholder Reports Proposing Release, the borders of the two prominent columns are formatted in bold, as is the text within the column and the numerals themselves. In the mock-up, however, only the numerals appear in bold. It can be difficult to discern the bolding, at least on a tablet, without zooming in on the image. Thus, the two columns in question may appear no more prominent than the others, at least on first inspection.

<sup>14</sup> Specifically, the fund would have to include in its annual report: (1) a statement of whether the former auditor resigned, declined to stand for re-election, or was dismissed and the date thereof; and (2) a brief, plain English description of disagreement(s) with the former auditor during the fund’s two most recent fiscal years and any subsequent interim period that the fund discloses on Form N-CSR. *Id.* at 147.

disclosure in funds' shareholder reports in summary form continues to be important because this would put investors on notice of the dismissal or resignation of an [independent] accountant and the existence of a material disagreement with that accountant."<sup>15</sup>

### *Summary of Material Changes*

**Recommendation Two: The Commission should consider 1) requiring funds to explain why any material changes occurred or 2) expressly permitting, and perhaps encouraging, an optional explanation.**

The Proposal would add a new section to the shareholder report summarizing material changes that occurred during the year.<sup>16</sup> The Proposal would prescribe a list of material changes that the fund would be required to disclose, including changes to a fund's principal investment strategy, principal risks, or fees.<sup>17</sup> We support this addition, but note that the Proposal would not require the fund to explain why a material change occurred. Investors also need to understand why any material changes occurred.<sup>18</sup>

### *A Broad-based Market Index and a Strategy-specific Benchmark*

The Proposal would require all funds to compare their performance to an "appropriate broad-based securities market index" in both the shareholder report and the prospectus.<sup>19</sup> The Proposal would clarify that the broad-based index must represent the overall domestic or international equity or debt markets applicable to the fund. This blanket requirement would apply to all funds, even narrow funds that invest only in a specialized segment of the overall market. In addition, funds would be permitted, but not required, to present additional benchmarks that more closely match their investment strategy.<sup>20</sup> We believe the rule should require both types of disclosure.

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<sup>15</sup> The text uses the word "accountant," not "auditor," but explains that this refers to "the independent accountant who was engaged as the principal accountant to audit the fund's financial statements, or an independent accountant who was previously engaged to audit a significant subsidiary and on whom the principal accountant expressed reliance in its report." *Id.* at n.293 and surrounding text.

<sup>16</sup> *Id.* at 132-141.

<sup>17</sup> *Id.* at 132-133.

<sup>18</sup> It is possible that the required disclosure of material changes could trigger concerns among funds of a perceived increase in liability risk. Requiring an explanation of why the material change occurred could further heighten those concerns. In a worst-case scenario, this could have the perverse effect of discouraging funds from deeming a given change as material and, therefore, subject to the disclosure requirement. This points to a common dilemma in rulemaking: a new rule may have an unintended chilling effect on the very action it is designed to elicit. As with any new rule, however, such doubts must be weighed against the benefits. In this case, permitting but not requiring explanations of why material changes occurred may mitigate any potential chilling effect.

<sup>19</sup> In the annual shareholder report, the Management Discussion of Fund Performance must include a line graph comparing the fund's performance to that of an appropriate benchmark. The prospectus includes a table comparing fund performance to that of the broader market.

<sup>20</sup> See Tailored Shareholder Reports Proposing Release, *supra* footnote 2, at 98 (noting that a fund would not satisfy the disclosure requirement by presenting an index "in a particular sector, industry, geographic location, asset class, or strategy (e.g., growth or value indexes).")

**Recommendation Three: The Commission should require, and not merely permit, disclosure of one or more additional benchmarks appropriate to the fund’s investment strategy, for purposes of the prospectus and annual shareholder report (unless the fund’s strategy is to mimic the market).**

Performance comparisons should help investors answer two key questions. First, how well was the fund managed in its specific investment strategy? Second, how did the fund perform against the broader market? To answer the first question, the investor should compare the fund’s performance to that of a benchmark that matches the fund’s investment strategy. But that will tell just part of the story. Even if a fund outperforms its benchmark, that may be slight consolation if the strategy itself performs poorly against the market. Therefore, the investor should also compare a fund’s returns against the market as a whole.

Consider, for example, a specialized fund that invests in a particular market segment. Suppose that the fund returned 5%, the market segment returned an average 3%, and the overall market returned 10%. Thus, the fund outperformed its benchmark. It did a good job under the constraints of its investment strategy, but the investor may wish to reassess the strategy itself. Put another way, it would be unfair to judge the performance of the portfolio manager against the broader market, but it would be valid to assess how the strategy itself fared against the broader market.

To gain a more complete the picture, investors would need to see the supplemental disclosure of a strategy-specific benchmark as well as the required disclosure of an overall market index.

**Recommendation Four: The text of any final release of the rule should distinguish between a benchmark and a broad-based market index and should not refer to one as the other.**

We would also draw a sharp theoretical distinction between a market-wide index and a benchmark. In our view, an appropriate benchmark must reflect the investment mandate, objective, or strategy of the fund. This definition of an appropriate benchmark comports with the Global Investment Performance Standards (GIPS®), which are the recognized standard for calculating and presenting investment performance around the world.<sup>21</sup> A market-wide index should not be confused with an appropriate benchmark.

### **Three. Sharpening the Distinction between the Prospectus and Shareholder Report**

The Proposal would sharpen the distinction between the prospectus, a document intended for new and prospective investors, and the shareholder report, which would become the primary source of disclosures that existing shareholders receive each year.<sup>22</sup> As result, funds would no longer be required to send

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<sup>21</sup> To comply with the GIPS standards, a fund’s benchmark must reflect the investment mandate, objective, or strategy of the fund. As of December 2020, CFA Institute has partnered with organizations in more than 40 countries and regions that contribute to the development and promotion of the GIPS standards.

<sup>22</sup> We agree with the Tailored Shareholder Reports Proposing Release in stating: “As a preliminary matter, fund prospectuses and shareholder reports have historically served different purposes. The prospectus acts as the principal selling document for investors to inform investment decisions and facilitate fund comparisons. The shareholder report, on the other hand, provides information to a fund’s current shareholders about the fund’s operations and



annual updated prospectuses to existing shareholders (provided that funds meet certain conditions).<sup>23</sup> We generally agree that this distinction should improve the readability of both documents by allowing each to focus on key information tailored to its audience.

In addition, the Proposal would make the prospectus more understandable to retail investors by modifying two key elements: the fees and expenses table and disclosure of fund risks. We discuss each in turn.

### ***Fees and Expenses Table***

The table headings would be changed to plain-English terms. For example, Maximum Sales Charge becomes Purchase Charge, and Maximum Deferred Sales Charge (Load) becomes “Exit Charge,” and “redemption fees” would become “early exit fees.” We believe these changes will improve clarity and transparency.

**Recommendation Five: The term “Distribution [and/or Service] (12b-1) Fees” should be replaced by “marketing fees.”**

In another change, the term “Distribution [and/or Service] (12b-1) Fees” would be renamed “selling fees.”<sup>24</sup> We agree that the current term may be meaningless to the lay reader. However, the proposed alternative, “selling fees,” could be misinterpreted as referring to the fees an investor incurs when redeeming her shares. The term “marketing fees” might avoid this confusion.

In an example of layering, a new simplified fee summary would replace the current fee table in the summary prospectus. The existing fee table would be moved to the statutory prospectus (with the updated terms as in the fee summary). We believe these improvements will enhance conciseness and focus readers on key of information.

**Recommendation Six: The Commission should 1) require online disclosure of transaction costs, research costs and best execution policies, and 2) establish a standard method of calculation of transaction costs if necessary.**

The Commission should take the opportunity to enhance disclosure of best execution policies and transaction and research costs. The disclosures should appear in the prospectus or another online document. We elaborated on our reasoning in a previous joint comment letter on the Proposal.<sup>25</sup>

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performance during the past fiscal period. Moreover, the shareholder report and prospectus present certain of the same types of information (e.g., fund performance and expenses) differently in light of their intended audiences.” See Tailored Shareholder Reports Proposing Release, *supra* footnote 2 at 42.

<sup>23</sup> *Id.* at 227.

<sup>24</sup> For a table showing current and proposed captions or terms, see *Id.*, Table 6 at 292.

<sup>25</sup> See Comment Letter of Healthy Markets, Council of Institutional Investors and CFA Institute on File No. S7-09-20, (Nov. 6, 2020), available at <https://www.sec.gov/comments/s7-09-20/s70920-7998614-225227.pdf>.

The Release cautions that, according to some reports, European efforts to require transaction cost disclosures have resulted in confusing and counter-intuitive disclosures flowing from disparate methods of calculating costs. To address that issue, we would suggest that the Commission establish a standard method of calculation if necessary.

### ***Risk Disclosures***

The Proposal would permit funds to disclose principal risks only, and to present them in order of importance, not alphabetically. These changes should substantially enhance the readability of the disclosure and facilitate investors' understanding of a fund's specific risks. Excessive and uninformative lists of generic risks serve only to obscure the most pertinent ones and to deter retail investors from reading the disclosure at all.

Some commentators may object that the ranking requirement will place funds in an untenable position, because it is impossible to know in advance which specific risks, out of a pool of many potential risks, will emerge as having the greatest impact in reality. While no one can predict the future (as this year has proved in ways few could have imagined), that should not deter funds from making their best efforts to list their principal risks in order of importance.

The Proposal would define a new quantitative standard to determine whether a risk is a principal risk. Specifically, a principal risk would be defined as one that places more than 10% of the fund's assets at risk or is reasonably likely to do so in the future. This strikes us as a reasonable definition. In any bright-line rule, precisely where to draw the line can seem arbitrary. For example, why not draw the line at 8% of assets at risk, or 11%, or some other number? The advantage of the bright line, however, is that it provides a measurable and objective standard.

We acknowledge the potential for the proposed 10% standard to produce anomalous results. For example, a narrow, highly specialized fund could have concentrated exposure to a small number of undiversified risks. A highly diversified fund, in contrast, could have exposure to a broader range of risks, with each affecting around 10% of assets. As a result, under this Proposal the specialized fund might disclose a much smaller number of risks than the diversified fund. That could lead to the misimpression that the specialized fund presented less risk to the investor, when in fact it presented a much higher level. To allay any such misimpression, however, the diversified fund could explain the advantages of exposure to multiple factors that, in aggregate, actually limit the overall risk. Therefore, we believe that on balance the advantages of the proposed 10% standard would outweigh any potential drawbacks. The Commission should not allow any potential anomalies to derail the proposed standard; to do so would be to make the perfect the enemy of the good.

**Recommendation Seven: The Commission should require that the shareholder report include at least a high-level reference to the fund's risk.**

Unlike the prospectus, the shareholder report would have no mandated discussion of risks other than 1) any risks that may appear in the discussion of material fund changes and 2) in certain cases, a streamlined discussion of the fund's liquidity risk management program. This fits with the Proposal's aim to reduce redundancies between the shareholder report and the prospectus. Nonetheless, certain matters may merit inclusion in both documents, because they convey key information that is material both for new and

existing shareholders. Risk disclosures, in our view, are a case in point. Moreover, an investor's risk profile can change from year to year, even if most of the fund's risks stay the same.<sup>26</sup> Therefore, it is a useful exercise for investors to review the risks of their mutual funds each year in light of their own current risk profile.

This would suggest that annual shareholder reports—intended as the “central source of fund disclosure” for existing investors—include at least some mention of the fund's risks. To omit that discussion would be to place the onus on the individual investor to undertake a multi-step analysis to match her individual risk profile with that of the fund.<sup>27</sup> These considerations suggest that there would be benefits to requiring some disclosure regarding the fund's principal risks in the annual shareholder report.

To avoid overburdening the document, the disclosure could at least provide a concise notice about risk. For example, a simple statement could 1) suggest that shareholders review fund risks in light of their own risk profile on an annual or regular basis; and 2) explain where in the prospectus to find the discussion of the fund's principal risks (providing a link and a contact number to request a paper copy).

**Recommendation Eight: The Commission should consider requiring the annual shareholder report to present both a line graph of returns in dollar terms and a bar chart of the annual percentage change in returns.**

As another indication of risk, we would suggest that the Commission reconsider adding a requirement for the shareholder report to include a bar chart showing the percentage change in annual returns, in the same format as that presented in the prospectus. As the Release explains, the Commission considered but rejected the alternative of replacing the required line graph of cumulative returns with the bar graph.<sup>28</sup> Nonetheless, the Commission recognized that the bar chart shows the variability of a fund's returns more clearly than the line graph. We agree. The bar chart is a visually compelling and intuitive way to present volatility, which constitutes one of the key risks of a fund.<sup>29</sup> Instead of replacing the line graph, the bar chart should accompany it.

**Recommendation Nine: The Commission should require online disclosure of 1) a fund's standard deviation of return and (2) correlations of the fund's returns with those of one or more standard indexes.**

<sup>26</sup> It is helpful to view an investor's risk appetite as a combination of the willingness and ability to take on risk. Both aspects will be expected to change dramatically over an investing lifetime.

<sup>27</sup> The investor would need to 1) review the fund's current full set of principal risks, as presented in the prospectus; 2) consider any changes to the fund's principal risks in the past year, as reflected in the section on material fund changes in the shareholder report; 3) assess the investor's own risk profile, which may have changed in the past year; and 4) determine whether the latest set of fund risks aligns with the investor's investing goals and risk profile.

<sup>28</sup> The Commission determined that, on balance, the line graph was the more beneficial disclosure because it showed the cumulative growth of returns in dollar terms. See Tailored Shareholder Reports Proposing Release, *supra* footnote 2, at 94-95.

<sup>29</sup> In their comment letter on the Proposal, the Independent Trustees of the Morningstar Funds Trust make the same suggestion, arguing that the “chart provides investors with a very quick and easily digestible assessment of the volatility of returns.” Independent Trustees of the Morningstar Funds Trust, Comment Letter (Oct. 20, 2020) at <https://www.sec.gov/comments/s7-09-20/s70920-7923217-224588.pdf>.

Finally, we believe that sophisticated investors would benefit from online disclosure of two additional risk measurements: a fund's standard deviation of return and correlations of the fund's returns with those of one or more standard indexes. These disclosures would enable investors to make more informed investment allocations, especially with respect to exotic funds with less clear risks and correlations. The disclosures could be made either in the prospectus or another of the documents available online.

#### **Four. Delivery: Back to Paper as the Default Option**

This Proposal would again make paper delivery of shareholder reports the default option for open-end funds and ETFs. To that end, the Proposal would exclude open-end funds and ETFs from the scope of Rule 30e-3. That rule permits such funds to post shareholder reports online and to mail notices to shareholders notifying them of online availability, rather than mailing the document itself. Funds complying with certain conditions can start to rely on Rule 30e-3 beginning as early as January 1, 2021. Many funds have been preparing to do so since the rule was adopted in 2018.

In our view, Rule 30e-3 made sense as an alternative to the prevailing practice of mailing of 100-plus shareholder reports to retail investors, many of whom did not even read the reports. That practice represented a substantial waste of paper and a cost to mutual funds and ETFs—costs ultimately borne by the shareholders themselves.

This Proposal, however, would change the context upon which Rule 30e-3 was predicated and, therefore, removes the justification for that rule. As noted above, the length of the proposed shareholder report would be expected to fall from more than 100 pages to just three or four. Moreover, the Proposal envisions the shareholder report as becoming the central source of fund disclosure for existing shareholders. It is meant to highlight key information that is most important to retail investors. Under these changed circumstances, we agree with the Commission that a return to the default of mail-based paper delivery of shareholder reports is the best way to “ensure that all fund investors would experience the anticipated benefits of the proposed new tailored disclosure framework.”<sup>30</sup> The thoroughly revamped shareholder report deserves a chance to take hold and gain acceptance as the central document that existing investors will actually read.

#### **Five. Updated Rules on Advertising and Sales Literature**

We applaud the Commission in proposing to update the rules governing advertising and sales literature of all registered investment companies.<sup>31</sup> Fee disclosures deserve special regulatory attention, both because of their significant long-term impact on investment returns, and because of the trend for some funds to market their investment products based on claims of low or no fees.

The Proposal specifically addresses advertisements that may mislead investors by creating an inaccurate impression of the costs associated with an investment. Specifically, the Commission highlights increasingly common claims of “no fee,” “zero fee,” or low fee accounts, based solely on information in the prospectus fee tables and with no additional disclosure that investors or the fund may incur other

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<sup>30</sup> See Tailored Shareholder Reports Proposing Release, *supra* footnote 2, at 39.

<sup>31</sup> The Proposal would require that, if a fund mentions fees and expenses in ads or sales literature, the presentations must be consistent with relevant prospectus fee table presentations and be reasonably current. The scope of the Proposal would encompass not only to open-end mutual funds and ETFs, but also closed-end funds and business development companies. *Id.* at 42.

costs. The Release cites several examples of extra costs that are omitted from the prospectus fee table, including wrap fees, intermediary fees, and transaction or ongoing fees that are collected by the adviser's affiliates.

The ideal disclosure would be a single, all-inclusive, bottom-line number showing the total amount of all fees that the investor can expect to pay. That, however, may not be feasible, especially if third parties charge fees that are outside the control, or even the knowledge, of the fund itself.<sup>32</sup> Nonetheless, at a minimum funds should be required to disclose the possibility or reality of additional external fees, even if the fund cannot calculate the amount.

In conclusion, we agree with the Commission that the proposed updates to the advertising rules will promote transparent and balanced presentations of fees and expenses in investment company advertisements.<sup>33</sup>

### **Six. The Need for Independent Investor Testing**

The Proposing Release draws on previous investor research and makes good use of the precepts of effective disclosure design.<sup>34</sup> The Commission has not, however, subjected the proposed disclosure changes to independent investor testing conducted (or overseen) by Commission staff.<sup>35</sup>

**Recommendation Ten: The Commission should direct its staff to conduct its own investor testing on the proposed changes – either before the Commission moves to final adoption of the rule or in a post-implementation staff study.**

Investor testing produces insights that cannot be obtained through surveys, focus groups, or other forms of self-reported feedback (including formal comment letters) that rely on self-reported opinions and

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<sup>32</sup> A recent experience may serve to illustrate the challenges that retail investors face in understanding the true cost of fees and expenses. The author of this comment letter noticed that one of the mutual funds in his portfolio offers three share classes. To his surprise, his investment adviser had not placed him in the share class with the lowest fees. Asked why not, the adviser explained in general that exchanging shares into a purportedly less expensive share class would incur transaction charges and possibly make the account subject to early redemption fees. Therefore, the adviser exchanges into a lower share class only if the reduction in fees outweighs the other costs. The client then reviewed the prospectus, which stated that the fund charged no transaction or early redemption fees for any of the share classes. When he queried his adviser once again, the adviser explained that, even though the fund would not charge these fees, the broker-dealer where the account was custodied would levy those fees.

<sup>33</sup> See Tailored Shareholder Reports Proposing Release, *supra* footnote 2, at 321.

<sup>34</sup> The past research includes independent investor testing conducted (or overseen) by the SEC staff itself. See Investor Testing of Selected Mutual Fund Annual Reports (Feb. 9, 2012) and SEC Staff, Study Regarding Financial Literacy Among Investors (Aug. 2012). *Id.* at n.26 and accompanying text. In addition, the Proposal is informed by the Division of Investment Management's commendable multi-year outreach initiative to retail investors. *Id.* at 18 (referencing the Fund Investor Experience RFC).

<sup>35</sup> See Commissioner Allison Herren Lee, Statement on Proposed Summary Shareholder Report (Aug. 5, 2020), at <https://www.sec.gov/news/public-statement/lee-open-meeting-summary-shareholder-report-2020-08-05> (“[E]xisting research related to disclosure effectiveness and investor preferences...is not a replacement for actual investor testing of the disclosure that we propose to require”).

preferences. Investor testing, in contrast, seeks objective measurements of the effect of disclosures on investor understanding and actual behavior.

Importantly, investor testing allows for the comparison of multiple versions of a document to determine which one is optimal. As a result, investor testing can help the Commission to determine not only whether the proposed disclosures are more effective than current requirements, but whether they are the most effective disclosures among a range of the best alternatives.

The Commission should carefully weigh the advantages of conducting pre-adoption independent investor testing with the potential disadvantage of a delay in adopting the final rule. This is a difficult policy choice, because we believe that the Proposal as is would significantly enhance the disclosure framework.

Should the Commission decide to adopt the Proposal without further investor testing, we recommend that it require a staff study with recommendations within two or three years of implementation of the rule. As a mandatory component of the study, the staff should conduct (or supervise) independent investor testing. This iterative approach would be in line with disclosure design best practices and a recommendation of the SEC Investor Advisory Committee.<sup>36</sup>

**Recommendation Eleven: Going forward, the Commission should 1) integrate investor testing at an early stage into all future rulemakings on retail investor disclosures; 2) conduct its own independent investor testing; and 3) deploy the objective research capabilities of the Office of the Investor Advocate in those efforts.**

Involving investor testing early in the rulemaking process accords with best practices in disclosure design.<sup>37</sup> It is also important for the SEC to conduct its own investor testing, rather than relying on research by (or on behalf of) industry participants who have an interest in the outcome of the rulemaking.<sup>38</sup> No matter how good their research, there will always be the perception, if not the reality, that it is less than independent.

Objectivity may also prove challenging for regulatory agencies when they conduct investor research on the very rulemaking policies that they are crafting.<sup>39</sup> For this reason, we urge the Commission to rely on the objectivity and investor testing capabilities of its Office of the Investor Advocate.<sup>40</sup> As its name implies, the Office of the Investor Advocate was designed by Congress to serve as an independent voice

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<sup>36</sup> See IAC Disclosure Effectiveness Recommendation, *supra* footnote 4 (recommending an iterative process incorporating research, design, investor testing, revision, and retesting).

<sup>37</sup> See *Id.* (citing expert testimony and recommending, “Experts in disclosure design should be involved in the disclosure development process from the beginning, working hand-in-hand with legal experts.”).

<sup>38</sup> See Commissioner Lee Statement, *supra* footnote 35 (“[W]e should undertake our own investor testing to ensure that rules are properly designed for retail investors.”).

<sup>39</sup> See SEC, Office of the Investor Advocate, Report on Activities, Fiscal Year 2020 (Dec. 29, 2020) at 12-18, at <https://www.sec.gov/advocate/reportspubs/annual-reports/sec-investor-advocate-report-on-activities-2020.pdf> (“Office of the Investor Advocate Report”) (“It can be tempting for policymakers to conduct research that is designed to provide data that supports a predetermined policy outcome.”).

<sup>40</sup> In the interest of full disclosure, we note that the author of this comment letter previously worked in the Office of the Investor Advocate.

for investors.<sup>41</sup> It has developed its own investor testing capabilities, in line with its statutory authority to conduct research,<sup>42</sup> and has explored mutual fund disclosures in particular.<sup>43</sup> Going forward, we encourage the Commission to make greater use of the investor research capabilities of this office and to protect the objectivity of its research.

### **Conclusion**

The Proposal would constitute a major restructuring of the disclosure framework for funds and, in our view, a major improvement. We generally believe the proposed changes would make it considerably more likely that retail investors actually read the disclosures, access and understand key information, and use it in their investment decisions. That said, there are several areas where we recommend further improvements.

Should you have any questions, please do not hesitate to contact Stephen Deane, CFA, at

[REDACTED].

Sincerely,

*/s/ Stephen Deane*

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<sup>41</sup> The Office of the Investor Advocate was established pursuant to Section 915 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Exchange Act Section 4(g), 15 U.S.C. § 78d(g). See also Office of the Investor Advocate Report, *supra* footnote 39, at 12-18, (describing the Office’s investor testing capabilities).

<sup>42</sup> *Id.* at 12-18 and 51-66 (“[W]e can conduct research to determine the optimal ways to deliver and present information to investors.”).

<sup>43</sup> *Id.* at 54.