May 21, 2004

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

Re: File No. S7-12-04; Proposed Rule: *Disclosure Regarding Portfolio Managers of Registered Management Investment Companies*

Dear Mr. Katz:

Morningstar, Inc. ("Morningstar") is pleased to provide comments on the Securities and Exchange Commission's (the "Commission") proposed rule, *Disclosure Regarding Portfolio Managers of Registered Management Investment Companies* (the "proposal"). This proposal would amend rules under the Investment Company Act of 1940 to improve the disclosures by registered management investment companies regarding their portfolio managers.

Overall, we wholeheartedly support the proposal, which should make it easier for investors to determine who is managing a mutual fund and whether the interests of those individuals are sufficiently aligned with those of fund shareholders.

Thank you again for the opportunity to express our views regarding this important proposal. We offer the following specific comments:

<u>Identification of Portfolio Management Team Members</u>

- *Should we require identification and disclosure with respect to all of the members of a portfolio management team or only certain members, e.g., the lead member?*

- *Are the proposed disclosure requirements regarding members of portfolio management teams appropriate? Should all of the proposed disclosure requirements be required with respect to every member of a portfolio management team? Is "jointly and primarily responsible" the appropriate standard to use in connection with portfolio management teams or should we use a different standard?*

  We do not believe that a fund should identify every single member of a portfolio management team. Rather, a fund should identify those persons who are directly responsible for security selection and portfolio construction. These individuals, whose decisions have the greatest bearing on the fund's success, are likely to be of primary interest to investors.

  Several questions are likely to arise in applying such a standard. For example, would an individual who *oversees* the security selection or portfolio management processes, but who does not contribute to day-to-day portfolio management decisions, be considered a manager of the fund? In such situations, we believe that accountability for the fund's performance should dictate whether such an individual is listed as manager. While a number of factors, including the structure of compensation, denote such responsibility, the fund's board of directors has the ultimate say in such matters. Thus, the individuals named as managers of the fund should correspond *exactly* to the list that the fund's board uses in evaluating the fund's performance.

  Of course, this approach presumes that the board's list is complete and accurate. Thus, we suggest that the Commission provide guidance on factors that a board should consider when determining who should be designated manager of a fund. For example, the Commission could suggest that a board consider which persons it would hold responsible if the fund were to perform poorly over a long stretch. That is, who would the board fire in such a situation? We believe this rule of thumb is useful in that it forces the board to focus on determining the identity of individuals who are truly responsible for a fund's performance. After all, why would a board terminate an individual who had only a secondary, or even tertiary, role in managing the fund's affairs? This, we also believe, would have the salutary effect of removing "figureheads", who have no real responsibility for the fund's success but are perhaps admired for their achievements or longevity elsewhere, from the listing of managers.

Another implementation issue arises in situations where portfolio management responsibility is diffused across a large number of individuals. For instance, some funds are managed by a group of analysts at the firm, with each analyst responsible for contributing a specified number of "picks" for use in the portfolio. It isn't clear from the proposal language whether the Commission's "jointly and primarily responsible" standard contemplates listing each and every one of these individuals, a potentially lengthy list which would often be in flux due to more frequent personnel turnover at the analyst level. We believe that a more prudent approach is to set a de minimis threshold, perhaps stated as a percentage of assets directly managed, that would trigger disclosure of the individual's name.

- *Should we require any additional information to be disclosed concerning portfolio management teams and their members, such as information about the team's structure and decision-making process?*

  The Commission also should consider additional disclosures describing the following:

  - ✓ *How the team is structured*. For example, does one member of the team have greater authority than others? How are decisions typically made – by committee; in a decentralized way; etc.? How many analysts, if any, are assigned to the fund? Who do analysts report to – the portfolio managers or another party?
  - ✓ *How responsibilities are divided.* What is each portfolio manager responsible for doing? Do analysts generalize or specialize on a narrow segment of the market? Are analysts dedicated to the fund, or do they support a number of other products?
  - ✓ *Aggregate staffing, tenure, and personnel turnover data.* What is the median and mean analyst tenure at the firm? What is the median and mean analyst tenure in the money management industry (considering only relevant prior experience)? How much analyst turnover has there been in each of the previous three fiscal years, stated as a percentage?

- *Is the fund prospectus the appropriate location for the proposed disclosure regarding members of portfolio management teams, or should this disclosure be provided in other locations, e.g., SAI, shareholder reports, or Form N-CSR?*

  We believe that the prospectus is the appropriate location for disclosure regarding the name, title, length of service, and business experience of each manager. Additional disclosure concerning the team's structure, division of responsibilities, and personnel turnover should be placed in the SAI. The prospectus disclosure should refer to the availability of this supplemental information in the SAI.

<u>Disclosure Regarding Other Accounts Managed, Potential Conflicts of Interest, and Policies and Procedures to Address Conflicts</u>

- *Are our proposed disclosure requirements with respect to other accounts managed by a portfolio manager appropriate? Is there any additional information about these other accounts that we should require to be disclosed? For example, should we require funds to identify some or all of the other accounts managed by their portfolio managers?*

  We do not believe it is necessary for funds to identify the other accounts managed. The Commission's overarching objective should be to transparently disclose any potential conflicts that may arise. To fulfill this objective, the Commission must ensure that funds describe these potential conflicts in a specific, but non-technical manner. Namely, the fund should place itself in the position of a novice investor who is concerned about whether his/her interests will be looked after or simply wishes to determine what conflicts might come to bear on the fund's manager. Legal boilerplate that describes potential conflicts in only the vaguest of terms, such as the utterly inscrutable language often used to describe "soft-dollar" and "shelf-space" arrangements, is unlikely to resonate with investors.

- *Are our proposed disclosure requirements with respect to conflicts of interest that may arise in connection with managing a fund and managing other accounts appropriate? Is there any additional information that we should require with respect to these potential conflicts of interest? Should we require disclosure with respect to actual conflicts of interest that occurred as a result of managing a fund and other accounts? If so, where?*

  The Commission should consider requiring additional disclosures that set forth the various types of incentives that managers can receive for running different types of accounts. For example, if a manager is likely to get a larger payout from a hedge fund that he/she also runs, what safeguards are in place to ensure that the hedge fund won't receive preferential treatment over a mutual fund? Similarly, if a manager's bonus for running a separate account is dependent on hitting specified performance targets but his/her compensation for managing a mutual fund is driven by asset growth, how does the manager's approach differ between the two vehicles? In addition, how does the firm ensure fair dealing when the manager runs accounts of varying sizes? For example, how are allocations of IPO shares handled and how are trades prioritized?

- *In the case of a fund with a portfolio management team, should we require the proposed disclosure regarding other accounts managed by a portfolio manager with respect to every member of the team or only certain team members, e.g., the lead member?*

  As stated above, we do not believe it's prudent to disclose the name of every member of a fund's management team. Investors are only likely to be interested in the persons who are primarily responsible for the fund's success. As such, we believe the proposed disclosure regarding other accounts managed by a portfolio manager should extend only to the persons who are directly responsible for final investment decisions.

- *Is the SAI the appropriate location for the proposed disclosure regarding other accounts managed by a portfolio manager, or should this disclosure be provided in other locations, e.g., prospectus, shareholder reports, or Form N-CSR?*

  We believe that the SAI is the appropriate location. However, the Commission should also consider requiring a fund to disclose such conflicts as an additional "risk" in the fund's prospectus. The disclosure could describe the risk in general terms and refer readers to the fund's SAI for further details regarding the policies and procedures that are designed to safeguard shareholders from harm.

- *Is disclosure of the potential conflicts in this area sufficient or should the Commission prohibit portfolio managers of registered management investment companies from managing certain types of accounts?*

  We do not believe that prohibition of side-by-side management is warranted, as such a move could cause a significant dislocation of management in the mutual fund industry. While the onus should remain on fund companies to adopt policies and procedures that reduce the potential harm suffered by shareholders from such conflicts, we believe that the loss of talent and other costs associated with an outright ban outweigh the benefits that investors would accrue.

  That said, it is imperative that the Commission address the potential for conflict--which is considerable when a manager runs multiple accounts pursuant to untenable objectives--in a way that makes it possible for a novice investor to appreciate and act upon the information provided. Unnecessarily opaque or legalistic language will serve little purpose other than to clutter the SAI. For that reason, we believe the Commission should strongly consider providing examples of disclosures that exemplify transparent disclosure of conflicts and the policies and procedures designed to protect investors from harm.

Disclosure of Portfolio Management Compensation Structure

- *Is our proposed requirement that a fund disclose the structure of, and the method used to determine, the compensation of each portfolio manager appropriate? Is there any additional information about portfolio manager compensation that we should require to be disclosed? Should we require disclosure of the actual amount of compensation paid to a portfolio manager?*

  Morningstar enthusiastically supports the Commission's proposed requirement that a fund disclose the structure of, and the method used to determine, the compensation of each portfolio manager.

  Morningstar Managing Director, Don Phillips, put the case for enhanced disclosure of portfolio management compensation structure this way in his testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on February 25, 2004:

  > All investors deserve to know if their interests are aligned with management's. Every week, we speak with mutual fund portfolio managers who tell us that before they buy stock in a company, they look to see how management is compensated. They want managers who "eat their own cooking" and whose interests are aligned with theirs. That's why institutional equity managers have long demanded and received detailed information about senior corporate executives' compensation and their holdings of company stock. In fact, stock investors would protest loudly if this information were denied to them. Why, then, are fund shareholders not given the same insights into their investments?
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  > [T]he aggregate investment that managers have in their funds is shielded from fund shareholders' view. While any equity investor can see exactly how many shares of Microsoft Bill Gates owns, there's no way for a fund investor to see if his or her manager has any "skin in the game." In the wake of the recent fund scandals, several mutual fund portfolio managers have stated publicly that because they invest heavily in their own funds, the kinds of trading abuses seen in other shops would not happen at theirs. This statement is a virtue that any fund manager can claim, but none has to prove. Why would such information that has long been disclosed about corporate insiders not be available about fund insiders?
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  > The same principle applies to management compensation and the incentives it creates. Disney shareholders know to the penny what Michael Eisner is paid to run their company. Like all holders of publicly traded stocks, they receive a statement from the compensation committee with their annual proxy materials outlining how the committee has structured the CEO's pay and on which metrics his or her bonus is based. It is not uncommon for these materials to include a CEO's entire employment agreement. Given the high level of disclosure on operating companies, it is hard to reconcile why no disclosure whatsoever is provided on fund manager compensation.
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  > Fund investors do not know if their manager's bonus is tied to short-term returns or to rolling five-year returns, to pre-tax or to after-tax profits. If the manager's pay is linked to pre-tax returns, surely a manager will be less concerned about the tax consequences of his or her decisions. How can this not be material information to an investor considering placing a fund in either a taxable account or an IRA? In addition, one would hope that a fund manager's compensation is tied to fund performance, rather than to the fund's asset growth. A manager's incentive should be to manage, not to sell. But, with no compensation disclosure, how can a fund investor be sure? If mutual funds are indeed investment companies, let's treat them as companies and give fund investors the same level of disclosure that stock investors have long enjoyed.

The Commission also should consider the following additional measures, which we believe will further enhance the meaning and value of disclosure concerning the structure of management's compensation:

- ✓ *Require disclosure of specific metrics used to measure performance.* For example, what time periods are considered and what weights are accorded to those periods? Trailing or rolling period returns? Pre-tax or after-tax? To what is the fund compared--a benchmark or peer group norm--for purposes of evaluating management's performance? If both a benchmark and a peer group average, what weights are accorded to each? Is risk a consideration?

  Whatever the metrics chosen, the Commission should require funds to disclose specifics about the plan. A general description, such as "management's bonus compensation is based on long-term performance measures," is tantamount to saying that a doctor's pay is tied to making patients feel better. While true in the most generic sense, it offers no insights into the specific factors that might serve as incentives to act in a certain way. Instead, funds should aim to provide a level of detail that would be sufficient to allow a portfolio manager--relying solely on the information provided in the SAI--to determine how to direct his/her efforts. Were this rule of thumb to be adopted, it's highly unlikely that funds would resort to nebulous descriptions like "management's pay is based on a mix of factors, including asset growth and performance-related measures," since a portfolio manager forced to rely on such disclosure would have no idea what to do.

- ✓ *Require a percentage breakdown of a manager's compensation between the various types of pay identified--salary, bonus, deferred compensation, retirement plans and arrangements.* While we acknowledge the practical difficulty associated with estimating the current year's percentage breakdown--since the size of the variable component isn't known until the year has concluded--the Commission could require funds to provide a historical breakdown. We believe that this disclosure would be more meaningful since it would give investors a better sense of where management's compensation is typically derived.

- ✓ *In situations where the benchmark or peer group average used to evaluate management's performance differs from the fund's stated benchmark, require the fund to explain the disparity.* Since the overarching goal is to provide information that would allow investors to determine whether management is "in their corner", it seems only natural to expect a fund to explain why, for instance, a manager is paid to eclipse an index that differs from the fund's own stated benchmark. After all, if a fund's manager is being incented to direct his/her efforts towards one goal, which differs from the fund's stated goal, it is difficult to get comfort that management's interests are properly aligned with those of investors.

- ✓ *Disclose the structure of compensation for the five most highly compensated individuals at the fund's advisor.* We acknowledge that there are implementation issues associated with such a requirement. For example, in the case of a public company that manages mutual funds, such as a bank or broker-dealer, there is little value in duplicating the compensation disclosure already provided for the five most highly compensated individuals in other filings. However, we believe that the structure of compensation for the individuals heading up the investment management unit charged with the responsibility of running the fund is quite germane. For example, if the investment management unit head's bonus compensation is driven *solely* by asset growth measures, this could have an indelible impact on the way funds are managed.

- *In the case of a fund with a portfolio management team, should we require the proposed disclosure regarding portfolio manager compensation with respect to every member of the team or only certain team members, e.g., the lead member?*

  We believe that disclosure regarding portfolio manager compensation should extend to each individual listed as manager. As stated previously, we do not believe that every member of the portfolio management team should be listed as manager. As such, it is appropriate to limit this disclosure to the individuals who are primarily responsible for the fund's performance.

- *Is the SAI the appropriate location for the proposed disclosure regarding portfolio manager compensation, or should this disclosure be provided in other locations, e.g., prospectus, shareholder reports, or Form N-CSR?*

  We believe that the SAI is the appropriate location for the proposed disclosure. While it would be desirable to set forth management compensation information in the fund's prospectus, we believe that the sheer length of this disclosure makes such a goal difficult to achieve. As such, we urge the Commission to require funds to include a clear reference in the management section of the prospectus that informs readers that management compensation information is available in the SAI.

  That said, we are unopposed to disclosure of management compensation information in the fund's prospectus.

<u>Disclosure of Securities Ownership of Portfolio Managers</u>

- *Is our proposed requirement that a fund disclose the ownership of securities of each portfolio manager with respect to each account managed by the portfolio manager as well as his ownership in other accounts managed by the investment adviser (or any person controlling, controlled by, or under common control with an investment adviser or principal underwriter of the fund) appropriate? Is the group of accounts that are covered appropriate, too broad, or too narrow? Is there any additional information about the ownership of securities of portfolio managers that should be required to be disclosed?*

  Morningstar believes this disclosure is entirely appropriate. Ownership of fund shares is the most direct and meaningful signal that a manager's interests are aligned with shareholders'.

  We also support the Commission's proposal to disclose ownership of other accounts managed by the fund's investment adviser. Indeed, there are legitimate reasons why a manager may be unable, or unwilling, to own a significant stake in the fund(s) he/she manages. For example, a 30-year old municipal bond fund manager's risk tolerance and investment objectives would likely dictate that the majority of his/her net worth be invested in more aggressive vehicles, such as equity funds. However, ownership of other accounts managed by the fund's adviser demonstrates conviction in other aspects of the firm's process, such as its culture and the depth and breadth of its analytical capabilities. We acknowledge that by itself, ownership of other accounts managed by the fund's investment adviser can't provide absolute assurance that a manager's interests are aligned with shareholders'. But when used in concert with other data, it can be quite useful.

- *Should we require disclosure of the dollar range of securities owned by the portfolio manager or would disclosure of the actual value be more appropriate? If a dollar range is appropriate, what should the required ranges be? Are the proposed ranges appropriate? Would a higher maximum range better differentiate between interests in different accounts (e.g., a $1,000,001 interest versus a much larger interest, e.g., $25,000,000)? Or would it be sufficient for the highest maximum range to begin at a lower level (e.g., over $100,000)?*

  Morningstar strongly believes that whatever form management ownership disclosure takes, the information provided *must* clearly convey whether management has a significant stake in the fund.

  Though the dollar range of securities owned by the portfolio manager is a useful measure, we believe that ownership is best expressed as a percentage of liquid net worth. (We define "liquid net worth" as the portion of a manager's net worth which is readily convertible to cash.) Ownership stated in this manner provides an unambiguous sense of how much skin a manager has in the game. That's not necessarily true of a dollar range disclosure format.

  While less desirable than disclosing management's ownership as a percentage of liquid net worth, disclosing the specific dollar amount of management's stake in fund shares is a worthwhile alternative in our view.

That said, if the Commission were to adopt a dollar range disclosure format, it is essential that the ranges chosen befit the likely value of fund shares owned by a representative cross section of managers in the industry. Simply duplicating the ranges currently used to express fund director ownership of fund shares is likely to prove meaningless, given that manager compensation far exceeds that of fund directors (meaning that, all things being equal, managers should have far more income at their disposal with which to demonstrate their conviction by investing in fund shares). For example, if the Commission were to adopt $100,000 as its maximum range, it's likely that an overwhelming majority of managers would exceed that threshold, greatly diminishing the disclosure's value.

- *Should we also or instead require a fund to disclose the percentage of a portfolio manager's net worth that is invested in securities of the fund or other accounts? If so, what should be included in the calculation of a portfolio manager's net worth (e.g., net worth of immediate family members)?*

  We do not believe it’s prudent to express ownership as both a dollar range or a dollar amount and a percentage of a portfolio manager’s liquid net worth, as this information could be used to compute a manager’s total liquid net worth, an invasion of privacy. Instead, we believe it’s sufficient to express ownership as a percentage of liquid net worth.

  We believe limiting the scope to immediate family members is appropriate.

- What is the most effective means for disclosing the relative magnitudes of a portfolio manager's interest in each of the accounts in which he owns securities? For example, should we require a fund to disclose, for each account listed in the table, the percentage that the value of the manager's interest in the account represents of the aggregate value of the manager's interest in all accounts listed in the table?

  We believe that the following tabular format--which we offer for illustrative purposes--would suffice:

	Value of Fund Shares Owned by Fund Management (Expressed as a Percentage of Liquid Net Worth)		
	This Fund	All Funds Managed	All Funds Advised by Acme Fund Co.
John Doe	10% (Class A)	30%[1]	35%[1]
Jane Smith	20% (Class B)	20%[2]	30%[2]

1 John Doe manages the following funds in addition to this offering: Acme Large-Cap Fund (5% of liquid net worth; Class A), Acme Equity Income Fund (15%; Class D), and Acme Dividend Growth Fund (0%).

Doe also owns shares in the following other funds managed by the fund's advisor, Acme Fund Co.: Acme Small-Cap Fund (5% of liquid net worth; Class D).

2 Jane Smith manages the following funds in addition to this offering: Acme Mid-Cap Fund (0% of liquid net worth) and Acme Growth Fund (0%).

Smith also owns shares in the following other funds managed by the fund's advisor, Acme Fund Co.: Acme Core Bond Fund (10% of liquid net worth, Class D).

- *Should we require that the disclosure of securities owned differentiate between securities that a portfolio manager is required to own as a condition of employment and securities that are owned voluntarily?*

  We do not believe that most investors will make this distinction. Whether a manager must own fund shares as a condition of employment or not doesn’t change the fact that his/her holdings serve as an incentive to act in shareholders' best interests. Since that outcome is consistent with the ultimate aim of the proposal, the distinction is unnecessary.

- *Are there any types of securities to which the proposed disclosure requirement should not apply, e.g., should we limit the disclosure to equity securities?*

  We see no reason to limit the disclosure. While there certainly will be instances where a manager, for reasons of diversification, owns a relatively small stake in fund shares, the additional ownership thresholds (i.e., percentage ownership of all funds run by the manager; percentage ownership of all funds run by the fund's advisor) should afford flexibility.

  In addition, the Commission certainly could encourage funds to provide accompanying narrative explanation to amplify the information presented in the table. In that way, a fund could describe the facts and circumstances that dictate the extent of a manager's fund ownership.

- *Should we require disclosure with respect to securities owned by immediate family members of portfolio managers? If so, should we broaden the definition of "immediate family member" to include, for example, the portfolio's manager's parents, siblings, in-laws, and children not residing with the manager? Should we limit the definition to, for example, the portfolio manager's spouse?*

  If the intent of this question is to determine whether the disclosure of manager ownership should distinguish between manager ownership (which would include the manager's spouse and children residing in the manager's household) and ownership by additional family members, including the manager's parents and other relatives, we are not in support. We believe the definition of manager ownership described in the proposal should suffice. Expanding the definition as described would add needless complexity without the potential for significant incremental benefits.

- *In the case of a fund with a portfolio management team, should we require the proposed disclosure regarding ownership of securities of portfolio managers with respect to every member of the team or only certain team members?*

  We believe that disclosure of manager holdings should suffice. As explained previously, we do not perceive the need to disclose the name and background of every member of the portfolio management team. Consistent with that view, we believe that investors are most interested in determining whether the interests of the individuals who are directly responsible for the fund's success--its managers--are sufficiently aligned with their own. The proposal's requirement to disclose each portfolio manager's ownership of fund shares should achieve that goal.

- *Is the SAI the appropriate location for the proposed disclosure regarding securities ownership of portfolio managers, or should this disclosure be provided in other locations, e.g., prospectus, shareholder reports, or Form N-CSR?*

  We believe the prospectus is the appropriate location. Management's incentives have a strong bearing on the way a fund is run and, in turn, the compatibility of that approach with shareholders interests. As such, we believe the disclosure demands prominent placement.

- *Should we require this securities ownership information, as well as information regarding other accounts managed and compensation structure discussed above, to be provided as of the end of the fund's most recently completed fiscal year, or should this information be required as of another date, e.g., most recent calendar year end or most recent practicable date prior to filing a new registration statement or an update to an existing registration statement? Is updating this information once a year for previously identified managers, as proposed, sufficient or should it be updated more frequently? If more frequent updates should be required, how frequent should they be? In the case of an initial registration statement, or an update to a fund's registration statement that discloses a new portfolio manager, should we require information with respect to any newly identified portfolio manager to be* *provided as of the most recent practicable date or some other date, e.g., most recent calendar- or fiscal year-end?*

We believe that disclosure as of the end of the most recently completed fiscal year strikes a reasonable balance between timeliness and practicality. We also believe that annual updating of this information should suffice.

<u>Remove of Exclusion for Index Funds</u>

- *Should we remove the exclusion for index funds? Should portfolio managers of index funds be subject to all of the proposed disclosure requirements regarding portfolio managers or only some of the proposed requirements?*

- *Is the fund prospectus the appropriate location for the disclosure regarding the name, title, length of service, and business experience of a portfolio manager of index funds? Should this disclosure be provided in other locations, e.g., SAI or Form N-CSR?*

- *Should we also remove the provision excluding money market funds from the requirement to identify and provide disclosure regarding their portfolio managers?*

We believe that all disclosure requirements described in the proposal should apply to managers of index funds. The location of that disclosure should be the same as the location of the disclosure provided for non-index funds. There is no substantive reason to allow different treatment for index funds.

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We thank the Commission for this opportunity to comment.

Sincerely,

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