

## SEC Reopens Comment Period on Proposal to Improve Mutual Fund Disclosure

On November 21, 2007, the U.S. Securities and Exchange Commission (the "SEC") proposed rule and form amendments (the "Proposed Rules") that would permit mutual funds to satisfy their prospectus delivery obligations under the Securities Act of 1933, as amended, by providing key information directly to investors in a "summary prospectus" and providing the statutory prospectus and certain other information on an Internet website.<sup>1</sup> The Proposed Rules would also require mutual funds to provide key investment information in plain English in a standardized order at the front of the statutory prospectus, using the same format as the summary prospectus.<sup>2</sup>

The initial comment period for the Proposed Rules closed on February 28, 2008. The SEC recently reopened that comment period to provide an opportunity for comment on the results of focus group testing and a telephone survey of investors regarding a mutual fund summary prospectus (the "Survey").<sup>3</sup>

Comments on the proposals are due by August 29, 2008.

### Survey Methodology

The SEC contracted with Abt SRBI Inc. to conduct three focus groups in April 2008 in order to assess investor views on a mutual fund summary prospectus.<sup>4</sup> The focus groups were conducted with investors in Boston, Denver, and Dallas. In order to qualify to attend the focus groups, interviewees had to have purchased one or more mutual funds within the past two years. Also, prospective participants could not have taken part in a focus group within the past 12 months, nor could they have a family member who worked in market or survey research. Screening was conducted using a sample of households with incomes of \$75,000 or greater in each of the three metropolitan areas.

<sup>1</sup> Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Release No. 33-8861 (Nov. 21, 2007), available at <http://www.sec.gov/rules/proposed/2007/33-8861.pdf>.

<sup>2</sup> See *DechertOnPoint* (Dechert LLP), February 2008, Issue 3, for a more detailed discussion of the proposing release and the Proposed Rules.

<sup>3</sup> Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Release No. 33-8949 (July 31, 2008), available at

<http://sec.gov/rules/proposed/2008/33-8949.pdf>.

<sup>4</sup> Final Report, Focus Groups on a Summary Mutual Fund Prospectus, May 2008, Prepared for the Securities and Exchange Commission, 100 F Street NE, Washington, D.C. 20549, Prepared by Abt SRBI Inc., 8493 Colesville Road, Suite 820, Silver Spring, Maryland 20910, (301) 608-3883, available at <http://www.sec.gov/comments/s7-28-07/s72807-142.pdf>.

A hypothetical summary fund prospectus was developed by SEC staff for testing in the focus groups and was compared with a long-form prospectus and two multiple-fund prospectuses during the sessions. Observers from the SEC were present at all of the focus groups.

The focus groups explored the following issues:

- importance of current information;
- portfolio holdings disclosures;
- intermediary compensation, sales disclosures, and portfolio turnover disclosures;
- multiple-fund disclosures;
- hard-copy versus online disclosures;
- reaction to statutory and summary prospectuses; and
- factors in investment decision-making.

## Comments on Summary Prospectus from Survey Participants and the Mutual Fund Industry

Summarized below are comments from Survey participants as well as comments received by the SEC on the Proposed Rules from industry participants and consumer groups on these topics.

### *Importance of Current Information*

Perhaps the most controversial provision in the Proposed Rules is the requirement that a summary prospectus contain average annual total returns and yield (if applicable) as of the most recent calendar quarter, as well as quarterly updated top ten portfolio holdings information. Survey participants said that they preferred receiving fund performance and portfolio holdings information as of the previous month or quarter, and indicated that they would be willing to access this information on a website. Some participants also thought asset allocation information should be included in the summary prospectus in addition to portfolio holdings information. The Investment Company Institute (“ICI”) and other industry participants have strongly opposed any requirement in the Proposed Rules that performance and portfolio holdings information be updated quarterly. The ICI stated in its

comment letter that implementation of the quarterly updating requirements would create “a significant barrier to broad adoption of the summary prospectus by the industry,” and some fund groups have commented that they would be less likely to voluntarily use the summary prospectus if quarterly updating is required.<sup>5</sup> Some commenters have argued that rather than requiring quarterly updating of the summary prospectus, the final rules should instead require that funds make performance and top ten portfolio holdings information available to investors on the Internet and add disclosure in the summary prospectus that informs investors how to obtain this updated information.<sup>6</sup>

### *Portfolio Holdings Disclosures*

As noted above, Survey participants believed that a fund’s top ten portfolio holdings should be disclosed in a summary prospectus, with some participants stating a preference for asset allocation information. Industry participants have generally opposed the proposed requirement to provide top ten portfolio holdings information in the summary prospectus.<sup>7</sup> These

<sup>5</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“ICI Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-92.pdf>; see also, Letter from Robert W. Uek, Chair, Governing Council, Independent Directors Council, to Nancy Morris, Secretary, SEC (Feb. 15, 2008) (“IDC Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-51.pdf>; Letter from Timothy McHale, Counsel and Katherine H. Newhall, Counsel, Capital Research and Management, to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“Capital Research Letter”), available at <http://sec.gov/comments/s7-28-07/s72807.shtml>; Letter from Karrie McMillan, General Counsel, Investment Company Institute and Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“ICI/SIFMA Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-93.pdf>.

<sup>6</sup> See, e.g., Letter from David J. Lekich, VP and Associate General Counsel, Charles Schwab Co. and Catherine M. MacGregor, VP and Chief Counsel of the Laudus Funds, Charles Schwab Investment Management, Inc., to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“Charles Schwab Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-98.pdf>; Letter from Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company, to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“Fidelity Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-105.pdf>.

<sup>7</sup> See ICI Letter; IDC Letter; Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“SIFMA Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-88.pdf>; Letter from Darrell N. Braman,

commenters generally have argued that inclusion of top ten holdings information is of limited value and could potentially be misleading or confusing to investors, and the need to update this information on a quarterly basis would create substantial operational burdens and costs.<sup>8</sup>

### ***Intermediary Compensation***

The Proposed Rules would require that the summary prospectus include disclosure regarding payments by the fund and its related companies to broker-dealers and other financial intermediaries for the sale of fund shares. Survey participants indicated that they would want to review information regarding intermediary compensation and conflicts of interest at the beginning of a relationship with a financial adviser, and many also wanted to be reminded of this information whenever they made a purchase. Survey participants noted that the term “intermediary” may be unfamiliar to some investors and therefore additional clarification of this term may be necessary. The ICI has commented that the disclosure regarding payments to broker-dealers and intermediaries should not be required in summary prospectuses for funds or share classes for which the statement would never be true, e.g., those that are sold directly and are eligible to be marketed as “no load” funds, or funds included in variable insurance products.<sup>9</sup> In its comment letter, the Securities Industry and Financial Markets Association (“SIFMA”) recommended that, because fees and costs are closely linked in investors’ minds with the issue of potential conflicts and incentives, the discussion regarding payments to broker-dealers and other financial intermediaries should be folded into the fees and costs section, rather than appearing separately at the end of the summary prospectus.<sup>10</sup>

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Associate Legal Counsel, Forrest R. Foss, Associate Legal Counsel, Henry H. Hopkins, Chief Legal Counsel, David Oestreicher, Chief Legal Counsel Elect and Brian R. Poole, Attorney, T. Rowe Price, to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“T. Rowe Price Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-118.pdf>; Letter from Leslie L. Ogg, Esquire, Eden Prairie, Minnesota, to Nancy Morris, Secretary, SEC (Feb. 1, 2008) (“Ogg Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-20.pdf>.

<sup>8</sup> See ICI Letter; IDC Letter; SIFMA Letter; T. Rowe Price Letter; Ogg Letter.

<sup>9</sup> See ICI Letter; see also T. Rowe Price Letter.

<sup>10</sup> See SIFMA Letter.

### ***Sales Disclosures***

Under the Proposed Rules, funds that offer breakpoint discounts for volume purchases would be required to disclose information about the availability of such discounts. Many Survey participants thought that the summary prospectus disclosure regarding these discounts was too vague. For example, some participants were unclear about the period of time over which the investment could be made in order to qualify for the discount. Participants generally thought that sales discount information in the summary prospectus would lead them to search for additional information on this topic in the statutory prospectus or elsewhere. Some industry members have indicated that while disclosure on breakpoint discounts is important, the SEC’s proposal to reference a specific discount level may not accommodate the complexity and variety of these policies.<sup>11</sup> To address this concern, industry groups have recommended using more generic language that requests investors to inquire for additional information.<sup>12</sup>

### ***Portfolio Turnover***

The Proposed Rules would require that summary prospectuses for funds other than money market funds disclose the fund’s portfolio turnover rate for the most recent fiscal year, as a percentage of the average value of its portfolio. Survey participants commented that the information about portfolio turnover in the summary prospectus was understandable, although somewhat vague or “ambiguous.” An average of data from five or ten years was perceived as potentially more useful by some Survey participants. Consumer groups have supported the SEC’s proposal to require disclosure regarding a fund’s portfolio turnover rate immediately following the fee example, but believe that incorporating portfolio transactions in the total expense ratio would be a superior alternative.<sup>13</sup> Fund industry participants generally have not opposed the proposed inclusion of

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<sup>11</sup> See SIFMA Letter; ICI Letter.

<sup>12</sup> See SIFMA Letter; ICI Letter.

<sup>13</sup> See Letter from Mercer Bullard, Founder and President, Fund Democracy, Barbara Roper, Director of Investor Protection, Consumer Federation of America, and Ken McElDowney, Executive Director, Consumer Action, to Nancy Morris, Secretary, SEC (Feb. 28, 2008) (“Fund Democracy Letter”), available at <http://sec.gov/comments/s7-28-07/s72807-108.pdf>.

disclosure regarding portfolio turnover.<sup>14</sup> Some have recommended that, because portfolio turnover can fluctuate significantly from year to year, the SEC should require disclosure of the portfolio turnover rate for each of the past three years and funds should be permitted to include a footnote to explain significant aberrations in their portfolio turnover rate.<sup>15</sup>

### ***Multiple-Fund Disclosures***

Under the Proposed Rules, a summary prospectus may include only information about a single fund or series. However, Survey participants generally favored multiple-fund disclosure and appeared to have no difficulty reading multiple-fund prospectuses. Survey participants commented that multiple-fund disclosure could be used as a screening tool to help determine which funds to research in greater detail. Mutual fund industry groups and participants generally agreed with this view, noting that a multiple-fund format may be more useful to investors in certain circumstances, in particular for groups of funds an investor may wish to compare, such as target date funds and asset allocation funds.<sup>16</sup> These commenters also noted that the requirement for fund-by-fund organization would actually result in lengthier presentations, due to duplicative information, such as disclosure regarding purchase and sale of fund shares, tax information, and intermediary compensation.<sup>17</sup> Some consumer groups commented that the summary prospectus should contain only information for a single fund as this would make evaluation of a fund less cumbersome for investors.<sup>18</sup>

### ***Hard-Copy Versus Online Disclosures***

The Proposed Rules would permit delivery of the summary prospectus on the Internet and would only require delivery of a paper prospectus upon request. Most Survey participants indicated that they were willing to research information about a fund on the Internet, although they liked the idea of receiving summary information in paper format. The availability of the

<sup>14</sup> See ICI Letter.

<sup>15</sup> See ICI Letter; IDC Letter.

<sup>16</sup> See ICI Letter; IDC Letter; Capital Research Letter; T. Rowe Price Letter; Charles Schwab Letter; Fidelity Letter.

<sup>17</sup> See ICI Letter; IDC Letter; Capital Research Letter; T. Rowe Price Letter; Charles Schwab Letter; Fidelity Letter.

<sup>18</sup> See Fund Democracy Letter.

summary prospectus in paper format and the statutory prospectus online was seen as acceptable by most Survey participants. Fund industry members generally viewed Internet availability of the summary prospectus and incorporated documents as a sound framework, although some commenters indicated that if the technology requirements for summary prospectuses make it necessary to radically revamp existing systems and formats, the costs involved will markedly dampen interest.<sup>19</sup> AARP noted in its comment letter that its research indicates older investors have a strong preference for receiving investment-related information by regular mail rather than by electronic means.<sup>20</sup>

### ***Statutory and Summary Prospectuses***

Survey participants were asked to review both a statutory and a hypothetical summary prospectus. Although participants found some aspects of the statutory prospectus helpful, there were numerous negative comments about the length of the document. Several Survey participants wanted the statutory prospectus to include information about who holds the funds, and said that an executive summary of the prospectus would be helpful, particularly if there were page number references to where in the prospectus an investor could look for additional information.

Survey participants generally reacted favorably to the summary prospectus, although several participants commented that the information about risk in the summary prospectus was essentially “boilerplate” and that the amount of risk disclosure provided in the summary prospectus was probably unnecessary. Suggestions from Survey participants for enhancements to the summary prospectus included comparing fund performance to multiple indexes, including information

<sup>19</sup> See ICI Letter.

<sup>20</sup> Letter from David Certner, Legislative Counsel and Director of Legislative Policy, Government Relations and Advocacy, AARP, to Nancy Morris, Secretary, SEC (Feb. 28, 2008), available at <http://sec.gov/comments/s7-28-07/s72807-114.pdf>; see also Letter from George Miller, Chairman, House Committee on Education and Labor; Edward M. Kennedy, Chairman, Senate Committee on Health, Education, Labor, and Pensions; Robert E. Andrews, Chairman, House Subcommittee on Health, Employment, Labor, and Pensions; Tom Harkin, Senator, Senate Committee on Health, Education, Labor, and Pensions; and Herb Kohl, Chairman, Senate Special Committee on Aging, to Nancy Morris, Secretary, SEC (Mar. 13, 2008), available at <http://sec.gov/comments/s7-28-07/s72807-132.pdf>.

about the tax consequences of portfolio turnover, and providing additional information about the fund manager. Overall, Survey participants viewed the short-form prospectus as a screening tool for determining whether to pursue additional research about a given fund. Several participants noted the importance of each fund using the same format for its short-form prospectus in order to facilitate investors' comparisons among funds.

The mutual fund industry has generally expressed strong support for the SEC's proposal and its layered disclosure approach.<sup>21</sup> Industry groups also generally agree that the standardized format of the summary prospectus would promote effective comparisons of funds, with the caveat that allowing flexibility for multiple-fund prospectuses in certain circumstances would be preferable.<sup>22</sup>

<sup>21</sup> See IDC Letter; ICI Letter; SIFMA Letter; ICI/SIFMA Letter.

<sup>22</sup> See IDC Letter; Capital Research Letter; T. Rowe Price Letter; Charles Schwab Letter; Fidelity Letter; ICI Letter.

## Observations

The fact that only a few Survey participants said that they use statutory prospectuses to evaluate mutual funds highlights the need for reforming the manner in which investors receive fund information. The comment letters received thus far and the results of the Survey suggest certain areas for improvement of the proposals. Interestingly, while the SEC and some well-known consumer groups support the one prospectus per fund requirement, Survey participants' views on this issue are more in line with the industry. You may wish to evaluate the results of the Survey and consider whether you have additional comment on the Proposed Rules. Comments must be received by August 29, 2008.



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