

Comment Letter on Issues Relating to Collective Investment Funds, October 2002

September 27, 2002

General Secretariat
International Organization of Securities Commissioners (IOSCO)
Plaza de Carlos Triás Bertrán, 7
Planta 3a
28020 Madrid
España

Re: Performance Presentation Standards for Collective Investment Schemes, Report from the Technical Committee of the International Organization of Securities Commissions (“Report”)

Dear General Secretariat:

The Investment Company Institute¹ appreciates the opportunity to comment on IOSCO’s [Report](#) regarding the advertising of performance information by Collective Investment Schemes (“CIS”). The Report presents an examination of the standards among the jurisdictions of the members of the Technical Standing Committee on Investment Management (“SC5”) for the presentation of the performance of CIS in advertisements and other marketing materials. The Report also presents general principles for the presentation of CIS performance information that were developed based on this examination. The Institute, in general, strongly supports this statement of general principles and believes that IOSCO should continue in its efforts to encourage jurisdictions to consider the comprehensiveness and effectiveness of their performance presentation standards (“PPS”) in order to enhance investor protection.

The Report discusses several matters that PPS may address: standardized formulas, fees and expenses, standardized time periods, use of performance benchmarks, use of disclaimers, and enforcement. In addition, the Report describes existing standards in various jurisdictions for the presentation of CIS performance in marketing materials including, among other things, the presentation of volatility information. We have provided below our comments on each of these matters. Our comments describe certain principles that we believe are necessary for an effective mutual fund performance reporting system. In summary our comments are as follows:

- Mutual funds should compute performance using a standardized methodology. The basic standardized performance figure for funds other than money market funds should be total return but funds also should be able to advertise a standardized yield and other types of non-misleading performance figures that are accompanied by the standardized total return figures.
- Any standardized total return formula should require the deduction of sales charges, fund expenses accrued during the appropriate measuring period, and any fees that are charged to all shareholder accounts.
- Funds should present performance for standardized time periods.
- Requiring funds to compare their performance to an index is inappropriate and potentially misleading.
- Funds advertising performance should meet specific minimum disclosure requirements.
- Performance presentation standards should be mandatory.
- Funds should not be required to report a single, standardized, numerical measurement of risk.

We encourage IOSCO to consider these principles in developing any best practice standards for the presentation of CIS performance information.

Standardized Formulas

Mutual funds should compute performance figures using a standardized methodology. While there may be different methods for computing fund performance, the use of different methods does not produce data investors can compare. Requiring funds to employ consistent, standardized formulae to compute their performance also can help ensure that funds will compete in a fair and equitable manner.

We believe that the basic standardized performance figure for funds other than money market funds should be total return. Total return is the sum of all fund earnings plus any changes in value of assets reduced by all expenses accrued during a measuring period. This figure is not affected by whether investment growth derives from income or capital appreciation or when income is distributed. The methodology for computing total return also does not require complex accounting judgments or rules. While the presentation of other types of non-misleading performance figures also should be permitted, any fund making performance claims should be required to include the prescribed standardized total return figures.²

In addition to total return, funds should be permitted to advertise a standardized yield. A fund's yield is derived by dividing the fund's net investment income per share by the maximum offering price on the last day of the period. The ability to advertise yield is of interest to bond funds and other funds that emphasize the production of current income.

If funds quote yields, they should do so pursuant to a standard formula. This can be a complex and controversial undertaking. While it is relatively easy to prescribe methodology for money market fund yields, it is much more difficult to standardize yield for other types of funds.³ Developing a standard way to measure yield can be complex and involves a number of arbitrary decisions. Net investment income determined under accounting principles may not provide a sound basis for calculating yield if those principles provide discretion as to the amount or timing of income to be recognized.⁴ While developing a standardized yield formula is complex and difficult, it is important to assure that fund yields are computed on a standardized basis.

Fees and Expenses

Any standardized total return should require the deduction of sales charges and fund expenses accrued during the appropriate measuring period (which includes all recurring fees that are charged to all shareholder accounts). Any standardized yield formula should reflect expenses accrued for the period being measured. In addition, if a fund has a sales charge, the advertisement's narrative should disclose the maximum amount of the charge. If the advertised performance does not reflect the sales charge (such as in non-standardized total return), the advertisement should also disclose that the performance data does not reflect its deduction, and that, if reflected, the charge would reduce the performance quoted. These requirements assure that potential investors are adequately informed of the existence and effect of the fund's fees and expenses on their investment.

Standardized Time Periods

Funds should be required to present performance for standardized time periods, which promotes comparability. More specifically, we believe that these standardized periods should represent sufficiently different lengths of time in order to provide a picture of fund performance over different market cycles (e.g., a short-term, medium-term, and long-term period).⁵ Annualizing return numbers ensures that returns for different periods (e.g., one-year versus 10-year) can be compared.

We believe that funds also should be permitted to advertise a non-standardized total return figure that covers other time periods, provided that it is accompanied by total return for the standardized time periods. This will give funds flexibility to provide additional performance information in a non-misleading manner.

Use of Performance Benchmarks

We believe that funds should not be required to compare their performance to an index because such a comparison is inappropriate and potentially misleading. Such a comparison, among other things, ignores that (a) for many funds, there is no appropriate index; (b) index performance is shown on a cost-free basis while funds may be required to deduct all expenses from performance (which we believe is appropriate); and (c) funds are required, as a practical matter, to maintain a portion of their portfolio in liquid assets to meet redemptions, which adversely affects performance in a rising market and which enhances performance in a falling market. We further believe that index comparisons are especially inappropriate in fund advertisements, given the limited space in such communications.

Use of Disclaimers

Funds advertising performance should meet specific minimum disclosure requirements. To prevent investor confusion about mutual fund performance claims and, in particular, to ensure that investors do not believe that these figures represent a promised return, mutual funds advertising performance should disclose that these figures represent historical performance and that the principal value of an investment in the fund will fluctuate. Funds should be permitted to have the flexibility to disclose this in any way that

communicates the required concepts. This enables funds to design advertisements that they believe best communicate the required information clearly and concisely.

Enforcement

Performance presentation standards should be mandatory. Mandatory rules ensure that all mutual funds that advertise performance are subject to the same requirements with respect to computation, currentness, and disclosure. Mandatory rules also guard against abuses that could result in the absence of such regulation, like cherry picking. Moreover, mandatory standards help to ensure that investors may rely on the veracity and fairness of the performance information provided in mutual fund sales material and enable investors to compare fairly uniform performance information among funds.

Use of Volatility Information

Funds should not be required to report a single, standardized, numerical measurement of risk. This approach is fundamentally flawed because it rests upon the erroneous assumption that there is a single, optimal measure of investment risk. It ignores the fact that risk is a multifaceted concept, necessarily having different meanings for different investors. (For example, measures based on short-term volatility are not especially meaningful for long-term investors.) Such measures also pose the danger that investors—neither understanding the limitations of such a measure nor accurately assessing its relevance and appropriateness to their particular circumstances and investment objectives—nonetheless will rely upon it to their detriment. We believe that there are better ways to communicate information about the risk of a fund to investors, such as narrative disclosures in fund prospectuses and disclosure of year-by-year performance information in fund prospectuses (which can highlight volatility in returns).

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The Institute appreciates the opportunity to provide these comments on the Report. If you have any questions concerning these comments or would like additional information, please contact the undersigned at 202-326-5826 or Dorothy Donohue at 202-218-3563.

Sincerely,

Mary S. Podesta
Senior Counsel

ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,973 open-end investment companies (“mutual funds”), 514 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.363 trillion, accounting for approximately 95 percent of total industry assets, and over 87.8 million individual shareholders.

² The use in advertisements of composites (i.e., aggregated performance information of more than one CIS or other account that is managed by a CIS operator) should not be required or, in our view, encouraged. The performance information that may be useful to an investor in evaluating a fund is the performance of the fund itself. Composite information on how the manager has performed with other funds or private accounts is likely to confuse investors and may be misleading. Any use of performance information in advertising a fund that is not specific to the fund should be strictly regulated to assure that investors are not misled.

³ Since money market funds have a stable net asset value, the change in value of an investment in the fund over a specified period (assuming reinvestment of distributions) is analogous to yield.

⁴ For example, at the time the Securities and Exchange Commission adopted its standardized yield formula, United States generally accepted accounting principles did not require amortization of premium on debt instruments in determining net investment income.

⁵ In the United States, performance advertisements must include total return information for one, five, and 10 year periods (or, if shorter, the life of the fund).