INVESTMENT COMPANY INSTITUTE

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GENERAL COUNSEL

February 14, 2003

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

Re: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies (File No. S7-51-02)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Commission's proposals to improve the disclosure provided in registered management investment company reports to shareholders and to require such companies to disclose their complete portfolio holdings on a quarterly basis.[2]

The Institute strongly supports the Commission's proposals that address the information contained in fund shareholder reports. We commend the Commission for continuing its efforts to improve disclosures provided to fund investors by making shareholder reports more comprehensible, informative and useful to the average investor. This initiative is an appropriate "next step" that builds on the Commission's 1998 overhaul of mutual fund prospectuses, authorization of fund profiles, and adoption of "plain English" requirements, all of which the Institute supported.[3] We are pleased that many of the Commission's proposed changes to improve shareholder report disclosure are consistent with recommendations the Institute previously has submitted to the Commission.[4] We also support the Commission's efforts to enhance investor understanding of fund fees and expenses.

[1]The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,935 open-end investment companies ("mutual funds"), 559 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.382 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

[2] SEC Release Nos. 33-8164; 34-47023; IC-25870 (December 18, 2002); 68 Fed. Reg. 160 (January 2, 2003) ("Proposing Release").

[3] *See* Letters from Paul Schott Stevens, Senior Vice President, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 9, 1997 (Form N-1A Amendments and Fund Profiles) and Letter from Paul Schott Stevens, Senior Vice President, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 24, 1997 (Plain English Disclosure).

[4] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated August 11, 1998; *see also* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and

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The Institute questions the benefits, however, of requiring all funds to disclose their portfolio holdings more frequently than semi-annually, and we remain concerned that this would facilitate abusive trading practices that will harm fund shareholders. Nevertheless, we would not oppose the Commission's proposal to require quarterly portfolio holdings disclosure with a 60-day lag, provided that it were revised as discussed below to address these concerns.

In summary, our comments are as follows:

- We strongly support the proposal to permit funds to include a summary portfolio schedule in their reports to shareholders. For funds with large numbers of holdings, a streamlined schedule would provide more meaningful information to investors than numerous pages showing all fund investments.

- We recommend that the Commission provide flexibility to funds with respect to the format of the summary schedule, instead of requiring that portfolio holdings be listed in order of descending value.

- We recommend that funds that use a summary portfolio schedule be permitted to provide their complete portfolio schedules to investors by posting this information on their websites, consistent with the approach the Commission has taken in the case of certain other new disclosure obligations.

- We support the proposal to exempt money market funds from providing a schedule of investments in their shareholder reports.

- We support the proposal to require each fund to include a presentation in its shareholder reports that uses tables, charts or graphs to depict the fund's portfolio by reasonably identifiable category, such as industry sector, geographic region, credit quality or maturity. This type of disclosure, which many funds already provide, can facilitate shareholders' understanding of fund portfolio composition.

- We support the proposal to require new disclosure concerning ongoing expenses in fund shareholder reports. The proposed disclosure would provide useful information that should assist fund shareholders in understanding the impact of expenses on fund returns and comparing expenses across funds. It would do so without imposing the substantial costs and burdens on funds and intermediaries that would result if individualized expense disclosure were required to be provided on quarterly account statements.

- We recommend, however, that the Commission simplify the proposed expense disclosure by requiring only one dollar amount figure – the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return. Providing this number and the required narrative explanation would accomplish all of the

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Exchange Commission, dated July 17, 2001, at 9 and Investment Company Institute, Proposals to Improve Investment Company Regulation (May 1, 2002) at 7-8.

Commission's objectives and would avoid the undue complexity and potential investor confusion that the second number the Commission has proposed (the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and an assumed return of 5 percent per year) could introduce.

- We recommend that the Commission continue to allow funds to include the Management's Discussion of Fund Performance either in their prospectuses or in their annual reports.

- Although we are skeptical about its benefits, we would not oppose the proposal to require all funds to disclose their portfolio holdings quarterly, rather than semi-annually, provided that it were revised to allow for confidential treatment of individual holdings in certain circumstances. This change is necessary to address our continuing concern that requiring more frequent disclosure will facilitate abusive trading practices that harm fund shareholders, such as front running fund trades and free riding on funds' research and investment strategies.

- We recommend that the Commission revise the reporting requirements for institutional investment managers under Section 13(f) of the Securities Exchange Act of 1934 to require semi-annual, rather than quarterly, reporting, and to require the filing of 13F reports within 60 days, rather than 45 days, after the end of the relevant period. These changes would help curb potential exploitation of the information in 13F reports to the detriment to fund shareholders.

Each of these comments is discussed in greater detail below.

I. Proposals to Improve Disclosure in Shareholder Reports

A. *Summary Portfolio Schedule*

1. General Comments

The Commission has proposed to permit funds to include a summary portfolio schedule in their reports to shareholders, while making the complete schedule available free of charge upon request to those investors who are interested in more detailed information. Under the proposal, funds would be required to disclose their 50 largest holdings and any holdings that account for at least one percent of net assets.

The Institute strongly supports this proposal. We agree that for funds with large numbers of portfolio holdings, a streamlined schedule of investments would provide more meaningful information to investors than numerous pages listing all fund investments. It would encourage investors to focus on a fund's most significant investments when evaluating its risk profile and investment strategy. In addition, as noted in the Proposing Release, the ability to provide a summary portfolio schedule should result in reduced printing and mailing costs for shareholder reports.

2. Format of Summary Portfolio Schedule

Under the proposal, the summary portfolio schedule would be required to list securities in order of descending value. The Proposing Release requests comment, however, on whether the Commission should adopt a different approach, such as listing portfolio securities by identifiable category.[5] The Institute recommends that the Commission not prescribe a specific format for the summary portfolio schedule. So long as the schedule contains at least the information the Commission has proposed to require,[6] we do not believe that a standardized format is necessary.

Providing flexibility with respect to the format of the summary schedule is consistent with the Commission's proposal, discussed below, to require graphic presentations of portfolio holdings but allow funds to determine the format. Funds should have leeway to use creativity in designing summary portfolio schedules and graphic presentations that complement each other to provide shareholders with important, "user-friendly" information about the nature of the fund's investments.[7] For example, an international fund could organize its portfolio schedule by country and provide a corresponding graphic presentation depicting the allocation of fund portfolio holdings among different countries.

3. Types of Investments Included in Summary Portfolio Schedule

As proposed, the portfolio holdings listed in the summary portfolio schedule would be limited to investments in securities of unaffiliated issuers; funds would still be required to disclose in full other types of investments.[8] The Institute recommends that the Commission revise the proposal to extend it to any (1) investment other than securities or (2) investment in an affiliate[9] that is one of the fund's 50 largest holdings or constitutes one percent or more of the

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[5] 68 Fed. Reg. at 165.

[6] This information would include name of issuer and title of issue, amount held, value, and percent of net assets.

[7] It is our understanding that listing securities in the summary portfolio schedule in order of descending value may not comply with current generally accepted accounting principles ("GAAP") for investment companies, which require the summary schedule to be broken down by security type and industry. *See* AICPA Investment Company Audit Guide, ¶7.10. If this is the case, auditors may not be able to certify that the financial statements are prepared in conformity with GAAP. The Institute is hopeful that this potential conflict can be resolved, and urges the Commission to coordinate with the AICPA toward this end. In the mean time, however, this is another important reason to provide flexibility to funds regarding the format of the summary schedule.

[8] In addition to Schedule I – Investments in securities of unaffiliated issuers, Regulation S-X requires management investment companies to provide the following four other schedules: Schedule II – Investments – other than securities; Schedule III – Investments in and advances to affiliates; Schedule IV – Investments – securities sold short; and Schedule V – Open option contracts written.

[9] The Commission could require funds to identify investments in affiliated issuers by an appropriate symbol or footnote. Other information currently required by Schedule III (Investments in and advances to affiliates) could be provided in a footnote to the summary schedule or in a footnote to the financial statements. We recommend, however, that identification and the related information not be required with respect to investments that are deemed to be issued by an affiliate solely because the fund owns 5% or more of the issuer's outstanding voting securities. We believe that it is not necessary to highlight these investments as investments in affiliates and that doing so may confuse investors and/or cause them to draw inaccurate conclusions about the fund's relationship with the issuer.

fund's net assets. Our recommendation would be consistent with the theory behind the summary portfolio schedule, which is that investors are well-served by disclosure that focuses their attention on the fund's most significant investments.[10] It also would make the Commission's proposal more consistent with GAAP for investment companies, which contemplate a summary schedule of investments that includes all types of investments.[11]

We understand that Commission staff and independent accountants may currently require funds to include short-term investments made with cash collateral from securities lending in their schedule of investments. We recommend that the Commission clarify that such collateral should be excluded from the summary portfolio schedule. (It would continue to be reflected elsewhere in a fund's financial statements.) To the extent that the value of investments representing cash collateral from securities lending constituted a significant percentage of a fund's net asset value, it would not be appropriate to portray such collateral as representing part of the fund's primary investments by including it in the summary portfolio schedule because this could create a distorted view of how the fund's portfolio is invested. Moreover, including these short-term investments in the summary schedule may cause certain of the fund's primary investments to fall out of the top 50 holdings.[12]

4. Criteria for Identifying and Disclosing Holdings

As noted above, the Commission's proposal would require funds to include in the summary portfolio schedule the 50 largest issues held by the fund and any other securities the value of which exceeded one percent of the fund's net asset value as of the close of the reporting period. For purposes of determining whether the value of a security exceeds one percent of net asset value, funds would be required to aggregate and treat as a single issue all securities of any one issuer.[13] For purposes of listing holdings in the summary schedule, however, each issue would be required to be listed separately, whether or not issued by a single issuer.[14]

The Institute is concerned that the proposed requirement to list each such holding separately would essentially nullify the benefits of the summary portfolio schedule in some cases. For example, it appears that under the proposal, a U.S. government securities fund would be required to list separately each issue that it owned (other than short-term debt or fully

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[10] Under our proposal, funds would continue to provide separate schedules reflecting any securities sold short and any open option contracts written. Intermingling short positions and options written with long positions in the summary schedule might be confusing in that the former two items represent liabilities rather than assets.

[11] *See* AICPA Investment Company Audit Guide ¶7.10.

[12] We note that our recommendation to exclude investments made with cash collateral from securities lending from the summary portfolio schedule could not be implemented without a corresponding change to GAAP requirements, and suggest that the Commission work with the AICPA to achieve consistency in this regard.

[13] It is not clear whether a holding that is one of the fund's fifty largest issues would be aggregated with other issues of the same issuer for this purpose.

[14] Under an exception to this general rule, the Commission's proposal would require funds, for purposes of the list, to aggregate and treat as a single issue, respectively, (1) short-term debt instruments of the same issuer, and (2) fully collateralized repurchase agreements. The Institute supports this approach.

collateralized repurchase agreements). We believe this is an unintended and inappropriate result, and strongly encourage the Commission to revise its proposal to address this concern.

5. Shareholder Reports for Multiple Funds

The Proposing Release seeks comment on whether a shareholder report covering more than one fund should be required to use the same type of portfolio schedule (summary or complete) for all funds included in the report.[15] The Institute urges the Commission not to constrain the ability of multiple funds that are included in a single report to shareholders to choose to use different types of portfolio schedules. There likely will be circumstances in which the same type of portfolio schedule is not optimal for all funds included within one report, due to the distinct nature of the funds' portfolios. Funds that choose to use a combined shareholder report should not be either precluded from taking advantage of the summary portfolio schedule, or forced to use it, for the sake of uniformity.[16] Shareholders in many cases will own shares of only one of several funds included in the same report; therefore, inclusion in the same report does not in and of itself provide a compelling basis for *requiring* use of one type of portfolio schedule.

6. "Miscellaneous Securities" Provision

Note 1 to Rule 12-12 of Regulation S-X (Investments in Securities of Unaffiliated Issuers) provides an exception from the requirement to list each issue separately in the fund's complete portfolio schedule. It states that "an amount not exceeding five percent of the total of Column C may be listed in one amount as 'Miscellaneous securities,' provided the securities so listed are not restricted, have been held for not more than one year prior to the date of the related balance sheet, and have not previously been reported by name to the shareholders of the person for which the schedule is filed or to any exchange, or set forth in any registration statement, application, or annual report or otherwise made available to the public." The Commission's summary portfolio schedule proposal does not contain a parallel provision. Consequently, funds that wish to take advantage of this provision would not be able to do so with respect to securities that meet the "miscellaneous securities" criteria described above but that constitute one of the fund's fifty largest holdings or account for one percent or more of the fund's net assets. Funds that wish to use the summary portfolio schedule should not be forced to reveal prematurely certain positions in securities of unaffiliated issuers. We therefore recommend that the Commission revise its proposal to incorporate an exception similar to that in Rule 12-12.[17]

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[15] 68 Fed. Reg. at 165.

[16] Funds that do not have large numbers of holdings, for example, may have no reason to use a summary schedule.

[17] As indicated *infra* at nn. 57-58 and accompanying text, funds also should be permitted to treat certain holdings as confidential, consistent with the standards for confidential treatment in Form 13F under the Exchange Act. We note that GAAP for investment companies do not currently provide for a "miscellaneous securities" category in the summary schedule or for confidential treatment of holdings that meet the Form 13F standards for confidential treatment. We encourage the SEC to work with the AICPA to address these potential conflicts.

7. Availability of Complete Portfolio Schedule

As noted above, the Commission's proposal would require a fund that uses a summary portfolio schedule to provide a complete schedule to investors upon request, free of charge.[18] The Proposing Release requests comment on whether a fund that uses a summary portfolio schedule should be permitted to provide its complete portfolio schedule to investors exclusively through posting this information on its website.[19] The Institute strongly supports giving funds this option, and further recommends that the Commission permit funds to satisfy the requirement by providing a hyperlink to the Commission's EDGAR website. We note that this approach would be consistent with other new Commission disclosure requirements,[20] and believe that it is appropriate to provide funds with similar flexibility in making their complete portfolio holdings schedules available.

B. *Exemption for Money Market Funds*

Under the Commission's proposal, money market funds would be exempt from the requirement to provide a schedule of investments in securities of unaffiliated issuers in their reports to shareholders.[21] The Institute strongly supports this proposal, which appropriately recognizes the strict restrictions that Rule 2a-7 under the Investment Company Act of 1940 imposes on money market fund portfolios.[22]

The Proposing Release requests comments on whether the exemption for money market funds from including a portfolio schedule in shareholder reports should apply to all of the

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[18] Funds also would be required to provide disclosure in their annual and semi-annual reports to shareholders concerning the availability of the complete schedule.

[19] 68 Fed. Reg. at 165.

[20] *See* SEC Release Nos. 33-8188, 34-47304, IC-25922 (January 31, 2003), 68 Fed. Reg. 6564 (February 7, 2002) at n. 49 (disclosure of investment company proxy voting records).

[21] The Proposing Release requests comments on whether index funds should be exempted from the requirement to include their portfolio holdings in their reports to shareholders, as long as the holdings are filed with the Commission and made available to shareholders upon request. 68 Fed. Reg. at 165. The Institute would oppose such an exemption. We believe that index funds should be required to provide their shareholders with the same level and type of portfolio holdings information that shareholders of other non-money market funds will be required to provide (*i.e.,* either summary or full portfolio schedules and tabular or graphic presentations of the portfolio). While such funds seek to track a designated index and thus generally have no discretion with respect to their portfolio holdings, not all index fund shareholders are intimately familiar with the composition of the particular index their fund seeks to track.

[22] As noted in our 1998 letter to the Commission, in which we recommended exempting money market funds from the requirement to list portfolio holdings in shareholder reports, the AICPA's Investment Company Audit Guide makes no special provision for money market funds. Accordingly, they are required to disclose, at a minimum, their top 50 holdings. Thus, in order for the Commission's proposal to be realized, the Investment Company Audit Guide would need to be changed. As we suggested above with respect to (1) the format of the summary portfolio schedule, (2) the exclusion of investments made with cash collateral from securities lending from the summary schedule and (3) the ability to designate a basket of "miscellaneous securities," the Commission should coordinate with the AICPA and encourage prompt resolution of this discrepancy.

required schedules, or only the schedule of investments in unaffiliated issuers.[23] We recommend that the proposal be expanded to apply to all of the required schedules.[24] It would seem odd and possibly confusing to list other investments, which often may represent only a small proportion of the fund's portfolio, while omitting the schedule of securities of unaffiliated issuers.[25]

C. *Tabular or Graphic Presentation*

The Commission has proposed to require each fund to include a presentation in its reports to shareholders that uses tables, charts or graphs to depict the fund's portfolio by reasonably identifiable categories, such as industry sector, geographic region, credit quality or maturity. The Institute strongly supports this proposal. Many funds already provide this type of disclosure voluntarily to facilitate shareholders' understanding of fund portfolio composition. Requiring it for all funds will benefit investors by making it more broadly available.

Under the Commission's proposal, funds would have the discretion to determine the format and content of the presentation. The Institute supports this approach because it recognizes the diversity of investment strategies available and provides the necessary flexibility to funds to design an appropriate presentation that is informative and comprehensible to shareholders.

Notwithstanding our strong support for the Commission's proposal, we are concerned about some of the proposed rule language that would implement the graphical presentation requirement. Proposed Item 21(d)(2) of Form N-1A indicates that the "categories should be selected, and the format of the presentation designed, to provide *the most useful information* to investors about the types of investments made by the Fund, given its investment objectives."[26] While providing "the most useful information" to investors should be the goal, articulating a regulatory standard in those terms is problematic. The usefulness of the information provided will be a subjective judgment, and to require that it be "the most useful" would be an open invitation to second-guessing. The Institute recommends that the wording of the proposed requirement be changed to specify that funds must provide useful information to investors.

The Commission's proposal would require the graphical presentation to indicate the percentage of the fund's net asset value attributable to each category depicted. The Institute recommends that funds be permitted, in the alternative, to provide a presentation that is based on the fund's total investments. We note that the AICPA Investment Company Audit Guide

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[23] 68 Fed. Reg. at 165.

[24] *See supra* n. 8.

[25] We note that the practical impact of our recommendation appears to be limited to any investments in affiliates that a money market fund might have. The other schedules relate to investments that would not be listed in a money market fund shareholder report because they are not permitted under Rule 2a-7 (*i.e.*, investments other than securities, short sales, and options).

[26] 68 Fed. Reg. at 183 (emphasis added).

authorizes funds to categorize fund holdings in the schedule of investments based on either net assets or total investments.[27] Both our recommendation and the Investment Company Audit Guide reflect the fact that neither approach is inherently superior; either could be appropriate so long as the basis for the presentation is clearly identified.[28]

In addition, consistent with our comment set forth above with respect to the summary portfolio schedule, we recommend that the Commission clarify in the adopting release that securities purchased with cash collateral from securities lending should be excluded for purposes of the graphic presentation. Otherwise, the presentation could create the impression that short-term debt securities are a major component of a fund's portfolio holdings in situations where it would be inappropriate to do so because they are not held as part of the fund's managed investments.

D. *Disclosure of Fund Expenses*

The Commission's proposal would require new disclosure concerning ongoing expenses in fund shareholder reports. In particular, each fund would have to disclose in its reports to shareholders: (1) the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return for the reporting period; and (2) the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and an assumed return of 5 percent per year. The dollar amount disclosures would be accompanied by a prescribed narrative explanation. According to the Proposing Release, the purpose of the proposed disclosure is "to increase investor understanding of the fees that they pay on an ongoing basis for investing in a fund."[29]

1. General Comments

The Institute agrees that it is important for mutual fund investors to understand how fees and expenses affect their investments and returns. We note that mutual funds already are required to provide detailed disclosure of their fees and expenses in a standardized table at the front of the fund prospectus, including a hypothetical example designed to illustrate the costs of a fund investment over specified periods (one, three, five and ten years). In addition, funds are required to present their performance net of fees. As a result, the transparency of mutual fund fees and expenses far exceeds that of any other financial product. Moreover, in recognition of the importance of investor understanding of mutual fund fees and expenses, the Commission and the fund industry alike have developed special tools and other materials designed to educate investors concerning fund fees and expenses.[30]

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[27] *See* AICPA Investment Company Audit Guide, ¶7.78.

[28] In many cases, total investments and net assets would be similar; however, there are some circumstances in which total investments would exceed net assets, such as where a fund borrows money for investment purposes and invests those borrowings in securities, and others where total investments would be less than net assets, such as when fund assets that are not included in total investments (*e.g.*, receivables, cash, unrealized gain on foreign currency contracts) exceed fund liabilities.

[29] 68 Fed. Reg. at 168.

[30] *See* 68 Fed. Reg. at nn. 14-15 and accompanying text.

The proposed shareholder report expense disclosure would provide shareholders with additional, useful information that should assist them both in understanding the impact of expenses on their investment return and in comparing expenses across different funds. Accordingly, we support the Commission's expense disclosure proposal, subject to the comments discussed below.[31] Moreover, we agree that, because the proposed disclosure would provide historical cost information, it is appropriate to place it in the shareholder report along with other backward-looking information for the period covered.

The Institute also strongly commends the Commission for proposing an approach through which it expressly seeks to balance the benefits of additional disclosure requirements with the costs and burdens of such requirements.[32] In this regard, the Proposing Release describes a report on mutual fund fees issued by the United States General Accounting Office (GAO) in 2000 in which the GAO concluded that additional disclosure could help increase investor awareness and understanding of mutual fund fees and promote competition among funds on the basis of fees. The GAO report recommended that the Commission require funds to provide each investor with an exact dollar figure for fees paid in each quarterly account statement, but also acknowledged the potential costs of such a requirement and encouraged the Commission to consider less costly alternatives.[33] The Proposing Release indicates that the Commission considered the GAO's recommendation for individualized expense disclosure in each quarterly account statement but determined that it would be more appropriate to propose including additional expense disclosure in shareholder reports, because the costs of the GAO's proposed approach may outweigh the benefits.[34]

The Institute agrees with the Commission's conclusion. Implementation of the GAO's recommendation would involve significant costs and logistical challenges because it would require not only funds and their servicing agents, but also the multitude of financial intermediaries through which fund shares are distributed, to develop and maintain coordinated systems capable of producing account statements containing the required disclosure. Over 80 percent of fund transactions involve the assistance of a financial intermediary, such as a broker-

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[31] Other important participants in the ongoing dialogue on disclosure of mutual fund fees also have expressed support for the Commission's proposal. *See* Letter from Michael G. Oxley, Chairman, U.S. House of Representatives, Committee on Financial Services and Richard H. Baker, Chairman, U.S. House of Representatives, Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, to The Honorable Harvey L. Pitt, Chairman, Securities and Exchange Commission, dated December 18, 2002 (commending the Commission for its expense disclosure proposal and stating that the proposal to require funds to disclose the dollar cost of a $10,000 investment, based on the fund's actual expenses and return, "is a significant step toward demystifying the expenses paid by fund owners.").

[32] *See* 68 Fed. Reg. at 168 (stating that, "[w]hile some have advocated that this information should be provided on an individualized basis in shareholder account statements, our proposals are intended to strike an appropriate balance between investors' need for this information and the costs and burdens that would be associated with providing this information on an individualized basis.").

[33] As noted in the Proposing Release, later that year, the Commission staff issued its own report on mutual fund fees and expenses which concluded, after considering the recommendations in the GAO report, that "disclosure of the dollar amount of fees paid for a preset investment amount would likely have the most favorable trade-off between costs and benefits." *Id.* at 163 (citation omitted).

[34] *Id.* at 169.

dealer, financial planner, bank, trust company, registered investment adviser, employee retirement plan, or financial "supermarket."[35] Current systems of and linkages among funds, their service providers and financial intermediaries simply do not accommodate the calculation of individualized shareholder expenses, nor do they support the communication and presentation of such information.

To better understand the extent and nature of the costs to comply with the GAO's individualized expense disclosure recommendation, the Institute conducted a survey of various industry participants in late 2000.[36] The survey found that the aggregate costs to survey respondents associated with calculating and disclosing the actual dollar amount of fund operating expenses attributable to each investor on quarterly account statements would be $200.4 million in initial implementation costs and $65 million in annual, ongoing costs.[37] It is important to note that the aggregate costs of the survey participants necessarily understate, most likely by a significant amount, the total costs that would be incurred by mutual funds, service providers, financial intermediaries and ultimately fund investors if the GAO recommendation were adopted, because the survey participants represented only a sample of affected organizations.[38]

Consistent with the findings of the Institute survey, the cost/benefit analysis in the Proposing Release predicts that the cost of providing fund shareholders with individualized information about the fees and expenses that they paid in quarterly account statements "would greatly exceed the cost of [the Commission's] proposal" and estimates that industry-wide costs "could easily exceed $100 million annually."[39] In contrast, the Commission's proposal would provide valuable information to investors while avoiding the very substantial costs and burdens that would result if individualized expense disclosure were required.

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[35] *See* Investment Company Institute, 2002 Mutual Fund Fact Book, at 33.

[36] ICI Survey on GAO Report on Mutual Fund Fees (January 31, 2001). The survey was conducted with the assistance of an industry task force and PricewaterhouseCoopers LLP. Respondents to the survey included 39 mutual fund complexes representing approximately 77 percent of total industry net assets as of June 30, 2000, nine national, regional and clearing broker-dealers, three major independent transfer and shareholder servicing agents, and four financial planning firms. A copy of the survey is attached as Appendix A to this letter.

[37] The results of the survey indicated that compliance with the GAO recommendation would involve four major cost elements, including: (1) enhancements to data processing systems, such as additional computing and data storage capacity, programming changes to enable computation of the required numbers, and system enhancements to permit the electronic communication of the information to intermediary organizations; (2) modifications to investor communications systems and media, including modifications to quarterly statement formats, to websites and telephone systems used to communicate directly with investors and to on-line account systems used by registered representatives; (3) development and documentation of new policies and procedures in fund accounting, transfer agent and financial intermediary operations to ensure that expense information is correctly calculated and provide for quality control of new tasks; and (4) employee training programs and customer support.

[38] The survey also estimated the costs of two other methods of account statement disclosure: (1) providing an estimate of fund operating expenses attributable to each investor; and (2) disclosing the actual dollar amount of fund expenses per thousand dollars invested in the fund. The aggregate costs that the entities surveyed would incur to implement these methods were estimated to be $189.4 million (initial costs)/$58.3 million (annual ongoing costs) and $141.3 million (initial costs)/$45.5 million (annual ongoing costs), respectively.

[39] 68 Fed. Reg. at 176 (citation omitted). *See also id.* at n. 80 (noting that assuming a cost of $1 per shareholder account to provide personalized disclosure in account statements, industry-wide costs would be approximately $248 million).

Moreover, while it is clear that the costs of individualized expense disclosure on account statements would be high, we believe that any benefits of such disclosure would be limited. Indeed, in our view, account statement expense disclosure would have several disadvantages. First, it would not provide any context for an investor to assess the expenses paid in a meaningful way or to make comparisons with different funds. For example, the account statement might reflect investments in several funds but, because the amount invested in each fund likely would be different, it would be hard to make a fair comparison of the expenses paid for each. By contrast, the Commission's proposed approach, which uses a standardized investment amount, is specifically designed to facilitate comparisons among funds. As such, we believe it would promote the goals articulated in the GAO report – increasing investor awareness and understanding of mutual fund fees and promoting competition among funds on the basis of fees. Second, it could be misleading for account statements to disclose fund expenses, because there could be other investments reflected on the same statement that would not include similar disclosure. This would imply, incorrectly, that mutual funds are the only type of investment that involves costs. Placing expense disclosure in fund shareholder reports, as proposed by the Commission, would avoid this problem. Finally, respondents to the Institute's cost survey identified certain concerns that the GAO recommendation for individualized expense disclosure on account statements would raise, including the likelihood of longer processing time frames, which would result in delays in delivering account statements. The Commission's proposal would not raise this concern.[40]

Based on the foregoing, we support the Commission's proposal to require additional expense information in shareholder reports, and not in quarterly account statements.

2. Requirement to Disclose Two Different Expense Numbers

Under the Commission's proposal, funds would be required to present two different expense numbers – one based on the fund's actual return over the period and the other based on a hypothetical 5% annual return. We believe the expense information would be more understandable to investors if the Commission simplified the disclosure and required only the first dollar amount figure, for the reasons set forth below.

First, we are concerned that presenting two numbers introduces an unnecessary level of complexity by requiring explanation of the purposes of each and the differences between the two. In addition to being complex, the required disclosure could become quite voluminous, especially in the case of funds with multiple classes that would have to disclose two sets of numbers.

Second, two numbers are not necessary to accomplish the Commission's objectives. The first number would provide information to shareholders about actual expenses paid during the reporting period and allow investors to estimate the actual costs that they bore. In addition,

[40] Account statement disclosure also would single out fund expenses from other equally important information about funds and might inappropriately suggest that expenses are the only item investors should consider. By contrast, providing the disclosure in shareholder reports with other information about an investment in the fund during the period covered, as the Commission has proposed, would substantially mitigate this potential problem.

because it is based on a standardized, $10,000 investment, it would provide a basis for comparison of the expenses of different funds. Thus, the second proposed number – the cost in dollars of a $10,000 investment, based on the fund's actual expenses and an assumed return of 5 percent per year – would be largely superfluous.

Moreover, this latter proposed number has certain specific drawbacks. For example, by using a hypothetical rate of return, it would diverge from the goal of providing investors with information about *actual* expenses paid.[41] In addition, it would be similar, but not identical, to the hypothetical dollar amount expense information that is required to be set forth in an example accompanying the fee table in fund prospectuses.[42] (One difference between the two is that the dollar figures in the fee table example reflect sales charges, whereas the proposed shareholder report dollar figure would not.) The similarities and differences between the two illustrations could be confusing to investors. While it might be possible to clarify these issues through narrative explanations, this would only lead to more lengthy and complicated disclosure, contrary to the overall intent of the Commission's shareholder report initiative. And, given that the first expense number the Commission proposes to require in fund shareholder reports would satisfy the goals the Commission seeks to achieve, we believe that a better course of action would be to eliminate the second proposed number.

E. *Management's Discussion of Fund Performance*

A mutual fund, other than a money market fund, currently is required to include in its prospectus a discussion of the factors that materially affected the fund's performance during the past fiscal year ("MDFP"), unless the information is included in the fund's latest annual report to shareholders. Most funds currently include the MDFP in their annual reports, and the Commission has proposed to require funds to do so.

The Institute in the past has supported requiring the MDFP to be placed in funds' annual reports.[43] We note, however, that the Commission recently adopted new Form N-CSR, which will require the principal executive and principal financial officers of registered management investment companies to certify the entire contents of shareholder reports.[44] The Institute remains concerned that applying the certification requirement to the MDFP will have a negative impact on the quality of the MDFP. In particular, funds may be reluctant to include subjective, albeit useful, information (such as the portfolio manager's opinion about why the fund performed as it did during the period covered), because it does not readily lend itself to

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[41] *See* 68 Fed. Reg. at 168 ("The numbers that we are proposing be disclosed in mutual fund shareholder reports are intended to provide information to investors about actual current period expenses.")

[42] Specifically, Item 3 of Form N-1A requires funds to include with the fee table a hypothetical example designed to show in dollar terms the aggregate expenses that an investor could expect to pay over 1-, 3-, 5-, and 10-year periods, assuming a $10,000 investment, no changes in fund expenses, and a 5 percent annual return.

[43] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated August 11, 1998, at 4.

[44] *See* SEC Release Nos. 34-47262; IC-25914 (January 27, 2003), 68 Fed. Reg. 5348 (February 3, 2003).

meaningful certification.[45] In light of these concerns, we believe that funds should continue to have the option of including the MDFP either in the prospectus or in the annual report.

The Commission requested comments on whether it should make any changes to the content of the MDFP.[46] The Institute does not believe any changes to the current requirements are needed. As mentioned in the Proposing Release, the staff has been asked to focus on MDFP disclosure in its review of fund disclosure documents. We support these efforts to check compliance with the existing requirements.

II. Proposal to Require Quarterly Filing of Portfolio Holdings

A. *General Comments*

In addition to proposing the changes to the contents of shareholder reports discussed above, the Commission has proposed to require funds to file their complete portfolio holdings schedules with the Commission on a quarterly basis, rather than semi-annually. As discussed below, although we question the benefits of this requirement, and remain concerned about the risks involved, the Institute would not oppose the Commission's proposal if it were revised to provide additional protection against these risks.

The Proposing Release suggests that requiring more frequent portfolio holdings disclosure could have several benefits. We are skeptical about the magnitude of any such benefits. For example, the Release mentions that investors may be interested in using quarterly portfolio holdings information for various purposes, such as to monitor a fund's compliance with its stated investment objective.[47] In a 2001 submission to the Division of Investment Management expressing our views on proposals to require funds to disclose their portfolio holdings more frequently than semi-annually, we noted, among other things, that our members had experienced virtually no demand for such disclosure from their shareholders.[48] In fact, members that had reported their holdings quarterly and subsequently discontinued the practice received no complaints from their shareholders.[49] After we made the submission, we conducted

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[45] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated October 16, 2002 (noting that "[r]equiring the MDFP to be certified almost certainly would result in a scaled back, less robust discussion of information that investors find useful.").

[46] 68 Fed. Reg. at 170.

[47] 68 Fed. Reg. at 166.

[48] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated July 17, 2001.

[49] Indeed, until December 1981, funds were *required* to file information about acquisitions and dispositions of portfolio securities with the Commission on a calendar quarterly basis on Form N-1Q. *See* SEC Release Nos. 33-6366, 34-18337, IC-12107 (December 16, 1981) ("N-1Q Release"). The Commission eliminated this requirement after concluding that "the limited benefit to the public of quarterly transaction reporting by investment companies is outweighed by the costs of such reporting." N-1Q Release at 26. More specifically, the Commission determined that the information was no longer required to aid the Commission in its regulatory responsibilities or to collect information for studies, and concluded that sufficient information was available to interested persons through reports on Form 13F and other portfolio disclosure requirements applicable to investment companies. *Id.* at 25-26.

an investor survey designed to assess shareholders' use of portfolio disclosure provided in fund shareholder reports and to gauge shareholders' interest in receiving this information more often than semi-annually.[50] The survey results confirmed a lack of fund shareholder interest.[51]

The Proposing Release asserts that another possible benefit of more frequent disclosure of portfolio holdings could be to discourage abusive practices known as "window dressing" and "portfolio pumping."[52] We note, however, that the Commission has provided no evidence of funds engaging in these practices. And we continue to believe, as we stated in our 2001 submission, that, to the extent such practices may occur, the Commission has ample authority to address them through its inspections and enforcement programs.[53]

In addition to questioning the benefits, our 2001 submission expressed concerns about the potential for harm to shareholders of some funds from requiring more frequent portfolio holdings disclosure. In particular, we noted that requiring such disclosure more frequently than semi-annually would expand opportunities for speculators and other professional traders to exploit the information in ways that are detrimental to fund shareholders. This could include, for example, "front running" fund trades in cases where an extended period of time is needed to build or reduce a position[54] and "free riding" on fund research and investment

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[50] The survey was conducted in August 2001 by interviewing 500 investors owning stock mutual funds outside of employer-sponsored retirement plans. A summary of the survey results is set forth in Appendix B to this letter.

[51] For example, 72% of those responding indicated that they were not interested in receiving quarterly portfolio holdings information, *even if the information is free of charge.* In addition, only 13% indicated that that would be willing to pay for quarterly portfolio disclosure. The vast majority of respondents (84 percent) indicated that they would be concerned about investors outside their stock funds having sufficient information to anticipate the timing of the fund managers' purchases and sales of specific stocks.

[52] 68 Fed. Reg. at 174.

[53] On a related point on which the Commission has requested comments, we would oppose requiring that the proposed summary portfolio schedule and/or the complete portfolio schedule identify securities acquired within a designated number of days before the end of the reporting period. This type of disclosure would be confusing to investors and could lead to misimpressions about the propriety of fund acquisitions of securities.

[54] The cost/benefit analysis in the Proposing Release suggests that mandating quarterly portfolio disclosure may not significantly increase the likelihood of front running of mutual fund portfolios. *See* 68 Fed. Reg. at 175-76. According to the cost/benefit analysis, for increased front running to occur, eight conditions must hold simultaneously and these conditions may rarely be met. This conclusion is based on the Commission's estimate in footnote 107 of the Proposing Release that essentially all mutual funds can unwind a position in any one portfolio security within an average of nine days. No information on the basis for this estimate is provided. However, even if this claim is true *on average*, based on our own analysis and our discussions with members, we believe that the estimate significantly understates the time within which some funds – particularly larger funds that have concentrated portfolios, hold more of particular issues or hold thinly-traded stocks – can buy or sell certain securities at reasonable cost. Moreover, the Commission's cost/benefit analysis ignores the basic fact that *any* additional information about fund portfolio holdings will facilitate front running that is already occurring. The better market participants are able to anticipate fund trades through publicly available information, the easier and more profitable front running will be. Requiring more frequent disclosure of fund portfolio holdings would add to the mix of information that is currently available about the individual portfolio securities of mutual funds (including information from reports filed by institutional investment managers on Form 13F, as discussed further below) and thus can be expected to compound the risk of front running of fund trades.

strategies.[55] According to the study commissioned by the Institute that accompanied our submission, if the required frequency of mutual fund portfolio holdings disclosure were increased, "the total return that shareholders receive from their mutual fund investments would likely be lower than under the current disclosure standard."[56]

The absence of clear benefits and the risk of harm discussed in our 2001 submission and summarized above call into question the wisdom of requiring funds to disclose their portfolio holdings more frequently. At the very least, they strongly indicate that the Commission should proceed cautiously in this area.

The Commission's proposal does attempt to minimize potential harms to fund shareholders by requiring disclosure on a quarterly basis with a 60-day lag. As the Wermers Study makes clear, the frequency and timing of portfolio holdings disclosure are important factors influencing the degree of risk of harm to funds; generally speaking, the more frequent and current the disclosure, the greater the opportunities for abuse will be. Thus, we agree that the standard proposed by the Commission should present significantly less risk than one that involves more frequent disclosure (*e.g.*, monthly) or a shorter lag period (*e.g.*, 30 or 45 days).

Still, we remain concerned that even under the Commission's proposal, shareholders of some funds would suffer as a result of the actions of speculators and other outside investors.

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[55] The Commission's cost/benefit analysis seems to be of the view that the costs of free riding resulting from requiring quarterly portfolio holdings disclosure are likely to be insignificant. *See id.* at 176. This is based partly on the premise, expressed in some academic research, that it is difficult to consistently identify skilled fund managers, as well as on the view expressed in the Proposing Release (at least implicitly) that information about fund trades must become stale or uninformative within 2 to 5 months after trades are initiated. In response to the Commission's request for comment on its analysis, the Institute notes that recent research indicates that fund managers *are* able to identify mispriced securities through research, that the benefits of that ability accrue to mutual funds and their investors through higher-than-average returns over a period of time, and that this period of time may be lengthy, from between 12 to 18 months to as long as six years. *See* R. Wermers, "Mutual Fund Performance: An Empirical Decomposition into Stock-Picking Talent, Style, Transactions Costs, and Expenses," *Journal of Finance*, 55, 2000, at 1658 (supporting the proposition that mutual fund managers can identify mispriced securities); Hsiu-Lang Chen, Narasimhan Jegadeesh, and Russ Wermers, "The Value of Active Mutual Fund Management: An Examination of the Stockholdings and Trades of Fund Managers," *Journal of Financial and Quantitative Analysis*, 35 (2000), at 353-55 (finding that excess returns on the stocks in mutual fund portfolios persist); and Melvyn Teo and Sung-Jun Woo (November 2001, working paper, Department of Economics, Harvard University) (finding that "differences in style-adjusted returns persist for up to *six* years" (emphasis added) and that that "is suggestive of managerial stock-picking ability."). Moreover, other recent research has indicated that it is possible to use the information from *semi-annual* disclosure of fund portfolio holdings to free ride on the research of actively managed mutual funds, by mimicking ("copy-catting") their portfolios, and garnering a higher return because the funds' research is obtained for free through their semi-annual reports. *See* Myers, Poterba, Shackelford, and Shoven, "Copycat Funds: Information Disclosure Regulation and the Returns to Active Management in the Mutual Fund Industry," MIT Department of Economics working paper 02-04, October 2001. In short, the evidence is at least as strong that free riding based on fund portfolio holdings disclosure can be achieved, is profitable, and will be facilitated by more frequent portfolio disclosure.

[56] Russ Wermers, "The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance," *Perspective,* Vol. 7, No. 1, June 2001, Investment Company Institute ("Wermers Study") at 1. As discussed in our 2001 submission, these concerns are not merely theoretical. In a scan of financial websites on the Internet, the Institute uncovered several examples of services that claim to provide clients with the ability to "piggyback" off of fund research and investment strategies. The gains for those who would exploit fund portfolio holdings information will come at the direct expense of fund shareholders.

We believe that the Commission could minimize these risks if it revised the proposal to give funds additional flexibility to keep certain holdings confidential. We recommend, therefore, that the Commission allow funds, in their shareholder reports and reports on Forms N-CSR and N-Q, to keep confidential holdings that meet the standards for confidential treatment applicable to Form 13F under the Exchange Act.[57] This should be *in addition* to the five percent basket of "miscellaneous securities" currently permitted under Regulation S-X.[58] We believe that this additional flexibility would provide funds with a targeted mechanism, in appropriately limited circumstances, to help protect their shareholders from the losses that could result from revealing a program of acquisition or disposition of a security.

B. *Reports on Form 13F*

In addition to recommending that the Commission revise its proposal to require quarterly filing of portfolio holdings information in the manner discussed above, the Institute urges the Commission to take steps to curtail opportunities for speculators and other outside investors to take undue advantage of information about fund portfolio holdings by revising the requirements for reporting by institutional investment managers on Form 13F. We are pleased that the Commission, through its requests for comment, has expressed a willingness to reexamine the current requirements.

As we have indicated before,[59] there is evidence that the information contained in Form 13F reports is being used for purposes that were not contemplated by Congress when it enacted Section 13(f) of the Exchange Act[60] and that are harmful to mutual fund shareholders. Technological advances since the enactment of Section 13(f) have greatly increased the speed and ease with which the information in 13F reports may be accessed and disseminated, thereby making it possible to package the information in ways that facilitate predatory trading practices. Indeed, commercial services (such as those referred to above) that offer the ability to trade securities on the basis of information regarding the holdings of mutual funds appear to rely in significant part on information from 13F reports.

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[57] Section 13(f) of the Exchange Act and Rule 13f-1 thereunder generally require institutional investment managers that manage more than $100 million in certain equity securities to file reports on Form 13F with the Commission within 45 days after the end of each calendar quarter. The instructions to Form 13F include instructions for requesting confidential treatment of information required to be reported.

[58] *See* note 1 to Rule 12-12 of Regulation S-X (*see* Section I.A.6, *supra* p. 6). In this regard, we note that the utility of the 5% basket of miscellaneous securities is somewhat limited because, for example, it only applies to positions that have not previously been reported and thus would not protect a fund against prematurely revealing the disposition of a security. Confidential treatment should be available whether a fund uses a summary portfolio schedule or includes its complete portfolio in its shareholder reports.

[59] *See* Investment Company Institute, Proposals to Improve Investment Company Regulation (May 1, 2002) at 61-64; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated July 17, 2001, at 7-8.

[60] The original purposes of Section 13(f) included, for example, creating a central repository of information about the investment activities of institutional investment managers in order to allow regulatory agencies to analyze the influence and impact of those managers on the securities markets as well as the public policy implications of their investment activities. *See* Exchange Act Release No. 14852 (June 15, 1978) at 5.

As the Institute has previously acknowledged, certain differences between the information in 13F reports and the schedule of investments in fund shareholder reports suggest that the disclosures included in 13F reports may not facilitate the same degree of harmful trading practices as disclosure of individual fund portfolio holdings.[61] Nevertheless, like fund portfolio holdings disclosure, and especially when combined with such disclosure, 13F reports likely facilitate front running and free riding practices that hurt fund shareholders.[62] An increase in the required frequency of fund portfolio holdings disclosure, as proposed by the Commission, could only be expected to exacerbate this situation, particularly for funds whose fiscal quarters do not correspond with calendar quarters. We note that for those funds, some form of portfolio holdings disclosure would be required *eight* times per year (by the individual fund within 60 days after the end of each fiscal quarter and as part of the investment manager's aggregated holdings disclosure in 13F reports within 45 days after the end of each calendar quarter.)

To minimize the abuses that may result from the availability of information contained in quarterly 13F reports, such as front running and free riding, we reiterate our recommendations that the Commission: (1) require semi-annual, rather than quarterly, reporting of this information; and (2) require the filing of such reports within 60 days after the end of the relevant period, instead of 45 days.[63]

C. *Proposed Form N-Q*

Under the Commission's proposal, funds would be required to file complete portfolio schedules for their first and third fiscal quarters on proposed new Form N-Q. The Institute has the following comments on proposed Form N-Q.

First, as proposed, Form N-Q would have to be signed on behalf of the fund by the fund's principal financial officer or officer(s). The Proposing Release requests comment on whether the Commission should designate Form N-Q as a reporting form under Sections 13(a) and 15(d) of the Exchange Act, which would subject the form to certification requirements

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[61] For example, as noted above, when filing 13F reports, investment managers are permitted to request confidential treatment of certain types of information, including information that would reveal an investment manager's program of acquisition or disposition that is ongoing both at the end of a reporting period and at the time of filing the Form 13F. As discussed above, we believe that if funds will be required to disclose their portfolio holdings on a quarterly basis, the Commission should adopt a similar confidential treatment provision.

[62] The Commission's Chief Economist, in a recent publication, noted that "[t]he information [in 13F reports] is particularly useful when the large trader is a seller whose investment policy prohibits short sales." Larry Harris, *Trading and Exchanges: Market Microstructure for Practitioners,* Oxford University Press, 2003, at 326. This would often be the case for a large mutual fund.

[63] Even if the Commission makes this change, it is important to maintain the provisions for requesting confidential treatment of information in 13F reports, especially if quarterly disclosure of fund portfolio holdings is required. As discussed above, the potential for outsiders to use portfolio holdings information to the detriment of fund shareholders would be reduced but not eliminated by a 60-day delay in disclosure of the information. Therefore, the need to request confidential treatment of 13F reports could still arise and the opportunity to do so should remain available.

under Section 302 of the Sarbanes-Oxley Act of 2002.[64] The Institute supports the approach proposed by the Commission and would oppose designating Form N-Q as an Exchange Act reporting form. There is no indication whatsoever that Congress, in enacting the Sarbanes-Oxley Act, intended to expand the reporting requirements for investment companies under the Exchange Act and thereby to increase the scope of certification requirements applicable to them. The Commission should not use this rule proposal as a way to do so. The resulting burdens would outweigh any conceivable benefits.

Second, as discussed earlier in this letter, the Commission has proposed to exempt money market funds from including portfolio schedules in their shareholder reports, which the Institute supports. In explaining the basis for this proposal, the Proposing Release notes that money market funds' portfolio investments are highly circumscribed by Rule 2a-7, that a list of a money market fund's portfolio securities may not assist the average investor in evaluating the fund or distinguishing one money market fund from another, and that investors generally are less interested in the composition of money market fund portfolios than other types of funds.[65] The Institute agrees and believes that for the same reasons, money market funds should be exempted from the Form N-Q filing requirement and should continue to file their full portfolio schedules with the Commission semi-annually. We recommend that the Commission revise its proposal accordingly.

III. Effective Date

The Proposing Release states that if the proposed amendments are adopted, the Commission would expect to require all fund reports to shareholders filed for periods ending on or after the effective date of the amendments to comply with the proposed amendments, and to require funds to file quarterly reports on Form N-Q with respect to any fiscal quarter ending on or after the effective date.[66] The Institute supports this approach and recommends that the Commission provide an appropriate transition period by designating an effective date that is 120 days after the adoption of the amendments.

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The Institute appreciates the opportunity to comment on the Commission's proposals. If you have any questions concerning our comments, or need additional information, please

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[64] 68 Fed. Reg. at 168.

[65] *Id.* at 165.

[66] *Id.* at 170.

The Institute appreciates the opportunity to comment on the Commission's proposals. If you have any questions concerning our comments, or need additional information, please contact me at (202) 326-5815, Amy Lancellotta at (202) 326-5824 or Frances Stadler at (202) 326-5822.

Sincerely,

Craig S. Tyle
General Counsel

Attachments

cc: The Honorable Harvey L. Pitt
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Paul F. Roye
Director, Division of Investment Management

Susan Nash
Associate Director, Division of Investment Management

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Chief Accountant, Division of Investment Management

January 31, 2001

ICI Survey on GAO Report on Mutual Fund Fees

ICI Survey on GAO Report on Mutual Fund Fees

Table of Contents

I. Executive Summary

A. Background

In response to a request from Congressman Michael Oxley, Chairman of the House Subcommittee on Finance and Hazardous Materials, and Congressman John Dingell, Ranking Member of the House Commerce Committee, the U.S. General Accounting Office issued a report, "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition," ("the Report") in June 2000. The Report recommends that the Securities and Exchange Commission (the "SEC") require mutual funds to disclose each investor's share of mutual fund operating expenses on quarterly investor account statements ("the Recommendation"). The Report suggests that the SEC examine the Recommendation's costs and burdens on the mutual fund industry and investors. In a letter to the SEC dated June 30, 2000, Chairman Oxley and Congressman Dingell urged the SEC to implement the Recommendation, although they stated they were "open to other effective suggestions." They requested two progress reports from the SEC; the first by year-end 2000; the second by June 2001.

The Report offers three alternative methods for satisfying the Recommendation. The primary method presented is to calculate and disclose the actual dollar amount of fund operating expenses attributable to each investor. The second method is to disclose an *estimate* of fund operating expenses attributable to each investor. The third method is to disclose the actual dollar amount of fund operating expenses per thousand dollars invested in the fund. The first two methods would require separate calculations for each investor account, while the third method would require only one calculation for all investors in a given fund.

To better understand the extent and nature of the costs to comply with the Recommendation, the Investment Company Institute ("ICI")[1] conducted a survey. The survey objectives were to gather information regarding the changes in processes, systems and controls that would be necessitated by the Recommendation, the initial and ongoing annual costs of compliance, and the operational difficulties likely to be encountered in implementing the Recommendation. An industry task force provided advice and guidance to the ICI in the development and management of the project, and PricewaterhouseCoopers LLP assisted in survey design, collection and compilation of the survey data, and the development of this report.

Responses to the survey were received from a sample of organizations affected by the Recommendation, including mutual fund complexes and their designated affiliates,[2] independent transfer agents and shareholder servicing agents, national and regional broker dealers, securities clearing firms, and financial planning firms. This includes 39 mutual fund complexes with total net assets of $4.8 trillion, representing approximately 77 percent of total industry net assets[3] as of

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1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,358 open-end investment companies ("mutual funds"), 489 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.161 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

2 Including fund accounting, transfer agent, shareholder servicing, and broker dealer operations.

3 Total industry net assets of $6,256,289,864 as reported by the Investment Company Institute as of 6/30/00 excluding variable annuity assets.

June 30, 2000, nine national, regional and clearing broker dealers, three major independent transfer and shareholder servicing agents, and four financial planning firms**.**

B. Industry Environment

The mutual fund industry provides asset management and account recordkeeping services to 87.9 million investors in 50.6 million households. Investors interact with their mutual funds in a variety of ways. Investors can purchase shares and maintain accounts directly with a fund company, through a broker dealer, within a fund supermarket, via a financial planner or registered investment adviser, within a 401 (k) plan or through a bank trust department. In addition, investors use various technologies to reach their mutual fund complex. An investor can obtain information and transact business by visiting a branch office, calling the 800 number of a fund complex or intermediary to speak with a representative, or by using a touch tone telephone service. In addition, many fund companies permit shareholder access to account information and transaction services through proprietary Internet websites. Each of these channels of distribution and technologies require mutual funds and the various companies that provide services to them to synchronize efforts and share data so that investors receive the same information regardless of the channel or technology used.

The chart contained in Appendix A on page 11 illustrates these various organizations, systems and other mechanisms, and the role required of each to develop and deliver the mutual fund expense information called for by the Recommendation. The entities depicted comprise a complex network of mutual fund processing and servicing centers. Compliance with the Recommendation will require an extraordinary amount of coordinated action to create the new procedures and programs, and to enhance the communication links necessary to accommodate the new information. Modifying this infrastructure to calculate and report the new information in an accurate and consistent fashion to all fund investors through all investor contact points is a complex undertaking that would result in significant costs and numerous practical difficulties.

C. Survey Results

1. <u>Costs of Compliance</u>

Aggregate estimated costs of the survey respondents to implement the primary method detailed in the Recommendation would exceed $200 million and the annual ongoing cost of compliance would exceed $65 million. It is important to note these costs represent the estimated costs of the *survey respondents only*. That is, the Institute did not attempt to use the survey data to project a cost estimate for the entire industry and all mutual fund investors. As noted above, the survey includes only a small sample of broker dealers and other mutual fund distributors, each of whom would separately have to create the calculation and reporting infrastructures necessary to comply with the Recommendation. Thus, the survey data understates, most likely by a significant amount, the total cost of compliance. Moreover, as it is not clear whether variable annuities, 401(k) plans and bank trusts are included in the Recommendation, they were excluded from the survey. If they are included in the Recommendation, the survey data understate by an even greater amount the total cost of compliance.

As noted above, the Recommendation also suggested two additional alternative methods. A description of the three methods contained in the Recommendation, costs of implementation and annual ongoing costs of compliance are presented later in this report.

2. Significant Cost Drivers

In estimating costs to comply with the Recommendation, survey respondents identified the following major activities or cost categories:

a. Enhancements to current data processing systems.

- Additional computing and data storage capacity will be required to complete the computations envisioned by the Recommendation within the time frames required to meet investors' expectations for high quality service.

- Programming changes will be needed to enable the computation of the recommended numbers.

- System enhancements will need to be made to permit the electronic communication of the information to all intermediary organizations.

Currently, the mutual fund industry does not have the systems or procedures to compute, store and communicate mutual fund operating expenses to investors. To accomplish this, mutual funds, their servicing agents, and their distribution partners, would be required to implement extensive programming changes. See attached Appendix A for a full description of the changes that will be required.

b. Modifications to investor communication systems and media.

- Quarterly statement formats must be modified for each fund to display the required numbers and provide explanatory information.

- Financial intermediaries, such as brokers, financial planners and registered investment advisers, must redesign customer account statements to include information gathered from several mutual fund companies and determine how to portray this information on statements containing non-mutual fund investments.

- Redesigning each statement format requires separate programming. Given the large number of different statement formats in use throughout the financial services industry, statement redesign can only be accomplished at a considerable cost.

- Websites and telephone systems used to communicate directly with investors, and on-line account systems used by registered representatives require modification so that when an investor looks up their account, or calls the representative to inquire about the expense information, the representative can adequately respond.

See the flowchart in Appendix A for a depiction of the range of communication systems and media affect by the Recommendation.

c. ***New policies and procedures.***

- Daily processes in fund accounting, transfer agent and financial intermediary operations must be developed and documented to ensure the financial information is correctly calculated and that quality control of new tasks is provided.

d. ***Employee training programs and customer support.***

- Personnel involved in the daily calculation and reporting of the required information must be trained to perform new tasks.

- Ongoing training and appropriate explanatory materials will be required to ensure shareholder support personnel are able to properly answer shareholder questions and inquiries. Shareholder service representatives will require training to help investors understand the new information and how to interpret it within the context of performance information already provided.

- An expected rise in investor inquiries related to the new information will require the deployment of additional trained customer support staff upon implementation.

3. Implementation Concerns

Three principal concerns were identified by survey respondents that will need to be addressed if the Recommendation is implemented. First, it is not clear whether variable annuities, defined contribution plans, banks, and trust companies are within the scope of the Recommendation. Second, there is no existing infrastructure to accommodate transfers of fund operating expense information when shareholder accounts are transferred from one financial intermediary to another within a reporting period. Third, the Recommendation is likely to result in longer processing timeframes, causing delays in delivery of monthly or quarterly account statements.

II. Survey Results and Findings

A. Survey Methodology

In August 2000 the Investment Company Institute initiated a survey to determine the costs and burdens of complying with the GAO Recommendation that mutual funds disclose each investor's share of fund operating expenses on quarterly investor account statements. The survey was designed to solicit cost and cost related data on the three methods outlined in the GAO Report as alternatives to satisfying the Recommendation. A detailed description and flow chart depicting the primary method used in the survey by respondents to develop their cost estimates is presented in Appendix A. To ensure that cost estimates were prepared on a consistent basis, a set of assumptions, described in Appendix B, was provided to survey participants. ***The methodology and assumptions described in Appendices A and B were developed solely for the purpose of the survey to ensure uniformity in estimating the cost to comply with the Recommendation. The ICI recognizes that other approaches may be adopted should some form of the Recommendation ultimately be required.***

B. Scope of Survey

The survey included a sample of organizations affected by the Recommendation including:

- mutual fund complexes and designated affiliates,
- independent transfer agents and shareholder servicing agents,
- national, regional and clearing broker dealers, and financial planners.

These organizations represent the types of organizations that will need to create or modify procedures and systems to comply with the Recommendation. The survey results presented in the remainder of this report provide a basis for understanding the types of costs that will be incurred to comply with the Recommendation. However, the aggregate costs of the survey participants necessarily understate the total costs that will be incurred by mutual funds, service providers, financial intermediaries and ultimately mutual fund investors, because only a sample of affected organizations are represented in the respondent population.

Respondents to the survey included 39 mutual fund complexes with total net assets of $4.8 trillion representing approximately 77 percent of total industry net assets as of June 30, 2000, nine national, regional and clearing broker dealers, three major external transfer and shareholder servicing agents, and four financial planning firms. Thus, while the survey population includes many of the largest mutual fund organizations and the major independent transfer agents and shareholder servicing agents serving the industry, a relatively small number of independent mutual fund distributors, such as broker dealers and financial planning organizations, participated in the survey. Also, as noted in the Executive Summary, variable annuities, 401(k) plans, and bank trusts were excluded from the survey, as it is not clear whether they are included in the Recommendation.

The mutual fund industry can be characterized as a complex structure of organizations serving the investing public. Not long ago, the mutual fund industry could be divided into two groups;

those mutual funds that offered their shares directly to investors, and those that offered their shares exclusively through a network of broker dealers. Today, virtually all mutual fund companies offer shares through a variety of financial intermediaries. Currently, about 80 percent of all mutual fund transactions are completed with the assistance of a financial intermediary. Such intermediaries include in addition to broker dealers, financial planners, banks, trust companies, registered investment advisers, employee retirement plans, and financial "supermarkets." To better understand how mutual funds, their service providers and intermediaries would be required to interact to provide investors the information suggested by the Recommendation the chart included in Appendix A on page 11 has been developed. This chart depicts the computations and information flow necessary to support the Recommendation in the context of a direct investor relationship with a mutual fund and where one or more financial intermediaries are positioned between the investor and the fund.

The systems and linkages that exist today, as shown in the flowchart, do not currently accommodate the required calculation for individual shareholders, nor do they support the communication and presentation of the information. Survey respondents highlighted many of the complexities organizations would confront in modifying the processing systems and technology linkages, and in creating adequate controls that would ensure information is consistently and accurately transmitted between parties in a timely manner. Many of the cost burdens arise from the extensive interdependencies within the reporting infrastructure.

C. Survey Results

The survey results include the total initial and annual ongoing costs of compliance as reported by survey respondents, a summary of the most significant operational changes affected organizations would need to undertake, and a discussion of the major cost elements of those changes. Respondents also identified a number of practical questions and concerns associated with implementing the necessary changes in their organizations, which are also summarized below.

1. Costs of Compliance

The survey solicited information from a sample of key organizations in the mutual fund industry affected by the Recommendation. The aggregate costs of initial and annual ongoing compliance for each of the three methods described in the Recommendation are presented below.

	Total Initial Costs	**Total Annual On-going Costs**
Method 1	$200.4 million	$65.7 million
Method 2	$189.4 million	$58.3 million
Method 3	$141.3 million	$45.5 million

Virtually all of the $200.4 million of initial implementation costs reported by survey participants for method 1 can be separated into systems and personnel costs of approximately $128.1 million and communications related costs, including statement redesign, of approximately $67.6 million. The annual ongoing costs reported for method 1 of $65.7 million includes $48.4 million and $15.4 million, respectively, for the same cost categories.

Method 1 is the most costly method because calculations are conducted for each shareholder account each day and communicated daily throughout the reporting infrastructure. Method 2 is only slightly less costly than method 1, because while calculations are conducted and communicated quarterly rather than daily, they must be performed retroactively for each account for each day in the reporting period. All of the other costs for methods 1 and 2 are substantially similar. Method 3 is the least costly alternative, because a single calculation is made for all shareholders of a given fund, rather than individual calculations for each shareholder. The costs for method 3 are not insubstantial, though, because the considerable costs of supporting the communication of the information throughout the reporting infrastructure are still present. Respondents generally reported that it would take approximately nine to twelve months to implement the Recommendation.

2. Operational Areas Requiring Significant Changes

The responsibility to implement the Recommendation will affect three major operational functions – (1) mutual fund accounting, (2) mutual fund transfer agent and shareholder servicing, and (3) financial intermediary operations. The implications to each functional area are described below.

Fund Accounting Agents

Mutual fund accounting agents would be responsible for the determination of an expense factor to be communicated to and used by transfer agents, broker dealers, and other investor recordkeepers to calculate each investor’s share of a fund’s expenses. A separate expense factor must be determined for each class of shares of multiple class funds.

The impact of the Recommendation on fund accounting operations varies among respondents. For a few large, complex organizations, the costs would be significant. These organizations typically employ multiple methods of distribution (direct, broker dealer, etc.) with intricate system interfaces that would require considerable programming to capture and forward all of the expense factors through the applicable data interfaces to the appropriate parties. Other organizations provided more modest estimates based on less complex system architectures and interfaces. Most respondents reported that existing system architectures and communication mechanisms could be modified to accommodate the necessary changes.

Transfer Agents and Shareholder Servicing Agents

Mutual fund transfer agents and shareholder servicing agents would be responsible for calculating the expense amounts allocable to each individual shareholder account and ensuring that this information was appropriately disseminated directly to investors or to financial intermediaries for further reporting to investors.

All transfer agent respondents believe that the Recommendation would require significant changes to existing data processing systems and electronic communication links. The magnitude of these system changes is largely dependent on the number and types of distribution channels (direct, broker dealer, etc.) supported by their mutual fund clients and the technological complexity of established interfaces. However, it should be noted that even those respondents with single distribution channels expect compliance with the Recommendation to require extensive and costly computer programming, hardware modifications, and procedural changes.

Transfer agent respondents also reported significant shareholder communications expenses. These include the costs of statement redesign, and explanatory and educational materials for investors. Cost estimates also include modifications to other communications media including shareholder websites, telephone voice response systems and customer support systems, so the applicable account information is readily available to service investors. Additional customer support to respond to inquiries would also be required, as well as education and training materials for investor service representatives.

Intermediary Organizations

Similar to mutual fund transfer agents and shareholder servicing agents, broker dealers expect compliance with the Recommendation will necessitate expensive systems changes, due primarily to the different forms in which mutual fund investments are held. Fund shares purchased through brokers (or any other financial intermediary) are generally held either "directly" with the fund, or in an "omnibus" account, where the individual investor accounts are maintained at the broker dealer. For accounts held directly, the fund's transfer agent would calculate each investor's share of fund expenses and the broker dealer would be responsible for communicating those amounts to clients. For omnibus accounts, broker dealers would need to calculate each investor's share of fund expenses *and* communicate the amounts to clients. The Recommendation would be particularly expensive for broker dealers and other intermediaries with extensive omnibus account operations, including mutual fund "marketplaces" or "supermarkets," where investors are offered a wide variety of funds from a large number of fund companies through one brokerage account.

Limited data were provided by financial planners. Therefore, we are unable to draw conclusions about the expected compliance costs of the financial planning community. However, those survey respondents generally confirmed that implementing the Recommendation would require a significant effort.

3. Major Cost Elements

The following major cost elements were highlighted by respondents when describing the significant operational changes required to comply with the Recommendation.

System Changes – Fund accounting, transfer agent, and financial intermediary systems, whether proprietary or provided by third parties, and the linkages between these systems, would require significant and costly modifications in order to develop the necessary calculation and reporting infrastructures. The new information would need to be developed and disclosed in conjunction with already compressed quarter-end processing cycles.

The data would need to be processed in an accurate and timely fashion so that vendors, intermediaries, and service providers to the industry could seamlessly and simultaneously complete statement production cycles and update shareholder communications media, including internet websites, telephone voice response and account representative systems, so that the required information is readily available to investors. Significant testing and data processing equipment upgrades would be required to handle the additional data. System hardware capacity would also need to be enhanced to accommodate additional data storage requirements for those methods requiring customized disclosure at the individual account level (methods 1 and 2).

Shareholder Communications – Numerous shareholder communications issues were identified by respondents. Shareholder statements would require redesigns both from a marketing/aesthetic and systems/print-mail perspective. In addition, communications kits or materials explaining the new information contained in the statement, including separate statement inserts, website postings, in-branch educational events, and re-prints of existing communication materials would be required.

Many mutual fund transfer agents in the survey reported that typically when new information is provided to shareholders, telephone call center volumes increase. Some respondents indicated that call volumes would increase as much as 20 percent over normal levels, raising concerns about the ability to handle the activity with current personnel and system capacities. Many broker dealer respondents also expect increased inquiries from customers. This would likely result in additional inquiries being made by the broker to the fund complex for clarification. Inquires received by telephone, in writing or through the fund's website would increase staffing requirements in the correspondence and compliance servicing areas of transfer agents and broker dealers.

New Procedures – Fund accounting operations would need new daily procedures to calculate expense factors, and to perform quality assurance checks, supervisory reviews and error correction practices. Quality control functions would need to be established to reconcile, proof and perform periodic audits of calculations.

Transfer agent organizations, brokerage firms and other financial intermediaries would also need to establish procedures for obtaining the appropriate information from the fund accounting agent, calculating the daily account level expense, accumulating expenses for the quarter, and for performing quality assurance checks, supervisory review procedures, and error correction practices.

Training – Shareholder representatives and intermediaries (broker dealers, financial planners, etc.) would also need to be trained to address potential questions from shareholders. This training would require the development of educational materials as well as standardized response scripts to assist in servicing investors.

As previously mentioned, both fund accounting and transfer agent personnel would require training to perform the calculations and to ensure adherence to established policies and procedures. Operations personnel supporting omnibus accounts at broker dealers would need similar training.

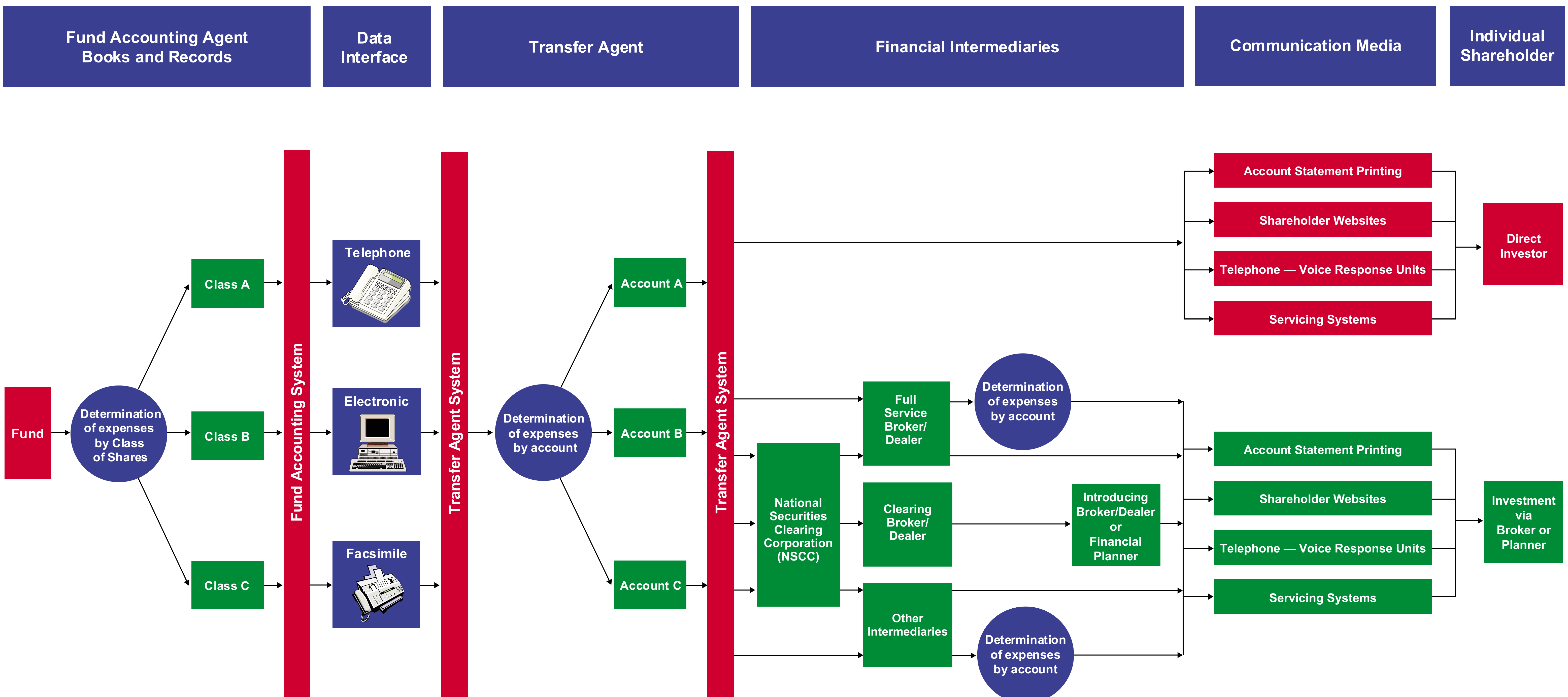
D. Implementation Concerns

There were several important questions or concerns identified by survey respondents that will need to be addressed if the Recommendation is implemented. First, it is not clear whether variable annuities, defined contribution plans, banks and trust companies are within the scope of the Recommendation. *Therefore, mutual fund shareholders that also maintain mutual fund investments within variable annuities or employer retirement plans may receive inconsistent information on their various account statements***.**

Next, there is no existing infrastructure to accommodate transfers of fund operating expense information when shareholder accounts are transferred from one financial intermediary to another within a reporting period, a common occurrence. Such account transfers could easily result in inconsistencies between reporting agents. For example, some agents will report the new information only on a quarterly basis while others may report cost information only for the time the account was open.

Last, while the survey requested that respondents assume no change in the timeliness of information reporting to shareholders in estimating costs, almost all said that the recommendation is *likely to result in longer processing timeframes, thus causing delays in delivery of monthly or quarterly account statements.* The delays are likely to be amplified in intermediary organizations relying on fund companies to provide information to complete their own customer statements, which is analogous to the annual Form 1099 reporting process between mutual funds and intermediaries. This is contrary to shareholder expectations for timely receipt of investment information.

Mutual Fund Operating Expense Information Flow — GAO Recommendation



APPENDIX A

This appendix is intended to assist the reader's understanding of the processes that industry participants (e.g. fund accounting agents, transfer agents and financial intermediaries) would need to establish to communicate fund operating expense information to individual shareholders in compliance with the GAO Recommendation.

Fund Operating Expense Information Flow

The diagram on page 11 illustrates the various organizations, systems and other mechanisms, and role required of each to develop and deliver the mutual fund operating expense information called for by the Recommendation. The fund's operating expense information for the principal method outlined in the Recommendation would be processed and reported to the individual shareholder as follows:

- The books and records of each mutual fund are the responsibility of the Fund Accounting Agent (FA). To comply with the primary method suggested by the Recommendation, on a daily basis the FA calculates a daily expense rate per share by dividing the total expenses by the number of fund shares outstanding used in that day's net asset value calculation. The rate per share, or "expense mil rate," is then communicated to the fund's transfer agent.
- Shareholder records are the responsibility of the Transfer Agent (TA). On a daily basis the TA multiplies the expense mil rate, obtained from the FA, by the number of shares each account holder owns to determine the portion of fund expenses allocable to that account for that day.
- The TA often maintains the mutual fund shares purchased by individuals through a Broker Dealer or Financial Planner Intermediary in an omnibus or "street" name account. That is, the investments in a particular fund of individual shareholders are aggregated and held by the TA in the Intermediary's name. The Intermediary, acting as a "Sub-Transfer Agent," maintains the relevant account information for each individual shareholder. For these omnibus accounts, on a daily basis the Intermediary would be required to multiply the expense mil rate by the number of shares each account holder owns to determine the portion of fund expenses allocable to that account for that day.
- Each day a new rate per share would be calculated by the FA, extended by the TA and any Intermediaries maintaining investor accounts, added to the previous day's accumulated balance for each shareholder account with a share balance, and stored in the investor recordkeeping systems.
- At the end of the reporting period, the cumulative expenses allocated to the individual shareholder's account would be communicated, and otherwise made available, to investors on printed account statements, voice-response units, websites and other shareholder servicing systems.

The processing steps outlined above would be essentially the same for alternative method 2. However, the fund transfer agent and any intermediaries maintaining investor accounts would not be required to process or determine fund operating expenses by account for alternative method 3.

Compliance with the Recommendation will require an extraordinary amount of coordinated action to create the new procedures and programs, and to enhance the communication links necessary to process the required information. Modifying this infrastructure to calculate and report the new information in an accurate and consistent fashion to all fund investors through all investor contact points is a complex undertaking that would result in significant costs and numerous practical difficulties.

APPENDIX B

Survey Assumptions

1. The Recommendation applies to open-end investment companies (mutual funds), and their SEC regulated financial intermediaries. Thus, it applies to broker dealers and registered investment advisers and financial planners. It is not clear whether the Recommendation applies to variable annuities, employer retirement plans or bank trusts. Accordingly, they are excluded from the survey.

2. Implementation of the Recommendation should not result in a degradation of investor services. Therefore when preparing your cost eliminates you should include any costs needed to ensure the data transmissions and other processing steps, and delivery of customer statements will occur in timeframes consistent with current processes.

3. The expenses and the shares used in the calculations are the same as those used in the daily calculation of the fund's net asset value.

4. The new disclosures will consist of the dollar amount of fund operating expenses allocable to the shareholder's account and a line or two of text labeling and/or explaining the dollar amount.

5. All shareholders will receive the new disclosure in a statement covering the quarter (or month) in which the redemption occurred.

6. Closed accounts will receive the disclosure either at the time of the redemption or in a statement covering the quarter (or month) in which the redemption occurred.

7. An ability to retroactively correct errors (mil rates, shares, NAV's etc.) will be built into systems and procedures developed to calculate and process the information, including procedures to determine if reprocessing and/or shareholder communication is necessary.

8. Sales loads, CDSCs, and other direct shareholder fees are not included in the calculation - only fund operating expenses.

9. Existing electronic interfaces between your organization and other parties my need to be modified or developed.

10. Personnel costs should include the costs of internal personnel and independent contractors or consultants hired to assist with implementing the Recommendation.

INTER-OFFICE MEMO

To: John Rea

From: Sandy West and Vicky Leonard-Chambers

Date: October 23, 2001

Subject: Results of Survey of Shareholders' Assessment of More Frequent Portfolio Disclosure

Background

Several advocacy groups filed petitions in July and August 2000 with the Securities and Exchange Commission (SEC) requesting the SEC to adopt rules mandating mutual funds to report publicly their portfolio holdings more frequently than the current semi-annual requirement. The advocacy groups contend that more frequent disclosure would help investors assess whether fund investments are consistent with their investment objectives. The advocacy groups also assert that more frequent portfolio disclosure would make it easier to discern if a fund manager is engaging in "style drift," "window dressing," and "portfolio pumping."[1]

In August 2001, ICI conducted a survey to assess shareholders' current use of portfolio disclosure provided in shareholder reports and gauge shareholders' interest in receiving this information more often than semi-annually. A total of 500 investors owning stock mutual funds outside employer-sponsored retirement plans were interviewed.[2] The findings of this survey are described in this memorandum.

Summary of Findings

- Very few stock mutual fund shareholders read the entire contents of shareholder reports. More than three-quarters of survey respondents skim the reports or read sections that are of interest to them. Nine percent do not read the reports at all. Only 14 percent say they read all of the information in the reports.

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[1] Letter from Mercer E. Bullard, Founder and CEO, Fund Democracy, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (June 28, 2000); and letter from Consumer Federation of America, Arizona Consumers Council, Consumer Action, Consumer Federation of California, Consumer Fraud Watch, Consumers Union, Democratic Processes Center, North Carolina Consumers Council, Pennsylvania Citizens Consumer Council, and Virginia Citizens Consumer Council to Jonathan G. Katz, Secretary, Securities and Exchange Commission (August 9, 2000).

[2] A random-digit dial (RDD) national probability sample was used to generate a representative sample of investors owning stock mutual funds outside retirement plans at work. All interviews were conducted with the primary decisionmaker or co-decisionmaker most knowledgeable about household savings and investments. The interviews were conducted by telephone and averaged 12 minutes. The overall sampling error for the survey is plus or minus 5 percent at the 95 percent confidence level. Region and income data from the survey were weighted to match those of a separate ICI survey sample of 1,371 investors owning stock mutual funds outside retirement plans collected in June 2001.

- Stock mutual fund shareholders who read all or some of the contents of shareholder reports generally do not focus on portfolio disclosure. Fifty-eight percent of these survey respondents briefly review the list of securities and 20 percent do not read it at all. Only 22 percent read the portfolio disclosure information thoroughly.

- Most stock mutual fund shareholders are not interested in receiving quarterly portfolio disclosure even if the information is free of charge. Seventy-two percent of survey respondents do not want to receive this information four times per year at no cost instead of the current two times per year.

- Very few stock mutual fund shareholders would be willing to pay for quarterly portfolio disclosure. Only 13 percent of all survey respondents were willing to pay to receive the additional information: 4 percent were willing to pay $20; 6 percent, $10 but not $20; and 3 percent, $5 but not $10.

- Front-running would be a concern to stock mutual fund shareholders. One-half of respondents were "very concerned" and 34 percent were "somewhat concerned" about investors outside their stock funds having sufficient information to anticipate the timing of stock fund managers' purchases and sales of specific stocks.

Detailed Findings

1. Level of Readership of Shareholder Reports

More than three-quarters of survey respondents only skim or read sections of the shareholder reports of interest to them (Figure 1). Fourteen percent read the reports entirely, and 9 percent do not read them at all.

Figure 1
Level of Readership of Shareholder Reports
(percent of all respondents)

Do not read any of the report	9
Skim the report	37
Read sections of interest	39
Read all of the report	14
Don't remember receiving the report (volunteered)	1
Number of respondents	50 0

The survey respondents who skim, read sections, or read all of the contents of shareholder reports were asked to describe their readership of specific sections of the report. Portfolio disclosure – described to respondents as "the complete list of the name, number of shares, and market value of every investment held by the fund" – was the item least likely to be read thoroughly and the item most likely not to be read at all. Only 22 percent of these respondents read the portfolio information thoroughly, 58 percent read it briefly, and 20 percent did not read it at all (Figure 2). Instead, these shareholders were more inclined to review the average annual total return of the fund and the listing of the fund's largest investments. Forty-seven percent of the shareholders who read the reports said they thoroughly review the average annual total return of the fund, and 43 percent said they thoroughly examine the list of the fund's largest investments.

Figure 2
Level of Readership of Specific Sections in Shareholder Reports
(percent of respondents skimming, reading sections, or reading all of the reports)

Section	Level of Readership of Section: Thoroughly	Briefly	Not at All
Average annual total return of the fund	47	47	6
List of the largest investments held by the fund	43	49	8
Fund performance compared with that of a market index	35	54	11
Portfolio manager's discussion of factors that affected fund performance	29	58	13
Percentage of the fund's investments by industry sector	24	60	16
Complete list of the name, number of shares, and market value of every investment held by the fund	22	58	20

Note: Number of responses varies.

Moreover, only about half of those respondents who said they read the entire contents of shareholder reports indicated thoroughly reading the portfolio information (Figure 3). Almost all of the rest of this group only briefly read the complete listing. The level of readership of portfolio disclosure is significantly lower among respondents who read shareholder reports less attentively.

Figure 3
Level of Readership of Portfolio Disclosure by
Overall Readership of Shareholder Reports
(percent of respondents skimming, reading sections, or reading all of the reports)

Readership of Portfolio Information	Readership of Shareholder Reports: Read All	Read Sections	Briefly Skim
Thoroughly	51	21	13
Briefly	47	61	60
Not at all	2	18	27
Number of respondents	70	198	184

2. Interest in Receiving Quarterly Portfolio Information at No Cost

Most stock mutual fund owners do not want more frequent disclosure of mutual fund portfolio holdings even if the information were free. Seventy-two percent of survey respondents said they are not interested in receiving portfolio information four times per year at no cost (Figure 4). Twenty-six percent said they would like to receive the information four times per year at no cost, and 2 percent indicated they already receive the information quarterly. Even the majority of respondents who thoroughly read the portfolio information said they are not interested in receiving this information more than twice a year.

Figure 4
Interest in Quarterly Portfolio Disclosure at No Cost by Level of Readership of Portfolio Disclosure Information
(percent of respondents)

Level of Interest in Quarterly Portfolio Disclosure at No Cost	All Respondents	Level of Readership of Portfolio Disclosure Information: Thoroughly	Briefly	Not at All
Interested	26	40	27	10
Not interested	72	55	72	90
Already receive four times per year	2	5	1	0
Number of respondents	500	100	262	88

The demographic and income characteristics of survey respondents interested in receiving quarterly portfolio information at no cost are similar to those of respondents satisfied with receiving this information twice per year (Figure 5). However, the financial assets and mutual fund assets of the two groups differ significantly. Median financial assets of the group wanting more frequent disclosure is about 40 percent less than that of the group satisfied with the current frequency of disclosure. Median mutual fund assets of the group wanting more frequent disclosure is about 20 percent less.

The group interested in quarterly disclosure at no cost tended to use the direct market channel more frequently than the group not interested in more frequent disclosure. The two groups, however, were about equal in their agreement with the statement "I usually rely on a professional financial advisor when making fund purchase decisions."

Figure 5
Characteristics of Respondents by Level of Interest in Quarterly Portfolio Disclosure at No Cost

Characteristic	Interested	Not Interested
	Percent of Respondents	
Age of respondent	46 years	49 years
Household income	$69,000	$65,500
Household financial assets[1]	$113,100	$193,900
Household financial assets in mutual funds	$59,700	$74,400
Household financial assets in stock mutual funds	$36,000	$49,000
Number of stock mutual funds owned	3	3
	Median	
Married or living with a partner	79	74
College or post-graduate degree	51	59
Employed full- or part-time	71	73
Own stock mutual funds through:		
Sales force channel	79	81
Direct market channel	62	52
Own:		
Bond mutual funds	34	35
Hybrid mutual funds	26	35
Money market mutual funds	64	54
Strongly or somewhat agree with statement:		
I usually rely on a professional financial adviser when making stock mutual fund investment decisions	74	70
I know a lot about investing in stock mutual funds	57	59
I buy and sell shares of stock mutual funds frequently	23	15[a]

[1]Includes assets in employer-sponsored retirement plans.
[a]Responses of respondents not interested in receiving quarterly portfolio disclosure at no cost are statistically different at the 95 percent confidence level from those who are interested in the quarterly disclosure at no cost.
Note: Number of respondents varies.

3. Willingness to Pay to Receive Quarterly Portfolio Disclosure

The 26 percent of respondents interested in quarterly portfolio disclosure were asked about their willingness to pay for the information. The cost of more frequent disclosure was specified as $5, $10, and $20. Respondents were initially asked if they would pay $10. If they were willing to pay $10, they were asked if they would pay $20; if they were not willing to pay $10, they were asked if they would pay $5.

Forty-nine percent of this shareholder group (or 13 percent of all respondents) indicated they would not pay for the information; 15 percent (or 4 percent of all respondents) were willing to pay $20; 24 percent (or 6 percent of all respondents) were willing to pay $10 but not $20; and 12 percent (or 3 percent of all respondents) were willing to pay $5 but not $10 (Figure 6).

Figure 6
Willingness to Pay for Quarterly Portfolio Disclosure
(percent of respondents)

Level of Interest and Cost	Respondents Interested in Receiving Portfolio Disclosure Information at No Cost	All Respondents
Interested	100	26
Would pay	51	13
Would pay $20	15	4
Would pay $10 but not $20	24	6
Would pay $5 but not $10	12	3
Would not pay	49	13
Not interested	NA	72
Already receive	NA	2
Number of respondents	131	500

NA = Not Applicable

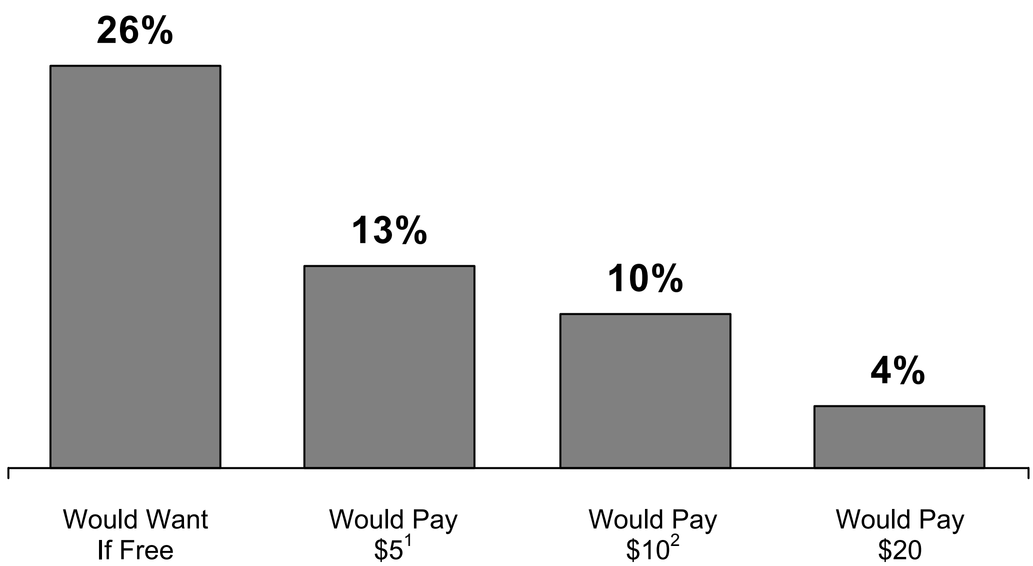
The responses to questions about willingness to pay can be used to construct a demand schedule for quarterly portfolio disclosure. Excluding the 2 percent of respondents already receiving quarterly disclosure, at a cost of $5, only 13 percent of the survey respondents would be willing to pay to receive a list of portfolio securities quarterly rather than semi-annually (Figure 7). These respondents include those willing to pay $5 but not $10, $10 but not $20, and $20. Reflecting the declining marginal value of quarterly information, 10 percent would want the information at a cost of $10, which includes respondents willing to pay $10 but not $20 and those willing to pay $20. Only 4 percent would be willing to pay $20.

The three cost figures are relatively low. Indeed, for the group of respondents unwilling to pay for the additional disclosure, the highest cost of $20 amounts to only 0.03 percent of their median household income.[3] The low level of these costs thus suggests that the 85 percent of respondents who either would not want or would be unwilling to pay for quarterly disclosure must see virtually no value in the information relative to semi-annual disclosure.

That the vast majority of respondents would not directly pay for quarterly portfolio disclosure implies that they would not knowingly pay indirectly for the same information through a reduction in the fund's total return. A lower return might occur from front running, that is, the use of the portfolio information by outside investors to trade ahead of the fund, thereby raising the fund's transactions costs.[4] At even the $5 direct cost of quarterly disclosure, which 85 percent of respondents would not be willing to pay, the cost would be less than one basis point of the median of stock fund assets held by this group of respondents. This characterization of the cost similarly suggests that the majority of respondents would place an extremely low value on the additional information provided by quarterly disclosure.

[3] Median household income of the respondents unwilling to pay for the additional disclosure is $67,200.
[4] See Russ Wermers, "The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance," *Perspective, Volume 7 No. 3* (Investment Company Institute, June 2001), p. 2.

Figure 7
Schedule of Demand for Quarterly Portfolio Disclosure
(percent of respondents)



[1] Sum of respondents who would pay $5 but not $10, $10 but not $20, and $20. All would pay $5.
[2] Sum of respondents who would pay $10 but not $20 and those who would pay $20.

4. Concern About Front Running

In response to a question about front running, the majority of respondents expressed concern about the possibility of investors outside their stock funds having sufficient information to anticipate their funds' purchases and sales of stocks.[5] One-half of the respondents were "very concerned" and 34 percent were "somewhat concerned" (Figure 8). Sixteen percent were either "not very concerned" or "not at all concerned."

For comparison, respondents also were asked about three possible changes in the management of their funds' portfolios. These included a change in investment goals, closing the fund to new investors, and a change in the portfolio manager. Respondents generally expressed much less concern about such changes than about front running. Twenty-nine percent were "very concerned" about a change in investment goals, 24 percent were "very concerned" about funds closing to new investors, and 22 percent were "very concerned" about a change in portfolio managers.

Concern about front running appears to be related to stock fund shareholders' financial situation. Survey respondents who were "very concerned" about front running had greater median household financial assets and median mutual fund assets than respondents not concerned about this issue (Figure 9). The respondents who were "very concerned" also tended to have higher household incomes.

Figure 8
Concern About Front Running and Portfolio Management Policies[1]
(percent of respondents)

Type of Concern	Very Concerned	Somewhat Concerned	Not Very Concerned	Not At All Concerned
If investors outside the fund had information that allowed them to anticipate the timing of the fund manager's purchases and sales of specific stocks	50	34	10	6
If the fund's investment goals were to change	29	54	14	3
If the fund were to close to new investors in order to meet its investment goals	24	37	22	17
If the fund's portfolio manager were to change	22	42	25	11

[1]If the issue were to arise over the next 12 months in one of the stock funds respondents own.
Note: Number of respondents varies.

[5] Survey respondents were asked to indicate their level of concern if, over the next 12 months, investors outside their stock mutual funds had information allowing them to anticipate the timing of fund managers' purchases and sales of specific stocks.

Figure 9
Characteristics of Respondents by Level of Concern About Front Running

Characteristic	Very Concerned	Somewhat Concerned	Not Very or Not at All Concerned
		Median	
Age of respondent	50 years	44 years	47 years
Household income	$71,800	$62,500	$60,600
Household financial assets[1]	$250,000	$140,300	$125,000
Household financial assets in mutual funds	$94,700	$60,000	$38,800
Household financial assets in stock mutual funds	$50,000	$40,000	$30,000
Number of stock mutual funds Owned	3	3	3
		Percent of Respondents	
Married or living with a partner	79	72	73
College or post-graduate Degree	58	52	59
Employed full- or part-time	72	78	69
Own stock mutual funds through:			
Sales force channel	83	81	72
Direct market channel	54	56	57
Own:			
Bond mutual funds	33	39	28
Hybrid mutual funds	35	32	31
Money market mutual funds	56	62	48
Strongly or somewhat agree with statement:			
I usually rely on a professional financial adviser when making stock mutual fund investment decisions	70	77	60
I know a lot about investing in stock mutual funds	57	63	56
I buy and sell shares of stock mutual funds frequently	18	20	9

[1]Includes assets in employer-sponsored retirement plans.
Note: Number of respondents varies.