

DODGE & COX

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August 7, 2015

Mr. Brent Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Submitted electronically to rule-comments@sec.gov

Re: File No. S7-08-15 (Release Nos. 33-9776; 34-75002; IC-31610: Investment Company Reporting Modernization)

The Independent Trustees of Dodge & Cox Funds and Dodge & Cox respectfully submit this letter in response to a request by the U.S. Securities and Exchange Commission (the “Commission”) for comments regarding the above-referenced release (the “Proposing Release”). The Proposing Release proposes new forms, rules, and rule amendments (the “Proposed Rules”), which are intended to modernize the reporting requirements for investment companies.¹ This comment letter addresses the proposed Form N-PORT.

We understand and support the Commission’s need for more detailed information presented in a format that is easier to use. We also support the Commission’s proposal to retain a quarterly public disclosure schedule. However, we are concerned that more frequent (i.e., monthly) reporting of portfolio holdings to the Commission has the potential to harm funds and fund shareholders due to the risk of unauthorized access to sensitive and confidential portfolio holdings data. Accordingly, for the reasons we discuss below, we strongly recommend that the Commission revise the Proposed Rules to require quarterly filing of Form N-PORT rather than monthly filing. If the Commission chooses to adopt a monthly filing requirement in spite of the security concerns, the Commission and its staff should take appropriate steps to protect the confidentiality and security of Form N-PORT information, including adopting procedures to immediately suspend monthly reporting in the event a security breach is detected.

Dodge & Cox Funds (the “Trust”) currently consists of six series (each a “Fund,” and collectively, the “Funds”).² Each Fund is governed by the Board of Trustees of the Trust, which meets regularly to review a wide variety of matters affecting the Funds. The Board of Trustees comprises six Trustees who are not “interested persons” of the Funds within the meaning of the Investment Company Act of 1940 (the “Independent Trustees”) and two Trustees who are interested persons. The Funds are recognized for their low fees, low turnover, and generally solid long-term performance record. More than 4 million shareholders invest in the Funds.

¹ See Investment Company Reporting Modernization, SEC Release No. IC-31610 (May 20, 2015).

² Dodge & Cox Stock Fund, Dodge & Cox Global Stock Fund, Dodge & Cox International Stock Fund, Dodge & Cox Balanced Fund, Dodge & Cox Income Fund, and Dodge & Cox Global Bond Fund.

Dodge & Cox is a value-oriented manager serving as investment adviser to the Funds and other accounts totaling over \$280 billion in assets under management. Dodge & Cox is one of the longest-standing professional investment management firms in the United States, having acted continuously as an investment manager since 1930. Dodge & Cox is known for its thorough, independent research, and focus on the long term.

I. Maintaining a Quarterly Schedule for Public Disclosure of Portfolio Information is Appropriate

Academic studies demonstrate that more frequent public disclosure of portfolio holdings harms fund shareholders by facilitating predatory trading tactics. For example, hedge funds and high frequency traders may use portfolio holdings information to forecast a mutual fund's trading, predict order flow, and front-run mutual fund trades.³ Equity index revisions are one well-known example of this phenomenon. Market participants know that index mutual funds will have to adjust holdings to reflect index revisions and can trade ahead of them.⁴

In 2004, the Commission adopted Form N-Q, which increased the required frequency of public portfolio holdings disclosure from semi-annually to quarterly.⁵ In the wake of N-Q, several studies were conducted and showed that the more frequent public disclosure of portfolio holdings decreased returns for the affected funds – by a range of 17 to 20 basis points per month in one study⁶ and 1.3% to 4.6% per year in another study.⁷ According to one study, “top-performing funds whose portfolios consist of stocks with smaller market capitalization, lower analyst coverage, and lower liquidity experience greater performance declines after the regulation change. Also, top funds that take longer to build or unwind their positions experience larger performance deterioration.”⁸ The Commission acknowledged this issue in the Proposing Release, stating that

Evidence indicates that the ability of copycat funds to outperform actively managed funds increased after the introduction of Form N-Q, and additional evidence indicates that the performance of those funds with better previous performance or that invest in low-

³ See, e.g., Brunnermeier, Markus K., and Lasse Heje Pedersen, *Predatory trading*. THE JOURNAL OF FINANCE 60, no. 4 (2005), 1825-1863. See also, Edelen, Roger, Richard Evans, and Gregory B. Kadlec, *Scale effects in mutual fund performance: The role of trading costs*. BOSTON COLLEGE, UNIVERSITY OF VIRGINIA, AND VIRGINIA TECH WORKING PAPER (2007). See also, Coval, Joshua, and Erik Stafford, *Asset fire sales (and purchases) in equity markets*. JOURNAL OF FINANCIAL ECONOMICS 86, no. 2 (2007), 479-512.

⁴ See Alexandra Scaggs, *Russell Stock Index Reconstitution Bets Speed Up*, WALL STREET JOURNAL (May 28, 2013).

⁵ *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Rel. No. 33-8393 (Feb. 27, 2004).

⁶ Parida, Sitikantha, and Terence Teo. *The impact of more frequent portfolio disclosure on mutual fund performance*. AVAILABLE AT SSRN 2097883 (2011).

⁷ Agarwal, Vikas, Kevin Mullally, Yuehua Tang, and Baozhong Yang. *Mandatory portfolio disclosure, stock liquidity, and mutual fund performance*. JOURNAL OF FINANCE, FORTHCOMING (2015), 6.

⁸ *Id.*

information stocks decreased following the introduction of Form N-Q.⁹

These academic studies are consistent with Dodge & Cox's data and analysis, which show significant price movement of portfolio securities after disclosure dates, indicating that others are trading on this information. Dodge & Cox's analysis, which we are willing to share with the Commission, shows that market participants react to the Funds' disclosures by copying or attempting to front-run the Funds' trades. Dodge & Cox reviewed new purchases and completed sales by two Dodge & Cox mutual funds over an extended period. For each stock, Dodge & Cox calculated the average cumulative price change in excess of returns of a benchmark index relative to the quarterly public disclosure date.¹⁰ There is a clear pattern of stock price increases for newly disclosed purchases and stock price declines for newly disclosed sales.

The Commission acknowledged in the Proposing Release the potential harm to funds and their investors, as well as investment managers, that front-running, free-riding, and other predatory trading resulting from more frequent public disclosures may cause:

The Commission, however, recognizes that more frequent portfolio disclosure could potentially harm fund shareholders by expanding the opportunities for professional traders to exploit this information by engaging in predatory trading practices, such as trading ahead of funds, often called "front-running." Similarly, the Commission is sensitive to concerns that more frequent portfolio disclosure may facilitate the ability of outside investors to "free ride" on a mutual fund's investment research, by allowing those investors to reverse engineer and "copycat" the fund's investment strategies and obtain for free the benefits of fund research and investment strategies that are paid for by fund shareholders. Both front-running and copycatting can reduce the returns of shareholders who invest in actively managed funds.¹¹

Investment advisers are paid by mutual funds to construct portfolios, often through careful research and analysis of undervalued securities.¹² Requiring public disclosure of fund portfolio holdings forces a fund to give up confidential, proprietary information belonging to the fund and its investment adviser. Such disclosure provides non-shareholders with free access to valuable investment information paid for by the fund's shareholders. Increasing the frequency of public

⁹ Proposing Release at text accompanying n. 668-669 (internal citations omitted). The Proposing Release notes that low information stocks include stocks with smaller market capitalization, less liquidity, and less analyst coverage.

¹⁰ Prior to the adoption of Form N-Q, Dodge & Cox voluntarily made portfolio holdings public on a quarterly basis. Such disclosure typically occurred on the 15th calendar day after quarter end.

¹¹ See *Proposing Release*, at text accompanying notes 170-172 (*citations omitted*).

¹² See Frank, Mary Margaret, James M. Poterba, Douglas A. Shackelford, and John B. Shoven. *Copycat Funds: Information Disclosure Regulation and the Returns to Active Management in the Mutual Fund Industry*. JOURNAL OF LAW AND ECONOMICS 47, no. 2 (2004): 515-541.

disclosure would exacerbate potential free-riding by non-shareholders and market participants and further disadvantage fund investors who pay for the advisory services.¹³

More frequent public disclosure of portfolio information would have a disproportionate and negative impact on retail investors – the very investors the Commission seeks to protect.¹⁴ Mutual funds are the primary means by which retail investors can access high quality, professional investment management services. As the Commission noted in the Proposing Release, the increased amount of publicly available information and the structured data format of Form N-PORT filings could facilitate front-running, free-riding, and other predatory trading activities. The prospect of predatory trading against mutual funds may incentivize investment advisers to offer their portfolio management and research services through private structures, such as hedge funds, that do not present the same predatory trading problems.¹⁵ The Commission itself recognized in the Proposing Release that activities such as front-running and predatory trading “could reduce the profitability from developing new investment strategies, and therefore could reduce innovation and impact competition in the fund industry.”¹⁶ This would likely lead to fewer high-quality investment options for retail investors. By contrast, institutional investors have access to hedge funds and separate accounts that are not required to publicly disclose portfolio-level holdings.

We acknowledge that some funds currently release portfolio information more frequently than quarterly, either as mandated by rule or voluntarily. However, more frequent disclosure is not appropriate for all funds. Due to the adoption of Form N-MFP, money market funds are now required to disclose holdings information on a monthly basis.¹⁷ We do not think money market funds offer an apt comparison for other mutual funds. Money market funds invest in relatively few security types, seek to maintain a stable net asset value, maintain shorter portfolio durations, and frequently make new investments as existing holdings mature. In the Proposing Release, the Commission notes that these characteristics, which mitigate concerns about front-running and free-riding in money market funds, are not present in other funds that “can pursue a variety of investment strategies and invest in a variety of securities and other investments.”¹⁸ In addition, non-money market funds that have high turnover, many holdings, and/or fewer assets under

¹³ See Verbeek, Marno, and Yu Wang. *Better than the original? The relative success of copycat funds*. JOURNAL OF BANKING & FINANCE 37, no. 9 (2013): 3454-3471.

¹⁴ Commission Chair Mary Jo White has stated that “[t]he retail investor must be a constant focus of the SEC – if we fail to serve and safeguard the retail investor, we have not fulfilled our mission.” Mary Jo White, Chair, U.S. Securities and Exchange Commission, Speech to Consumer Federation of America, 2014 Consumer Assembly (Mar. 21, 2014), available at, <http://www.sec.gov/News/Speech/Detail/Speech/1370541226174>.

¹⁵ See Wermers, Russ, Tong Yao, and Jane Zhao. *The investment value of mutual fund portfolio disclosure*. UNPUBLISHED WORKING PAPER, UNIVERSITY OF MARYLAND (2007).

¹⁶ Proposing Release, at 288.

¹⁷ Form N-MFP was originally adopted with a 60-day delay for public disclosure. See *Money Market Fund Reform*, Rel. No. IC-29132 (Feb. 23, 2010). In 2014, the Commission eliminated the 60 day delay in the public disclosure of Form N-MFP. See *Money Market Fund Reform; Amendments to Form PF*, Rel. No. IC-31166 (July 23, 2014). Money market funds are also required to post portfolio holdings information monthly on their websites.

¹⁸ Proposing Release, at text accompanying note 174.

management are typically less susceptible to predatory trading and, based on our analysis, are more likely to disclose portfolio holdings on a monthly basis than funds with low portfolio turnover, limited or concentrated holdings, and/or more assets under management.

In addition to the harm caused by predatory trading, more frequent public disclosure can cause investors to focus on and react to short-term market volatility. Fund managers like Dodge & Cox focus on the long term and we encourage Fund shareholders to do the same to achieve their long-term investment goals. Rather than provide shareholders with valuable actionable information, more frequent disclosure is likely to serve as a distraction and lead to reactive behavior that is not in a shareholder's long-term best interest.

For the reasons outlined above, we strongly oppose any increased frequency in the public disclosure of portfolio holdings information.

II. Confidential Data Must be Protected from Cyber Threats and other Misuse

Safekeeping of confidential portfolio holdings information is a significant concern for the Trust's Board of Trustees and Dodge & Cox. If Form N-PORT is adopted as proposed, monthly N-PORT data for every registered investment company (except money market funds and small business investment companies) would be stored in one place. A cyber criminal would be able to access monthly portfolio data for every Form N-PORT reporting entity with a single breach, rather than having to gain access to the systems of each reporting entity or its manager. This represents a significant risk for fund investors, as well as fund advisers, should such data be breached or used for improper purposes.

This cyber threat is more than theoretical. Recent news reports have highlighted cybersecurity breaches involving the Office of Personnel Management,¹⁹ the Internal Revenue Service,²⁰ the White House, and the State Department.²¹ The Commission's Office of Inspector General (OIG) has identified issues related to the Commission's information security environment.²² In the OIG's semi-annual report to Congress, the OIG found that the Commission's technology office

¹⁹ See, e.g., Damian Paletta, *Security Clearance Forms Accessed in Federal Hack*, WALL STREET JOURNAL (June 13-14, 2015); David E. Sanger & Julie Hirschfeld Davis, *Hacking Linked to China Exposes Millions of U.S. Workers*, NEW YORK TIMES (June 4, 2015). See also, Michael S. Schmidt et al., *Chinese Hackers Pursue Key Data on U.S. Workers*, NEW YORK TIMES (July 9, 2014).

²⁰ See, e.g., John D. McKinnon and Laura Saunders, *Breach at IRS Exposes Tax Returns*, WALL STREET JOURNAL (May 26, 2015).

²¹ Michael S. Schmidt & David E. Sanger, *Russian Hackers Read Obama's Unclassified Emails, Officials Say*, NEW YORK TIMES (Apr. 25, 2015).

²² See U.S. Securities and Exchange Commission, Office of Inspector General, *Federal Information Security Management Act: Fiscal Year 2014 Evaluation* (Feb. 5, 2015), available at <http://www.sec.gov/oig/reportspubs/oig-information-security-fy-2014-evaluation-report-529.pdf>; see also, U.S. Securities and Exchange Commission, Office of Inspector General, *Controls over the SEC's Inventory of Laptop Computers* (Sep. 22, 2014), available at <http://www.sec.gov/oig/reportspubs/524.pdf>. In the report on laptop computers, the OIG noted that its investigative and review work identified weaknesses in the SEC's laptop inventory records and encryption controls and made recommendations for corrective action that address these areas.

had not addressed several areas of potential risk identified in prior evaluations under Federal Information Security Management Act (FISMA) including:

(1) failure to implement personal identity verification (PIV) cards for logical access to the maximum extent practicable; (2) lack of full implementation of continuous monitoring; (3) lack of multi-factor authentication of external systems; (4) outdated procedures and inconsistencies with policy and (5) improper review of user accounts.²³

The report also found that the Commission's security awareness training failed to include a required component regarding insider threats. The OIG also identified as a matter of interest that the Commission's technology office had not addressed certain known vulnerabilities within established timeframes.

In addition to the OIG reports, the Government Accountability Office (GAO) has designated information security a "government-wide high-risk area"²⁴ and, in April 2014, reported that the "SEC's financial information and systems were exposed to increased risk of unauthorized access, disclosure, modification, and disruption."²⁵ The GAO report identified several significant problems, including inconsistent control over access, ineffective protection for sensitive data during transmission, inconsistent contractor oversight, and insufficient progress in remediating previously reported information security weaknesses, among others. If monthly reporting on Form N-PORT is adopted, the amount of non-public fund data potentially accessible through the Commission's systems makes the Commission's cybersecurity plan all the more important and any shortcomings more troubling.

Given the sensitivity of Form N-PORT information, the potential vulnerability created by gathering such information in one location, the documented weaknesses in the Commission's security systems, and the persistent threat posed by hackers and cyber criminals, a breach of security appears eminently possible. Accordingly, we strongly recommend that the Commission adopt a quarterly filing requirement that contains monthly data. We believe this approach balances the Commission's need for more and better data against the need to protect investors and does not require fund shareholders to sacrifice returns in the name of greater transparency. In this regard, we note that the Proposing Release does not set forth any concrete or compelling reasons in support of monthly reporting.

If the Commission adopts a monthly reporting requirement in spite of the potential harm to investors, mutual fund investors should have at least the level of protection afforded to investors

²³ U.S. Securities and Exchange Commission, Office of Inspector General, *Semi-Annual Report to Congress (10.01.14 to 3.31.15)*, available at <http://www.sec.gov/oig/reportspubs/office-of-inspector-general-semiannual-report-spring-2015.pdf>.

²⁴ U.S. Government Accountability Office, Report to the Chair, *U.S. Securities Exchange Commission: Information Security: SEC Needs to Improve Controls over Financial Systems and Data* (2014), available at <http://www.gao.gov/assets/670/662612.pdf>.

²⁵ *Id.* at 4–5.

in private funds. As noted in the adopting release for Form PF, several commenters confirmed that the information collected on Form PF is competitively sensitive or proprietary and emphasized the importance of controls for safekeeping.²⁶ In the Form PF Adopting Release, the Commission noted several recommendations from commenters regarding data protection including:

- (1) storing identifying information using a code; (2) limiting the ability to transfer Form PF data by email or portable media; (3) limiting access to personnel who “need to know”; (4) extending filing deadlines so the data contains less current information; and (5) sharing the data with other regulators only in aggregated and anonymous form.

Form N-PORT data is much more sensitive than Form PF data because the former includes information about specific holdings, not just portfolio characteristics. The precautions outlined above would help to mitigate the risk of unauthorized access to sensitive data by external as well as internal parties.²⁷

The Division of Investment Management recently issued cybersecurity guidance discussing measures that funds and advisers should consider when addressing cybersecurity risks.²⁸ The Office of Compliance, Inspections and Examinations also included cybersecurity in its list of 2015 examination priorities for the National Exam Program.²⁹ In the IM Guidance, the

²⁶ *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF*, Rel. No. IA-3308 (Oct. 31, 2011) (“Form PF Adopting Release”).

²⁷ *See, e.g.,* Rajgopal, Shivaram and White, Roger A, *Stock Picking Skills of SEC Employees*, preliminary (Mar. 11, 2014), http://goizueta.emory.edu/profiles/documents/publications_working_papers/rajgopal/SEC%20trading%20paper_SR_March6.pdf. This working paper highlighted that SEC employees were more likely to sell a security in the run up to the announcement of SEC enforcement actions and in the interim period between a corporate insider’s paper filings for restricted stock and the appearance of the filing in the electronic filing system. While the paper acknowledges that SEC policies may require employees to sell securities before working on a matter related to that issuer, it also notes that most inquiries are conducted in private and therefore SEC employees have information not available to the market as whole. *See also*, Alan J. Ziobrowski et al., *Abnormal Returns From the Common Stock Investments of Members of the U.S. House of Representatives*, 13 BUS. & POLITICS (2011) (indicated that members of Congress invest abnormally well, potentially due to what they term “a substantial informational advantage” over the public); Brody Mullins et al., *Congressional Staffers Gain From Trading in Stocks*, WALL STREET JOURNAL (Oct. 11, 2010, 12:01 AM), <http://www.wsj.com/articles/SB10001424052748703431604575522434188603198> (identifying several dozen congressional staffers trading on companies that their supervisors helped to govern in 2008 and 2009); U.S. Securities and Exchange Commission, *SEC Charges FDA Chemist With Insider Trading Ahead of Drug Approval Announcements* (2011), available at <https://www.sec.gov/news/press/2011/2011-76.htm> (charging FDA chemist with trading on non-public information about upcoming drug approvals).

²⁸ U.S. Securities and Exchange Commission, Division of Investment Management, Guidance Update No. 2015-02: Cybersecurity Guidance (Apr. 2015), available at <http://www.sec.gov/investment/im-guidance-2015-02.pdf> (“IM Guidance”).

²⁹ U.S. Securities and Exchange Commission, Office of Compliance, Inspections and Examinations, National Exam Program: Examination Priorities for 2015 (Jan. 13, 2015), available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf>.

Commission suggests that funds and advisers consider a strategy of “controlling access to various systems and data via management of user credentials, authentication and authorization methods, firewalls and/or perimeter defenses, tiered access to sensitive information and network resources, network segregation, and system hardening.” The Commission also recognized that while “it is not possible for a fund or adviser to anticipate and prevent every cyber attack,” a rapid response capability could “assist funds and advisers in mitigating the impact of any such attacks and any related effects on fund investors and advisory clients.”

Before imposing a monthly Form N-PORT filing requirement, it is imperative that the Commission review its systems and controls for the use and handling of Form N-PORT data and adopt strategies similar to those set forth in the IM Guidance.³⁰ We respectfully request that the release accompanying the final rule discuss the measures that the Commission will take to protect the confidentiality and security of Form N-PORT information, including the Commission’s response plan in the event of a security breach. Among other things, the Commission should have procedures in place to immediately suspend monthly reporting upon learning of a breach.

III. Conclusion

In order to address potential harm to mutual fund investors due to front-running and other predatory trading practices, as well as cyber threat concerns, we propose the following modifications to the Proposed Rules:

- Report monthly portfolio information on a quarterly basis. We strongly support this alternative in light of the security concerns raised in this letter.
- If the Commission adopts monthly reporting as proposed in spite of the concerns raised, we strongly recommend that the Commission develop procedures to prevent, detect, and respond to security breaches, including a plan to immediately suspend monthly reporting on Form N-PORT if a breach is detected.

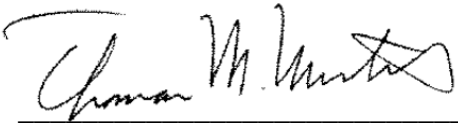
It is important for the Commission to have the information it needs to better monitor the fund industry; however, the potential benefits need to be weighed against the real risks to mutual fund investors of front running and predatory trading, as well as the potential for security breaches or other opportunities for misuse of the confidential proprietary information that will be in the hands of the Commission.

³⁰ We note that in the Form PF Adopting Release, the Commission committed to reviewing its systems and controls for the use and handling of Form PF data prior to the compliance date of the final rule. The Commission also agreed to consider delaying the compliance date depending on its progress toward the development and deployment of such controls and systems.

We appreciate the opportunity to comment on the Proposing Release. Please contact Thomas M. Mistele or Roberta R.W. Kameda at (415) 981-1710, with any questions about this submission.

Very truly yours,

THE INDEPENDENT TRUSTEES OF DODGE & COX FUNDS and
DODGE & COX

By: 

Thomas M. Mistele
Secretary of Dodge & Cox Funds and Dodge & Cox