Consumer Federation of America

October 31, 2018

Brent Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-12-18
Request for Comment on Fund Retail Investor Experience and Disclosure

Dear Secretary Fields:

I am writing on behalf of the Consumer Federation of America[1] in response to the Commission's Request for Comment on Fund Retail Investor Experience and Disclosure. Improving how we communicate critical information to retail investors has long been a priority for CFA, both in terms of our research and our advocacy, because of the potential to make much needed improvements in the quality of retail investor decision-making. We agree that fund disclosures are an appropriate place to focus, given the important role funds play in the portfolios of retail investors. Moreover, we share the view expressed in the Release that disclosures should be "inviting and usable by a broad spectrum of investors,"[2] that they "should help investors: find what they need; understand what they find; and use what they find to make informed investment decisions,"[3] and that technology has a role to play in achieving those goals.[4]

CFA has conducted two research projects over the years that are particularly relevant to this project. In 2006 we produced a report on investors' mutual fund purchase practices.[5] (See Appendix A) We followed up on that report in 2014 with research on whether and how the Internet can be used to improve disclosures.[6] (Appendix B) Both reports included survey research analyzing many of the key issues that are the topic of this Request for Comment, and both began with an extensive literature review. More recently, we have participated in testing of

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[1] The Consumer Federation of America is a non-profit association of nearly 300 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education

[2] Securities and Exchange Commission, Request for Comment on Fund Retail Investor Experience and Disclosure, File No. 27-12-18, available at: https://www.sec.gov/rules/other/2018/33-10503.pdf, at 5.

[3] *Id.* at 6.

[4] *Id.* at 6-7.

[5] Barbara Roper and Stephen Brobeck, Consumer Federation of America, Mutual Fund Purchase Practices: An Analysis of Survey Results, June 2006, available at: https://bit.ly/2Okcpfc.

[6] Barbara Roper, Consumer Federation of America, Can the Internet Transform Disclosures for the Better?, January 2014, available at: https://bit.ly/2IQFTAB.

the Commission's proposed Customer Relationship Summary, an experience that has deepened our awareness of the challenges the Commission faces in attempting to develop clear disclosures to convey complex topics.[7] That research, which suggests: that fund disclosures generally fall short in all of the areas identified in the Release as the hallmarks of effective disclosure; that improvements are needed to the timing, content, and format of disclosures to rectify those short-comings; and that technology, appropriately harnessed, can be used to help deliver those improvements. We therefore commend you for taking up this project, for making a special effort to reach out to retail investors directly for input, and for approaching the issue with an appropriately broad set of questions.

Based on our research, we have identified a series of basic principles that we view as essential to improving the quality of disclosures. While these principles may seem obvious, all reflect areas either where anti-investor proposals have been advanced by industry in the name of disclosure "modernization" or where we find the current disclosure system to be lacking. We therefore encourage the Commission to keep these principles in mind as it considers ways in which to enhance the quality of fund disclosure:

- For investors to make good use of disclosures, they need to know the information is available to them. Delivery methods, such as "access equals delivery," that require investors to seek out the information all but guarantee that only the most financially sophisticated and technologically adept individuals will receive information that the Commission deems to be essential to an informed investment decision. If that occurs, everything else the Commission does to improve disclosure quality would be rendered meaningless.

- For investors to make good use of disclosures, they need to receive the information early enough (e.g., point of recommendation) to incorporate it in their decision-making process. Disclosure that arrives after a decision has already been made (e.g., point of sale) or worse, after a purchase has already been made, defeat the purpose of disclosure as a decision-making tool. This is an area where technology has enormous potential to address a serious weakness in our disclosure system, at least for those investors who are willing to receive disclosures electronically.

- For disclosures to be effective, investors need to review them. Disclosures that are long and densely packed with technical jargon are unlikely to be read, no matter when or how they are delivered. Here again, for those investors who are willing to receive disclosures electronically, technology has enormous potential to make disclosures more appealing and, thus, more likely to be reviewed. For investors who prefer to receive paper documents, improvements to readability could still be made by incorporating basic principles of plain English and effective disclosure design.

- While getting investors to review disclosures is important, the real test of disclosure effectiveness is whether investors are able to use the disclosures to make an informed decision. For example, in considering the adoption of summary disclosures as part of a

[7] Letter from AARP, Consumer Federation of America, and the Financial Planning Coalition to SEC Chairman Jay Clayton, September 12, 2018, available at: https://bit.ly/2CXfz6W.

layered disclosure system (something we have supported), the Commission needs to ascertain not just whether investors "like" this approach, but whether they can and will use it to obtain the information they need. An attractively designed, hyperlinked summary document that investors are willing to read is a step forward, but it only gets you halfway there. If investors do not glean sufficient understanding of the information provided to make an informed investment decision, the disclosure cannot be deemed to be a success.

- The Commission's staff of subject matter experts – with their extensive knowledge of the securities markets and securities law – are well positioned to identify the information investors should know to make an informed investment decision. But they are not necessarily the best situated to understand how to convey that information to a non-expert investor. With all due respect, the hypothetical fund summary provided in Appendix A perfectly illustrates that point. (They type is too small, the language is too technical, the fee table is too busy, etc.) The same is true, in our view, of the hypothetical document accompanying the Commission's recent proposal to develop a summary disclosure for variable annuities.[8] As the Commission moves forward with plans to revise its fund disclosures, it should incorporate an iterative process of cognitive usability testing to ensure that its proposed changes are effective in communicating key information to investors so that they have their intended effect of promoting better investment decision-making. This should be done on the front end, as proposals are being developed and not delayed until after prototypes have been developed.

- Even with the best disclosures, the investment decision-making process is likely to be overwhelming for many, if not most, investors. Reviewing the investment goals, risks, costs, and other material characteristics of even a few funds is likely to take hours – time that many busy individuals do not feel they have. As the Commission looks at ways to modernize its disclosures, it should seek to develop a system that makes it as easy as possible for third parties to develop simple tools investors can use to narrow down their selections based on specific criteria. This one step has the potential to do more than the most innovative disclosure design changes to assist the many investors who will never take the time to pore through disclosure documents for multiple funds to select the one that is best for them.

- Many investors will continue to rely on financial professionals to make investment selections for them. Improved disclosures cannot substitute for a heightened standard of care that requires broker-dealers and investment advisers alike to recommend investments based on which are best for the client, rather than which are most profitable for them or their firm. Neither the proposed Guidance on the Investment Advisers Act fiduciary duty nor the proposed Regulation Best Interest for broker-dealers, as currently drafted, meets that goal. Both should be strengthened and clarified to comport with investors' reasonable expectations of the standards financial professionals must meet.

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[8] Securities and Exchange Commission, Appendix A: Hypothetical Initial Summary Prospectus Prepared by SEC Staff—For Illustrative Purposes Only, available at: https://www.sec.gov/rules/proposed/2018/33-10569-appendix-a.pdf.

The attached reports address many of the issues addressed in the Commission's request for input. We hope they are useful to the Commission as you move forward with this effort. We stand ready to assist the Commission in any way that we can to ensure that the disclosures relied on by retail investors convey the information they need to make informed investment decisions, at a time when it is useful to them in making those decisions, and in a form that they can readily access and understand. While the current disclosure system falls far short of this ideal, in our opinion, this effort by the Commission has the potential to bring us closer to that ideal and deliver significant benefits to retail investors if it follows the basic principles outlined above.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection

Appendix A:

Consumer Federation of America

Mutual Fund Purchase Practices

An Analysis of Survey Results
Prepared by Barbara Roper and Stephen Brobeck

Executive Summary

Opinion Research Corporation conducted a survey on behalf of CFA as part of a research project funded by the NASD Investor Education Foundation examining mutual fund purchase practices. The survey reveals a gap between how experts recommend investors go about making mutual fund purchase decisions and how investors describe their actual fund selection practices.[1] Significant differences between expert recommendations and actual practices are found in: the factors investors consider when selecting a mutual fund, the extent to which they research their fund purchases using available written information sources, and the degree of reliance they place on the recommendations of financial services professionals. This gap may have significant implications for the development of investor education materials, both by identifying areas where educators need to do a better job of conveying their message, and by identifying areas where expert recommendations are unrealistic or fail to reflect the environment in which different purchase groups make their fund selections.

<u>Factors Considered</u>

Virtually all financial experts (including regulators, personal finance writers, and investor educators) consider a fund's risks, including the volatility of its past returns, and its expenses to be among the most important factors for investors to consider when selecting a fund. Only a third of current owners considered either costs or volatility to be very important when making

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[1] During the initial stage of this project, CFA conducted an extensive review of investor education materials prepared by regulators, fund companies, investor advocates, and personal finance writers. Materials reviewed included brochures, websites, newspaper and magazine articles, and books. That review indicated there is broad agreement among experts about the key factors investors should consider when investing in mutual funds and how they should go about making those selections.

their most recent mutual fund selection, however, and just four in ten considered risks to be very important. Most investors gave more weight to fund company reputation and the past performance of the fund compared with that of other funds. Those who purchased most of their funds directly were significantly more likely than either workplace purchasers or those who purchased most of their funds through a professional to consider costs important. Those who purchased their funds through a financial services professional were more likely than others to consider the fund's past performance compared with that of other funds as very important.

Extent to which Fund Owners Research their Funds

Experts typically recommend that investors carefully review a fund's prospectus before making a fund purchase. At a minimum, fund investors are advised to consider certain key information contained in briefer summary documents describing funds. In addition, fund investors have extensive information available to them from independent third parties, such as the fund ranking services and newspaper and magazine articles. However, none of these written information sources was viewed as highly influential by most current fund investors. While those who purchased most of their funds directly indicated that they got greater value than others from the prospectus, just over a third of even these direct investors rated the prospectus as highly influential and just over half rated the prospectus as either highly or somewhat influential. Those who purchased funds through a workplace-based retirement plan were least likely to describe written materials as influential. In addition, the vast majority of investors in all three groups indicated that they do not take advantage of the independent, third-party information sources available to them. On the other hand, the survey did not support the conventional wisdom that many investors simply select funds from advertisements. Strong majorities rated fund ads as either not very or not at all influential.

Reliance on Advice

Investors rely heavily on advice when selecting funds, doing less research than experts typically recommend in evaluating the recommendations they receive from financial services professionals. Among those who purchased most of their funds from a financial services professional, nearly three in ten said they relied totally on that professional's recommendation without doing any independent evaluation of the fund. Another 36 percent said they relied a great deal on the professional's recommendation but reviewed some written material about the fund before the purchase. Even among those who purchased most of their funds through a workplace retirement plan, where one-on-one expert advice is often not available, such advice outranked other more commonly available information sources as influential to purchase decisions. Women were significantly more likely than men both to value one-on-one expert advice and to act on that advice without doing any additional research.

Attitudes Toward Mutual Funds

A strong majority of current fund owners have positive attitudes toward funds, even though they realize owning funds carries risks and may not always be profitable. In contrast, those who either owned funds in the past but do not now or who indicate they do not ever expect to own funds have far less positive attitudes toward funds. In particular, they are far less likely to view funds as safe or profitable. Those who do not own funds but expect to do so in the future have attitudes toward funds that are neither as positive as those of current owners nor as negative as those of other non-owners.

Use of the Internet

All survey respondents, including non-investors, were asked about their willingness to use the Internet for various activities if they were to purchase a fund in the future. The survey revealed widespread willingness to use the Internet for several mutual fund purchase-related activities. For example, strong majorities of individuals aged 18 to 54 expressed a willingness to use the Internet to obtain general information about mutual funds and to research individual funds. In addition, a majority of individuals in the youngest three age groups (18-44) expressed a willingness to use the Internet to receive reports and disclosure documents and to use a cost calculator.

However, the survey also revealed a widespread lack of willingness to use the Internet among certain groups and for certain purposes. More than two in ten survey respondents indicated they would not use the Internet at all, including a majority of those 65 and older. Among this oldest group, no more than 24 percent indicated they would use the Internet for any of the specific activities listed. Even among the youngest three groups of survey respondents, significantly fewer were willing to use the Internet to communicate with a financial services professional or to purchase funds than for other purposes. And, among current investors who purchased most of their funds from a financial services professional, fewer than half indicated they would be willing to receive periodic reports or disclosure documents for the funds they own over the Internet, and just over a third indicated they would be willing to use the Internet to communicate with their financial services professional.

Purchase Group Profiles

The survey reveals significant differences among the three purchase groups – workplace purchasers, purchasers through professionals, and direct purchasers – in how they approach the purchase process. Some of these differences have important implications for the design and development of investor education materials. The report includes brief profiles of the three purchase groups. (See pages 18-23.)

Introduction

In September 2005, Opinion Research Corporation conducted a survey of consumer use of mutual fund information sources. The survey was administered to a representative sample of 2,048 adult Americans, including both individuals who currently invest in mutual funds and those who do not. It was conducted for the Consumer Federation of America (CFA) as part of a research project funded by the NASD Investor Education Foundation.[2]

[2] The survey was developed by CFA with extensive input from members of an advisory group assisting the research project. The advisory group included the following members: Don Blandin, President and CEO, Investor Protection Trust; Mercer Bullard, Founder and President, Fund Democracy, Inc.; Denise Voigt Crawford, Texas Securities Commissioner; Timothy Forde, Vice President of Fund Administration, Capital Research and Management

The survey included questions on the factors mutual fund investors consider when selecting funds and the information sources on which they rely in making those selections. In addition, both investors and non-investors were asked about the sources they would be likely to consult for information and advice if they were to make a mutual fund purchase in the near future. The entire sample was also asked about their willingness to use the Internet for various mutual fund purchase-related activities. The following is a summary of key survey findings.

General Characteristics of Mutual Fund Investors

Of the entire sample of 2,048 adult Americans, 43 percent identified themselves as current owners of mutual funds. Another 15 percent indicated that they do not currently own mutual funds but expect to in the future, 12 percent said they had owned mutual funds in the past but do not currently own mutual funds, and 25 percent said they had never owned mutual funds and do not intend to own funds in the future. Five percent answered "Don't know."

<u>Purchase Method</u>: Workplace-based retirement plans are the most common means of obtaining mutual funds. Among current mutual fund owners, 58 percent had obtained most of their funds through a workplace-based retirement plan, 28 percent had purchased most of their funds through a financial professional such as a broker or financial planner, 8 percent had bought most of their funds either directly from a fund company or through a discount broker or fund supermarket, and 4 percent had inherited most of their funds.

<u>Length of Ownership</u>: Most fund owners have owned funds for a considerable time. Nearly half (48 percent) of all current mutual fund owners said they had owned mutual funds for more than ten years. A little over a quarter (27 percent) of current mutual fund owners said they had owned funds for five to ten years, and one quarter (25 percent) said they had owned funds for five years or less, including just 5 percent who said they had owned funds for two years or less. Those who purchased most of their funds at work were significantly more likely than others to have owned funds for five years or less, while those who purchased most of their funds directly were significantly more likely than others to have owned their funds for ten years or more.

<u>Size of Fund Holdings</u>: Mutual fund owners' household fund holdings are fairly modest in light of the long time many individuals have been investing in funds and the level of assets

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Company; John Gannon, Secretary, NASD Investor Education Foundation; Mellody Hobson, President, Ariel Capital Management; William Lutz, Professor of English, Rutgers University; Don Phillips, Managing Director, Morningstar, Inc.; John Rea, Chief Economist (retired), Investment Company Institute; Dallas Salisbury, President and CEO, Employee Benefit Research Institute; and Tom Selman, Senior Vice President, NASD. In addition, Susan Wyderko, then Director of the Securities and Exchange Commission's Office of Investor Education and Assistance, and Susan Nash, Associate Director of the SEC's Division of Investment Management, acted as observers. The advisory group and observers assisted in analysis of initial research on mutual fund investor education materials and disclosure documents, development of the survey instrument, and analysis of survey findings. CFA gratefully acknowledges their contributions. However, participation as an advisory group member or observer does not imply endorsement of the survey report.

experts estimate people need to retire comfortably. Over one-third (35 percent) of current fund owners have $25,000 or less invested in funds, and nearly half (48 percent) have $50,000 or less invested in funds.[3] Mutual fund investors' retirement plan fund assets are even more modest. Among those who purchased most of their mutual funds through a workplace-based retirement plan, nearly six in ten (56 percent) indicated they had $50,000 or less in mutual fund retirement plan assets, including 40 percent with $25,000 or less in mutual funds in these accounts.

Table 1: Current Owners' and Workplace Purchasers' Mutual Fund Assets

	$25,000 or less	$25,000-$50,000	$50,000-$100,000	$100,000 or more	Don't know
Current owners' household fund assets	35%	13%	14%	20%	18%
Workplace purchasers' retirement plan fund assets	40%	16%	14%	14%	16%

Knowledge of Mutual Funds: Approximately two-thirds (66 percent) of current mutual fund owners indicated they know either a great deal or a fair amount about mutual funds.[4] Of these, 14 percent expressed confidence that they know a great deal about mutual funds, and 52 percent said they know a fair amount. On the other hand, only 4 percent said they know nothing about funds. Not surprisingly, those who have never owned funds and never intend to have much lower levels of self-reported knowledge about funds, with nearly half (48 percent) indicating they know nothing about funds. Those who expect to own mutual funds in the future had self-assessed knowledge levels that fell largely in the middle. A third (34 percent) said they know a fair amount about mutual funds, and four in ten (40 percent) said they knew a little about funds.

Table 2: Self-Assessed Knowledge of Mutual Funds

	Great Deal	Fair Amount	Little	Nothing
Current Owners	14%	52%	30%	4%
Past Owners	12%	47%	35%	5%
Future Owners	6%	34%	40%	20%
Never Owners	5%	14%	33%	48%

Conventional wisdom suggests that those who purchase funds through workplace-based retirement plans are significantly less knowledgeable than other mutual fund investors. However, these

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[3] This includes money held both inside and outside workplace-based retirement plan accounts.

[4] The survey did not attempt to assess respondents' actual knowledge levels. It asked only for respondents to assess their own knowledge level. Typically, surveys that have tested investor knowledge have found actual knowledge levels that are significantly lower than self-assessed knowledge.

fund owners expressed confidence in their knowledge that was equivalent to that of those who purchase through financial professionals. Roughly two-thirds of both groups (66 percent of workplace purchasers and 68 percent of those who purchased through a financial services professional) said they knew either a great deal or a fair amount about mutual funds. Those who purchased most of their funds directly expressed the greatest confidence in their fund knowledge, with 77 percent saying they knew either a great deal or a fair amount about funds. Nearly three times as many direct purchasers (33 percent) said they knew a great deal about funds as either workplace purchasers (12 percent) or those who purchased from a financial services professional (13 percent).

General Demographic Characteristics: The survey found significant demographic differences between the various mutual fund ownership categories – i.e., current owners, future owners, past owners, and those who never expect to own mutual funds. For example, current mutual fund owners on average are older, are better educated, and have higher incomes than future owners. Those who say they never expect to own funds are significantly older than future owners. While their education level is comparable to that of future owners, they are significantly less likely than either current or future owners to be employed full-time, and their mean income is substantially lower than that of the other groups. Past owners are significantly less likely than either current or future fund owners to be employed full-time. They are far more likely than either of these groups to be retired. Their mean income is higher than that of those who never expect to own funds, but lower than that of current owners. They are also slightly older than current owners.

Table 3: Age, Education, and Income by Ownership Category

	Current Owners	Future Owners	Past Owners	Never Owners
Mean Age	46.2	33.2	50.3	48.0
Mean Income	$66,500	$42,900	$47,800	$37,400
% with At Least a Bachelor's Degree	49%	17%	26%	17%

The survey indicates that minorities, particularly African Americans, expect to increase their fund ownership in the future. Most notably, a quarter (25 percent) of those who identify themselves as future owners of mutual funds are African American, compared with just 8 percent of current owners. Similarly, 17 percent of those who identify themselves as future fund owners are Spanish, Hispanic, or Latino, compared with just 8 percent of current owners. While the percentage of future owners who are Spanish, Hispanic, or Latino is comparable to the percentage of those who never expect to own mutual funds who fall within this group, the percentage of future owners who are African American (25 percent) is more than twice as high as the percentage of those who never expect to own funds who are African American (11 percent).

Attitudes toward Mutual Funds

All survey respondents were asked a series of questions about their attitudes toward funds. Specifically, they were asked to rate on a one-to-five scale whether their views toward funds are generally favorable or unfavorable, whether they view funds as safe or risky, whether they view funds as profitable or unprofitable, and whether they view funds as easy or difficult to purchase.

A large majority of current mutual fund owners have positive attitudes toward mutual funds. At the same time, many of these owners express an understanding that there are risks associated with owning mutual funds, including the risk that they will not always be profitable. In contrast, past fund owners and those who never expect to own funds have significantly less positive views of funds. Those who indicated that they expect to own funds in the future have attitudes that fall somewhere in the middle – not as positive as those of current owners but more positive than those of other non-owners. One exception involves attitudes towards the ease of purchasing funds. Similar percentages of future owners (20 percent) and other non-owners (19 percent) view funds as either very or somewhat difficult to purchase. Only five percent of current owners view funds as very or somewhat difficult to purchase.

Table 4: Attitudes toward Mutual Funds among Owners and Non-Owners

	Current Owners	Past/Never Owners	Future Owners
Favorable/Unfavorable	64/8	27/25	52/16
Safe/Risky	44/10	20/26	38/19
Profitable/Unprofitable	47/9	23/19	43/12
Easy/Difficult to Purchase	72/5	36/19	42/20

Note on Data: The first number in each entry represents the percentage of 4s or 5s for each category. The second number represents the percentage of 1s and 2s.

Among current owners, those who purchased their funds directly from a fund company or through a discount broker or fund supermarket expressed the most positive views toward mutual funds. Nearly seven in ten (68 percent) of these investors had either a somewhat or very positive view of funds, including more than four in ten (42 percent) who had a very positive view. While the survey did not reveal significant differences among purchase groups in perceptions of fund risks or profitability, it did reveal that those who purchase funds through work are significantly less likely to view funds as easy to purchase. Specifically, well under half (44 percent) of those who purchased most of their funds through a workplace-based retirement plan said funds were very easy to purchase, compared with roughly six in ten of both direct purchasers and those who purchased through a financial professional.

Among the general population, including both investors and non-investors, those 65 and older express significantly less positive attitudes toward mutual funds than younger respondents. Only 34 percent of those 65 and older said they view funds either somewhat or very favorably, compared with 48 percent of the entire sample, while nearly a quarter (23 percent) said they view them either somewhat or very unfavorably. They were particularly likely to view funds as risky and unprofitable. This may reflect the fact that this age group is significantly less likely than younger groups to have been introduced to funds through a workplace retirement plan.

Those who rate themselves as knowing either a great deal or a fair amount about mutual funds tend to have the most positive views toward funds. In particular, they are disproportionately likely to regard funds as relatively safe and profitable. While these individuals make up only 47 percent of the total sample, they account for 62 percent of those who rate funds as somewhat or very safe, and 58 percent of those who view funds as somewhat or very profitable. These findings, along with the generally positive attitudes among current owners, seem to indicate that greater familiarity with mutual funds is associated with more positive attitudes.

Factors Investors Consider When Selecting a Fund

A primary goal of the survey is to better understand how mutual fund investors go about making their investment decisions. With that in mind, the survey asked all current owners of mutual funds how significant each of five factors was in their most recent mutual fund purchase decision. Those factors were the fund's risks, the fund's performance compared with that of other funds, the reputation of the fund company or fund manager, the volatility of the fund's past returns, and the fund's expenses. Respondents were asked to rate the importance of each factor to their purchase decision on a five-point scale from not at all important to very important.

Virtually all financial experts consider a fund's risks and its expenses to be among the most important factors for investors to consider when selecting a mutual fund. They typically identify the volatility of a fund's past returns as one of the best measures of risk. But just under a third of current mutual fund investors (32 percent) considered expenses to be very important when making their most recent mutual fund purchase, the same number considered volatility to be very important, and just under four in ten (39 percent) considered the fund's risks very important. Approximately one-third of investors (31 percent) did not consider a fund's risks even somewhat important. More than a third (35 percent) did not consider the volatility of its past returns even somewhat important. And four in ten (41 percent) did not consider a fund's expenses even somewhat important. Investors gave higher priority to the reputation of the fund company or fund manager and to the fund's past performance compared with that of other funds, factors most financial experts consider to be somewhat less important.

The survey also revealed significant differences among the different purchase groups regarding the factors members of those groups considered when selecting a fund. Investors in all three groups gave greatest weight to the reputation of the fund company or fund manager in making their selection, but direct investors gave by far the greatest weight to this factor. Direct purchasers were also significantly more likely than members of other groups to weigh expenses when selecting a fund. Those who purchased most of their funds through a financial services professional were more likely than others to view a fund's past performance compared with that of other funds as very important to their purchase decision.

See Table 5 on the following page for detailed findings.

Table 5: Percentages of Investors who Rated Various Factors as Very or Somewhat Important to their Most Recent Mutual Fund Purchase

	Current Owners	Direct Purchasers	Purchasers through a Professional	Workplace Purchasers
Fund Company Reputation	52/23	72/16	59/21	46/24
Fund Expenses	32/22	50/24	33/22	30/21
Past Performance	41/30	39/41	49/26	38/30
Fund Risks	39/26	46/25	43/31	36/24
Volatility	32/30	30/27	31/30	32/30

Note on Data: The first number in each entry represents the percentage who rated the factor as very influential (5). The second number represents the percentage who rated the factor as somewhat influential (4).

Importance of Advice

Investor advocates and other experts counsel investors to research the funds recommended to them by financial services professionals, on the grounds that some professionals may have conflicts of interest that could bias their recommendations. According to the survey, however, investors typically do little independent research of the funds recommended to them by professionals. Nearly three in ten (28 percent) current mutual fund owners who purchased most of their funds through a financial services professional said they relied totally on that professional's recommendation, without doing any additional research. Another 36 percent said they relied a great deal on the recommendation of the financial services professional, but reviewed some written material about the fund before the purchase. For this latter group, it is impossible, based on the results of this survey, to know for certain what types of material they reviewed. While that written material could include a fund prospectus or Morningstar report, it could also simply consist of marketing material.

Women were more likely than men to say they relied totally on the recommendation of a professional. Nearly one-third (32 percent) of women who purchased through a financial professional said they relied totally on that professional's recommendation, compared with 23 percent of men. Men were more likely to say they relied a great deal on the professional's recommendation. Nearly four in ten men (39 percent) compared with one-third of women (32 percent) said they relied a great deal on the professional's recommendation.

This heavy reliance on expert advice can be seen even among mutual fund owners who purchased most of their funds through a workplace retirement plan. Although many of these investors do not have access to one-on-one expert advice in selecting mutual funds, those who do appear to rely heavily on their recommendations. For example, nearly half (45 percent) of those who purchased most of their funds through a workplace retirement plan said one-on-one advice from an expert that they consulted outside the workplace was either a very influential (22 percent) information source in choosing their workplace mutual fund investments or somewhat influential (23 percent). Slightly fewer said one-on-one advice from an expert consulted at the workplace was either very (20 percent) or somewhat (18 percent) influential. Furthermore, expert advice was either as influential as or more influential than other information sources that are more commonly available, such as written and website materials provided by employers, information sought out by the investor, or information provided in workplace seminars.[5]

Table 6: Percentages of Workplace Purchasers Who View Various Sources of Information as Influential or Not Influential

	Expert away from work	Expert at work	Written material from employer	Written material found on own	Workshop at Work	Friends, Family, Fellow Workers
Very/Somewhat Influential	22/23	20/18	18/21	14/23	13/17	13/14
Not Very/Not at All Influential	7/22	9/25	12/17	12/24	13/29	17/29

Note on Data: In the first row of entries, the first number represents those who rated the information sources as very influential (5), and the second number represents those who rated the information sources as somewhat influential (4). In the second row of entries, the first number represents those who rated the information sources as not very influential (2), and the second number represents those who rated the information sources as not at all influential (1).

Women's tendency to place greater value on expert advice was evident among those who purchased most of their funds through a workplace-based retirement plan. Nearly half of these women (49 percent) said one-on-one advice from an expert away from work was either very or somewhat influential to their most recent retirement plan mutual fund purchase, compared with just 40 percent of men. More than four in ten women (45 percent) said one-on-one advice from an expert at work was either very or somewhat influential, compared with less than a third of men (31 percent). And more than a third of women (35 percent) compared with just a quarter of men (25 percent) said information provided in a workplace seminar was very or somewhat influential. In contrast, men were much more likely to conduct their own research and rely on written and website publications. Four in ten men (41 percent) said information that they found on their own on a website or in a printed publication was very or somewhat influential, compared with less than a third (32 percent) of women.

[5] The term expert in this case does not necessarily refer to a financial services professional, as the term was not defined. It could, for example, refer to a human resources employee. However, the question did refer specifically to one-on-one advice and did distinguish between an expert and friends and colleagues.

The less affluent also expressed both a greater reliance on advice and a greater interest in obtaining advice. For example, workplace purchasers with incomes under $50,000 were significantly more likely than those with higher incomes to have been influenced by one-on-one advice from an expert at work or information obtained in a workplace seminar, while those with incomes over $50,000 were more likely to have relied on information on a website or in a printed publication they found on their own. When the entire sample was asked about sources of advice they would be likely to turn to if they were to make a fund purchase in the future, those with incomes between $25,000 and $50,000 were more likely than those with higher incomes to indicate they would definitely turn to each type of financial services professional. This is true, despite the fact that these individuals are less likely to be able to afford the services of such professionals.

Value of Various Written Materials

Experts almost universally recommend that investors carefully review the fund prospectus before purchasing a mutual fund. In addition to the prospectus, mutual fund investors have a variety of written materials available to assist them in selecting mutual funds. These include briefer fund summary documents prepared both by the fund companies and by independent parties, ranking services such as Morningstar and Lipper, and newspaper and magazine articles evaluating funds. In addition, many fund companies advertise widely, often including performance information and fund ratings in the ads.

The survey asked current mutual fund investors who purchased most of their funds how influential each of these documents was in their most recent mutual fund purchase. Supporting the view that mutual fund investors do relatively little research when selecting mutual funds, none of these documents was viewed as highly influential by most current fund investors. On the other hand, the survey did not support the conventional wisdom that many investors simply select funds from advertisements. Strong majorities in all three categories (71-75 percent) said ads were either not very or not at all influential.

As expected, those who purchased funds either directly from the fund company or through a discount broker or fund supermarket indicated the greatest willingness to research funds using available written materials. Over one-third of these investors (37 percent) rated the prospectus as highly influential, and more than half (55 percent) rated it as either somewhat or highly influential. That still leaves more than four in ten (43 percent) of these investors who did not consider the prospectus, the fund's primary disclosure document, even somewhat influential. Direct purchasers also gave much higher ratings than those who purchased through other methods to the independent ranking services, such as Morningstar or Lipper. Still, only two in ten (19 percent) rated these ranking services as highly influential, and under half (46 percent) rated them as either highly or somewhat influential.

Those who purchased most of their funds through an employer-sponsored retirement plan were least likely to rate written materials as highly influential. None of the documents evaluated in the survey was rated highly influential by more than two in ten workplace purchasers. The prospectus was described as very influential by 19 percent, followed by the brief summary document (16 percent), and ranking services (11 percent). Moreover, more than half of investors who purchased through retirement plans did not consider any of the documents as even somewhat influential. Just over half (52 percent) did not consider the prospectus even somewhat influential. Nearly six in ten (59 percent) did not consider brief summary documents as even somewhat influential. Nearly seven in ten (68 percent) did not consider ranking services even somewhat influential. This makes some sense, given the relatively limited choices most retirement plan investors have available to them. It is also consistent with the preference workplace purchasers expressed on a separate question for advice rather than written documents (See "Importance of Advice" above).

Those who purchased most of their funds through a financial services professional were significantly more likely than the others to rate briefer summary documents highly. Specifically, more than half (55 percent) rated the briefer summary documents as either somewhat or very influential, including nearly one quarter (23 percent) who rated them as very influential. The prospectus was next behind summary documents, rated somewhat or very influential by 44 percent, including 22 percent who rated it as very influential. Less than a third rated any of the other documents as somewhat or very influential.

Table 7: Percentage of Investors in Different Purchase Groups Who Viewed Various Documents as Either Very or Somewhat Influential

	Direct Purchasers	Purchasers through a Professional	Workplace Purchasers
Prospectus	37/18	22/22	19/24
Fund Summary	18/15	23/32	16/23
Ranking Service	19/27	13/17	11/15
Magazine article	12/13	6/15	6/15
Fund ad	4/2	3/3	3/3

Note on Data: In each entry, the first number represents the percentage who rated the document as very influential. The second number represents the percentage who rated the document as somewhat influential.

In addition, the entire survey sample was asked what documents they would consult if they were to purchase a mutual fund and the documents were readily available. The briefer summary document was viewed most favorably, rated as being of great interest by 23 percent and as of some or great interest by 46 percent. The prospectus followed, considered of great interest by 20 percent and of some or great interest by 35 percent. The prospectus's negatives, however, were very high. More than four in ten (41 percent) rated the prospectus as of little or no interest, compared with just 26 percent for the briefer fund summary document. Women were more likely than men to favor the brief summary, and men were more likely than women to favor the full prospectus.

Survey respondents showed particularly little interest in the independent sources of information available to assist them with their fund purchases. Among these categories (ranking services, general information about funds, and magazine or newspaper articles rating funds), only ranking services were viewed as of some or great interest by at least a third of survey respondents (34 percent). Interestingly, this is a significantly higher rating from hypothetical investors than ranking services received from any of the actual fund purchasers except the direct purchasers. (Unlike the previous questions about investors' actual experiences in selecting funds, this survey question is premised on the ready availability of the information sources, which may contribute to the discrepancy.)

The survey also reveals significant differences in attitudes toward these information sources between current owners and those who do not currently own funds but expect to in the future. In particular, future owners expressed far greater enthusiasm than current owners for the briefer fund summary documents. More than a third (35 percent) of future owners rated these documents as being of great interest, and more than six in ten (62 percent) rated them as being of either some or great interest. In contrast, fewer than two in ten current owners (19 percent) rated them of great interest, and just under half (49 percent) rated them as either of some or great interest. Future owners also expressed greater interest in mutual fund ranking services (47 percent rated them as either of great or some interest, compared with 36 percent of current owners), general information about mutual funds (48 percent compared with 28 percent), and newspaper and magazine articles rating funds (43 percent compared with 25 percent). A variety of factors could explain this difference, including perhaps an overly optimistic view among future investors of the amount of research they are likely to be willing to do once it comes time actually to make a fund purchase or a less favorable view of the value of existing written documents among current investors who have actually been exposed to them. However, these results do suggest a possible opening to reach future fund investors with well designed abbreviated disclosure documents as well as easily accessible education materials.

Sources of Advice for Future Purchases

The entire survey sample was asked from whom they would be likely to seek advice if they were to purchase a mutual fund. By far the largest number indicated they would be likely to consult a financial planner, with one-third (33 percent) indicating they definitely would consult a financial planner and another quarter (24 percent) indicating they probably would do so. This is significantly more than indicated they would consult a stockbroker (the second highest ranking source of advice). Just two in ten (19 percent) indicated they definitely would consult a broker, and another 18 percent indicated they probably would do so. Brokers' negatives were also much higher than the negatives for financial planners, with nearly four in ten (38 percent) saying they either definitely or probably wouldn't consult a broker for advice compared with just over two in ten (22 percent) for financial planners. In considering these findings, it is important to keep in mind that investors do not clearly distinguish between brokers and financial planners.

Survey respondents were fairly evenly divided in the likelihood that they would consult brokers, banks or credit union representatives, accountants, and friends and family members (with numbers of those who would definitely or probably consult each group ranging from a high of 37 percent for brokers to a low of 30 percent for friends, family members and coworkers). Far fewer indicated they would be likely to consult an insurance agent, with only 10 percent saying they would definitely do so and 18 percent saying they would either definitely or probably do so. More than half (57 percent) said they either probably or definitely would not consult an insurance agent for advice.

In each category, future owners were more likely than current owners to say they either definitely or probably would consult that particular type of financial services professional. This likely reflects the greater uncertainty that these investors bring to a purchase process they have not yet engaged in. Current owners are more likely to know how they would approach their next purchase than those who have never made such a purchase. Interestingly, the most marked difference between the two groups was seen in their attitude toward consulting a representative of a bank or credit union. More than twice as many future owners (52 percent) as current owners

(24 percent) indicated they would either definitely or probably consult a bank or credit union representative when making a mutual fund purchase. The least marked difference between the two groups was seen in their attitude toward financial planners, with 63 percent of current owners and 71 percent of future owners indicating they either definitely or probably would consult a member of this profession.

Reflecting the same value they place on advice that they revealed on other questions, women were more likely than men to indicate they would consult each type of financial services professional, with the exception of insurance agents. The difference was particularly notable with regard to financial planners, where 36 percent of women, compared with 30 percent of men, said they would definitely consult a financial planner for advice.

Use of the Internet

Policymakers are increasingly looking to the Internet to reduce the cost and increase the ease of communicating with investors. Already, an enormous amount of valuable information is available online to assist mutual fund investors in making fund selections. Not only can prospectuses be downloaded, but many fund companies provide on-line fund snapshots that make key information about the fund easily accessible. In addition, fund ranking services and others offer tools for evaluating funds, including calculators that enable investors to compare the costs of various funds. The entire sample of survey respondents was asked about their willingness to use the Internet for various purchase-related activities.

Survey respondents were most interested in using the Internet to obtain general information about funds (59 percent) and to research individual funds (58 percent). Fewer than half of survey respondents expressed a willingness to use the Internet for any of the other suggested activities, including: to receive periodic reports and disclosure documents (49 percent), to use a calculator to compare costs (47 percent), to communicate with a financial services professional (39 percent), or to purchase mutual funds (26 percent). More than two in ten survey respondents (21 percent) said they would not use the Internet at all.

As expected, younger people are significantly more likely than older people to be willing to use the Internet. For example, roughly three-quarters of respondents in the 18-24, 25-34, and 35-44 age groups would plan on using the Internet to obtain general information about mutual funds or to research individual mutual funds. Six in ten (61 percent) of those age 45-54 would do so. In contrast, just 45 percent of those age 55 to 64, would use the Internet for these purposes, and less than a quarter of those age 65 and older would do so.

Younger respondents also express greater willingness than others to use the Internet for purposes beyond research. For example, roughly six in ten survey respondents in the youngest three age groups said they would use the Internet to receive periodic reports and disclosure documents about mutual funds they owned or to use a fund cost calculator. Even among younger respondents, however, only about half or less said they would use the Internet to communicate with a financial services professional, and just over a third said they would use the Internet to purchase mutual funds.

Table 8: Willingness of Different Age Groups to Use the Internet for Various Mutual Fund Purchase-Related Activities

	18-24	25-34	35-44	45-54	55-64	65+
Obtain general info	72%	74%	73%	61%	45%	24%
Research individual funds	77%	69%	71%	62%	45%	22%
Receive reports, documents	57%	61%	62%	50%	36%	21%
Use cost calculator	64%	58%	56%	45%	35%	19%
Communicate with professional	53%	43%	45%	43%	34%	17%
Purchase funds	38%	34%	33%	21%	18%	9%
Would not use	6%	10%	9%	20%	32%	54%

Men were also significantly more willing than women to use the Internet for various mutual fund activities. Just 16 percent of men, compared with 26 percent of women, said they would not use the Internet for any purpose. For each of the activities included in the survey except one, significantly more men than women said they would be willing to use the Internet. The exception was using the Internet to communicate with a financial services professional, where men were only slightly more likely than women to say they would use the Internet for this purpose. Despite men's greater willingness to use the Internet, fewer than half indicated they would be willing to use the Internet to communicate with a financial services professional (40 percent) or to purchase a mutual fund (31 percent), and just over half (53 percent) said they would use the Internet to receive periodic reports and disclosure documents about mutual funds they own.

The question about willingness to use the Internet was asked of all survey respondents. This included those individuals who indicated they had never owned funds and never planned to, a group with the most negative attitudes overall toward use of the Internet. When looked at separately, current owners and future owners expressed significantly greater willingness than the overall population to use the Internet. In particular, current owners expressed greater willingness than the overall population to use the Internet to obtain general information about mutual funds, to research individual funds, and to receive periodic reports and disclosure documents for funds they own. On the other hand, their willingness to use the Internet to use a cost calculator, communicate with a financial services professional, or purchase funds was roughly the same as that of the general population. Those who indicated they expect to own funds in the future, a younger group than current owners, expressed the greatest willingness to use the Internet for mutual fund purchase-related activities. In contrast to other ownership groups, two-thirds of future owners expressed a willingness to use the Internet to compare costs using a cost calculator, nearly two-thirds expressed a willingness to use the Internet to receive periodic reports, and more than half expressed a willingness to use the Internet to communicate with a financial services professional.

Table 9: Willingness to Use the Internet among Current and Future Mutual Fund Owners

	Overall Population	Current Owners	Future Owners
Obtain general info	59%	66%	74%
Research individual funds	58%	65%	74%
Receive reports, documents	49%	56%	63%
Use cost calculator	47%	48%	67%
Communicate with professional	39%	42%	56%
Purchase funds	26%	27%	40%
Would not use	21%	16%	9%

Among the three purchase groups, those who purchased most of their funds through a workplace retirement plan expressed the greatest willingness to use the Internet for at least some purchase-related activities. The vast majority of these investors (87 percent) indicated they would be willing to use the Internet. This may reflect in part the younger age of these investors as well as widespread use of the Internet as the primary tool for managing workplace retirement accounts. Internet use also has high acceptance among the other two purchase groups, with 80 percent of direct investors and 73 percent of those who purchased most of their funds from a financial services professional indicating they would be willing to use the Internet for at least some purposes. However, this willingness does not extend to all uses. Among current investors who purchased most of their funds from a financial services professional, for example, fewer than half (48 percent) indicated they would be willing to receive periodic reports or disclosure documents for the funds they own over the Internet, and just over a third (36 percent) indicated they would be willing to use the Internet to communicate with their financial services professional.

In order to understand which of various demographic factors have the greatest influence on investors' willingness to use the Internet, CFA conducted a tri-variate analysis of the survey findings for current and future fund owners.[6] Factors analyzed included age, income, education, race, and ethnicity. As expected, the analysis showed that age is the biggest variable affecting willingness to use the Internet. In particular, there is a consistent and significant drop-off in willingness to use the Internet after age 65. This is true for each type of use except fund purchase, which has strong negatives across virtually all age groups. The tri-variate analysis also showed a fairly strong association between both education and income and willingness to use the Internet. Race and ethnicity, on the other hand, had no identifiable influence.

Purchase Group Profiles

The survey revealed distinct differences between the three purchase groups in a variety of areas, many of which have been described in the body of the report above. This suggests that different approaches to investor education and information will be needed to communicate effectively with these groups. In order to facilitate thinking about how to develop investor education and information practices targeted at each group, we are including brief profiles of these three purchase groups here. These profiles will largely repeat information scattered throughout the report, but consolidate that information in one place and provide greater detail.

Direct Purchasers: Among current mutual fund owners identified by the survey, eight percent indicated they had purchased most of their mutual funds directly from the fund company or through a discount broker or fund supermarket. These investors are somewhat older (mean age 54.7), wealthier (mean income $70,100), and better educated than other investors (86 percent have at least some college education and 64 percent have at least a bachelor’s degree). Half of direct purchasers are employed full time, and more than a third (37 percent) are retired. They are disproportionately male (64 percent). Although they have a high degree of Internet usage (79 percent), it is the lowest of the three purchase groups – perhaps reflecting their somewhat older age. Of those who use the Internet, 75 percent use it at home, 48 percent use it at work, and 44 percent use it both at home and at work.

Direct purchasers have, on average, owned mutual funds for longer than members of the other two purchase groups. Nearly three-quarters (72 percent) of direct purchasers have owned funds for more than ten years. Only 10 percent have held funds for less than five years. The mean length of ownership for direct purchasers is 10.3 years. They also have larger fund holdings. A third of direct purchasers have over $100,000 in total household fund holdings. The mean amount of household fund holdings for direct purchasers is $68,500.

Direct purchasers are the most likely of the three groups to view themselves as very knowledgeable about mutual funds. This is not surprising, since confidence in their level of knowledge would make it far more likely that someone would take on the task of selecting mutual funds without the assistance of a financial services professional. A third of direct purchasers rate themselves as very knowledgeable. They have the most favorable attitude toward funds. More than four in ten direct purchasers (42 percent) indicate they have a very favorable

[6] Current fund owners were divided into two groups for the purpose of this analysis, workplace purchasers and retail purchasers. The latter category included both those who purchased most of their funds directly and those who purchased most of their funds through a financial services professional.

view of funds. They are also most likely to indicate that purchasing funds is very easy (63 percent), even though this purchase method requires them to do considerably more work than is typical for either workplace purchasers or those who purchase through a financial services professional.

Direct purchasers are the only group to give fund costs significant weight in their purchase decision. This is logical, since minimizing costs is a primary reason to purchase funds directly. Half of direct investors considered fund costs very important to their last fund purchase decision, and three-quarters (74 percent) considered costs at least somewhat important. That said, direct purchasers gave greater weight to the reputation of the fund company or manager. Nearly three-quarters (72 percent) considered reputation very important. Since fund company reputation, particularly in the direct purchase market, may be based in significant part on low costs, investing based on reputation may have the same effect as investing based on costs. (On the other hand, some investors may interpret investing based on personal finance magazine articles featuring the latest "hot" funds as investing based on reputation.) The survey does not allow us to distinguish between these factors.

Consistent with their other characteristics, direct purchasers are the most likely of the three groups to place significant reliance on written materials to research their fund selections. In particular, they are more likely than members of other groups to consider the fund prospectus and mutual fund ranking services as influential. Just over a third of direct purchasers considered the prospectus to have been very influential in their last fund purchase, and 55 percent considered the prospectus somewhat influential. Nearly half (46 percent) considered the fund ranking services to be at least somewhat influential. Although this represents greater use of these materials than was found in other groups, it still seems to indicate that a significant number of direct purchasers are not doing extensive research of the funds they purchase.

Much of the existing investor education materials appear to have been written with this relatively small group of investors in mind. Certainly, their purchase practices most closely resemble those advocated by many experts. Indeed, the recommendation to reduce costs by investing directly is an explicit message of many investor education materials. Nonetheless, gaps can be seen between how experts recommend investors select funds and how even these direct purchasers go about that process. For example, a significant number of these investors appear to be ignoring the message to carefully review the fund prospectus before purchasing a fund. Nearly half (45 percent) did not consider the prospectus even somewhat influential to their most recent fund purchase. Fund risks join fund costs at the top of the list of factors experts recommend investors consider and understand when selecting a fund. While a large majority (71 percent) considered fund risks at least somewhat important to their most recent fund purchase, fewer than half (46 percent) considered fund risks very important. Many appear to be giving little if any consideration to the volatility of past returns – a factor experts typically equate with fund risk. Only three in ten (30 percent) considered volatility very important, and less than six in ten (58 percent) considered it even somewhat important. They were more likely to be influenced by how a fund performed compared to other funds, a practice experts often warn against. Eighty percent considered past performance at least somewhat important, including 39 percent who considered it very important. This suggests that, even with this group, there is a significant gap between expert recommendations and actual investor practices.

Purchasers through Professionals: Just under three in ten survey respondents (28 percent) indicated that they had purchased most of their funds through a financial services professional, such as a broker or financial planner. In their general demographic characteristics, these investors are similar to direct purchasers but are slightly younger, slightly less wealthy, and somewhat less well educated. The mean age of those who purchase funds through professionals is 51.6. Their mean income is $67,600. More than three-quarters (77 percent) have at least some college education, including 54 percent with at least a bachelor's degree. More than half (52 percent) are employed full-time, and 28 percent are retired. In contrast to direct purchasers, who are disproportionately male, those who purchase through professionals are slightly more likely to be female (53 percent).

Purchasers through professionals have less money, on average, invested in mutual funds than direct purchasers and have not owned funds for as long. Just over half of this group has owned funds for ten years or more (53 percent). The mean length of ownership for purchasers through professionals is 9.1 years. The mean amount they have invested in funds is $57,300. Roughly a quarter (24 percent) has more than $100,000 in total household mutual fund holdings.

A defining difference between direct purchasers and those who purchase through a professional is their confidence in their level of knowledge about mutual funds. Only 13 percent of those who invest through a professional rate themselves as very knowledgeable. They also have a less favorable view of mutual funds. Only 30 percent have a very favorable view of mutual funds.

When purchasing funds, those who purchase through a professional appear to give greater weight than others to how a fund performed in the past compared to other funds – a factor experts often suggest investors should de-emphasize. Nearly half (49 percent) considered past performance very important. However, they were slightly less likely than direct purchasers to consider past performance at least somewhat important. Three-quarters (74 percent) of those who purchased through a professional, compared with 80 percent of direct purchasers, considered past performance at least somewhat important. Those who purchase through a professional gave little weight to fund costs, which in their case include sales charges as well as fund operating expenses. Only a third (33 percent) considered costs very important, and just over half (55 percent) considered costs even somewhat important.

Those who purchase through professionals appear to make little use of written materials when selecting funds. This is consistent with the fact that a majority of these investors indicate that they rely either totally (28 percent) or heavily (36 percent) on the recommendation of their professional when selecting funds. Less than a quarter of these investors rated any of the written materials as very influential to their most recent mutual fund purchase. They were most likely to consider fund summaries as influential, with 23 percent rating a fund summary as very influential and 55 percent rating a summary as at least somewhat influential. Less than half (44 percent) considered the fund prospectus as even somewhat influential, including 22 percent who considered it very influential. This latter finding is not surprising, since those who invest through a financial professional typically do not receive the prospectus until after the sale.

Although a large majority (82 percent) of these investors uses the Internet at home, at work, or both, somewhat fewer (73 percent) indicated they would be willing to use the Internet for at least some mutual fund purchase-related activities. Significantly, fewer than half of these investors (48 percent) indicated they would be willing to use the Internet to receive periodic reports and disclosure documents about mutual funds they own. Even fewer (36 percent) indicated they would be willing to use the Internet to communicate with a financial services professional.

Although roughly three-quarters of retail fund purchasers buy most of their funds through a professional, most existing mutual fund investor education materials do not appear to have been designed with these investors in mind. Logic suggests that individuals who expect to rely heavily or exclusively on the recommendations of a financial professional are unlikely to heed advice to carefully research their funds by reading the prospectus and comparing costs, risks, and investment objectives of various funds recommended. This supposition appears to be borne out both in the purchase practices and preferences described by survey respondents who purchase most of their funds through a professional. Consideration should be given to development of investor education materials that take these investors' attitudes and behavior into account.

Workplace Purchasers: The largest group of current fund holders identified by the survey (58 percent) indicated that they had purchased most of their funds through a workplace-based retirement plan, such as a 401(k) plan. Consistent with the fact that most first-time fund purchases are made through such a plan, these investors are significantly younger (mean age 43.1) than members of the other two groups. Not surprisingly, they are also much more likely to be employed full-time (73 percent) and less likely to be retired (7 percent). Their mean income of $67,300 is comparable to that of those who purchased most of their funds through a financial professional. Their education level is somewhat lower than those of the other two groups, particularly direct purchasers. Seven in ten have at least some college education, including 46 percent with at least a bachelor's degree. Unlike the other two groups, workplace purchasers are fairly equally divided between males (51 percent) and females (49 percent). They have the highest rate of Internet usage (91 percent) among the three purchase groups, and the greatest willingness (87 percent) to use the Internet for at least some mutual fund purchase-related activities.

Consistent with their younger age, these investors tend to have somewhat more modest household mutual fund holdings. The mean value of workplace purchasers' holdings is $47,900. They are significantly more likely than members of other groups to have less than $50,000 in household fund holdings (53 percent) and are significantly less likely to have more than $100,000 in funds (17 percent). They also have owned funds for a shorter period of time on average than members of the other two groups. More than a quarter (28 percent) have owned funds for five years or less, and only 44 percent have owned funds for ten years or more. The mean length of fund ownership for this group is 8.3 years.

Like those who purchase through a professional, these investors have a noticeably less favorable view of funds than direct purchasers. Only 32 percent have a very favorable view of funds. They are also the least likely of the three groups to view funds as easy to purchase, with fewer than half (44 percent) viewing funds as very easy to purchase. Workplace purchasers also resemble those who purchase through professionals in their lower confidence in their fund knowledge. Just 12 percent rate themselves as very knowledgeable about mutual funds. Nearly a third (32 percent) rate themselves as knowing only a little.

Workplace purchasers typically operate within a very different purchase process than that for either of the other two groups. While both direct purchasers and those who purchase through a professional have, at least in theory, thousands of funds to choose among, workplace purchasers typically choose from a fairly limited menu of funds that have been pre-selected by their employer.

It should come as no surprise, then, that the survey findings indicate that they approach the purchase process differently than those who purchase funds in the retail marketplace. In each case except volatility, workplace purchasers were the least likely of the groups to consider any of the factors – cost, risk, reputation, or past performance -- as important to their purchase decision. They were also the least likely to consider any of the written materials as influential on their most recent purchase decision. Not even two in ten workplace purchasers considered any of the documents very influential, and fewer than half considered any of the documents as even somewhat influential. When asked about their most recent purchase through a workplace plan, 48 percent indicated the fund prospectus was at least somewhat influential and 38 percent indicated a fund summary was at least somewhat influential. When asked what types of documents they would be interested in using, fund summaries did somewhat better, with nearly half of workplace purchasers (49 percent) rating these documents as of either great or substantial interest. This suggests that employers who do not already do so might want to consider making or promoting greater use of either the fund snapshots produced by fund companies or the fund summaries prepared by third parties, such as Morningstar or Yahoo!Finance.

Many employers provide a wealth of educational materials and tools to help their employees make their fund selections. The survey findings suggest that employees are not making good use of these materials, that they are not aware of their availability, or that these materials are not serving workplace purchasers as well as they could. Consideration should be given to conducting further research to determine how employees view the educational materials available to them and what could be done to improve them, whether through better design, content, or delivery.

Conclusion

The gap the survey reveals between how experts recommend investors go about making mutual fund purchase decisions and how investors actually do so has important implications both for policy-makers and for investor educators. In some cases, the survey findings may reveal a real failure on the part of investors to take important steps to protect their interests. In these cases, the challenge for investor educators is to figure out how to convey their message more effectively. In other cases, however, the gap between expert recommendations and investor behavior may reveal unrealistic expectations on the part of experts as they develop their education messages, a failure to tailor their messages for different segments of the market, or both. By beginning to explore the nature of the gap between expert recommendations and investor behavior, this survey can help us develop more effective investor education materials and methods that coincide more closely with the real world experiences of mutual fund investors and build on their preferences for receiving information.

Appendix B

Consumer Federation of America

Can the Internet Transform Disclosures for the Better?

By Barbara Roper
Director of Investor Protection
January 2014

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Executive Summary

At a time when the transition to a primarily Internet-based system of disclosure is well underway in the securities industry, this report examines how the Internet can be used to improve the effectiveness of financial disclosure. Toward that end, the report identifies potential benefits and pitfalls of Internet disclosure; the pre-conditions necessary for effective Internet disclosure; the most significant barriers to effective disclosure, regardless of delivery method; and how Internet disclosure may be able to help reduce those barriers. Our analysis of these questions is informed by an extensive literature review, examination of industry websites, interviews with experts, and surveys of investors and financial professionals. The following is a brief summary of our findings, which are described in greater detail in the body of the report.

The Potential Benefits and Pitfalls of Internet Disclosure

It has long been recognized that Internet disclosure allows for information to be disseminated much more quickly, updated more easily, and delivered at a significantly lower cost to financial services firms. As the Internet has evolved, however, views of its potential benefits have expanded. Among the key additional potential benefits of well-designed Internet disclosures identified in our literature review and expert interviews are:

- the ability to layer disclosures, enabling investors to choose the level of detail they wish to receive;
- increased capacity to incorporate graphic and even video elements, to make disclosures more appealing and accessible;
- enhanced ability to search disclosures for the most relevant information;
- access anywhere and anytime from a variety of devices;
- improved archiving of information;
- the ability to package disclosures with tools, such as calculators, and other educational materials in order to improve investor comprehension;
- environmental benefits from the reduced demand for paper; and
- enhanced ability for third parties to analyze and repackage the information to make it more useful to investors.

Despite these considerable potential benefits, even the strongest Internet disclosure advocates acknowledge that there are also potential pitfalls to electronic delivery that must be taken into account when developing policies and practices in this area. Traditionally, the leading issue has been lack of Internet access for significant portions of the population (discussed further below), followed closely be concerns about privacy and information security. Experts have identified the following additional potential pitfalls:

- Internet users who have become accustomed to rapidly scrolling through long legal contracts and clicking the "I agree" button at the bottom may give electronically delivered disclosure documents the same cursory review;

- investors who have been taught to be leery of clicking on links in emails, because of concerns about "phishing" or malware, may be reluctant to accept delivery of disclosures through hyperlinks in email messages;

- email may be easier to ignore or lose track of than paper mail or may get caught in spam filters;

- disclosures may get lost, inadvertently or intentionally, on websites that serve a variety of competing functions; and

- even as we are becoming more accustomed to computer-based disclosures, increasing numbers of individuals now access the Internet primarily through a smart phone, raising a whole new set of issues with regard to security and readability.

Investors Express Mixed Views about Internet Disclosure

Investors surveyed for this report expressed mixed views about the benefits of Internet disclosure. For example, most (60 percent) strongly agreed that electronic delivery is better for the environment than paper disclosure. On the other hand, just under half of surveyed investors expressed strong agreement with regard to other potential benefits identified by experts, including: that electronic delivery makes it easier to access information prior to meeting with their broker or adviser; that it could significantly reduce the cost of disclosure and therefore reduce their fees; that the interactive nature of the Internet can make it easier to find the information that is most relevant to them; and that the layered disclosure possible on the Internet enables investors to choose the degree of detail they want to receive. Financial professionals expressed significantly more favorable views about the potential benefits of Internet disclosure in each of these areas.

Moreover, privacy and information security clearly remain a major concern for a substantial minority of investors, and these concerns appear to pose the most significant impediment to investor acceptance of electronic delivery. Nearly a third (32 percent) of surveyed investors indicated significant reluctance to permit Internet disclosure because of concerns about security and/or privacy. Similarly, a perception that paper-based disclosures are more secure and better protect privacy was considered the strongest selling point of paper delivery among surveyed investors. Despite these concerns, most investors appear to have an open mind about Internet disclosure. Only slightly more than a third (37 percent) of those surveyed expressed a strong preference for receiving all disclosures as paper documents for the foreseeable future.

Many Firms Make Good Use of Internet in Presenting Information to Investors

Our website evaluations turned up numerous real-world examples of how financial services firms are using the flexibility and functionality of the Internet to present information effectively. We found numerous examples of firms' incorporating visually appealing design elements into their websites, layering information in order to provide that information in more consumable chunks, providing easy navigation within and among topic areas, supplementing written materials with video, putting disclosures in context by providing a broad range of supporting tools and educational materials, providing appropriate security protections around sensitive personal financial data, and allowing access through a variety of devices. On the other hand, we also found examples of potential pitfalls and one major missed opportunity. In particular, use of pleasing design elements was sometimes selectively applied and was not always extended, for example, to information about fees or revenue sharing payments that the firm did not wish to highlight. Also, links to important disclosures were in some cases less than prominent. As for the missed opportunity, while many firms offered a tool investors could use to locate a financial adviser in their area, none of the sites we reviewed provided direct access along with that tool to an individual broker's or adviser's BrokerCheck or IAPD reports.

<u>The Pre-conditions for Effective Internet Disclosure: Investor Access and Attitudes</u>

For Internet disclosure to function effectively, investors must have ready access to the Internet, and the legal framework for disclosure must permit electronic delivery. These basic requirements have largely been met. For Internet disclosure to reach its full potential, however, investors must fully embrace this disclosure mechanism, and the legal framework for disclosure must be flexible enough to allow for innovations that take full advantage of the Internet's capabilities. Challenges remain in each of these latter two areas, as discussed further below.

Uneven or limited Internet access, which once was a major impediment to expanded use of the Internet for mandatory disclosures, appears to be largely a thing of the past. Research indicates, for example, that a sizeable majority of American adults (roughly 80 percent) and nearly all investors are Internet users, and most today access the Internet through broadband connections. While a persistent minority, particularly among older and less well educated adults, do not use the Internet and have no intention of changing, use among minorities and among more moderate income households has grown significantly in recent years. Moreover, those who do use the Internet use it more frequently and for uses closely related to investing, such as making online purchases and online banking. While efforts can and should be made to further close the digital divide, inadequate Internet access is not concern it was even just a decade ago.

Although attitudes appear to be evolving, ready access to and frequent use of the Internet does not necessarily equate to willingness to use the Internet for investment-related purposes. Slightly more than half of our survey respondents reported using the Internet for investment-related purposes at least "sometimes," but nearly as many reported using it for this purpose either rarely or never . Fewer than one in ten reported using the Internet for investment-related purposes "very frequently," while another 15 percent reported doing so "frequently." Among the survey findings with particular relevance for this study, just over half of those surveyed indicated they would be willing to use the Internet to receive reports and documents. Investors expressed greatest willingness to use the Internet to view account information, obtain general information, and research individual investments, with significant majorities expressing a willingness to use the Internet for each of these purposes.

On the other hand, some of this lukewarm support for receiving disclosure electronically may reflect a general lack of interest in reading disclosures, rather than a strong bias against using the Internet for this purpose. In fact, when asked about their preferences for receiving certain types of disclosure either electronically or on paper, survey respondents were slightly more likely to express a preference for electronic delivery, particularly with regard to information on compensation practices and background information on individual professionals. Not surprisingly, preferences were strongly correlated with age, with younger investors preferring electronic delivery and older investors preferring paper disclosures. Nonetheless, even among younger investors, a significant minority continues to prefer traditional paper disclosures over electronic delivery.

Despite these pockets of resistance, our findings suggest that a majority of the investors surveyed are willing to at least consider a transition to electronic delivery, including a significant minority who are already making that transition.

<u>The Pre-conditions for Effective Internet Disclosure: The Legal Framework</u>

The Securities and Exchange Commission established the legal framework permitting electronic delivery of disclosures in the mid-1990s. In doing so, it identified a set of simple, flexible principles for electronic delivery that have allowed electronic disclosure practices to grow and develop in concert with the subsequent dramatic expansion and technological evolution of the Internet. The framework turns on three basic requirements: direct notice of the availability of electronic disclosures, access that does not make it too burdensome for the investor to locate and read the disclosure document, and evidence of delivery. The latter can be satisfied either through direct evidence or through informed consent of the investor and compliance with the notice and access requirements. The Electronic Signatures in Global and National Commerce Act (or ESIGN Act), enacted by Congress in 2000, imposed an additional requirement to obtain consent to electronic delivery through an electronic consent method. While the SEC has the authority to adopt an exemption, it has so far chosen not to do so for broker-dealer and investment adviser disclosures.

Some now suggest that the SEC's electronic disclosure policy needs to be updated. Among the issues that are raised in that context are questions of what constitutes delivery and whether the time has come to switch the delivery default from paper to electronic in order to speed the transition to an Internet-based disclosure system. In addition, some suggest that the legal framework needs to be updated for a different purpose: to enable firms to take full advantage of the flexibility of the Internet in designing disclosures for electronic delivery.

What Constitutes Delivery?

Since at least 2000, various industry groups have periodically urged regulators to eliminate the disclosure delivery requirement in favor of an "access equals delivery" model. Under this model, "delivery" could be accomplished solely by an issuer posting a document on the issuer's or a third-party's web site. Advocates have strongly objected to that approach. Although the Commission has decided the issue differently in different contexts, it has generally upheld the notion that some form of notice is required to satisfy the delivery obligation. Meanwhile, technological changes – including widespread access to email over high-speed connections and techniques for providing password-protected access to account information online – have significantly eased the burdens of electronic delivery. It is now possible to deliver even very lengthy documents via email, either as an attachment or through a link to the firm website.

Financial professionals surveyed for this study appeared at the very least to be confused about what satisfies delivery requirements. When asked their view of delivery obligations, for example, roughly two-thirds of financial professionals said that obligation was satisfied by providing transparent access. On the other hand, while an overwhelming majority of financial professionals viewed mailing of paper documents and email with printable attachments as satisfying the delivery requirement, only half believed that sending an email with a hyperlink to the document would constitute delivery, and fewer still felt that providing a link on a website would constitute delivery. This may represent their view of what would satisfy legal requirements rather than what ought to be sufficient. However, the SEC's electronic delivery policy clearly suggests that an email containing a link to a document would satisfy the delivery requirement, so long as the investor had consented to electronic delivery.

Investors surveyed for this report were highly skeptical of an approach based on access alone. Asked their preference among various electronic delivery methods, fewer than one in ten expressed a preference for receiving disclosures through notices on their broker's website. Half expressed a preference, if disclosures are delivered electronically, for receiving those disclosures in the form of a printable attachment to an email, while three in ten expressed a preference for receiving disclosures in the form of a hyperlink within the email. In other words, an overwhelming majority of investors wants even electronic disclosures to be delivered to them in some fashion.

Meanwhile, some firms are using electronic delivery to improve the likelihood that disclosures are actually read by investors. One firm with a heavily retail customer base has adopted the practice of monitoring whether those customers who have chosen electronic delivery are in fact accessing disclosures they receive electronically. When customers go too long without accessing the disclosure documents, the firm sends them a message which, if ignored, causes the customer to be defaulted back into paper delivery. Another firm described a system of A/B testing they use when emailing notices to customers. Testing two different versions of the email, the firm can determine almost immediately which is the more effective, i.e., which is most likely to be opened and read by recipients. They then switch to the more effective version. These efforts to increase the likelihood that disclosures will be read simply wouldn't be possible or practical in the context of paper disclosures.

Who Gets to Choose the Delivery Method?

In recent years, the debate appears to have shifted away from whether firms have an obligation to deliver disclosures to the question of who gets to choose the delivery mechanism.

Consumer advocates have traditionally argued for an “opt in” approach, requiring consumers to affirmatively choose to receive disclosures electronically. Some industry representatives and Internet disclosure advocates see this approach as impeding the transition to electronic delivery, as simple inertia keeps individuals who might be willing to receive disclosures electronically from making the switch. The issue is important, since research has shown that how we set the defaults – opt in versus opt out – has a dramatic effect on the choices investors will make. Indeed some behavioral science research suggests that defaults have a far stronger influence on the actual choices made than preferences. This suggests that an approach that aligns defaults with preferences will produce the optimal outcome. However, survey data on investor preference for paper versus electronic delivery offers no such clear signposts.

The significant percentage of investors who continue to prefer paper delivery suggests that investors may not yet be ready for electronic delivery to be the default option for investment disclosures. On the other hand, the discrepancy between those who indicated a preference for electronic delivery (44 to 48 percent) and those who actually report receiving at least some disclosures electronically (30 percent) suggests that the current opt-in approach is not producing results that align with investor preferences. Although investors generally expressed satisfaction with their disclosure delivery mechanism, respondents who said they receive some of their disclosures electronically were more likely to say they are “very satisfied” with their delivery method.

If it were possible to move away from the opt-in/opt-out paradigm and structure choices about delivery as a neutral choice, such an approach might produce decisions about delivery that more closely reflect actual customer preference. In the meantime, many firms are offering investors what one might characterize as the best of both worlds. At these firms, even those who prefer to receive disclosures in paper form have the option of accessing those same documents online, often through a special password-protected area of the website where their account information and relevant documents are maintained.

Is More Design Flexibility Needed?

Disclosure rules often dictate such details as what information must be provided the document’s cover, the order in which other items must be presented, and in some cases even the minimum type size for certain disclosures. A number of experts have suggested that investors will not receive the full benefits of Internet disclosure – such as greater use of layering of information or break-down of documents into multiple screens of information – until rules are revised to allow more flexibility in the design of disclosures to take advantage of the Internet’s capabilities. The review of company websites for this report provided ample support for this viewpoint. A striking contrast exists between the innovative design many companies employ in presenting supplemental information on their websites, such as investor education material, and the much more mundane presentation of mandatory disclosures.

The question is whether it is possible to achieve the benefits of design flexibility without losing the benefits of standardization. While some experts are optimistic, and believe exploring ways to provide that flexibility should be a priority, others suggested that the liability that attaches to mandatory disclosures, rather than inflexibility in the rules themselves, is the main factor inhibiting innovation. Meanwhile, some firms are already experimenting with ways to realize the design benefits of the electronic delivery within the existing disclosure framework for mandatory disclosure documents. One firm, for example, is exploring presenting portions of the online version of the mutual fund shareholder report in video format. Several firms let investors customize the presentation of their account documents on the password-protected area of their website. Among other things, they offer investors the option of having information consolidated across all their accounts or presented in ways that most prominently feature the information of greatest interest to that investor. However, even those who are doing most to explore the possibilities offered by electronic delivery seem to agree that to do more they would need more flexibility under the rules.

<u>Barriers to Effective Disclosure</u>

Disclosure is an essential investor protection tool, but there are limitations to what even the best designed disclosures can be expected to accomplish. The report discusses a number of barriers to effective disclosure:

- Investment decisions are complex, with virtually limitless options available and numerous, often technical factors to consider in order to identify the best option.

- Many investors lack the skills and expertise to make good investment decisions.

- Investors don't make good use of the information that is provided to them, often spending little time researching their investment decisions.

- Disclosures do not reflect investor preferences for disclosures that are brief, readable and delivered before they have to make an investment decision.

- Investors are often overwhelmed by the volume of information provided which may have the perverse effect of causing them to make less use of the information provided.

- Many investors don't want to make their own investment decisions, preferring to rely instead on recommendations from financial professionals.

- Investors struggle to understand and use information about conflicts of interest, which takes on added importance given their heavy reliance on professionals.

In our survey of financial professionals, we asked about their views on the effectiveness of disclosures generally and to what degree they felt that different factors constituted a barrier to effective disclosure. A majority of financial professionals (56 percent) agreed that mandatory disclosures are "generally effective tools for protecting retail clients." On the other hand, less than a fifth of financial professionals believe that retail clients make good use of the mandatory disclosures provided to them. Asked to rate how strongly they agree with a series of statements about possible barriers to effective disclosure, financial professionals surveyed were most likely to agree that "excessively technical or legalistic language," "difficulty in finding useful information in lengthy, printed materials," and "lack of interest in disclosure information among clients" undermined disclosure effectiveness. In addition, half of all financial professionals strongly agreed that clients prefer to rely on advice rather than research investments on their own.

How Internet Disclosure Can Help

Recent research suggests that even minor changes in presentation can influence investors' willingness to read disclosures, their understanding of the information presented, and the choices they make as a result. Given the significant impact that these design choices can have on disclosure effectiveness, it seems logical that, properly implemented, Internet disclosure could have similarly beneficial effects. We are not suggesting that Internet disclosure is a panacea capable of curing all the problems that undermine disclosure effectiveness, but the research for this report does suggest that there are ways in which Internet disclosure can help. While some may require policy changes, others can be achieved within the existing regulatory framework.

The report identifies the following as key areas where electronic delivery can help to improve investors' willingness to use and ability to comprehend the disclosures they receive.

- Investors consistently express a preference for receiving disclosures well in advance of any investment decision. Financial services firms have traditionally resisted such a requirement on the grounds that it would impose unacceptable delays. Internet disclosure offers a variety of easy and affordable means of delivering disclosures prior to any investment decision.

- Internet disclosure can help to reduce information overload through the layering and better design of disclosures. Layered disclosures allow for a less intimidating introduction of disclosure information and enable investors to choose the degree of detail they wish to explore. Housing disclosure documents on the Internet also opens up new possibilities in designing disclosure documents in ways that present information in more visually appealing and consumable screen-size chunks. Investors who can as a result approach disclosures a topic at a time may be less likely to feel overwhelmed and thus less likely to be turned off by disclosure documents.

- Internet disclosure can't make investment decisions less complex, nor can it eradicate financial illiteracy. But presenting disclosure documents on websites in combination with Internet-based tools and investor education materials could help to promote increased investor comprehension. At the very least, it could ensure that investors have ready access to the background information necessary to make a more informed choice. At the same time, Internet disclosure also could make it possible to provide certain types of disclosures, most notably cost disclosures, in ways that are more relevant to the investor. When a financial adviser recommends a dollar amount investment in a particular product to the investor, for example, or compares two or more investment options, it ought to be quite easy, using Internet-based tools, to provide the investor with dollar amount cost information.

While some investors are unlikely ever to make more than minimal use of disclosure materials, preferring to rely exclusively on a financial professional for advice, others could reap significant benefits. The easier the materials are to access, the more relevant their content, and the more appealing their design, the more likely it would seem to be that investors would make use of them.

Can the Internet Transform Disclosures for the Better?

I. Introduction

Since the 1990s, which saw both the advent of nearly instantaneous communication via email and the emergence of the worldwide web as the dominant repository of information, financial services firms and regulators have expressed a growing interest in expanding use of the Internet to provide disclosures to investors. For the firms, the Internet offers obvious advantages in the form of reduced costs to print and mail paper documents they are required to provide to investors. Investor advocates have been slower to embrace the idea of Internet disclosure, based primarily on a concern that many investors were not ready for the transition and that those who lack access or willingness to use the Internet should retain control over the choice of delivery mechanism. In recent years, however, advocates have increasingly come to recognize the potential benefits the Internet offers to improve both the timing and effectiveness of disclosures.

Today, the transition to a predominantly Internet-based disclosure system is well underway.[1] Virtually all securities firms maintain a presence on the web, and a majority of them use their websites and email to provide both government-mandated disclosures and additional information to investors. Some have begun to explore creative ways to use the functionality of the Internet to improve the effectiveness of their communications with investors. By the same token, nearly all investors today have access to the Internet over high-speed connections and are frequent Internet users. Many recognize at least some advantages to electronic delivery, and most express a willingness to use the Internet for at least some investment-related purposes. Not surprisingly, younger investors express the strongest interest in and acceptance of an Internet-based disclosure system. Yet mailing of paper documents remains the dominant delivery method for mandatory disclosures, and a significant number of investors continue to express a preference for paper delivery.

Although resistance persists and the timing is unpredictable, the ultimate evolution to a predominantly Internet-based disclosure system seems inevitable. The decisions that we make now, during this period of transition, could determine whether we capture the potential benefits of Internet disclosure and avoid the potential pitfalls. The purpose of this report is to begin to identify the most promising means of achieving that goal. The research began with a literature review analyzing the legal framework for electronic delivery of disclosures, the most significant barriers to effective disclosure, and whether and how the Internet can help to address those barriers. Two surveys, one of financial professionals and one of investors, helped to clarify where we are in the transition from paper to Internet-based disclosure and the attitudes that are likely to determine that transition.[2] Reviews of a sampling of industry websites and interviews with experts from the consumer community, academia, and industry have helped to round out

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[1] See Appendix B for a more detailed discussion of the current status of the transition from a paper-based to electronic disclosure system.

[2] The findings of those two surveys are presented in a final report, "Internet Disclosure Research Report from the Industry and Retail Surveys," prepared for the FINRA Investor Education Foundation and Consumer Federation of America by Applied Research & Consulting LLC, June 12, 2013. (Hereinafter ARC Survey Report)

our view of how the landscape of Internet disclosure is changing, what are best practices in use of the Internet for communicating with investors, and what additional changes could help to realize the full potential benefits of this disclosure method.

Synthesizing the results of that research, this report will address:

- the potential benefits and pitfalls of Internet disclosure;
- the pre-conditions necessary for effective Internet disclosure, including issues related to access, notice and delivery;
- the most significant barriers to effective disclosure, regardless of delivery method, and
- how Internet disclosure may be able to help reduce those barriers.

Throughout, the report includes information from our surveys of financial professionals and investors as well as real world examples of industry practices that are relevant to the issues being discussed.

II. The Potential Benefits and Pitfalls of Internet Disclosure

This research is informed by a belief that, properly implemented, Internet disclosure[3] has the potential to significantly improve the quality of disclosure to investors. Among these is the potential to disseminate information more quickly and cost-effectively, as the SEC noted when it first issued its guidelines for electronic delivery in 1995, and "the promise of electronic distribution of information in enhancing investors' ability to access, research, and analyze information."[4] As the Internet has evolved, the concept of how it can be used to disseminate information has evolved with it. In the process, our views of its potential benefits have also expanded.

Potential Benefits of Internet Disclosure

The following are among the key benefits that its enthusiasts ascribe to the electronic delivery of disclosures:[5]

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[3] Throughout this report, we use the terms Internet disclosure and electronic delivery interchangeably to refer to a variety of Internet-based delivery mechanisms, including delivery through email containing attachments or hyperlinks, for example, as well as documents available through links on either publicly accessible or password-protected areas of company websites.

[4] Use of Electronic Media for Delivery Purposes, Rel. Nos. 33-7233, 34-36345, and IC-21399 (Oct. 6, 1995).

[5] This list is based in part on interviews with disclosure experts and industry members as well as previous research. The issue was discussed extensively, for example, in both: Swire, Peter P. and Ahmad, Kenesa, *Delivering ERISA Disclosure for Defined Contribution Plans: Why the Time Has Come to Prefer Electronic Delivery*, June 2011; and Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors*, study by the SEC staff as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (August 2012).

- Internet disclosure allows for timelier disclosures, speedier distribution to investors, and easier and faster updates to content of disclosure documents, all at a significant cost savings to financial firms.

- The Internet is ideally designed to deliver layered disclosure that enables investors to choose the level of detail they want to receive and provides for a simpler, more easily understood "first layer" of disclosure.

- The Internet allows for innovation in the design of disclosures, to include video content, for example, and interactive graphics, making disclosures more appealing and accessible for investors.

- Well-designed digital documents are easier for investors to search for the information that is most relevant and useful to them.

- Online disclosures can be accessed from anywhere and at any time using the device of the investor's choosing (e.g., desktop, laptop, tablet or phone).

- Internet disclosure allows for easier archiving of information, with the financial firm's website providing the organizing framework.

- Disclosures can be packaged with tools, such as calculators, other educational resources, and supporting content such as FAQs, glossaries, and help sections designed to improve investor understanding of the disclosures and their significance.

- Internet disclosure offers environmental benefits from the reduced demand for paper to produce documents, many of which will end up in the trash.

- Electronic delivery allows for quicker notification of non-delivery, through email bounce-backs, and easier testing for investor access.

- When disclosures are provided in search-friendly formats (e.g., XBRL), independent third parties can more easily analyze and package that information in ways that are useful to investors.[6]

[6] For example, when the SEC adopted its final rule requiring public companies to file financial statements using XBRL (*Interactive Data to Improve Financial Reporting*, File No. S7-11-08, January 30, 2009, available here: http://www.sec.gov/rules/final/2009/33-9002.pdf), it stated: "We are adopting rules requiring companies to provide financial statement information in a form that is intended to improve its usefulness to investors. In this format, financial statement information could be downloaded directly into spreadsheets, analyzed in a variety of ways using commercial off-the-shelf software, and used within investment models in other software formats." This same or similar technology can be used for text documents as well as financial data.

Potential Pitfalls of Internet Disclosure

In short, the potential benefits of Internet disclosure are considerable. But even its strongest advocates acknowledge that there are also potential pitfalls to Internet disclosure that must be taken into account in developing policies and practices in this area. Setting aside for the moment issues of access and choice, which the report discusses below, the biggest concerns traditionally raised with regard to Internet disclosure have involved the privacy and data security risks. With hackers periodically making headlines taking down corporate and government websites, people are understandably concerned about the safety of their accounts and the security of their sensitive financial data. Internet disclosure advocates typically respond to these concerns with two points: 1) with the exception of account statements, much of what we refer to when we discuss mandatory disclosure does not involve sensitive personal financial data and thus does not require a high degree of security; and 2) companies have developed sophisticated authentication practices designed to protect financial account privacy and security.[7]

On the other hand, the authentication procedures themselves can also be seen as a factor that may inhibit investors' willingness to use the Internet for this purpose. If the first thing that happens when people attempt to access their account online is that they are asked a lot of authentication questions to which they may or may not know the answers, some are likely to become suspicious or quit in frustration. Moreover, many Internet users fail to follow commonly recommended security practices, such as using different login names and passwords for different accounts and using difficult to decode passwords. Instead, they choose the convenience of an easily remembered username and password and use them over and over again for all their accounts, thus undermining their own information security.

Other potential pitfalls include the following:

- Internet users have become accustomed to rapidly scrolling through long legal contracts, describing terms and conditions of use for example, and clicking the "I agree" button at the bottom. If mandatory disclosure documents look like the typical paper legal document, they may get the same cursory review.

- One of the primary methods used to deliver disclosures electronically is through hyperlinks in email messages. But investors who have been taught to be leery of clicking on links in emails, because of concerns about "phishing" or malware, may be reluctant to accept this delivery method.[8]

- Email may be easier to ignore or lose track of than paper mail. In addition, emails can get caught in spam filters if investors don't take appropriate steps to ensure delivery.

[7] See, for example, Swire and Ahmad, *Delivering ERISA Disclosure*.

[8] Phishing is the term used for a form of fraud in which crooks, pretending to be from well-known companies, organizations, or government agencies, contact individuals and trick them into revealing their Social Security numbers, financial account information, passwords, or other personal information. Malware, short for malicious software, is a general term for software that is used to disrupt computer operation, gather sensitive information, or gain access to private computer systems.

- Disclosures may get lost, inadvertently or intentionally, on websites that serve a variety of competing functions.

- Even as we are becoming more accustomed to computer-based disclosures, increasing numbers of individuals now access the Internet primarily through a smart phone, raising a whole new set of issues with regard to security and readability.

Survey Findings[9]: Our surveys of investors and financial professionals both included a number of questions designed to elicit their views of the benefits and risks of Internet versus paper disclosure. On the investor survey, for example, respondents were asked to rate, on a scale of 1 to 10, how strongly they agreed with a series of statements about the potential benefits of both paper and Internet disclosure.

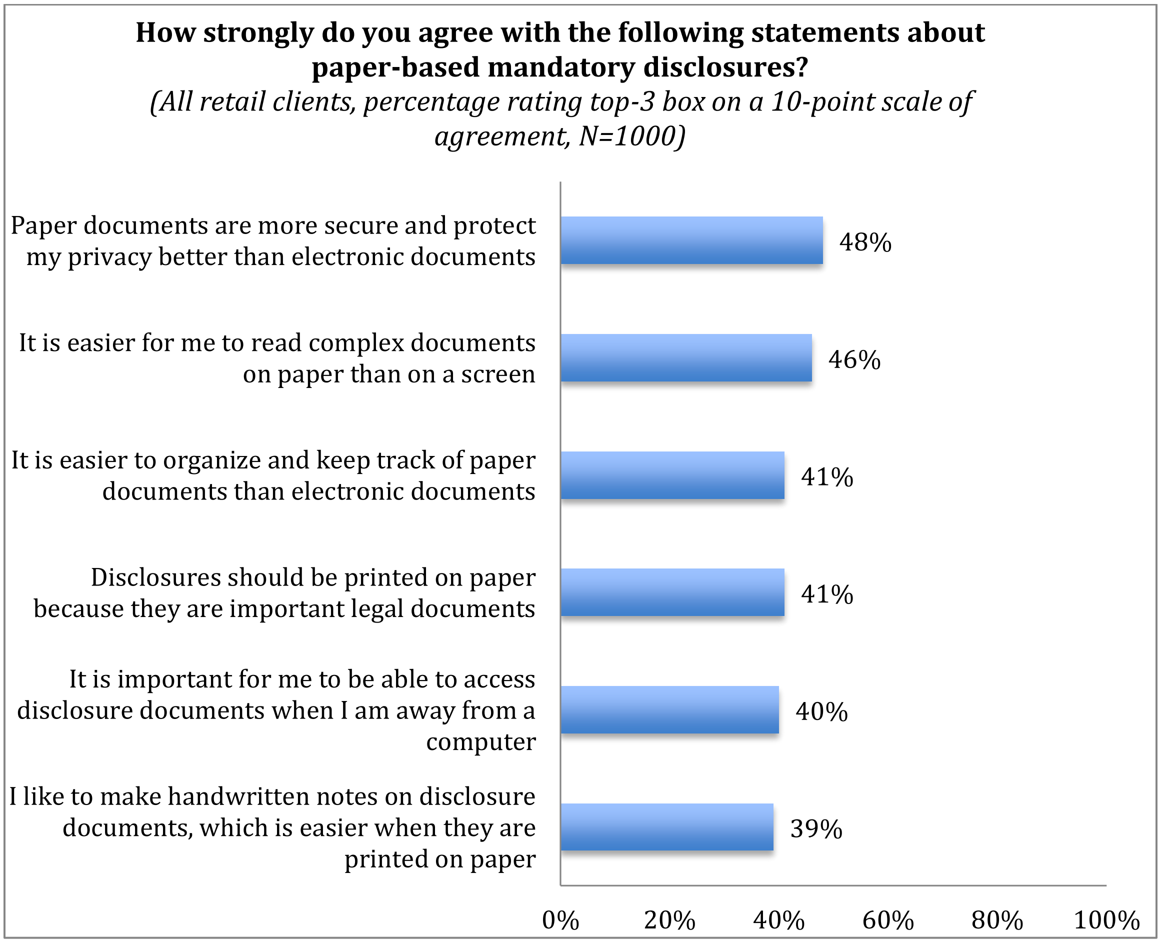
None of statements regarding the benefits of paper disclosure elicited strong agreement[10] from a majority of survey respondents, though a significant minority expressed strong agreement with each statement.[11] They were most likely to agree that paper documents are more secure and protect their privacy better, with 48 percent expressing strong agreement with this statement. Nearly half (46 percent) also expressed strong agreement that they find it easier to read complex documents on paper than on a screen. For each of the other four statements tested, roughly four in ten expressed strong agreement: that it is easier to organize and keep track of paper documents than electronic documents (41 percent); that disclosures should be printed on paper because they are important legal documents (41 percent); that it is important for them to be able to access disclosure documents when they are away from a computer (40 percent); and that they like to make handwritten notes on disclosure documents, which is easier when they are printed on paper (39 percent).

[9] Throughout the report, sections on "Survey Findings" discuss the findings of the ARC Survey Report.

[10] Throughout this discussion, those who rated their agreement with a statement as an 8, 9 or 10 on a 10-point scale are deemed to have expressed strong agreement.

[11] See ARC Survey Report, page 40-41.

Figure 1: Investor Views of the Benefits of Paper Disclosures



Source: ARC Survey Report (page 41).

Overall, investors expressed stronger agreement with statements regarding the benefits of Internet disclosure.[12] For example, 60 percent strongly agreed that replacing paper-based disclosures with electronic disclosures would be better for the environment. On the other hand, many investors appear to be either unconvinced by or unaware of some of the strongest selling points for an Internet-based system of disclosure. Notably, just under half of survey respondents strongly agreed that:

- Internet disclosure makes it easier to access information prior to meeting with their broker or adviser (49 percent).

- Using the Internet for mandatory disclosure could significantly reduce the cost of disclosure and therefore reduce their fees (48 percent).

[12] See ARC Survey Report, page 36-38.

- The interactive nature of the Internet can make it easier to find the disclosure information that is most relevant to them (47 percent).

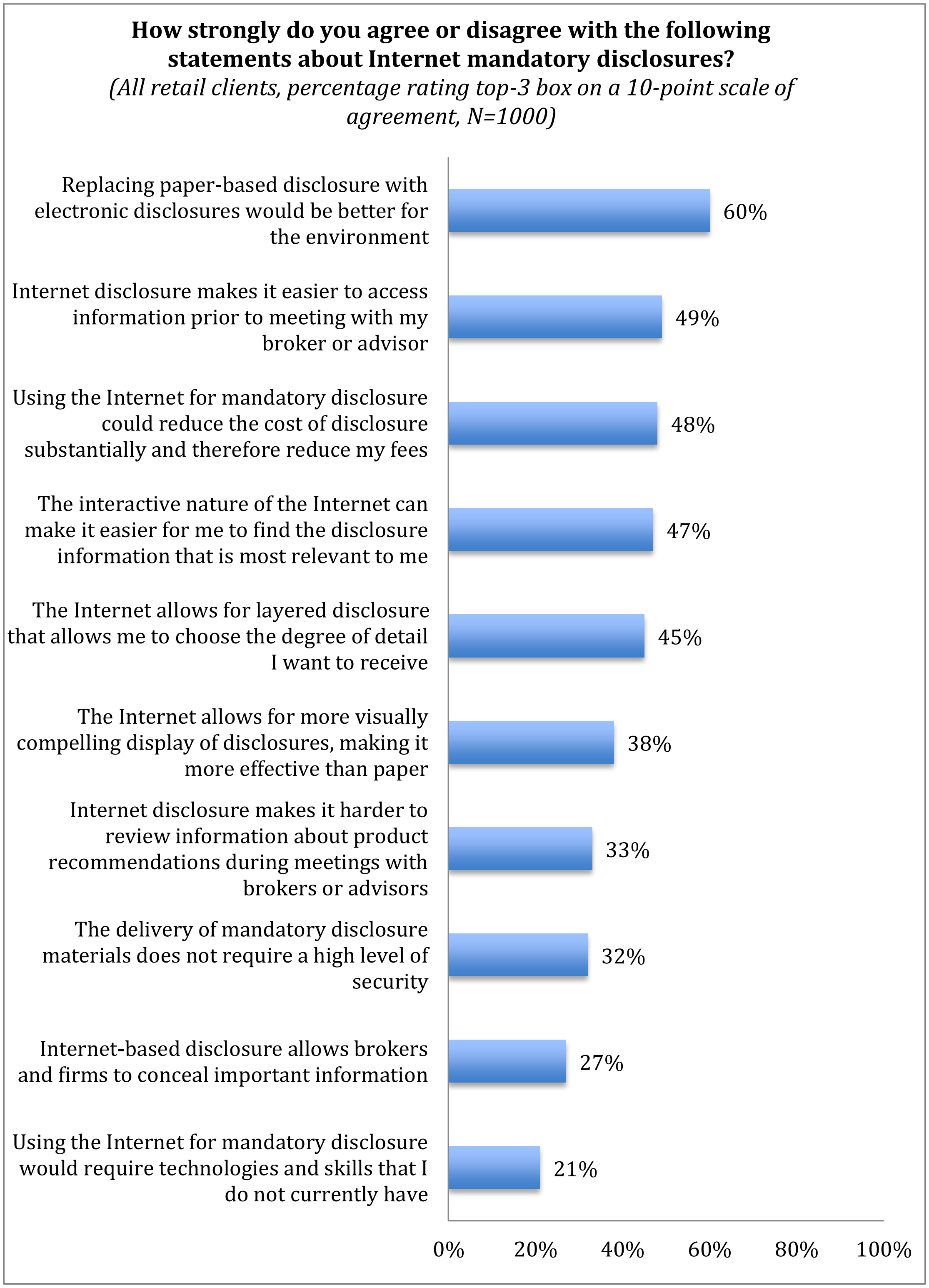
- The Internet allows for layered disclosure that enables investors to choose the degree of detail they want to receive (45 percent).

Investors were more skeptical that Internet disclosure allows for more visually compelling display of disclosures, making it more effective than paper. Only 38 percent of survey respondents strongly agreed with this statement.

Moreover, security clearly remains a concern for many investors. Only about a third (32 percent) strongly agreed that the delivery of mandatory disclosure materials does not require a high level of security. (On a separate survey question, 32 percent expressed strong agreement with the statement that they are reluctant to permit Internet disclosure because of concerns about security and/or privacy.[13]) On the other hand, investors surveyed expressed significantly less agreement with several negative statements about Internet disclosure. Only two in ten (21 percent) strongly agreed that it would require technologies and skills that they do not currently have.[14] Just 27 percent expressed strong concern that Internet-based disclosure allows brokers and firms to conceal important information. And only a third (33 percent) expressed strong agreement that Internet disclosures make it harder to review information about product recommendations during meetings with brokers or advisers. On a separate question, just over a third of investors (37 percent) strongly agreed that, for the foreseeable future, they prefer to receive all disclosures as paper documents.[15]

[13] See ARC Survey Report, page 45.
[14] This survey was conducted online, suggesting that results may under-represent the views of those who do not use or only rarely use the Internet.
[15] See ARC Survey Report, page 45.

Figure 2: Investor Views of the Benefits of Internet-based Disclosures



Source: ARC Survey Report, page 38.

Financial professionals were asked a similar set of questions about the benefits of Internet disclosure, offering an interesting contrast in viewpoints.[16] Financial professionals were far more positive about the benefits of Internet disclosure in several areas, including areas where investors expressed relatively strong agreement:

- 78 percent of financial professionals strongly agreed that replacing paper-based disclosure with electronic disclosure would be better for the environment, compared with 60 percent of investors.

- 69 percent strongly agreed that the Internet allows for layered disclosure that empowers customers to choose the degree of detail they want to receive, compared with 45 percent of investors;

- 65 percent strongly agreed that using the Internet for mandatory disclosures would reduce the cost of disclosure substantially, compared with 48 percent of investors;[17]

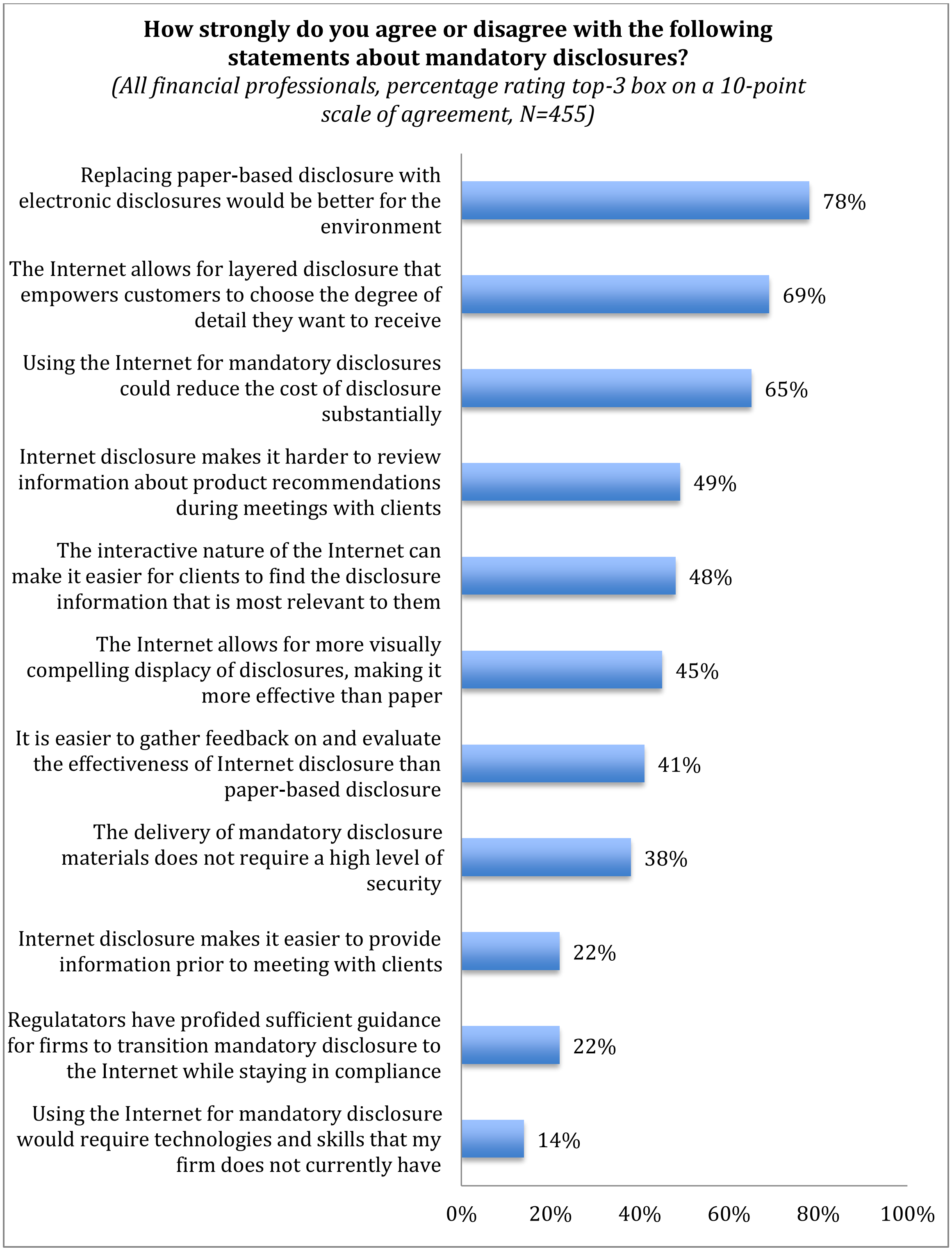
- 45 percent strongly agreed that the Internet allows for more visually compelling display of disclosures, making it more effective than paper, compared with just 38 percent of investors.

On the other hand, financial professionals were also significantly more likely than investors to strongly agree that Internet disclosure makes it harder to review information about product recommendations during meetings with clients. Roughly half of all financial professionals surveyed (49 percent) strongly agreed with this statement, compared with just 33 percent of investors. Financial professionals were also significantly less likely than investors to strongly agree that Internet disclosure makes it easier to provide information prior to meeting with clients. Only 22 percent of financial professionals strongly agreed with this statement, compared with 49 percent of investors.

[16] See ARC Survey Report, page 19-21.

[17] The question to investors included a secondary aspect – that the reduced costs would flow through to investors in the form of reduced fees – which was not included in the question to financial professionals.

Figure 3: Financial Professionals' Views of the Benefits of Internet-based Disclosures



Source: ARC Survey Report, page 21.

Best Practices: While many investors remain to be fully convinced of the potential of the Internet to improve the quality of disclosure, the review of financial services websites and interviews with experts conducted for this report offer numerous real-world examples of these potential benefits. Indeed, this project had its origins in a previous project on investors' mutual fund purchase practices. In conducting research for that mutual fund project, we were struck by how innovative many fund companies were in using their websites to present information effectively and how far the typical mandatory disclosure document falls short of this ideal. The review of financial firm websites for this project[18] confirmed our previous impression that there is unrealized potential to improve the effectiveness of disclosures by taking advantage of the flexibility and functionality that the Internet offers. In keeping with that finding, many of the following examples of good practices are based on how firms present supplemental information as opposed to mandatory disclosures, where they may not have the same degree of flexibility.

- Visual Appeal

In contrast to many mandatory disclosure documents, which include large amounts of complex information in dense paragraphs of type, many firms provide supplemental material and investor education material on their websites in much more visually appealing ways. In keeping with the recommendations of digital design experts, they make good use of white space, break information up into smaller chunks viewable on a single screen, use eye-catching graphics to illustrate the material, and present information in question and answer format with headers that make it easy for the user to find the information they are seeking. This can be an important technique to prevent the "scroll down" problem identified by several experts as a potential pitfall of Internet disclosure.

Some of these design techniques that are prevalent on firm websites would certainly be applicable to paper disclosures. However, the costs associated with printing and mailing these documents may discourage design practices, such as liberal use of white space, graphics and color that could drive up the page-count and overall cost. In other cases, prescriptive rules regarding how disclosures must be presented may inhibit the ability of firms to take advantage of these techniques in mandatory disclosure documents. As we move to a more Internet-based system of disclosure, it should be possible to incorporate these design changes into mandatory disclosure documents. One expert warns, however, that if website disclosures are presented in more easily consumed screen-sized chunks, it will be important that investors retain the ability to easily view or print the document as a whole so that investors who place a value on maintaining paper copies of important documents will retain that ability.

- Layering of Disclosures

The Internet is ideally designed, in a way that paper disclosure documents are not, to allow for "layering" of disclosures. The SEC has begun to experiment with this concept with its mutual fund summary prospectus rule, which allows delivery of a summary prospectus to

[18] A total of 14 websites, selected to represent a variety of business models, were reviewed for this project. They included several large full-service brokers, several independent brokers, several brokers with a significant on-line discount brokerage business, small advisory firms, firms specifically oriented toward smaller retail accounts, and a mutual fund company.

substitute for delivery of the full prospectus so long as the full prospectus is available on the Internet and can be requested by the investor. The summary prospectus is designed to provide a brief introduction to key topics that are dealt with in detail in the prospectus. But it still largely resembles a paper document and makes only limited use of layering's potential.

A number of firms have made much fuller use of layering in their presentation of supplemental information and investor education materials on their websites. The following is an example from one website we reviewed that makes particularly good use of layering. The website home page includes a "Your Needs" tab at the top of the page that lists a number of topics (e.g., saving for retirement, living in retirement, paying for education, etc.). Clicking on the paying for education link takes you to a page with a brief, high level introduction of the topic and links to several subtopics (e.g., common questions, tools and resources, investments and services). The common questions link again includes a brief text and links to three basic questions: 1) How can I prepare for my child's education expenses? 2) How could saving for financial education affect financial aid? 3) How do I balance saving for education with saving for retirement? Clicking on one of those links takes the user to a more detailed discussion of that particular topic, but still presented in a visually appealing way, with good use of white space and subheads. Similarly, clicking on the Investments & Services link takes the user to a page providing a menu of various investments and services for education funding, including brief descriptions of each. Click on a particular option, e.g., 529 plans, and you get a more detailed discussion of that particular type of account.

All this clicking through to different pages may sound laborious when described in this way, but in practice it is quite easy to navigate. And the benefits are significant. Instead of being overwhelmed by receiving all the information on the topic in one intimidating mass, the investor is able to go through it a step at a time, focusing on the information they want and receiving it in more consumable bites. If this concept were more fully and effectively integrated into the mandatory disclosures that are provided to retail investors, it could have the potential to increase investors' willingness to read these documents and improve their understanding of the disclosures.[19] As noted above, however, it would be important for investors to retain the ability to easily view or print the document as a whole, if that is their preference.

- Navigation

Most of the websites we reviewed offered extremely easy navigation around the website, with tabs across the top of the page, drop-down menus listing topics addressed under each tab, additional menus down the side of the page, and prominent account log-in buttons. On the other hand, these website reviews did also turn up examples of how information can be lost or buried on busy websites. For example, several sites we reviewed offered good, well-organized disclosure pages, but accessible through a tiny hyperlink buried amid boilerplate disclosures at the bottom on the page. (Because we did not have access to the customers' password protected portion of the site, we could not determine whether a more prominent link was provided on that area of the website.) In contrast, one firm we interviewed and whose website we reviewed described how, in a recent redesign of their website, they had incorporated elements intended to

[19] Testing of disclosures for effectiveness would help to determine whether this assumption is correct and how best to design a layered approach to achieve the desired outcome.

drive more users to the disclosures housed on the site. A couple of websites we reviewed included a prominent disclosure link and/or a prominent pricing link in a tab at the top of the page instead of burying it at the bottom of the webpage. In one case in particular, the pricing link takes the user to a very well-designed section of the website with clear, easy to read information on account fees and charges for various types of investments.

- Use of Video

Several firms made particularly good use of video on their websites to supplement written materials. Examples included tutorials on how to make use of the various website features as well as videos on particular investor education topics. One of the firms interviewed for this report is even exploring using video for portions of the online versions of certain of its mandatory disclosure documents. They view this as a way to make the disclosures more dynamic and appealing to investors.

- Putting Disclosures in Context

Internet-based disclosure offers a unique opportunity to combine required disclosures with supplemental materials to improve investor understanding of the disclosures and their significance. A number of the websites reviewed for this study made excellent use of this feature. Although the websites varied greatly based in part on the business model of the firm, most websites reviewed included a wealth of investor education materials. These included background material to help investors determine which type of account would be best for them, material describing the important features of various types of investment products they might consider purchasing, articles on particular investment topics (e.g., retirement planning), and information on basic investment concepts (e.g., the power of compounding, the importance of diversification). Tools include calculators of various types, asset allocation tools, fund finders (identifying mutual funds that meet certain criteria defined by the investor), and tools for finding a financial adviser. Glossaries to help investors understand technical terms are commonplace, as are FAQs and help sections.

Several of the sites reviewed were particularly noteworthy for the degree of investor education and support they offered on their websites. Several offered extensive investor education material or links to material from outside providers (e.g., FINRA, SEC, and Morningstar). One firm did a particularly good job of presenting basic topics in plain English. Another did a particularly good job of including investor education materials for each type of investment provided through the firm, directly accessible from the investment products page on the site. Another firm offered a particularly extensive array of calculators and other tools for the more self-directed investor. On a couple of sites, a pop-up window opens offering the opportunity for a live chat with a licensed representative for investors who may be struggling to understand the website materials.

As a result of all these practices, the investor who accesses disclosure documents on a well-designed website has tremendous resources available to help him or her better understand the information being disclosed.

➢ Password Protected

Nearly all of the websites reviewed for this study included a password-protected portion of the website where customers are able to access their accounts. Based on the non-representative sample of websites reviewed, investment advisers serving retail customers appeared to be somewhat less likely than brokers to offer this option.[20] While it was not possible for this study to access this area of the websites (except for those firms where we have accounts), several of the firms offered video tutorials and written materials describing the features available in this area of the website. According to these tutorials, customers are typically able to check account balances, make transfers, get tax forms, and otherwise manage the accounts on this portion of the website. Other features include To Do reminders, which allow the investor to track progress on account activities, and message centers that allow secure communications with their adviser online. Several sites offer customers the ability to get information consolidated across all their accounts, and some appear to offer customers significant ability to customize how they receive and view that information.

In addition, many sites appear to offer customers access to all the relevant disclosure documents for their accounts in this password-protected portion of the site. The documents specific to their account are housed here; the customer does not have to seek them out. Several sites offer customers the ability to save and organize these documents by folders on the website. One site reviewed includes, with every disclosure document posted to the account, the option to click a button and view it, save it as a PDF to the customer's computer, or print it – helping to ensure that documents the customer wishes to retain will remain available on the website or in paper form for as long as the customer wishes.

Access to this password-protected portion of the website is typically prominently featured on the home page and accessible through other back pages of the website as well. Login appears to generally be through the standard username and password method. However, at least one site requires the customer, after correctly entering his or her username and password, to also enter a PIN – offering an additional layer of security. Another firm requires users to periodically change their password, presumably for the same security purpose.

➢ Alternative Access

Several of the websites reviewed promote the availability of apps for use on smart phones. While this report does not attempt to analyze these apps, and some may question the wisdom of accessing sensitive financial data through this method, their availability does support those who note the high degree of access (anytime, anywhere) that Internet disclosure can provide. In addition, one firm interviewed for this study noted that its financial advisers all now carry iPads, which allow them to use Internet-based materials in their face-to-face meetings with customers.

<u>Room for Improvement</u>: While the website reviews for this study provided ample evidence of the potential benefits of Internet disclosure, these reviews also turned up examples of potential pitfalls and one missed opportunity. For example, on a number of the websites, the use

[20] This was born out by our survey of financial professionals. For further discussion of this topic, see Appendix B.

of appealing design elements and clear navigational guides seemed to be selectively applied. A prime example was the disclosure of revenue sharing payments. On several sites that otherwise featured very appealing design elements, these disclosures were presented as an unrelieved block of grey type, accessed through a less than prominent link. On one site, useful information on the distinction between brokers and advisers was provided, but only if the investor happened upon it in the advisory section of the website. Comparable information was not provided in the brokerage section. While some sites provided clear, plain English information on various fees and other charges, others provided this information, if at all, in a dense mass of complex, difficult-to-digest text.

Many of the websites reviewed included tools for finding a financial adviser. By entering a zip code, the user can get a listing of the firm's representatives operating in that area. Information provided generally includes name, address, phone number, and often a brief bio. What was missing from all the websites reviewed was any link to the broker or adviser's BrokerCheck or IAPD disclosures. Some firms provided links to the FINRA website somewhere on the firm's website, and at least one mentioned the availability of BrokerCheck, but none provided a prominent link to the disclosures on the portion of the website where they would be most relevant to an investor searching for a financial professional. This failure to provide a direct link seems to be a real missed opportunity, where firms could easily provide access to information that is intended to assist investors in making a more informed choice among financial advisers. In addition, while a number of firms included a link to the firm's ADV Form on the website, it was not typically prominently displayed.

III. The Pre-conditions for Effective Internet Disclosure

For Internet disclosure to function, investors must have ready access to the Internet, and the legal framework for disclosure must permit electronic delivery. For all intents and purposes, these basic requirements have been met. For Internet disclosure to reach its full potential, however, more is needed. Investors must fully embrace this disclosure mechanism. And the legal framework for disclosure must be flexible enough to allow for innovations that take full advantage of the Internet's capabilities. The following section of the report discusses the current state of affairs in these three areas: investor access to the Internet, investor willingness to use the Internet for investment-related purposes, and the legal framework for Internet disclosure. It then discusses whether it is necessary to update the legal framework for Internet disclosure in order to reap the potential benefits of Internet delivery of mandatory disclosures.

Investor Access to the Internet

Today, according to research released last year by the Pew Internet and American Life Project, roughly four out of five American adults use the Internet.[21] After a rapid rise in Internet use in the 1990s and early 2000s, overall Internet adoption rates have leveled off. Among

[21] Unless otherwise noted, the following discussion is based on information found in *Digital Differences*, by Kathryn Zickuhr and Aaron Smith of the Pew Internet and American Life Project (April 13, 2012) or a subsequent survey conducted by Pew in November and December of 2012. Data from the latter survey is available here: http://pewinternet.org/Static-Pages/Trend-Data-(Adults)/Whos-Online.aspx.

Internet users, however, Internet use has grown. On the other hand, today's adult non-users show little interest in changing their status; only one in ten non-users told Pew researchers that they were interested in using the Internet or email in the future. Age, education, income and race/ethnicity remain significant factors affecting Internet use, according to the Pew research.

> *Age:* While fully 94 percent of adults between the ages of 18 and 29 are Internet users, only 54 percent of those 65 and over are.[22] Interestingly, the drop-off above age 65 is quite dramatic. In the 50 to 64 age group, 77 percent identify themselves as Internet users.
>
> *Education:* Level of education shows a similarly strong correlation. While 95 percent of those with at least a college degree are Internet users, just 51 percent of those without a high school education are.[23]
>
> *Income:* The effect of income is less dramatic, but still significant. Nearly all of those making more than $75,000 a year are Internet users (98 percent), but a fairly robust 67 percent of those making less than $30,000 are as well.[24] This contrasts sharply with the mere 28 percent of under $30,000 earners who were Internet users when Pew began studying the issue in 2000.
>
> *Race and Ethnicity:* Gaps in Internet use based on race and ethnicity remain a factor, though use among minorities has grown. By late 2012, 84 percent of non-Hispanic whites were Internet users, compared with 73 percent of Blacks and 74 percent of Hispanics.

The way we access the Internet has also changed dramatically in recent years. As recently as 2001, at a time when roughly half of all adults were online, only 4 percent of American households had broadband access. As of December 2012, nearly two-thirds of Americans (65 percent) have broadband access in their homes. Home broadband access is significantly lower among Hispanics and African Americans.[25] One factor helping to reverse that digital divide is the growing popularity of smartphones and other devices that provide wireless access to the Internet. As the Pew Internet and American Life Project noted in its report, *Digital Differences*, "Groups that have traditionally been on the other side of the digital

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[22] The earlier Pew Research report found Internet usage among those 65 and older of just 41 percent and 74 percent among those in the 50-65 age group. This would suggest that Internet usage among older Americans continues to grow dramatically.

[23] Again, the November-December 2012 survey shows a significant increase in Internet usage among non-high school graduates over the earlier Pew Research, which found that just 43 percent of those without a high school diploma report using the Internet.

[24] The earlier Pew Research, *Digital Differences*, reported Internet usage among those earning less than $30,000 at 62 percent.

[25] The December 2012 data on broadband access is available here: http://pewinternet.org/Trend-Data-(Adults)/Home-Broadband-Adoption.aspx. This data does not break out broadband numbers by race. *Digital Differences* reported overall broadband access at 62 percent in 2011, including two-thirds of whites (66 percent), but only about half of Hispanics (51 percent) and African Americans (49 percent).

divide in basic internet access are using wireless connections to go online. Among smartphone owners, young adults, minorities, those with no college experience, and those with lower household income levels are more likely than other groups to say that their phone is their main source of internet access."

The Investment Company Institute has also examined changes in Internet use among mutual fund investors over the years, research that generally shows higher levels of Internet access in the investing population than in the population at large. According to research conducted by ICI in 2008, for example, fully 95 percent of mutual fund investors reported having access to the Internet, and three-fourths reported going online at least once a day.[26] While the ICI initially found that Internet access was greatest among young, highly educated, and higher-income mutual fund investors, their research has shown the gap to be narrowing.[27] For example, the proportion of mutual fund investors 65 or older with Internet access grew from 30 percent in 2000 to 70 percent in 2010, according to their recent research.[28]

Survey Results: Since our investor survey was conducted online, all respondents were by definition Internet users. Three-quarters of the survey sample (75 percent) reported using the Internet "very frequently," and another 21 percent reported using the Internet "frequently." [29] While the percent who describe themselves as very frequent users declines with age, even in the over-60 age group 67 percent of survey respondents described themselves as very frequent users, compared with 81 percent of 21-to-39-year-olds. Most reported having some sort of high-speed Internet connection at home – either a cable modem (45 percent), a DSL-enabled phone line (30 percent), or fiber optic connection (13 percent).[30] In addition, half of survey respondents reported accessing the Internet on a mobile device. Younger investors are far more likely to have mobile access to the Internet than older investors. Among those in the 21-to-39 age group, 84 percent of respondents reported having mobile Internet access, compared with just 28 percent of those 60 and older and 47 percent of those aged 40 to 59.[31]

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[26] Investment Company Institute, *Investor Views on U.S. Securities and Exchange Commission's Proposed Summary Prospectus* (March 14, 2008), available here.

[27] Ibid.

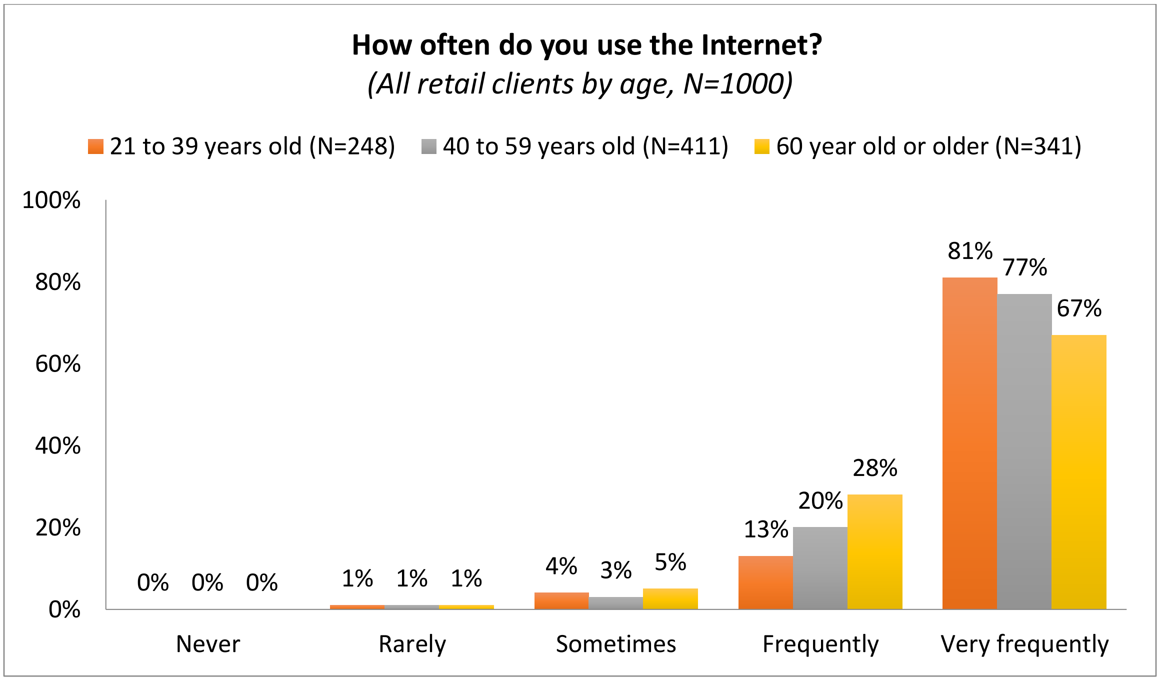
[28] Ibid.

[29] See ARC Survey Report, page 47-48.

[30] Ibid., page 49.

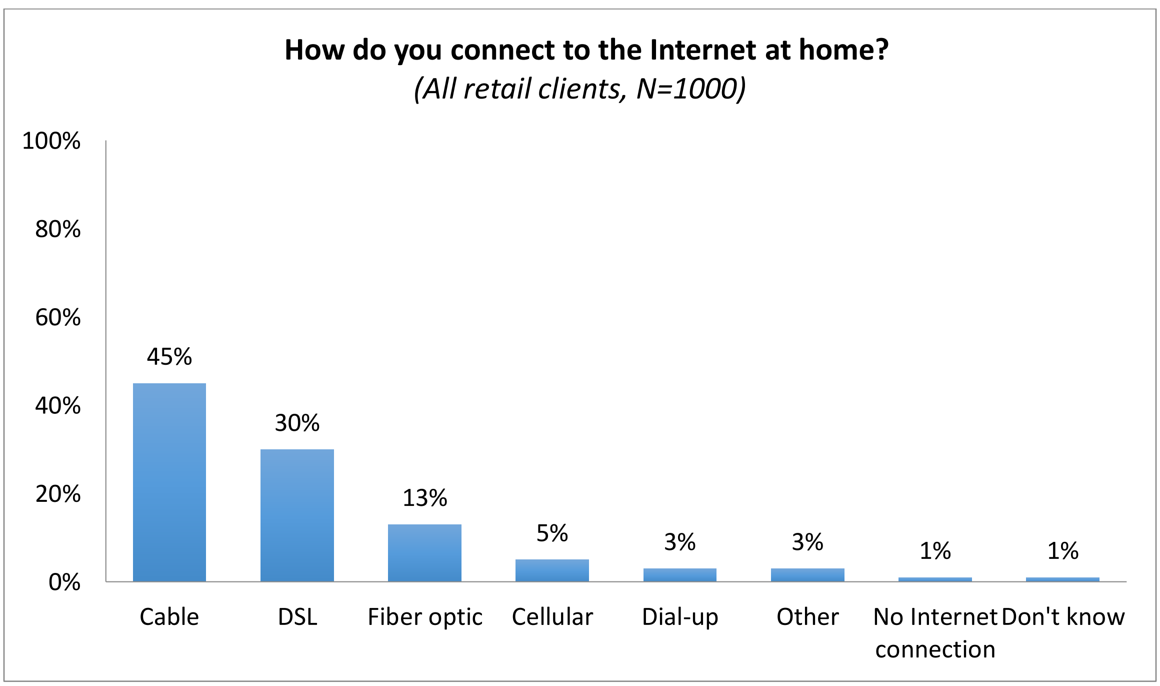
[31] Ibid., page 51.

Figure 4: Frequency of Internet Use among Investors



Source: ARC Survey Report, page 48.

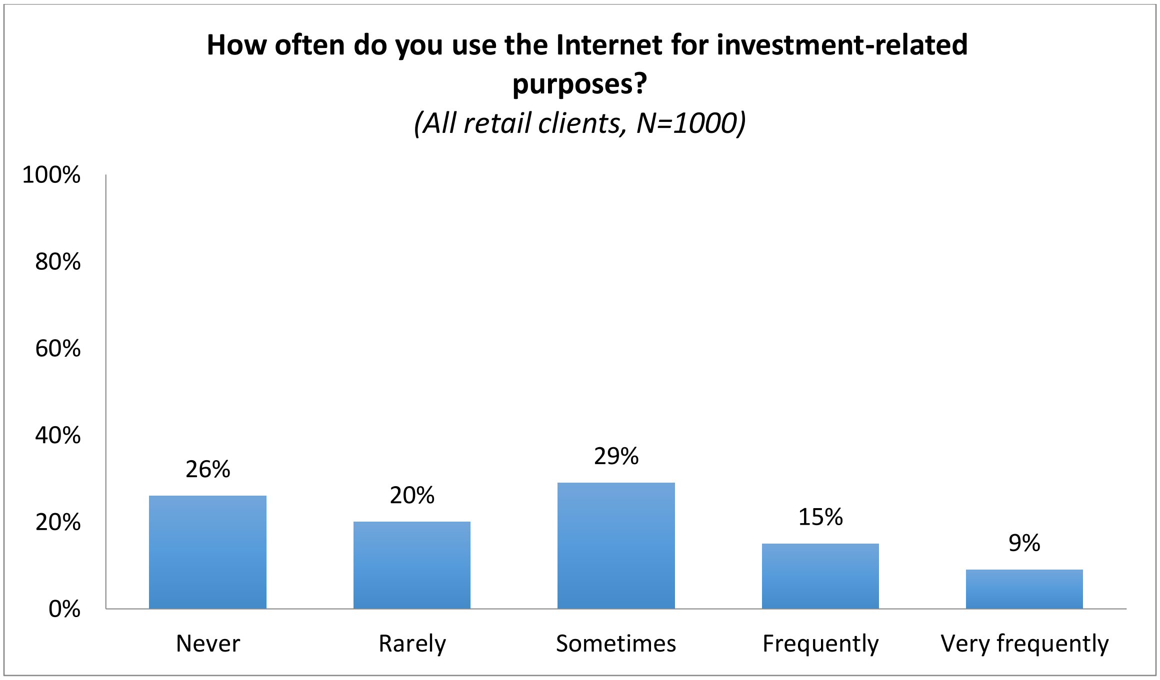
Figure 5: Method of Internet Access among Investors



Source: ARC Survey Report, page 49.

Over half of our survey respondents (53 percent) reported using the Internet for investment-related purposes at least "sometimes," but nearly as many reported using it for this purpose either rarely (20 percent) or never (26 percent).[32] Even among our sample of relatively frequent Internet users, fewer than one in ten (9 percent) reported using the Internet for investment-related purposes "very frequently," while another 15 percent reported doing so "frequently." Just under three in ten (29 percent) said they "sometimes" use the Internet for investment-related purposes.

Figure 6: Frequency of Investors' Use of the Internet for Investment-Related Purposes



Source: ARC Survey Report, page 52.

Willingness to Use the Internet to Receive Financial Disclosures

As access to and use of the Internet has grown, the suspicion with which many Americans viewed the Internet in its early days seems largely to have abated.[33] As a result, willingness to use the Internet for financial activities has grown.

- In its research on how Americans use the Internet, for example, Pew found a growing willingness to use the Internet for online banking, a use closely related to investing. According to their research, 61 percent of American adults today use the Internet for

[32] Ibid., page 52.

[33] *Digital Differences*, in 2000 a majority of non-users (54 percent) felt that the Internet was "a dangerous thing" while 36 percent said it was "confusing and hard to use." Today, non-users are most likely to say they just aren't interested (31 percent).

online banking and 66 percent use it to purchase products. However, those over the age of 65 are significantly less likely either to bank or to purchase products online.[34]

- Like Pew, ICI also has documented a growing interest in using the Internet for financial purposes. According to its research, by 2010 82 percent of all mutual fund investor households reported accessing the Internet for financial purposes, such as checking their investment information.[35]

Despite these encouraging developments, questions remain over whether investors are willing to move to a primarily Internet-based system of financial disclosure. For example, the SEC financial literacy study included a number of questions related to investor preference with regard to delivery method and found preferences split.[36] SEC survey respondents generally preferred receiving disclosures in hard-copy, either sent through the mail or presented in-person by the adviser. On the other hand, a significant percentage of SEC survey respondents expressed a preference for electronic delivery in some form.

Evidence from other sources suggests that younger Americans increasingly view the ability to conduct their financial business online as a necessity. According to recent research from Scivantage and the Aite Group, for example, 44 percent of Gen-X and Gen-Y investors surveyed had shifted assets to another investment firm or switched investment providers due to availability of online tools. And 42 percent of Gen-X and Gen-Y respondents said their bank would need to offer more convenient services and/or more robust online brokerage/trading capabilities in order for them to move more assets to their bank.[37] As Scivantage Vice President Chris Psaltos said in the news release announcing the research, "Online investing capabilities are now second nature to Gen-X and Gen-Y investors and will be a requirement for banks that want to attract future high-net-worth or current affluent members of this segment. As younger, tech-savvy investors look for greater control of the investment decision-making process, wealth management firms, particularly banks, must ensure that their online investment platforms are keeping pace with the latest consumer technology innovations."

When CFA looked at mutual fund investors' purchase practices, in a 2006 study funded by the FINRA Foundation, we found similarly mixed views, with younger investors expressing stronger interest in using the Internet for various investment-related purposes. On that survey:

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[34] *Digital Differences*

[35] Swire and Ahmad, *Delivering ERISA Disclosure*

[36] Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors*, study by the SEC staff as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (August 2012)

[37] Scivantage and Aite Group, Press Release, "Wealth Management Industry Not Sufficiently in Tune with the Needs of Young Investors, According to Aite Group Research," Jul 30, 2012

- Just under 60 percent of all mutual fund investors indicated they would use the Internet to obtain general information about funds and to research individual funds, but 70 percent or more of fund investors between the ages of 18 and 45 said they would do so.[38]

- On the other hand, fewer than half of survey respondents expressed a willingness to use the Internet for any of the other suggested activities, including to receive periodic reports and disclosure documents (49 percent), to use a calculator to compare costs (47 percent), to communicate with a financial services professional (39 percent), or to purchase mutual funds (26 percent).

- Younger investors were more willing to use the Internet for these purposes, with roughly six in ten survey respondents in the youngest three age groups saying they would use the Internet to receive periodic reports and disclosure documents about mutual funds they owned or to use a fund cost calculator. Even among younger respondents, however, only about half or less said they would use the Internet to communicate with a financial services professional, and just over a third said they would use the Internet to purchase mutual funds.

- At the same time, more than two in ten survey respondents (21 percent) said they would not use the Internet at all, including 54 percent of those 65 and older.

Survey Findings: For the purposes of this study, we sought both to update the mutual fund survey findings on investor willingness to use the Internet[39] and to dig deeper into the reasons behind their preferences. While our recent survey showed a slight increase in willingness to use the Internet for various purposes, the difference is not as dramatic as one might expect given the time that has elapsed between the two surveys and the fact that this survey was conducted online while the previous survey was conducted over the phone. Specifically: [40]

- In a finding of particular relevance for this research, the percentage of survey respondents who indicated they would be willing to use the Internet to receive reports and documents rose from 49 percent on the earlier survey to 54 percent. On the other hand, the percentage who indicated they would be willing to use the Internet to communicate with a professional was essentially unchanged, at 40 percent.

- Investors on our updated survey expressed greatest willingness to use the Internet to view account information and performance, an online activity not asked about on our previous survey. Two-thirds of investors surveyed (67 percent) said they would be willing to use the Internet for this purpose.

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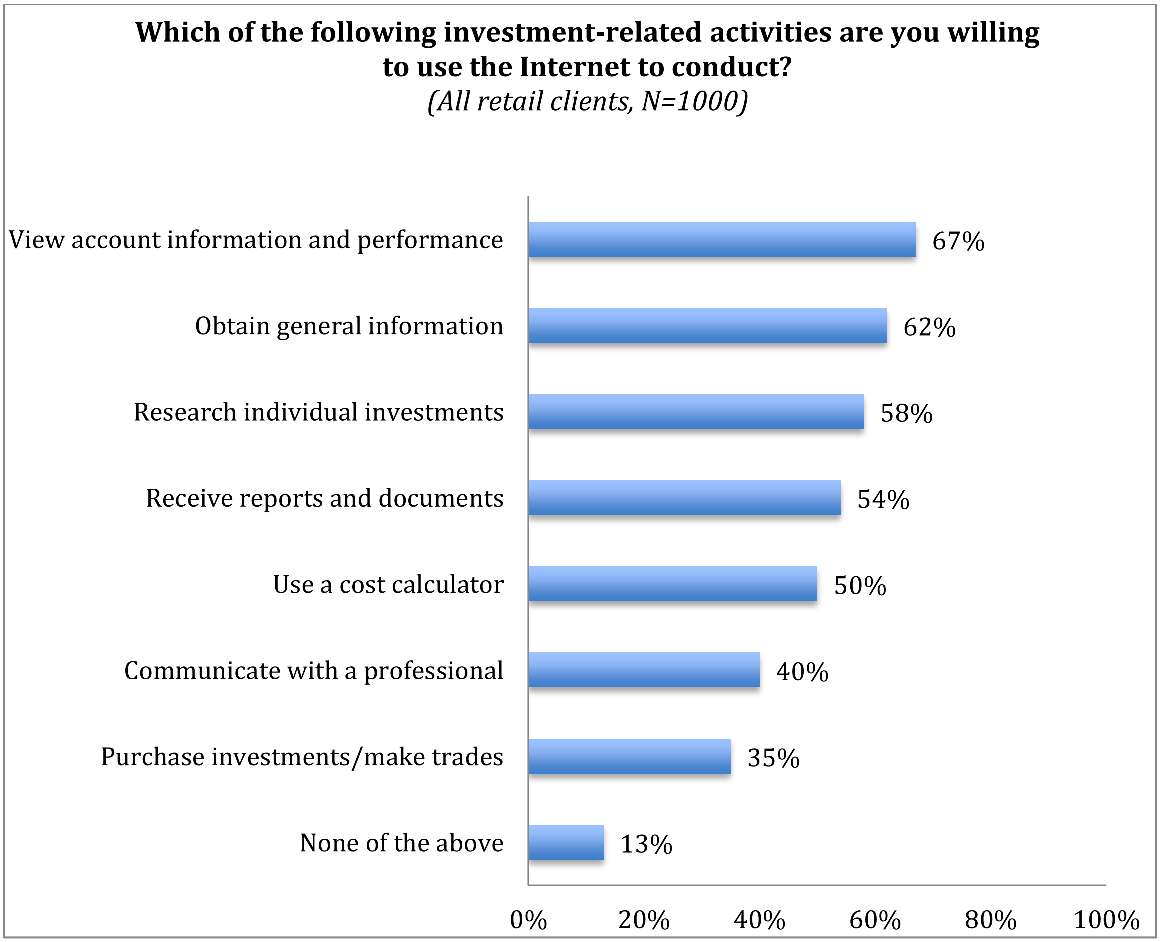
[38] Roper, Barbara and Brobeck, Stephen, "Mutual Fund Purchase Practices, An Analysis of Survey Results," (June 2006)

[39] In revising the survey, we changed the options to reflect general investment purposes, rather than mutual fund-specific purposes, and we added one additional activity: view account information and performance.

[40] See ARC Report, page 52-53.

- As with our previous survey, the other areas where investors expressed greatest willingness to use the Internet were to obtain general information (62 percent) and to research individual investments (58 percent). Willingness to use the Internet to obtain general information showed a slight increase over the earlier survey, but willingness with regard to researching individual investments was essentially unchanged. It is possible, of course, that this reflects many investors' general lack of interest in researching investments as much as it reflects their attitude toward the Internet.

Figure 7: Investors' Willingness to Use the Internet for Investment-Related Purposes



Source: ARC Survey Report, page 53.

In addition to asking a hypothetical question about investors' willingness to use the Internet for various investment-related purposes, we also asked about their preference for receiving various types of documents either on paper or electronically.[41] The only areas where the data indicates a clear preference for one format over the other are:

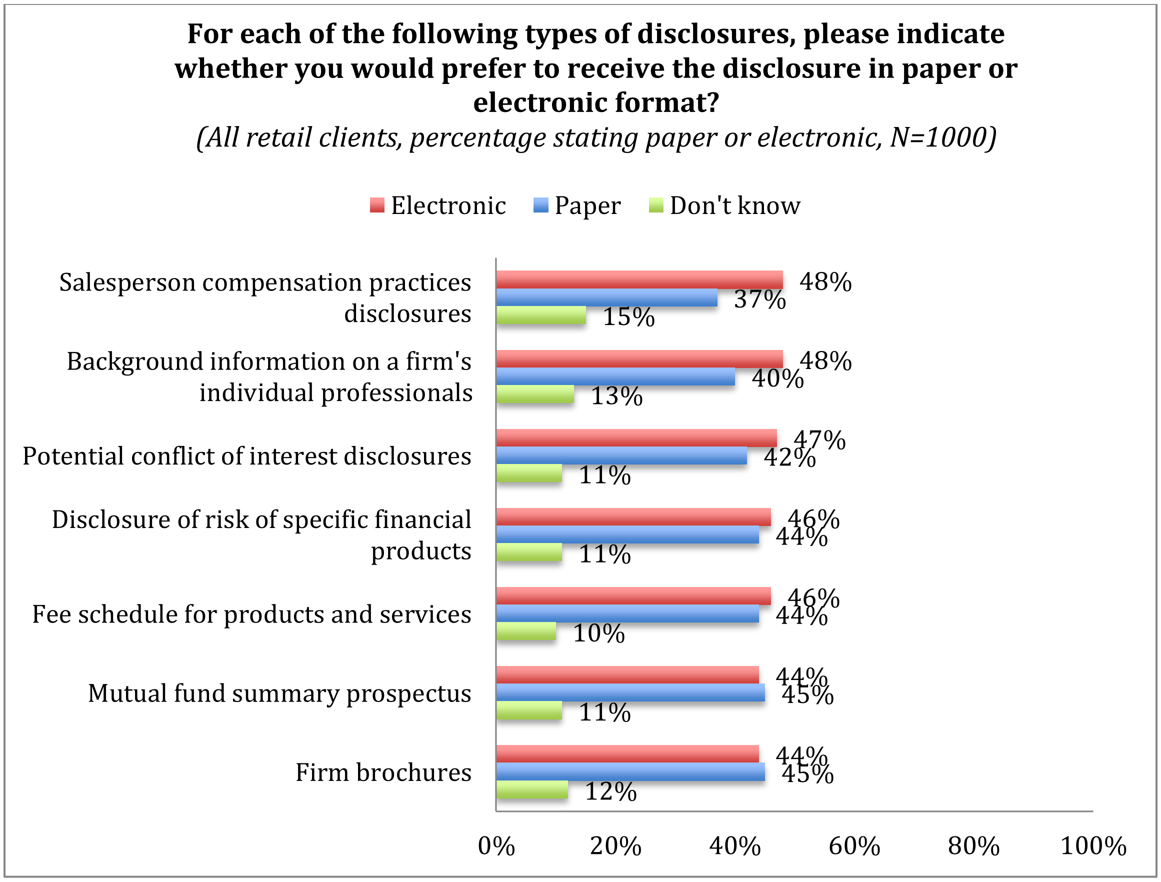
[41] See ARC Survey Report, page 41-44.

- disclosure regarding salesperson compensation practices (where 48 percent expressed a preference for electronic delivery, 37 percent expressed a preference for paper, and 15 percent said they don't know); and

- background information on a firm's individual professionals (where 48 percent expressed a preference for electronic delivery, 40 percent preferred paper, and 13 percent expressed no preference).[42]

Overall, preferences for electronic delivery ranged from 44 to 48 percent, while preferences for paper delivery ranged from 37 to 45 percent.

Figure 8: Investors' Delivery Preferences for Various Types of Disclosure



Source: ARC Survey Report, page 42

As expected, paper versus electronic disclosure preferences are strongly correlated with age, according to the survey results. For each type of disclosure, investors between the ages of 21 and 39 were much more likely to prefer electronic delivery than individuals 60 and over.

[42] These were both areas of only moderate interest to survey participants – with an average rating of 6.64 on a 10-point scale for compensation disclosures and 6.73 for background information – though firm brochures scored lower.

However, even in this younger age group a significant minority expressed a preference for paper delivery. For example:

- In the area of fees for products and services (the disclosure topic in which survey respondents expressed the greatest interest),[43] 54 percent of investors in the 21-39 age group expressed a preference for electronic delivery, as did 47 percent of investors in the 40-59 age group and 39 percent of investors 60 and over. On the other hand, 34 percent of investors in the younger age group expressed a preference for paper delivery of such disclosures, as did 47 percent of 40-to-59-year-olds, and 51 percent of those 60 and over.

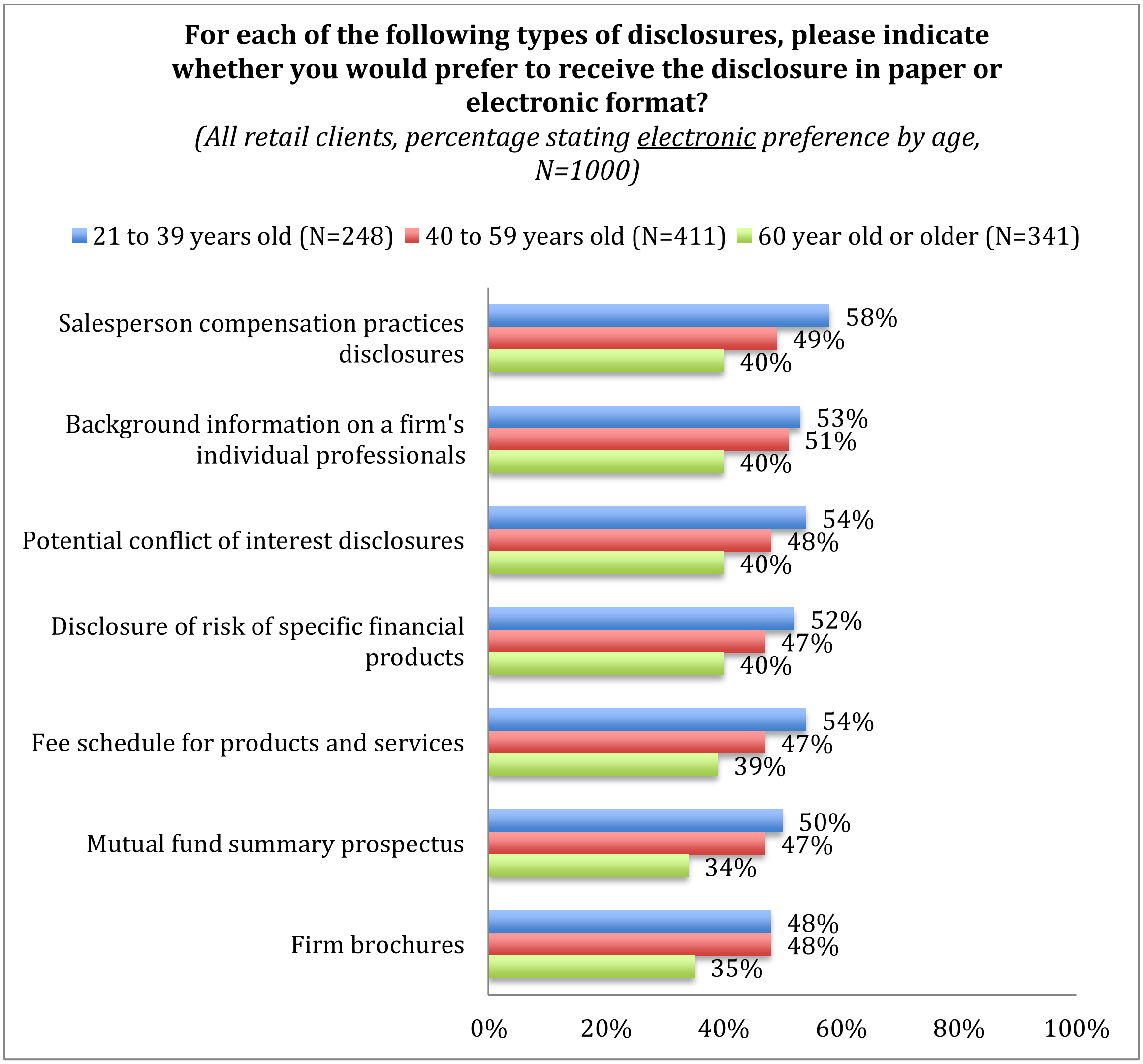
- Regarding risk disclosures for specific investment products (another area of relatively strong overall interest),[44] 52 percent of younger investors expressed a preference for electronic delivery compared with 47 percent in the 40-59 age group and 40 percent of those over 60. On the other hand, 34 percent of younger investors, 45 percent in the middle age group, and 51 percent of older investors indicated a preference for receiving risk disclosures through paper documents.

Preference for paper delivery ranged from 43 to 53 percent among over-60 investors and from 30 to 39 percent among younger investors.

[43] Survey respondents gave fee disclosures an average rating of 7.69 on a 10-point scale.

[44] Survey respondents gave risk disclosures an average rating of 7.39 on a 10-point scale.

Figure 9: Investors' Delivery Preferences for Various Types of Disclosure by Age



Source: ARC Survey Report, page 44

In order to better understand the reasons for these preferences, we asked investors surveyed a series of questions based on common reasons cited for preferring Internet or paper delivery. (See Figure 2) As discussed above,[45] many investors clearly see value in using the Internet for this purpose, particularly with regard to its potential environmental benefits. On the other hand, many investors appear to be either unconvinced by or unaware of some of the strongest selling points for an Internet-based system of disclosure, such as its potential to promote pre-sale disclosure, to reduce costs, to make it easier to find relevant information, to give investors more control over the degree of detail they choose to review on various disclosure topics, and to provide for more visually compelling disclosure. And concerns about security remain a significant concern for many investors.

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[45] See a more detailed discussion above, at pages 2-10, in the section on potential benefits and pitfalls of Internet disclosure.

One thing seems clear from the survey findings, however: most investors appear to be keeping an open mind. Just over a third of investors (37 percent) strongly agreed that, for the foreseeable future, they prefer to receive all disclosures as paper documents. This suggests that a majority of the investors surveyed are willing to at least consider a transition to electronic delivery, including a significant minority who are already making that transition.

The Legal Framework for Internet Disclosure

The Securities and Exchange Commission (SEC) first formally published its views on the use of electronic media to deliver mandatory disclosures to investors in 1995.[46] In that document, which focused on delivery of prospectuses, annual reports and proxy solicitation materials, the Commission affirmed that "issuer or third party information that can be delivered in paper under the federal securities laws may be delivered in electronic format."[47] It identified a set of simple, flexible principles for electronic delivery that have allowed electronic disclosure practices to grow and develop in concert with the subsequent dramatic expansion and technological evolution of the Internet. In the interim, the Commission has updated that commentary twice, once in 1996 and once in 2000, but each time it reaffirmed the same basic framework for electronic delivery.[48] The 1996 release focused on electronic delivery of required disclosure by broker-dealers, municipal securities dealers and transfer agents under the Exchange Act and investment advisers under the Investment Advisers Act of 1940. The 2000 release focused on disclosures by both issuers and market intermediaries.

That electronic delivery framework turns on three basic requirements: notice, access and evidence of delivery.

> *Notice:* In its 1995 guidance, the Commission affirmed that "direct notice of the availability of electronic disclosure documents is necessary." Thus, simply providing notice on a website or in another publication would not be deemed sufficient.[49] Moreover, notice must be given each time a document is delivered electronically**,** unless the issuer can demonstrate that delivery to the investor has been satisfied.[50] [51]

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[46] *Use of Electronic Media for Delivery Purposes*, Rel. Nos. 33-7233, 34-36345, and IC-21399 (Oct. 6, 1995)

[47] Ibid.

[48] *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Rel. Nos. 33-7288, 34-37182, and IC-21945 (May 15, 1996) and *Use of Electronic Media*, Rel. Nos. 33-7856, 34-42728, and IC-24426 (Apr. 28, 2000). In 2008, the Commission issued additional guidance on the use of company websites to provide information to investors, but it did not revise its standards with regard to electronic delivery in that document. *See* Commission Guidance on the Use of Company Websites, Release No. 34-58288 (August 7, 2008).

[49] SEC guidance, 1995

[50] Financial Services Institute, *On the Brink of a New Disclosure Regime: Effective Disclosure as Opposed to Comprehensive,* September 2010

[51] The 1995 Release provided that one method for satisfying the evidence-of-delivery requirement is to obtain an informed consent from an investor to receive information through a particular electronic medium. The 1996 Release stated that informed consent should be made by written or electronic means. In the 2000 release, the Commission

Access: For a disclosure delivered electronically to satisfy the access standard, it must not be "too burdensome" for the investor to locate and read the document. For example, investors "cannot be required to 'proceed through a confusing series of ever-changing menus to access a required document so that it is not reasonable to expect that access would generally occur.'"[52] In addition, the investor must have the opportunity to retain a permanent record of the disclosure.[53]

Evidence of Delivery: Evidence of delivery may include direct evidence, such as an email return-receipt message, accessing a hyperlink, or confirmation of downloading or printing the disclosure. However, the Commission also accepted indirect evidence of delivery, in the form of informed consent by the investor to receive documents through a particular delivery mechanism combined with compliance with the notice and access standards.[54] (See footnote 45.)

In each of the three guidance documents it issued, the Commission provided numerous examples of practices that would and would not satisfy the electronic delivery framework.

In 2000, Congress enacted the Electronic Signatures in Global and National Commerce Act (or ESIGN Act), which sets standards to facilitate the use of electronic documents and electronic signatures in interstate and foreign commerce. The law sets a standard for consumer consent to electronic delivery that is tougher than the standard previously set by the SEC. The SEC had allowed for written or electronic consent; ESIGN permits consent only through an electronic consent method.[55] While the SEC has authority under ESIGN to adopt an exemption, it has so far not chosen to do so with regard to broker-dealer or investment advisor disclosure documents.[56]

Does the Legal Framework for Internet Disclosure Need to be Updated?

The Commission's electronic delivery guidance is a remarkable regulatory achievement. At the time when this policy was first adopted, just under half of all U.S. households owned a computer, according to contemporary surveys, and roughly 16 percent of those subscribed to an

stated that an issuer or market intermediary may obtain an informed consent telephonically, as long as a record of the consent is retained. The 1995 release also stated that consent to electronic delivery could relate to all documents to be delivered by or on behalf of a single issuer. The 2000 release affirmed this, stating that an investor may give a global consent to electronic delivery -- relating to all documents of any issuer -- so long as the consent is informed.

[52] FSI, *On the Brink*, quoting the SEC 1995 guidance

[53] SEC guidance, 1995

[54] Ibid.

[55] FSI, *On the Brink*

[56] Ibid. The Financial Services Institute, which generally favors an "access equals delivery" policy for electronic disclosure, has identified the SEC's failure to provide an exemption as "a major barrier to more widespread use of electronic delivery of adviser and broker-dealer disclosure documents."

online service.[57] And yet, at the dawning of the Internet age, the Commission succeeded in establishing a regulatory framework that was sufficiently flexible to continue to work effectively despite the dramatic technological changes that have occurred since that time. Some now suggest that this policy needs to be updated.[58] Among the issues that are raised in that context are questions of what constitutes delivery and whether the time has come to switch the delivery default from paper to electronic in order to speed the transition to an Internet-based disclosure system. In addition, some suggest that the legal framework needs to be updated for a different purpose: to enable firms to take full advantage of the flexibility of the Internet in designing disclosures for electronic delivery.

What Constitutes Delivery?

One issue that has long divided industry from investor advocates in the area of Internet disclosure is the question of what constitutes delivery. Since at least 2000, various industry groups have periodically urged regulators to eliminate the disclosure delivery requirement in favor of an "access equals delivery" model. Under this model, "investors would be assumed to have access to the Internet, thereby allowing delivery to be accomplished solely by an issuer posting a document on the issuer's or a third-party's web site."[59] Advocates have strongly objected to that approach. The Commission has decided the issue differently in different contexts but has generally upheld the notion that some form of notice is required to satisfy the delivery obligation.

- As it was updating its electronic delivery guidance in 2000, the Commission rejected the "access equals delivery" argument, citing concerns about a digital divide and investor resistance to an Internet-only approach. In doing so, it reaffirmed the notice, access and delivery requirements included in the agency's original guidance.[60]

- On the other hand, the Commission adopted the "access equals delivery" approach to disclosure in 2005 in the context of securities offerings under the Securities Act of 1933.[61] The rules relieve issuers of the requirement to deliver a final or statutory prospectus to the investor before the earlier of the delivery of either the confirmation or the security as long as the prospectus is filed with the Commission and posted on the Commission website via EDGAR. Investors retain the right to receive a paper copy upon request.[62]

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[57] Ibid., footnote 4

[58] This was a recurring theme in interviews conducted for this study. Also, see for example, FSI, *On the Brink*. Similar issues are raised in the context of ERISA disclosures in Swire and Ahmad, *Delivering ERISA Disclosure*.

[59] *Use of Electronic Media*, Rel. Nos. 33-7856, 34-42728, and IC-24426 (Apr. 28, 2000)

[60] Ibid

[61] *Securities Offering Reform*, Securities Act Rel. No.33-8591 (July 19, 2005)

[62] FSI, *On the Brink*

- In updating disclosure requirements for mutual funds in 2009, the Commission adopted a hybrid approach.[63] Rather than adopting a pure "access equals delivery" policy, as it had for securities offerings, the Commission allowed funds and financial intermediaries to substitute delivery of a plain English summary fund prospectus for delivery of the full statutory prospectus, so long as the full prospectus and other disclosure documents are made available on the Internet and paper copies are provided upon request.[64] Moreover, the Commission requires that hyperlinks be provided to enable easy navigation through the prospectus and between the summary document and other disclosures.

- In 2010, when the Commission adopted revisions to Form ADV,[65] the disclosure document for investment advisers, it rejected calls from some industry groups to amend its electronic delivery guidance so that disclosures placed on the adviser's website or posted on the Investment Adviser Registration Depository (IARD) would be deemed to be delivered, "regardless of whether the clients have provided consent to electronic delivery."[66] In rejecting that approach, the Commission concluded that "electronic access, without evidence that the adviser's delivery obligation has been met … would not, in our judgment, serve to adequately protect client interests."[67]

In the years since the SEC began actively deliberating the question of whether "access equals delivery," technological changes – including widespread access to email over high-speed connections and techniques for providing password-protected access to account information online – have significantly eased the burdens of electronic delivery. It is now possible to deliver even very lengthy documents via email, either as an attachment or through a link to the firm website. Under the circumstances, it would seem that a transition to electronic delivery ought to mute the calls for an "access equals delivery" disclosure model. Nonetheless, some industry representatives continue to press for a policy change that eliminates the delivery requirement.[68]

<u>Survey Findings:</u> The surveys conducted for this study shed light on this issue. When asked their view of delivery obligations, for example, a significant majority of financial professionals surveyed (67 percent) said that obligation was satisfied by providing transparent access; a third (33 percent) indicated that firms had an obligation to go further and ensure that mandatory disclosure documents are actually viewed by the client.[69] On the other hand, asked

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[63] *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Rel. No. 33-8998 (March 31, 2009). Final rule release available here.

[64] Ibid. See also FSI *On the Brink*.

[65] *Amendments to Form ADV*, Rel. No. IA-3060 (July 28, 2010).

[66] Ibid, at 49-50.

[67] Ibid, at 50.

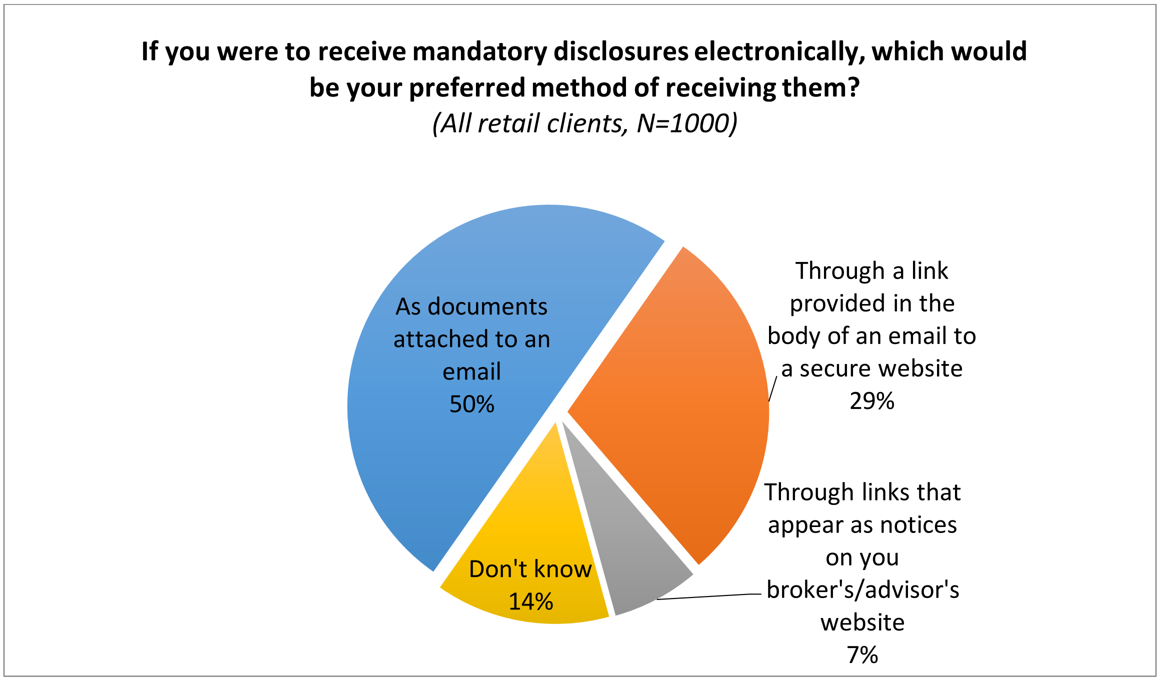
[68] See, for example, FSI *On the Brink.*

[69] See ARC Survey Report, page 8-9.

what constitutes delivery, a majority did not appear to believe that access alone is sufficient.[70] While an overwhelming majority of financial professionals viewed mailing of paper documents (85 percent) and email with printable attachments (74 percent) as satisfying the delivery requirement, far fewer (49 percent) believed that sending an email with a hyperlink to the document would constitute delivery, and fewer still (39 percent) felt that providing a link on a website would constitute delivery. This may represent their view of what would satisfy legal requirements rather than what ought to be sufficient, though the SEC's electronic delivery policy clearly suggests that an email containing a link to a document would satisfy the delivery requirement, so long as the investor had consented to electronic delivery.

Investors surveyed for this report were even more skeptical of an approach based on access alone. They made it clear that they do not want to have to go in search of information on company websites, with fewer than one in ten (7 percent) indicating that this would be preferable. Half expressed a preference, if disclosures are delivered electronically, for receiving those disclosures in the form of a printable attachment to an email, while three in ten (29 percent) expressed a preference for receiving disclosures in the form of a hyperlink within the email.[71] As discussed in greater detail above, investors in our online survey were about equally divided as to whether they prefer paper or electronic disclosure.[72]

Figure 10: Investor Preference among Electronic Delivery Methods



Source: ARC Survey Report, page 46

[70] Ibid, page 9.

[71] Ibid, 14 percent said they did not know.

[72] Ibid, page 46

This decision of whether we retain the actual delivery requirement for electronic disclosures is crucial to determining whether Internet disclosure increases or undermines disclosure transparency. Technological changes have largely eliminated the traditional arguments for removing delivery requirements, at least in the retail context. If delivery of an email notifying the customer that new disclosure documents are available and providing either a PDF or a link to that document satisfies the delivery requirement, what justification would there be for not providing that notification? Both the costs and the time required appear to be minimal.

Best Practices: While some have focused on policies to reduce delivery requirements, less attention has been devoted to the fact that electronic delivery offers the potential to improve the quality of delivery. When a firm mails a paper document to a customer, it has no way of determining whether that document gets read. If firms want to ensure that paper disclosures are actually viewed by the customer, they would arguably have to have their representative review the document with the customer in a one-on-one meeting.[73] In contrast, when a firm provides a disclosure document through a hyperlink in an email, it is possible for that firm to determine whether the customer opens that link to access the document.

- One firm with a heavily retail customer base has adopted the practice of monitoring whether those customers who have chosen electronic delivery are in fact accessing disclosures they receive electronically. When customers go too long without accessing the disclosure documents, the firm sends them a message which, if ignored, causes the customer to be defaulted back into paper delivery.

- Another firm described a system of A/B testing they use when emailing notices to customers. Testing two different versions of the email, the firm can determine almost immediately which is the more effective, i.e., which is most likely to be opened and read by recipients. They then immediately switch to the more effective version.

These examples show how firms are using the functionality of the Internet to increase the likelihood that disclosures will be read in ways that simply wouldn't be possible or practical in the context of paper disclosures.

Who Gets to Choose?

In recent years, the debate appears to have shifted away from whether firms have an obligation to deliver disclosures to the question of who gets to choose the delivery mechanism. Consumer advocates have traditionally argued for an "opt in" approach, requiring consumers to affirmatively choose to receive disclosures electronically. Some industry representatives and Internet disclosure advocates see this approach as impeding the transition to electronic delivery, as simple inertia keeps individuals who might be willing to receive disclosures electronically from making the switch. The issue is important, since research has shown that how we set the

[73] When as part of its financial literacy study the SEC asked investors about their preferences regarding how they receive information from their financial professional, 45.4 percent favored receiving that information orally from the person advising them. Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors*, study by the SEC staff as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (August 2012), page 260.

defaults – opt in versus opt out – has a dramatic effect on the choices investors will make. Some years ago, for example, the Thrift Savings Plan moved from an opt-in to an opt-out system for electronic delivery. After the change, participants received electronic delivery unless they took steps to opt out and receive documents in paper. In January 2007, after the change was made, only about 10 percent of Thrift Savings Plan participants had elected to have their paper statements mailed.[74]

In describing the importance of defaults, behavioral economists often cite as an example research on choices about becoming an organ donor. The typical example given is that European countries with no other strong differences in their views about organ donation have dramatically different organ donation rates based on whether their enrollment depends on an opt-out or opt-in approach. Specifically, European countries with opt-in policies have organ donor rates ranging from 4.25 to 27.5 percent, while European countries with opt-out policies have organ donor rates ranging from 85.9 to 99.98 percent.[75] Presented with a neutral choice – with no default option present – a large majority (79 percent in one study) say they would choose to become organ donors. Reflecting on the policy implications of their research, the authors suggested that, in deciding between an opt-in and opt-out approach, policymakers should consider which default would most closely replicate the selection that individuals would make in a neutral situation.[76] For example, since nearly 80 percent of individuals choose organ donation when presented with a neutral choice, the logical conclusion is that an opt-out approach to organ donation decisions would produce results more closely aligned with actual individual preferences.

Survey Findings: Survey data on investor preference for paper versus electronic delivery offers no such clear signposts. According to the investor survey conducted for this study, investors are nearly equally divided on whether they prefer to receive disclosures in the form of a paper document or delivered electronically.[77] (See Figures 8 and 9) Overall, preferences for electronic delivery ranged from 44 to 48 percent, while preferences for paper delivery ranged from 37 to 45 percent.[78]

When, as part of its financial literacy survey, the SEC asked investors how they prefer to receive information from their financial professional, its results showed a stronger preference for paper over electronic delivery. In considering the SEC's survey results, it is important to note that its question referred more generally to "information" rather than disclosure documents, it allowed multiple answers, it included several different approaches to electronic delivery among its options, and it included one option (orally from the adviser) that isn't entirely relevant to the

[74] Swire and Ahmad, *Delivering ERISA Disclosure*

[75] See, for example, Johnson, Eric J. and Goldstein, Daniel, "Do Defaults Save Lives?" *Science*, November 21, 2003, Vol. 302, www.sciencemag.org, available here

[76] Ibid

[77] See ARC Survey Report, page 41-44

[78] As noted above, because our survey was conducted online those who do not feel comfortable using the Internet may be under-represented in the sample and results could therefore be skewed at least slightly toward electronic delivery. On the other hand, the high level of Internet use among investors suggests that any such under-representation would likely be minimal.

paper versus electronic choice. The most popular responses were orally from the person who advises them and paper documents sent through the mail (at 45.4 percent each).[79] Various types of electronic delivery were favored by between a quarter and just over a third of respondents, including: through a written notice (either mailed or e-mailed) providing a web address where the information can be found (35.6 percent); in writing (either mailed or e-mailed) with a hyperlink to the exact webpage (34.9 percent); available for viewing on the Internet (32.6 percent); in the body of an email or sent as an attachment (27.6 percent).[80]

The significant percentage of investors who continue to prefer paper delivery suggests that investors may not yet be ready for electronic delivery to be the default option for investment disclosures. On the other hand, the discrepancy between those who indicated a preference for electronic delivery (44 to 48 percent) and those who actually report receiving at least some disclosures electronically (30 percent)[81] suggests that the current opt-in approach is not producing results that align with investor preferences. In addition, while investors surveyed generally expressed satisfaction with the content of disclosures and even higher satisfaction with their current delivery mechanism, respondents who said they receive some of their disclosures electronically were more likely than those who do not receive disclosures electronically to state that they are "very satisfied" with both the content and delivery of the disclosure documents they receive.[82]

Best Practices: If it were possible to move away from the opt-in/opt-out paradigm and structure choices about delivery as a neutral choice, such an approach might produce decisions about delivery that more closely reflect actual customer preference.[83] In the meantime, many firms are offering investors what one might characterize as the best of both worlds. At these firms, even those who prefer to receive disclosures in paper form have the option of accessing those same documents online, often through a special password-protected area of the website where their account information and relevant documents are maintained.

- For documents posted on the website, one firm whose website was reviewed for this report provides account holders with the option of simply viewing the file, saving it as a PDF (which could of course be printed out as a paper document), or archiving it so that it is saved on the company's system and is accessible from anywhere.

- As an added measure of security, one firm requires users to enter a PIN as well as a username and password to access the account. While the username and password can be

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[79] Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors*, study by the SEC staff as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (August 2012), page 260.

[80] Ibid

[81] See ARC Survey Report, page 35.

[82] Ibid, page 36

[83] This issue is discussed in greater detail in the Next Steps section of this report in Appendix A below.

entered using autofill (once the first letter of the username is entered), the PIN must be entered manually.

- Some firms allow the customer to choose different delivery options for different types of documents.

- Another firm interviewed for this report described how its financial advisers now take iPads to meetings with clients, enabling them to combine the oral and electronic delivery of information.

Is More Design Flexibility Needed?

Disclosure rules often dictate such details as what information must be provided the document's cover, the order in which other items must be presented, and in some cases even the minimum type size for certain disclosures. A number of experts have suggested that investors will not receive the full benefits of Internet disclosure – such as greater use of layering of information or break-down of documents into multiple screens of information – until rules are revised to allow more flexibility in the design of disclosures to take advantage of the Internet's capabilities. The review of company websites both for this report and for the earlier mutual fund study provided ample support for this viewpoint. A striking contrast exists between the innovative design many companies employ in presenting supplemental information on their websites, such as investor education material, and the much more mundane presentation of mandatory disclosures.

Even when presented on the Internet, the typical disclosure document simply looks like a paper document posted on the website, perhaps with the addition of a few hyperlinks. The SEC's mutual fund summary prospectus is a typical example. It lacks the more appealing design features evident in the best of the fund snapshots that mutual fund companies were producing prior to the summary prospectus rulemaking, such as tabs at the top of the screen to organize information into topics, presentation of information in screen-size amounts, additional layers of information on various topics rather than simply a link to the prospectus. On the other hand, it also lacks more troubling features found in some examples reviewed, in particular giving less prominence to cost information for relatively high-cost funds.

The question is whether it is possible to achieve the benefits of design flexibility without losing the benefits of standardization. While some experts are optimistic, and believe exploring ways to provide that flexibility should be a priority, others suggested that the liability that attaches to mandatory disclosures, rather than inflexibility in the rules themselves, is the main factor inhibiting innovation. According to this school of thought, as long as disclosures are subject to strict liability, disclosure documents will be written by lawyers to satisfy legal requirements rather than being designed and written to enhance investor understanding.

<u>Best Practices</u>: Some firms are already experimenting with ways to realize the design benefits of the electronic delivery within the existing disclosure framework for mandatory disclosure documents. For example:

- One firm is exploring presenting portions of the online version of the mutual fund shareholder report in video.

- Several firms let investors customize the presentation of their account documents on the password-protected area of their website. Among other things, they offer investors the option of having information consolidated across all their accounts or presented in ways that most prominently feature the information of greatest interest to that investor.

However, even those who are doing most to explore the possibilities offered by electronic delivery seem to agree that to do more they would need more flexibility under the rules.[84]

IV. Barriers to Effective Disclosure

Disclosure is an essential investor protection tool, but there are limitations to what even the best designed disclosures can be expected to accomplish. This section of the report describes some of the key factors that tend to limit disclosure effectiveness, regardless of how those disclosures are delivered. The following section examines whether Internet disclosure can help address the problem.

➢ Investment decisions are complex.

The simple fact is that investment decisions are complex.[85] The options available to investors are virtually limitless. Whether the investor is selecting a financial adviser or selecting an investment product, the factors to consider in an effort to identify the best or most appropriate option are often numerous and difficult to analyze.[86] This is true even when the investor is selecting among fairly straightforward products and services. To select a mutual fund, for example, experts are nearly unanimous in recommending that investors consider the fund's investment objectives and strategies, risks, fees and expenses, past performance, including the volatility of that performance, the reputation of the fund manager, tax implications of an investment in the fund, and information about such account features as investment minimums.[87] That is a daunting task, made more difficult by the fact that some of these factors – such as investment strategy and risk – can be difficult to convey in clear language that the investor is likely to understand. In recent years more complex products and services have entered the retail

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[84] This issue is discussed further in Appendix A: Next Steps.

[85] See, for example, Chater, Nick; Huck, Steffen; Inderst, Roman; and Goethe, Johann Wolfgang, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective,* November 2010 (Coordinated by Decision Technology Ltd with participation by Online Interactive Research Ltd.) for a discussion of the vast choices and complex factors investors must weigh in making those choices.

[86] See, for example, SEC 913 Study and RAND Study for a discussion of investors' inability to distinguish between brokers and investment advisers, the services they offer, and the legal duty they owe clients.

[87] Roper, Barbara, *Mutual Fund Essential Knowledge: What Do Investors Need to Know and What is the Best Way to Provide that Information?* (2005).

marketplace, further complicating those choices. The more complex the product, the more difficult it becomes to convey the relevant information clearly.

- Many investors lack the skills and expertise to make good investment decisions.

Extensive research has documented the disturbingly low financial literacy levels among Americans. It has been shown, for example, that many adults "do not possess basic knowledge of interest rates, inflation or risk, all of which are essential to making well-informed investment decisions."[88] Indeed, as researchers working in this area have pointed out, successful investing requires financial knowledge beyond the basic financial concepts generally tested for in financial literacy surveys. It also requires, for example, an understanding of such topics as "the relationship between risk and return; how bonds, stocks, and mutual funds work; and asset pricing."[89] Unfortunately, the data here is even less encouraging.

Results of the Financial Capability Survey illustrate the problem.[90] To evaluate financial knowledge, the survey included "a battery of questions covering fundamental concepts of economics and finance expressed in everyday life, such as calculations involving interest rates and inflation, principles relating to risk and diversification, the relationship between bond prices and interest rates and the impact that a shorter term can have on total interest payments over the life of a mortgage." Results ranged from a low of 21 percent correct on a question about bond prices to 70 percent correct on a question about mortgages, but "fewer than half of respondents (46 percent) correctly answered both a question about interest rates and a question about inflation. Less than one-third (30 percent) correctly answered those questions plus a question about risk and diversification correctly. And fewer than 10 percent of respondents were able to answer all questions correctly." Moreover, evidence suggests that people overrate their financial knowledge. On the Financial Capability Survey, for example, "most respondents gave themselves high scores."

The SEC's recently released Financial Literacy Study adds to an understanding of the problem, both by further documenting low levels of financial literacy and by providing evidence of how that affects individuals' ability to understand financial disclosures. The online surveys conducted for the study found, for example:

- Among survey respondents who reviewed a sample ADV Form, 46 percent said they fully understood the fees and compensation exhibit they reviewed, and another 50.9 percent said they understood it somewhat. However, fewer than three in ten (28.9

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[88] Chater, Huck, Inderst, and Goethe, *Consumer Decision-Making in Retail Investment Services*

[89] Lusardi, Annamaria and van Rooij, Maarten, *Financial Literacy: Evidence and Implications for Consumer Education,* November 2009.

[90] FINRA Investor Education Foundation, *Financial Capability in the United States, National Survey—Executive Summary*, December 2009. See also, Lusardi, Annamaria and Mitchell, Olivia S., *How Ordinary Consumers Make Complex Economic Decisions: Financial Literacy and Retirement Readiness,* March 2010 and Lusardi and van Rooij, *Financial Literacy*.

percent) were able to correctly identify the likely amount they would be charged, based on the information presented in the exhibit they reviewed.[91]

- Among survey respondents who reviewed a sample confirmation for a mutual fund transaction, well over half (57.9 percent) could correctly identify the type of investment, but only 12.7 percent recognized that the financial firm was acting as a dual agent.[92]

- Having reviewed a sample disclosure that begins as follows, "In addition to sales loads and 12b-1 fees described in the prospectus, we receive other compensation…," just over half (54.8 percent) correctly answered a question about whether the firm gets compensation other than sales loads and 12b-1 fees.[93]

- After reviewing a sample chart providing information on additional payments the firm receives from mutual fund companies, only 31.8 percent indicated they definitely knew what the term "annual asset fees" means, and another 46.2 percent indicated they thought they knew what it means.[94] Survey respondents were generally unable to determine the significance of the information provided.[95]

This is just a sampling of the survey findings showing widespread inability among investors to comprehend typical disclosure documents. In some cases, improvements to the disclosures may help to increase comprehension. But lack of financial knowledge is also clearly a factor.

➢ Investors don't make good use of the information that is provided to them.

Despite the importance and the complexity of investment decisions, studies have found that investors do not spend a lot of time researching their selections. One of the findings of the Financial Capability Study, for example, is that "few compared the terms of financial products or shopped around before making financial decisions." A study conducted in the European Union reached a similar conclusion, finding that "information search is very limited. Only around 33 percent of investors compare investments from more than one provider or consider more than one product from a single provider. Just 27 percent of investors shop around to get the best deal."[96] There is little if any reason to believe practices in the United States are any more thorough. On the contrary, an early U.S. study in behavioral economics looking at retirement

[91] SEC Investor Research Study, page 89 and 91.

[92] Ibid, page 134.

[93] Ibid, page 172.

[94] Ibid, page 277.

[95] Ibid, page 278.

[96] Chater et al, *Consumer Decision-Making*.

plan selections concluded that investors spend relatively little time on even very important decisions, such as their asset allocation decision.[97]

These conclusions were borne out in CFA's earlier study of mutual fund investors' purchase practices. In response to a question about the written sources of information investors considered important to their purchase decision, none of the written information sources we identified – the prospectus, a summary document, and third-party information sources, such as fund ranking services and personal finance articles – was viewed as highly influential by most current fund investors.[98] "While those who purchased most of their funds directly indicated that they got greater value than others from the prospectus, just over a third of even these direct investors rated the prospectus as highly influential and just over half rated the prospectus as either highly or somewhat influential…In addition, the vast majority of investors in all three groups indicated that they do not take advantage of the independent, third-party information sources available to them."[99]

➢ Disclosures do not reflect investor preferences.

One reason investors may make poor use of the disclosures available to them is that those disclosures do not reflect investor preferences. As the SEC financial literacy study and other research has shown, investors want disclosures that are brief, readable and delivered before they have to make an investment decision. The SEC study found, for example, that:

- Investors "favor summary documents containing key information about the investment product."[100]
- Investors "prefer that disclosures be written in clear, concise, understandable language, using bullet points, tables, charts, and/or graphs."
- Investors "prefer to receive disclosures before making a decision on whether to engage a financial intermediary or purchase an investment product or service," ideally receiving that information far enough in advance to think about it before making a decision.

Instead they typically receive long, densely worded documents – documents written by lawyers to comply with legal requirements – after they have already made the investment decision.

➢ Investors are often overwhelmed by the volume of information provided.

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[97] Benartzi, Shlomo and Thaler, Richard H., *Risk Aversion or Myopia? Choices in Repeated Gambles and Retirement Investments* (June 1998).

[98] Roper and Brobeck, *Mutual Fund Purchase Practices*.

[99] Ibid.

[100] Researchers who have tested disclosure documents with investors have reached similar findings. See, for example, Greenwald, Mathew, *Report on Consumer and Financial Advisor Reaction to Annuity Disclosure Documents: A Report on Seven Focus Groups and Four In-depth Interviews*, prepared for ACLI by Mathew Greenwald & Associates; also, ICI, *Investor Views*.

As a result of these factors – the difficulty of the investment decisions they must make, their generally poor skills for evaluating those decisions, and the density of the disclosures they receive to help them make those decisions – investors often end up feeling overwhelmed by the volume and complexity of the information they receive. According to a recent survey of investor sentiments, 40 percent of investors believe investment products are "overly complex," and 34 percent feel "overwhelmed" by the investment choices available to them.[101] A study in annuity choice provided this insight from early behavioral economics research into how this can affect investors' decision-making practices: "Research in the decision-making literature suggests that consumers tend to reduce the amount of effort they expend when decisions become more complex."[102] Similarly, another study of the insurance market finds that, "More information may deflect attention from what is really important. A pervasive finding … is that cue competition occurs: more salient cues weaken the effects of less salient ones, and the presence of irrelevant cues causes subjects to make less use of relevant cues. Introducing additional accurate information may therefore lead to worse outcomes."[103] In other words, providing more information may cause investors to make less use of that information.

- Many investors don't want to make their own investment decisions.

It is not surprising, then, that many investors turn to financial professionals to help them make investment decisions. Our disclosure policies are based on the assumption that investors will carefully research their investment decisions, even when they are relying on a financial professional for recommendations, but research suggests that this is often not the case. For example, when for CFA's mutual fund study we asked investors about their purchase practices, nearly three in ten of those who purchased most of their mutual funds from a financial professional said they "relied totally on that professional's recommendation without doing any independent evaluation of the fund. Another 36 percent said they relied a great deal on the professional's recommendation but reviewed some written material about the fund before the purchase."[104]

Other research has examined how this reliance on advice relates to disclosure practices. In a study conducted for the United Kingdom's Financial Services Authority, for example, researchers found that buyer psychology, specifically the degree to which buyers have trusting natures, had greater impact on their insurance purchases than their degree of risk aversion. They concluded that, "in markets where persuasion is important, public policy designed to increase consumer information is likely to be ineffective."[105] Research designed to test the effectiveness

[101] MFS Investments news release, "Complexity of Investment Products Overwhelming Investors" (May 7, 2012)

[102] Agnew, Julie R.; Anderson, Lisa R.; Gerlach, Jeffrey R.; and Szykman, Lisa R., *An Experimental Study of Annuity Choice* (June 2008)

[103] De Meza, David; Irlenbusch, Bernd; Reyniers, Diane; *Disclosure, Trust and Persuasion in Insurance Markets*, Institute for the Study of Labor (IZA), Discussion Paper No. 5060 (July 2010)

[104] Roper and Brobeck, *Mutual Fund Purchase Practices*

[105] DeMeza et al, *Disclosure, Trust and Persuasion*

of a new, abbreviated disclosure document similarly found that investors were heavily reliant on the adviser both to explain the document and to recommend a course of action. They found that, “the majority felt that the explanation given by the adviser was the most important factor for them in gaining a good understanding of the product. This was not to say that they felt the documentation was unclear or insufficient, rather that they preferred to listen to and rely upon the adviser . . . A number admitted that they would not have read the documents in the ‘real situation’ but would have relied wholly on the adviser.”[106] The SEC’s Financial Literacy Study similarly found that investors look to their financial adviser to explain things to them.[107]

- Investors struggle to understand and use information about conflicts of interest.

Given this heavy reliance on advice by many investors, the effectiveness of disclosures about conflicts of interest is of significant concern. Here, however, the research indicates that many investors are largely impervious to these concerns, and that disclosure can in fact have perverse effects. European researchers found, for example, that: “The majority of investors mostly or completely trust the advice they receive, and do not perceive their advisor to be biased. Conflicts of interest are often only verbally disclosed, if at all, and most investors disregard the information or do not think about it.”[108] The online surveys conducted as part of the SEC’s Financial Literacy Study found that investors struggled to understand information provided about conflicts, and a majority of respondents were either ambivalent (30.5 percent) about whether information about conflicts would affect their selection of adviser or convinced that it would not (28 percent).[109]

Some researchers have found that conflict of interest disclosures can induce a “knee-jerk” reaction that can be either beneficial or harmful.[110] Other research has shown that, far from putting investors on their guard, disclosure regarding conflicts of interest may have the perverse effect of making them more trusting. For example, one study found that:

> First, people generally do not discount advice from biased advisors as much as they should, even when advisors’ conflicts of interest are disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse.[111]

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[106] IFF Research Ltd, *Investment Disclosure Research*, prepared for the Financial Services Authority by IFF Research Ltd. (November 2006)

[107] See, for example, Investor Research Study, page 260. Nearly half said their preferred method to get information about financial services products is orally from the individual who advises them (45.4 percent).

[108] Chater et al, *Consumer Decision-Making*

[109] See, for example, Investor Research Study, Conflict of Interest Module, beginning on page 106.

[110] Chater et al, *Consumer Decision-Making*

[111] Cain, Daylian M.; Loewenstein, George; and Moore, Don A., “The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest,” *Journal of Legal Studies*, vol. 34 (January 2005). This potentially perverse effect

For disclosure to be effective in addressing this concern, the authors conclude, "the recipient of advice must understand how the conflict of interest has influenced the advisor and must be able to correct for that biasing influence. In many important situations, however, this understanding and ability may be woefully lacking."[112]

Survey Findings: In our survey of financial professionals, we asked about their views on the effectiveness of disclosures generally and to what degree they felt that different factors constituted a barrier to effective disclosure. A majority of financial professionals (56 percent) agreed that mandatory disclosures are "generally effective tools for protecting retail clients," while a third (33 percent) said they are not generally effective.[113] On the other hand, less than a fifth (19 percent) of financial professionals believe that retail clients make good use of the mandatory disclosures provided to them.[114] Asked to rate on a scale of 1 to 10 how strongly they agree with a series of statements about possible barriers to effective disclosure, financial professionals surveyed were most likely to agree that "excessively technical or legalistic language" (7.83), "difficulty in finding useful information in lengthy, printed materials" (7.59), and "lack of interest in disclosure information among clients" (7.45) undermined disclosure effectiveness.[115] In addition, half of all financial professionals surveyed strongly agreed with the statement that "disclosures serve more to limit liability than to inform investors." Half also strongly agreed that clients prefer to rely on advice rather than research investments on their own.

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of disclosures has been found in other contexts as well. See, for example, Lacko, James M. and Pappalardo, Janis K., *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, Federal Trade Commission Bureau of Economics Staff Report (February 2004), which found that certain types of mortgage cost disclosures actually made consumers more likely to choose the more costly loan.

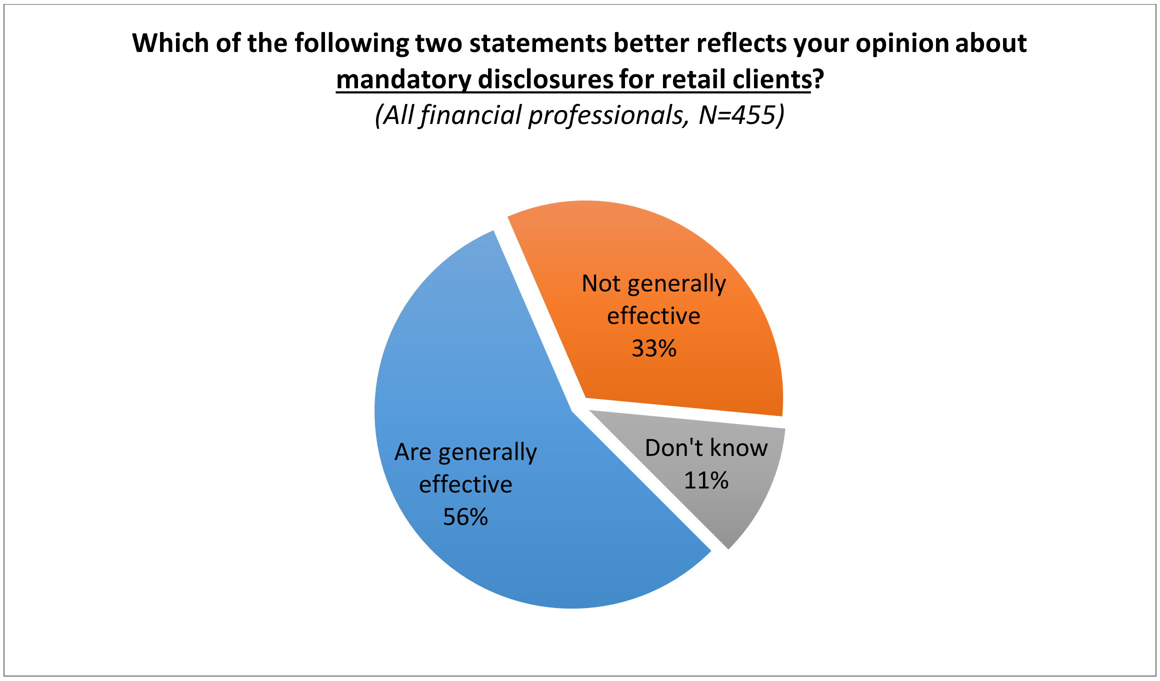
[112] Cain et al.

[113] See ARC Survey Report, page 5-6.

[114] Ibid, page 6.

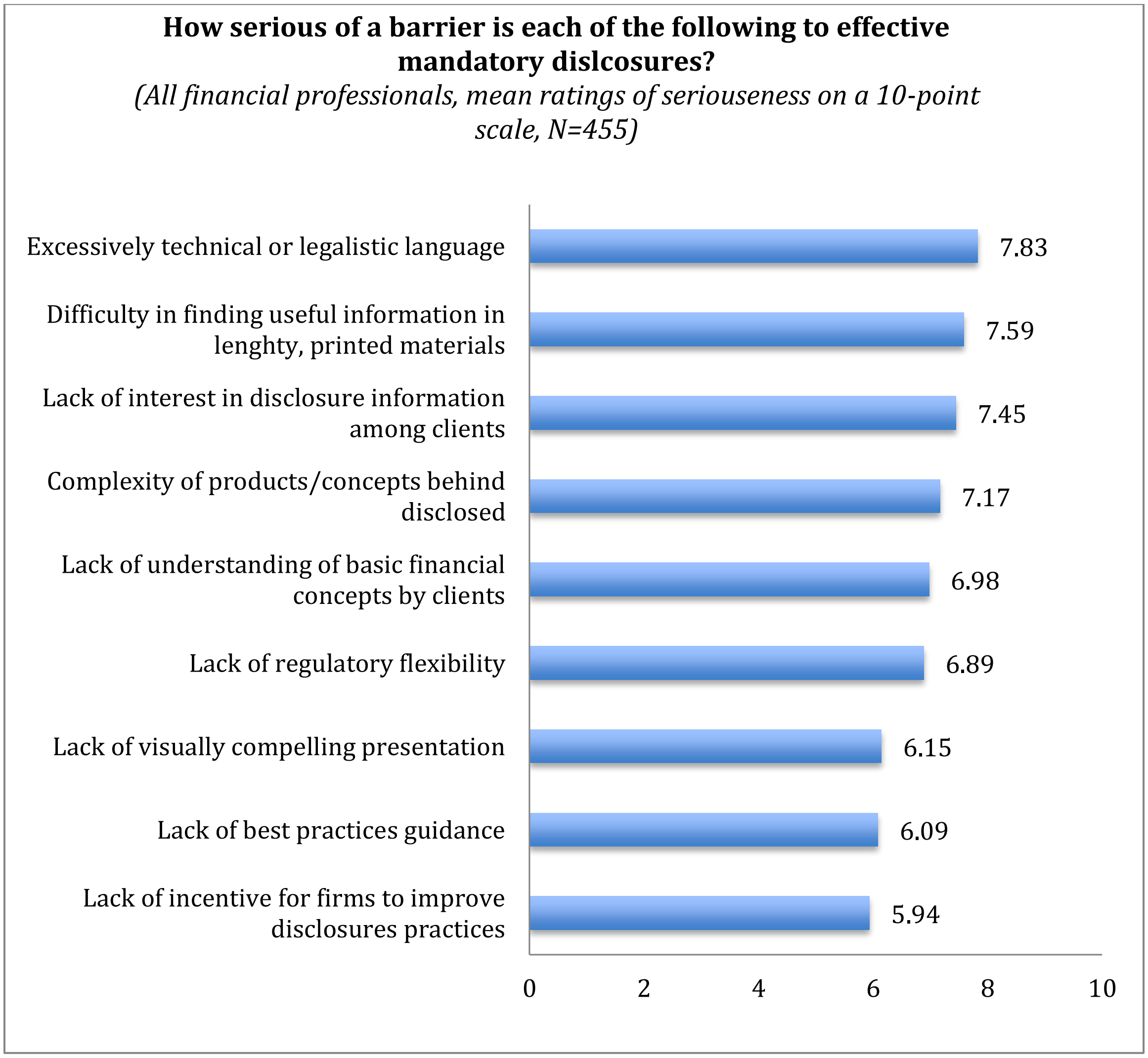
[115] Ibid, page 10-11

Figure 11: Financial Professionals' Views of Disclosure Effectiveness



Source: ARC Survey Report, page 6

Figure 12: Financial Professionals Views Regarding Barriers to Effective Disclosure



Source: ARC Survey Report, page 10

V. How Internet Disclosure Can Help

One clear message from the SEC's financial literacy study is that our current system of disclosure is not functioning well to promote informed investment decision-making. This is a serious problem given the key role disclosure is supposed to play in protecting investors' interests. The good news is that research suggests that even minor changes in presentation can influence investors' willingness to read disclosures, their understanding of the information presented, and the choices they make as a result.[116] For example, testing of consumer privacy notices found that consumers were more likely to read notices that were simple, provided key

[116] This issue is discussed in some detail in the Literature Review for this research.

context up front, and had pleasing design elements, such as large amounts of white space. [117] Another study that involved extensive testing to design a graphic illustration of risk found that something as simple as the directional orientation of a risk thermometer could have a measurable impact on investor comprehension. Moreover, this research demonstrated that the impact of design decisions can be dramatic. Specifically, researchers reported that "moving from the text-based disclosure to one that uses the original thermometer design as a pictorial indicator of risk and reward is equivalent to raising participants' financial literacy levels by 21.8 percent. Using the CESR thermometer rather than text has an equivalent impact to raising financial literacy by 27.5 percent.[118]

Given the significant impact that method of presentation can have on disclosure effectiveness, it seems logical that, properly implemented, Internet disclosure could have similarly beneficial effects. While no one is suggesting that Internet disclosure is a panacea capable of curing all the problems that undermine disclosure effectiveness, the research for this report does suggest that there are ways in which Internet disclosure can help. While some may require policy changes, such as the increased regulatory flexibility for disclosure design discussed above, others can be achieved within the existing regulatory framework. This section describes some of the ways in which Internet disclosures can help to improve investors' willingness to use and ability to comprehend the disclosures they receive.

- Timing

For years when investor advocates have urged regulators to require pre-sale disclosure of the information investors need to make an informed decision, industry groups have countered that such a requirement would be too costly and would unacceptably slow the investment process. As noted above, one of the clear benefits of Internet disclosure is that it both dramatically reduces the cost of delivering disclosures and allows for essentially instantaneous delivery.

A variety of options exist to provide this instant delivery. A number of firms maintain basic disclosure documents – such as fund summaries and prospectuses for the mutual funds and annuities they sell – on their websites. Not only can these online documents be accessed by the customer at any time, including during a telephone call with the financial professional, they can be "sent" instantaneously using either email or the message system some firms maintain on the password-protected areas of their website. Even where disclosure documents are not housed on the website in a way that is accessible by account holders, email can be used to deliver an electronic version of a disclosure document in PDF form. Any of these approaches should allow for delivery at the point of recommendation when such recommendations are made during a telephone call with a client. One firm interviewed for this report noted that all of its financial advisers now take iPads into the field with them. Use of tablet computers would provide another convenient option for providing electronic point-of-recommendation disclosures during in-person meetings with customers.

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[117] Swire and Ahmad, *Delivering ERISA Disclosure*

[118] Driver, Rebecca; Chater, Nick; Cheung, Benny; Latham, Mark; Lewis, Rich; and Stott, Henry, *Helping Consumers Understand Investment Risk: Experimental Research into the Benefits of Standardising Risk Disclosure* (ABI RESEARCH PAPER NO 25, 2010), report from Association of British Insurers Research Department and Decision Technology Limited.

In short, Internet disclosure appears to offer an easy means of addressing the clear preference investors express for receiving disclosure documents well in advance of any investment decision.

- Information Overload

Investors generally express a preference for more abbreviated disclosure documents and complain of feeling overwhelmed and intimidated by complex disclosure documents. Research has shown that how information about choices is presented to the investors can affect their sense of information overload. Specifically, as one behavioral finance paper that looks at asset allocation decisions concludes, "when information is easier to obtain and evaluate, consumers are more likely to use it when making decisions or choices … So if information about investment options is presented in a simpler way, investors should suffer less information overload and be more likely to use it when making … decisions."[119]

The review of financial firm websites conducted for this study suggests that Internet disclosure could help to address this problem. A key selling point of Internet disclosure is that it allows for the layering of disclosures, providing a less intimidating introduction of disclosure information and allowing investors to choose the degree of detail they wish to explore. Housing disclosure documents on the Internet also opens up new possibilities in designing disclosure documents in ways that present information in more visually appealing and consumable screen-size chunks. Investors who can approach disclosures a topic at a time may be less likely to feel overwhelmed and thus less likely to be turned off by disclosure documents. A review of financial firms' use of these techniques in the supplemental information they provide on their websites suggests that incorporating these design elements into online disclosure documents could help increase investor use and comprehension of disclosure documents.

While the evidence compiled for this report is persuasive, it is based on a limited and non-scientific review of financial firm websites. Before committing to such an approach, which would require policy changes to allow additional flexibility in online disclosure design, it would be appropriate to conduct further research to provide solid evidence that the benefits in this area are real and not simply cosmetic. (For a further discussion of this topic, see Appendix A: Next Steps below.)

- Complexity of Investment Decisions

Internet disclosure can't make investment decisions less complex, nor can it eradicate financial illiteracy. But presenting disclosure documents on websites in combination with Internet-based tools and investor education materials could help to promote increased investor comprehension. At the very least, it could ensure that investors have ready access to the background information necessary to make a more informed choice, even if not all investors take advantage of this opportunity. At the most basic level, online disclosures can include hyperlinks

[119] Agnew, Julie R. and Szykman, Lisa R., "Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience," *The Journal of Behavioral Finance,* 2005, Vol. 6, No. 2, 57–70.

to a glossary of technical terms. But a number of the websites do much more. For example, a number of firms provide extensive investor education materials – both written and video – on their websites. These materials cover both general personal finance topics (investing for income in retirement, funding a college education, or the benefits of dollar cost averaging) and more specific investment-related subjects (information about mutual funds, annuities, bonds, ETFs, etc.). Some provide access to materials produced by third parties, such as Morningstar and FINRA, in addition to providing their own proprietary content.

Not surprisingly, firms that cater at least in part to more self-directed investors were more likely to provide more and higher quality investor education materials and tools. Such firms provided a variety of different tools, including asset allocation tools and various calculators, that could be useful to investors seeking to understand their investment goals and options for reaching those goals. In the best examples, investor education materials and tools were well integrated with other web content, including mandatory disclosures, so that investors were not forced to go searching for the relevant information in an isolated area of the website. For example, one firm that caters in part to self-directed investors includes an "educational resources" link on its website for each category of investment product offered by the firm. Another firm presents its calculators with easy to understand headings that seem likely to appeal to users. For example, under retirement savings calculators, the firm offers calculators under the following headings: Am I saving enough? What can I change? What will Social Security provide? What effect can inflation have?

One area that seems like a real missed opportunity on financial firm websites was the general lack of good material relevant to selecting a financial professional, including information on differences between brokers and advisers and links to BrokerCheck and IAPD reports for individual representatives. Many firms offer tools for investors to use in locating a representative in their area. But none of those reviewed for this study included a link to the BrokerCheck or IAPD reports for those individuals. It was equally difficult on most websites to get information on the differences between brokerage accounts and advisory accounts and why the customer might prefer one over the other. Indeed, it was often difficult to distinguish between such accounts based on the information provided.

Whether investors would make good use of investor education material and Internet-based tools remains an open question. When our survey asked investors about their interest in using various different types of Internet-based tools, they expressed moderate interest in each option.[120] Specifically, tools to compare fees of different mutual funds scored a 7.43 on a 10-point scale; interactive tools to illustrate risk/return scenarios for various products scored 7.34; and interactive tools to help investors evaluate their financial goals scored 7.28. Access to disciplinary records for broker-dealers and investment advisers, something most experts agree investors should evaluate when selecting a financial professional, scored a 7.16. Younger investors expressed the greatest interest for each type of Internet-based tool.

One possibility that Internet disclosure opens up is providing certain types of disclosures, most notably cost disclosures, in ways that are more relevant to the investor. When a financial adviser recommends a dollar amount investment in a particular product to the investor, or

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[120] See ARC Survey Report, page 39-40.

compares two or more investment options, it ought to be quite easy, using Internet-based tools, to provide the investor with dollar amount cost information. This would likely be far more compelling to investors than the percentage fees that are typically provided. It could be made even more compelling if it included the impact of those costs over the expected lifetime of the investment. Investors who see the significant impact that apparently minor differences in cost could have on their financial well-being, and see that information not in generic terms but particularized to their personal situation, may come to place significantly more value on cost disclosures. The capacity of the Internet for providing this information quickly and at little cost enables us to think differently about not just how we deliver information but the kinds of information we are able to provide.

While some investors are unlikely ever to make more than minimal use of disclosure materials, preferring to rely exclusively on a financial professional for advice, others could reap significant benefits. The easier the materials are to access, the more relevant their content, and the more appealing their design, the more likely it would seem to be that investors would make use of them.

VI. Conclusion

In the nearly two decades since the SEC first issued its guidance regarding electronic delivery of disclosures, financial services firms have enthusiastically embraced the Internet as a central component of their communication strategy. While different firms take very different approaches, use of the Internet to communicate with customers is all but universal today. In many ways, firms are able to make better use of the Internet for purposes other than the delivery of mandatory disclosures, which is the topic of this study. Operating outside the legal constraints imposed on mandatory disclosures, firms are able to explore more freely how the Internet can be used to improve the way we communicate with investors. Advances firms have made in these areas can offer valuable insights into how the effectiveness of mandatory disclosures could be enhanced in an Internet-based system of disclosure. These insights come at an important time, where serious questions have been raised regarding the effectiveness of our current disclosure system in providing investors with the information they need, in a form they can understand, at a time when it is useful to them in making an investment decision.

Appendix A: Next Steps

Resolving the full range of questions about how the Internet can be used to improve the effectiveness of disclosure will require a more in-depth policy discussion. The following are two areas where we believe additional steps would be useful in furthering that policy discussion.

- Alternatives Approaches to Decisions about Delivery

Evidence suggests that, under today's opt-in approach to electronic delivery, fewer investors receive disclosures electronically than are willing, or even prefer, to do so. On the other hand, the percentage of investors who prefer paper disclosures is large enough that an opt-out approach, under which investors would be defaulted into electronic delivery, seems no more likely than opt-in to produce optimum results. In order to try to resolve this stalemate, a policy discussion could be convened to examine possible alternatives to the opt-in/opt-out delivery paradigm.

- One question ripe for discussion is whether it is possible to design a forced-choice approach that requires the investor, as part of the account-opening process, to make an affirmative choice between paper and electronic delivery rather than being defaulted into one option or the other. If so, how would such an approach work? What safeguards could and should be built into the system to ensure easy switching among delivery mechanisms? What if any policy changes would be needed to bring it about?

- Short of a forced choice, are there other alternatives that ought to be considered to ensure that actual delivery choices more closely track delivery preferences? For example, in accordance with the E-SIGN Act, current policy requires that investors who choose to receive disclosures electronically make that choice through an electronic format. Could that requirement be loosened to allow for investors to choose electronic delivery when filling out account-opening paper work? If so, what safeguards should be included to ensure that investors make an informed choice? Are there additional safeguards, such as monitoring to ensure that investors actually access their disclosure documents, that would ease concerns regarding such an approach?

- Another issue deserving further consideration is whether all of the documents that are currently subject to a delivery requirement are appropriately required to be delivered. Are there certain documents currently subject to a delivery requirement where ready access, and an ability to choose to have the document delivered, would be sufficient? If so, what safeguards should be built into the system to ensure that investors are receiving adequate notice of and easy access to the additional disclosures that are not subject to a delivery requirement? Would such documents need to be reconfigured to move certain information into other documents that are subject to a delivery requirement?

Investor advocates, regulators, academics, Internet policy experts, and industry representatives could be brought together for a discussion or series of discussions to explore these questions. The goal of such a discussion would be to seek ideas, and possibly even consensus, about alternative approaches that might help promote a transition to Internet disclosure without impeding the ability of those who prefer to receive documents in paper form to continue to do so.

- Alternative Approaches to Disclosure Design

A repeated refrain in the course of this research was that additional regulatory flexibility is needed if disclosure documents are to be designed in ways that promote innovation and fully capitalize on the capacity of the Internet to improve disclosure effectiveness. A useful experiment would be to recruit financial firms to develop mock Internet-based disclosure documents freed from the rigid requirements that govern those disclosures today. Two documents – the mutual fund summary prospectus and the ADV form – would lend themselves particularly well to such experimentation. Both are commonly used with retail investors. Both supply information that is directly relevant to important investment decisions (e.g., selecting a mutual fund and choosing a financial adviser). And both could benefit from greater design innovation. Ideally, it would be possible to test the new approaches with investors to determine whether they are, in fact, more effective in conveying essential information.

As part of this experiment, it would be useful to discuss the policy changes that would be needed to permit and encourage design innovations. Would enhanced regulatory flexibility be sufficient? If so, what safeguards are needed to ensure a basic level of comparability among disclosures and to ensure that important information doesn't get lost? Or is legal liability, as some have suggested, the real culprit that prevents design innovation? If so, is it possible to design a system that promotes innovation without sacrificing accountability? What would the key features of such a system include?

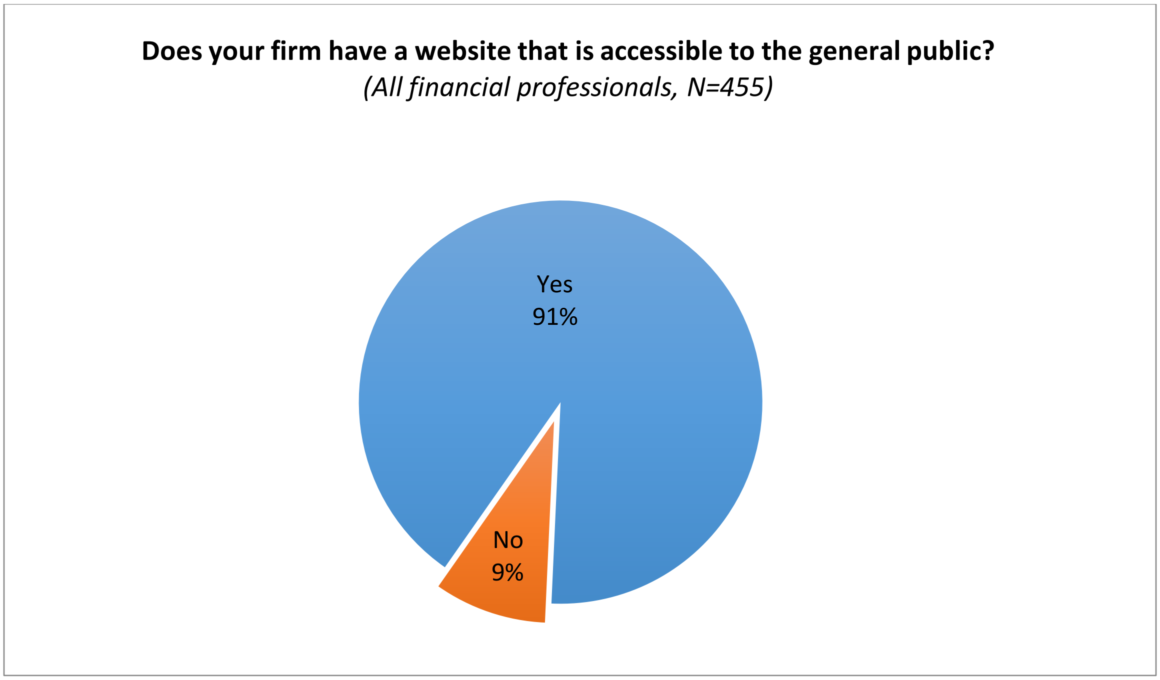
- Best Practices

While some changes designed to capture the benefits of Internet disclosure will require additional policy changes, there remains much that firms can accomplish by adopting best practices under the existing legal framework. Indeed, financial firms are out ahead of regulators when it comes to capturing the benefits of the Internet for communicating with investors. One goal of this report is to identify industry best practices that can be adopted to improve communications with investors and can be adapted to mandatory disclosures in ways that enhance the effectiveness of those disclosures. Disseminating this report more broadly can help to promote that goal and – as additional feedback comes in from financial services firms, regulators, other policymakers, investor advocates, and academics – further refine the report findings.

Appendix B: The Transition to an Internet-based System of Disclosure is Well Underway

A basic premise of this paper is that we are currently in a transition from a paper-based system of disclosure to one that will eventually be primarily Internet-based. The survey of financial professionals conducted for this study provides extensive supporting evidence. The following is a summary of key survey findings describing the current state of play in the transition to an Internet-based system of disclosure.

Figure 13: Financial Firms' Presence on the Internet



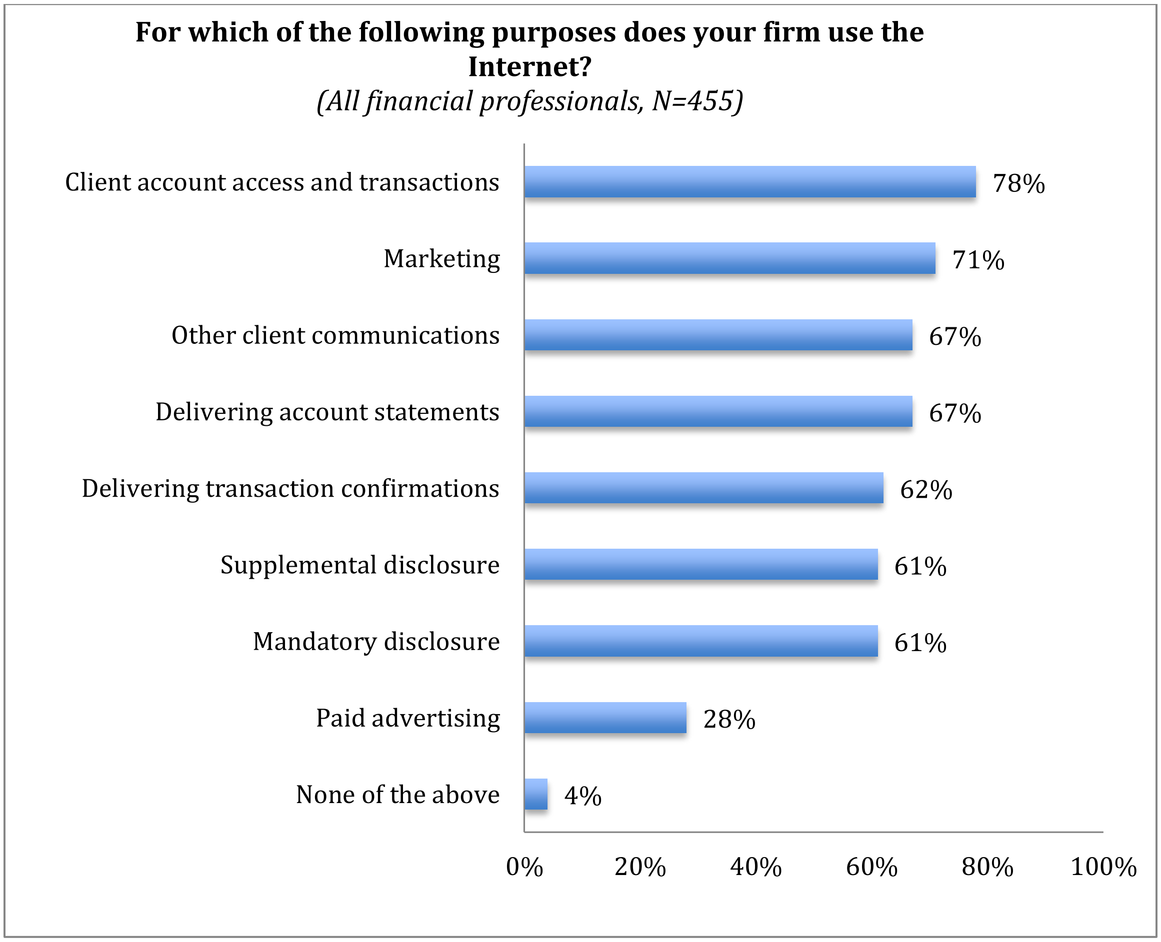
Source: ARC Survey Report, page 24

The vast majority of financial firms maintain a presence on the Internet. Fully 91 percent of the financial professionals surveyed for this study stated that their firm has a website that is accessible to the general public.[121] Firms use their websites for a variety of purposes, including: client account access and transactions (78 percent), marketing (71 percent), delivering account statements (67 percent), other client communications (67 percent), and delivering transaction confirmations (62 percent). Six in ten (61 percent) reported using the Internet to provide mandatory disclosures to investors, and the same percentage reported using the Internet to provide supplemental disclosures. Brokers are more likely than other types of financial firms to report using the Internet to deliver mandatory disclosures.[122] Among the financial professionals surveyed, 70 percent of broker-dealers, but just 54 percent of other firms, reported using the Internet for this purpose.

[121] See ARC Survey Report, page 23-25.

[122] Ibid, page 12-13

Figure 14: Purposes for Which Financial Firms Use the Internet



Source: ARC Survey Report, page 25

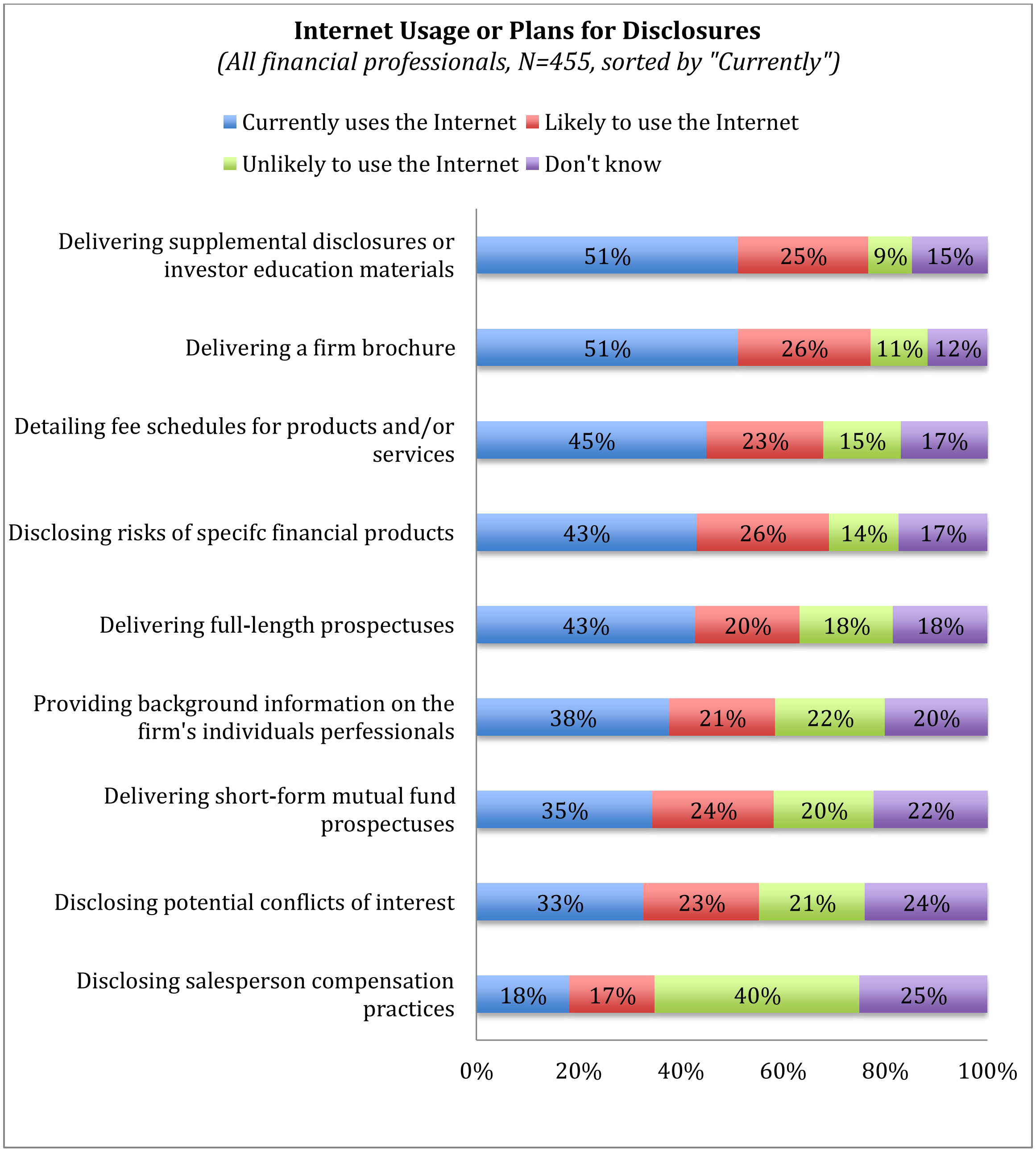
Financial professional survey respondents were asked about their firm's use of the Internet to deliver certain types of disclosures to investors. The list included both mandatory disclosures and other supplemental information that is viewed as valuable for investors but that is not required to be disclosed.[123] For each, the financial professional was asked whether their firm currently uses the Internet for the stated purpose, expects to do so within a few years, or does not expect to do so within a few years.[124] Firms were most likely to be using the Internet to deliver investor education and other types of supplemental information to investors, with 51 percent indicating that they currently do so and another 25 percent indicating that they expect to do so within a few years. Firms were least likely to be using the Internet to provide information on salesperson compensation practices, with only 18 percent indicating they currently do so and 40 percent indicating that they do not expect to do so in the near future. Interestingly, 38 percent of

[123] The list included: supplemental disclosures or investor education materials, a firm brochure (mandatory for investment advisers but not brokers), fee schedules for products and services, information on risks for specific financial products, full-length prospectuses, background information on the firm's financial professionals, short-form mutual fund prospectuses, potential conflicts of interest, and salesperson compensation practices.

[124] See ARC Survey Report, page 17-19.

survey respondents said their company uses the Internet to provide background information on the firm's individual professionals, something that was not common on financial firm websites reviewed for this study.

Figure 15: Financial Firms' Current and Expected Website Usage



Source: ARC Survey Report, page 17

Among the financial firm websites reviewed for this study, it was common practice to include a password-protected area of the website where customers of the firm can access account documents. However, our survey found this to be less common: 37 percent of financial professionals said their firm has online resources that are available only to the client, while 52 percent indicated that they did not.[125] In using the Internet to deliver disclosures, a plurality of financial professionals (46 percent) said their company makes disclosure documents available to the general public, while just over a third (36 percent) said they make those disclosures available to customers only.[126] Broker-dealers were significantly more likely than other firms to make such disclosures available to the general public. Whereas 55 percent of broker-dealers said they made their disclosures available to the general public, only 37 percent of other firms indicated that they did so.

Figure 16: Password-protected Access on Financial Firm Websites

Source: ARC Survey Report, page 24

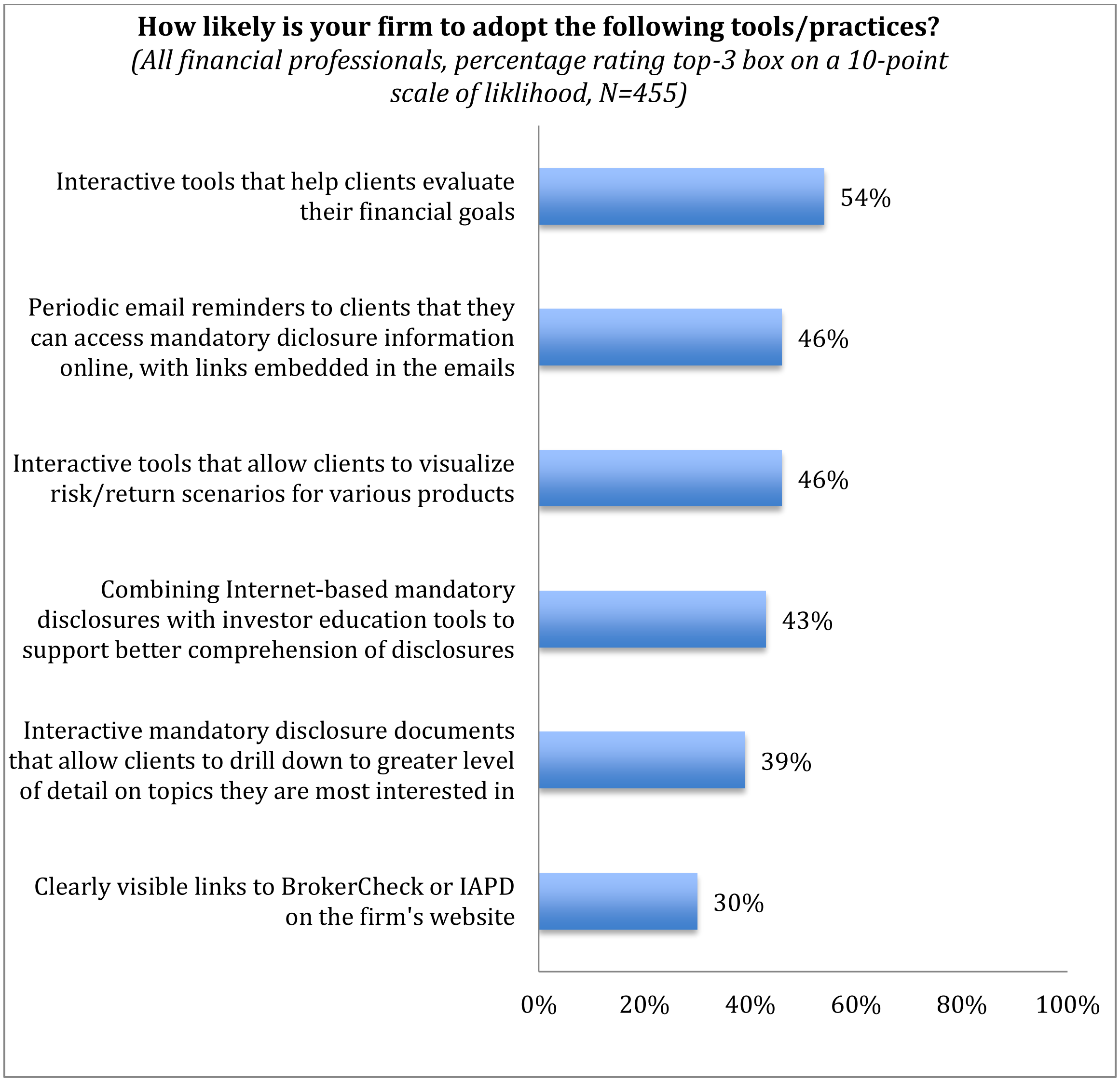
Asked about a list of Internet-based tools that firms might consider adopting for their retail clients, financial professionals suggested that the most likely tools to be adopted are "interactive tools that help clients evaluate their financial goals."[127] Just over half of financial professionals (54 percent) indicated that their firm would be likely to adopt such a tool. None of the other examples was cited by half of the financial professionals surveyed. In general the likelihood of adopting Internet-based tools appears to be associated with the size of the firm as firms with more than 5,000 employees are significantly more likely to adopt Internet-based tools and practices than firms with fewer than 5,000 employees.

[125] Ibid, page 23

[126] Ibid, page 12. Another 18 percent said they did not know what their firm policy was.

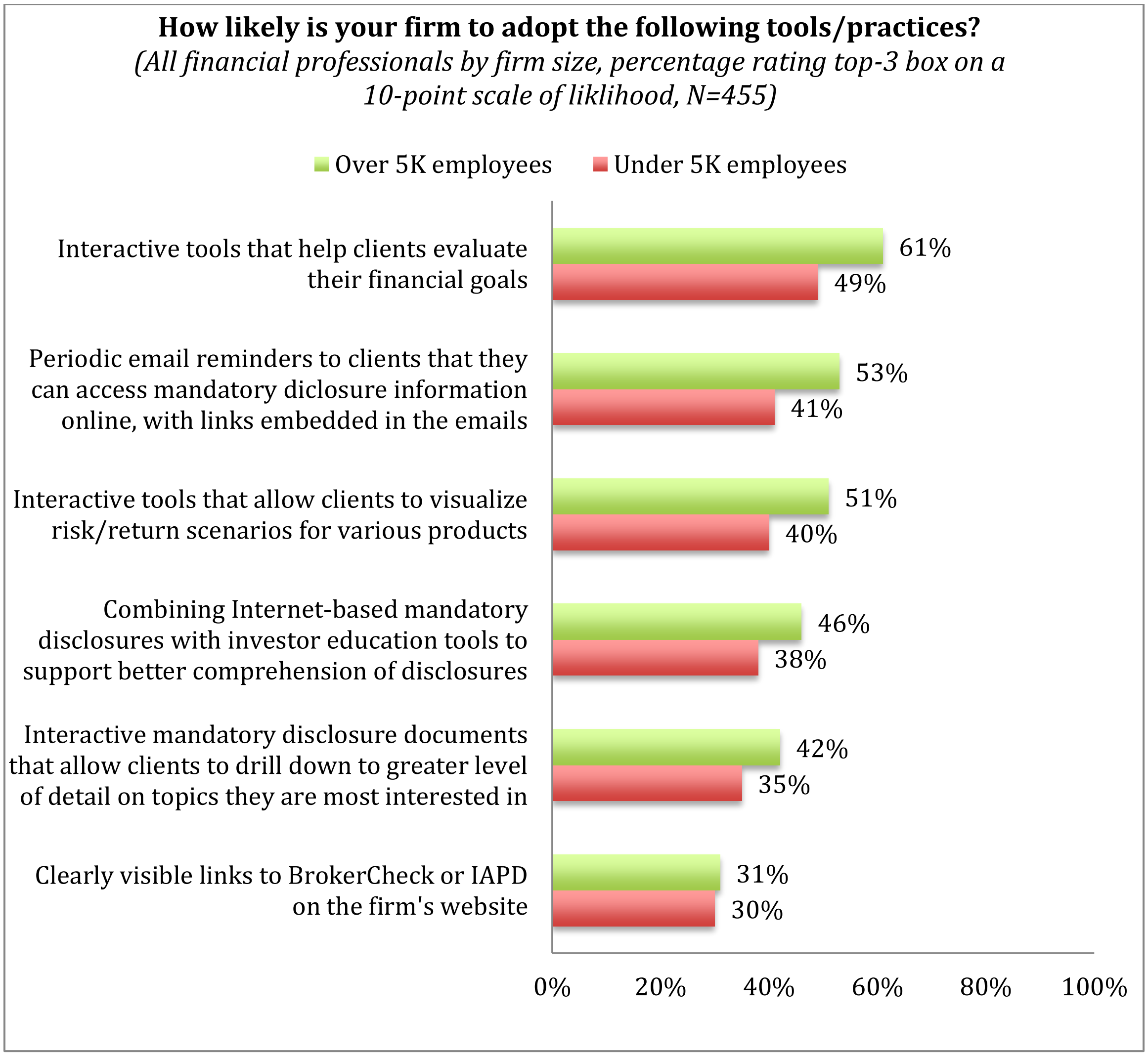
[127] Ibid, page 17-19

Figure 17: Likelihood that Financial Firms Will Adopt Internet-based Tools and Practices



Source: ARC Survey Report, page 18

Figure 18: Likelihood of Adopting Internet-based Tools and Practices by Firm Size



Source: ARC Survey Report, page 19

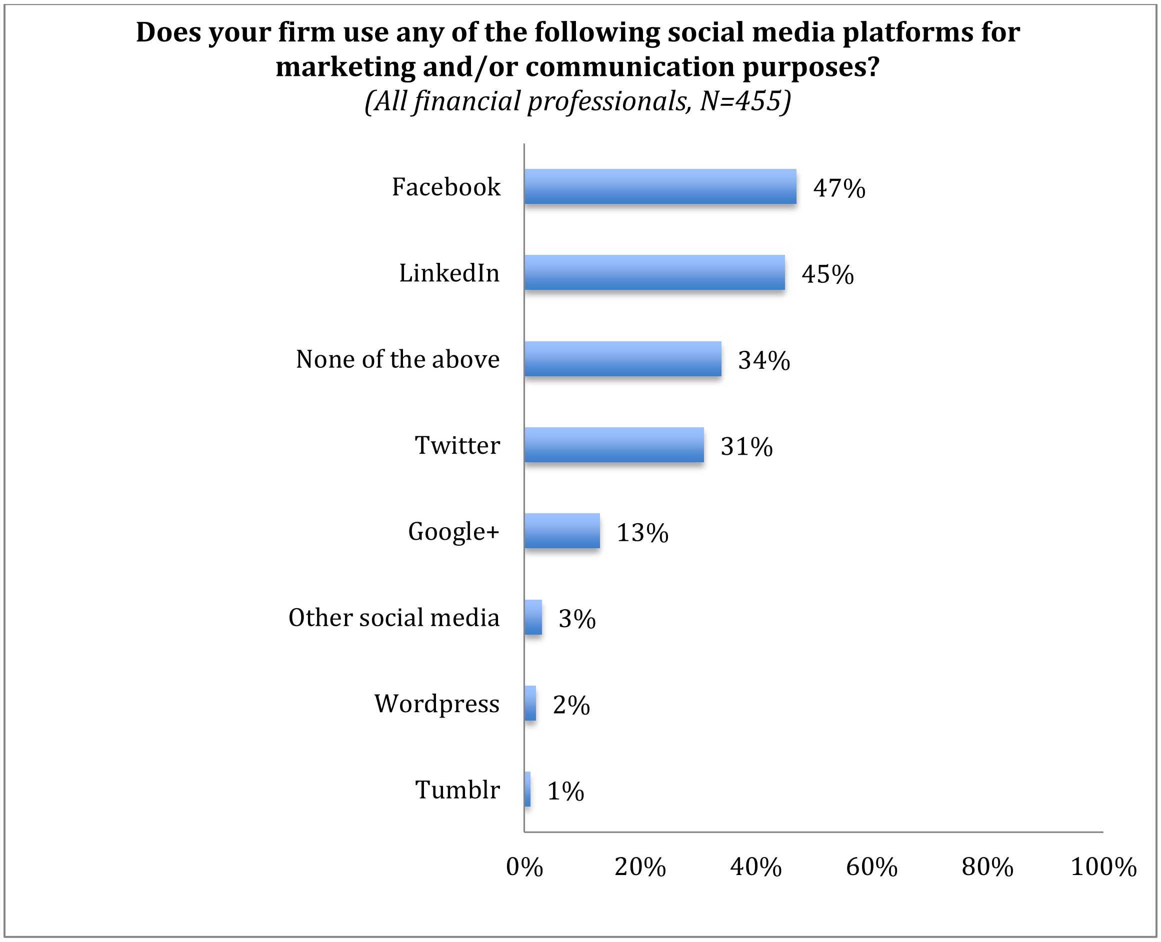
Even as we grapple with the implications of Internet disclosure, social media and other technological developments are introducing a whole new set of challenges. According to our survey of financial professionals, usage of social media among firms is fairly widespread.[128] Facebook (47 percent), LinkedIn (45 percent) and Twitter (31 percent) are the most used platforms. Larger firms (with more than 5,000 employees) are more likely to utilize the major social media platforms. A third of financial professionals (34 percent) indicated that their firm does not use any social media platforms. At the same time, 65 percent of financial services firms have taken steps to make their online resources available through mobile technologies.[129] Of those firms that have not yet moved their resources to mobile platforms, one quarter (25 percent) indicate that they plan to do so in the near future. As with social media, larger firms are more

[128] Ibid, page 26-27

[129] Ibid, page 27-28

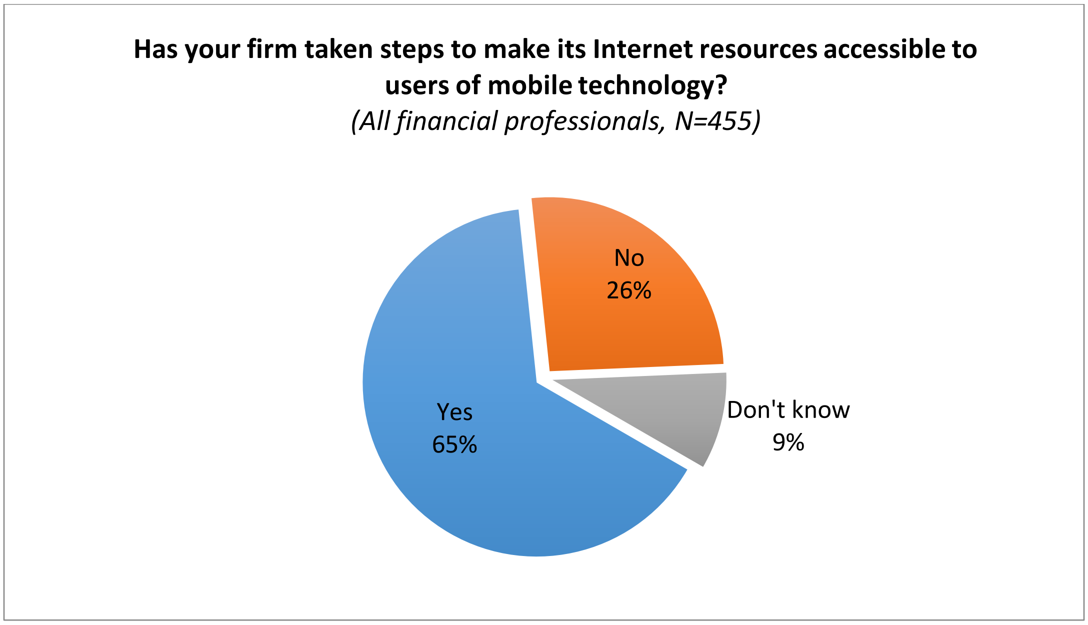
likely to have dedicated resources to mobile technologies. The vast majority of companies with more than 5,000 employees (87 percent) have started to make their resources available on mobile devices compared to only 49 percent of firms with fewer than 5,000 employees. Broker-dealer firms (71 percent) are also more likely than other firms to enable mobile users.

Figure 19: Financial Firm Use of Social Media



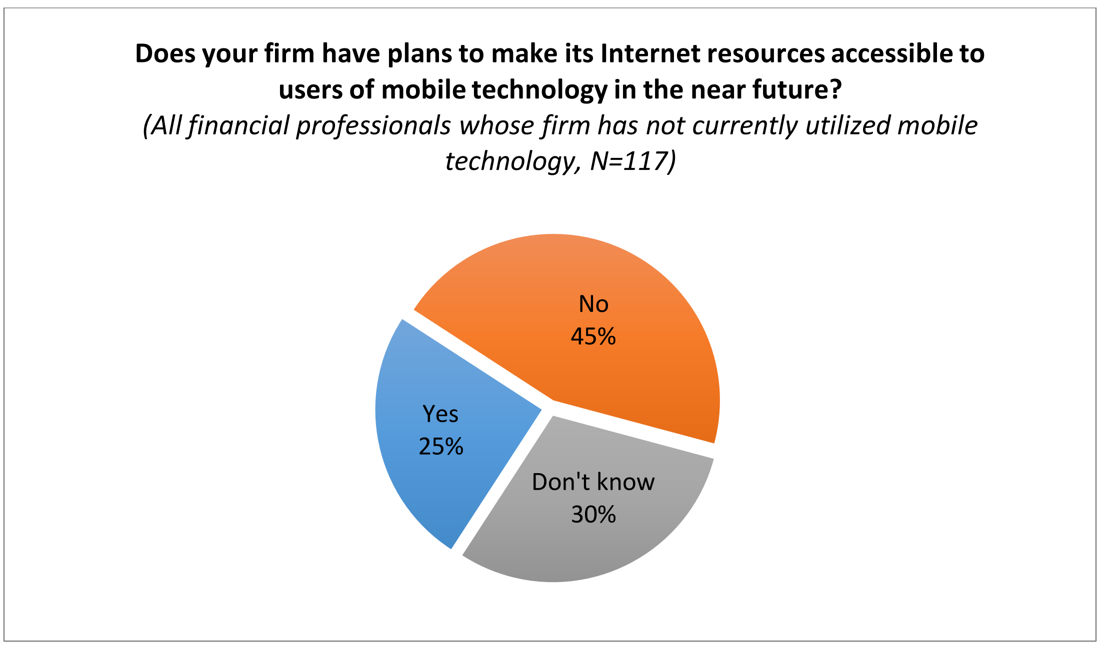
Source: ARC Survey Report, page 27

Figure 20: Financial Firms' Current Provision of Mobile Access



Source: ARC Survey Report, page 28

Figure 21: Financial Firms' Plans for Provision of Mobile Access



Source: ARC Survey Report, page 28

While this paper does not deal specifically with issues related to social media and mobile apps, clearly any long-term policies addressing electronic disclosure will have to grapple with the particular issues these new media raise.