

Improving the Quality of Mutual Fund Disclosure  
Speaker Comments  
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Thank you for giving me the opportunity to participate in this discussion on improving the quality of mutual fund disclosure. My name is Don Phillips and I'm a Managing Director at Morningstar. Morningstar is an investment research company that provides data on more than 145,000 investment securities, including over 50,000 mutual funds, around the world. We serve large audiences of individuals, financial advisors, and institutional investors, giving us a panoramic view of the way many different constituents use investment data.

First, let me applaud the Securities and Exchange Commission for its continuing efforts to help investors make better decisions. The U.S. financial markets are the most transparent in the world. No where else do investors receive as fair an opportunity to participate in the financial markets as they do here, and the free and open flow of information is at the heart of all investor protections. The Commission and the many other interested parties participating in today's discussion, including the Investment Company Institute, deserve credit for their role in maintaining the well-lit playing field on which mutual funds operate.

There's always room for improvement, however, and that's why the current discussion of the types of information that are most useful to mutual fund investors is so vital. Much of this debate will likely be about condensing the large amount of information in mutual fund prospectuses into a handful of significant data points that can be presented to an investor at or near the point of sale. That's a noble and worthy endeavor; the current documents are unwieldy and difficult for the average investor to navigate. One could argue that the marketplace has addressed this need in many ways. Investment snapshots from firms like mine and others are widely available in print and on the web. Moreover, these reports have a significant advantage over a prospectus summary in that they can provide opinion and counsel as to the relative merit of a fund. But objective third-party reports aren't legal documents that can be required disclosure at the point of sale. There's a need for an official, simplified disclosure document.

At the same time, there's a risk of streamlined disclosure that should also be considered. Ensuring that some minimum amount of data is communicated will be helpful, but there's a danger if the public believes that this subset of information is all that they need to know or if fund companies operate as if this handful of facts is all that they must communicate. Consider the recent market timing scandals in the mutual fund industry. No discussion of a streamlined prospectus has advocated the inclusion of language concerning a fund's market timing policy, yet the events of the past few years have highlighted how

significantly market timing can scar a fund's performance record. Clearly, this is information investors have a right to know about if they so choose. While a shortened disclosure document has its place, there needs to be a place where all the terms under which a fund will operate are disclosed. The profile cannot replace the prospectus.

Very few investors buy mutual funds solely on their own. The vast majority have their choices influenced by some sort of intermediary, be it a financial advisor, their employer who selects funds for their defined contribution plan, a journalist who writes about funds, or a research firm like Morningstar. These parties are not only able to process more information than many individual investors, they have a professional, and sometimes a fiduciary, responsibility to do so. If the push toward a profile prospectus limits the flow of information to these parties, then investors will be ill-served.

The fund industry often complains of "disclosure creep," claiming that additional information would confuse investors and be costly to deliver. (They also complain that added disclosure would hurt them competitively relative to less regulated vehicles like hedge funds, but this claim is foolish and short-sighted; the fund industry has won its position of trust and has been rewarded with preferred positioning in government sanctioned programs like 401(k) plans primarily because it accepts higher standards.) The current discussion of how better to communicate with fund investors offers a solution to both these objections. If a prospectus summary were available, then added disclosure in the full prospectus wouldn't add to the clutter. If the full prospectus were available via the Internet or in print upon request, rather than mailed to every shareholder annually, then costs could be contained. For those professionals who access fund data this would be a fine solution, especially if the data in electronic filings were made easier to access, as will be discussed later today. This solution would allow both a basic document that has data an investor is deemed "to need to know" and a longer, electronic document that contains information that shareholders have a right to know and professionals have a responsibility to know.

Much of the discussion in the coming weeks will likely surround what data goes into the shortened document, but I'd encourage the Commission not to take its eye off the quality of information in the full prospectus, as that helps investors every bit as much, if not more so, as the summary. Let me give an example. In the wake of the fund trading scandals, the SEC required funds to disclose the philosophy of fund manager compensation. Few individual investors have likely read this disclosure, but many are apt to benefit from its effects. Since having to disclose this information, a number of major fund groups have told Morningstar analysts that they have reconsidered their manager compensation policies. Fund companies have told us that they are moving away from rewarding managers for asset growth (something few investors would care about) and have focused more on performance relative to peers (something investors decidedly do care about.) We've also seen the time period over which equity managers are evaluated stretch out from very short periods (one year or less) to three- and five-year periods. The fund companies making these changes have told us that the recently required disclosure was the catalyst for these changes. Thanks to this added disclosure, the time periods and measurements used to reward fund managers have become much more closely aligned

with the interests and time horizons of the investors they serve. So, even though few investors see this disclosure, many benefit from it.

I'd urge the Commission to continue to focus on the quality of information provided in the full prospectus and to do so with an eye not to what some party thinks an investor should know, but with the standard of what a shareholder as an owner has a right to know. There's an army of advisors and analysts who are able and willing to sort through this information and incorporate it into their recommendations. With most assets in the industry being influenced by these third parties, it is imperative that they continue to have the best information possible. On behalf of Morningstar and the investors we serve, I urge the Commission to continue its efforts to streamline point-of-sale disclosure, but at the same time remember that the fuller disclosure of the prospectus is every bit as important in helping investors. In the age of the Internet and with the large number of advisors and intermediaries willing to help, there's no reason investors can't have it both ways—consolidated and simplified data available upfront and more detailed information available separately via the web or on request.