



March 31, 2005

Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

*Re: Investment Company Act Release No. 26778 (March 1, 2005) (the "Supplemental Request for Comment")*

Dear Mr. Katz:

NASD staff appreciates the opportunity to express its view on the Securities and Exchange Commission's Supplemental Request for Comment.<sup>1</sup> While, in formulating our views, we reviewed thoroughly the recommendations of the Mutual Fund Task Force (the "Task Force"), which NASD organized and I chaired, this letter sets forth the views of NASD staff.<sup>2</sup>

NASD commends the Commission's significant efforts to assure that investors are provided effective disclosure of information concerning mutual funds and other products at the point of sale. The Commission's proposal is an important step forward for the investing public. We would be pleased to discuss any aspect of the Supplemental Request for Comment. However, in this letter, we are commenting on certain specific aspects of the Supplemental Request for Comment. In particular, NASD staff recommends the following:

- § The SEC should require focused disclosure about the risks, investment strategies, and other characteristics of a mutual fund, in addition to disclosure about fees, expenses and dealer incentives. The "Profile Plus" document developed by the Task Force would accomplish this result.

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<sup>1</sup> The comments provided in this letter are solely those of the staff of NASD; they have not been reviewed or endorsed by the Board of Governors of NASD. For ease of reference, this letter may use "we," "NASD" and "NASD staff" interchangeably, but these terms refer only to the NASD staff.

<sup>2</sup> For ease of reference, we enclose a copy of the Task Force report.

- § Internet disclosure is the only effective way to assure that investors receive the information they desire at the point of sale. The Commission should mandate Internet delivery of the point of sale disclosure document.
- § The SEC should take an “access equals delivery” approach to mutual fund prospectus delivery.
- § In the point of sale disclosure document, the SEC should simplify disclosure about annual expenses into a single, bottom-line number.
- § The SEC should not require disclosure of expenses based upon actual investment amount because it would be confusing to investors. If the Commission nonetheless decides to require such disclosure, delivery via the Internet is the way to facilitate implementation of this requirement.

*1. Point of Sale Disclosure through the Profile Plus*

Commission Rule 498, adopted in 1998, allows funds to deliver a short, simple summary prospectus, called a “profile.” The profile was designed to provide all of the information about a mutual fund that an informed investor would need to know. Nevertheless, few mutual funds have used the fund profile in the retail market, primarily because of liability concerns.

Building upon the original profile, the Task Force developed the Profile Plus, a simple, two-page document that includes hyperlinks to additional and more detailed information, the efficacy of which depends on use of the web-based delivery, as discussed below. The Profile Plus contains:

- basic information about the fund’s investment strategies and risks, with hyperlinks to additional information in the prospectus;
- a ten-year performance chart to illustrate the volatility of the fund’s shares;
- average annual returns of the fund over the past 1-, 5- and 10-year periods;
- the total fees and expenses paid by a shareholder – both transaction fees and fund operating expenses, presented in dollar and percentage terms, based on \$1,000, \$50,000 and \$100,000 hypothetical investments – with a hyperlink to further detail in the prospectus;
- a brief explanation of portfolio transaction costs, with a hyperlink to detailed information about the fund’s portfolio transaction costs;<sup>3</sup> and

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<sup>3</sup> The Task Force recommended this disclosure of portfolio transaction costs in its earlier report. *See Report of the Mutual Fund Task Force: Soft Dollar Practices and Portfolio Transaction Costs 15-17* (Nov. 2004, available at [www.nasd.com](http://www.nasd.com)).

- through two “yes/no” questions, basic information about revenue sharing and differential compensation arrangements, with hyperlinks to additional information in a dealer disclosure statement.

To support the Task Force, NASD engaged Applied Research and Consulting LLC (“ARC”) to conduct usability testing of the Profile Plus and compare the point of sale disclosure document recently proposed by the Commission and the Profile Plus.<sup>4</sup> All investors interviewed by ARC were interested in the information provided on page one of the Profile Plus regarding the fund’s investment strategies, risks and performance. For example, investors had the following comments concerning the risk disclosure:

§ *“This is good. It’s common knowledge (i.e., volatility), but it’s scary to see it.”*

§ *“[The SEC form] is missing a couple of key features. I would add the performance and risk information [to the SEC form], and the other basic information about the kind of fund.”<sup>5</sup>*

§ *“I think they need to tell you that there is a risk. No surprises there. I would expect this information.”*

NASD recommends that the Commission mandate delivery by broker-dealers of a Profile Plus for each fund that the broker-dealer sells. Through this mandate, the Commission would ensure that simple, clear disclosure reaches the retail investor. Moreover, Commission-mandated, line item disclosure might address some of the liability issues that flow from voluntary disclosure in a simplified format. The inclusion in the Profile Plus of hyperlinks to the full fund prospectus, which depends on delivery via the Internet, also should alleviate liability concerns.

## 2. *Internet Disclosure*

NASD recommends that the Commission require that broker-dealers post the Profile Plus on their web sites, with activated hyperlinks.<sup>6</sup> The Commission also should require that, contemporaneously with making a recommendation to purchase a fund, a registered representative either refer the customer to the Profile Plus on the broker-dealer’s web site or e-mail a web site link to the customer. In referring a customer to the disclosure, the registered representative should explain that the Profile Plus contains important information concerning costs and potential conflicts of interest.

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<sup>4</sup> For ease of reference, we are enclosing a copy of the ARC report.

<sup>5</sup> ARC did not tell the investors interviewed that one form was developed by the SEC and the other by the Task Force.

<sup>6</sup> Direct-sold mutual funds should be required to provide the Profile Plus, modified as appropriate, and the fund prospectus on the fund complex web site, so that investors in those funds have access to comparable disclosure.

Internet delivery of the Profile Plus would allow investors to review the information at the level of detail that they prefer and to compare different funds easily. The Profile Plus should provide the level of disclosure that many investors would desire. However, any investor that seeks additional information could hyperlink to the full fund prospectus and to the dealer disclosure statement concerning potential conflicts of interest. Absent an Internet delivery requirement, the federal securities laws would continue to impose an inflexible regime that delivers virtually the same level of disclosure to every investor.

Most investors today have ready access to the Internet, as the Commission itself has recognized.<sup>7</sup> Internet delivery has other advantages for these investors. For example, through on-line disclosure, an investor can more easily compare the features of different funds. And as the Commission stated in the Supplemental Request for Comment, point of sale disclosure is intended to provide investors with key information contemporaneously with their investment decision.<sup>8</sup> For most investors, web site disclosure is the quickest and most straightforward way to deliver point-of sale information to investors.<sup>9</sup> Finally, Internet delivery of information facilitates prompt updating when needed.

An oral delivery requirement would present distinct difficulties. It is difficult for firms to monitor oral delivery by their registered representatives. Moreover, it is difficult for investors to digest complex information received through oral disclosure.

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<sup>7</sup> In proposing changes to the registration, communications, and offering processes under the Securities Act of 1933, the Commission recently stated:

“Internet usage in the United States has grown considerably since 2000 when we published our most recent interpretive guidance on the use of electronic media in securities offerings, including with regard to prospectus delivery by electronic means. For example, recent data indicates that 75% of Americans have access to the Internet in their homes, and that those numbers are increasing steadily among all age groups. See, Three out of Four Americans Have Access to the Internet, Nielsen/NetRatings, March 18, 2004; Robyn Greenspan, Senior Surfing Surges, ClickZNetwork, Nov. 20, 2003 (citing statistics from Nielsen/Net Ratings and Jupiter Research). In addition, there is evidence suggesting that the “digital divide” is diminishing. See, for example, Kristen Foundain, Antennas Sprout, and a Bronx Neighborhood Goes Online, The N.Y. Times, June 10, 2004, at G8; Steve Lohr, Libraries Wired, and Reborn, The N.Y. Times, Apr. 22, 2004 at G1.”

Securities Exchange Act Rel. No. 50624 (Nov. 3, 2004) at n.353 (the “Prospectus Delivery Release”).

<sup>8</sup> See Supplemental Request for Comment at 28.

<sup>9</sup> As the Task Force recognized, some investors may not have access to the Internet or for other reasons may not want to obtain this information in electronic form. We support the Task Force’s recommendation that the Commission require that broker-dealers offer their customers the option to elect to receive the Profile Plus and dealer disclosure statement in hard copy form. If a customer elects hard copy delivery, the Commission should require that the broker-dealer transmit the Profile Plus and the dealer disclosure statement by e-mail or in paper form through regular mail or hand-delivery as soon as practicable after the mutual fund recommendation is made.

Hard copy disclosure presents its own problems. If broker-dealers must provide hard copy disclosure before accepting an order, then the customer may be precluded from executing the order as quickly as desired.<sup>10</sup> Web site delivery avoids these problems and provides investors instantaneous access to the necessary disclosure.

The ARC Report showed an investor preference for web site delivery. Surveyed investors had the following comments:

- *“It is much easier to navigate online than to sit down and read. If I need to I can print it, but a big package mailed to me with all that stuff is too much.”*
- *“The less paper I get the better. I think e-mail is the way to go.”*
- *“It is better to read it for yourself, and online is much better. Waiting for mail is archaic.”*
- *“The more I think about it, the more I’d like to have it online. I’d like to receive an e-mail and then go to the website. Then I can look at the stuff I want to see.”*
- *“Just send it to me in an e-mail. In the e-mail, not an attachment. . . [A website] would be nice. Those kind of links are good.”*

Needless to say, we disagree strongly with the statement in the Supplemental Request for Comment that “web site disclosure . . . could be ineffective at providing investors with key information about costs and conflicts contemporaneous with investment decisions as point of sale disclosure.”<sup>11</sup> As a regulator charged with the protection of investors, NASD feels strongly that a web site model best furthers that critical objective. Simply put, web site delivery – accompanied by the appropriate referral of the investor to the information – is by far the most effective mode of delivery; it is the right way to deliver the right information to investors at the right time.

### 3. “Access Equals Delivery”

In November 2004, the Commission proposed an “access equals delivery” approach to delivery of industrial company prospectuses.<sup>12</sup> Under this model, issuers and broker-dealers can satisfy their final prospectus delivery obligations if a final prospectus is on file with the Commission within the required

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<sup>10</sup> See Supplemental Request for Comment at 28-29.

<sup>11</sup> *Id.* at 28.

<sup>12</sup> See Prospectus Delivery Release.

time. The Commission did not, however, propose to apply this model to registered investment companies.<sup>13</sup>

NASD urges the Commission to extend the “access equals delivery” approach to mutual funds. An investor’s access to the fund prospectus through the Internet should constitute delivery for purposes of the federal securities laws. The Commission has recognized the need to modernize prospectus delivery obligations in view of technological and market structure developments of recent years. These developments also justify an “access equals delivery” position with respect to mutual fund prospectuses.

Few firms have used the mutual fund profile prospectus, in part because there has been concern over the potential liability exposure that the profile presents. By adopting an “access equals delivery” approach to the full prospectus, the Commission would ameliorate many of these concerns, and would better ensure that investors receive concise, useful disclosure concerning the mutual funds that they are considering.

#### 4. *Disclosure of Total Expenses*

The Profile Plus includes a “Fees and Expenses” table, which sets out the total fees and expenses paid by a shareholder – both transaction fees and fund operating expenses -- in dollar and percentage terms, based on \$1,000, \$50,000 and \$100,000 hypothetical investments. Total fund operating expenses would be presented as a single number, and not broken down into components.

ARC’s research revealed that investors are interested primarily in the total amount of the fees that they pay, and the effect of these fees on fund performance, not on a breakdown of fees.<sup>14</sup> Some investors expressed the view that only the total amount was important to them, and others found the breakdown categories unclear or vague.<sup>15</sup> Investors commented:

- *“It adds up to 1.38%. I already knew that from before. Why should I care about this? It won’t affect how much I’m paying.”*
- *“This is what it’s going to cost. Whether you call it a management fee –what does it matter to me? It doesn’t help any.”*
- *“This is where I tune out. It’s just gobbledygook.”*

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<sup>13</sup> The Commission noted that funds “are subject to a separate framework and that it would be more appropriate to consider any changes to our prospectus delivery requirements as they apply to registered investment companies and business development companies in the context of a broader reconsideration of this framework.” Prospectus Delivery Release, 69 Fed. Reg. at 67439.

<sup>14</sup> Of course, the Profile Plus allows those investors interested in a breakdown of total fund expenses to obtain this information easily by clicking through to the appropriate section of the fund prospectus.

<sup>15</sup> See ARC Report at 10.

For this reason, NASD recommends that the Commission require point of sale disclosure of total expenses, without requiring disclosure of the various expense components.

5. *Problems with Fee Disclosure Based on Actual Investment*

The forms accompanying the Supplemental Request for Comment provide disclosure of fees and expenses that are based upon hypothetical \$1,000, \$50,000 and \$100,000 investment amounts. In doing so, they achieve the primary purpose of fee disclosure, which is to allow investors to compare the fees and expenses of different funds. Investors were interested in this information and the current version of the Profile Plus follows the Commission's lead concerning hypothetical investment amounts.

However, the Commission forms also provide an opportunity for an investor to request disclosure with respect to his actual investment.<sup>16</sup> This "actual investment" disclosure could confuse or mislead investors, particularly with respect to ongoing expenses. Although the proposed forms would provide an "estimated 1<sup>st</sup> year" amount, and would disclose the assumption that the value of the investment remains static, many investors likely would believe that the dollar amount represents the investor's actual share of expenses each year, for the life of the investment. In fact, this would rarely be the case, since the value of the investment would change.

In contrast, disclosure based upon the three hypothetical amounts allows the investor to compare the costs of different funds, without the potential confusion and without imposing the additional expense of actual investment disclosure.<sup>17</sup> Therefore, NASD recommends that the SEC require fee disclosure based only upon hypothetical investment amounts.

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<sup>16</sup> See Supplemental Request for Comment at 10.

<sup>17</sup> If the Commission determines to the contrary, NASD believes that the best way to deliver that additional disclosure is by allowing an investor to access an Internet-based calculator that would display the pertinent information after the investor enters his or her actual investment amount. This could be developed as an industry-wide utility, assuring consistency and radically decreasing expenses. Provision of this tool depends on the use of the Internet to deliver the information.

Mr. Jonathan G. Katz

March 31, 2005

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NASD appreciates the opportunity to express its views on the Supplemental Request for Comment and point of sale disclosure for mutual fund investors. If you have any questions regarding the foregoing or require additional information, please call Elisse Walter, Executive Vice President, at 202-728-8230, Tom Selman, Senior Vice President, at 240-386-4533, or Angela Goelzer, Associate Vice President, at 202-728-8120.

Very truly yours,

A handwritten signature in black ink that reads "Robert R. Glauber". The signature is written in a cursive, flowing style.

Robert R. Glauber  
Chairman and CEO

Enclosures

cc: Chairman William H. Donaldson  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Cynthia A. Glassman  
Commissioner Harvey J. Goldschmid  
Annette L. Nazareth  
Robert L.D. Colby  
Catherine McGuire  
Paul Roye  
Robert Plaze



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**MUTUAL FUND POINT OF SALE DISCLOSURE**  
**INVESTOR RESEARCH FINDINGS**

*PREPARED FOR*

**NASD**

*BY*

**APPLIED RESEARCH & CONSULTING LLC**

MARCH 23, 2005

## **BACKGROUND & OBJECTIVES**

In 2004, the SEC retained Siegel & Gale and Gelb Consulting Group to design and test forms for broker/dealers' disclosure of mutual fund sales fees to investors. The design process was conducted iteratively, with changes made to the forms after each round of research.

NASD engaged the services of Applied Research & Consulting (ARC) to conduct a further round of research to:

- Evaluate the usability of an alternative form designed by NASD;
- Understand how the effectiveness of NASD's alternative form compares to the effectiveness of the SEC's proposed form; and,
- Gather in-depth investor feed-back on a few specific design components of NASD's form.

## METHODOLOGY

In order to achieve the research objectives, ARC conducted in-depth, in-person interviews with individual investors in White Plains, NY; Alexandria, VA; and Bethesda, MD. Respondents were screened to ensure eligibility on several criteria, including:

- Having sole or shared responsibility for making decisions regarding purchases of investments;
- Having recently purchased at least one of the following categories of investment through a broker:
  - “loaded” mutual funds,
  - variable annuities, or
  - 529 plans where the underlying investment are mutual funds;
- Having total investments of at least \$2,000 and less than \$500,000; and,
- Being a high school or college graduate (excluding persons with graduate degrees).

In all three research locations, the NASD document was presented on a laptop computer as a PDF file with active online links to the underlying prospectus. The SEC forms were presented in hard-copy paper format.

All interviews began with a brief discussion of the respondents’ general approach to investing (including the type of investments they make and the ways in which they use brokers) to provide a context for their responses to the document. Following the introductory section, respondents were asked to evaluate the relevance and utility of the NASD prototypes and in Alexandria and Bethesda to compare them to the most recent version of the SEC form, as noted in the table below. Respondents were not told that one form was designed by NASD and the other by the SEC.

<b>White Plains</b> February 22, 2005 7 interviews	<b>Alexandria, VA</b> February 24, 2005 5 interviews	<b>Bethesda, MD</b> March 16, 2005 8 interviews
NASD Disclosure Form	NASD Disclosure Form	Revised NASD Disclosure Form
	SEC Disclosure Form (v3 pos class A, 11.10.04 from Gelb/Siegel & Gale research)	Revised SEC Disclosure Form (as of 3.16.05)

## RESEARCH FINDINGS – DAYS 1 AND 2 (WHITE PLAINS, NY AND ALEXANDRIA, VA)

Overall, the research yielded consistent results: respondents welcomed the information provided on the NASD Disclosure Form and generally reported that the two-page document is easy-to-understand, relevant, and informative. The document achieved its purpose of informing individual investors about the various sales charges and other fees, as well as brokers' potential conflicts of interest.

However, while respondents reported that they understood the main points of the document, they evidenced confusion in two areas:

- 1) On page two, some of the language and the order in which information was presented decreased the clarity of the message.
- 2) Respondents' understanding of the material occasionally decreased when they "clicked through" to the fund prospectus.

Other key findings include the following:

- Most of the respondents indicated that they preferred to receive the information online, instead of by mail or having their broker read the information over the phone.
- All respondents appreciated the information that was provided on page one regarding the fund's investment approach, risks, yearly performance and average performance.
- While respondents indicated that they are unlikely to read all the "fine print" included in the underlying fund prospectus, they valued having the ability to "click here for more information" without requesting a mailed prospectus or having to go to an online version of a prospectus.
- Following are the specific research findings about the document, organized by the same evaluative criteria used in the Gelb/Siegel & Gale report for the SEC:
  - Utility
  - Navigational Ease
  - Relevance
  - Clarity, and

- Educational Value

## Utility

The document created by NASD is organized into two pages. The first page provides “big picture” information to the investor about the fund’s investment approach, principal risks, and performance history.

- Investment Objective
- How We Invest
- Risks to You
- Year-by-Year Performance
- Average Performance

The second page details the fees, other charges and potential conflicts of interest a broker may have when recommending/selling the fund (i.e., revenue-sharing issues).

- Fees and Expenses
  - Sales Charges – Paid Directly By You
  - Annual Fund Expenses – Deducted from Fund Assets
  - Portfolio Turnover
- Potential Conflicts of Interest
  - Does the Fund or its affiliates pay us extra to promote this fund over other Funds?
  - Do we pay our personnel more for selling this Fund than for selling other funds we offer?

### *Findings:*

Page One: The information provided on page one was familiar to respondents, and they all indicated that this is the kind of information that they would expect to receive from their broker when considering an investment in a mutual fund. They liked having this information summarized for them and did not indicate any impatience or boredom in receiving the basic fund specifications, even if they were to receive similar information from other sources. On the contrary, several respondents indicated that they want even more in-depth data: specifically, a percentage breakdown of the kinds of industries that the fund invests in, with representative companies listed.

*“This is good. It’s common knowledge (i.e., volatility), but it’s scary to see it.” –  
White Plains*

*“I think the risk factors are explained well.” – Alexandria*

*“I think they need to tell you that there is a risk. No surprises there. I would  
expect this information.” – White Plains*

*“I wish there was more information about what’s in the fund.” – Alexandria*

Page Two: Respondents reported that the information on page two was not information that they typically receive before making an investment. While some respondents asserted that such fees and financial incentives are to be expected and would not change how they work with their broker, others indicated that the disclosure would prompt them to inquire more closely why their broker was recommending this particular fund over another.

*“That’s interesting. That seems like a lot of money. . . It’s direct, it’s clear. I’ve  
never seen the conflicts of interest spelled out before, but I suspected that they  
were there.” – Alexandria*

*“It breaks it down into layman’s terms. Normally it’s not like this. You never see  
numbers like this – I’ve never seen a dollar fee before.” – White Plains*

## **Navigational Ease**

Respondents viewed the document as a PDF file on a laptop computer. Links to the additional information were “live” and brought the respondents to a website.

Each of the two pages was organized in vertical columns with horizontal heading breaks.

### *Findings:*

Computer Literacy: All the respondents reported considerable experience with reviewing investment information online and demonstrated ease and comfort navigating through a computer-based document. In addition, no one demonstrated any problems with accessing more information by means of the “click-through” prompts.

*“It is much easier to navigate online than to sit down and read. If I need to I can print it, but a big package mailed to me with all that stuff is too much.” – White Plains*

**Delivery Mode:** When asked what method of delivery they preferred, the majority indicated a strong preference for online delivery. A small number of respondents were less firm in their preference, stating that either online or mail would be fine. No one indicated a preference for disclosure by phone.

*“The less paper I get the better. I think e-mail is the way to go.” – Alexandria*

*“It’s better to read it for yourself, and online is much better. Waiting for mail is archaic.” – White Plains*

*“The more I think about it, the more I’d like to have it online. I’d like to receive an e-mail and then go to the website. Then I can look at the stuff I want to see.” – Alexandria*

**Layout:** While most respondents reported no difficulties with the document set-up and layout, two respondents indicated that they prefer a horizontal orientation to a vertical one. One of those respondents also indicated a preference that the information be presented as hyperlink headlines (like the online *Wall Street Journal*), so that he can quickly assess all the topics and then click only on the ones that interest him.

*“This is easy to focus on section-by-section. I like that.” – White Plains*

*“I don’t see why there are two columns like this with a tall section on one side (i.e., Fees and Expenses) and short on the other (i.e., Potential Conflicts of Interest). I’m more into balance.” – White Plains*

## Relevance

Respondents demonstrated a very high degree of enthusiasm for the content of the NASD Disclosure Form. They asserted that if they were asked by their broker to read this document, they would do so, and that the information provided would be valuable in helping make investment decisions.

*“If someone I trusted sent it and said I should read it, I would.” – Alexandria*

*“All of this is basic, but you need to read it. . . But I still need to talk to someone – I would call [my broker] and ask what’s going on.” – White Plains*

*“I’ve never seen an upfront acknowledgement of getting paid more for promoting certain funds.” – Alexandria*

*“From what I’m hearing I’m constantly giving somebody money. . . I’m complaining, but it’s good for me to understand. For the most part, you’re telling me what I need to hear.” – White Plains*

However, not surprisingly, respondents generally demonstrated a great deal of trust toward their brokers – such trust being part of a successful, ongoing relationship. Respondents reported that the disclosure information might lead them to ask additional questions of their brokers about the merit of the fund, but implied that – given the underlying trust of the relationship – it probably would not lead to a strong movement away from their brokers’ initial recommendations.

*“The bottom line is that it’s not enough of an incentive for the broker to push it. I would have a problem if they’re pushing crap, but if [two funds are equivalent], I’m comfortable with what my broker recommends. He was referred by my father.” – White Plains*

*“As long as it doesn’t cost me more, that’s o.k. But it would make me wonder – is the fund not doing well if they’re trying to get the broker to push it more?” – White Plains*

## Clarity

All the respondents reported that the information provided on the two-page disclosure document was clear and understandable. However, when asked to explain to the interviewer what each section meant, respondents often “read back” incorrect information. The mis-readings seemed to stem from a combination of unclear language (e.g., the use of indefinite pronouns), a misleading hierarchy of information, and individual respondents’ inability to understand the meaning of the text.

Furthermore, as indicated above, clicking for more information sometimes actually increased misunderstanding. Because the NASD is not currently engaged in changing formats or specifications for investment prospectuses, ARC will only focus on text that the NASD can immediately make improvements upon (i.e., the two-page disclosure document and the “Message from XYX Broker”).



## Findings

Sales Charges – Paid Directly By You: Although there is a general understanding among respondents that brokers receive compensation for executing a mutual fund sale, respondents report that the exact amount of that fee is rarely – if ever – explicitly disclosed. Respondents liked to see the actual fee in dollars for each \$1,000 investment and reported that they clearly understood what the fee represented. One respondent, however, misunderstood the term “Sales Charge” to mean a fee he would pay when he sells the fund. Others demonstrated a lack of understanding that the fee is a one-time charge.

- Therefore, ARC recommends that the section be re-titled “One-Time Sales Charges – Paid Directly By You.”

In addition, the sentence immediately preceding the section referring to break-point fee reductions caused respondents to be distracted from the key point about the sales charge.

- ARC recommends that the sentence be moved after the Sales Charges disclosure and that it be re-written as follows for greater clarity:

“If you and your family invest at least ~~\$25,000~~ \$50,000 (NB: the dollar amount should match chart in the click-through) in the John Doe Family of Funds, then you may be eligible for a ~~fee~~ reduction in this charge.”

*“I want to know what a fee reduction is . . . [After click-through]. It’s not what I expected. . . I’m a little confused with this page. As a Class A shareholder, I might be eligible for a fee reduction, but I clicked on it and didn’t see anything.” – White Plains*

When they compared the NASD document to the SEC document, respondents indicated that they liked the SEC chart that presented three examples under the following column headings: “Contribution amount,” “Up front fee you pay,” “Your net investment value,” “Up front fee %.” Respondents were attracted by the easy interactivity of the bold fill-in boxes – and they assumed that if the document were online, the fees they would actually pay would be automatically calculated.

- ARC recommends at least providing additional examples of fees in a chart form, as well as an auto-calculation function, if feasible.

*“Do I have to pay 25 times \$57.50 if I were investing \$25,000?” – White Plains*

Only one respondent in Alexandria explicitly noted that he/she valued the fee comparative scale provided on the SEC document. This seemed to be a feature that was less necessary than others, but because of the small number of interviews, the findings on this feature are inconclusive.

#### Annual Fund Expenses:

While respondents claimed to understand this section, not all of them actually grasped that the fees are charged annually.

- Therefore, ARC recommends altering the heading to “Annual Fund Expenses – Deducted from Fund Assets Each Year.”
- ARC also suggests that the parenthetical phrase “(per \$1,000 investment over 12 months)” be edited as indicated and, for consistency, suggests it be moved below the phrase “Total Fund Operating Expenses.”
- To help respondents fully understand that they themselves will be paying these operating costs, it is recommended that “Total Fund Operating Expenses” be changed to “Estimated Annual Fee You Pay.”
- As with the “Sales Charges” section, respondents appreciated the SEC version, which featured a small chart of examples, as well as fill-in boxes that automatically calculate the annual fees they would pay.

Respondents did not find the detailed breakdown of Annual Fund Expenses (available by “clicking” for more information) either clear or useful. Several respondents observed that only the total amount was relevant to them as individual investors. Furthermore, respondents found the breakdown categories to be vague.

*“It adds up to 1.38%. I already knew that from before. Why should I care about this? It won’t affect how much I’m paying.” – Alexandria*

*“What is this ‘other expenses?’ That doesn’t tell me anything.” – White Plains*

### Portfolio Turnover:

This section seemed to be the source of the most confusion. Many respondents did not fully understand the implications of portfolio transaction costs. And a few even thought that the turnover percentage of 47% indicated the return on investment.

*“Turnover of 47% – I could use more of an example.” – White Plains*

*“47%. That’s high. That’s good. Remember, they lost money in 2002.” – White Plains*

*“47%. That sounds like profit to me.” – White Plains*

However, research indicated that the wording was clear for most respondents and need not be changed.

### Potential Conflicts of Interest:

Most respondents volunteered that they liked the question-answer format of the Conflicts of Interest Section. A majority of the respondents understood that this section revealed that their broker might not be working in the investor’s best interest by recommending this fund over funds with similar investment objectives and performance.

*“It’s telling you that they get more if they end up selling the fund, which I look at somewhat negatively, because it’s not in my best interest.” – Alexandria*

*“To think that there’s a conflict of interest is interesting. It’s good that you’re being told up front – it’s not so sleazy.” – White Plains*

*“That’s interesting information – not information I’d expect to see. I can see why the SEC would want us to know that.” – White Plains*

*“As long as they pay, I don’t care.” – White Plains*

The greatest misunderstanding in this section stemmed from the use of indefinite pronouns instead of proper nouns. The two main bullet points would be easier for respondents to understand if they were edited as follows:

- Does the John Doe Small Cap Fund or its affiliates pay ~~us~~ XYZ Brokerage Firm extra to promote ~~this~~ the John Doe Small Cap Fund over other funds?  
**Yes**
- ~~Do we pay our~~ Does XYZ Brokerage Firm pay its own personnel more for selling this Fund than for selling other funds ~~we~~ XYZ Brokerage Firm offers? **Yes**

In addition, the first sentence in the section (“Of the \$57.50 in sales charges, XYZ Broker receives \$50.”) misdirects investors from the main point of the Conflicts of Interest section: namely that the brokerage firm receives additional payments from the Fund, over and above the sales charges paid by the investor.

- ARC strongly recommends that this sentence be moved to the Sales Charges section: 1) to prevent a misunderstanding that the investor is paying for revenue sharing and 2) to focus investors on the potential conflict of interest, itself.

A Message From XYZ Broker: One of the biggest differences between the SEC form and the NASD form is the NASD’s “Message From the Broker” document. Investors expressed great appreciation for the additional information provided in this “click-through” document. However, respondents also demonstrated a wide range of interpretations of the document. In some cases, the language served to obfuscate – rather than clarify – the payments made by the Fund family to the Brokerage Firm and the incentives paid by the Brokerage Firm to its own registered sales reps. The greatest misunderstanding seemed to stem from the chart of fees: the headings were confusing to respondents and some respondents did not understand the rankings provided in parentheses.

*“It’s their ranking according to the best. . . Because it’s so popular, they [the broker] are getting more money.” – White Plains*

*“They’re comparing their fees to others?. . . This is confusing to me. . . And I don’t know what this 5, 3, 2 means.” – White Plains*

- It is also recommended that the table heading “Annual Asset Fees” be retitled “Fees Paid Annually By John Doe Small Cap Fund to XYZ Brokerage Firm” and “Sales Fees” be retitled “One-Time Fees Paid by John Doe Small Cap Fund to XYZ Brokerage Firm.” In addition, ARC suggests that the columns be switched to reflect the progression of fee payments.

## Educational Value

Most respondents were demonstrably surprised to learn the specifics of the purchase fees and on-going charges they pay when purchasing a mutual fund through a broker. Their comments often focused on their perceptions that the fees seem high, and that this is information that is important for them to know.

*“On top of sales charges, the fund has an operating expense. I think it’s pretty high. It’s good to know this information up front.” – White Plains*

*“It’s good. I like that it tells what the fund invests in, the risk, and the performance. How much it would cost per year. Right now, with my broker, I don’t really see that too often – it’s been kind of nebulous. It’s good to know that up front.” – Alexandria*

Overall, the five respondents in Alexandria preferred the NASD Disclosure Form to the SEC form for two main reasons:

- 1) the ease of reading and working with an online document, including the convenience of the “click-through” options, and
- 2) the inclusion of investment objectives, approach, risks and performance on page one.

The greatest relative advantage of the SEC version over the NASD alternative seemed to be the examples of the fees for varying investment amounts and bold fill-in boxes.

*“There’s more information on the NASD version, because of page one. Often prospectuses leave you wondering what you’re looking at. The NASD version gives me enough to make a decision – the SEC form would require me to look for more [information]. I’d go with the NASD, except possibly for the fees broken out by dollar amounts.” – Alexandria*

### RESEARCH FINDINGS – DAY 3 (BETHESDA, MD)

The reactions from respondents were consistent with those of the first two days of research. In this final day of research, investors responded favorably to “Page One” of the NASD prototype and typically preferred the SEC’s format to the NASD’s “Page Two.” As before, most respondents indicated a preference for electronic delivery, citing the benefits of instant access, ease of comparing the information to other investment options, and reduced paper clutter.

#### Page One

Respondents indicated that they value the first page of the NASD form, and they noted its absence from the SEC version. One respondent pointed out that the “Page One” material addresses the aspects of mutual funds that are of greatest interest to investors, suggesting that the inclusion of that information will increase the likelihood of the document being read. Some respondents stated that the performance information provides an essential context for evaluating the fees and other disclosed data. Everyone agreed that the “Risks to You” column was relevant, clear and helpful.

*“This was informative. I think it’s really smart. I think it’s good that it’s the first page. Immediately you’re grounded.” – Bethesda*

*“[The SEC form] is missing a couple of key features. I would add the performance and risk information [to the SEC form], and the other basic information about the kind of fund.” – Bethesda*

*“There isn’t any fund performance stuff [on the SEC form]. That’s the only advantage [of the NASD form] that I see.” – Bethesda*

*“It’s well-written, brief and to the point. The first word I see is ‘Risk.’” – Bethesda*

*“I like this [the SEC version]. But [‘Page One’] is important to know. If you forget about [the risks], you could be in a world of trouble.” – Bethesda*

## Page Two

Almost all respondents thought that the SEC's presentation of the sales fee information was superior to the NASD version.

- **Introductory Language:** Several respondents mentioned and appreciated that the SEC form included an "Ask before you buy" section at the top of the form, which made clear that the primary purpose of the document was the disclosure of fees and conflicts.

*"It's good. Right up top, it warns you upfront: we are required to tell you about fees and conflicts. 'Ask before you buy.'" – Bethesda*

*"'Ask before you buy' is at the top of the page. This seems like a much more straightforward presentation." – Bethesda*

- **Section Titles:** Most respondents preferred the SEC's language to the NASD's language for the two fee sections: "You pay when you buy" and "You also pay each year." These two labels were considered to be perfectly clear and user-friendly.

*"I like the wording – 'You pay when you buy.'" – Bethesda*

*"This is easier to understand. 'You pay when you buy.' It shows you exactly how much you're investing. The percentage is nice to see – it shows that the more you invest, the lower the fee you pay." – Bethesda*

*"Here it makes it clear that it's going to be every year. It slaps you in the face." – Bethesda*

- **Layout of Sales Fee Disclosure:** Investors appreciated the four-column approach of the SEC document: "Total payment amount," "Estimated upfront fee you pay," "Your investment amount," and "Upfront fee as % of your investment amount."

*"This is shorter, more concise [than the NASD version]. It has both numbers and percentages." – Bethesda*

*"This is considerably more user-friendly. It's got the percentages." – Bethesda*

*"It immediately shows you what you have to invest and what's being taken off the top. It's very clear. I think that's good." – Bethesda*

- **Fill-In Boxes:** The blank boxes received mixed reactions. Some investors found the interactivity to be appealing and the (inferred) automatic calculation helpful. Others found the presentation of the boxes to be condescending.

*“I’d use this on a website.” – Bethesda*

*“I like the blocks that let you put in the amount you’re going to invest.” – Bethesda*

*“What do you need that for?” – Bethesda*

*“I think it’s a gimmick. I always feel that they treat me like a half-wit.” – Bethesda*

- **Annual Fund Expenses:** Some respondents were misled by the use of a fixed dollar amount rather than a percentage in the annual fee section of the NASD form. The table of examples in the SEC document was puzzling to some because the percentage did not change. A simple statement of the percentage would be less likely to confuse investors.

*“I guess I’d like to see a percentage. That’s typical.” – Bethesda*

*“I read it as \$13.80 coming out every year as a flat amount. [After respondent clicked through for additional information] It’s a percent. Not a flat amount. The 1.38% is helpful.” – Bethesda*

*“It expresses [the fee] in dollars that the average layman understands. I deal in percentages. Maybe it could do both – it wouldn’t hurt.” – Bethesda*

*“It’s always good to have the percentage.” – Bethesda*

*“Why are you showing four different figures? It’s the same percentage.” – Bethesda*

*“Get rid of the blank boxes [in the SEC form] because that’s just more confusion. . . The fee is a percentage of the value.” – Bethesda*

- **Account Fee:** The annual account fee was noticed by a few respondents and was seen as being a relevant disclosure that was missing from the NASD form.



- **SEC's Annual Fee Breakdown:** Most respondents considered the breakdown of the annual fee to be unnecessary and unhelpful. When they tried to interpret the fee sub-categories (distribution, management, and other), they were unable to do so.

*"I guess I don't care. These fees are used to fund the company. They're not all going to one person."* – Bethesda

*"'Other' – whatever the hell that means. Just call these management fees and give the total."* – Bethesda

*"This is what it's going to cost. Whether you call it a management fee – what does it matter to me? It doesn't help any."* – Bethesda

*"This is where I tune out. It's just gobbledygook."* – Bethesda

- **Portfolio Turnover:** The turnover section was very confusing to many respondents, especially because it appears in a document that focuses on disclosing the fees being charged to investors. In several cases, respondents assumed that "transaction costs" referred to would be charged directly to them, which made them question the validity and meaning of the annual fee disclosures they had just finished reading.

*"I don't know if turnover is relevant. I think it's excess information."* – Bethesda

*"They put [that information] there to tell me they're aggressive. . . It's an impressive number if things are going well."* – Bethesda

*"Why are you charging me transaction fees if I'm already paying an operating expense?"* – Bethesda

*"I think the average layman would be upset by this. . . They can charge anything they darn well please. Why are you charging me more?"* – Bethesda

*"Maybe it's [included] so that when they sell a stock they used to own when I bought the fund, I won't complain . . . But what are these transaction costs you're going to hit me with? Boy, this is really getting confusing now."* – Bethesda

## Delivery Mode

Consistent with the first round of research, most respondents said they would prefer to receive these disclosures electronically through some combination of e-mail and online access. They cited the following reasons for this preference: instant access; ease of comparing the information to other investment options; reduced paper clutter; and the ability to print part – or all – of the document, if desired. Seniors are more likely than younger investors to indicate a preference for hardcopy over electronic delivery.

*“I’d like it by e-mail, where I can go to the web and read it.” – Bethesda*

*“I prefer a piece of paper.” – Bethesda*

*“Just send it to me in an email. In the email, not an attachment. . . [A website] would be nice. Those kind of links are good.” – Bethesda*

*“I don’t want it over the phone. Email or mail. Email now is a pretty secure thing.” – Bethesda*

*“Probably mailed would be better. . . It would be interesting if it was on a web page where you could enter in an amount and it would calculate for you.” – Bethesda*

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## **Report of the Mutual Fund Task Force: Mutual Fund Distribution**

NASD formed the Mutual Fund Task Force (“Task Force”) to consider issues relating to soft dollars, mutual fund portfolio transaction costs and distribution arrangements. The Task Force was established after discussions between the Securities and Exchange Commission (“SEC”) and NASD staffs, to provide guidance to the SEC as it considers these issues.<sup>1</sup>

The Task Force is comprised of senior industry executives who represent broker-dealers and mutual fund management companies, as well as representatives from the academic and legal communities. The Task Force divided its work into two phases. In the first phase, it considered mutual fund portfolio transaction costs, particularly “soft dollar” services and disclosure. On November 11, 2004, the Task Force submitted its Report on these issues to the SEC.<sup>2</sup>

Immediately following the submission of its Phase One Report, the Task Force commenced its work on Phase Two, which covered distribution arrangements, including fees paid pursuant to Rule 12b-1 under the Investment Company Act of 1940 (“1940 Act”) and revenue sharing. This Report presents the results of the Task Force’s deliberations on these issues.

### ***I. Background and Summary of Task Force Recommendations***

Mutual fund investors pay for the distribution of fund shares in a number of direct and indirect ways, including front-end, back-end and spread loads paid directly by investors, Rule 12b-1 payments paid from fund assets, and revenue sharing payments made by the fund’s adviser. The adoption of Rule 12b-1 in 1980 and the development of multiple class funds encouraged an array of fee structures. As funds developed new distribution channels, such as fund supermarkets and the retirement market, the number of alternative fee structures increased. Thus, for example, load funds can be offered on a load-waived basis in some markets, “no load” funds may pay service fees to broker-dealers and investment advisers, and multiple class funds offer an increasing number of choices to retail and institutional investors.<sup>3</sup>

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<sup>1</sup> See SEC Rel. No. IC-26313 (Dec. 18, 2003), 68 Fed. Reg. 74819 (Dec. 24, 2003). See also SEC Rel. No. IC-26356 (Feb. 24, 2004), 69 Fed. Reg. 9725 (Mar. 1, 2004) and SEC Rel. No. IC-26591 (Sept. 2, 2004), 69 Fed. Reg. 54727 (Sept. 9, 2004).

<sup>2</sup> See Report of the Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs, November 11, 2004 (“Phase One Report”), available at: [http://www.nasd.com/web/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_012356.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf).

<sup>3</sup> A multiple class fund has one portfolio and one investment adviser, but offers more than one class of its shares to investors. Each class represents a similar interest in the mutual fund’s portfolio. The principal difference between the classes is that the investor pays different types of distribution fees depending upon the class chosen.

The Task Force reviewed the history of Rule 12b-1, including the purposes for which it was adopted and the use of the rule by the fund industry. The Task Force also discussed different forms of distribution payments and the extent to which these payments serve a legitimate purpose in the distribution of mutual funds. In particular, the Task Force considered investor understanding of the existence of revenue sharing and differential compensation and the potential conflicts that these payments may present. Finally, the Task Force reviewed the development of multiple class funds and their effect on investor understanding of mutual fund distribution costs.

The Task Force believes that many of the developments in distribution payments since the adoption of Rule 12b-1 have benefited investors by allowing them to choose to pay distribution costs up-front, over time, or when fund shares are redeemed. At the same time, the variety and complexity of these choices, and the fact that many distribution costs are incurred at the fund level, may tend to obscure the extent of these costs and the incentives that they may create.

The Task Force concludes that the most important changes that the Commission should consider are those that make the costs and potential conflicts associated with mutual fund distribution more visible to the retail investor. In the Task Force's view, the Commission should require that a broker-dealer make available to investors, at the point of sale, a short, easy to understand document that describes the salient features of a fund, including revenue sharing and differential compensation arrangements (the "Profile Plus"). While this disclosure would include fees and expenses and the existence of particular incentives at the dealer level, it also would summarize information about the fund's investment strategies, risks and other significant features. This disclosure would build upon the Commission's recent initiatives in this area.<sup>4</sup>

The Task Force recommends that a broker-dealer be required to provide the Profile Plus on its web site and refer investors to the disclosure, unless an investor opts out of this form of delivery. By referring an investor to a point of sale document on its web site, a broker-dealer could provide disclosure in a timely and comprehensible manner at the point of sale. Web site delivery of the Profile Plus also would provide investors with ready access to additional, more detailed disclosure through hyperlinks to the fund prospectus and a dealer disclosure statement concerning revenue sharing and differential compensation arrangements. Web site delivery would allow investors to compare funds offered by their broker-dealer. By giving investors a short disclosure document with access to further information through hyperlinks, the Profile Plus would allow investors to review as much or as little detail about a fund as may be desired. The Task Force also urges the Commission to issue interpretive guidance providing that an investor's access to the Profile Plus, the full fund prospectus and the dealer disclosure document through

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<sup>4</sup> Proposed rule and form amendments would require broker-dealers to provide certain information about mutual fund costs and dealer incentives at the point of sale and in confirmation statements. *See* SEC Rel. No. IC-26341 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004) (the "Point of Sale Proposal"). The Commission recently reopened the comment period on these proposals and issued a supplemental request for comment. *See* SEC Rel. No. IC-26778 (Feb. 28, 2005), 70 Fed. Reg. 10521 (March 4, 2005) (the "Supplemental Request for Comment").

the Internet would constitute delivery of these documents for purposes of the federal securities laws.

The Task Force's recommendation of the Profile Plus and the manner in which it should be delivered were guided by the results of in-depth, in-person interviews conducted with individual investors. These interviews indicated a high level of enthusiasm for the information set forth in the Profile Plus, and a preference for web site delivery of the disclosure.<sup>5</sup>

In addition to its disclosure recommendations, the Task Force recommends that the Commission consider changes in the substantive regulation of mutual fund distribution arrangements. The Task Force recommends that the Securities and Exchange Commission consider the following measures:

- Update and modernize the findings that a fund board must make in approving and continuing a Rule 12b-1 plan;
- List Rule 12b-1 fees in the prospectus fee table solely in a manner that describes their purpose, *e.g.*, as “distribution and shareholder servicing fees,” without reference to a rule number that may be confusing to many investors;
- Mandate better disclosure to investors about the costs of Class B shares and, along with NASD, consider other regulatory issues concerning Class B shares; and
- Reconsider the unified fee proposal set forth in the SEC Staff's 1992 Report *Protecting Investors: A Half Century of Mutual Fund Regulation* (the “*Protecting Investors Report*”).

## ***II. Disclosure of Revenue Sharing and Differential Compensation Arrangements***

Investors would benefit from better disclosure about mutual fund distribution costs, including revenue sharing and differential compensation arrangements.

Broker-dealers and their registered representatives are compensated for the sale of mutual fund shares in various ways, and the disclosure that investors receive depends upon the

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<sup>5</sup> To conduct the investor testing, NASD retained Applied Research and Consulting (“ARC”), which conducted the investor interviews in White Plains, New York on February 22, 2005 and Alexandria, Virginia on February 25, 2005. On March 17, 2005 in Bethesda, Maryland, ARC conducted further investor testing of a revised Profile Plus and the new mutual fund point of sale disclosure documents included in the Supplemental Request for Comments. The investors interviewed were not told that one form was designed by NASD for the Task Force and the other by the SEC. A copy of the resulting report (“NASD Investor Report”) is enclosed and posted on NASD's web site along with a copy of this Report. The Task Force made a number of refinements to the Profile Plus in response to comments and questions received from investors during ARC's interviews. A number of these changes incorporated aspects of the point of sale disclosure forms proposed in the Supplemental Request for Comment.

particular compensation arrangement. For example, compensation that is deducted from the purchase price or from fund assets, such as sales charges and Rule 12b-1 fees, is disclosed in the fee table that appears in the mutual fund prospectus. Other forms of compensation, such as payments from a mutual fund adviser for “shelf space,” are not disclosed prominently.

- Revenue sharing arrangements occur when an investment adviser agrees to pay a broker-dealer cash compensation not otherwise disclosed in the prospectus fee table. Thus, revenue sharing includes payments for shelf space and marketing support to distribute the investment company’s shares, but does not include payments made to fund intermediaries for services such as sub-accounting for fund shareholders.
- Differential cash compensation arrangements typically occur when a broker-dealer provides higher payouts or similar subsidies to its registered representatives for the sale of certain investment company products, such as investment companies that are proprietary funds of the broker-dealer.

Revenue sharing and differential cash compensation arrangements may create incentives to favor some funds over others inappropriately. These compensation arrangements may encourage broker-dealers and their registered representatives to sell certain funds to maximize their compensation, rather than to best meet their customers’ needs. Thus, they may provide point of sale incentives that could compromise proper customer suitability considerations.

The Task Force recommends that the SEC address these concerns by requiring broker-dealers to disclose these incentives to their customers in a simple, understandable way. Disclosure of revenue sharing and differential cash compensation arrangements would enable investors to ask informed questions and evaluate whether a registered representative’s recommendation may be inappropriately influenced by these arrangements. Disclosure of these arrangements could be an important adjunct to existing suitability, sales practice, and disclosure requirements and may help to ensure that there is an appropriate match between the needs of an investor and the mutual fund in which he or she invests.

The disclosure provided by the Profile Plus will give investors the tools they need to evaluate the potential conflicts of interest that these payments present.

### ***III. Point of Sale Disclosure Through the Profile Plus***

In 1998, the Commission adopted significant changes to the disclosure requirements for mutual funds.<sup>6</sup> First, it substantially revised Form N-1A, the mutual fund prospectus, in

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<sup>6</sup> The federal securities laws require delivery of a mutual fund prospectus to an investor at or before the time that the investor receives a confirmation statement for the investment. In addition, an investor must be provided with a Statement of Additional Information upon request.

order to simplify its disclosure and put it in “plain English.” The amendments to Form N-1A were designed to focus prospectus disclosure on the features unique to a particular fund, with less emphasis on technical, legal, and operational matters generally common to all funds.

In addition, the Commission adopted Rule 498 under the Securities Act of 1933, which allows funds to deliver a short, simple summary prospectus, called a “profile.” An investor who receives a fund profile may purchase fund shares based on the profile or request the full fund prospectus. In any event, an investor who purchases fund shares based on the profile will receive the fund’s full prospectus with the purchase confirmation. Profiles may be distributed through any means, including direct mail, print media, broadcast, and electronic media.

To date, few mutual funds have used the fund profile in the retail market. One concern that has been voiced about the fund profile is that it could expose funds to unforeseen liability. For example, by summarizing disclosure that appeared in the full prospectus, some fear that the fund profile could be deemed to have omitted material information.

In the Point of Sale Proposal and the Supplemental Request for Comment, the Commission proposed new confirmation and point of sale disclosure requirements for transactions in mutual funds. The proposals are designed to improve the disclosure that investors receive at the point of sale and in transaction confirmations regarding the costs and potential conflicts of interest that arise from the distribution of mutual fund shares.

The Task Force’s recommendations would enhance and build upon the Commission’s proposals and incorporate key concepts of the profile prospectus and the disclosure forms proposed in the Supplemental Request for Comment. The Task Force recommends that the Commission adopt the following measures that would improve mutual fund disclosure:

- First, the Commission should mandate delivery by broker-dealers of a Profile Plus document. We have attached a sample Profile Plus for shares of a Class A equity fund.<sup>7</sup> By mandating delivery of this document, the Commission would ensure that simple, clear disclosure reaches the retail investor. Moreover, Commission-mandated, line item disclosure might alleviate some of the liability issues that flow from voluntary disclosure in a simplified format. The inclusion in the Profile Plus of hyperlinks to the full fund prospectus also should alleviate liability concerns.

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<sup>7</sup> See Attachment A. The sample Profile Plus includes hyperlinks to a prototype fund prospectus and a dealer disclosure statement, which an investor may click for further information. Attachment B is a sample prototype prospectus. Attachment C is a sample dealer disclosure statement. For a demonstration of how the Profile Plus and hyperlinks would work for investors, please see: [http://apps.nasd.com/prototype/profile\\_prototype.pdf](http://apps.nasd.com/prototype/profile_prototype.pdf)

- Second, disclosure on broker-dealer web sites, with broker-dealers referring investors to this disclosure, generally should be the mode of delivery mandated by the Commission. Web site disclosure provides the best means to provide meaningful disclosure to investors at the time the sale is being made. The Profile Plus would contain hyperlinks to the full fund prospectus and to a dealer disclosure statement. Therefore, web site disclosure would allow an investor to quickly obtain additional information about the risks, investment strategies, dealer-level incentives and other information associated with a particular fund.<sup>8</sup> Moreover, web site disclosure would provide an investor with access to similar disclosure for all of the funds that the broker-dealer sells, making comparisons easier.

A. *The Profile Plus*

The Profile Plus is a two-page, easy to understand document that includes key characteristics of the fund and all fees and expenses of the fund, including the costs and potential conflicts associated with mutual fund distribution.

The following features of the Profile Plus should be highlighted:

- The Profile Plus is, in some ways, broader than the profile permitted by Rule 498. In particular, the Profile Plus would require disclosure by a broker-dealer of revenue sharing and differential compensation arrangements.
- The Profile Plus is, in other ways, less comprehensive than the profile. For example, the Profile Plus does not include information on how to redeem fund shares, how often the fund intends to make distributions, or information about the portfolio manager.
- Page One Disclosure:

Page one sets forth a brief statement of the fund's principal investment strategies and principal investment risks, with hyperlinks for more information.

- Under "How We Invest," an investor would receive information about the fund's principal investment strategies, with a hyperlink to the relevant section of the fund prospectus for more information.
- Under "Risks to You," an investor would receive information about the fund's principal investment risks, again with a hyperlink to the relevant section of the fund prospectus for more information.

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<sup>8</sup> See NASD Investor Report at 4, which states that investors favor a format that allowed them to "click through" for more information if desired.



- Page one also includes a bar chart that shows the fund’s total return for the past ten years, and a chart that shows average annual return of the fund over the past 1-, 5- and 10-year periods.

The Task Force’s decision to include information in addition to mutual fund fees and expenses in the Profile Plus is supported by our investor research. The NASD Investor Report notes that all investors interviewed were interested in the information provided on page one of the Profile Plus regarding the fund’s investment strategies, risks and performance. For example, concerning the risk disclosure investors had the following comments:

- § *“This is good. It’s common knowledge (i.e., volatility), but it’s scary to see it.”*
- § *“I think the risk factors are explained well.”*
- § *“I think they need to tell you that there is a risk. No surprises there. I would expect this information.”*
- § *“The [SEC form] is missing a couple of key features. I would add the performance and risk information [to the SEC form] and the other basic information about the kind of fund.”*
- § *“I like this [the SEC version]. But [‘Page One’] is important to know. If you forget about [the risks], you could be in a world of trouble.”*

The Task Force believes that it is extremely important to include information concerning investment strategies and risks in point of sale disclosure.

- Page Two Disclosure:

Page two highlights the costs associated with fund ownership and possible conflicts of interest.

- The “Fees and Expenses” tables (“You Pay When You Buy” and “You Also Pay Each Year”) show the total fees and expenses paid by a shareholder – both transaction fees and fund operating expenses – based on the fund’s current prospectus. The Profile Plus would present the costs in dollars and percentages, based on \$1,000, \$50,000 and \$100,000 hypothetical investments. Moreover, total fund operating expenses would be presented as a single number, and not broken down into components (e.g., Rule 12b-1 fees, transfer agency fees). In addition, the disclosure of fees based on hypothetical investment amounts is clearer and more helpful to investors than

a presentation of fees based on the customer's actual investment.<sup>9</sup> Based on the results of the NASD Investor Report, the Task Force believes that investors are interested primarily in the total amount of the fees that they pay, and the effect of these fees on fund performance, rather than in a detailed breakdown of the various components of total fees. Investors likely will not find a breakdown of annual fund expenses either clear or useful.<sup>10</sup> Several interviewed observed that only the total amount was relevant to them as individual investors. Others found the breakdown categories to be vague.<sup>11</sup> Investor comments on a breakdown of fund annual fund expenses into component costs included:

- *“It adds up to 1.38%. I already knew that from before. Why should I care about this? It won't affect how much I'm paying.”*
  - *“What is this ‘other expenses?’ That doesn't tell me anything.”*
  - *“This is where I tune out. It's just gobbledeygook.”*
- The attached sample Profile Plus relates to Class A shares of an equity fund. Consequently, we have included only those fees and expenses that pertain to Class A shares. We recommend that the Commission require funds and distributors to include the specific fees and expenses that would apply to a substantial number of their investors in the pertinent class of mutual fund

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<sup>9</sup> The forms accompanying the Supplemental Request for Comment not only provide disclosure with respect to hypothetical investment amounts, but also provide an opportunity for an investor to request disclosure with respect to his or her actual investment. See Supplemental Request for Comment at 10. This “actual investment” disclosure could confuse or mislead investors, particularly with respect to ongoing expenses. Although the proposed forms would provide an “estimated 1<sup>st</sup> year” amount, and would disclose “This estimate assumes the value of your investment does not change,” many investors likely would believe that the dollar amount presented represents the investor's actual share of expenses each year, for the life of the investment. In fact, this would rarely be the case, since the value of the investment would change.

In contrast, disclosure based upon the three hypothetical amounts allows the investor to compare the costs of different funds, without imposing the additional expense of actual investment disclosure, and without potentially confusing investors.

If the Commission determines to the contrary, the Task Force believes that the best way to deliver that additional disclosure is by allowing an investor to access a Internet-based calculator that would display the pertinent information after the investor enters his or her actual investment amount. This could be developed as an industry-wide utility, assuring consistency and radically decreasing expenses. Provision of this tool depends on the use of the Internet to deliver the information.

<sup>10</sup> Of course, for those investors interested in a breakdown of total fund operating expenses, the Profile Plus allows them to obtain this information easily by clicking through to the appropriate section of the fund prospectus.

<sup>11</sup> See NASD Investor Report at 10.

shares, such as deferred sales loads with respect to Class B shares and dealer transaction fees (e.g., \$25 charge per transaction). In addition, we recommend that the Commission ensure that intermediaries disclose other comparable fees (e.g., wrap account fees charged by investment advisers, and fees charged by broker-dealers in fee-based brokerage accounts). The Profile Plus also provides a hyperlink to the prospectus fee table.

- Page two provides disclosure concerning the availability of breakpoint discounts and a hyperlink to further information.<sup>12</sup> This disclosure would advance one of the goals of the Joint NASD/Industry Task Force on Breakpoints, which was to improve investor understanding of the nature and availability of sales discounts on large investments.<sup>13</sup>
- Page two provides a brief explanation of portfolio transaction costs and portfolio turnover rate. We have revised this section to address investor comments that our earlier proposed disclosure was confusing. A hyperlink would connect an investor to detailed information about the fund's portfolio transaction costs and portfolio turnover.<sup>14</sup>
- Page two includes a "Potential Conflicts of Interest" section that provides information about revenue sharing and differential compensation arrangements. This disclosure is made through the following two "yes/no" questions that, in the event of a "yes" answer, would include a hyperlink to more information provided by the broker-dealer:

§ **Does the fund or its affiliates pay XYZ Firm extra to promote this Fund over other similar funds?** If the answer to this question is "yes," an investor may click on a hyperlink to additional information about the revenue sharing payments that the broker-dealer receives. The hyperlinked information would provide an explanation of the nature of

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<sup>12</sup> The Profile Plus presents breakpoint disclosure in a manner that makes clear that the discount applies to sales charges only and does not affect an investor's share of total fund operating expenses. The Task Force respectfully suggests that the breakpoint disclosure included in the forms proposed in the Supplemental Request for Comment may create the mistaken impression that breakpoint discounts apply to all mutual fund fees and expenses, not just mutual fund sales charges.

<sup>13</sup> See Report of the Joint NASD/Industry Task Force on Breakpoints, July 2003; available at: [http://www.nasd.com/web/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_006434.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_006434.pdf).

<sup>14</sup> The Phase One Report recommended that the Commission improve the disclosure to fund shareholders of fund trading costs. Specifically, the Task Force recommended that fund prospectuses include a chart covering a five-year period that shows total commissions paid; total commissions paid to affiliates; commissions as a percentage of net asset value; percentage of transaction volume executed on a commission basis; average commission rate per share; and portfolio turnover rate. The web site version of our Profile Plus prototype includes a hyperlink to a sample of this disclosure as part of the prototype prospectus.

revenue sharing payments and a ranking of the fund families that make revenue sharing payments to the broker-dealer.<sup>15</sup> (See dealer disclosure statement at Attachment C.)

- § **Does XYZ Firm pay its personnel more for selling this Fund than for selling other similar funds?** If the answer to this question is “yes,” an investor may click on a hyperlink to additional information about the differential compensation arrangements that the broker-dealer has with its registered representatives. The hyperlinked information would include an explanation of differential compensation and a ranking of the fund families offered by the broker-dealer.<sup>16</sup> (See dealer disclosure statement at Attachment C.)

#### B. *Web Site Disclosure*

As discussed above, the Task Force recommends that the Commission require that all broker-dealers provide the Profile Plus, dealer disclosure statement and the fund’s

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<sup>15</sup> These internal rankings would list fund families based on the revenue sharing payments received per \$1,000 in fund assets held by clients of the broker-dealer and per \$1,000 in fund sales made by the broker-dealer.

Attachment 15 to the Supplemental Request for Comment includes the Commission’s proposal for Internet-based disclosure of compensation arrangements as a supplement to point of sale disclosure. *See* Supplemental Request for Comment at 57-59. With respect to revenue sharing, the proposed disclosure includes the rates of revenue sharing payments from the particular fund. The Task Force believes that the ranking information recommended in this Report is critical to investor understanding of the potential conflict of interest presented by revenue sharing. With respect to disclosure of revenue sharing rates, a majority of the Task Force believes that it is inappropriate to publicly disclose this information, thereby disclosing the proprietary financial arrangements of fund families to all others in the industry. Some members of the Task Force, however, preferred rate disclosure.

Attachment 15 also includes disclosure of other payments a broker-dealer receives from a fund family, for transfer agency or recordkeeping services performed. *See id.* at 61-62. The Task Force does not believe that this disclosure should be required, since bona fide performance of, and payment for, these services does not present the same potential conflicts of interest as revenue sharing. Similarly, the Task Force questions the utility of the proposed disclosure in Attachment 15 of “compensation-related conditions.” *See id.* at 63-64. In the Task Force’s view, the most important information that may be conveyed through a dealer disclosure document is information that reveals the incentives that a registered representative may have to favor one fund over another offered by the broker-dealer. Disclosure of the fact that the broker-dealer only sells funds that charge sales fees or Rule 12b-1 fees does not advance this objective and may distract investors from other, more pertinent disclosure.

<sup>16</sup> Fund families would be ranked from highest to lowest, based on the payouts to registered representatives for fund sales.

In Attachment 15, the Commission proposes disclosure of differential compensation that is centered on comparison to the “typical” compensation received. *See id.* at 66-68. The Task Force believes that the ranking it recommends is preferable.

prospectus on their web sites.<sup>17</sup> We recommend that the Commission require that a registered representative either refer the investor to the Profile Plus on the broker-dealer's web site or e-mail a web site link to the investor. This should occur contemporaneously with a recommendation to an investor that he or she invest in a particular fund. In referring an investor to the disclosure, the registered representative should explain that the Profile Plus contains important information concerning costs and potential conflicts of interest.

Most investors today have ready access to the Internet.<sup>18</sup> Web site disclosure, as well as the availability of hyperlinks to additional information, will permit each investor to tailor the disclosure according to his own interests and needs. Moreover, web site disclosure would facilitate an investor's ability to compare different funds.<sup>19</sup>

In its Supplemental Request for Comment, the Commission observed that a fundamental goal of point of sale disclosure is to provide investors with key information about costs and conflicts contemporaneously with their investment decision.<sup>20</sup> Web site disclosure would, for most investors, be the simplest and most straightforward way to deliver information to investors quickly and in a format that allows them to easily review as much or as little detail as may be desired.

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<sup>17</sup> We also recommend that direct-sold mutual funds provide the Profile Plus, modified as appropriate, and the fund prospectus on the fund complex web site, so that investors in those funds have access to comparable disclosure.

<sup>18</sup> The Commission's recent release concerning the disclosure regime for industrial companies states:

"Internet usage in the United States has grown considerably since 2000 when we published our most recent interpretive guidance on the use of electronic media in securities offerings, including with regard to prospectus delivery by electronic means. For example, recent data indicates that 75% of Americans have access to the Internet in their homes, and that those numbers are increasing steadily among all age groups. See, Three out of Four Americans Have Access to the Internet, Nielsen/NetRatings, March 18, 2004; Robyn Greenspan, Senior Surfing Surges, ClickZNetwork, Nov. 20, 2003 (citing statistics from Nielsen/Net Ratings and Jupiter Research). In addition, there is evidence suggesting that the "digital divide" is diminishing. See, for example, Kristen Foundain, Antennas Sprout, and a Bronx Neighborhood Goes Online, The N.Y. Times, June 10, 2004, at G8; Steve Lohr, Libraries Wired, and Reborn, The N.Y. Times, Apr. 22, 2004 at G1."

SEC Rel. No. 34-50624 (Nov. 3, 2004) at n.353, 69 Fed. Reg. 67391, 67438 n.353 (Nov. 17, 2004) (the "Prospectus Delivery Release").

<sup>19</sup> The ability to deliver the Profile Plus to investors on broker-dealer web sites is fundamental to the Task Force's support for the development of this new disclosure document. Many Task Force members would not support the Profile Plus absent the ability to deliver the document to investors through the Internet.

<sup>20</sup> See Supplemental Request for Comment at 28.

As the Commission notes, there are distinct difficulties presented by oral and hard copy delivery requirements. Oral delivery is difficult to monitor and, when information is complex as is the case at hand, hard for investors to digest.<sup>21</sup> Requiring broker-dealers to provide investors with hard copy disclosure before acceptance of an order may prevent investors from executing telephone orders as quickly as desired.<sup>22</sup> Web site delivery would avoid these issues and provides investors instantaneous access to information in a format that allows them to review the information at their own pace and level of interest. In discussing mutual fund disclosure reform, Chairman Donaldson indicated recently that the Commission should “examine ways that we can make better use of technology, including the Internet, in our disclosure regime.”<sup>23</sup> The Task Force respectfully suggests that web site delivery of the Profile Plus would be an important step in this direction.

The NASD Investor Report demonstrates an investor preference for web site delivery. Investors interviewed cited the following reasons for this preference: instant access; ease of comparing the information to other investment options; reduced paper clutter; and the ability to print part – or all – of the document, if desired.<sup>24</sup> Surveyed investors had the following comments:

- *“It is much easier to navigate online than to sit down and read. If I need to I can print it, but a big package mailed to me with all that stuff is too much.”*
- *“The less paper I get the better. I think e-mail is the way to go.”*
- *“It is better to read it for yourself, and online is much better. Waiting for mail is archaic.”*
- *“The more I think about it, the more I’d like to have it online. I’d like to receive an e-mail and then go to the website. Then I can look at the stuff I want to see.”*

We respectfully disagree with a conclusion of the Supplemental Request for Comment that “web site disclosure . . . could be ineffective at providing investors with key information about costs and conflicts contemporaneous with investment decisions as point of sale disclosure.”<sup>25</sup> Web site disclosure – accompanied by the appropriate referral of the investor to the information – is the **only** mode of delivery that will ensure that

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<sup>21</sup> If the Commission rejects web site delivery, the Task Force supports optional oral delivery as an alternative to required delivery in hard copy. For example, the Commission could allow firms to choose to deliver the required information orally if they have adopted policies and procedures reasonably designed to ensure that oral disclosure is properly carried out.

<sup>22</sup> *Id.* at 28-29.

<sup>23</sup> *See Remarks before the Mutual Fund and Investment Management Conference*, SEC Chairman William H. Donaldson, March 14, 2005, Palm Desert, California.

<sup>24</sup> *See* NASD Investor Report at 17.

<sup>25</sup> Supplemental Request for Comment at 28.

investors can obtain the right information at the right time. By giving investors a short disclosure document with access to further information through hyperlinks, the Profile Plus would allow investors to review as much or as little detail about a fund as desired and to easily compare all funds offered by a particular broker-dealer. To the extent that the Commission is concerned that investors will not actually go to the Profile Plus on the broker-dealer's website, that is a matter of investor choice, exactly the same as choosing not to read hard copy disclosure or not to listen to oral disclosure. The web site mode of delivery is, in the Task Force's view, critical to effective and timely disclosure of this information for the benefit of investors.

Some investors, however, may not have access to the Internet or for other reasons may not want to obtain this information in electronic form. To address this situation, the Task Force recommends that the Commission require that broker-dealers offer their customers the option to elect to receive the Profile Plus and dealer disclosure statement in hard copy form. If a customer elects hard copy delivery, the Commission should require that the broker-dealer transmit the Profile Plus and the dealer disclosure statement by e-mail or in paper form through regular mail or hand-delivery as soon as practicable after the mutual fund recommendation is made.

### C. *“Access Equals Delivery”*

In November, the Commission proposed rules that would modernize the registration, communications, and offering processes under the Securities Act of 1933 (the “Securities Act”).<sup>26</sup> The proposals include reforms to the prospectus delivery requirements under the Securities Act.

The Securities Act requires delivery of a “final prospectus” meeting the requirements of Section 10(a) to each investor in a registered offering. A final prospectus must accompany or precede a written confirmation. Section 5(b)(2) of the Securities Act makes it unlawful to deliver a security “unless accompanied or preceded” by a final prospectus.

The proposal would modify these prospectus delivery requirements. In particular, the Commission proposes to adopt an “access equals delivery” approach to prospectus delivery. Under an “access equals delivery” model, investors would be presumed to have access to the Internet, and issuers and intermediaries could satisfy their delivery requirements if the filings or documents are posted on a web site. The access concept is premised on the information or filings being readily available. Under this model, issuers and broker-dealers can satisfy their final prospectus delivery obligations if a final prospectus is on file with the Commission within the required time.

The proposal would not apply to registered investment companies. In this regard, the Commission notes that funds “are subject to a separate framework and that it would be more appropriate to consider any changes to our prospectus delivery requirements as they

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<sup>26</sup> See Prospectus Delivery Release.

apply to registered investment companies and business development companies in the context of a broader reconsideration of this framework.”<sup>27</sup>

The Task Force urges the Commission to apply an “access equals delivery” approach for the mutual fund prospectus. The Commission should take the position that an investor’s access to the fund prospectus through the Internet would constitute delivery for purposes of the federal securities laws. The Commission’s release recognizes the need to modernize prospectus delivery obligations in view of technological and market structure developments of recent years. These developments also justify an “access equals delivery” position with respect to mutual fund prospectuses.

Few firms have used the Rule 498 profile. One issue that has impeded its wider acceptance has been concern over the potential liability exposure that the profile presents. For example, a profile summarizes the risks associated with the fund, which are described in greater detail in the full fund prospectus. By providing two levels of disclosure, the summary at the time of sale and the more detailed disclosure after the sale has been executed, the profile system presents an opportunity for litigation over the issue of whether the profile omitted material information. The fact that the profile is a voluntarily used document, rather than an SEC-required disclosure document with line item summaries, may exacerbate this litigation risk.

By mandating the Profile Plus and prescribing the line items of disclosure within the Profile Plus, the Commission could ameliorate some of these litigation concerns. Moreover, if the Commission were to adopt an “access equals delivery” approach to the full prospectus, then for liability purposes an investor would be deemed to have received the full prospectus on the Internet when he obtains the Profile Plus. This simultaneous delivery should resolve the existing liability concerns.

#### *D. Responsibility for Information in the Profile Plus*

The Task Force urges the Commission to carefully delineate the respective responsibilities of funds and broker-dealers to provide various items of information to be included in the Profile Plus. In this regard, it will be important for the fund management companies and broker-dealers to work with NASD to develop common industry practices for the prompt delivery of information for inclusion in the Profile Plus. A broker-dealer should be able to rely in good faith on information included in the Profile Plus that is provided to the firm by a fund management company. Further, a fund manager should be permitted to transmit information for inclusion in the Profile Plus as part of its regular schedule for updating fund prospectuses.<sup>28</sup> Otherwise, inconsistencies between the Profile Plus and the fund prospectus inadvertently may occur, to the detriment of effective disclosure.

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<sup>27</sup> Prospectus Delivery Release, 69 Fed. Reg. at 67439.

<sup>28</sup> A fund must keep its prospectus current, updating financial and other information on a periodic basis. A fund typically sends shareholders an updated prospectus annually.



#### *E. Disclosure In Other Distribution Channels*

Mutual funds are distributed not only by broker-dealers, but also by other intermediaries, including banks, investment advisers, and retirement plan sponsors. Distribution through these channels presents many of the same concerns about fee disclosure and sales incentives as distribution through broker-dealers or directly from the fund. For example, investment advisers who recommend mutual funds may receive a service fee from the mutual fund sponsor and may impose their own “wrap” or other advisory fees. Investors in the defined contribution market do not always receive adequate information concerning their underlying mutual fund investment choices. Clear disclosure at the point of sale concerning the fees, investment strategies, risks, and other information associated with the purchase, as well as disclosure concerning the intermediaries’ own potential conflicts of interest, would benefit investors in these other distribution channels.

The Task Force recommends that the Commission require that other regulated intermediaries provide investors with a disclosure document similar to the Profile Plus at the point of sale. In addition, the Task Force recommends that the Commission work with other agencies, including the Department of Labor, toward a common goal of ensuring that all intermediaries provide point-of-sale information that will help investors reach an informed investment decision.

#### ***IV. Substantive Changes in the Regulation of Mutual Fund Distribution Payments***

As noted above, the substantive regulatory scheme for mutual fund distribution payments is fundamentally sound, and improved disclosure at point of sale is the most important change that the Commission should consider. The Task Force has the following additional observations regarding substantive regulation of mutual fund distribution payments.

##### *A. Deducting Rule 12b-1 Fees at the Shareholder Account Level*

In 2004, the Commission issued a release seeking public comment on ways to improve Rule 12b-1.<sup>29</sup> The Release seeks comment on whether the rule should be rescinded or amended to provide that funds may deduct distribution-related costs directly from shareholder accounts, but not from fund assets.

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<sup>29</sup> SEC Rel. No. IC-26356 (Feb. 24, 2004), 69 Fed. Reg. 9726 (March 1, 2004) (the “Rule 12b-1 Release”). A 2001 SEC staff report on mutual fund fees and expenses noted some of the staff’s concerns with Rule 12b-1. *Report on Mutual Fund Fees and Expenses* (January 10, 2001). The staff report recommended that the Commission consider whether it would be appropriate to review the requirements of Rule 12b-1. The report notes that modifications may be needed to reflect changes in the manner in which funds are marketed and distributed and the experience gained from observing how Rule 12b-1 has operated since it was adopted in 1980. The rule essentially encourages fund directors to view a fund’s 12b-1 plan as a temporary measure even in situations where the fund’s existing distribution arrangements would collapse if the Rule 12b-1 plan were terminated. Under the rule, fund directors must annually approve any Rule 12b-1 plan that will extend for more than one year.

Proponents assert that account-level fees would allow an investor to pay distribution costs over time, but would be more transparent to the customer than fund-level expenses such as Rule 12b-1 fees and revenue sharing payments. Nevertheless, the conversion of Rule 12b-1 fees from the fund level to the shareholder account level would require costly systems changes by fund distributors, transfer agents and intermediaries. Moreover, it is unclear where this approach would leave directly distributed funds that today pay their distribution costs out of fund assets.<sup>30</sup>

A simpler way to make all fund fees and expenses transparent – including the costs of distribution – would be to mandate better point of sale disclosure to the investor. The Task Force’s recommended Profile Plus would accomplish this objective.<sup>31</sup>

### *B. Updating the Requirements of Rule 12b-1*

The Rule 12b-1 Release states, “[t]he current practice of using 12b-1 fees as a substitute for a sales load is a substantial departure from the use of the rule as envisioned by the Commission when we adopted the rule in 1980.”<sup>32</sup> In this regard, the Task Force urges the Commission to review the provisions of the rule, particularly its procedural requirements, with a view to whether the requirements should be modernized. For example, some suggest that the factors set forth in the Commission release adopting Rule 12b-1 no longer provide helpful guidance to independent directors in determining whether to adopt or continue a Rule 12b-1 plan.<sup>33</sup> Moreover, it appears unnecessary for directors to make quarterly findings as to continuing benefits to the fund and its shareholders in connection with the continuation of existing plans, as currently required

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<sup>30</sup> Requiring that distribution costs be paid at the shareholder account level may have adverse tax consequences for investors. In this regard, the Task Force notes Rule 6c-10 under the 1940 Act permits installment loads. Few funds have taken advantage of installment loads, apparently due to the tax effect of moving distribution charges from the fund level, where they are treated as deductible expenses, to the account level, where they are not deductible expenses and where they can produce gains taxation to the investor. The SEC’s Division of Investment Management previously considered requiring that Rule 12b-1 fees be deducted at the shareholder level, and rejected this approach because of its tax implications. *See Protecting Investors Report* at 327. We urge the Commission to consider the tax ramifications of any changes in mutual fund distribution payments.

<sup>31</sup> The Task Force also considered whether NASD should revise its sale charge limitations in Rule 2830. The Task Force concluded that these limits have served to maintain the level of Rule 12b-1 fees. In particular, the annual limitations of .75% on asset-based sales charges and .25% on service fees have been effective at keeping total Rule 12b-1 fees at 1% or lower.

<sup>32</sup> *See* Rule 12b-1 Release, 69 Fed. Reg. 9731.

<sup>33</sup> These factors included the need for independent counsel or experts to assist the directors; the nature of the problems or circumstances that make implementation of the plan necessary or appropriate, and the causes of those problems or circumstances; the merits of alternative plans; the interrelationship between the plan and activities of any other person who finances the fund’s shares; the possible benefits of the plan to any other person; the effect of the plan on existing shareholders; and, in deciding whether to proceed with the plan, whether it has produced the anticipated benefits. *See* SEC Rel. No. IC-11414 (Oct. 28, 1980).

by Rule 12b-1(e). Rather, the board should annually review continuation of the plan, and in doing so focus on specific concerns, such as whether the plan or portion thereof will continue with respect to a fund that has been closed to new investors.

*C. Prospectus Fee Table Disclosure of Rule 12b-1 Fees*

The prospectus fee table is a key source of information for investors about mutual fund fees and expenses. Rule 12b-1 fees are listed in the fee table as “Distribution [and/or Service] (Rule 12b-1) fees,” a label that likely is meaningless to many retail investors. The Task Force suggests that it would be helpful to investors if Rule 12b-1 fees were listed in the prospectus fee table solely in a manner that describes their purpose, *i.e.*, as “distribution and shareholder servicing fees,” without reference to a rule number that may be meaningless and confusing to most investors.

*D. Class B Shares*

A single mutual fund, with one portfolio and one investment adviser, may offer more than one class of its shares to investors. Each class represents a similar interest in the mutual fund’s portfolio. The principal difference between the classes is that the mutual fund charges different types of distribution fees depending upon the class chosen.

Funds distributed through intermediary channels frequently offer investors at least three classes of shares – A, B, and C.<sup>34</sup> Class A shares typically charge a front-end sales charge. When they also impose an asset-based sales charge, it generally is lower than the asset-based sales charge imposed by the other classes. Class B shares typically do not charge a front-end sales charge. Instead, they impose Rule 12b-1 fees that are greater than those of Class A shares, as well as a contingent deferred sales charge (CDSC) that is paid if shares are redeemed within a certain period of time. The CDSC normally declines and eventually is eliminated after a specified number of years. Once the CDSC is eliminated, Class B shares often convert into Class A shares. Upon conversion, the shares will charge the asset-based sales charge of Class A shares.

Rather than charging a front-end load, Class C shares typically impose higher asset-based sales charges than Class A shares. Since their shares generally do not convert into Class A shares, their asset-based sales charge will not be reduced over time. Class C shares often impose a small CDSC if the investor sells his shares within a short time of purchase, usually one year.

Many factors affect whether a particular share class may be appropriate for a particular investor. These factors may include the length of time the investor expects to hold the

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<sup>34</sup> Although the use of Class A, B, and C shares is common in intermediary channels, some intermediaries do not offer all three classes of shares or may offer other share classes depending on the circumstances. The discussion in the text above reflects the more common situation where an intermediary distributes Class A, B, and C shares, and not situations in which other classes or combinations of classes may be offered.

shares, the size of the investment, whether the investor is eligible for a breakpoint discount, and the expenses charged by each class. In particular, an investor purchasing Class B or C shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares.

The sale of Class B shares has been the subject of regulatory scrutiny in recent years, resulting in a number of enforcement actions. One way to address these concerns is to provide better disclosure to investors of the costs of a Class B share investment. While the attached prototype Profile Plus concerns Class A shares, we also recommend that the Commission require a Profile Plus for every class. Requiring delivery of the Profile Plus for Class B shares, as with the other classes, would make the fees and expenses more transparent to the investor and would facilitate a comparison of those fees between classes and funds. In particular, the Profile Plus for Class B shares should present the annual, total fund operating expenses (which would include the Rule 12b-1 fee) and the maximum contingent deferred sales load. Both should be presented in dollar amounts, based upon \$1,000, \$50,000 and \$100,000 hypothetical investments. The broker-dealer disclosure should describe the dollar amounts of the total fund operating expenses and the CDSC that are retained by the mutual fund and the dollar amounts that are paid to the broker-dealer.

In addition, the Task Force identified the following areas that may be appropriate for regulatory consideration:

- *Limitations on the length of time before a holding of Class B shares convert to A shares.* The higher Rule 12b-1 fees associated with Class B shares generally permit a mutual fund distributor to recoup the up-front distribution costs that it has incurred. The Task Force does not believe that a mutual fund should continue to charge an investor the higher Rule 12b-1 fees after it has recouped its up-front distribution costs. Regulatory guidance on when conversion from Class B to Class A shares should take place may be appropriate.
- *Guidance on when a closed fund may no longer charge distribution related Rule 12b-1 fees.*<sup>35</sup> When a mutual fund closes to new investors, it may continue to charge Rule 12b-1 fees in order to recoup its up-front distribution costs, or to support the continued bank financing of those costs. It also is appropriate for a closed fund to continue to charge Rule 12b-1 fees if the fees are charged for shareholder servicing or ongoing advice to existing fund shareholders. It is inappropriate for a closed fund to charge Rule 12b-1 fees or distribution-related

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<sup>35</sup> This issue generally affects Class B shareholders only. Class A shares typically pay a Rule 12b-1 fee for shareholder servicing only, and Class C shareholders may pay a Rule 12b-1 fee that covers ongoing, well-defined advisory services. Neither of these payments should be affected if the fund closes to new investors. For example, service fees, which may not exceed .25% of the fund's average net asset value under NASD Rule 2830, are intended to pay for personal service and the maintenance of existing shareholder accounts.

expenses in other circumstances, and regulatory guidance on this issue may be needed.

- *Possible limitations on the size of cumulative Class B sales, and guidance concerning the mutual fund sponsor's responsibility to police these limitations.* The principal enforcement issue associated with the sale of Class B shares has concerned the availability of Class A breakpoints that would have provided a lower-cost alternative to the investor. Many funds and broker-dealers have established their own limitations on the size of Class B share sales that they will accept. The Task Force recommends that the Commission and NASD consider providing guidance on this issue, including placing limitations on the size of cumulative Class B share sales. In addition, the Commission and NASD may wish to provide guidance on the extent to which the mutual fund distributor must monitor for compliance with any limitations that the Commission might establish, and the procedures that the distributor should adopt to make this monitoring most successful.<sup>36</sup>

#### *E. Unified Fee Funds*

The Task Force recommends that the SEC reexamine the unified fee investment company (“UFIC”) concepts that were set forth in the *Protecting Investors* Report and considered by Congress in the mid-1990s.<sup>37</sup> A UFIC structure should be permitted as an option under mutual fund regulation. This would allow fund investors to choose to invest in a UFIC if they considered its fee structure to be an attractive alternative to traditional fee structures.

A UFIC would be a new type of investment company structure under which all fund expenses would be paid out of a single fee, with no separate sale charges or redemption fees.<sup>38</sup> This single fee could be prominently disclosed to investors, which would allow a fund and investors to understand the fund’s costs without having to analyze various components of the total cost. The proposed single fee structure could facilitate cost comparisons among funds, which, in turn, could increase competition and place downward pressure on fee levels. Under a UFIC approach, Rule 12b-1 would no longer be necessary. Instead, “unconscionable or grossly excessive” unified fees would be prohibited.

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<sup>36</sup> Mutual fund advisers, of course, cannot monitor the suitability of share class investments, except with regard to size limitations.

<sup>37</sup> The UFIC model was considered as part of the Investment Company Act Amendments of 1995, H.R. 1495, 1<sup>st</sup> Sess, Sec. 6 (1995). H.R. 1495 was not enacted. The following year, Congress enacted the National Securities Market Improvement Act of 1996, Pub. Law 290, 104<sup>th</sup> Cong., 2d Sess. (1996), which made a number of major changes to the Investment Company Act.

<sup>38</sup> Some funds already have a type of “unified fee” structure, in which the fund adviser pays all or most of the fund’s expenses, including distribution expenses, directly out of the management fee. These fee structures do not include Rule 12b-1 fees or sales charges.

As envisioned by the 1995 legislation, a UFIC generally would have the same corporate structure as that of a typical mutual fund, including a board of directors. The fee would be set by the fund's investment manager, which could impose no additional sales charges or other fees. To make investors aware of the fee paid in connection with their UFIC investment, the legislation would have required the fee to be prominently disclosed on the cover of the fund's prospectus. The fee could not be changed more frequently than annually and only upon adequate notice to shareholders. In addition, to provide a check on the amount of the unified fee and the manager's control over the UFIC's operations, the legislation would require at least two-thirds of a UFIC's board of directors to be independent. The directors would be responsible for approving the management contract and other key service arrangements.

## **V. CONCLUSION**

Mutual fund distribution practices and costs present very important policy issues. The Task Force commends the Commission for addressing these issues and believes that the most important changes that the Commission can undertake are those that would improve the disclosure that investors receive, at point of sale, about the total costs of fund ownership and the potential conflicts that may affect a broker-dealer's recommendation. The Task Force greatly appreciates the opportunity to present its views on possible ways to address some of these issues. The Task Force and its members stand ready to help in any way that they can as the SEC and its staff proceed in addressing these important matters.