



INVESTMENT COMPANY INSTITUTE

September 17, 2004

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

Re: NASD Proposed Rule Change Relating to Disclosure
of Fees and Expenses in Mutual Fund Performance Sales
Material; File No. SR-NASD-2004-043

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to express its support for proposed NASD rule changes to require prominent disclosure of annual expense ratios in mutual fund performance advertisements.² The Institute has supported – and continues to support – initiatives to improve investor awareness of mutual fund costs and to facilitate comparisons among funds.³ Requiring fund performance advertisements to disclose prominently the fund’s annual expense ratio will promote these important goals.

At the same time, the Institute is concerned about NASD’s proposal to mandate the format of certain advertising disclosures in a “text box.” We believe that overly restrictive format requirements can undermine effective communications to fund investors, particularly in the case of electronic communications. For this reason, we recommend that NASD avoid imposing the text box format. We also recommend that NASD’s proposal accommodate the use of hyperlinks (the “one click away” approach) in electronic advertisements.

These and our other comments are discussed below.⁴

¹ The Investment Company Institute is the national association of the American investment company industry. More information about the Institute is included at the end of this letter.

² See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material, 69 Fed. Reg. 52738 (Aug. 27, 2004) (“SEC Notice”). NASD has revised its original proposal, which was published for comment in NASD Notice to Members 03-77 (Dec. 2003).

³ See, e.g., Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, dated Jan. 23, 2004 (commenting on NASD’s original proposal); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Feb. 14, 2003 (supporting disclosure of ongoing expenses in fund shareholder reports).

⁴ In providing our comments, we again urge the Commission to provide more than 21 days for soliciting public comment on significant SRO rule initiatives such as this. The comment period for this proposal began on the last Friday in August and spanned the Labor Day weekend – which, in effect, further shortened the period. As we have indicated previously, this timing is neither desirable nor sufficient if the Commission wishes to provide interested persons a meaningful opportunity to develop thoughtful comments. See, e.g., Letter from Dorothy M. Donohue,

Presentation of Required Information

Text Box Requirement

NASD's proposal requires that *all* fund advertisements containing performance data present the fund's standardized performance, maximum sales charge, and annual expense ratio in a text box.⁵ Fund advertising materials span a broad range, including newspaper advertisements for a single mutual fund, magazine advertisements for funds within a complex sharing common characteristics (*e.g.*, state bond funds), and Web sites, which typically include performance and other important information for all funds in a complex. We believe that the proposed one-size-fits-all format fails to take into account the wide variety of fund advertising materials and will interfere with effective communication of important information to investors.

Advertisements containing information about multiple funds, which are common in the industry, illustrate this point. Such advertisements often provide various key items of information in a chart that allows investors easily to compare several important features of different funds. To comply with the text box requirement, these materials will have to be restructured to segregate certain information, thus either requiring investors to piece together complete information relating to any given fund or funds to repeat the same information in different locations, adding length and complexity. As a result, information such as a fund's investment objective, public offering price, and nonstandardized performance (*e.g.*, cumulative and yearly returns) will be separated from the fund's standardized total return, maximum sales charge, and expense ratio. Along the same lines, the requirement will preclude fixed income funds from presenting 30-day yield numbers alongside their standardized total returns, thereby preventing them from providing a more complete picture of fund performance in one place. Contrary to NASD's intent, these results do not serve the interests of investors.

The revised proposal extends the text box requirement to Web sites and other electronic advertisements. Flexibility to devise effective communications is especially important in the context of electronic media. Web sites, for example, enable investors to navigate large amounts of information in a convenient and logical fashion. They provide the capability to call attention to specific information through the use of visual effects and other techniques, such as hyperlinks, that are not feasible on paper. A restrictive text box format will hamper effective electronic communications.⁶

Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 4, 2004 (File No. S7-18-04) (Proposed Rule Changes of Self-Regulatory Organizations).

⁵ As revised, the text box requirement applies only to "advertisements" as defined in Rule 2210 (and not to "sales literature"). Rule 2210 defines "advertisement" broadly to include material in any public media such as newspapers, magazines, Web sites, radio or television. We understand that NASD staff generally consider material to be "sales literature" and not "advertisements" when there is an ability to control who views the material (*e.g.*, direct mailings). We believe this is an appropriate way to distinguish advertisements from sales literature and recommend that NASD address this approach in connection with the final rule. In particular, password-protected Web sites should not be considered advertisements for purposes of Rule 2210. Limitations on access to such sites distinguish them from public Web sites that anyone can access at will. Password-protected Web sites do not constitute "public media" as contemplated by the definition of "advertisement" in Rule 2210.

⁶ If NASD does not eliminate the text box requirement altogether, at a minimum, the requirement should not apply to electronic advertisements.

Significantly, the text box requirement is unnecessary to achieve the goal of ensuring that the required information is sufficiently prominent. Less than one year ago, the
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Commission amended Rule 482 under the Securities Act of 1933 to enhance disclosure in fund advertisements.⁷ Rule 482 includes detailed requirements specifically addressing the presentation of standardized performance quotations and maximum sales charges.⁸ There is no indication that these requirements are not working as intended. Therefore, we recommend that NASD revise its proposal to require that the presentation of a fund's annual expense ratio meet the requirements of Rule 482 that apply to disclosure of maximum sales charges.⁹ Our recommendation will provide for consistent requirements under Commission and NASD rules. Such consistency is appropriate where, as here, the rules share the same policy goal of ensuring fair and balanced presentations that effectively communicate important information to investors. Establishing uniform standards also will facilitate both the NASD review process and compliance by NASD members.¹⁰

"One Click Away" Approach

The Institute urges NASD to reconsider its decision not to permit a "one click away" approach for electronic communications. Through this approach, an investor can click on a hyperlink in close proximity to nonstandardized performance (for example, month-end returns) to access the information required by the proposal.¹¹ Internet users are well-acquainted with and adept at using these features. As discussed above, electronic media offer unique

⁷ SEC Release Nos. 33-8294; 34-48558; IC-26195 (Sept. 29, 2003), 68 Fed. Reg. 57760 (Oct. 6, 2003).

⁸ Rule 482 prescribes specific type size and style requirements for certain required disclosures, including information about a fund's maximum sales charge, in print advertisements. In an electronic advertisement, these type size and style requirements may be satisfied by presenting the disclosure in any manner reasonably calculated to draw investor attention to the information. In a radio or television advertisement, the disclosures must be given emphasis equal to that used in the major portion of the advertisement.

In addition, Rule 482 requires certain disclosure (including maximum sales charge information) to be presented in close proximity to performance data and, in a print advertisement, to be presented in the body of the advertisement and not in a footnote. A fund's one, five, and ten year average annual total returns must be set out with equal prominence and any other performance measures must be set out in no greater prominence than the required quotations of total return. *See also* Rule 34b-1(b)(1) under the Investment Company Act of 1940, which extends these presentation requirements to investment company sales literature that contains performance data.

⁹ These requirements are discussed above. We suggest that NASD implement this recommendation by revising the proposal to require a fund's expense ratio to be presented in the manner required by paragraph (b)(5) of Rule 482 for information required to be disclosed by paragraph (b)(3) of Rule 482. *See* Rule 34b-1(b)(1)(i), which follows a similar approach.

¹⁰ NASD's proposal provides that the required information must be set forth "clearly and prominently." In addition, the proposal requires standardized performance to be in a type size that is at least as large as that used to present any nonstandardized performance and radio, television or video advertisements to present the required information with equal emphasis to that given to any nonstandardized performance. These requirements are similar to, but not exactly the same as, the presentation requirements under Rule 482. To the extent that these provisions are meant to be consistent with the Rule 482 presentation requirements, they are redundant and therefore unnecessary. If they purposely differ from the Rule 482 requirements, their precise intent is not clear and they are likely to raise interpretive issues. Our recommendation regarding the presentation of expense ratio disclosure should replace these provisions. It would address the same purpose but would avoid complicating compliance and generating additional interpretive issues in the course of NASD review. If NASD does not follow our recommendations, it should provide additional guidance on how to reconcile the presentation requirements in Rule 482 with the NASD text box and other presentation requirements.

¹¹ *See* SEC Notice at 52740.

opportunities for presenting and highlighting information. As a result, there can be many effective approaches to conveying important information to investors. Successful approaches might well differ depending on the nature of the particular communication. Investors are well-

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served by allowing funds flexibility to devise appropriate ways to present disclosure, including using a “one click away” approach.¹²

Calculation of Annual Operating Expenses

NASD’s proposal requires annual operating expenses included in fund advertisements to be calculated without giving effect to expense reimbursements and fee waivers. As discussed in the SEC Notice, the Institute and other commenters recommended that NASD require expense ratios to be based on the fund’s *actual* expenses for the period covered. NASD rejected our recommendation because fee waivers and reimbursements are subject to termination.¹³

NASD should reconsider its position because the proposed approach will result in inaccurate disclosure. Assume, for example, that a fund’s expense ratio is .40% with a fee waiver in effect. Absent the waiver, the fund’s expense ratio would be .80%. Requiring a fund to disclose that its current expense ratio is .80% when its actual current expense ratio is .40% is inappropriate. It also reduces comparability among funds, because some funds (those without fee waivers) will disclose their actual, current expense ratio while others (those with fee waivers) will disclose a hypothetical number (*i.e.*, what their expense ratio would be absent the fee waiver). Presumably, this is why actual expense ratios typically are used by industry analysts to present and compare expenses of different funds.

More importantly, when fee waivers and expense reimbursements are in effect, requiring disclosure of the fund’s gross expense ratio in fund performance advertisements may be misleading. The gross ratio could wrongly imply that the fund’s performance was better than it really was. Presenting a fund’s gross expense ratio alongside performance quotations may give investors the impression that the fund’s performance attributable to a fee waiver or expense reimbursement is the result of the skill of the fund’s portfolio manager. Investors may not recognize that the fund’s performance would have been lower if not for the fee waiver or expense reimbursement. NASD’s requirement that any explanation in an advertisement must appear outside the text box exacerbates this problem.

To avoid these significant problems, NASD should revise its approach and require disclosure of the fund’s expense ratio to include fee waivers or expense reimbursements.

Compliance with the Rule Changes

¹² We understand that NASD has permitted funds to use a “one click away” format to provide certain standardized performance information on their Web sites for purposes of complying with Rule 482. Under this approach, investors are invited to click on the fund’s most recent month-end performance to view standardized performance as of the most recent calendar quarter. We support permitting such an approach because it enhances funds’ ability to design effective presentations that provide investors with convenient and easy access to standardized performance quotations. Thus, we strongly recommend that NASD continue its existing practice of allowing funds to comply with Rule 482 in this manner.

¹³ SEC Notice at 52739-40.

As we indicated in our earlier letter, adequate lead-time is necessary for the preparation of performance materials meeting the new requirements and their filing with, and approval by, NASD. We recommend that NASD: (1) provide a compliance period of approximately six months and coordinate the compliance date for the rule changes with a regularly scheduled update of fund performance materials; and (2) permit the filing with NASD of templates, rather than each individual piece of performance material. Each of these recommendations is discussed below.

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Compliance Date

Revisions to the content requirements of Rule 2210 will require NASD members to undertake substantial efforts to meet the new requirements. While the precise impact will vary depending on the nature of the final requirements, any changes will need to be incorporated not only in all existing performance materials but also in all of the systems, policies and processes associated with the design, production, internal review and approval, filing, distribution and use of such materials. Changes to fund Web sites, in particular, involve substantial commitments of time and resources, as well as coordination with other initiatives affecting those sites. Since our initial comment letter, our members have analyzed the steps that they expect will have to be taken to implement the new requirements and have informed us that they anticipate needing at least six months after the adoption of final rule changes to achieve compliance.

The Institute therefore recommends that NASD provide a compliance period of approximately six months. Instead of requiring fund performance materials to comply with revised Rule 2210 within 180 days after adoption or as of an arbitrary effective date, we recommend that the compliance date be the second calendar quarter end after the adoption of the final rule changes. Basing the compliance date on a calendar quarter end will enable NASD members to coordinate their implementation of the rule changes with a regularly scheduled update to their performance materials.

Use of Templates

It is not uncommon for fund complexes to utilize templates in designing performance materials. The use of templates enables a fund complex to establish a uniform style and provides for consistent presentations of information in such materials. It promotes efficiency and reduces production costs by minimizing the amount of information that needs to be updated over time or changed in materials relating to different funds.¹⁴

In connection with complying with the final rule changes, the Institute encourages NASD to permit its members to file templates of performance materials, rather than filing each individual piece. This approach is consistent with the NASD staff's treatment of statistical updates to advertisements.¹⁵ Importantly, it will facilitate the NASD review process and will

¹⁴ A fund complex may utilize a variety of templates depending on the advertising medium - e.g., templates for print advertisements may differ from templates for electronic advertisements.

¹⁵ See Letter to Forrest R. Foss, Vice President and Associate Legal Counsel, T. Rowe Price Associates, Inc., from Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, NASD Regulation, Inc., dated January 28, 2002.

help avoid potential delays, while allowing NASD staff to identify and address any regulatory concerns with the format and contents of fund performance materials. It also will reduce filing costs, which can be substantial.

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We appreciate the opportunity to comment on NASD's proposal. Investors will benefit from requiring fund advertisements to prominently disclose the fund's annual expense ratio. To achieve the best results, NASD should refrain from mandating a format (the text box) that could interfere with effective communication of important information. Instead, NASD should provide its members with flexibility to design successful disclosure approaches, including using a "one click away" approach in electronic communications. Any new presentation requirements should be consistent with existing, carefully crafted Commission requirements.

If you have any questions about our comments or need additional information, please contact me at 202/326-5822 or Dorothy Donohue at 202/218-3563.

Sincerely,

Frances M. Stadler
Deputy Senior Counsel

cc: Paul F. Roye, Director
Division of Investment Management
Securities and Exchange Commission

Angela C. Goelzer, Counsel
Investment Company Regulation, Regulatory Policy and Oversight
NASD

About the Investment Company Institute

The Investment Company Institute's membership includes 8,600 open-end investment companies ("mutual funds"), 630 closed-end investment companies, 135 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about \$7.351 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.