SECURITIES AND EXCHANGE COMMISSION
INVESTOR ADVISORY COMMITTEE

POSSIBLE REFINEMENTS TO THE DISCLOSURE REGIME

JULY 27, 2009

Introduction

The first meeting of the Investor Advisory Committee ("the Committee") will be largely devoted to organization. Among these organizational tasks is agreeing upon (a) what issues the Committee will consider in the next year, (b) the relative priorities and sequencing of these issues, and (c) what external sources of expertise will be called upon to aid the Committee in its considerations. However, because the Committee's meeting time is limited, we also did not want to lose the opportunity to begin the discussion of certain topics that we believe are likely to fall within the Committee's 2009-2010 agreed-upon agenda. These issues involve the Commission's disclosure regime.

Ensuring that investors have the information that they need to make informed decisions is one of the core goals of the Commission. SEC rules that mandate specific disclosure – whether by public companies or by financial intermediaries such as investment advisers and brokers – represent the foundation for this investor information.

The Commission's disclosure regime crosses all programs, products and practices within our jurisdiction. Any review of all SEC-mandated disclosure would be immense. For purposes of this Committee meeting, this Briefing Paper identifies a limited number of key disclosure areas for preliminary discussion. All of these discussion topics have recently been cited by some stakeholders as in need of enhanced disclosure. **However, it is important to recognize that this Paper is not intended to represent a complete list of all areas potentially in need of enhanced disclosure, or to provide an exhaustive analysis of the few issues that are identified.** Rather, this Paper is intended to provide the Committee with an opportunity to **begin** discussions in this area, and to help the Committee determine the relative priority of these issues.

This paper was developed by the staff of the SEC to foster discussion among the members of the Investor Advisory Committee. It is not a statement of the Commission, nor does it necessarily reflect the views of the Commission or its staff.

The disclosure topics are divided into two sections: disclosure involving investment products and financial intermediaries, and disclosure involving public companies. Discussion questions are posed throughout the Paper, and will form the foundation for the discussion at the Committee's meeting.

Section 1: Disclosure Related to Investment Products & Financial Intermediaries

Mutual Fund Point of Sale Disclosure

The Securities Act of 1933 requires that investors be provided with a prospectus prior to, or at the time of, confirmation or delivery of securities. Under this framework, prospectuses may be delivered after the investment decision has occurred. As a result, concerns have been raised that mutual fund investors often are not receiving material information at the "point of sale" when it would be most helpful in making informed investment decisions. Particular concerns have been raised regarding the need at the point of sale for information about broker compensation and related potential conflicts of interest.

In 2004, the Commission proposed rules that would have required disclosure of broker compensation and conflicts to investors at the point of sale in transactions involving mutual fund shares. The Commission received a significant number of comments in response to these proposals, and the Commission engaged a consultant to conduct investor testing of possible forms for point of sale disclosure. The comments and investor testing suggested areas where the disclosure requirements could potentially be revised to more effectively communicate information to investors and to more appropriately balance the benefits of disclosure against the costs of compliance. Furthermore, some comments suggested the adoption of a layered approach to disclosure, whereby brokers would post additional disclosure on the Internet to supplement point of sale disclosure. Concerns were also raised about the potential impact of point of sale disclosure on the sales process. In response to the foregoing, the Commission in 2005 published a supplemental request for comment and reopened the comment period on the proposals. No action has as yet been taken on the supplemental request for comment.

Recently, the Obama Administration delivered proposed legislation to Congress that would give the Commission express authority to require that information be provided to mutual fund investors before the investment transaction occurs.

Discussion Questions –

1. What, if any, information should be disclosed to mutual fund investors at the point of sale to better enable them to make informed investment decisions?

2. How should point of sale disclosure be provided (*e.g.,* written, electronic, oral)? Should more than one method be used?

3. What impact would point of sale disclosure have on the mutual fund sales process, and what would be the competitive impact of requiring point of sale disclosure for mutual funds without requiring such disclosure for competing financial products?

Mutual Fund/Broker Fee Disclosure

Fees and expenses are an important consideration for investors when selecting a mutual fund because they can have a significant impact on the return an investor earns from a fund investment. For example, a 1% increase in a fund's annual expenses can reduce an investor's ending account balance in that fund by 18% after 20 years.

Because of the importance of fund fees and expenses, the Commission has long sought to ensure that funds provide investors with disclosure of fund costs that will promote informed investment decisions and permit cost comparisons across funds. Since 1988, the Commission has required uniform cost disclosure in mutual fund prospectuses in a tabular format. The fee table is accompanied by a numerical example that illustrates the total dollar amounts that an investor could expect to pay on a $10,000 investment if the fund achieved a 5% annual return and the investor remained invested in the fund for 1-, 3-, 5-, and 10-year periods. To encourage investors to give greater attention to costs and cost comparisons, the Commission recently moved the fee table to a more prominent location earlier in the prospectus and provided the same prominence for the fee table in the new summary prospectus. Several years ago, the Commission took steps to increase investor awareness and understanding of the significance of the ongoing costs that they pay in connection with mutual fund investments by requiring funds to disclose examples of such costs in fund shareholder reports. Together with FINRA, the Commission also took steps to enhance investor understanding of available discounts on front-end sales loads.

The Commission has also undertaken efforts to educate investors about the significance of the costs that they pay in connection with mutual fund investments. For example, the Commission's website contains a Mutual Fund

Cost Calculator, an Internet-based tool that enables investors to compare the costs of owning different mutual funds over a selected period.

Nevertheless, some concerns remain about investor understanding of the costs associated with mutual funds, as well as the compensation of brokers who sell mutual fund shares and the potential for conflicts of interest arising from such compensation. Some of the concerns that have been raised include: (1) whether disclosure of so-called 12b-1 fees that are used to pay for distribution and shareholder servicing is effective; (2) whether the costs of mutual fund portfolio transactions could be quantified and included in the fund's expense ratio; (3) how and when compensation of brokers who sell fund shares, as well as the potential for conflicts of interest arising from broker compensation, should be disclosed; (4) whether fund cost disclosure should, to a greater extent than presently, be stated in dollar terms rather than as a percentage of assets; (5) whether fund cost disclosure should be accompanied by comparative cost information for comparable funds and, if so, how to determine what funds should be considered comparable for this purpose; (6) what are the most effective times and locations for cost disclosure; (7) how to facilitate cost comparisons not only across mutual funds but across different financial products, which impose costs in different ways, some of them implicit rather than explicit; and (8) the role of education efforts in enhancing investor understanding of mutual fund costs.

Discussion Questions –

1. What steps could the Commission take to further enhance investor understanding of mutual fund costs and the ability of investors to compare costs across funds and other financial products (*e.g.*, additional disclosure, investor education)?

2. What could be done to enhance disclosure of broker compensation for mutual fund transactions, as well as the potential conflicts of interest arising from such compensation?

Disclosure to Investors in 401(k) Plans

Defined contribution plans, which place the investment decision-making responsibility and investment risk on plan participants, are the primary retirement-savings vehicle for millions of Americans. At the end of 2008, approximately 9 percent of household financial assets were invested in 401(k) and other defined contribution retirement plans, with assets totaling $3.5 trillion. Approximately 44% of those assets were invested in mutual funds. It is critically important that 401(k) plan investors be provided the information necessary to make informed investment decisions with respect to their retirement plan assets.

Today, the disclosure that retirement plan investors receive depends upon the regulatory regime that governs the underlying investment option, and on decisions of the plan sponsor. If the underlying investment option is an investment product registered under the Securities Act of 1933, such as a mutual fund, and if the plan sponsor is relying on a safe harbor under Section 404(c) of the Employee Retirement Security Act of 1974, plan participants must be provided a copy of the most recent prospectus provided to the plan.[1] Collective investment trusts, fixed insurance products, and other investment options that are not registered under the Securities Act do not provide comparable prospectus disclosure. In 2008, the Department of Labor proposed rules that, if adopted, would require standardized disclosure of information about all 401(k) plan investment options, including fee and expense information, to participants and beneficiaries.[2]

The transparency of revenue sharing arrangements involving 401(k) plans and the underlying mutual funds, and the resulting potential for conflicts of interest, have been a concern. For example, mutual fund “12b-1 fees” are sometimes used to pay third party record-keepers for back-office services that would otherwise be paid for by the plan or its sponsor. To the extent that some investment options offered under a 401(k) plan provide such payments and other investment options provide lesser or no such payments, plan participants invested in those investment options that offer the payments may pay a proportionally greater share of their retirement plan’s costs.

Another disclosure issue that affects many retirement plan participants relates to target date funds. Target date funds are mutual funds that allocate their investments among several asset classes and shift that allocation to more conservative investments as a “target” retirement date approaches. These funds have become popular, with growth in target date fund assets likely to continue because these funds are permitted default investments in 401(k) plans under the Pension Protection Act of 2006. Concerns have been raised as a result of recent losses by target date funds with near-term target dates. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds, including different timeframes for shifting into more conservative investments, produced widely varying results, as returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent. On June 18, the Commission and the Department of Labor held a joint hearing on target date funds. The SEC staff is currently considering whether

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1 Plans relying on Section 404(c) bear no responsibility for investment losses resulting from a plan participant’s investment decisions as long as certain information regarding the underlying investment options is provided to plan participants.

2 See Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 FR 43014 (July 23, 2008).

additional disclosure measures and/or fund names rule changes are appropriate with respect to target date funds.

Discussion Questions –

1. What steps could the Commission take to facilitate better disclosure to retirement plan participants regarding available investment options?

2. How can the transparency of 401(k) plan revenue sharing arrangements, and associated potential conflicts of interest, be improved?

3. Do target date funds raise any disclosure issues, including fund name issues, which should be addressed by the Commission?

Section 2 - Environmental, Climate Change and Sustainability Disclosure

Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 to provide for full and fair disclosure to investors. The disclosure framework created by these statutes and the rules and regulations implemented by the Commission pursuant to these statutes require companies to disclose material information that enables investors to make informed investment and voting decisions. When a company is subject to a disclosure obligation under the Federal securities laws, it is required to disclose specific information described in the Commission's forms and regulations, including with respect to the its business, legal proceedings, management, and financial condition, among other matters.

In most cases, the disclosure requirements include a materiality qualifier. Materiality is a legal standard defined by the Commission and interpreted by the courts that is always based upon a company's specific facts and circumstances. In addition to the detailed disclosure requirements specified in Commission forms and regulations, companies must also disclose any other material information necessary to make the required disclosure not misleading.

Over the past few years, the Commission and its staff have received requests to revise the disclosure requirements in Commission regulations, or publish an interpretation of them, to require more detailed disclosure regarding environmental, social and governance matters. Proponents of these types of disclosures, which are sometimes referred to as "sustainability reporting," "corporate responsibility reporting" or "triple bottom line," argue that these matters may present material risks for companies or may otherwise be material to an investment or voting decision. Further, proponents believe that these disclosures help investors better understand the broader impact of a company's business practices. Sustainability reporting commonly includes disclosure about:

- climate change risk;
- environmental impacts and liability;
- labor practices;
- occupational health and safety;
- human rights;
- supply chain management;
- diversity and equal opportunity;
- community relations;
- public policy positions and participation; and
- product responsibility.

The interest in sustainability reporting has resulted in a few organizations being formed to support and encourage the disclosures. Some of the more well-known organizations, such as the Coalition for Environmentally Responsible Economies (CERES) and the Global Reporting Initiative (GRI), have issued reporting guidelines. The GRI's "Sustainability Reporting Guidelines" and "Reporting Framework" appear to be gaining acceptance as international standards.

A number of global companies issue sustainability reports. The list of U.S. public companies issuing these reports includes Anheuser-Busch, AT&T, General Motors, Intel, Johnson & Johnson, McDonald's, Nike and PepsiCo. Companies that issue these reports generally do so voluntarily, although some emerging market stock exchanges require reporting on these matters. It appears, however, that support for reporting on sustainability matters is gaining in certain European countries.

Climate Change and Other Environmental Issues

Although the Commission's forms and regulations do not include specific line item disclosure requirements for matters relating to the environment and climate change, a number of more general line items do relate to environmental issues, such as a requirement to disclose:

- the material effects that compliance with Federal, State and local provisions concerning the protection of the environment may have upon the capital expenditures, earnings and competitive position of a company;

- certain material pending administrative or judicial proceedings arising under any Federal, State or local environmental provisions, including any pending or contemplated governmental actions involving potential monetary sanctions under environmental provisions when the company reasonably believes that the sanctions will exceed $100,000;
- any known trends or uncertainties that will or are reasonably likely to have a material impact on a company's liquidity, revenues or income; and
- any material risks facing a company and its investors.

Furthermore, public companies generally must file financial statements prepared in accordance with U.S. GAAP in their annual and quarterly reports. Under GAAP, companies are required to record liabilities, including environmental liabilities, in their financial statements if the liabilities' occurrence is "probable" and their amounts are "reasonably estimable." Probable means that the future event or events are likely to occur. A liability is estimable if company management can develop a point estimate or determine that the amount falls within a particular dollar range. GAAP does not require disclosure of environmental liabilities unless management considers it "reasonably possible" that an adverse impact will be material. "Reasonably possible" means that the chance of the future event or events occurring is more than remote, but less than likely.

Social, Governance and other Operational Matters

Similarly, although the Commission's forms and regulations do not include specific line item disclosure requirements for matters relating to social, governance and other sustainability matters, as in the case with environmental and climate change disclosure, a number of more general line items may require disclosure related to these issues if they are material to an investor. These disclosures include business disclosures, such as the sources and availability of raw materials, dependence on foreign operations, and employee relations, disclosures regarding material business trends, and general disclosure of all material risks to the company and investors. Financial statements prepared in accordance with U.S. GAAP also generally require that any liabilities related to sustainability matters be recorded if probable and reasonably estimable.

Discussion Questions –

1. Do investors consider environmental compliance, climate change and sustainability issues important in making investment or voting decisions?

2. Are current disclosure practices with respect to environmental compliance, climate change and sustainability issues sufficient for investors to make informed investment and voting decisions, or do investors need expanded disclosure in any of these areas?

3. If additional disclosure in these areas would be useful to investors, should the Commission require additional disclosure on these matters by revising its forms and regulations? Alternatively, should the Commission highlight how its current forms and regulations may require disclosure in these areas?