Consumer Federation of America
AARP
Consumer Action
Consumers Union
Fund Democracy, Inc.

December 6, 2004

The Honorable William Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Chairman Donaldson:

Our organizations would like to congratulate the Commission for testing its proposed point-of-sale mutual fund disclosures with average investors. This testing has provided valuable insights into how the content, format, and timing of these disclosures all affect investors' understanding and use of the information the disclosures are intended to convey. We therefore urge the Commission to adopt the substantial changes the testing indicates are needed to ensure the disclosures fulfill their intended purpose, even if doing so requires re-proposing the rule.

Specifically, we believe the independent consultants' report[1] offers strong support for the following points:

- It is essential to disclose total costs, including fund operating costs, not just distribution costs.
- The costs must be put in context, by providing comparative cost information in dollar amounts, if investors are to understand their importance.
- The disclosures must be provided in writing using standardized format and language.
- The disclosures must be provided early in the process, at the point of recommendation rather than at point of sale.

If the rule is revised to reflect these findings, it should dramatically improve investors' ability to

[1] *Results of In-Depth Investor Interviews Regarding Proposed Mutual Fund Sales Fee and Conflict of Interest Disclosure Forms*, Report to the Securities and Exchange Commission, Siegel & Gale, LLC and Gelb Consulting Group, Inc., November 4, 2004.

take fund costs and conflicts of interest into account when making a fund selection. Without these changes, the rule is likely to be ineffective at best and counter-productive at worst.

1. Total costs

As originally proposed, the rule would require disclosure only of those costs associated with distribution of the fund. It would not cover fund operating costs. The consultants who tested the disclosure documents, however, found a "strong investor preference" for including both operating costs and distribution costs in the Point of Sale documents.[2] They also found high levels of frustration associated with having to look for operating cost information in another location.[3] More importantly, they found that failure to provide complete operating cost information led some investors to believe that 12b-1 fees were the only annual expenses they would pay.[4] In other words, the rule as proposed would have the perverse effect of causing some investors to under-estimate and possibly even ignore the operating costs of the funds they purchase. This would be a step backward indeed.

2. Putting fees in context

In one of their more interesting, albeit disturbing, findings, the independent consultants found no evidence that investors understand the impact higher fees have on investment returns.[5] Given the extensive attention this issue has been given in investor education materials, this clearly demonstrates the urgent need to do a better job of communicating this impact. It also helps to explain the persistent lack of effective cost competition among funds in the broker-sold market. The lack of effective competition is further highlighted by the independent consultants' finding that, "[w]ithout comparison ranges, investors assumed the up-front or back-end sales loads and the annual fees were 'reasonable.'"[6]

Including cost comparison ranges on the forms, as the independent consultants recommend, would be a significant improvement. Investors received this suggestion enthusiastically, and several noted that they could use these comparison ranges to better evaluate the fees disclosed on the form.[7] We believe, however, that the prototypes submitted in response to the original rule proposal by Nancy M. Smith, former director of the Office of Investor Education and Assistance, offer a superior approach, by clearly illustrating the long-term impact of costs on fund returns in a form investors are likely to understand and to which they are likely

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[2] Ibid., p. 6.

[3] Ibid, p. 6.

[4] Ibid., p. 7 and p. 27.

[5] Ibid., p. 12.

[6] Ibid., p. 6.

[7] Ibid., p. 27.

to pay attention. By providing the comparative cost information in dollars and over the long-term, this approach makes it significantly more likely that investors would understand the impact of fees on returns. This approach would also help to alleviate the problems investors experienced in distinguishing the higher annual costs associated with B shares.[8] It is unfortunate that this approach was not tested as part of the independent consultants' review.

3. Standardized format and language

The report offers numerous examples throughout of how minor changes in format or wording have a significant impact on investor attention to and understanding of key information. Unless the Commission requires that these disclosures be standardized, we will inevitably see a variety of forms, all in compliance with the rules, that nonetheless vary greatly in their effectiveness. Worse, some brokers may be tempted to use their knowledge of disclosure design to de-emphasize issues they would rather investors ignored. The result could be poor disclosure by those firms with the most to hide. If these concerns are true of written documents – and past experience confirms that they are – they are all the more true of oral disclosures, which will be virtually impossible to police. If the Commission is serious about encouraging investors to take costs and conflicts of interest into account when making fund selections, it must require that these disclosures be provided in writing using standardized format and wording.

4. Timing of disclosures

We have maintained from the outset that investors will only use this information if they receive it early enough to include it in their decision-making process. This view was confirmed by investors in the study, who expressed a preference for receiving the Point of Sale form as "early as possible" in the process so they could use it to evaluate several fund choices.[9] This is exactly how the information can most effectively be used. We therefore urge the Commission to require that the disclosures be provided at the point when the broker recommends a specific fund or funds, not just before the sale is finalized as the original rule proposal would allow.

5. The limits of disclosure

The test results also clearly illustrate the limits of disclosure. Although a major goal of the proposed disclosure documents is to put investors on their guard about conflicts of interest that could cause their broker to recommend funds not in their best interests, the independent consultants found that those investors most likely to rely heavily on the recommendations of their broker were unlikely to change that reliance based on these disclosures.[10] This confirms a view we have long held, that disclosure is better at illuminating costs than at counteracting conflicts of interest. Recently, the Commission took the strongly pro-investor step of banning directed brokerage arrangements. We encourage you to continue to explore whether other broker

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[8] Ibid., p. 13.

[9] Ibid., p. 20.

[10] Ibid., p. 2, 12, 13.

compensation practices should be reformed or eliminated, including the most basic practice of having funds determine the level of payments to the brokerage firm for services provided by the broker to the investor. We believe such reform is long overdue.

These findings further support our view that it is foolish to expect a single disclosure document to overcome multi-million-dollar advertising campaigns designed to send the opposite message. As long as investors are encouraged by the titles brokers use, the services they offer, and the advertisements they display to view their brokers as impartial advisers, they are unlikely to give significant weight to disclosures about conflicts of interest. This is a problem the Commission must attack through more than just disclosure. Rather, it clearly should require brokers who hold out to the public as advisers and offer extensive advisory services to comply with the fiduciary duty and disclosure obligations that accompany that role. Then, it should lend weight to that action by interpreting that fiduciary duty to include an obligation to take costs into account when making recommendations, and it should look for violations when conducting its regulatory and enforcement inspections.

Conclusion

Requiring pre-sale cost and conflict disclosure for mutual funds has the potential to offer enormous benefits to investors. But it will only do so if the requirement is implemented effectively. The Commission is to be congratulated for taking the essential first step toward achieving that goal – testing the proposed disclosures with investors to determine their effectiveness. We now urge the Commission to take the next step, and adopt the changes that the real world tests support. We further urge the Commission to make this approach standard practice both when considering new disclosures and when evaluating existing disclosures.

Respectfully submitted,

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