Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

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Consumers Union
Publisher of Consumer Reports

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

Re: File No. S7-06-04

Dear Secretary Katz:

We are writing on behalf of Consumer Federation of America,[1] Fund Democracy,[2] Consumer Action,[3] and Consumers Union[4] with regard to the rule proposal to improve disclosure of certain mutual fund costs and conflicts of interest at the point of sale and on confirmation statements. We applaud the Commission's proposal to correct the longstanding gap in the regulation of fund sales that has deprived mutual fund investors of confirmation statement disclosures, which are standard for other securities, about the compensation brokers receive in connection with the purchase and sale of those securities. We also applaud the Commission's efforts to address additional regulatory gaps by requiring that brokers provide information on mutual fund distribution costs and conflicts before the sale and by requiring disclosure of some comparative distribution information. Finally, we congratulate the Commission for making a concerted effort to obtain comments on its proposals from typical mutual fund investors.

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 national, state, and local consumer groups, which in turn represent approximately 50 million Americans. CFA was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Fund Democracy is a nonprofit advocacy group for mutual fund shareholders. It was founded in 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments.

[3] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 6,500 community based organizations.

[4] Consumers Union, publisher of *Consumer Reports* magazine, is an independent nonprofit testing, educational and information organization serving only the consumer.

Although we view this proposal as an improvement over the current woefully inadequate state of mutual fund disclosure, we are nonetheless forced to conclude that it is seriously flawed. As we will discuss in more detail below, the proposed disclosures fail to provide all the information mutual fund investors need about costs and conflicts, they fail to ensure that the information is provided at a time when it is likely to influence the purchase decision, and they fail to ensure that it is provided in a form that average, unsophisticated investor will easily understand. We therefore strongly recommend that the Commission adopt major revisions to the content, timing, and format of its proposed disclosures.

We also believe that there are limits to what disclosure alone should be expected to accomplish, particularly when it comes to combating conflicts of interest. This is especially true when those disclosures are forced to counteract multi-million-dollar advertising campaigns designed to send exactly the opposite message, as is the case with regard to brokerage industry conflicts of interest.

The recent mutual fund sales practice scandals – involving inappropriate sale of B class shares, failure to provide appropriate breakpoint discounts, and use of undisclosed sales competitions to promote the sale of certain funds, as well as a history of recommending funds based on the compensation they offer to the broker rather than the benefits they offer to the client – have, in our view, made it abundantly clear that the Commission must finally act to close the enormous gap between the image brokers promote of themselves as objective financial professionals and the reality of their conflict-laden sales practices. It simply makes no sense to continue to allow brokers to use titles that imply they are objective advisers rather than salespeople and promote their services as if they were primarily advisory in nature without imposing both a fiduciary duty to act in the best interests of their clients and a requirement that they disclose any and all conflicts of interest prior to the engagement. Furthermore, that fiduciary duty must be interpreted to require brokers and investment advisers to include costs as one of the factors they take into account when recommending mutual funds and other investment products.

Even if such an approach were adopted, we believe the complexity of the mutual fund distribution conflicts will inevitably undermine the effectiveness of cost and conflict disclosure. Many of these conflicts are a direct result of the Commission's record of lax interpretation of Section 12(b) of the Investment Company Act. In that provision, Congress wisely prohibited the use of fund assets to sell fund shares. The Commission's past overly permissive positions on 12b-1 fees, revenue sharing arrangements, and directed brokerage arrangements have practically repealed Section 12(b). When these positions are coupled with the Commission's refusal to fulfill its statutory responsibility under Section 36(b) of the Act to take action against fund managers who charge excessive fees, the concept of regulatory limits on the use of shareholders' funds to sell fund shares loses all meaning. We appreciate that the Commission has proposed banning use of directed brokerage to promote distribution and is exploring additional 12b-1 fee reforms. We urge the Commission to take the strongest possible action to end these and similar conflicts of interest.

As part of that review, we encourage the Commission to revisit a recommendation it has

made in the past to repeal or amend section 22(d) of the Investment Company Act.[5] By allowing mutual funds to set the compensation brokers receive for the services they provide to investors for selling the fund – a price that logically should be negotiated between the broker and the investor – the provision exempts these costs from the market forces that have dramatically reduced commissions on stock transactions. At the same time, this provision has helped create the system in which funds compete to be sold, by offering financial incentives to the salesperson, rather than competing to be bought, by offering a good product and good service at a reasonable price. If funds were removed from the role of fixing broker compensation, the incentive for brokers to recommend funds that are not in their clients' best interests would be sharply reduced, and investors should reap enormous benefits as a result.

Principles That Should Govern Timing and Content of Disclosure

The proposed confirmation and point-of-sale disclosure serve different, but complementary, purposes. As the Commission noted in its release, the purpose of point-of-sale disclosure is to "allow customers to consider material information when they make their investment decisions."[6] The confirmation disclosure, on the other hand, serves primarily to quantify fund distribution costs, including payments that may have influenced the fund recommendation. While we generally agree with the basic principles for point-of-sale and confirmation disclosure laid out by the Commission in the proposing release, we do not believe the actual proposals live up to these principles.

In revising the content and timing of its proposed disclosures to conform to those principles, we urge the Commission to employ the following logic. Information that is relevant to the selection of the financial professional, including information about practices they engage in that create conflicts of interest, should be required to be provided prior to the engagement, as it is for investment advisers.[7] Information relevant to the purchase of a particular product – including, but by no means limited to, information about distribution related costs and financial incentives that may influence the product selection – should be provided at the point when that purchase is recommended. Confirmation and other post-sale disclosure should quantify the costs incurred as a result of the transaction, including any costs or payments that may have been estimated in pre-sale disclosures.

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[5] See *Report on the Public Policy Implications of Investment Company Growth,* Report of the Committee on Interstate and Foreign Commerce, pursuant to Section 136 of the Legislative Reorganization Act of 1946, Public Law 601, 79th Congress, and House Resolution 35, 89th Congress, December 2, 1966. *Protecting Investors: A Half Century of Investment Company Regulation*, SEC, Division of Investment Management, May 1992.

[6] Proposing Release at Part V. B. See also Proposing Release at Part V. D. (The purpose of point-of-sale disclosure is "to enable customers to consider material information prior to a transaction being finalized.")

[7] The SEC's long neglected rule proposal revising ADV form disclosures for investment advisers offers an excellent model for how this disclosure could be provided.

Specific Comments on the Point-of-Sale Disclosure Rule Proposal

A. Content of Point-of-sale Disclosures

Under current rules, brokers can sell fund shares without providing any written document to shareholders until days after the investment decision has been made and the purchase has been finalized, when the fund prospectus arrives in the mail with the confirmation. This disclosure gap increases the likelihood that investors will make uninformed investment decisions. The apparent justification for this system is that a broker's suitability obligation substitutes for full pre-sale disclosure. However, the complexity and pervasiveness of conflict-laden sales practices and the failure of the suitability obligation to result in recommendations that are in the client's best interests make clear the folly of perpetuating such a system.

The Commission's point-of-sale proposal is a step in the right direction, but falls far short in addressing this problem. The most significant problems are threefold: the proposed point-of-sale disclosure omits important information, including non-distribution-related expenses; it is not required to be in writing; and it is not required to be delivered far enough in advance of the purchase to allow its use in making an informed investment decision.

Material Information: As the purpose of point-of-sale disclosure articulated by the Commission makes clear, these disclosures should cover all "material" factors relevant to the individual's investment decision. Having taken the bold step of requiring pre-sale disclosure, the Commission should not stop short by requiring only that information about distribution-related costs and conflicts be disclosed. While distribution-related costs are certainly significant, they will generally be less significant to the long-term investor than the fund's operating costs, yet these costs are omitted from the pre-sale disclosure. Similarly, while distribution-related conflicts are important, so are risks associated with the fund, what investment purposes it is suitable for, and its investment strategies. Again, however, these clearly "material" factors are not required to be covered in the pre-sale disclosure. We urge the Commission to rectify this major short-coming in its proposal by requiring that mutual fund investors receive either a full prospectus or a fund profile (as designed in rule 498 under the Securities Act) before the sale.

Fund Operating Expenses: With respect to fund expenses, the pre-sale disclosure should provide investors with a good faith estimate of all the expenses the investor will actually incur if the investment is made. In addition to distribution-related costs, this should include fund operating expenses (which should include portfolio transaction costs, as we have previously proposed), redemption fees, account fees, small account fees (if relevant), and other non-distribution-related fees. As the Commission has stated, fund fees "can have a dramatic effect on an investor's return. A one percent annual fee, for example, will reduce an ending account balance by 18 percent on an investment held for 20 years."[8] Clearly, these costs are a material factor that fund investors ought to consider when making their purchase decision.

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[8] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 25870 at Part I.B. (Dec. 18, 2002).

The Commission has also made clear its preference that markets, rather than regulators, discipline fund costs. Pre-sale disclosure is a prerequisite to meaningful cost competition. It is absolutely inexplicable that, having taken the step of requiring pre-sale cost disclosure, the Commission would pass up this opportunity to require pre-sale disclosure of fund operating costs. Until it rectifies this major oversight, the Commission's policy of relying on markets to discipline mutual fund costs will lack all credibility. In fact, failure to include operating costs in the pre-sale disclosures could have the perverse effect of decreasing the likelihood that investors will consider these costs when making a fund purchase, since the clear impression created by their omission will be that they are less important than distribution costs.

Basis for Cost Disclosures: We also believe the basis for providing cost disclosures under the rule must be strengthened. The proposed rule provides that disclosure of covered expenses shall be "by reference to the actual value of the purchase, or, if that value is not reasonably estimable at the time of the disclosure, by reference to a model investment of $10,000." We believe that this will allow too much leeway for a broker to base the disclosure on a $10,000 investment, even when the actual investment amount is likely to be much higher. Given that leeway, we fear that brokers will too often improperly base the disclosure on the $10,000 amount in order to minimize the apparent cost of the investment.

When recommending a mutual fund purchase, a broker will often recommend an amount for that purchase. Where the actual value of the purchase is not known, but where a purchase amount has been recommended, the broker should be required to disclose expenses by reference to the recommended purchase value. Where no such specific recommendation is made, the broker should be required to inquire as to the expected amount or approximate amount of the investment (and keep a record of the response). In such instances, disclosures should be made by reference to this estimated amount of purchase provided by the client. Finally, when neither of these alternatives is available, the broker should be required to make a good faith estimate of the actual amount of the investment and base the disclosure on an amount that is close in value to the estimated value of the investment: e.g., $10,000, $50,000, $100,000, $500,000, etc. Such an approach will reduce the ability of brokers to minimize the costs and will make it possible for regulators to identify brokers that routinely do so.

Comparative Cost Information: The pre-sale disclosure is also the point when comparative cost information should be provided. The proposed rule would relegate this information to the confirmation. But learning, after the sale is completed, that the distribution costs were among the highest in the industry is hardly helpful. Investors need this information while they can still do something about it. While we favor the Commission's suggested approach of comparing cost information to industry norms, we believe the value of this disclosure will be all but lost if it is not provided in advance of the sale.

Consistent with our recommendation that pre-sale disclosure include fund costs as well as distribution costs, we think it is essential that these costs also be placed in the context of industry norms. Ideally, the long-term effect of all costs should also be shown. The prototype disclosures submitted to the Commission by Nancy M. Smith, former Director of the SEC's Office of Investor

Education and Assistance – and prepared with the assistance of plain English expert, William Lutz, and a design team from The Corporate Agenda – offer an excellent model for how this can be accomplished in a way that average, unsophisticated investors are likely to understand. Showing an investor, for example, that the fees they can expect to pay for buying and owning the fund will cost them an estimated 14 percent of their investment value or $1500 over 10 years when alternatives are available that would cost just 2.75 percent or $300 over the same period would be far more likely than either current disclosures or the newly proposed disclosures to motivate investors to make truly cost-conscious decisions.

Differential Compensation: The point-of-sale disclosure is also the document that should carry the most complete explanation of conflicts of interest that are relevant to the particular fund being recommended. The Commission has made a start, by requiring that qualitative information be disclosed at the point-of-sale about directed brokerage, revenue-sharing payments, and the existence of higher payments for sale of proprietary funds as well as funds that carry a back-end sales load. We are concerned, however, that the proposal does not do nearly enough to highlight all the various types of differential compensation a broker might receive for selling a particular fund.

The purpose of differential compensation disclosure is to direct the investor's attention to the broker's most significant conflict of interest – the incentive to recommend one fund over another, not because it is a better investment for the client, but because the broker will receive a higher fee. It is imperative, therefore, that differential compensation disclosure cover all situations where a broker (including its associated persons) has an incentive to prefer sales of one fund over another or one class of fund shares over another. To aid in the investor's understanding of this concept, disclosures of differential compensation should include a clear statement that the differential payments create an incentive for the broker to recommend a fund in order to increase his or her own compensation regardless of whether it is the best fund for the investor.

The issues to be covered by differential compensation disclosure should start with the fact that some funds charge higher sales loads than others, resulting in a higher commission payment to the broker. Investors need to be able to assess, not just the amount of the commission that they are likely to pay and that the broker is likely to receive, but how that amount compares to those of other funds. For example, if a broker was paid a 4 percent commission for selling Fund A, and would have been paid a 3.5 percent commission for selling Fund B, that differential should have to be disclosed.

That is a key reason why we think it is so important to move comparative cost information from the confirmation statement to the point-of-sale disclosure and to expand the information that is provided. The significance of the incentive to sell a particular fund depends on its size relative to the amounts received for selling other investments. If there is little relative differential, then the broker's bias may be insignificant. If there is a large relative differential, the broker's bias may be substantial. This is clearly material information that ought to be considered as part of the investment decision.

It is ironic that the disclosure proposal would require disclosure of differential payments

where the conflict is most obvious – where the fund is an affiliate – but would require no such disclosure of differential payments where the conflict is most insidious – where the fund appears to be independent. In fact, the proposed disclosure with regard to affiliated funds is misleading, since a "No" response to the question of whether the associated person receives more to sell affiliated funds might suggest that he has no extra financial incentive to sell those funds. In fact, the broker always has an extra financial incentive to favor affiliated funds because of the other fees paid by the fund to the broker's affiliates.

We recognize that requiring disclosure of all differential compensation arrangements may require complex and lengthy disclosure, but this is not a problem inherent to disclosure. It is a problem that exists because of a history of non-disclosure and the complex structure of distribution arrangements that archaic Commission positions have allowed to evolve unchecked by competitive forces. It also results from the fact that fund distribution payments are set by the fund and are required to be fixed at the broker level. As long as these structural problems remain unaddressed, adequate disclosure of distribution costs and conflicts may be both difficult and costly to achieve.

Once again, however, the prototype disclosure documents submitted by Nancy Smith offer a good model for how this disclosure could be achieved. Using a heading such as, "Facts you should know about conflicts of interest," and a simple explanations in a question and answer format helps to highlight the significance of the information being provided. All of the information regarding various types of differential compensation should be presented in this format. To the degree that other sales incentives exist, such as sales contests to promote a particular fund family, that fact should also be disclosed here.

Share Class and Breakpoint Disclosures: Two other areas of point-of-sale disclosure content deserve special mention. The disclosure regarding costs associated with different share classes should be provided in dollar amounts and in a comparative format. In other words, regardless of which share class the broker recommends, he or she should have to show what the projected costs to the investor would be over various time periods, so that the investor can make an informed decision up front about which share class is in their best interests. Similarly, on the issue of breakpoint disclosure, the point-of-sale document should indicate the dollar amount at which the next breakpoint discount is available. This would be a helpful supplement to the boilerplate disclosure required by the rule proposal.

Summary of Point-of-Sale Content Recommendations: To sum up, we believe point-of-sale disclosures should include either a full fund prospectus or a fund profile, as well as a plain English document listing the following key information about fund costs and conflicts based on either the recommended amount of the purchase or the estimated amount of the purchase:

- all distribution-related expenses, including commissions, 12b-1 fees, revenue sharing payments, directed brokerage payments, and any other compensation paid or received in connection with the transaction, along with industry norms, presented as both a dollar amount and a percentage of assets, and a clear statement that these payments create an incentive for the broker to recommend a fund based on the payments he receives rather

than the best interests of his clients;

all expenses of owning the fund, including fund operating expenses (with portfolio transaction costs incorporated), redemption fees, account fees, small account fees (as relevant), and any other non-distribution-related expenses, along with industry norms, presented as both a dollar amount and a percentage of assets;

comparative information on costs associated with different share classes, including a statement of whether the broker gets paid more to sell a certain class of shares; and

the dollar amount of the next available breakpoint discount.

All cost information would have to be provided cumulatively for each year for the greater of either five years or a period one year longer than the first year in which a deferred commission (if any) is no longer payable.

B. Timing of Point of Sale Disclosures

It does little good to give investors all the material information they need to make an informed investment decision if you don't also require that they receive the information in time to be incorporated in the investment decision. The rule proposal fails this test. The Commission has proposed only that the point-of-sale disclosure must be provided "immediately prior to the time that the broker, dealer or municipal securities dealer accepts the order from the customer." Clearly, this is not enough time to "allow customers to consider material information when they make their investment decisions."[9]

We cannot urge strongly enough that the Commission move this disclosure obligation to a point earlier in the process. At a minimum, the investor should have enough time to evaluate the information and ask questions before making an investment decision. In any instance where the purchase is based on a recommendation from the broker, the broker should have to provide the disclosures either at that time, if the recommendation is made in writing, or immediately following the recommendation, if it is made orally and the investor expresses an interest in following up on the recommendation.

C. Requirement for Written Point-of-Sale Disclosure

The Commission has proposed that brokers be permitted to provide point-of-sale disclosures orally. This is clearly an unworkable arrangement. In light of the complexities of the proposed disclosures, particularly as amended to conform to our recommendations, it is hard to imagine how a broker could provide the disclosures without the assistance of written materials. And, without written documentation, it will be all put impossible to ascertain whether the disclosures have been

[9] Proposing Release at Part V.B.

fully and accurately provided. Furthermore, allowing oral disclosure makes it easier for the broker to rush through or downplay information they don't want to highlight. It also makes it impossible for the investor to carefully "consider" the information, since they will have no thorough and reliable record of that information. For these reasons, we believe it is absolutely necessary for point-of-sale disclosure to be in writing in order for it to have its intended effect.[10] Failure to amend the rule in this regard will render these reforms all but meaningless.

D. Effect of Disclosure on Sale of Mutual Funds

The Commission has requested comment on whether point-of-sale disclosure might "have the effect of directing investors away from mutual funds and related securities." This question seems to be based on an assumption that we reject – that, if full and clear disclosure has the effect of making a particular type of investment less attractive than a competing type of investment, then the disclosure should not be required. Once you embrace that principle – even to protect mutual funds from unfair competition from less well regulated investment products – you inevitably start a regulatory race to the bottom, which each regulator competing to reduce cost and risk disclosure to help the products it regulates compete more effectively. Clearly, that is not in investors' best interests. It also ignores the fact that the purpose of point-of-sale disclosure is in fact to "direct investors away" from certain mutual funds – i.e., those that are not suitable investments – and to direct investors toward investments that are suitable, be they mutual funds or other investment options. If lack of a level playing field is a legitimate concern, however, then the Commission could better help rectify the situation by applying similar principles of full and complete disclosure to all the investment products under its jurisdiction, and it could encourage a similar approach for products outside its jurisdiction.

E. Exception for Certain Transactions

The Commission has proposed to exempt from the point-of-sale disclosure transactions resulting for orders received from the customer via U.S. mail, messenger delivery, or similar third-party delivery service if the broker does not receive compensation from persons who do not have accounts with the broker and has provided at least semiannually generic disclosure regarding certain distribution-related expenses. We believe that this exception is overly broad and needs to be narrowed.

We recognize that if an order arrives by mail unsolicited – and not based on any prior contact with the broker that is related to that transaction where the point-of-sale disclosure could have been provided – it would be unreasonable to effectively prohibit the broker from executing the order without first locating the customer and delivering the point-of-sale disclosure. Under no circumstances, however, should the exception be available where a broker has recommended the purchase, simply because the client has entered the order via mail or other similar third-party delivery service. To ensure that brokers are not able to evade the disclosure requirements simply by

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[10] A requirement that the information be provided in writing does not preclude its being provided through electronic means, such as email.

having their customers enter their orders by mail, the rule needs to be amended so that it applies only to transactions were there has been no prior contact with the broker related to the transaction where point-of-sale disclosure could have occurred.

In addition, the disclosure requirement should be strengthened. There is no reason, for example, why the generic disclosure required in paragraphs (e)(1)(i)(A) through (D) of proposed rule 15c2-3 could not include, instead of or in addition to those disclosures, an actual point-of-sale disclosure document based on a $10,000 investment in a representative equity and fixed income fund. Assuming the Commission were to adopt our other strengthening amendments for the point-of-sale disclosure, this approach would ensure that the investor got the comparative information on how costs and compensation amounts compare to industry norms, which we view as key information every investor should have in advance of the sale. We therefore recommend that the Commission amend the exemption to limit it to its intended purpose – the receipt of a blind, impersonal order request from a client with an existing brokerage account – and enhance the required disclosure in this situation.

F. Applicability of the Point-of-Sale Disclosure Rule

The Commission has requested comment on whether the point-of-sale disclosure rule should apply to persons other than brokers, dealers, and municipal securities dealers, such as banks. We believe investors' need for written disclosure of the most important factors affecting the suitability of investments does not depend on the source of the recommendation. We therefore recommend that the rule apply to all mutual fund sales.

The Commission has also requested comment on whether the point-of-sale disclosure rule should apply when an investor is switched to a new investment. Since the switch will generate new costs for the investor and since the new fund may have entirely different characteristics than the one the investor is being switched out of, clearly the disclosures are needed in this instance. In fact, because there is a significant risk that the switch will be recommended by the broker in order to generate additional distribution compensation, the need for point-of-sale disclosure may be even greater in this context.

Specific Comments on the Confirmation Disclosure Rule Proposal

For 25 years, investors in mutual funds have been deprived of the protection afforded by transaction-based disclosure that is provided to purchasers of other types of securities. This is a result of the fact that, in 1979, the Commission effectively exempted mutual fund sales from rule 10b-10, which requires that brokers disclose the compensation they receive in connection with the purchase and sale of securities. We applaud the Commission for acting to correct this longstanding gap in the regulation of fund sales.

A. Purpose of Confirmation Disclosure

The overall purpose of the confirmation disclosure is twofold: to direct investors' attention to total fund distribution costs and to alert investors to brokers' conflicts of interests. As stated by the Commission in the proposing release, "More complete disclosure also may help customers understand the ***costs associated with purchasing fund share*** classes that carry deferred sales loads, as well as the ***potential conflicts of interest*** that broker-dealers and their associated persons have in connection with the sale of those share classes."[11] In this regard, it serves as a supplement to the point-of-sale disclosure and an opportunity to provide actual dollar amount costs where only estimated costs were available pre-sale. The comments we have made above about the appropriate content (except the requirement that all material information be disclosed) and format of disclosures apply equally here.

B. Presentation of Information in the Confirmation[12]

The proposal would require that confirmation disclosures be provided "in a manner that is consistent with Schedule 15C." We are concerned that the "consistent with" requirement will permit the disclosure of information that is unclear. We also believe that Schedule 15C can and must be substantially improved.

First, we believe it is essential that presentation of distribution expenses in the confirmation (and point-of-sale disclosure) be standardized so as to ensure that this information is easy to understand and use. Brokers' record of transparent disclosures is not encouraging. Just as some firms may favor funds that make revenue sharing payments or that make asset-based distribution payments in the form of 12b-1 fees rather than front loads for the very reason that those forms of payments are less transparent, they may also opt for a confirmation (and point-of-sale) disclosure format that is less transparent. This is a particular risk because of the complexity of distribution arrangements in the fund industry. For these reasons, we urge the Commission to adopt a standard format or formats to prevent brokers from using confusing formats that are "consistent with" the informational requirements, but not the spirit, of the confirmation rule.

We also believe that Schedule 15C can be substantially improved in a number of respects. The confirmation should clearly label the nature of the information being disclosed. The approach followed in the prototype submitted by Nancy Smith – with its heading, "Facts you should know about conflicts of interest" and its easy to follow, question and answer format – offers a good model. In addition, we favor dividing the information on costs into two sections. One should be clearly labeled as payments that the investor pays directly or indirectly in connection with the transaction. This should include both distribution-related costs and operating expenses of the fund. Another should be clearly marked as the payments the broker receives directly or indirectly in connection with the transaction. All payments in this category, such as revenue sharing payments

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[11] Proposing Release at Part A.3.

[12] Comments about the appropriate presentation of information in the confirmation apply equally to the point-of-sale disclosure, except where those comments pertain specifically to information that is not required to be disclosed at point-of-sale.

and directed brokerage payments should be disclosed in language that makes clear that these payments are designed to encourage the broker to select this fund or class of funds rather than another.

General Comments on Confirmation and Point-of-Sale Disclosure Proposals

A. Designing Standardized Disclosure Forms

The Commission made an obvious effort to develop clear, straightforward sample disclosure documents and to seek comments from average investors. The prototypes submitted by Nancy Smith, however, demonstrate the difference that having the forms written and designed by experts in plain English and information design can make. In keeping with our recommendation that the point-of-sale and confirmation disclosure forms be standardized, we further recommend that they be designed by experts in these fields. Furthermore, we recommend that they be tested for effectiveness in conveying the information with a representative sample of investors. Such an approach should ensure that the cost of implementing the disclosures in not wasted on disclosures that fail to serve their intended purpose.

B. Monitoring of Compliance and Effectiveness

We strongly recommend that the Commission develop and implement a program to monitor compliance with, and the effectiveness of, the new disclosure rules. As part of that program, we recommend that the Commission develop tools to determine whether brokers are evading disclosure requirements by disguising distribution compensation as compensation for non-distribution services, such as payments for transfer agency services. This should include a reminder to fund directors of their responsibility to compare such payments to payments made to non-brokers. To test for effectiveness, the Commission should conduct and/or sponsor research regarding how the new disclosures are being used by investors and their effect on the pricing of distribution services and mutual fund costs, conflicts of interest, and the investment decision-making process.

C. Applicability of Confirmation and Point-of-Sale Disclosure

The Commission has requested comment on whether the confirmation and point-of-sale rules generally should apply to unit investment trusts, exchange-traded funds, variable annuity products, interval funds, and closed-end funds. We strongly recommend that these rules be applied in all situations in which a broker is compensated by someone other than the investor for effecting transactions or where the broker has a financial incentive to recommend one product over another. In each such case, it is important that investors know the costs and conflicts related to distribution payments. This reasoning applies to all of the aforementioned products, and we therefore recommend that the rules apply to all of them.

Comments on Registration Statement Disclosure

The Commission has proposed to amend the registration statement for mutual funds to revise disclosure requirements relating to distribution payments and arrangements. We recommend that registration statement disclosure be improved in two respects, as discussed below.

A. Effects of Investing in Different Share Classes

As the Commission has noted, brokers may recommend a class of fund shares based not on the benefits to the investor but on the amount of compensation the broker receives. To address this problem, we recommend requiring disclosure in the prospectus of the relative costs of investing in each class that is available to the investor. The disclosure should cover a 15-year period and should be accompanied by a narrative disclosure explaining the advantages and disadvantages of investing in each class.

A recent court decision highlights the need for the disclosure. In Benzon v. Morgan Stanley, the court held that, even assuming there was no rational investor for whom Class B shares would be the best investment, the fund had no duty to disclose this fact in the prospectus.[13] It should go without saying that this decision is flatly inconsistent with the requirements of the securities laws, and we encourage the Commission to seek its reversal. But we also believe that additional steps must be taken to clarify the obvious: that an issuer cannot offer securities that it knows cannot be in the best interests of any rational investor.

B. Disclosure of Revenue Sharing Payments

We also recommend that the Commission require meaningful disclosure in fund prospectuses regarding revenue sharing payments, unless of course it adopts our recommendation to ban such payments. As noted by the Commission:

> "Prospectus disclosure does not identify which individual broker-dealers receive revenue sharing, let alone quantify those arrangements. Yet the magnitude of revenue sharing payments – estimated in 2001 to be $2 billion annually – suggests that those arrangements influence the mutual fund choices that broker-dealers and their representatives present to investors."[14]

When a fund knows that brokers may recommend its shares over the shares of other funds because the fund's manager is making additional incentive payments to brokers, and that brokers' recommendations to purchase that fund are therefore biased and may even be unsuitable, the federal securities laws demand the prominent disclosure of such highly material information in the fund prospectus. This obligation exists regardless of whether differential payment disclosure is made by the broker, as the fund is equally responsible for creating, and thus disclosing, the relevant conflict

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[13] 2004 WL 62747 (M.D. Tenn.).

[14] Proposing Release at Part A.3. (footnote omitted).

of interest.

Comments on the Costs of the Proposed Disclosures

The brokerage industry has come out in strong opposition to the proposed point-of-sale disclosure rule in particular on the grounds that it imposes potentially enormous costs that are not justified by the benefits.[15] Clearly, given the complexity of the distribution payment system and the pervasiveness of the conflicts of interest it creates, effective disclosure cannot be accomplished without considerable cost. The answer, however, is not the ersatz disclosure alternative proposed by the SIA, which creates the impression that disclosure is being provided without any assurance that the information is being conveyed to those who need it. The unsophisticated investors who are most likely to place blind trust in their brokers are the very ones who are least likely to seek out the information about costs and conflicts on websites or by calling and requesting it in writing.

The Commission must not weaken disclosure on account of its complexity. Once you adopt that approach, the industry need only build excessive complexity into a system to avoid full disclosure to investors. The current complexity is not the fault of investors, nor was it designed with their interests in mind. It is rather largely the result of decisions by the fund and brokerage industries that have been unrestrained by the disciplining effect of full disclosure over the last 25 years. Had the Commission not exempted transactions in fund shares from the confirmation rule in 1979, had it not allowed rule 12b-1 to be used for purposes for which it clearly was not intended, or had it required full pre-sale disclosure of material information from the outset, many of today's complex distribution arrangements would not have developed. In short, one reason some of these arrangements have developed is precisely because of their weak or nonexistent transparency. The Commission made a similar point in the proposing release, when it stated, "The increase in the number of mutual funds has made broker-dealer 'shelf space' more critical to investment companies, leading to revenue sharing and other distribution arrangements ***that quietly compensate broker-dealers for distribution***."[16] It is imperative that the Commission not weaken the point-of-sale and confirmation disclosure rules to accommodate complexity in the structure of fund distribution payments, any more than the Commission would consider weakening disclosure of investment risks for funds that chose to adopt a more complex, riskier investment strategy.

If conflicts cannot be disclosed in a cost-effective manner that allows all investors an opportunity to carefully consider the relevant information before the sale, the only acceptable alternative is to ban the conduct that creates the conflicts. In fact, as we have noted above, we believe it is long past time for the Commission to revisit the policy that allows mutual funds (and other financial products) to fix the price that investors pay for the services of their broker. If the Commission were to repeal Section 22(d), so that mutual funds no longer determined the rate at which brokers would be compensated for fund sales, repealed section 12(b), so that funds could no longer use shareholder assets to pay for brokers' compensation, and banned directed brokerage and

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[15] Comments of George R. Kramer, Vice President and Acting General Counsel, on behalf of the Securities Industry Association, with regard to File No. S7-0604, April 12, 2004.

[16] Proposing Release at Part A.3. (Emphasis added).

revenue sharing payments,[17] there would be very few conflicts to disclose. This would simultaneously create a distribution compensation system that minimizes conflicts of interest and allow for a very simple, straightforward disclosure regimen that would be far less expensive to implement.

Conclusion

We commend the Commission for its recognition of longstanding regulatory deficiencies that facilitate abusive sales practices and hinder investors' ability to make informed investment decisions. We hope that this recognition will lead to an informed, critical evaluation not only of specific problems with the present proposal, but also of the need to completely revamp the distribution compensation system to minimize conflicts of interest.

Respectfully submitted,

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[17] We believe that the Commission should view revenue sharing payments as distribution payments that are made indirectly by the fund in violation of Sections 12(b) and 48(a) of the Act. That revenue sharing constitutes payment by the fund is reflected in the fact that the structure of the advisers' payments to brokers parallels the structure of the funds' payments to the advisers. The Commission's position that revenue sharing payments can be considered to have been made out of the adviser's profits conflicts with the internal accounting of such costs by the advisers as an expense. The Commission's paid out of profits position also creates an absurd situation in which fund directors must effectively turn a blind eye to revenue sharing payments, because their considering such expenditures would undermine their compliance with the requirements of Section 36(b), as interpreted by the Second Circuit in Gartenberg. (See Remarks of Robert Pozen, President and chief Executive Officer, Fidelity Management & Research, at the Roundtable on the Role of Independent Investment Company Directors, Washington, D.C., Feb. 23, 1999.) This is flatly contrary to investors' best interests.