

February 14, 2003

BY ELECTRONIC AND U.S. MAIL

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. S7-51-02

Dear Mr. Katz:

Fund Democracy,¹ for itself and on behalf of the Consumer Federation of America,² welcomes this opportunity to comment on the Securities and Exchange Commission's proposal to improve portfolio and fee disclosure by registered investment companies ("mutual funds" or "funds").

We applaud the Commission's portfolio disclosure proposal. It will both reduce disclosure costs and provide important information that investors need to make informed investment decisions. This proposal is discussed in Sections I, II and III below. We also support the concept of disclosure of fund expenses in dollars, although we believe that the Commission's proposal in this respect could be substantially improved, as discussed in Section IV below.

I. Quarterly Filing of Complete Portfolio Schedule

On June 28 and August 9, 2000, respectively, Fund Democracy and the Consumer Federation of America³ petitioned the SEC to adopt a rule requiring more frequent and more accessible disclosure of fund portfolio holdings. The petitions specifically requested that mutual funds be required to disclose their holdings on a monthly basis, and that such disclosure be provided in an electronic format that is easy to download and

¹ Fund Democracy, a 501(c)(3), nonprofit membership organization, provides a voice for mutual fund shareholders by publishing articles that target mutual fund practices, policies and rules that are harmful to fund shareholders and by lobbying legislators and regulators on mutual fund reform issues. Fund Democracy also has led a number of legal challenges to practices that harm shareholders' interests. Fund Democracy was founded in 2000 by Mercer Bullard, a law professor at the University of Mississippi and a former Assistant Chief Counsel in the Commission's Division of Investment Management.

² The Consumer Federation of America is a non-profit association of some 300 pro-consumer groups that was founded in 1968 to advance the consumer interest through advocacy and education.

³ Nine other consumer groups joined the Consumer Federation of America's petition, including Consumer Action and Consumers Union.

analyze.⁴ Fund Democracy's petition was accompanied by a Memorandum in Support of Rulemaking Petition ("Memorandum"), which is hereby incorporated into this letter. The Financial Planning Association, AFL-CIO, International Brotherhood of Teamsters and National Association of Investors Corporation subsequently filed similar petitions (collectively with Fund Democracy's and the Consumer Federation of America's petitions, "Petitions").⁵

The arguments made in the Petitions and Memorandum are even stronger today than they were 32 months ago. The number of mutual fund shareholders has risen from 83 million to over 95 million, representing over half of U.S. households. Mutual funds have solidified their central role in protecting the financial security of tens of millions of investors.

It is more important than ever to ensure that investors have the information they need to make informed investment decisions, and that they are adequately protected against fraudulent sales practices and other abuses. It therefore is critical that investors and their advisers know how mutual funds are actually investing their money so that they can assess whether fund investments are consistent with the risks that they have chosen to assume.

Unfortunately, current rules regarding the disclosure of fund portfolio disclosure prevent investors and their advisers from making fully informed investment decisions. The lack of information increases the risks of investing in funds by preventing investors from effectively diversifying their holdings. Diversification depends on having confidence that a fund is investing consistently based on a particular style, but current disclosure rules prevents investors from protecting themselves against style drift and portfolio overlap.⁶

Inadequate disclosure rules also facilitate window dressing and portfolio pumping. Window dressing occurs when portfolio managers add high-performing stocks, and remove low-performing stocks, to and from fund portfolios just before the portfolios are publicly disclosed. This practice is intended to lead investors to believe that the managers picked winners and avoided losers during the preceding period.

⁴ The petitions also asked the Commission to adopt a rule prohibiting funds from using misleading names. The Commission adopted such a rule on January 17, 2001. Investment Company Names, Investment Company Act Rel. No. 24828 (Jan. 17, 2001).

⁵ Copies of all of the petitions and Fund Democracy's memorandum are available at http://www.funddemocracy.com/truth_in_mutual_funds.htm and in the Commission's public reference room.

⁶ See Memorandum at pages 7 – 9.

Portfolio pumping occurs when portfolio managers buy stocks at the end of the quarter or the end of the year that their funds already hold in order to give their funds' performance a one-day boost. This manipulative practice inflates the funds' performance results, which under SEC regulations are calculated and advertised on a quarterly and annual basis. Portfolio pumping also may adversely affect investment performance for 401(k) and other retirement plan participants, who frequently buy shares at the end of each quarter.

There is substantial empirical and anecdotal evidence that window dressing and portfolio pumping occur in the mutual fund industry.⁷

A. Commission Proposal

The Commission's proposal to require quarterly disclosure will substantially improve mutual fund portfolio disclosure. Investors and their advisers will be better able to make informed investment decisions based on their particular risk-return objectives. Window dressing and portfolio pumping will become more transparent, thereby providing additional deterrence to such fraudulent practices.

Nonetheless, Fund Democracy believes that the Commission's proposal could be improved. First, the Commission should require that funds disclose their portfolios on a monthly basis. Monthly disclosure would provide significantly more certainty that funds are investing consistent with their investment objectives and better enable shareholders to determine how funds have achieved their investment results. Monthly disclosure also would effectively eliminate window dressing by shortening the period between disclosure dates so as to reveal purchases and sales made solely for appearance's sake. Monthly disclosure is critical to deterrence of portfolio pumping because it is at the end of each quarter that this practice is most likely to occur, and only if holdings for the immediately preceding month are available will investors be given any indication as to whether there was an unusual level of trading activity just before the end of the quarter.

As an alternative to monthly disclosure, Fund Democracy recommends that the Commission require funds to disclose their holdings on two or three random dates throughout the year and to disclose purchases and sales made within the last five trading days before the end of each reporting period. These requirements would greatly increase the disciplining effect of disclosure by putting portfolio managers on notice that they may be held accountable for the way they invest shareholders' assets. Random disclosure and disclosure of purchases and sales just before disclosure dates also would further deter window dressing and portfolio pumping. Any increased risk of front running can be addressed by increasing the period between the end of the quarter and the disclosure date

⁷ See Memorandum at pages 15 – 21.

(“lag time”) to avoid any possibility that traders could exploit this information in their trading activities.

Responses to additional requests for comment in Part II.A.4:

- The only effective way to deter window dressing and portfolio pumping is disclosure. Both practices are virtually impossible to prove because in both cases proof of fraudulent intent is necessary. When window dressing or portfolio pumping, the manager can claim that he or she was buying or selling the stock for bona fide investment purposes and not to defraud investors. Unless the Commission is prepared to sue fund managers on the basis of statistical evidence of window dressing or portfolio pumping, it will be very difficult to deter these practices through enforcement. More frequent disclosure will enable the market to identify and punish managers who engage in these practices.
- The arguments that front running will occur or that traders will otherwise be able to exploit more frequent portfolio disclosure are thoroughly rebutted in the Commission’s cost-benefit analysis, which explains that an extremely improbable set of conditions must be present for even the *possibility* of harmful trading to exist.⁸ As stated by the second largest U.S. fund complex, “with a 60-day lag in the disclosure of holdings from the close of a quarter, fund investors would be adequately protected from such predatory trading practice as ‘front running’ by aggressive traders and ‘free riding’ by those seeking to copy a fund’s proprietary

⁸ These conditions are as follows:

1. To accomplish the goals of the trade that might be front run, the fund manager has limited discretion over the timing of the trade.
2. The trade occurs during a quarter at the end of which the fund otherwise would not have had to report its portfolio holdings.
3. The order is so large that it cannot be reasonably completed within the disclosure window.
4. The market is sufficiently illiquid so that large orders may be reasonably expected to have a substantial impact on price.
5. When the fund’s portfolio is revealed, the size of the remaining order is sufficiently large that it is worth front-running.
6. Other traders recognize the front-running opportunity.
7. Other traders are willing to assume the risks of trading on the front-running opportunity.
8. The fund manager cannot delay the trade without a significant effect on performance.

approach and research.”⁹

Even if front running were a realistic concern, it would not outweigh the substantial benefits of more frequent portfolio disclosure. If the Commission concludes otherwise, the problem of front running can easily be addressed by lengthening the lag time.¹⁰ The purpose of more frequent disclosure is not to facilitate market timing by investors who need current portfolio data, but rather to provide a historical record on the basis of which to evaluate how fund managers have actually invested shareholders’ assets, or to determine whether funds have engaged in window dressing or portfolio pumping.

- Funds should be required to disclose their *entire* portfolios. A principal purpose of more frequent disclosure is to bring to light smaller investments that might have a disproportionate impact on a portfolio’s performance. Partial disclosure also would make it more difficult to compare portfolios of different funds.
- The \$100 million threshold for Section 13(f) filings should be raised to reflect the effects of market inflation. The \$100 million threshold was based on the impact that such a portfolio could have on the market at the time that that Section 13(f) was adopted. If the same standard were applied today, the threshold would exceed \$1 billion dollars. The \$100 million threshold no longer accomplishes the stated purpose of Form 13F disclosure and the review of confidentiality requests of managers with less than \$100 million under management is a waste of SEC resources.

II. Summary Portfolio Schedule

Fund Democracy agrees that the most efficient and effective way to provide information to shareholders is through a layered approach. This approach mirrors the way that the market provides information to investors (and consumers generally), by offering products ranging from brief summaries of key features to detailed analyses and reports.

⁹ Vanguard Supports SEC Proposal for Greater Holding and Cost Disclosure, Vanguard Press Release (Feb. 12, 2003).

¹⁰ In June 2001, the Investment Company Institute commissioned a report on the issue of front running. Wermers, *The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance, Perspectives*, Investment Company Institute. Though the report argues that more frequent disclosure of fund holdings would increase front running, it nowhere addresses the numerous conditions that would have to be present for more frequent portfolio disclosure to increase the likelihood of front running. See note 8 supra. Nor does it address the mitigating effect that allowing for a 60-day or longer lag time would have on front running if front running were a realistic concern. The report does provide, however, an alarming picture of the high costs of trading and a compelling argument for incorporating those costs into the fund fee table, from which they are currently excluded.

By greatly reducing the amount of portfolio information in shareholder reports, the Commission will make the information far more useful to investors. Fund Democracy believes, however, that the manner of layering portfolio information in the summary schedule could be greatly improved. Fund Democracy also recommends that funds be **required** to provide the summary schedule in their shareholder reports to promote consistency of reporting.

The Commission believes that top-50 disclosure “would result in inclusion of the most significant portfolio holdings information in shareholder reports.” Yet the Commission also would require inclusion of additional holdings that exceed 1% of the fund’s net asset value (“NAV”). If 1% of NAV reflects the cutoff for significance, why should holdings in fund’s top-50 that equal less than 1% of a fund’s NAV be included in the chart? Does the number “50” have independent significance?

The Commission suggests that the number “50” was proposed in part because requiring disclosure of more than 50 holdings would effectively require disclosure of a fund’s entire portfolio. SEC Release at Part II.A.1. This suggests that one criterion for the summary disclosure requirement was whether it would result in most funds being required to disclose less than their entire portfolios, regardless of whether disclosing 50 -- or 40 or 60 -- holdings would provide the right level of layering for purposes of the shareholder report.

The summary disclosure requirement is also problematic because while it abridges portfolio information in some respects, it includes relatively complex information in other respects. For example, the proposal calls for specific identification of open put or option contracts, loans for short sales and restricted securities. It also would require disclosure, with respect to repurchase agreements, of the range of dates of the repurchase agreements, the total purchase price of the securities, the total amount to be received upon repurchase, the range of repurchase dates, and a description of the securities subject to the repurchase agreements.

While this information will be useful to some investors, it is not consistent with an approach that seeks to provide investors with a top layer of information. Investors who will be interested in option contracts or the details of repurchase agreements will not be the investors who will rely on the summary portfolio schedule for their portfolio information. They will review the entire portfolio.

The appropriate portfolio disclosure for the shareholder reports is not an objectively discernible number, although top layer portfolio disclosure provided in other contexts can be used as a guidepost. For example, Morningstar’s top layer of portfolio disclosure in its fund snapshot includes a fund’s top five holdings. Many fund complexes provide top layer disclosure of their funds’ top ten portfolio holdings. Thus, while it is unclear

whether the market appears to prefer a top layer of 5, 10 or 15 holdings, the optimal number probably is significantly below 50.

Furthermore, other sources also lack the level of complexity that would be required in the summary schedule. They do not include, for example, information about restricted securities or repurchase agreements. While this information may be important to some investors, it is not appropriate for the top layer of portfolio information provided to investors. The proposed schedule will make the information inaccessible to many investors and thereby fail to provide a useful top layer of portfolio information.

Fund Democracy recommends that the summary schedule include a fund's ten top holdings in order of descending value, and show on each line on which a holding appears (1) the percentage of fund assets represented by that holding and (2) the principal category by which the holding is identified in the tabular or graphic presentation (see section III below). Fund Democracy also recommends that the schedule disclose, immediately below the list of holdings, the percentage of fund assets represented by all ten holdings combined and the total number of holdings in the fund's portfolio. No other portfolio information should be provided other than the tabular and graphic material discussed in section III of this letter.

Responses to additional requests for comment in Parts II.A.1 & 2:

- Funds should not be required to have a minimum number of securities to utilize the summary schedule. The purpose of the schedule is both to eliminate unnecessary costs *and* to provide a consistent disclosure format that will be easily understood and recognized by shareholders.
- Index funds should be exempt from the full portfolio delivery requirement only if they provide a summary schedule, and, as discussed above, the summary schedule should be required. Even for index funds, the summary schedule, if abridged as described above, will provide useful top layer information for investors by giving them a more tangible sense of the kinds of companies in which the index invests.
- A shareholder report covering more than one fund should be required to use the same summary schedule for all funds in order to provide investors with a consistent format.
- Money market funds should not be required to provide portfolio information in their shareholder reports. The portfolio holdings of a money market are not important to investors who are interested in a top layer of portfolio information.

III. Tabular or Graphic Presentation

Fund Democracy strongly agrees that tables or graphs showing portfolio holdings by reasonably identifiable categories will provide concise and user-friendly information that effectively conveys to investors key information about a fund's investments. Indeed, Fund Democracy believes that this information is more important top layer portfolio information than the summary schedule, and that tabular and graphical information therefore should precede the summary schedule in shareholder reports.

There is a significant risk, however, that the degree of flexibility proposed by the Commission will dilute the utility of this information. If funds are permitted to choose any reasonably identifiable categories, then the information will lack any consistency across different funds. When presenting top layer information, at least some degree of consistency is necessary to make the information accessible and understandable to investors.

Fund Democracy recommends that the Commission require that all funds provide tabular or graphic information according to two specific categories, such as market capitalization and industry sector for stock funds, and maturity or government/non-government for fixed income funds, including money market funds. Another required category might be the type of securities that is suggested by the name of the fund.

The tabular or graphic presentation of information in these categories should appear first in the report, in a standardized format, to be followed by presentations of up to four additional categories selected by the fund. This would provide the benefits of flexibility without producing an incoherent mix of types of tables and graphs across different funds.

Responses to additional requests for comment in Part II.A.3:

- The Commission should identify special categories for certain types of funds, such as tracking error for index funds. This information will help investors compare different index funds that track the same index.
- The same information should be required for funds regardless of the number of holdings in their portfolios. This will provide useful information to shareholders and have the advantage of consistent presentation.
- All funds should be subject to the tabular/graphic information requirement, regardless of whether they deliver a complete list of portfolio holdings. The tabular/graphic information will provide a more consistent format that will make the information more useful and accessible.

- The tabular and graphic information should be required regardless of whether the summary schedule also is required. The tabular/graphic information will provide more useful top layer information than the summary schedule.

IV. Disclosure of Fund Expenses

Fund Democracy strongly agrees that investors would be benefited by disclosure of their actual costs in dollars. Current rules that require the disclosure of expenses as a percentage of assets provide a good tool for comparison of different funds, but this information does not effectively convey the true cost of funds.

To illustrate, consider an actively managed stock fund with a below-average expense ratio of 1.2%. An expense ratio of 1.2% seems like a small number when compared with the total value of an investor's account. That fee could reasonably be viewed, however, as representing **50% of the value obtained**, depending on an investor's performance expectations. This figure is derived by deducting from the 1.2% fee the amount that an investor would pay for an index fund (approximately 0.2%), which fund would provide the investor with all of the services and performance provided by an actively managed fund with the sole exception that the actively managed fund is expected to outperform the market. If the investor expects the actively managed fund to outperform the market (*i.e.*, an index fund) by 2 percentage points every year, then the investor is paying half of that premium (one percentage point) to the fund's manager in return for the value the investor expects to obtain.

The Commission's proposal is a promising first step in providing information to investors to help improve their understanding of the true costs of mutual funds. Providing investors with the dollar amount actually spent will give concrete form to an indefinite concept and make investors consider more fully the costs of different investment options.

The Commission's proposal, however, has two significant problems. First, shareholders typically do not read shareholder reports; they pay much closer attention to their quarterly statements. In addition, the quarterly statement has the advantage of showing the change in and ending value of the shareholder's balance in dollars, which will provide a far more meaningful and effective context in which to disclose the amount that the shareholder paid in fees during the period. Although including dollar disclosure in shareholder reports would be better than no disclosure at all, disclosure in quarterly statements would be far more effective.

In contrast, Fund Democracy believes that investors may be better served if no dollar disclosure were provided than if the dollar disclosure were calculated as proposed. The current proposal would essentially restate the dollar disclosure provided in the fee example in the prospectus under slightly different assumptions. These slight differences would confuse investors for whom such a hypothetical illustration of the dollar cost of

investing – if presented in a consistent format – might be useful. Fund Democracy recommends that the Commission require personalized dollar disclosure, as discussed below, which would provide shareholders with an approximation of their actual expenses while not necessitating the expensive calculation of every investor's individual fees.

A. Location of Dollar Disclosure

The Commission proposes that dollar disclosure be provided in shareholder reports, yet there is no reason to believe that shareholders regularly review such reports. When a shareholder initially invests in a fund, he or she considers the fund's expenses at that time. The shareholder generally has no reason to subsequently reconsider a fund's fees unless the fund asks for approval of a fee increase.

This stands in contrast to shareholder reports, which generally disclose information about a fund's ongoing operations. The fund's performance, management discussion and analysis, and portfolio holdings are all dynamic aspects of mutual funds. Although technically a fund's actual expenses will rise and fall (without a request for a formal fee increase), this aspect of funds is not generally evaluated by investors on an ongoing basis. Nor is it the purpose of the Commission's proposal to draw shareholders' attention to the fact that actual expenses may be higher or lower than the expenses stated in the prospectus. In any case, shareholders receive an updated prospectus every year, where any such changes in fund expenses already are disclosed.¹¹

The purpose of dollar disclosure in fees is to direct shareholders' attention to the actual cost of fund ownership – the amount in dollars that they are paying to fund management each period. This is not information that shareholders will actively seek; they already have made their investment decision, which hopefully took into account the fund's expense ratio at that time. Rather, the ongoing dollar cost of fund fees is information to which shareholders' attention *needs to be directed*. This information therefore should be provided in a document that shareholders will review, such as the quarterly statement.

Shareholders actually review their quarterly statements, which also have the advantage of presenting the value of a shareholder's account, and the change in that value, in dollars. Providing fee disclosure in this context would enable shareholders to consider dollar disclosure of fees in the context of the dollar value of their accounts, thereby making the dollar disclosure of fees more relevant and useful. The Commission could better promote fee competition in the fund industry by directing shareholders' attention to the dollar amount of fees that they are paying in a document that they will actually review.

¹¹ Fund Democracy notes that the annual update requirement would better serve investors if their attention were directed to changes in fund management, operations and expenses that occurred during the preceding year. This approach also would provide substantial cost savings. The Commission staff has considered such a proposal, but apparently has retreated from it due to industry opposition.

B. Calculation of Dollar Disclosure

The principal drawback of hypothetical dollar disclosure is that it echoes disclosure already provided in the prospectus. As noted by the Commission, the prospectus includes an example of fees paid on a \$10,000 account for one-, five- and ten-year periods that is inclusive of sales charges and fees reflected in the expense ratio and assumes a 5% annual return (“prospectus fee example”). In contrast, the hypothetical dollar disclosure proposal would cover a six-month period and include fees in the expense ratio, but not sales charges. One form of hypothetical dollar disclosure would assume a 5% annual return; the other would not.

Thus, the proposal would create three numbers in two different disclosure documents that all provide illustrative fees in dollars on a \$10,000 account, in one case inclusive of sales charges, in another case assuming no annual return, in two cases covering only a six-month period, and in the third a one-year period. The purpose of each would be to accomplish the same thing – hypothetical dollar disclosure of fees – in a simple, understandable format, but the combination of the three numbers in actuality may create substantial confusion and leave investors worse off, and fees effectively less transparent and understandable, than they were before.

The stated purpose of the new hypothetical dollar disclosure should be, as discussed above, to direct investors’ attention to the costs of investing in a manner that will be more effective than merely presenting fees as a percentage of assets. The purpose *should not* be to promote comparability, as the current prospectus fee example and expense ratio (but for their omission of transaction costs) are very effective means of accomplishing this goal. The fee table and fee example represent years of careful consideration by the Commission regarding how best to present comparative figures. It would be unfortunate for the new hypothetical dollar disclosure to compromise the utility of the prospectus fee example, especially when dollar disclosure holds out real promise of providing a different, complementary means of making investors more aware of the costs of investing in mutual funds.

As noted above, the purpose of hypothetical dollar disclosure should be to direct investors’ attention to fees in a new way, by showing those fees in dollars and cents. Dollar disclosure is inherently more likely to drive home to shareholders the message that -- “Each quarter, we deduct about **\$121.38** from your account” – with a force that an expense ratio of “**1.21%**” simply cannot match.

To accomplish this goal, Fund Democracy believes that the Commission should require funds to disclose the actual dollar amount of expenses incurred by individual shareholders. Fund Democracy appreciates, however, that this will impose much larger costs on funds than providing hypothetical dollar disclosure, and recommends that the Commission carefully consider whether the additional costs truly outweigh the potential

benefits, including lower expenses, that improved fee disclosure and the attendant increase in price competition would provide.

If the Commission concludes that the cost of individualized dollar disclosure is too high, Fund Democracy strongly recommends that the Commission require funds to provide dollar disclosure that includes an individualized aspect without imposing excessive costs. Such disclosure could be calculated by determining the hypothetical expenses during each quarter for a one dollar account (assuming disclosure in quarterly statements) and multiplying that number by the shareholder's average account balance ("personalized hypothetical fees"). The Commission's proposal already would require the calculation of the hypothetical costs, and shareholders' account statements already include a beginning and ending balance. Calculation of personalized hypothetical fees would not be costly and would provide substantially more useful and less confusing information.

Personalized hypothetical fees would provide dollar disclosure that in most cases was very close to the actual fees paid by the shareholder during the period.¹² The information would be more useful than hypothetical disclosure because shareholders would not have to extrapolate their expenses in dollars from the fees paid on a \$10,000 account. Because investors already can multiply their balances by the percentage expense ratio to get an approximation of their actual fees, hypothetical dollar disclosure would not reduce the number of steps necessary for shareholders to appreciate their actual costs.

Finally, if the Commission is opposed to personalized hypothetical fees, it should consider requiring a table that shows the range of fees paid on different size accounts, so that investors would not have to take the extra step of extrapolating their own fees. Of course, this would be unnecessary if the fee were personalized and disclosed on the shareholder's quarterly statement, where its impact relative to the size of the shareholder's account would be far more emphatically communicated.

¹² In some cases, such as when an investor made a large purchase at the end of the quarter, the fee would not reflect an approximation of actual expenses. The Commission's proposal is subject to the same problem, however. In both cases, this problem can be overcome by disclosure that the fee assumes an average, not actual, balance throughout the period. In any case, the fee calculated probably would be very close to actual fees in subsequent periods.

V. Conclusion

Fund Democracy and the Consumer Federation of America commend the Commission for proposing to require more frequent portfolio disclosure while also reducing the costs of such disclosure. Fund Democracy and the Consumer Federation of America also support the Commission's proposal to require dollar disclosure of fund fees, but strongly recommend that significant revisions be made to the final rule.

Sincerely,

Mercer Bullard
Founder and President
Fund Democracy, Inc.

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc (U.S. mail only):

The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
Paul F. Roye, Esq.
Robert E. Plaze, Esq.
Susan Nash, Esq.