Fund Democracy
Consumer Federation of America
Consumer Action

February 28, 2008

BY EMAIL AND US MAIL

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N. E.
Washington, D.C. 20549-1090

RE: File No. S7-28-07

Dear Secretary Morris:

On behalf of Fund Democracy and the Consumer Federation of America, we are writing to comment on the Commission's proposal to require mutual funds to create a summary prospectus ("Summary") that could be used to satisfy a fund's prospectus delivery requirement under the Securities Act of 1933. We strongly agree that a short form alternative to a lengthy statutory prospectus can both improve the quality and usefulness of fund disclosure and reduce fund expenses. The Summary would provide a standardized document that generally included the most important information that investors should consider when evaluating different funds. We support the Commission's proposal, although we believe that it could be improved in certain respects.

One general concern that we have is that the summary prospectus proposal will not draw investors' attention to factors that should be considered before the decision to invest in a type of mutual fund has been made. For example, the summary prospectus will be very helpful to the investor who has already decided to invest in a large cap stock fund, but it will not be particularly helpful at deciding on the right type of fund in the first place. Choosing the right large cap stock fund is an important decision, but choosing to invest in a stock fund at all is a more important one. Cash that is intended to be available in the short-term for a downpayment on a house purchase should not be placed in a stock fund – even the best stock fund. The investor would be better off with a low-yielding money market fund than a top-performing stock fund, yet the summary prospectus will provide no information that directly addresses this crucial aspect of investing.

The Summary's risk discussion and its annual performance bar chart will provide raw information that it relevant to this issue, but it will not be provided in a context that will help typical investors think about whether they are looking at the right type of fund. We therefore recommend that the Commission consider requiring standardized disclosure in the summary prospectus that addresses this issue, such as a timeline that shows the

minimum length of time the investor should plan to own the fund in light of its risk characteristics.[1] Another approach that some funds have taken in their on-line fund snapshots is to discuss the type of investor for whom the fund is and is not appropriate.

Summary v. Statutory Prospectus

We generally agree that the Summary proposal will both improve fund disclosure and reduce costs and agree that it is appropriate to allow delivery of the Summary to satisfy the prospectus delivery requirement. Research, including research conducted by CFA, has shown that most investors do not find the full prospectus to be a particularly useful document and do not rely heavily on it in making a fund selection.[2] It seems to us to make little sense to continue to require delivery of a document to all investors that most say they do not value.

Furthermore, as the Commission notes, funds already are permitted to sell shares off a short fund profile. However, funds still must deliver a statutory prospectus with the confirmation of the transaction. Funds typically also deliver a statutory prospectus annually because most shareholders will have made purchases during the year, and those purchases will not have been made off of a current prospectus. One disadvantage of this approach has been that the fund that uses a profile still incurs the cost of delivering the full prospectus. In contrast, the current proposal obviates delivery of the statutory prospectus at the time of a new investment and on an annual basis, which will allow funds to eliminate the cost of delivering the statutory prospectus (except as specifically requested). The current proposal therefore may create greater incentives to use a Summary in place of the statutory prospectus and generate significant savings for funds and their shareholders.

We believe that the Commission could further reduce costs and improve fund disclosure by permitting the delivery of annual updates rather than a Summary. We recommend that all current shareholders be provided annually with a document that directs shareholders' attention to material changes that have occurred during the period covered. Under current law, the event that triggers the annual delivery requirement is the fund's financials having become stale, but, under the Summary proposal, the financials would not even be included in the document (the Summary) delivered to shareholders. It would not make sense for stale financials to require the delivery of a document that does not include updated financials.

We believe that it would make sense to allow the annual delivery requirement to be satisfied by delivering a document that draws shareholders' attention to information that has changed during the preceding year. This could be accomplished by permitting funds to deliver an annual update that included the most recent performance results, current

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[1] Although the annual performance bar chart provides the raw information that is relevant here, the chart provides no indication regarding what it means in terms of the investor's expected holding period.

[2] See Roper, B. and Brobeck, S., *Mutual Fund Purchase Practices*, p. 13. Only among direct purchasers of mutual funds did a majority of survey respondents view the full prospectus as even somewhat useful.

expense ratios and turnover rates, and updated fee information. Certain changes would be required to be highlighted, such as an increase in the fund's expense ratio. This approach would: (1) eliminate information that had not changed and therefore provided no benefit to shareholders, (2) focus shareholders attention on the factors that are most likely to affect their continuing evaluation of the fund, and (3) impose lower costs than delivery of a longer Summary.

Use of Technology

As a general matter, we are disappointed with the proposal's use of technology to improve mutual fund disclosure, reduce costs and promote competition. The Commission acknowledges the potential of technology to provide fund information in an "interactive format that facilitates comparisons of key information, such as expenses, across different funds and different share classes of the same fund," and to "replace one-size-fits-all' disclosure with disclosure that each investor can tailor to his or her own needs," but the Summary proposal fails to make significant progress in using technology to achieve these goals.

One benefit of technology is that it enables information to be formatted in interconnected layers, rather than the one-dimensional structure of written documents. Where paper documents generally interconnect their parts only through a static table of contents and index, electronic documents can interconnect parts at many levels and in ways that are user-defined. A paper document has a fixed table of contents and index, each of which is located in a single place. An electronic document can offer a hyperlinked table of contents and a hyperlinked index, and both can be located on the same screen as the part or parts of the document the user is currently viewing. An electronic document also permits user-defined searches that provide a true alternative to "one-size-fits-all" information management.

We recognize that the Summary proposal will enhance the interconnectedness of fund information by requiring hypertexting from the Summary to the Prospectus to the SAI. Indeed, this requirement holds out the promise of integrating the SAI into the disclosure process for persons who seek more detailed information in a particular area. Currently, the SAI is provided only upon request and at least one author of this letter has occasionally encountered fund phone representatives who do not believe that an SAI exists, much less that it is required to be sent within three days of a request. We applaud this improvement, but we believe that the Commission can do much more.

Fund information continues to be organized around three layers of data that reflect legal structures more than the structures by which investors can most efficiently access information. We recommend that the Commission consider restructuring fund information from the current, three-tiered linear format to a three-dimensional model in which information is defined not by its document and Item number, but by each information point's links to other fund information. Technology permits the presentation of fund information to reflect the way that the human mind actually maps such information, with each information point being connected to every other information

point by only a few degrees of separation. As disclosure rules under the federal securities continue to migrate from a delivery model to an access model, the Commission needs to promote the parallel migration from top-down information management where regulators decide what information should be available and in what format, to bottom-up information management where investors are provided the alternative of accessing the specific information that they need. Obviously, such an approach will pose new challenges with regards to ensuring the information presented is appropriate and not misleading. However, we believe the potential benefits make these challenges worth engaging.

Another benefit of technology is that it removes practical limits on the ability to organize information across different categories. The Commission's proposal is entirely focused on the category of the single fund, whereas the concept of comparability militates for categorizing information by the aspects of funds that investors wish to compare. The only comparability achieved by the immediate proposal is that the standardization of the Summary will make it easier to lay the Summary for two funds side-by-side and compare different features. This approach fails to exploit technology that would enable investors to organize information by category, rather than by fund, and conduct comparisons across multiple funds for a single category. For example, the Commission could develop software that allowed investors to search funds by the total expense ratio or portfolio turnover rate in the Summary, or both, by selecting one or more information points and then selecting up to 10 or 15 funds for purposes of comparison. Ultimately, this structure should be adopted for all fund information points, so that investors could compare funds based on how they voted portfolio stocks on certain issues or how many of their directors have more than $100,000 invested in the fund. We recognize that the Commission's parallel XBRL initiative may be moving in this direction and encourage the Commission to do more to integrate its approach to the disclosure process with its approach to its database management role.

Limitation on Liability

The Commission's proposal would permit the Summary to incorporate by reference information contained a fund's statutory prospectus, SAI and most recent annual report. This proposal reverses the Commission's position taken just 10 years ago that incorporation by reference was "inconsistent with the profile and not in the public interest." We believe this step raises serious questions that are not adequately addressed in the proposal. We do not believe the Commission should move forward with this proposal without first answering those questions and therefore strongly recommend that the Commission issue further explanation prior to taking final administrative action.

Our first concern about the Commission's proposal is that it does not explain why incorporation by reference is necessary to accomplish any purpose other than to limit issuers' liability. As the Commission is aware, the issue of liability was hotly contested when the profile was proposed, and the Commission rejected incorporation by reference on the ground that it was not in the public interest. To our knowledge, the only purpose that commentators claimed incorporation by reference would serve was to limit liability

for false statements and misleading omissions in the profile. There was no suggestion then that incorporation by reference somehow promoted the principal purpose of providing investors with a short, concise summary of key information about the fund. Now the Commission appears to argue that incorporation by reference accomplishes a "layering" of information, but it is unclear why incorporation is necessary to achieve this goal. The layering of information achieved by providing electronic access to various fund documents, and hyperlinking one document to another, has no apparent relationship to whether information from those documents has been incorporated by reference, or whether Rule 159's assumption regarding when information is deemed to have been conveyed for purposes of sections 12(a)(2) and 17(a)(2).

It appears to us that the proposal to permit incorporation by references serves one and only one purpose, and that is to limit the potential liability of issuers for false statements and material omissions in the Summary. Consistent with the spirit if not the letter of the Administrative Procedures Act, the Commission owes it to the investing public to provide a clear explanation as to why it considers it appropriate to restrict issuer liability by administrative fiat. As discussed further below, it has not done so in the Summary proposal, and it should do so prior to taking any final action. As there is no dispute that sections 12(a)(2) and 17(a)(2) are intended to cover summary prospectuses such as the Summary, there should be good reasons for limiting liability under those provisions before any such action is taken, and those reasons should be fully and ingenuously disclosed in the Commission's proposed rulemaking.

Although the Commission obliquely suggests why, in more of a legislative than administrative analysis, liability under sections 12(a)(2) and 17(a)(2) might not be necessary in light of its Summary proposal, it nowhere explains why it is so eager to surrender its own authority to prosecute claims under section 17(a)(2) or to forfeit the private right of investors to bring claims expressly granted by Congress under section 12(a)(2). Does the Commission believe that excessive litigation would result if liability were not limited? In the profile adopting release, the Commission specifically disagreed with "commenters' claims that the use of profiles will lead to significant potential liabilities under the federal securities laws." Has the Commission changed its position on this question? Does it believe that the risk of liability would be greater for a Summary than for a profile? Even if potential liabilities were significant, does that mean that they would be unwarranted unless incorporation by reference established that claims regarding the Summary should take into account mitigating disclosure in other documents? Would not defendants argue, with or without incorporation by reference, that the statutory prospectus should be considered in the context of any claims regarding false statements or material omissions in the Summary?

Perhaps the Commission believes that funds will not use the Summary unless liability is limited, and the fact that the profile is never used might support this position. But another reason for the profile's lack of popularity might have been the requirement to deliver a statutory prospectus with the confirmation. By eliminating this added expense, the Summary might achieve the success that eluded the profile without surrendering claims based on a misleading Summary. Even if the problem with the profile was the

liability risk, the Commission has nowhere discussed whether the benefits of Summary that satisfied prospectus deliver obligations is worth the cost of relieving issuers of legal responsibility for misleading disclosure, much less whether such a tradeoff is even appropriate. The Commission nowhere discusses the kind of claims that its proposal might affect, much less how it might affect them. As currently presented, the Commission's proposal could reasonably be characterized as arbitrary and capricious in view of the complete absence of any reasonable basis for its incorporation by reference proposal.

As to the very limited analysis offered by the Commission, it appears that one argument for incorporation by reference is that the Internet has permeated the information marketplace to such an extent that it is reasonable to treat an undelivered statutory prospectus as effectively having been made available (if not delivered) to the investor. This might make sense to the extent that the Internet was deemed to have accomplished effective delivery of the statutory prospectus that is the subject of the statutory delivery requirement, but this factor has not been the basis of permitting incorporation by reference previously and it is not clear what its limits would be here. When the Commission permitted incorporation by reference of the SAI, which permits defendants to defeat claims that the prospectus was not misleading because of information in the SAI,[3] it did so not on the ground that the SAI was easily accessible, but on the ground that the information in the SAI was at a level of detail that would have made its inclusion in the prospectus inappropriate.[4] Is the Commission now suggesting as a policy matter that any claim, including fraudulent sales practices claims brought against brokers, can now be defended by citing information that the plaintiff can be deemed to have received because it is easily accessible online? Liability under sections 12(a)(2) and 17(a)(2), at least as affected by incorporation by reference, should not turn on whether the investor had easy access to mitigating information in an online document, but on whether the mitigating information in the other document can appropriately be viewed as rendering the alleged false statement or misleading omission in the Summary not fraudulent.

We also have grave concerns about the Commission's proposal to eliminate prospectus liability under section 11 when a Summary prospectus is used to satisfy the prospectus delivery requirement. Section 11 is designed to provide for limited, strict liability for misleading registration statements. Congress drafted section 11 on the assumption that the registration statement would be the exclusive vehicle by which issuers could sell securities publicly. While there may be reasonable arguments for changing what should constitute an adequate selling document under the Securities Act, it is unclear what justification exists for changing whether such document, once established, should be

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[3] *See*, *e.g.*, *White v. Melton*, 757 F.Supp. 267 (S.D.N.Y. 1991).

[4] We can think of no basis for extending the protection offered by incorporation by reference outside of the boundaries of the registration statement to include the annual report. A basic premise of prospectus liability under section 12(a)(2) is that issuers should be held to the integrity of their selling documents. The Commission's suggestion that the annual report could be used for any purpose other than showing the absence of transaction causation (which is not an element under section 12(a)(2)) renders meaningless the concept of prospectus liability under that provision.

subject to section ll liability. The Commission proposes to use a 10(b) prospectus to permit issuers to escape from section 11 despite that fact that section 11's exclusion for section 10(b) prospectuses was premised on the assumption that there would be some form of final, section 10(a) prospectus to which liability would attach, and ***that document would be the primary selling document through which the transaction was effected***. If the Commission proposes to permit a section 10(b) prospectus to fill the place of a section 10(a) prospectus, it would make sense that the section 10(b) prospectus would step into the shoes of the section 10(a) prospectus for purposes of section 11 liability. In any case, it is impossible to determine on what basis the Commission believes this liability two-step to be appropriate, because the discussion of this dramatic shift in liability (the elimination of section 11 liability as to the only document to which a delivery obligation attaches) in the proposal is limited to one sentence on pages 73 to 74 of the proposing release. We believe a far more thorough discussion of these important issues is essential before the Commission acts on this proposal. Only then will it be possible for commenters to assess its likely impact.

Format and Content of the Summary Prospectus

We generally agree with the Commission's proposal regarding the content and format of the Summary. As to the format, we believe format does affect disclosure effectiveness. Much could be gained by field testing these disclosure requirements to determine whether certain format and presentation approaches facilitate investor understanding. Anything learned from this testing could be used to set general guidelines that funds would be expected to follow in presenting the material. Such an approach could leave funds free to develop alternative approaches where they can show that these approaches are equally effective or more effective in promoting investor attention to and understanding of the information disclosed. Such an approach could also support fund experimentation with Internet formatting options for connecting disclosures that are layered in their complexity.

Our comments regarding the content of the prospectus are provided below.

Table of Contents

The Commission has proposed that no information precede the substantive information in the summary prospectus except for a cover page and a table of contents. It appears that the table of contents would be required to include a detailed listing of parts of the remainder of the statutory prospectus.[5] Such a detailed listing could be lengthy and distract readers with ancillary information. We therefore recommend that the Commission provide a standardized table of contents that shows a detailed listing of the contents of the summary prospectus and additional page citations only for the first page of the non-summary prospectus and Statement of Additional Information ("SAI'), and that a detailed table of contents for these documents appear on the first page of each.

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[5] *See* Securities Act Rule 481(c) (requiring "reasonably detailed table of contents").

Fee Disclosure

We strongly support the proposal to give greater prominence to fee information. As the Commission notes, fee information can be buried deep within the prospectus. The summary will place fee information in a more prominent location and thereby encourage investors to give greater emphasis to fees and conduct fee comparisons. The Commission's proposal will improve clarity as well. One example is the proposal to revise the parenthetical following the fee table heading to make it clearer that the fees are paid by the shareholder as opposed to continuing to use the vacuous phrase "deducted from Fund assets."

Clarity will also be enhanced by requiring that the Summary show the information for a single fund. The traditional approach of permitting the integration of summary information about multiple funds defeats the purpose of summarizing information, which is to facilitate investors' understanding of the most important factors relating to a fund. This traditional approach made the evaluation of a single fund extremely cumbersome because each category of key information about the fund would appear in a different location, not to mention that it would appear in a document that was five or ten times as long as it needed to be. Furthermore, the relevant comparator for a fund in a given complex is likely to be a fund in another complex, so the juxtaposition of the fees of different funds within a complex is often unhelpful, if not misleading.

As discussed further below, however, we recommend certain modifications to the fee table.

Total Expense Ratio. First, we recommend that the summary include only the fund's total expense ratio. The current breakdown of fees among management fees, 12b-1 (distribution) fees and "Other" is not crucial information to an investor's investment decision. To the extent that the current breakdown implies something about the amount of fees expended on distribution, the current breakdown is misleading. Many funds pay for distribution out of the management fee, and 12b-1 fees are often used to pay for administrative expenses.

Fee Comparisons. Second, we strongly recommend that the Commission require some form of fee comparison in the fee table. The Commission repeatedly cites facilitating comparisons among funds as a guiding principal for its proposal, yet its proposed fee table provides for no fee comparators. In contrast, funds are required to compare their investment performance to an appropriate benchmark. For this purpose, the Commission permits funds to use wholly inappropriate benchmarks (*e.g.*, internet stocks typically use the S&P 500), and the Commission is well aware that performance comparisons are inherently limited because past performance is a poor predictor of future performance. Fees are highly predictable from year-to-year, and there is far greater homogeneity across fund fee structures than there is across funds' investment objectives and the performance benchmarks they use. Nothing would promote comparison shopping and competition in the fund industry more than a mandatory fee comparison in the fund fee table.

Portfolio Turnover. Third, while we support the Commission's proposal to require non-money market funds to disclose their portfolio turnover rate immediately following the fee example, we believe that incorporating portfolio transactions in the total expense ratio would be a superior alternative.[6] We agree that giving greater prominence to portfolio turnover will direct investors' attention to a factor that is excluded from the fee table but that can have a greater impact on costs incurred by investors than the total expense ratio.[7] The success of this disclosure will depend largely on whether the required explanation of the effect of portfolio turnover on portfolio transactions costs is sufficiently clear. We are concerned that funds will soft pedal this disclosure and accordingly recommend that the Commission provide further clarification that this explanation must state that a high turnover rate can impose costs that are two or three times the fund's total operating expenses and result in significant adverse tax consequences for taxable accounts, or something that is similarly explicit.

We also continue to believe that the disclosure of a fund's portfolio turnover rate is inferior to requiring that funds provide a total expense ratio that includes portfolio transaction costs, and expect the Commission to provide a separate, complete response to comments on its concept release on the disclosure of portfolio transaction costs. Nonetheless, we agree that prominent disclosure of the portfolio turnover rate accompanied by an appropriate explanation will significantly improve fee disclosure in this respect.

Waiver-Reduced Fees. Fourth, we support the Commission's proposal regarding the disclosure of fee reimbursements or waivers ("waivers") provided that the Commission modifies its position regarding the length of the waiver commitment. In short, we believe that the one-year commitment should be a rolling one-year commitment so that waiver-reduced fee disclosure will not become stale after it is used.

The Commission proposes to permit the disclosure of waiver-reduced fees in the Summary as long as the waiver will continue no less than one year from the effective date

[6] While we support enhanced disclosure of breakpoints, we strongly object to the implications that: (1) a primary purpose of the disclosure is to enable investors to confirm that they have received the breakpoints to which they are entitled and (2) the recent breakpoint scandal was attributable to investors' failure to understand breakpoints. *See Summary Proposal* at text accompanying nn. 47 – 48. The purpose of the disclosure is to ensure that investors can properly evaluate distribution expenses. The failure of 41 of 43 brokerage firms to give their clients the breakpoints to which they were entitled was a systemic failure of basic compliance by brokers and oversight by fund directors and regulators, not a failure by investors who were cheated. *See* Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (March 2003) (finding shareholders were overcharged with respect to 32% of transactions that were eligible for discounts) at http://www.sec.gov/news/studies/breakpointrep.htm.

[7] *See Jason* Karceski, Miles Livingston & Edward O'Neal, Portfolio Transaction Costs at U.S. Equity Mutual Funds.(November 2004), *available at* http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf.

of the registration statement.[8] It appears that this would allow a Summary to be used that showed a wavier-reduced fee with a one-year commitment without any notification to shareholders if the commitment period was reduced to less than one year. To illustrate, a shareholder could purchase shares off of a Summary showing a waiver-reduced fee subject to a one-year commitment that, eleven months later, would expire in one month. At that time, the last impression on the investor would still be a waiver-reduced fee with one year to run. Although in theory the investor would know that the one-year period could be growing shorter with the passing of each day after the share purchase, we believe that this is unrealistic and misses the point of disclosing waiver-reduced fees.

The purpose of fee disclosure is to apprise investors of fees he will pay going forward. The disclosure of the waiver-reduced fee is that, assuming that it will remain in place a minimum period of time, it may provide a more accurate reflection of the fees the investor will pay going forward. In both cases, the goal is the investor's understanding not only at the moment of the initial investment, but also on an ongoing basis. Otherwise, why would the period remaining on the waiver commitment matter? It matters because it means that at the moment of disclosure and for some period thereafter the representation of the fee retains its validity. If a one-year waiver commitment begins to expire one day after the effective date of the registration statement, then its value as a reasonable predictor of fees begins to deteriorate immediately after the disclosure.

We believe that funds should be required to inform investors when the commitment remaining on a fee waiver becomes shorter than one year.[9] Under this approach, the initial disclosure to a new purchaser remains would be equally valid after the purchase and until corrective disclosure is provided that states that the waiver commitment no longer runs for at least one year. This redirects the disclosure of fee waivers to serve the goal of keeping investors informed as to the amount of fees a fund will incur in the future.[10] Just as a fund should sticker its prospectus to disclose a material increase in fees

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[8] It is not clear, however, that the effective date of the registration statement will be the date of the most recent version of the Summary. The Commission proposes to require that the Summary be updated quarterly as to certain information, but that these updates would not apply to the Prospectus. In that case, it appears that a Summary could be used up to nine months after the effective of the registration statement and disclose waiver-reduced fees with a commitment of only 3 months because the commitment would still run for 12 months from the effective date of the registration statement. The Commission should clarify that the Summary cannot include waiver-reduced fees unless the commitment runs at least one year from the date of the Summary.

[9] In practice, fund service providers would simply agree to a rolling one-year commitment that, if terminated and allowed to run, would trigger disclosure to current shareholders and updating of the Summary so that shareholders would be apprised that the most recent waiver-reduced fee disclosed to them was no longer subject to a one-year commitment. This would not be burdensome, as fund service providers could simply terminate the rolling one-year commitment only on dates on which the registration statement and the annual delivery of the Summary occurs. The potential burden of notification also could be mitigated by permitting the notification requirement to be satisfied by electronic communications and website posting.

[10] In contrast, investors would reasonably expect fund performance and portfolio holdings to change from quarter to quarter, whereas investors generally would not expect the same of fees. For this reason, we believe that a previously provided Summary (or Prospectus) should be considered current notwithstanding

above the amount disclosed in a current prospectus (that is, any prospectus with 16-month current financials), it should sticker it prospectus to disclose a reduction in a fee waiver commitment to less than one year.[11]

For the same reasons, we would support moving the disclosure regarding the length of the commitment, and who can terminate the commitment and under what circumstances, from the Summary to the statutory prospectus. A narrative explanation that essentially explains the minimum commitment period necessary to permit the disclosure of the waiver-reduced fee seems redundant. Is it essential that investors know not only the waiver-reduced fee but also the basis on which its disclosure was made? We believe that if the investor is told when the waiver-reduced fee commitment has been reduced to less than one year, then there is no reason that the Summary must include the explanation. In short, we recommend that funds be required to inform shareholders when a fee waiver that was previously disclosed in the Summary is subject to a commitment of less than one year, in which case the proposed explanation could be moved to the statutory prospectus. This would apply to both the fee table and the fee table example.

Multi-class Funds. Fifth, we believe that expenses for each class of shares that is eligible for purchase by a particular group of investors (*e.g.*, A, B and C shares) should be shown together in the fee table with an illustration that shows the relative cost advantages and disadvantages of each class. The Commission proposes to permit funds – in effect, their sponsors – to provide information regarding multiple classes separately or together, "or to use another presentation that is consistent with disclosing the summary information in a standard order at the beginning of the prospectus." The Commission states that "this flexibility has resulted in effective presentation of class-specific cost and performance information that facilitate comparison among classes." We strongly disagree with this position. The differences between multiple classes generally reflect differences in distribution arrangements and, if anything, the disclosure of such arrangements has been designed to obscure these differences and frustrate comparisons rather than facilitate them. While the flexibility provided in the proposal might be used to facilitate comparisons in some instances, it is in our view even more likely to be used to impede them.

What the current disclosure approach has facilitated is the sale of share classes that generate the highest compensation for the broker rather than the best investment results for the client. In a recent case, it was alleged that a 92% of a particular fund complex's

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subsequent performance and holdings updates to the Summary (or Prospectus), and that a previously provided Summary (or Prospectus) should *not* be considered current as of the shortening of the fee waiver commitment to less than one year.

[11] At a minimum, the Commission should require that the fee table be updated quarterly to reflect a waiver with a commitment that is less than one year, just as it proposed to require quarterly updates for performance and portfolio holdings. It is unclear to us, however, how the Commission could consider the latter updates to "contribute significantly to the usefulness of the document" but a failure to update not to constitute an omission of material information. Any required updates to the Summary should be required in the statutory prospectus as well.

domestic equity assets were invested in B shares although B shares virtually were never the best alternative. The trial court held that there was nothing misleading about selling B shares that could not be the best option for the investor or for failing to disclose this fact in the prospectus. The court found that the "prospectus at issue discloses information which would permit any investor to determine the 'best' investment for him or her, under the circumstances. It is up to each investor to take the facts provided, evaluate options, make calculations, and decide on the best investment strategy for his or her particular circumstances, taking into account the myriad changes which occur daily, both in the market and in the individual's own financial situation."[12] Perhaps the Commission accepts this formulation as an appropriate standard for disclosure regulation, but we decidedly do not.

The presentation of different classes of shares without specific disclosure that one class is virtually always an inferior option is inherently misleading, and if courts refuse to recognize this then it becomes incumbent on the Commission to expressly require such disclosure. Courts may tend to assume that, when the Commission has considered and rejected certain disclosure requirements, the failure to make such disclosure cannot be misleading. The Commission's failure to act becomes tacit approval of a fraudulent practice and implicitly encourages the kind of abusive sales practices that have plagued B shares for year. The Summary should be required to show a comparison of the expenses of each class that a particular type of shareholder would be eligible to purchase. We recognize that some funds offer a wide range of complex distribution arrangements for which comparisons are difficult, but that is their choice. This factor should not militate for less disclosure, but for reconsideration of the structure of the distribution arrangements offered.

Differential Compensation Disclosure

We generally support the Commission proposal to require disclosure in the Summary of the conflict of interest created by differential compensation paid to brokers for the distribution of fund shares.[13] As the Commission is aware, conventional fund distribution arrangements create economic incentives for brokers to recommend funds or share classes of funds that pay them the most compensation rather than the fund or share class

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[12] *Benzon v. Morgan Stanley*, 2004 WL 62747 at *4 (M.D. Tenn. Jan. 8, 2004). The court assumed "that Class B shares are never the best investment for anybody at any time under any rational investment strategy," but, remarkably, still found nothing misleading about the fund's failure to disclose this assumed fact. *Id*.

[13] The full text of the proposed disclosure is as follows:

> If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may influence the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information."

Summary Proposing Release at text accompanying n. 77.

that would be the best fit for the client. Whereas brokers charge the same commission regardless of whether a client buys shares of IBM or Dell, brokers can charge more for selling one fund or share class than for selling another even though the services provided by the broker are the same. Notwithstanding this conflict of interest, the Commission exempts fund distribution compensation from disclosure on the transaction confirmation. Although fund commissions and 12b-1 fees are disclosed in the fee table, the conflict created by differential compensation is not. The Commission has not required disclosure ***anywhere*** of the amount of revenue sharing paid to brokers out of the fund's management fee. Although the differential compensation disclosure in the Summary would be a step in the right direction, it would be a very small step and serve primarily to highlight the grossly inadequate rules for the disclosure of fund distribution compensation.

We support the Commission's attempt to begin to direct investors' attention to the fact that differential compensation payments creates an economic incentive to recommend funds based on the distribution compensation the broker receives rather that the best interest of the client. The utility of this disclosure will be limited, however, because Summary will not even be provided to investors who purchase shares through intermediaries before the investor makes the relevant investment decision, much less before that investor retains the broker to advise him. The prospectus delivery requirement typically is not triggered with respect to intermediary sales until the delivery of the transaction confirmation – days after the client has made the decision to invest in the fund. We believe that the logical time at which to inform investors of brokers' financial incentives to sell funds that are most remunerative to the broker is at the inception of the relationship with the broker. This view is reflected by the requirement that investment advisers provide clients with a written brochure at the inception of the relationship and to disclose all material information on an ongoing basis. Investment advisers' fiduciary duty requires them to inform their clients about differential compensation, whereas the Commission and FINRA continue to take the position that this is not necessary for brokers.

For the same reason that funds would be required to deliver a Summary prior to a sale of fund shares, funds or their distributors (or both) should be required to deliver disclosure when shares are sold through intermediaries that quantifies the financial incentives that conventional distribution arrangements create for brokers to recommend the highest-paying fund, regardless of the best fit for the client. We appreciate that the "Commission has recognized these concerns in a separate initiative," but the point-of-sale proposal to which the Commission refers was released on March 4, 2005, which means that its 3-year anniversary will pass just 4 days after the date of this letter. As we discussed in our comments on that release, the proposed point-of-sale disclosure would be inadequate to apprise any but the most self-directed investor to understand the nature of their brokers' conflicts of interest. If the Commission wishes to ensure that investors are apprised of the conflict created by differential compensation, it should promptly adopt rules requiring that brokers disclose the amount of differential compensation they receive from different funds and different share classes. Furthemore, the reliance on Internet disclosure as the primary delivery mechanism for the Summary eliminates the brokerage firms' primary argument against pre-sale delivery – that it is too slow and too costly.

Indeed, we are concerned that the Commission is not genuinely committed to ensuring that investors are aware of the conflicts created by differential compensation, as illustrated by the last sentence of the proposed Summary disclosure, which states: "Ask your salesperson or visit your financial intermediary's Web site for more information." To exhort shareholders to actively seek out information on their own that the Commission has not formally required to be provided in a standardized, accessible format is impractical to the point of disingenuousness. If investors routinely ***asked*** for information they should ask for or ***visited*** websites to ***gather*** information they need, there would be no need for disclosure rules at all. We are gratified that state regulators have taken steps to ensure that material information regarding revenue sharing arrangements is disclosed to investors, but we believe that the problem is a national one that is best addressed by the Commission.

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In conclusion, we generally support the Commission's proposal to permit a standardized document that generally includes the most important information that investors should consider when evaluating different funds to be used in place of a statutory prospectus, with certain reservations as discussed above. We applaud the Commission's efforts to further simplify fund disclosure and reduce costs for investors and appreciate this opportunity to share our views with you.

Respectfully submitted,

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cc: (U.S. Mail only)

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