



March 31, 2005

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

*Re: Investment Company Act Release No. 26778 (March 1, 2005) (the "Supplemental Request for Comment")*

Dear Mr. Katz:

NASD staff appreciates the opportunity to express its view on the Securities and Exchange Commission's Supplemental Request for Comment.<sup>1</sup> While, in formulating our views, we reviewed thoroughly the recommendations of the Mutual Fund Task Force (the "Task Force"), which NASD organized and I chaired, this letter sets forth the views of NASD staff.<sup>2</sup>

NASD commends the Commission's significant efforts to assure that investors are provided effective disclosure of information concerning mutual funds and other products at the point of sale. The Commission's proposal is an important step forward for the investing public. We would be pleased to discuss any aspect of the Supplemental Request for Comment. However, in this letter, we are commenting on certain specific aspects of the Supplemental Request for Comment. In particular, NASD staff recommends the following:

- The SEC should require focused disclosure about the risks, investment strategies, and other characteristics of a mutual fund, in addition to disclosure about fees, expenses and dealer incentives. The "Profile Plus" document developed by the Task Force would accomplish this result.

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<sup>1</sup> The comments provided in this letter are solely those of the staff of NASD; they have not been reviewed or endorsed by the Board of Governors of NASD. For ease of reference, this letter may use "we," "NASD" and "NASD staff" interchangeably, but these terms refer only to the NASD staff.

<sup>2</sup> For ease of reference, we enclose a copy of the Task Force report.

- Internet disclosure is the only effective way to assure that investors receive the information they desire at the point of sale. The Commission should mandate Internet delivery of the point of sale disclosure document.
- The SEC should take an “access equals delivery” approach to mutual fund prospectus delivery.
- In the point of sale disclosure document, the SEC should simplify disclosure about annual expenses into a single, bottom-line number.
- The SEC should not require disclosure of expenses based upon actual investment amount because it would be confusing to investors. If the Commission nonetheless decides to require such disclosure, delivery via the Internet is the way to facilitate implementation of this requirement.

*1. Point of Sale Disclosure through the Profile Plus*

Commission Rule 498, adopted in 1998, allows funds to deliver a short, simple summary prospectus, called a “profile.” The profile was designed to provide all of the information about a mutual fund that an informed investor would need to know. Nevertheless, few mutual funds have used the fund profile in the retail market, primarily because of liability concerns.

Building upon the original profile, the Task Force developed the Profile Plus, a simple, two-page document that includes hyperlinks to additional and more detailed information, the efficacy of which depends on use of the web-based delivery, as discussed below. The Profile Plus contains:

- basic information about the fund’s investment strategies and risks, with hyperlinks to additional information in the prospectus;
- a ten-year performance chart to illustrate the volatility of the fund’s shares;
- average annual returns of the fund over the past 1-, 5- and 10-year periods;
- the total fees and expenses paid by a shareholder – both transaction fees and fund operating expenses, presented in dollar and percentage terms, based on \$1,000, \$50,000 and \$100,000 hypothetical investments – with a hyperlink to further detail in the prospectus;
- a brief explanation of portfolio transaction costs, with a hyperlink to detailed information about the fund’s portfolio transaction costs;<sup>3</sup> and

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<sup>3</sup> The Task Force recommended this disclosure of portfolio transaction costs in its earlier report. *See Report of the Mutual Fund Task Force: Soft Dollar Practices and Portfolio Transaction Costs 15-17* (Nov. 2004, available at [www.nasd.com](http://www.nasd.com)).

- through two “yes/no” questions, basic information about revenue sharing and differential compensation arrangements, with hyperlinks to additional information in a dealer disclosure statement.

To support the Task Force, NASD engaged Applied Research and Consulting LLC (“ARC”) to conduct usability testing of the Profile Plus and compare the point of sale disclosure document recently proposed by the Commission and the Profile Plus.<sup>4</sup> All investors interviewed by ARC were interested in the information provided on page one of the Profile Plus regarding the fund’s investment strategies, risks and performance. For example, investors had the following comments concerning the risk disclosure:

- *“This is good. It’s common knowledge (i.e., volatility), but it’s scary to see it.”*
- *“[The SEC form] is missing a couple of key features. I would add the performance and risk information [to the SEC form], and the other basic information about the kind of fund.”<sup>5</sup>*
- *“I think they need to tell you that there is a risk. No surprises there. I would expect this information.”*

NASD recommends that the Commission mandate delivery by broker-dealers of a Profile Plus for each fund that the broker-dealer sells. Through this mandate, the Commission would ensure that simple, clear disclosure reaches the retail investor. Moreover, Commission-mandated, line item disclosure might address some of the liability issues that flow from voluntary disclosure in a simplified format. The inclusion in the Profile Plus of hyperlinks to the full fund prospectus, which depends on delivery via the Internet, also should alleviate liability concerns.

## 2. *Internet Disclosure*

NASD recommends that the Commission require that broker-dealers post the Profile Plus on their web sites, with activated hyperlinks.<sup>6</sup> The Commission also should require that, contemporaneously with making a recommendation to purchase a fund, a registered representative either refer the customer to the Profile Plus on the broker-dealer’s web site or e-mail a web site link to the customer. In referring a customer to the disclosure, the registered representative should explain that the Profile Plus contains important information concerning costs and potential conflicts of interest.

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<sup>4</sup> For ease of reference, we are enclosing a copy of the ARC report.

<sup>5</sup> ARC did not tell the investors interviewed that one form was developed by the SEC and the other by the Task Force.

<sup>6</sup> Direct-sold mutual funds should be required to provide the Profile Plus, modified as appropriate, and the fund prospectus on the fund complex web site, so that investors in those funds have access to comparable disclosure.

Internet delivery of the Profile Plus would allow investors to review the information at the level of detail that they prefer and to compare different funds easily. The Profile Plus should provide the level of disclosure that many investors would desire. However, any investor that seeks additional information could hyperlink to the full fund prospectus and to the dealer disclosure statement concerning potential conflicts of interest. Absent an Internet delivery requirement, the federal securities laws would continue to impose an inflexible regime that delivers virtually the same level of disclosure to every investor.

Most investors today have ready access to the Internet, as the Commission itself has recognized.<sup>7</sup> Internet delivery has other advantages for these investors. For example, through on-line disclosure, an investor can more easily compare the features of different funds. And as the Commission stated in the Supplemental Request for Comment, point of sale disclosure is intended to provide investors with key information contemporaneously with their investment decision.<sup>8</sup> For most investors, web site disclosure is the quickest and most straightforward way to deliver point-of sale information to investors.<sup>9</sup> Finally, Internet delivery of information facilitates prompt updating when needed.

An oral delivery requirement would present distinct difficulties. It is difficult for firms to monitor oral delivery by their registered representatives. Moreover, it is difficult for investors to digest complex information received through oral disclosure.

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<sup>7</sup> In proposing changes to the registration, communications, and offering processes under the Securities Act of 1933, the Commission recently stated:

“Internet usage in the United States has grown considerably since 2000 when we published our most recent interpretive guidance on the use of electronic media in securities offerings, including with regard to prospectus delivery by electronic means. For example, recent data indicates that 75% of Americans have access to the Internet in their homes, and that those numbers are increasing steadily among all age groups. See, Three out of Four Americans Have Access to the Internet, Nielsen/NetRatings, March 18, 2004; Robyn Greenspan, Senior Surfing Surges, ClickZNetwork, Nov. 20, 2003 (citing statistics from Nielsen/Net Ratings and Jupiter Research). In addition, there is evidence suggesting that the “digital divide” is diminishing. See, for example, Kristen Foundain, Antennas Sprout, and a Bronx Neighborhood Goes Online, The N.Y. Times, June 10, 2004, at G8; Steve Lohr, Libraries Wired, and Reborn, The N.Y. Times, Apr. 22, 2004 at G1.”

Securities Exchange Act Rel. No. 50624 (Nov. 3, 2004) at n.353 (the “Prospectus Delivery Release”).

<sup>8</sup> See Supplemental Request for Comment at 28.

<sup>9</sup> As the Task Force recognized, some investors may not have access to the Internet or for other reasons may not want to obtain this information in electronic form. We support the Task Force’s recommendation that the Commission require that broker-dealers offer their customers the option to elect to receive the Profile Plus and dealer disclosure statement in hard copy form. If a customer elects hard copy delivery, the Commission should require that the broker-dealer transmit the Profile Plus and the dealer disclosure statement by e-mail or in paper form through regular mail or hand-delivery as soon as practicable after the mutual fund recommendation is made.

Hard copy disclosure presents its own problems. If broker-dealers must provide hard copy disclosure before accepting an order, then the customer may be precluded from executing the order as quickly as desired.<sup>10</sup> Web site delivery avoids these problems and provides investors instantaneous access to the necessary disclosure.

The ARC Report showed an investor preference for web site delivery. Surveyed investors had the following comments:

- *“It is much easier to navigate online than to sit down and read. If I need to I can print it, but a big package mailed to me with all that stuff is too much.”*
- *“The less paper I get the better. I think e-mail is the way to go.”*
- *“It is better to read it for yourself, and online is much better. Waiting for mail is archaic.”*
- *“The more I think about it, the more I’d like to have it online. I’d like to receive an e-mail and then go to the website. Then I can look at the stuff I want to see.”*
- *“Just send it to me in an e-mail. In the e-mail, not an attachment. . . [A website] would be nice. Those kind of links are good.”*

Needless to say, we disagree strongly with the statement in the Supplemental Request for Comment that “web site disclosure . . . could be ineffective at providing investors with key information about costs and conflicts contemporaneous with investment decisions as point of sale disclosure.”<sup>11</sup> As a regulator charged with the protection of investors, NASD feels strongly that a web site model best furthers that critical objective. Simply put, web site delivery – accompanied by the appropriate referral of the investor to the information – is by far the most effective mode of delivery; it is the right way to deliver the right information to investors at the right time.

### 3. “Access Equals Delivery”

In November 2004, the Commission proposed an “access equals delivery” approach to delivery of industrial company prospectuses.<sup>12</sup> Under this model, issuers and broker-dealers can satisfy their final prospectus delivery obligations if a final prospectus is on file with the Commission within the required

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<sup>10</sup> See Supplemental Request for Comment at 28-29.

<sup>11</sup> *Id.* at 28.

<sup>12</sup> See Prospectus Delivery Release.

time. The Commission did not, however, propose to apply this model to registered investment companies.<sup>13</sup>

NASD urges the Commission to extend the “access equals delivery” approach to mutual funds. An investor’s access to the fund prospectus through the Internet should constitute delivery for purposes of the federal securities laws. The Commission has recognized the need to modernize prospectus delivery obligations in view of technological and market structure developments of recent years. These developments also justify an “access equals delivery” position with respect to mutual fund prospectuses.

Few firms have used the mutual fund profile prospectus, in part because there has been concern over the potential liability exposure that the profile presents. By adopting an “access equals delivery” approach to the full prospectus, the Commission would ameliorate many of these concerns, and would better ensure that investors receive concise, useful disclosure concerning the mutual funds that they are considering.

#### 4. *Disclosure of Total Expenses*

The Profile Plus includes a “Fees and Expenses” table, which sets out the total fees and expenses paid by a shareholder – both transaction fees and fund operating expenses -- in dollar and percentage terms, based on \$1,000, \$50,000 and \$100,000 hypothetical investments. Total fund operating expenses would be presented as a single number, and not broken down into components.

ARC’s research revealed that investors are interested primarily in the total amount of the fees that they pay, and the effect of these fees on fund performance, not on a breakdown of fees.<sup>14</sup> Some investors expressed the view that only the total amount was important to them, and others found the breakdown categories unclear or vague.<sup>15</sup> Investors commented:

- *“It adds up to 1.38%. I already knew that from before. Why should I care about this? It won’t affect how much I’m paying.”*
- *“This is what it’s going to cost. Whether you call it a management fee –what does it matter to me? It doesn’t help any.”*
- *“This is where I tune out. It’s just gobbledygook.”*

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<sup>13</sup> The Commission noted that funds “are subject to a separate framework and that it would be more appropriate to consider any changes to our prospectus delivery requirements as they apply to registered investment companies and business development companies in the context of a broader reconsideration of this framework.” Prospectus Delivery Release, 69 Fed. Reg. at 67439.

<sup>14</sup> Of course, the Profile Plus allows those investors interested in a breakdown of total fund expenses to obtain this information easily by clicking through to the appropriate section of the fund prospectus.

<sup>15</sup> See ARC Report at 10.

For this reason, NASD recommends that the Commission require point of sale disclosure of total expenses, without requiring disclosure of the various expense components.

5. *Problems with Fee Disclosure Based on Actual Investment*

The forms accompanying the Supplemental Request for Comment provide disclosure of fees and expenses that are based upon hypothetical \$1,000, \$50,000 and \$100,000 investment amounts. In doing so, they achieve the primary purpose of fee disclosure, which is to allow investors to compare the fees and expenses of different funds. Investors were interested in this information and the current version of the Profile Plus follows the Commission's lead concerning hypothetical investment amounts.

However, the Commission forms also provide an opportunity for an investor to request disclosure with respect to his actual investment.<sup>16</sup> This "actual investment" disclosure could confuse or mislead investors, particularly with respect to ongoing expenses. Although the proposed forms would provide an "estimated 1<sup>st</sup> year" amount, and would disclose the assumption that the value of the investment remains static, many investors likely would believe that the dollar amount represents the investor's actual share of expenses each year, for the life of the investment. In fact, this would rarely be the case, since the value of the investment would change.

In contrast, disclosure based upon the three hypothetical amounts allows the investor to compare the costs of different funds, without the potential confusion and without imposing the additional expense of actual investment disclosure.<sup>17</sup> Therefore, NASD recommends that the SEC require fee disclosure based only upon hypothetical investment amounts.

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<sup>16</sup> See Supplemental Request for Comment at 10.

<sup>17</sup> If the Commission determines to the contrary, NASD believes that the best way to deliver that additional disclosure is by allowing an investor to access an Internet-based calculator that would display the pertinent information after the investor enters his or her actual investment amount. This could be developed as an industry-wide utility, assuring consistency and radically decreasing expenses. Provision of this tool depends on the use of the Internet to deliver the information.

Mr. Jonathan G. Katz

March 31, 2005

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NASD appreciates the opportunity to express its views on the Supplemental Request for Comment and point of sale disclosure for mutual fund investors. If you have any questions regarding the foregoing or require additional information, please call Elisse Walter, Executive Vice President, at 202-728-8230, Tom Selman, Senior Vice President, at 240-386-4533, or Angela Goelzer, Associate Vice President, at 202-728-8120.

Very truly yours,

A handwritten signature in black ink that reads "Robert R. Glauber". The signature is written in a cursive style with a large, prominent initial "R".

Robert R. Glauber  
Chairman and CEO

Enclosures

cc: Chairman William H. Donaldson  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Cynthia A. Glassman  
Commissioner Harvey J. Goldschmid  
Annette L. Nazareth  
Robert L.D. Colby  
Catherine McGuire  
Paul Roye  
Robert Plaze