



January 23, 2004

Barbara Z. Sweeney  
NASD  
Office of the Corporate Secretary  
1735 K Street, NW  
Washington, D.C. 20006-1500

Re: Request for Comment Regarding Disclosure of Mutual Fund Expense Ratios in Performance Advertising (NASD Notice to Members 03-77)

Dear Ms. Sweeney:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to express its views on NASD's proposal to amend Rules 2210 and 2211 to require enhanced disclosure in all member communications with the public that contain investment company performance information.<sup>2</sup> Under NASD's proposal, any fund communication with the public that includes performance information permitted by Rule 482 under the Securities Act of 1933 or Rule 34b-1 under the Investment Company Act of 1940 ("performance advertisements") would be required to disclose: the standardized performance information required by Rule 482 and Rule 34b-1; the fund's maximum sales charge; and the fund's annual expense ratio in a prominent text box.<sup>3</sup>

The Institute supports requiring fund performance advertisements to disclose the fund's annual expense ratio.<sup>4</sup> We believe that requiring a fund's annual expense ratio to appear in fund performance advertisements will provide investors with additional information about the costs of buying and owning mutual funds and will facilitate comparisons among funds.

We have several specific comments on the proposal. These comments are intended to refine the proposal to allow funds more flexibility in their presentation of information about

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<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,601 open-end investment companies ("mutual funds"), 604 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.240 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

<sup>2</sup> NASD Notice to Members 03-77 (December 2003) ("Notice").

<sup>3</sup> Proposed Rule 2210(d)(3)(B).

<sup>4</sup> Of course, as the Notice points out, investment company sales literature and advertisements that contain performance information already are required to include disclosure of the fund's maximum sales charges and standardized average annual returns.

fees and expenses, make the proposal more consistent with existing Securities and Exchange Commission ("Commission") requirements, and respond to questions posed in the Notice.

In summary, the Institute's comments are as follows.

- The Institute recommends revising the proposal to require disclosure in performance advertisements of the same annual expense ratio that appears in a fund's most recent report to shareholders.
- The Institute supports NASD's decision not to propose requiring disclosure in performance advertisements of the actual dollar amount of expenses incurred by a hypothetical fund shareholder (as an alternative to requiring disclosure of a fund's annual expense ratio). We believe that it is more appropriate to require such dollar amount disclosure in reports to shareholders.
- The Institute believes that it is not necessary to require funds to disclose their annual expense ratios in sales material that does not present performance information.
- The Institute recommends that NASD not require fund performance advertisements to provide disclosure of standardized performance information, the fund's maximum sales charge, and the fund's annual expense ratio in a text box. Rather, we recommend requiring this disclosure to be presented in performance advertisements in any manner reasonably calculated to draw investor attention to the information.
- The Institute recommends that NASD require that fund performance advertisements present a fund's standardized performance information, maximum sales charge, and annual expense ratio in a type size at least as large as that used in the major portion of a print advertisement and that radio, television, and video advertisements be required to provide this information emphasis equal to that used in the major portion of the advertisement.
- The Institute recommends that NASD provide for a compliance date ranging from three to six months from the date of adoption, depending on the nature of the new requirements.

Each of these comments is discussed more fully below.

*I. Proposed Disclosure in Fund Performance Advertisements*

*A. Content of Disclosure*

**1. Calculation of Annual Operating Expenses**

Proposed Rule 2210(d)(3)(A)(iii) would require fund advertisements to disclose a fund's annual operating expenses, "computed as a percentage of total assets in accordance with Item 3

[of Form N-1A], as of the most recent calendar quarter.”<sup>5</sup> A mutual fund typically calculates its annual expense ratio, in accordance with Item 9 of Form N-1A,<sup>6</sup> as a percentage of its net assets after its fiscal year-end for inclusion in its annual report to shareholders and after the first six months of its fiscal year for inclusion in its semi-annual report to shareholders.<sup>7</sup> Third-party fund industry analysts typically use annual expense ratios that appear in fund shareholder reports as the basis for generating reports presenting, and comparing, fund expenses.

The Institute is concerned that it will be confusing for investors and the marketplace if funds are required to present an expense ratio based on a different measure and a different time period solely for the purpose of performance advertisements. Accordingly, the Institute recommends requiring funds to disclose in performance advertisements the fund’s annual expense ratio that appears in the fund’s most recent shareholder report.<sup>8</sup>

## **2. Disclosure of Dollar Amount of Fund Expenses**

The Notice requests comment on whether, rather than requiring disclosure of a fund’s annual expense ratio, NASD should require disclosure of the actual dollar amount of expenses incurred by a hypothetical shareholder in the fund (*e.g.*, dollar amount of expenses per a \$10,000 investment). The Institute supports NASD’s decision not to propose requiring such disclosure. Given the space limitations associated with performance advertising (*e.g.*, newspaper advertisements), existing disclosure requirements regarding fund fees and expenses, and enhancements to those requirements recently adopted by the Commission,<sup>9</sup> the Institute

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<sup>5</sup> Item 3 of Form N-1A requires a fund to include in its prospectus a fee table that describes the fees and expenses that an investor may pay if it buys and holds fund shares. The fee table includes, among other items, a fund’s annual operating expenses that must be calculated in accordance with Item 9 of Form N-1A, with two exceptions. If there have been any changes in the annual operating expenses that would materially affect the information disclosed in the fee table, a fund is required to restate the expense information using the current fees as if they had been in effect during the previous fiscal year. In addition, a fund is required to include in its annual fund operating expenses amounts that would have been incurred absent expense reimbursement or fee waiver arrangements.

<sup>6</sup> Item 9 of Form N-1A requires a fund to include in its prospectus a financial highlights table that is intended to help fund shareholders understand the fund’s financial performance for the past 5 years (or, if shorter, the period of the fund’s operations). The financial highlights table includes, among other items, a ratio of the fund’s expenses to average net assets that is required to be calculated using the amount of expenses shown in the fund’s statement of operations for the relevant fiscal period. The Item 9 expense ratio is a measure of the fund’s actual/historical expenses and as such, it reflects any waiver or reimbursement of fees or expenses. Similarly, the fund’s standardized performance information reflects the fund’s actual historical rate of return.

<sup>7</sup> We note that the sample disclosure provided in Attachment B to the Notice provides that the fund’s expenses should be shown as a percentage of the fund’s net assets.

<sup>8</sup> If NASD determines to go forward with a proposal that would require fund performance advertisements to include the fund’s expense ratio calculated as of the most recent calendar quarter, the Institute requests that NASD clarify that the expense ratio would have to be calculated as of the most recent calendar quarter *ended prior to submission of the advertisement for publication*. This would make the proposal consistent with a comparable requirement under Rule 482. See Rule 482(d)(3) (standardized average annual total return is deemed to be timely for purposes of Rule 482 if it is current to the most recent calendar quarter ended prior to the submission of the advertisement for publication).

<sup>9</sup> See SEC Release Nos. 33-8294; 34-48558; IC-26195 (September 29, 2003) 68 Fed. Reg. 57760, 57765 (October 6, 2003) (adopting an amendment to Rule 482 that requires fund advertisements that contain performance data to direct prospective investors to consider a fund’s charges and expenses and alert them that the fund’s prospectus contains this and other information about the fund). Fund advertisements submitted for publication after March 31, 2004 will be required to comply with the enhanced disclosure requirements.

believes that any benefits of dollar amount disclosure in fund performance advertisements would be outweighed by the burdens associated with such a requirement.

In considering the appropriateness of requiring disclosure of the actual dollar amount of expenses in fund performance advertisements, it is important to keep in perspective the purpose of fund advertisements – *i.e.*, they are used to bring to the attention of potential investors the availability of various funds, and to provide investors basic information about funds. Fund advertisements are not intended to be the exclusive source for investors of information about the fund, which is why all advertisements under Rule 482 are required to encourage potential investors to read the fund's prospectus carefully before investing and include information about how an investor may obtain the prospectus.<sup>10</sup> Indeed, an investor may not buy fund shares off of an advertisement. Given this, we do not believe that it is appropriate to require fund performance advertisements to disclose the actual dollar amount of expenses incurred by a hypothetical fund shareholder.<sup>11</sup>

We believe that it is more appropriate for funds to provide dollar amount expense disclosure, accompanied by appropriate narrative explanation, in reports to shareholders. In fact, the Commission has indicated that such a requirement likely will be adopted in the near future.<sup>12</sup> Requiring fund performance advertisements to include a fund's annual expense ratio should provide prospective fund investors with sufficient information about the cost of investing in a fund. They can use this information to evaluate the particular fund and to compare the costs of different funds.

### **3. Disclosure of Expense Ratio in All Sales Material**

Although not part of NASD's proposal, the Notice requests comment on whether all sales material should be required to disclose a fund's annual expense ratio. The Institute believes that disclosure already required regarding fund fees and expenses and the proposed disclosure of expense ratios in all fund performance advertisements will adequately inform

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<sup>10</sup> Sales literature under Rule 34b-1 must be preceded or accompanied by a prospectus.

<sup>11</sup> One of the difficulties associated with requiring this information in performance advertisements, which the Notice does not address, is determining whether to require disclosure of the cost in dollars of an investment in the fund based on the fund's actual expenses and return for the reporting period or based on the fund's actual expenses and an assumed rate of return. *See* note 12, *infra*.

<sup>12</sup> Chairman Donaldson recently indicated that he anticipates that the Commission will consider a final rule to require funds to disclose semi-annually the dollar amount of fees and expenses that their shareholders pay in February 2004. *See Speech by SEC Chairman: Opening Statement at Open Commission Meeting*, William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (December 17, 2003). The Commission has proposed to require funds to include in reports to shareholders: (1) the cost in dollars of a \$10,000 investment in the fund, based on the fund's actual expenses and return for the reporting period; and (2) the cost in dollars of a \$10,000 investment in the fund, based on the fund's actual expenses and an assumed return of 5 percent per year. *See* SEC Release Nos. 33-8164; 34-47023; IC-25870 (December 18, 2002); 68 Fed Reg. 160 (January 2, 2003). *See also* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 14, 2003 (expressing support for the proposal generally but recommending that only the first dollar amount figure be required).

fund investors with respect to a fund's fees and expenses. Therefore, we believe that it is not necessary to require funds to disclose their annual expense ratios in all sales material.<sup>13</sup>

*B. Presentation of Required Information*

**1. Text Box Presentation**

Under the proposed amendments to Rule 2210, funds would be required to present the standardized performance information, the fund's maximum sales charge, and the fund's annual expense ratio in a prominent text box that contains no other information. The Notice explains that the proposed amendments are intended to ensure that these key items of information are presented in a manner that promotes investor awareness. We do not believe that the proposed text box requirement is the most appropriate way to achieve this objective.

The proposal would impose an unnecessarily restrictive requirement on the format of fund advertisements. Fund advertisements, for example, often contain performance information for more than one fund. These advertisements often include the net asset value, public offering price, standardized and non-standardized performance information, and benchmark information for each fund advertised. If funds have to comply with the proposed text box requirement, it would be difficult, if not impossible, for funds to present information about multiple funds in a format that permits the information to be easily understood by prospective investors. For example, funds would be forced to put the required information in the text box and then to describe other relevant fund information elsewhere, likely having to repeat some of the information included in the text box. Such advertisements would be unduly complex, lengthy, and expensive.

For these reasons, the Institute recommends that NASD revise its proposal to require that fund advertisements present standardized performance information, the fund's maximum sales charge, and the fund's annual expense ratio in any manner reasonably calculated to draw investor attention to these disclosures. Our recommended approach would satisfy NASD's goal of helping to ensure that certain key items of information are presented in a manner that promotes investor awareness while providing funds with more flexibility in designing their

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<sup>13</sup> The Notice specifically requests comment on whether all sales material that refers to a fund as "no-load" should be required to disclose the fund's annual expense ratio. We do not believe that such a requirement is necessary or appropriate for the reasons stated in the text above and in light of the additional disclosure already required of no-load funds with respect to fees charged. *See, e.g.*, Notice to Members 98-107 (December 1998) (any sales material that refers to a fund as no-load or as part of a no-load family or states that a mutual fund imposes no sales charge must disclose the fact that other fees and expenses do apply to a continued investment in the fund and are described in the fund's current prospectus). We believe that this combination of requirements is sufficient to alert prospective no-load fund investors about a fund's ongoing operating expenses.

advertisements.<sup>14</sup> It also is consistent with NASD's proposed requirement with respect to materials delivered through an electronic medium, which the Institute supports.<sup>15</sup>

## **2. Type Size Requirements**

Proposed Rule 2210(d)(3)(B)(ii) would require a fund's standardized performance information, maximum sales charge, and annual expense ratio to be presented in any written communications in a type size at least as large as that used to present any non-standardized performance. Similarly, with respect to radio, television, or video advertisements, proposed Rule 2210(d)(3)(C) would require this information to be given prominence equal to that given to any non-standardized performance information.

The Commission took a somewhat different approach to the required presentation of narrative disclosures regarding fund performance data in the recently adopted amendments to Rule 482. The Commission required that the narrative disclosures be presented in a type size at least as large as (and of a style different from, but at least as prominent as) that used in the major portion of a print advertisement. Radio and television advertisements must give the required narrative disclosures emphasis equal to that used in the major portion of the advertisement. The policies underlying both NASD's and the Commission's requirements appear to be the same.<sup>16</sup> The Institute recommends that NASD follow the Commission's approach with respect to presentation requirements. This change would ease compliance burdens on funds and would be consistent with the apparent purpose underlying this aspect of the proposal.

## ***II. Disclosure of Deferred Sales Charge***

Proposed Rule 2210(d)(3)(A)(ii) would require disclosure of the "maximum sales charge imposed on purchases or the maximum contingent deferred sales charge, computed in accordance with Item 3 of Form N-1A" (emphasis added). We recommend that NASD remove the word "contingent" from any new requirement and instead require disclosure of the "maximum sales charge imposed on purchases or the maximum deferred sales charge."<sup>17</sup> Item 3 requires a fund to disclose the "maximum sales charge imposed on purchases" and the

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<sup>14</sup> Indeed, we note that even the sample disclosure in Attachment B to the Notice does not adhere to the proposed requirement that the text box contain no information other than the fund's standardized performance, maximum sales charge, and annual expense ratio. It includes a statement explaining that the performance numbers reflect the deduction of sales charges and annual expenses. We agree that disclosure along these lines may be appropriate and believe that this further illustrates the disadvantages of imposing unduly rigid format requirements.

<sup>15</sup> Proposed Rule 2210(d)(3)(C). Under our recommended approach, the phrase, "in any manner reasonably calculated to draw investor attention" would be substituted for the phrase "in a manner intended to draw investor attention." This change is intended to make any NASD requirements regarding performance advertisements more consistent with existing Commission requirements. See Rule 482(b)(5).

<sup>16</sup> See Release No. 33-8294, *supra* note 9, at 57766 (the prominence requirements are designed to prevent advertisements from marginalizing or minimizing the presentation of the required disclosure and to encourage fair and balanced advertisements).

<sup>17</sup> Similarly, we recommend making any sample disclosure provided consistent with the rule text. The sample disclosure provided in Attachment B to the Notice calls for disclosure of the fund's current maximum "back-end" sales charge.

“maximum deferred sales charge.” Our recommended change would make any new NASD requirement consistent with existing Commission requirements and eliminate the potential for confusion created by the use of different terminology to describe a deferred sales charge.

The Institute also requests that NASD make clear that a fund would be required to disclose the maximum front-end or deferred sales charge only if it has such a sales charge.<sup>18</sup>

### ***III. Application of the Proposed Amendments to Institutional Sales Material and Correspondence***

The proposed amendments would apply to fund communications with institutional investors as well as retail investors.<sup>19</sup> We do not believe that the proposed requirements are necessary in communications distributed exclusively to institutional investors. In recently adopted amendments to its advertising rules, NASD treated institutional sales material and correspondence differently than retail sales material and correspondence, based on the sophistication and expertise of institutional investors.<sup>20</sup> The Institute recommends that, based on the same rationale, fund communications with institutional investors not be subjected to the proposed requirements. In view of their sophistication and expertise, institutional investors would not benefit from disclosure of a fund’s expense ratio.

### ***IV. Compliance Date***

NASD has not proposed a transition period in connection with the proposed requirements. The Institute recommends that NASD provide for a compliance date ranging from three to six months after adoption, depending on the nature of the new requirements. For example, funds currently do not have the infrastructure to comply with a requirement that they calculate their annual expense ratio quarterly, and they would need sufficient lead time (*e.g.*, six months) to develop appropriate systems to comply with such a requirement. If NASD determines not to adopt such a requirement, providing funds with three months from the date of adoption should be sufficient. It is important to keep in mind that under any approach adopted, adequate lead-time is necessary for the preparation of new advertisements and their filing with, and approval by, NASD.

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<sup>18</sup> See, *e.g.*, Rule 482(a)(6) (if a sales load is charged, the advertisement must disclose the maximum amount of the load).

<sup>19</sup> Proposed Rule 2211(d)(1).

<sup>20</sup> See Notice to Members 03-38 (July 2003) (eliminating the pre-use approval and filing requirements applicable to communications that are distributed or made available only to institutional investors and excluding institutional sales material from some of the content standards of Rule 2210).

Barbara Z. Sweeney

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The Institute appreciates the opportunity to comment on this significant proposal. If you have any questions or need additional information, please contact me at (202) 218-3563 or Amy B.R. Lancellotta at (202) 326-5824.

Sincerely,

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Associate Counsel

cc: Angela C. Goelzer, Counsel,  
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