INVESTMENT COMPANY INSTITUTE

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October 24, 2018

Mr. Brent J. Fields
Secretary
US Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *SEC Request for Comment on Fund Retail Investor Experience and Disclosure (File No. S7-12-18)*

Dear Mr. Fields:

The Investment Company Institute[1] commends the Commission for its recent request for comment on enhancing fund disclosure to improve the investor experience and to help investors make more informed investment decisions.[2] The Commission has invested substantial time and resources in continual efforts to improve mutual fund disclosure over nearly four decades.[3]

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$22.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.3 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *See* Request for Comment on Fund Retail Investor Experience and Disclosure, SEC Release Nos. 33-10503;34-83376; and IC-33113 (June 5, 2018), available at https://www.sec.gov/rules/other/2018/33-10503.pdf ("Release").

[3] *See*, *e.g.*, Registration Form Used by Open-End Management Investment Companies, SEC Release Nos. 33-6479 and IC-13436 (Aug. 12, 1983) (introducing two-part disclosure concept, consisting of a simplified prospectus with more detailed information available upon request in the Statement of Additional Information, or SAI); Registration Form Used by Open-End Management Investment Companies, SEC Release Nos. 33-7512, 34-39748, and IC-23064 (Mar. 13, 1998) (amending Form N-1A to focus prospectus disclosure on key information to assist in investment decisions) (1998 Release); New Disclosure Option for Open-End Management Investment Companies, SEC Release Nos. 33-7513 and IC-23065 (Mar. 13, 1998) (fund profile rule); Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, SEC Release Nos. 33-8393, 34-49333, and IC-26372 (Feb. 27, 2004) (amendments to improve disclosure in fund shareholder reports) (2004 Release); Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies (Jan. 13, 2009) (2009 Release); Investment Company Reporting Modernization (Oct. 13, 2016) (modernizing the disclosure of certain information in fund prospectuses and financial statements); Optional Internet Availability of Investment Company Shareholder Reports (June 5, 2018) (creating an optional new delivery mechanism for fund shareholder reports) (Rule 30e-3 Release).

The industry has been an active partner in these efforts.[4]

The importance of these efforts is indisputable. With millions of investors choosing mutual funds to save for retirement, education, and other important financial goals, it is critical that those investors and the financial professionals who assist them have ready access to the information they want and need in a form they can use.

In 2017, 95 percent of US households owning mutual funds identified themselves as having internet access (up from 68 percent in 2000).[5] In a remarkably short period of time, the internet has transformed and accelerated investors' ability to gather financial information. Investors have the ability to choose whether to access financial information in different mediums—electronic or paper—such as on a computer, tablet, smartphone, printing or requesting a paper version of a document. They also can choose to engage a financial professional to screen this information.

A modern fund disclosure system should provide investors with adequate information as well as choice. Their preferences should be honored—whether they prefer to read full-length or summary disclosure documents, paper or electronic; or simply be notified that fund documents are available online or in paper format. Some fund information should be presented in a manner that allows investors to compare funds. Importantly, the Commission recently took a significant step to modernize the way funds deliver shareholder reports by adopting Rule 30e-3 under the Investment Company Act of 1940.[6] At the same time, the Commission issued this request for comment regarding ways in which fund disclosure, including shareholder reports, may be improved.

In furtherance of the Commission's efforts to enhance the investor experience, we recommend that the Commission consider proposing a rule creating a new, optional summary shareholder report with key information in a prescribed order. Results from our investor testing of a prototype for a summary shareholder report indicate investors would be more likely to read the summary than the full-length shareholder report and find a summary helpful to compare different funds.

We strongly encourage the Commission to modernize the delivery of fund prospectuses. We also address some of the Commission's specific questions related to new disclosure. Many of our

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[4] *See, e.g.*, ICI, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders (Summary of Research Findings)* (May 1996), available at https://www.ici.org/pdf/rpt_profprspctus3.pdf; ICI, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders (Volume I)* (May 1996), available at https://www.ici.org/pdf/rpt_profprspctus.pdf; ICI, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders (Volume II)* (May 1996), available at https://www.ici.org/pdf/rpt_profprspctus2.pdf; ICI, *Understanding Shareholders' Use of Information and Advisers* (Spring 1997), available at https://www.ici.org/pdf/arc-dis/rpt_undstnd_share.pdf; West and Leonard-Chambers, *Understanding Investor Preferences for Mutual Fund Information*, Washington, DC: Investment Company Institute (2006), available at https://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf; Holden, Bogdan, and Schrass, "What US Households Consider When They Select Mutual Funds," *ICI Research Perspective* 24, no. 5 (August 2018), available at https://www.ici.org/pdf/per24-05.pdf; and Holden, Schrass, and Bogdan, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2017," *ICI Research Perspective* 23, no. 7 (October 2017), available at https://www.ici.org/pdf/per23-07.pdf.

[5] *See* Holden, Schrass, and Bogdan (October 2017), *supra*.

[6] Rule 30e-3 provides funds with the option to provide shareholders with a notice and access to the full shareholder report, provided they meet certain conditions to assure investor preferences are met.

comments are intended to achieve a balance that permits enough flexibility so that funds can create a variety of documents that can vary in length and manner of delivery while assuring easy access to additional information. In developing our comments, we weighed the benefits of disclosure options with the costs to fund shareholders, including potentially overwhelming them with complex, difficult to understand, information.

Executive Summary

Summary Shareholder Report. We recommend that the Commission propose a new, optional summary shareholder report. This summary should include critical information from the full-length shareholder report provided in a specific order, mirroring the Commission's design of the summary prospectus and similarly facilitating comparison of funds. In particular, the summary shareholder report for a fund should include:

- performance highlights;
- total return;
- expenses;
- graphical representation of portfolio holdings;
- operation and effectiveness of its liquidity risk management program over the past year; and
- instructions on how to access the full shareholder report.

Consistent with the summary prospectus rule, funds should have the option to use the summary shareholder report and investors should be able to request a full-length shareholder report. Funds also would have the option, under recently adopted Rule 30e-3, to send shareholders a notice to satisfy their obligation to transmit shareholder reports by, among other things, making such reports and other materials accessible on the internet.

ICI created a prototype of a summary shareholder report and tested it using a nationally representative survey that included more than a thousand mutual fund shareholders. More than 90 percent of these mutual fund investors agreed the prototype summary shareholder report is enough to stay informed, is a document they would be more likely to read, and that the more concise document made it easier to compare funds. The survey also included three comprehension-related questions to discern whether the prototype could convey valuable facts about a fund. In fact, a majority of mutual fund investors answered each content-related question correctly using the prototype. We have published the survey results on our website and summarized the results below.[7]

We also recommend that the Commission propose a summary shareholder report tailored for closed-end funds requiring the same information as that which appears in the mutual fund summary shareholder report (except for information related to liquidity risk management programs) and, additionally:

- total return based on the market prices of fund shares;

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[7] The survey results are available in the *ICI White Paper*, "Mutual Fund Investors' Views on Shareholder Reports: Reactions to a Summary Shareholder Report Prototype," available at https://www.ici.org/pdf/ppr_18_summary_shareholder.pdf.

- material changes in any of the following—the fund's investment objectives or policies, the fund's principal risk factors, and portfolio managers;
- structural leverage;
- managed distribution policies;
- dividend reinvestment plans; and
- share repurchases.

Appendices to this letter include the prototype summary shareholder report (Appendix A) and a comparison of the information in the full-length shareholder report to that in the summary shareholder report (Appendix B).

Modernizing Delivery of Fund Prospectuses. We strongly recommend that the Commission provide firms with the flexibility to choose to send investors a notice informing investors that a summary prospectus or full-length prospectus is available. Doing so will result in significant cost savings for fund shareholders and align much more effectively with shareholder preferences. It also will be consistent with Rule 30e-3, thereby enhancing the coherence of the delivery framework for fund disclosure.

New One-Page Sheet. We strongly oppose the Commission requiring a one-page sheet at the beginning of each prospectus or summary prospectus. Both the summary and statutory prospectuses provide investors with key information. The summary prospectus is a short document by nature and the same key information appears in the front of the statutory prospectus. Funds already produce one-page fact sheets. Thus, there is no information gap to fill.

User-Friendly Display of Information. We recommend that the Commission: (i) allow funds to satisfy federal securities law obligations by providing access to additional information through smartphone applications; (ii) not dictate the content or placement of information on fund websites and more generally strive to maintain technology-neutral requirements; and (iii) consider initiating a pilot program to allow funds to develop more creative approaches to disclosure accompanied by any necessary safe harbors.

Customized Expense Disclosure. We strongly oppose the Commission requiring funds to provide customized calculations of fund expenses. Along with the fee table in the prospectus, there are fund fee examples in both the prospectus and shareholder report. In addition, there are fund comparison tools, including fee calculators, readily available to investors. A requirement for individualized expense information would have exceptionally high costs, logistical complexity, and is unnecessary because of calculators and other resources already available for investors.

Transaction Cost Disclosure. There is sufficient information about transaction costs in fund disclosure and therefore we do not recommend any changes. Appendix C to this letter describes experiences in the European Union with confusing transaction cost disclosure.

Investment Research Disclosure. We recommend that the Commission continue to require funds to disclose, among other things, how the fund selects brokers and determines the overall reasonableness of brokerage commissions paid and the nature of brokers' research services used by the fund.

Acquired Fund Fees and Expenses. We recommend that the Commission permit funds to exclude business development companies, or BDCs, from “acquired fund” for purposes of the fee table presentation. This would allow funds to treat BDCs in the same manner as investments in operating companies for expense presentation purposes.

Investing Related Expense Disclosure. We recommend that the Commission require funds to disclose investing related expenses (*i.e.,* interest expense and dividends paid on short sales) in the fund’s Statement of Additional Information (SAI) (similar to information about brokerage costs) and financial statements rather than in the fee table.

Risk Disclosure. We strongly oppose the Commission mandating that funds disclose a standardized risk measure or risk rating and strongly urge the Commission to neither mandate nor create standardized risk measures or risk ratings. It would be dangerous for the Commission to create its own risk indicator or encourage an investor to rely on a particular risk indicator. Risk is inherently complex and multi-faceted. There is no single agreed-upon standard measure of risk. Investors can, and do, view risk very differently, (*e.g.,* a retired investor as compared to a recent college graduate). Requiring funds to provide a standardized risk measure at best could be misleading but more likely harmful. Further, the experiences of the European Union and Canada provide object lessons in the hazards of regulators imposing standardized risk measures. We have included an appendix with an analysis of risk rating experiences (Appendix D).

Each fund prospectus includes a bar chart showing the fund’s annual returns for 10 calendar years, illustrating graphically the variability of a fund’s returns. In addition, each fund must disclose its best and worst returns for a quarter during the 10-year period to show investors in a straightforward manner that the value of fund shares may fluctuate over shorter periods. This disclosure adequately depicts for investors the risk associated with investing in the fund.

Performance. We recommend that: (i) funds continue to be required to provide short-term performance along with medium-term and long-term performance; (ii) funds not be required to disclose how they determined that their benchmark is an appropriate broad-based securities market index; (iii) the Commission or the staff consider providing more clarity around what constitutes an appropriate broad-based index; (iv) the Commission consider permitting funds to use an index other than a broad-based securities market index as its primary benchmark; and (v) the Commission retain the current disclosure requirements related to portfolio managers.

We adamantly oppose any proposal which would require funds to compare their fees or performance to other unaffiliated funds. It is simply inappropriate, unduly burdensome, and complex. How would this practically work? Why should a fund’s shareholders pay to include this information in their fund’s documents? Third-party vendors already track thousands of mutual funds and make these data available for public consumption.

Management’s Discussion of Fund Performance. We recommend that: (i) funds be permitted, but not required, to link the management’s discussion of fund performance (MDFP) to an on-line video presentation; (ii) funds be required to include in semi-annual shareholder reports’ MDFP the 1-, 5-, and 10-year average annual return for the fund and its benchmark; and be permitted, but *not* required, to include the portfolio manager commentary and line graph in the semi-annual shareholder report; and (iii) the Commission continue to provide funds with flexibility to explain factors that materially affected their performance.

Fund Advertisements. The Commission's current regulatory framework for advertisements works well and strikes an appropriate balance. This framework allows funds to provide useful information that is not misleading, yet is abbreviated, as compared to other fund regulatory documents. It is not necessary to: (i) enhance disclosure to better distinguish advertisements and prospectuses; (ii) change requirements for risk and return disclosure; or (iii) require new disclosures depending on fund type.

We urge the Commission to: (i) encourage the Financial Industry Regulatory Authority (FINRA) to permit broker-dealers to provide retail investors with "related performance information;" (ii) modernize the testimonial rule under the Investment Advisers Act of 1940 to facilitate advisers' and funds' use of social media; (iii) allow funds and advisers to calibrate the information provided in advertisements depending on the audience, recognizing that the information needs of retail and institutional investors differ; and (iv) encourage FINRA to amend its requirements to permit streamlined expense information in fund advertisements. These four initiatives will further promote an enhanced investor experience and more informed decision-making.

Closed-End Funds. We recommend that the Commission: (i) not develop a summary prospectus for non-continuously offered closed-end funds; (ii) consider requiring closed-end funds to provide an MDFP and improve the presentation of performance in shareholder reports; and (iii) modernize delivery of Section 19(a) notices.

Future Commission Initiatives. We support the Commission exploring enhanced investor testing, pilot programs to test potential disclosure alternatives, and the use of roundtables or committees to engage investors and market participants on fund disclosure matters. We caution however that the Commission should not give the same weight to such small-sample non-representative exercises as a nationally representative survey research effort.

I. Summary Shareholder Report Well-Received by Mutual Fund Investors

ICI strongly believes that investors benefit from clear and concise disclosure of key information and access to more detailed information. Given our commitment to enhancing disclosure for fund shareholders, we formed an ICI member working group to apply these principles in developing a summary shareholder report that funds would have the option to provide to their shareholders.

The group spent significant time considering the content of a mutual fund summary shareholder report prototype, modeled on the summary prospectus.[8] Our member working group consisted of a variety of fund firms (*e.g.*, small funds, large funds, broker-sold and direct-sold funds) represented by a combination of legal, operations, accounting and financial reporting professionals. ICI

[8] ETFs and mutual funds generally provide the same types of information in shareholder reports and, therefore, we recommend that they provide the same categories of information in any new summary shareholder report. For closed-end funds, we recommend including the same categories of information that appears in the mutual fund summary shareholder report prototype with slightly modified performance information and, additional disclosures related to operational changes and common closed-end fund features.

surveyed the working group on the content of the current shareholder report to ascertain, based on their experience, the information that fund shareholders consider most relevant. With the same goal in mind, ICI reviewed an array of information on fund websites, including fund fact sheets and prior ICI research on investor preferences. The group had multiple discussions over the course of several months, reviewing various versions of the prototype and incorporating feedback, including from independent fund directors. From these efforts, we developed the summary shareholder report prototype in Appendix A. We include a comparison of the content of the summary shareholder report to the content currently required in shareholder reports in Appendix B.

We describe below:

- the selection of the elements of the summary shareholder report and their consistency with investor information priorities;
- the approach to investor testing conducted with the prototype summary shareholder report;
- content of, and investors' positive reaction to, the prototype;
- additional content of the summary shareholder report in certain circumstances;
- content in the full-length shareholder report only;
- tailored requirements for a summary shareholder report for closed-end funds;
- modernizing options for delivering shareholder reports; and
- recommendations for amending FINRA's advertising rules to accommodate the summary shareholder report.

A. Selection of Summary Shareholder Report Elements and ICI Research on Information Investors Consider Important When Selecting a Mutual Fund

Our prototype for the summary shareholder report pulls critical information from the existing shareholder report, mirroring the Commission's design of the summary prospectus.[9] In particular, our summary shareholder report includes information on a fund's performance highlights, total return, expenses, and portfolio holdings, as well as information on how to access the full shareholder report online.

In identifying the key disclosure relevant to shareholders for monitoring their fund investments, we relied on input from the ICI member working group and investor research.[10] ICI's 2017 Annual Mutual Fund Shareholder Tracking Survey included a question that asked mutual fund–owning households to rank the importance of a variety of factors when making their mutual fund purchase

[9] This manner of design facilitates compliance by requiring funds to review and condense existing disclosure rather than creating new disclosure from scratch. We recommend including in both the full-length semi-annual shareholder report and the summary thereof the fund's and the benchmark index's 1-,5-, and 10-year average annual total returns. This information currently is not required in semi-annual shareholder reports.

[10] In the past, ICI has surveyed mutual fund investors about the information they use when selecting funds as well as their reactions specifically to the SEC's summary prospectus. The research related to "Mutual Fund Shareholders' Use of Information" is available at https://www.ici.org/research/investors/information. We recognize that investors use shareholder report information to monitor, rather than select, mutual funds. However, we believe that the information considered important to a purchase is relevant to monitoring the funds selected for purchase.

decisions.[11] When asked about the information they consider when choosing a mutual fund, 92 percent of mutual fund–owning households said that they reviewed the historical performance of a fund, with 50 percent indicating a fund's historical performance was very important when making their fund purchase decision (*see* Figure 5, *infra*). Eighty-seven percent of mutual fund–owning households indicated that they considered a fund's performance compared with an index, when making their purchase decision, with 35 percent saying it was very important. Fund fees and expenses were found to be a very important consideration in fund selection. About nine in 10 mutual fund–owning households indicated they reviewed the fund's fees and expenses, with 40 percent indicating the fund's fees and expenses were very important when making their purchase decision.

Consistent with these levels of importance, our prototype summary shareholder report includes not only an initial high-level look at total return, performance of a benchmark, and expenses, but also graphical representations of the fund's holdings, and tabular presentations of (i) average annual compound total returns, after factoring in sales charges and, (ii) a fund expense example. Having designed our summary shareholder report prototype, our next step was to test it with mutual fund investors.

B. Summary Shareholder Report Prototype Works Well for Mutual Fund Investors

ICI fielded a survey to a nationally representative online sample of 3,000 US adults, of which 1,233 reported mutual fund ownership.[12] Survey respondents identified as mutual fund investors were asked about their recollection of current full-length shareholder reports and their impression of those reports. Survey respondents were then shown the summary shareholder report prototype and asked to evaluate the importance of each element as well as their impression of the document as a whole. Finally, three questions of comprehension of the material were included to get an idea of the usability and understandability of the summary prototype. The full results from this survey have

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[11] *See* Holden, Bogdan, and Schrass (August 2018), *supra*. This annual survey gathers information on mutual fund–owning households. In mid-2017, the survey found that 56.2 million US households, or 44.5 percent, owned mutual funds.

[12] ICI research staff designed the survey, and the GfK Group administered the survey using the KnowledgePanel®. The web-enabled KnowledgePanel® is a probability-based panel designed to be representative of the US population. Initially, participants are chosen scientifically by a random selection of telephone numbers and residential addresses. Persons in selected households are then invited by telephone or mail to participate in the web-enabled KnowledgePanel®. For those who agree to participate, but do not already have internet access, GfK provides a laptop and ISP connection at no cost. People who already have computers and internet service are permitted to participate using their own equipment. Panelists then receive unique log-in information for accessing surveys online, and are sent emails throughout each month inviting them to participate in research. The survey was fielded through the GfK KnowledgePanel® from late July to mid-August 2018. Reported sample counts are weighted and representative of the US population of adults aged 18 or older.

been published in an ICI white paper, "Mutual Fund Investors' Views on Shareholder Reports: Reactions to a Summary Shareholder Report Prototype."[13]

C. Design and Content of Our Prototype: Strong Majorities of Mutual Fund Investors Rate Each Element Important

Our summary shareholder report requires a specific order of items, similar to the summary prospectus.[14] This approach facilitates the ability of investors to compare funds. We do not recommend specifying a page limit or other formatting requirements (*e.g.*, font size or layout style). The better approach is to instruct funds to prepare the summary shareholder report consistent with the Commission's plain language disclosure principles rather than placing one inflexible, artificial limit on all funds, regardless of type or investment objective.[15] We do recommend that the Commission limit the summary shareholder report to key information. We believe including too many items of information along with expanding the length of the required disclosure, which sometimes happens over time (*i.e.*, disclosure creep), will be overwhelming for investors and cause them to be less likely to engage with a summary shareholder report.

Results from ICI's recent survey of mutual fund investors regarding a full-length shareholder report illustrate this point. Two-thirds of mutual fund investors who recall receiving shareholder reports indicated that the current reports are difficult to understand, including 24 percent who indicated they were "very difficult to understand."[16] Sixty-three percent of mutual fund investors who recall receiving a shareholder report admit that they read very little or none of the shareholder report.[17]

We describe in Figure 1 below mutual fund investors' reactions to each of the five elements in the summary shareholder report prototype. We then describe, in detail, each of the elements of our summary shareholder report in the order in which they would appear along with investors' reaction to each element.

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[13] The *ICI White Paper,* "Mutual Fund Investors' Views on Shareholder Reports: Reactions to a Summary Shareholder Report Prototype," is available at https://www.ici.org/pdf/ppr_18_summary_shareholder.pdf.

[14] In contrast, the Commission permits a fund to determine how to organize and present the information within the full-length shareholder report, provided all the required information is included**.**

[15] *See* Rule 421 under the Securities Act of 1933 (Securities Act).

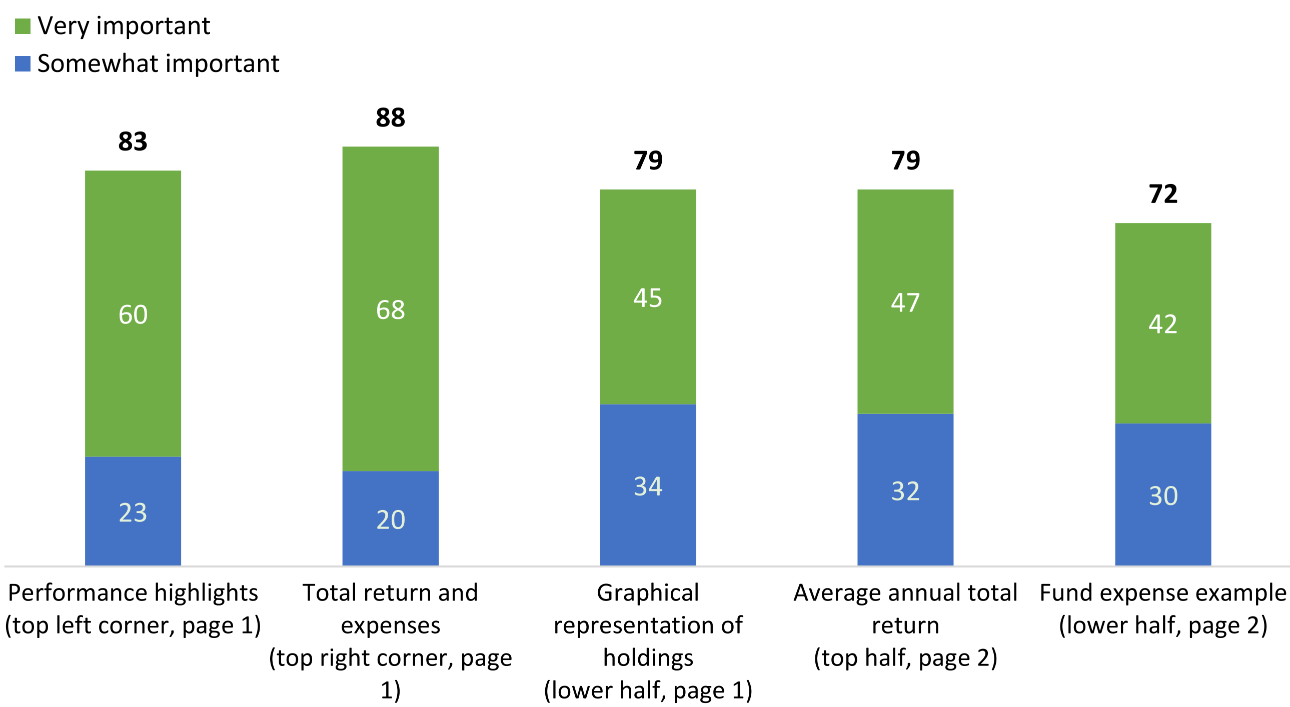
[16] Specifically, among the 81 percent of mutual fund investors who recall receiving shareholder reports, 24 percent indicated current shareholder reports are "very difficult to understand," 43 percent indicated they were "somewhat difficult to understand," 26 percent indicated they were "somewhat easy to understand," and 7 percent indicated they were "very easy to understand." *See* Figure 1 in the *ICI White Paper*, *supra.*

[17] Specifically, among the 81 percent of mutual fund investors who recall receiving shareholder reports, 29 percent indicated they "do not read the shareholder report and throw it away or recycle it;" 8 percent "do not read the shareholder report but save it;" 26 percent "read very little of the shareholder report;" 24 percent "read some of the shareholder report;" 9 percent "read most of the shareholder report;" and 4 percent indicated they "read all of the shareholder report." *See* Figure 2 of the *ICI White Paper*, *supra*.

Figure 1

Mutual Fund Investors Generally Approve Suggested Components of the Summary Shareholder Report Prototype

Percentage of individuals owning mutual funds finding each section of the summary shareholder report important, 2018



Note: The figure reports the percentage of mutual fund–owning individuals who find each section "very important, need to keep in summary document" or "somewhat important, keep if space available." The remaining mutual fund investors find each section "useful, but having the information available online or by request is sufficient" or "not important, don't need to keep." The sample is 1,233 mutual fund investors.

Source: ICI tabulation of GfK KnowledgePanel® OmniWeb survey data (summer 2018)

Performance Highlights. Our summary semi-annual and annual shareholder reports provide the fund's total return and the total return for a benchmark index for the reporting period. The full-length semi-annual shareholder report is not required to include the MDFP. Therefore, it would not include the benchmark performance for the 6-month period. We recommend requiring the benchmark performance for the 6-month period to also be included in the full-length semi-annual shareholder report for consistency. Further, the summary shareholder reports would include figures for only one share class—the same class that the fund selects for the summary prospectus's bar chart of annual total returns. This format would be less complex, promoting investor understanding.

The performance highlights for the annual shareholder report briefly describes the markets in which the fund invests and the factors that affected the fund's performance during the reporting period. This performance commentary currently is required only in the annual report, and we therefore recommend including it only in the annual summary shareholder report. Members believe the performance commentary annual production schedule remains appropriate, given that drafting this disclosure requires significant time and effort of the fund's portfolio manager.[18]

More Than Eight in 10 Mutual Fund Investors Find the Performance Highlights Important. Specifically, 83 percent of mutual fund investors surveyed thought that the performance highlights were important to include in the summary shareholder report (*see* Figure 1, *supra*). Support for this element was high, with 60 percent indicating this element was "very important, need to keep in summary document" and 23 percent indicating it was "somewhat important, keep if space available." Although support was high across all age groups, 87 percent of mutual fund investors younger than 35 indicated the performance highlights were important to keep, compared with 78 percent of mutual fund investors aged 65 or older.[19] Support for the performance highlights also was high across all income groups, rising from 76 percent of those with household incomes less than $50,000 indicating this element was important to keep to 88 percent of those with household incomes of $150,000 or more.[20]

Support for including this element also was high among mutual fund investors who were less engaged with the current full shareholder report or found the current full shareholder report difficult to understand. While 83 percent of mutual fund investors thought it was important to include performance highlights in a summary, a similar 82 percent of mutual fund investors who read, at most, very little of the current full shareholder report and 82 percent of mutual fund investors who found the current full shareholder report difficult to understand thought it was important to include (Figure 2). Ranking of performance highlights as very important, or needed, also was similar across these groups of mutual fund investors at about six in 10.

[18] A few fund groups voluntarily include this disclosure in their funds' semi-annual reports. The fund groups that do not include this information explained that in weighing the costs and benefits, on balance, the time and expense associated with gathering, documenting, and reviewing this information outweighed the benefits, particularly since preparation requires portfolio management personnel's close involvement. Of course, some funds could choose to include this information in semi-annual summary reports. On balance, we believe that funds should have the flexibility to determine their preferred approach rather than the Commission mandating funds to include the performance commentary in both the semi-annual and annual reports. This principle should be applied consistently to both summary and full-length shareholder reports.

[19] *See* Figure 5 in the *ICI White Paper, supra*.

[20] *Id.*

Figure 2

Less-Engaged Mutual Fund Investors Also Strongly Support Elements of the Summary Shareholder Report Prototype

Percentage of individuals owning mutual funds, 2018

	All mutual fund investors[1]		Mutual fund investors who read, at most, very little of the current shareholder report		Mutual fund investors who indicate the current shareholder report is difficult to understand	
	Important[2]	Needed[3]	Important[2]	Needed[3]	Important[2]	Needed[3]
Performance highlights	83	60	82	58	82	60
Total return and expenses	88	68	86	67	87	68
Graphical representation of holdings	79	45	78	44	79	45
Average annual total return	79	47	77	46	77	45
Fund expense example	72	42	69	40	70	42

[1]These numbers are also reported in Figure 1, *supra*.
[2]This column reports the percentage of mutual fund–owning individuals who find each section "very important, need to keep in summary document" or "somewhat important, keep if space available." The remaining mutual fund investors find each section "useful, but having the information available online or by request is sufficient" or "not important, don't need to keep."
[3]This column reports the percentage of mutual fund–owning individuals who find each section "very important, need to keep in summary document."
Source: ICI tabulation of GfK KnowledgePanel® OmniWeb survey data (summer 2018)

Total Return and Expense Ratio. We recommend that each summary shareholder report include a bar chart that provides the fund's total return for the most recent fiscal period and the fund's net expense ratio. Similar to the approach taken with respect to the presentation of performance highlights, this chart would include figures for only one share class—the same class that the fund selects for the summary prospectus's bar chart of annual total returns.[21] This will provide investors with an easy-to-understand, graphic summary of performance and expenses at the beginning of the summary report. Further detail about their particular share class's performance and expenses is provided later in the summary report in the Average Annual Total Return Table and the Expense Example.

We also recommend that the bar chart include total return of a benchmark—the same appropriate broad-based securities market index that the fund selects for the line graph of performance in the annual shareholder report's MDFP.[22] The fund additionally would be permitted to include total return for a more narrowly based index that reflects the market sector in which the fund invests if the fund includes that additional index in the line graph of performance in the annual shareholder report's MDFP.[23]

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[21] *See* Form N-1A Item 4(b)(2).

[22] *See* Form N-1A Item 27(b)(7)(ii)(a) and Instruction 5.

[23] Our recommended approach is consistent with the current requirement for the full shareholder report. *See* Form N-1A Item 27(b)(7)(ii)(a) and Instruction 6.

Nearly Nine in 10 Mutual Fund Investors Find the Total Return and Expense Ratio Chart Important. Mutual fund investor support of the inclusion of this element was very high: 88 percent of mutual fund investors indicated it was important to include this graphical representation of these key measures in the summary shareholder report (*see* Figure 1, *supra*). Sixty-eight percent of mutual fund investors indicated this element was very important and 20 percent indicated it was somewhat important. Support for this element was high across mutual fund investors in all age or income groups.[24] Furthermore, support also was high among less-engaged mutual fund investors (*see* Figure 2, *supra*). Indeed, about two-thirds of mutual fund investors indicated the total return and expense ratio chart was very important and needed to be kept in the summary document, even if they had read, at most, very little of the current full shareholder report or found the current full shareholder report difficult to understand.

We did not include in the summary shareholder report other items from the financial highlights table (*i.e.*, NAV at beginning and end of period, per share operating performance, net assets at end of period, ratio of net income to average net assets, and portfolio turnover rate) because we expect that the average investor may have difficulty understanding this information. As part of our research developing a summary shareholder report prototype, we found evidence that among mutual fund investors who recall receiving shareholder reports, those finding the full shareholder report difficult to understand were less inclined to read it. Specifically, 74 percent of mutual fund investors who found the current shareholder reports somewhat or very difficult to understand read very little or none of the current report.[25] Also, investors with interest in this additional detailed information can access it easily online or by calling and requesting a mailed copy of the full-length shareholder report.

The current annual shareholder report and summary prospectus allow multi-class funds to present multiple classes within one document. Our summary shareholder report similarly permits funds to present information for all classes in the fund, except for the Total Return and Expense Ratio bar chart. This allows funds to create one summary document for all classes of a fund and investors to review that information simultaneously. Summary shareholder reports that cover multiple classes would provide expense and return information for those classes in the Average Annual Total Return Table and the Expense Example.[26]

Graphical Representation of Portfolio Holdings. The Commission currently requires a fund's annual and semi-annual shareholder reports to provide one or more tables, charts, or graphs depicting the portfolio holdings of the fund by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic regions, credit quality, or maturity) showing the percentage of

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[24] *See* Figure 5 in the *ICI White Paper*, *supra*.

[25] Two-thirds of mutual fund investors who recall receiving a shareholder report indicated the report was somewhat or very difficult to understand. *See* Figure 3 in the *ICI White Paper*, *supra*.

[26] Members expressed concern with the costs that would be associated with creating, printing and mailing a separate shareholder reports for each class in a multiclass fund. This is not inconsistent with the Commission's design of the summary prospectus, which permits funds to choose whether to integrate information about multiple classes in a single document or create separate documents for each class.

net asset value or total investments attributable to each.[27] The Commission also requires funds to format the information in a manner reasonably designed to depict clearly the types of fund investments.

Our annual and semi-annual summary shareholder reports similarly would provide a graphical representation of the fund's holdings. We recommend that the Commission permit the same flexibility for funds to provide graphical representations of fund holdings in forms such as a table showing top ten holdings, asset allocation, style or capitalization box, geographical concentration, sector diversification, credit rating, maturity, etc. in summary shareholder reports. Maintaining flexibility in the graphical representation of holdings would allow funds to present information that is tailored to a fund's investment objective. For example, our summary report prototype includes graphical representations of holdings appropriate to an equity mutual fund—*e.g.*, tables and charts labeled "Asset Allocation," "Industry Allocation," and "Ten Largest Holdings." A fixed-income fund, for example, may provide graphical representations depicting the credit quality or maturity of the fund's securities.

About Eight in 10 Mutual Fund Investors Find the Graphical Representation of Holdings Important. Seventy-nine percent of mutual fund investors surveyed thought that the graphical representations (of asset allocation, industry allocation, and ten largest holdings) were important to include in the summary shareholder report (*see* Figure 1, *supra*). Forty-five percent indicated this element was "very important, need to keep in summary document" and 34 percent indicated it was "somewhat important, keep if space available." Support for including the graphical representations was highest among mutual fund investors aged 35 to 49 (84 percent) and among mutual fund investors with household incomes of $100,000 or more (83 percent).[28]

Average Annual Total Return Table. The SEC currently requires a fund's annual (but not semi-annual) report to provide a table of returns for 1-, 5-, and 10-year periods for each class in a multi-class fund.[29]

We recommend requiring each summary report (both annual and semi-annual) to include a table of returns (with and without sales charge, as applicable) for 1-, 5-, and 10-year periods along with index performance for the same periods.[30] Showing returns with and without sales charge (as applicable) will permit investors to review the effect of any applicable sales charge. Providing index performance will allow investors to compare the average annual total return of their particular share class against the performance of the same broad-based index used in the Total Return and Expense Ratio bar chart (our second recommended item, discussed above). Although the Commission currently does not require funds to include the average annual total return table in the semi-annual report, we believe it provides important performance information that investors would find useful

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[27] *See* Form N-1A Item 27(d)(3).

[28] *See* Figure 5 in the *ICI White Paper, supra*.

[29] *See* Form N-1A Item 27(b)(7)(ii)(B).

[30] The SEC currently does not require funds to provide index performance in this table. Instead, funds currently must include a line graph of performance compared to an index, but we do not recommend including the line graph, as we explain below.

on a semi-annual basis. We also understand that it would not be overly burdensome for funds to provide this information.

About Eight in 10 Mutual Fund Investors Find the Average Annual Total Return Table Important. The summary shareholder report prototype included a table with average annual total returns on the top half of the second page. Mutual fund investors generally indicated it was important to include this element in a summary report (79 percent), with nearly half (47 percent) indicating it was very important and needed to be kept and nearly one-third (32 percent) indicating it was somewhat important and should be kept if space is available (*see* Figure 1, *supra*). Support for this element varied little by investor age, ranging from 75 percent of mutual fund investors aged 65 or older indicating it was important to 82 percent of mutual fund investors aged 35 to 49.[31] Support for this item rose with household income, ranging from 71 percent of mutual fund investors with household income less than $50,000 indicating the average annual total return table was important to include in a summary to 83 percent of mutual fund investors with incomes of $150,000 or more.[32]

Expense Example. The Commission currently requires a fund's annual and semi-annual shareholder reports to include an expense example, using a hypothetical $1,000 account, that shows the dollar amount of expenses paid for the most recent fiscal half-year using actual returns and a hypothetical 5 percent return. This item also requires extensive narrative disclosure.[33]

We recommend simplifying the current disclosure in two respects for the summary shareholder report:

- expenses paid for the most recent fiscal half-year would be portrayed using actual returns only; and
- the narrative disclosure before the table would be condensed into one sentence of disclosure.

Our recommended summary report therefore includes a table showing expenses paid for the most recent fiscal half-year using actual returns, based on an investment of $1,000 invested at the beginning of the period and held for the entire six-month period and a simplified narrative disclosure. We also recommend that the summary shareholder report additionally include the annualized expense ratio for each share class that appears in the full-length report's Financial Highlights.

Providing an expense example is responsive to investors' keen interest in knowing how much it will cost them to invest in a fund. However, providing a simpler, more approachable presentation of fund expenses should make investors more likely to review and understand the information. Further, it would allow investors to see their fund expenses in terms of both dollars and percentage in the Expense Example.

More Than Seven in 10 Mutual Fund Investors Find the Fund Expense Example Important. The summary shareholder report prototype included a table with fund expense examples for each share

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[31] *See* Figure 5 in the *ICI White Paper, supra*.

[32] *Id.*

[33] *See* Form N-1A Item 27(d)(1).

class on the lower half of the second page. Mutual fund investors generally indicated it was important to include this element in a summary report (72 percent), with 42 percent indicating it was very important and needed to be kept and 30 percent indicating it was somewhat important and should be kept if space is available (*see* Figure 1, *supra*). Support for this element varied little by investor age, ranging from 70 percent of mutual fund investors aged 65 or older indicating it was important to 75 percent of mutual fund investors younger than 35.[34] Support for this item rose with household income, ranging from 67 percent of mutual fund investors with household income less than $50,000 indicating the fund expense example table was important to include in a summary to 75 percent of mutual fund investors with household incomes of $150,000 or more.[35]

D. Mutual Fund Investors Are Overwhelmingly Positive Regarding the Summary Shareholder Report Prototype

After being asked to rank the importance of each element of the summary shareholder report prototype, mutual fund investors were asked to rate the entire document overall. Mutual fund investors overwhelmingly reacted positively to the sample summary. In response to the structure and elements of the summary prototype, over 90 percent of mutual fund investors agree that:

- "A summary document like this is enough for investors who want to stay informed about their mutual fund investments, as long as the longer and more detailed document is available upon request free of charge."
- "I am more likely to read a summary document like this than the longer and more detailed shareholder report."
- "Having summary documents like this will make it easier for me to compare different funds."

Indeed, 95 percent of mutual fund investors agree that such a summary document was enough to stay informed, 92 percent agree they were more likely to read such a summary document, and 92 percent agree such a summary document made it easier to compare different funds (Figure 3). Agreement with these views was resoundingly consistent across all age and income groups.

[34] *See* Figure 5 in the *ICI White Paper, supra*.

[35] *Id*.

Figure 3

Mutual Fund Investors Favorably View the Summary Shareholder Report Prototype

Percentage of individuals owning mutual funds agreeing with each statement by investor age or household income, 2018

		Investor age			
	All	**Younger than 35**	**35 to 49**	**50 to 64**	**65 or older**
A summary document like this is enough for investors who want to stay informed about their mutual fund investments, as long as the longer and more detailed document is available upon request free of charge.	95	93	95	96	95
I am more likely to read a summary document like this than the longer and more detailed shareholder report.	92	89	92	94	94
Having summary documents like this will make it easier for me to compare different funds.	92	91	90	94	94
Number of respondents:	*1,233*	*261*	*316*	*397*	*259*

		Household income			
	All	**Less than $50,000**	**$50,000 to $99,999**	**$100,000 to $149,999**	**$150,000 or more**
A summary document like this is enough for investors who want to stay informed about their mutual fund investments, as long as the longer and more detailed document is available upon request free of charge.	95	92	95	96	95
I am more likely to read a summary document like this than the longer and more detailed shareholder report.	92	89	91	93	96
Having summary documents like this will make it easier for me to compare different funds.	92	93	91	92	94
Number of respondents:	*1,233*	*186*	*410*	*302*	*335*

Note: The figure reports the percentage of mutual fund–owning individuals who "strongly agree" or "somewhat agree" with the statement. The remaining mutual fund investors "somewhat disagree" or "strongly disagree" with each statement.
Source: ICI tabulation of GfK KnowledgePanel® OmniWeb survey data (summer 2018)

E. Summary Shareholder Report Prototype Successfully Communicates Content

One of the challenges with testing a prototype is that respondents may express that they value the prototype without demonstrating that they can use it to locate and understand the information presented. After gathering mutual fund investors' opinions about the summary shareholder report prototype and each of its elements, the survey included three questions to discern whether the prototype could convey valuable facts about a fund. Specifically, the survey asked respondents to identify:

- the largest holding of the mutual fund in our example,
- which share class had the lowest annualized expense ratio, and
- which share class earned a higher total return than its benchmark (the S&P 500 index).

A majority of mutual fund investors answered each question correctly. Specifically,

- 76 percent correctly identified the largest holding of the mutual fund;

- 54 percent correctly identified the share class with the lowest annualized expense ratio; and
- 64 percent correctly identified the share class that had a higher total return than the S&P 500 index (the fund's benchmark).

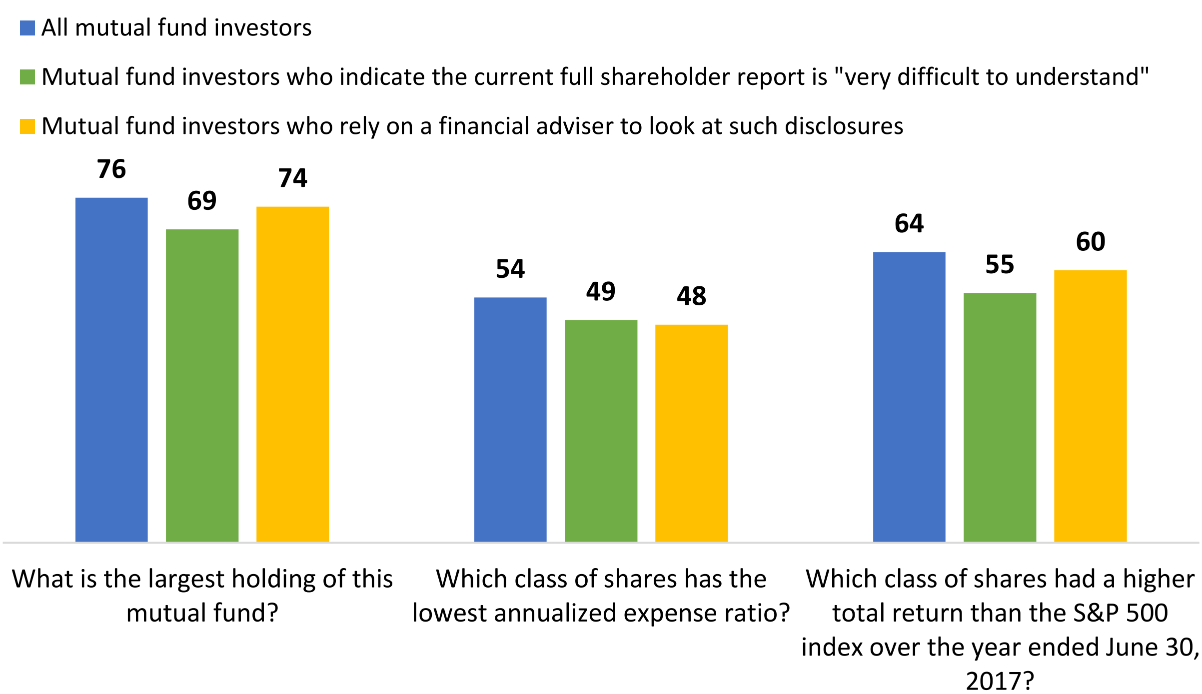
Ability to answer the questions correctly using the summary report prototype varied somewhat by investor age or household income.[36] Slightly higher percentages of the oldest mutual fund investors (aged 65 or older) indicated they didn't know, compared with younger mutual fund investors. Similarly, slightly higher percentages of the lower-income mutual fund investors (household income less than $50,000) indicated they didn't know compared with higher-income mutual fund investors. However, it should be noted that those groups of mutual fund investors were more likely to indicate that they relied on a financial adviser to look over such disclosures.

Not surprisingly, those who reported finding current full-length shareholder reports "very difficult to understand" were somewhat less likely to answer correctly (Figure 4). Similarly, mutual fund investors who indicated that they rely on their financial adviser to look at these sorts of documents, and thus are getting professional financial advice to manage their investments, were somewhat less likely to answer correctly. Nevertheless, a majority of these groups correctly answered the largest holding and benchmark comparison questions using the summary.

Figure 4

Using the Summary Shareholder Report Prototype, Significant Numbers of Mutual Fund Investors Correctly Answered Content-Related Questions

Percentage of individuals owning mutual funds answering correctly, 2018



Source: ICI tabulation of GfK KnowledgePanel® OmniWeb survey data (summer 2018)

[36] *See* Figure 11 in the *ICI White Paper, supra*.

F. Options for Additional Content

Liquidity Risk Management Program Description. The Commission recently amended Form N-1A to require certain funds' shareholder reports to include a brief discussion of the operation and effectiveness of the fund's liquidity risk management program over the past year if the board of directors reviewed the fund's liquidity risk management program pursuant to the liquidity risk management rule.[37] Under the rule, if the board reviews the liquidity risk management program more frequently than annually, a fund may choose to include a discussion of the program's operation and effectiveness over the past year in one of either the fund's annual or semi-annual reports but does not need to include it in both reports.

We recommend that the summary shareholder report be required to include a brief summary of any discussion of the operation and effectiveness of the fund's liquidity risk management program over the past year.[38] Investors who are interested in the full discussion can access it in the full-length report.

Discussion of Effect of Any Stable Distribution Policy. The Commission currently requires a mutual fund's annual shareholder report to discuss the effects of maintaining a specified level of distributions to shareholders. The shareholder report also must discuss the extent to which the fund's distribution policy resulted in distributions of capital. [39] We recommend that only mutual funds with stable distribution policies include this information in the summary annual shareholder reports. Our summary report prototype reflects the typical items that would be relevant for an equity mutual fund, so it does not reflect this item.

The Commission has granted exemptive relief to many closed-end funds with "managed" (or "stable") distribution policies permitting them to distribute long-term capital gains more than once annually. The Commission requires those closed-end funds to describe their managed distribution policies in their annual and semi-annual shareholder reports. We recommend in Section X, *infra*, that the Commission require closed-end funds to include the same disclosure that appears in their full-length shareholder reports to appear in the corresponding summary shareholder report.

Changes in and Disagreements with Accountants. The Commission currently requires a fund's annual and semi-annual shareholder reports to disclose changes in and disagreements with accountants.[40] Whenever there are changes in, or disagreements with, accountants the fund must provide the disclosures required by Item 304 of Regulation S-K describing the reason for the change and the nature of the disagreement.

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[37] *See* Rule 22e-4(b)(2)(iii) under the Investment Company Act.

[38] The disclosure would appear in either the summary semi-annual or annual shareholder report, depending on which corresponding longer shareholder report contains the disclosure. We did not include sample disclosure in our prototype because the requirement was not effective when we created and tested the prototype. Therefore, we had no disclosure to model.

[39] *See* Form N-1A Item 27(b)(7)(iii).

[40] *See* Form N-1A Item 27(b)(4) and 27(c)(4).

We recommend requiring a fund to include this information in the summary shareholder report if there is a change in, or disagreement with, the fund's accountants. Changes in and disagreements with accountants are not common, so we did not include this item in the prototype. However, when they do occur, we regard this as key information for shareholders.

G. Content in Full-Length Shareholder Report Only

Funds are required to include a line graph showing the change in account value over a 10-year period assuming a $10,000 investment as compared to a broad-based index as part of the MDFP in the annual shareholder report. We extensively considered recommending that funds include the line graph of performance compared to an index in summary shareholder reports. We ultimately concluded not to do so for two reasons. First, the graph looked misleading when compressed into the limited space available in the summary shareholder report without adding a full page with this depiction. Second, in balancing length with importance of the information, we concluded that investors would be adequately informed about the fund's long-term performance via a table of returns for 1-, 5-, and 10-year periods for the fund and index performance for the same periods (the fourth element of our summary prototype, discussed above).

With respect to the remainder of the information that currently is required to appear in a shareholder report, we concluded that it was of a more technical nature that would be readily available online for those investors who wish to access it.[41]

H. Tailored Requirements for Closed-End Funds

We recommend that the Commission propose a summary shareholder report tailored for closed-end funds. This summary should include the same information that appears in the mutual fund summary shareholder report and, additionally:

- total return based on the market prices of fund shares;
- material changes in any of the following—the fund's investment objectives or policies, the fund's principal risk factors, and portfolio managers;
- structural leverage;
- managed distribution policies;
- dividend reinvestment plans; and
- share repurchases.[42]

[41] The information we did not include is as follows: Financial Statements (Auditor's Opinion); Remuneration Paid to Directors, Officers, and Others; Management Information; Statement about Availability of Additional Information about Fund Directors in the SAI; Statement Regarding Availability of Quarterly Portfolio Schedule; Statement Regarding Availability of Proxy Voting Policies and Procedures; Statement Regarding Availability of Proxy Voting Record; Statement Regarding Basis for Approval of Investment Advisory Contract; and Disclosure About Matters Submitted for a Shareholder Vote.

[42] We recommend that each of these items be reported with the same frequency as required today for full-length shareholder reports. The information about total return, managed distribution policies, and share repurchases would be included in both semi-annual and annual summary shareholder reports. Information about material changes to the fund's

The Commission recognizes that many, if not most, investors purchase closed-end fund shares at market prices on the secondary market. It therefore requires closed-end funds to report total investment return in closed-end funds' financial highlights based on the market prices of fund shares, not net asset values.[43] Closed-end funds, at their option, also may provide total investment return based on net asset values.[44]

We recommend that the Commission require closed-end funds to provide the total investment return based on the market prices of fund shares (that appears in the financial highlights today) in the same format as mutual funds would provide in the "Total Return and Expenses" chart and the "Average Annual Total Return" table.[45] This performance information would better reflect the typical closed-end fund shareholder experience of purchasing shares on the secondary market. We also recommend that the Commission provide closed-end funds with the option to supplement the required information in both the chart and table with performance information based on net asset values.

Closed-end funds that do not continuously offer their shares typically do not update their prospectuses to reflect changes to their operations that occur after the public offering period. Instead, they announce these important changes in much the same way operating companies do—in shareholder reports. Investors understand that closed-end funds are managed investment vehicles and are most concerned with a fund's investment objectives, policies, risks, and management. The Commission, therefore, requires that closed-end funds disclose in their annual shareholder reports: (a) material changes to the fund's investment objectives or policies; (b) material changes to the fund's principal risk factors; and (c) changes to personnel primarily responsible for day-to-day portfolio management.[46]

We recommend that the Commission require closed-end funds to disclose this same information in annual summary shareholder reports.

Through various regulations and exemptive orders, the Commission requires closed-end funds to provide information about structural leverage, managed distribution policies, dividend reinvestment

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investment objectives or policies, principal risk factors, and portfolio managers; structural leverage; and dividend reinvestment plans would be included in the annual summary shareholder report.

Certain closed-end funds are continuously offered and not required to include information about material changes to the fund's investment objectives, policies, principal risk factors, and portfolio managers; structural leverage; and dividend reinvestment plans in their annual shareholder reports. Instead, these funds provide this updated information in their registration statements. *See* Rule 8b-16 under the Investment Company Act. We therefore recommend that the Commission not require these funds to include this information in summary shareholder reports, provided they include it in their registration statements.

[43] *See* Instruction 13 to Form N-2 Item 4.1.

[44] *See* Instruction 14 to Form N-2 Item 4.1.

[45] *See* discussion in Section I, *supra*.

[46] *See* Rules 8b-16(b)(2), (b)(4) and (b)(5) under the Investment Company Act (requiring closed-end funds to disclose this information in annual reports, unless they annually update their registration statements).

plans, and share repurchases in shareholder reports. The current requirements and our recommendations for the summary shareholder report are described below.

If a closed-end fund has outstanding indebtedness or preferred shares, the Commission requires it to disclose in its annual shareholder report the effects of leverage on the fund, including: the annual rate of interest or dividend payments on those senior securities; the annual return that funds must experience in order to cover annual interest or dividend payments on those senior securities; and a table and narrative illustrating the effects on returns to a common shareholder.[47] We recommend that the Commission require closed-end funds' annual summary shareholder reports to include this same information.

Many closed-end funds receive an exemptive order to distribute long-term capital gains more than once per year.[48] The Commission requires several standard conditions for a fund to receive such an order, including disclosing on the inside front cover of its annual and semi-annual shareholder reports: the terms of the distribution policy; the fund's total return in relation to changes in net asset value; and certain narrative disclosure.[49] For closed-end funds, we recommend that the Commission require annual and semi-annual summary shareholder reports to include this information.[50]

The Commission requires a closed-end fund that offers a dividend reinvestment plan to shareholders to describe material aspects of their plan in annual shareholder reports.[51] We recommend that the Commission require closed-end funds simply to identify whether it has a dividend reinvestment

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[47] *See* Rule 8b-16(b)(4) under the Investment Company Act; Form N-2 Item 8.3.b.

[48] *See* Section 19(b) of the Investment Company Act (limiting distributions of long-term capital gains to one time per year).

[49] The narrative disclosure consists of a statement that, "[y]ou should not draw any conclusions about the fund's investment performance from the amount of [a] distribution or from the terms of the fund's distribution policy."; a statement that the distribution policy provides that the fund's board may amend or terminate the distribution policy at any time without prior notice to fund stockholders; and a description of any reasonably foreseeable circumstances that might cause the fund to terminate the distribution policy and any reasonably foreseeable consequences of such termination. *See*, *e.g.*, Vivaldi Opportunities Fund, *et al*., SEC Release Nos. IC-33147 (July 3, 2018) (Notice) and IC-33185 (July 31, 2018) (Order).

[50] As discussed above, we are recommending that closed-end funds optionally provide performance information based on net asset values. To the extent that a closed-end fund has a managed distribution policy, we recommend that the Commission require those funds to provide performance information based on both market prices and net asset values.

[51] *See* Rule 8b-16(b)(1) under the Investment Company Act; Form N-2 Item 10.1.e. In particular, closed-end fund shareholder reports must briefly describe material aspects of the dividend reinvestment plan including, but not limited to: (1) whether the plan is automatic or whether shareholders must affirmatively elect to participate; (2) the method by which shareholders can elect to reinvest stock dividends or, if the plan is automatic, to receive cash dividends; (3) from whom additional information about the plan may be obtained (including a telephone number or address); (4) the method of determining the number of shares that will be distributed in lieu of a cash dividend; (5) the income tax consequences of participation in the plan (i.e., that capital gains and income are realized, although cash is not received by the shareholder); (6) how to terminate participation in the plan and rights upon termination; (7) if applicable, that an investor holding shares that participate in the dividend reinvestment plan in a brokerage account may not be able to transfer the shares to another broker and continue to participate in the dividend reinvestment plan; (8) the type and amount (if known) of fees, commissions, and expenses payable by participants in connection with the plan; and (9) if a cash purchase plan option is available, any minimum or maximum investment required.

plan in the annual summary shareholder report**.** Shareholders who are interested in additional information about the plan then can access it in the full-length report.

Section 23(c) of the Investment Company Act requires a closed-end fund that repurchases its shares on the secondary market to notify shareholders of its intention to repurchase the shares by letter or report addressed to shareholders. Many closed-end funds include this information in annual and semi-annual shareholder reports to preserve the closed-end fund's ability to make secondary market repurchases. We recommend that the Commission permit closed-end funds to make the same Section 23(c) notifications in the annual and semi-annual summary shareholder reports. Permitting closed-end funds to provide notices in this manner would highlight the option for shareholders and facilitate the continued operation of repurchases.

I. Modernizing Options for Delivering Summary Shareholder Reports

Consistent with the summary prospectus rule, use of the summary shareholder report would be optional. Funds could choose to send shareholders the summary shareholder report or the full-length shareholder report, and investors who receive the summary shareholder report could make individual requests for a full-length paper shareholder report. Funds also would have the option, under recently adopted Rule 30e-3, to mail shareholders a notice that their fund's full-length shareholder report is available online (or a paper copy can be requested by phone).[52]

Under our recommended approach, the notice could include instructions for how an investor could elect to receive in the future either summary shareholder reports or full-length shareholder reports in paper or make individual requests to receive particular reports—in summary or full-length form. Rule 30e-3 also will require funds to include instructions for shareholders to receive full-length shareholder reports in perpetuity.

We recommend that funds that choose to use summary shareholder reports be required to send full-length shareholder reports on only an *ad hoc* basis. This approach would encourage funds to create a summary shareholder report because they would avoid the costs associated with vendors managing the preferences of shareholders.[53] Further, this approach keeps delivery requirements for the summary shareholder report consistent with those for the summary prospectus.

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[52] Rule 30e-3 requires that a paper notice be sent to an investor each time a current shareholder report is accessible online. The notice must include instructions for how an investor can elect—at any time—to receive all future reports in paper, or request to receive particular reports in paper on an *ad hoc* basis.

[53] Processing fees may be significantly lower for delivering summary shareholder reports as compared to mailing a Rule 30e-3 notices. Under the current New York Stock Exchange (NYSE) processing fee schedule, funds pay two separate processing fees for delivering a Rule 30e-3 notice to a beneficial account: a 15 cent processing fee and a variable, tiered notice and access fee that Broadridge Financial Solutions, Inc., the dominant vendor for delivery of fund disclosure documents, has estimated costing an average of 20 cents per notice. Under the current NYSE schedule, funds would pay one fee—the 15-cent processing fee for delivering summary shareholder reports. We will be filing a comment letter recommending changes to the fee schedule in response to the SEC's request for comment. *See* Request for Comments on the Processing Fees Charged by Intermediaries for Distributing Materials Other than Proxy Materials to Fund Investors, SEC Release No. IC-33114 (June 5, 2018), available at https://www.sec.gov/rules/other/2018/33-10505.pdf.

Under our recommended approach, investors would be allowed opt into electronic delivery of summary shareholder reports as they are today with respect to other fund disclosure documents. Electronic delivery permits funds to satisfy their delivery obligations by notifying investors via email of the online availability of fund disclosure documents, along with a link to the website address where the documents are available.

In sum, funds would be permitted to choose to select one or a combination of the following to satisfy shareholder report transmission obligations:

- mail a Rule 30e-3 notice stating that a summary or full-length shareholder report is available on-line or in paper as requested consistent with Rule 30e-3;[54]
- mail a summary shareholder report which would inform investors that the full-length shareholder report is available on-line or in paper upon request; or
- mail the full-length paper shareholder report.

Investors also would be able to opt into electronic delivery.

Our recommended approach furthers the Commission's policy objective in adopting Rule 30e-3—modernizing the manner in which periodic information is made available to investors to improve investors' experience while reducing expenses associated with printing and mailing shareholder reports. It also is consistent with the Commission's conclusion that funds are in the best position to choose the manner(s) of transmission after considering the costs and benefits of the available methods, including consideration of the needs and preferences of the fund's particular investors.[55]

J. Relationship of Shareholder Reports to Fund Advertisements

We recommend that the Commission encourage the Financial Industry Regulatory Authority (FINRA) to amend Rule 2210 to treat both full-length and summary shareholder reports the same way that it treats fund prospectuses, *i.e.*, as exempt from the rule's content requirements.[56]

In contrast to its treatment of fund prospectuses, FINRA currently treats the MDFP section of fund shareholder reports as advertisements subject to its content requirements. However, shareholder reports, including the MDFP section, are more similar to prospectuses than advertisements. Like prospectuses, shareholder reports are (and summary shareholder reports would be) required

[54] As stated above, investors then could choose to receive the summary on an *ad hoc* basis or the full-length reports in paper on an *ad hoc* basis or in perpetuity.

[55] *See* Rule 30e-3 Release at 2 and 29.

[56] FINRA Rule 2210(c)(7)(F) already exempts from the rule's filing requirements "[p]rospectuses, preliminary prospectuses, fund profiles, offering circulars, *annual or semi-annual reports* and similar documents that have been filed with the SEC…" (Emphasis added.) We would expect FINRA to interpret this filing exemption to cover summary shareholder reports if the Commission implements our recommendation.

documents subject to a highly-prescribed set of Commission content and filing requirements. Moreover, their purpose is to provide existing shareholders with current fund information. [57]

Our recommendation is critical especially for new summary shareholder reports because if FINRA treats them as advertisements, FINRA could require additional content for some funds and not others. This unfortunately would undermine the objective of providing investors with standardized, key, and comparable information. Moreover, given the prospect of this additional regulatory burden, funds simply may choose not to use summary shareholder reports. As a more general matter, SEC-required documents such as fund shareholder reports should not be subject to additional FINRA-imposed disclosure requirements.

II. Modernizing Delivery of Fund Prospectuses

The Commission asks whether investors would prefer to receive a brief notice informing them that fund disclosure is available. It also indicated in the release adopting Rule 30e-3 that it was receptive to considering a notice and access delivery system for documents other than shareholder reports. We strongly recommend that the Commission do so, adopting a very similar approach for delivering funds' prospectuses and summary prospectuses as it permits for shareholder reports via Rule 30e-3.

We support such an approach because it:

- will result in significant cost savings for fund shareholders;
- aligns much more effectively with shareholder preferences; and
- will reap environmental benefits.

The Commission adopted Rule 30e-3, in part, because it recognized that this type of regulatory action would reap significant cost savings for funds and investors. The Commission estimates that the potential aggregate cost savings for fund shareholders from reliance on Rule 30e-3 (beginning in year two, after the transition period) will be $141.4 million annually.[58] We expect fund shareholders to experience comparable cost savings if funds were permitted to follow a notice and access approach for prospectuses.[59]

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[57] The Commission approved amendments to Rule 2210 in 2016 to exempt from the rule's filing (but not content) requirements "annual or semi-annual reports." Prior to the amendment, FINRA required firms to file the MDFP portion of a fund shareholder report if the report was distributed or made available to prospective investors. This approach subjected virtually all fund MDFPs to filing because funds typically post shareholder reports on their websites and therefore the reports technically are "made available to prospective investors." In proposing the amendment, FINRA reasoned that "the MDFP typically presents less investor risk than other types of communications concerning investment companies, since it usually focuses on the most recent period covered by the report rather than containing promotional content that is intended to encourage future investments." *See, e.g.*, *SEC Approves Amendments to Rules Governing Communications With the Public*, FINRA Regulatory Notice 16-41 (October 2016), available at www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-41.pdf.

[58] Rule 30e-3 Release at 118.

[59] We recommend that the Commission permit a one-year transition period during which shareholders would be notified that they would be mailed a notice instead of a summary prospectus. This will permit funds to deliver cost savings to

The Commission also adopted Rule 30e-3 to modernize fund delivery of information and align delivery much more effectively with shareholder preferences for accessing financial information on-line.

The release adopting the rule stated very clearly the Commission's objectives:

> We believe it [Rule 30e-3] will improve investors' ability to access and use this information (for example, by providing investors with access to at least a full year of complete portfolio holdings information in one location), while reducing expenses associated with printing and mailing that are borne by funds, and ultimately, by their investors. The rule draws on the Commission's experience of more than twenty years with use of the internet as a medium to provide documents and other information to investors. [footnote omitted] The rule also draws on the Commission's investor testing efforts and other empirical research concerning investors' preferences about methods of delivery for required disclosure documents and use of the internet for financial and other purposes generally.[60]

Applying a notice and access framework to prospectuses likewise will produce cost savings and align much more effectively with shareholder preferences for accessing financial information on-line. In fact, 95 percent of US households owning mutual funds identify themselves as having internet access.[61] Further, according to data from the Federal Communications Commission (FCC) and Pew Research, access to broadband internet or high-speed mobile LTE services is nearly universal, regardless of urban or rural location.[62]

There are likely additional benefits from electronic delivery for mutual fund shareholders. In the defined contribution retirement plan context, research indicates that the interactivity of electronic delivery has contributed to increased savings rates.[63] Data also indicate that retirement plan participants are more likely to act in response to materials provided electronically. According to one recordkeeper, participants who provided email addresses to their plans saved 72 percent more than participants without an email address on file and were three times more likely to be "on plan" with their saving and investing. They also were 12 times more likely to go to the plan website to review an account, make changes, or explore a tool or educational content; four times more likely to use support tools; and twice as likely to attend an educational workshop, compared with participants

shareholders more quickly. Also, one year of notice should be sufficient to adequately inform shareholders of the coming change since they already will have had experience with a transition from the shareholder report to a notice.

[60] Rule 30e-3 Release at 7.

[61] *See* Holden, Schrass, and Bogdan (October 2017), *supra*.

[62] FCC, *2018 Broadband Deployment Report* (February 2018), available at https://www.fcc.gov/document/fcc-releases-2018-broadband-deployment-report; Pew Research Center, "Internet/Broadband Fact Sheet," (Feb. 8, 2018), available at http://www.pewinternet.org/fact-sheet/internet-broadband/.

[63] Peter Swire and DeBrae Kennedy-Mayo, *2018 Update to Delivering ERISA Disclosure for Defined Contribution Plans: Why the Time Has Come to Prefer Electronic Delivery*, available at http://peterswire.net/wp-content/uploads/2018-Update-to-Delivering-ERISA-Disclosure-for-DC-Plans-002.pdf.

who do not engage digitally.[64] Notices, like email, may drive more shareholders on-line in addition to encouraging shareholders to choose electronic delivery.

We therefore strongly recommend that the Commission act promptly to provide firms with the flexibility to choose to send investors:

- a notice informing investors that a summary prospectus or prospectus is available on-line or by request;
- summary prospectus; or
- full statutory prospectus (hereinafter referred to together as "prospectuses").

Funds then will be in a better position to satisfy a range of investor preferences while producing meaningful cost savings, operational efficiencies, and other important benefits. Moving away from paper also would have an immediate, positive impact on the environment, saving millions of trees every year and significantly reducing the industry's carbon footprint.[65]

III. A New One-Page Sheet at the Beginning of Prospectuses Is Unnecessary

The Commission requests comment on whether a one-page sheet at the beginning of each prospectus or summary prospectus would be helpful for investors. We explain below why that is simply unnecessary, and we would strongly oppose the Commission instituting such a requirement. Both the summary and statutory prospectuses provide investors with key information and funds produce one-page fact sheets. Fund shareholders today have access to a tremendous amount of information, including in many different formats. There is no information gap to fill. We recommend that the Commission instead focus its efforts on improving the content of prospectuses to the extent necessary and appropriate.

It is unnecessary for the Commission to require a new one-page sheet at the beginning of prospectuses. The summary prospectus and the summary section at the beginning of each statutory prospectus now provide investors with key information in plain English in a standardized order. The Commission purposely designed the summary prospectus and the beginning of statutory prospectuses to serve investors' need for more concise and understandable information. The

[64] Letter from the American Retirement Association and ICI, to the Honorable Preston Rutledge, Assistant Secretary, US Department of Labor, dated September 25, 2018, available at https://www.ici.org/pdf/31411a.pdf.

[65] We previously have explained similar points with respect to shareholder reports and Rule 30e-3 in detail to the Commission. *See* Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated August 11, 2015, available at http://www.sec.gov/comments/s7-08-15/s70815-315.pdf; Letter from Paul Schott Stevens, President and CEO, ICI, to Brent J. Fields, Secretary, SEC, dated March 14, 2016, available at www.sec.gov/comments/s7-08-15/s70815-581.pdf; and Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated September 12, 2016, available at www.sec.gov/comments/sr-nyse-2016-55/nyse201655-4.pdf.

Commission aptly communicated this intent when it adopted the summary prospectus stating as follows:

> The disclosure framework that we are adopting has the potential to revolutionize the provision of information to the millions of investors who rely on mutual funds for their most basic financial needs. It is intended to help investors who are overwhelmed by the choices among thousands of available funds described in lengthy and legalistic documents to access readily key information that is important to an informed investment decision.[66]

Further, funds prepare a variety of documents for investors to use, including one-page sheets, typically referred to as fact sheets. These often appear on fund websites, and third parties also produce one-page fact sheets describing funds. These fact sheets are very well received by investors and are considered fund sales literature, subject to a number of requirements, including filing with, and review by, FINRA. In addition, if the Commission permits funds to produce summary shareholder reports, they will have the opportunity to publish a succinct, informative document with current fund information every six months.

Instead of a new one-page sheet at the beginning of the prospectus, the Commission should consider improving the content of prospectuses to the extent necessary and appropriate. For example, the Commission could consider working towards making the summary prospectus shorter and more standardized (*e.g.*, require topics to be preceded with headings, content to be limited to a few sentences, and the staff could issue guidance setting forth their expectations regarding content). We also recommend that the staff and industry work toward keeping content short. Indeed, members have indicated that one reason summary prospectuses continue to get longer is the addition of content in response to staff comments.[67]

In summary, there is no need for the Commission to create a new one-page sheet at the beginning of fund prospectuses. We remind the Commission of the myriad of documents that funds produce for investors, including summary prospectuses, shareholder reports, quarterly portfolio holdings, proxy voting reports, and sales literature. There are lots of fund tools that have been developed as well as many forms and types of fund information available to inform investors. It would be more prudent to consider ways to improve the existing summary prospectus rather than creating a new document.

IV. Funds' Use of Technology to Improve the Retail Investor Experience

The Commission notes that recent technological developments could enable more interactive, user-friendly disclosure that funds can tailor to investors' needs. For example, funds could use technology to help investors better navigate disclosure to find and understand information of

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[66] *See* 2009 Release at 15, available at https://www.sec.gov/rules/final/2009/33-8998.pdf.

[67] We would not support the Commission requiring funds to provide summary prospectuses in Q&A format. A rigid requirement dictating the format of the disclosure would not necessarily result in effective communication of information to investors. Rather, the Commission should allow funds the opportunity to design effective disclosure. *See* Release at 25.

interest. The Commission requests comment on how it can encourage or require funds to display information in a more user-friendly manner. As we explain below, the Commission should:

- consider allowing funds to satisfy federal securities law obligations by providing access to additional information through smartphone applications;
- not dictate the content or placement of information on fund websites but strive to maintain technology-neutral requirements; and
- consider initiating a pilot program to allow funds to develop more creative approaches to disclosure accompanied by any necessary safe harbors.

Given the rapid growth in the use of smartphones and other mobile devices, some investors may be more apt to access information on smartphone applications or "apps" than a website.[68] Therefore, the Commission should consider allowing funds to satisfy federal securities law obligations by providing access to additional information through an app in addition to websites or other means.[69]

In considering how to use technology to improve the retail investor experience, it is *critical* that the Commission not dictate the content or placement of information on fund websites, and strive to maintain technology-neutral requirements.[70] Many fund complexes have voluntarily invested substantial resources in technology to develop and maintain websites that offer investors and intermediaries a wealth of fund and other investment and market information, educational materials, and interactive features such as expense calculators and retirement planning tools. These have been developed in response to specific feedback and testing. Funds clearly are committed to using electronic media in ways that benefit investors, but our members are highly concerned that any new requirements could cause them to have to radically revamp existing systems and formats that were developed with significant study and testing. Such changes would involve substantial costs and run the genuine risk of quickly becoming outdated.

It is essential that the Commission not be prescriptive so funds can best use technology for the benefit of fund investors. Any approach must be flexible enough to allow funds to respond to innovation and change to best serve their investors.

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[68] Pew Research Center data indicate that the vast majority (95 percent) of Americans own cellphones of some kind in 2018. Seventy-seven percent of Americans own smartphones (in 2018), up from just 35 percent in 2011 (Pew Research Center's first survey of smartphone ownership). *See* Pew Research Center, "Mobile Fact Sheet" (Feb. 5, 2018), available at http://www.pewinternet.org/fact-sheet/mobile/.

[69] For example, the Commission likely would have to amend, among other rules, Rule 482(b)(3) under the Securities Act which requires fund advertisements with performance data to identify a website address or toll-free number where an investor may access the most recent month-end performance data.

[70] The Commission asks several questions throughout the Release related to whether it should encourage or require additional disclosure on fund websites such as whether the Commission should require funds to include interactive performance presentations on their websites (question 90); and whether it would be more effective if funds supplemented the shareholder report's MDFP by linking the section to an online video presentation (question 92). We believe that the Commission should not institute these or other similar requirements.

The Commission could better assist investors and lead in improving the use of technology by initiating a pilot program to allow for more creative approaches to disclosure and accompany the pilot program with safe harbors to permit experimentation. This would help investors and funds, large and small.

V. Customized Expense and Transaction Cost Disclosure

A. Customized Expense Disclosure

The Commission requests comment on how to improve the disclosure requirements associated with fees and expenses to promote more informed investment decisions. The Commission particularly requests comment on whether investors are able to determine the costs of investing in a fund based on the expense example in the fund prospectus, or whether they would prefer to receive a customized calculation of their specific expenses from the fund.[71] As we discuss in more detail below, what is most critical for retail investors is to have information that they can easily compare across funds. The Commission already requires this type of information in the summary prospectus, which is superior to customized information that is subject to various issues, including access to information held by intermediaries.

We strongly oppose the Commission requiring funds or intermediaries for funds to provide individualized fund expense information. Individualized expense disclosure simply is not necessary to provide fund investors with information about the amount or range of fund fees they pay. Such information is readily available, and investors already consider it. Further, there are other expenses typically incurred with fund investments, and the Commission would need to ensure investors also understand those costs. Some of the reasons the Commission should approach this issue with extreme caution, include:

- there is no market failure that needs to be addressed;
- personalized expense information for funds may confuse, rather than inform, certain investors;
- the Commission would have to not only require funds, but also intermediaries subject to the Commission's jurisdiction, to provide personalized expense information;
- even then, at best, investors would be provided with a patchwork of incomplete information because the Commission does not have jurisdiction to require *all* intermediaries to provide funds with the information necessary to prepare customized expense information;
- mandated shareholder report disclosure permits fund investors to evaluate expense information and allows comparison across funds; and

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[71] The Commission does not describe who would be responsible for delivering or preparing this information or the "customized" information that would be required to produce this calculation. For example, there are many inputs that could be considered for a calculation, *e.g.*, whether the calculation is intended to be forward- or backward-looking, based on a single one-time investment, or a series of investments, reinvestment of dividends or distributions, and holding period. The Commission also does not address how this information might be prepared for various types of registered investment companies, including ETFs and closed-end funds.

- there are a number and variety of mutual fund expense calculators and fund analyzer tools already available, including from FINRA, the Commission, and others.

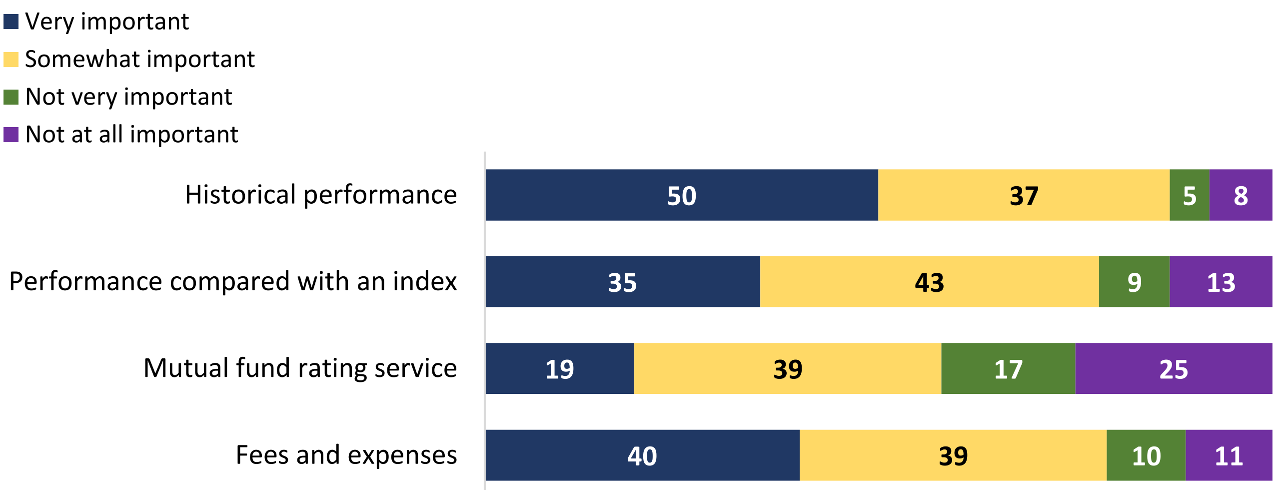
Providing investors with individualized expense information is unnecessary because there is no market failure that needs to be addressed. Fee information is readily available, and investors consider this information and evaluate their investments with that information in mind.

Recent ICI investor research demonstrates that fund fees and expenses were a very important consideration in fund selection. In mid-2017, about nine in 10 mutual fund–owning households indicated they reviewed the fund's fees and expenses (Figure 5). Indeed, 40 percent indicated the fund's fees and expenses were very important when making their purchase decision.[72]

Figure 5

Nine in 10 Mutual Fund–Owning Households Review Fund Performance, Fees, and Expenses

Percentage of mutual fund–owning households, mid-2017



Source: Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey; *see* "What US Households Consider When They Select Mutual Funds," *ICI Research Perspective* (August 2018)

Likely reflecting their self-reported emphasis on reviewing mutual fund fees, which are available in the currently required fee information, mutual fund investors tend to concentrate their assets in lower-cost funds. For example, fund investors incurred an asset-weighted average expense ratio of 0.59 percent for equity mutual funds, which was less than half the industrywide simple average of 1.25 percent for all equity mutual funds offered in the United States in 2017 (Figure 6).[73] Mutual fund investors also have concentrated their assets in lower-cost hybrid, bond, and money market funds.

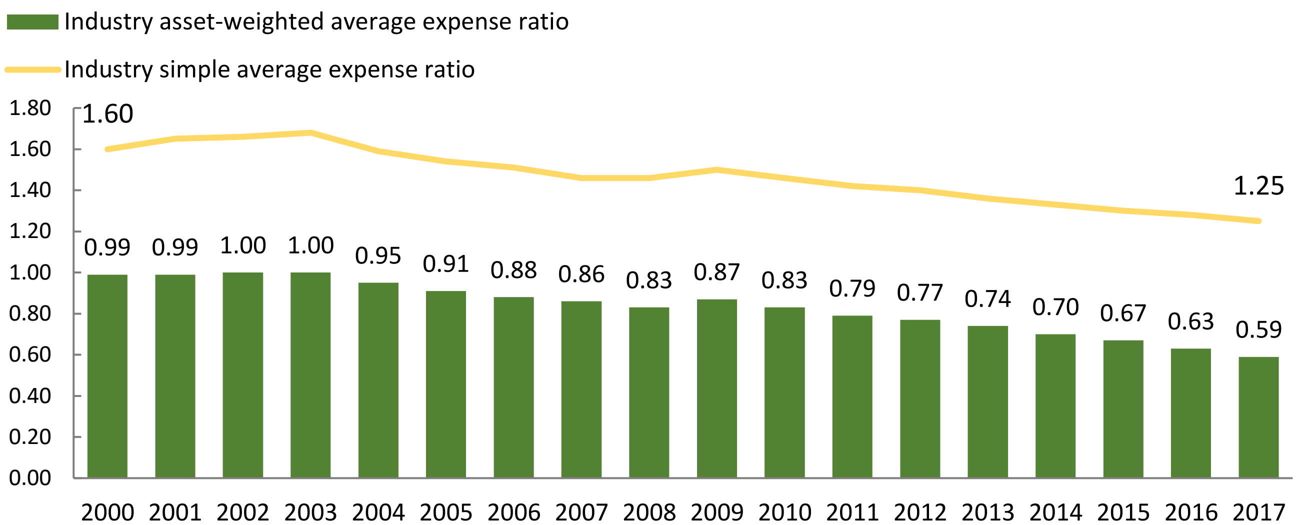
[72] Households that place less emphasis on fees and expenses may be choosing among a set of funds already pre-screened for them by financial advisers or defined contribution retirement plan sponsors, who already considered fees and expenses when building the fund lineup. *See* Holden, Bogdan, and Schrass (August 2018), *supra*.

[73] *See* Duvall and Mitler, "Trends in the Expenses and Fees of Funds, 2017," *ICI Research Perspective* 24, no. 3 (April 2018), available at www.ici.org/pdf/per24-03.pdf.

Figure 6

Mutual Fund Investors Tend to Pay Lower-Than-Average Expense Ratios

Equity mutual fund expense ratios; percent, 2000–2017



Note: Data exclude mutual funds available as investment choices in variable annuities.
Sources: Investment Company Institute, Lipper, and Morningstar; *see* "Trends in the Expenses and Fees of Funds, 2017," *ICI Research Perspective* (April 2018)

Personalized expense information may confuse, rather than inform, certain shareholders.[74] An investor's eligibility for certain share classes, each with inherently different expense structures, may depend on the nature of their account. For example, a fund held in a taxable account may have a different expense structure than the same fund held in retirement account. The different expenses may confuse the shareholder, including leaving an inaccurate impression that one is "free" of expenses.[75] Similarly, the Commission would need to consider how investors might compare the cost of buying and holding mutual funds and ETFs. Also, if the personalized expense information is used as a forward-looking hypothetical projection—what would it cost if I chose to invest in some specific fund?—various assumptions would need to be identified to calculate the projected expenses.

[74] Individualized cost disclosure also will impede investors' ability to make effective comparisons because fees paid will vary depending on the amount invested in a particular fund. For example, consider an investor that invests $10,000 in Fund A, which has a 0.50 percent expense ratio and $6,000 in Fund B, which has a 0.75 percent expense ratio. After one year, (assuming no change in the value of the funds), the investor's individualized cost information would show $50 of expense paid to Fund A and $45 of expense paid to Fund B. Looking at the dollar amount of expenses paid for the year, the investor mistakenly may conclude that Fund B is the less expensive fund.

[75] A shareholder may hold the same fund in an advisory account and a separate taxable account where the advisory share class has very limited expenses, but the shareholder also pays an external asset-based wrap fee. As above, the fee disclosure for the non-advisory account will look very different than the disclosure for the advisory account position. Unless the overall fee structure includes the wrap fee, the information to the shareholder is highly misleading.

Most funds are sold through intermediaries, and it is the intermediaries, not the funds, who hold customer-specific investment details. As a result, the Commission would have to require intermediaries to give funds adequate information if funds had to produce this information.[76]

Notably, however, the Commission does not regulate certain intermediary types—banks and retirement intermediaries. More than half of assets in defined contribution plans are invested in mutual funds.[77] Consequently, this presents a unique barrier as the Commission could not require those intermediaries to provide funds with the information to calculate personalized expenses or require these intermediaries to provide investors with this information. If funds had to provide this information, this gap would result in funds providing investors with a patchwork of information that could not be compared.[78] As the Commission considers ways to enhance expense disclosure for investors, it must consider this topic holistically. Otherwise, it risks overemphasizing the expenses of one investment product without similar information for another, ultimately misleading investors.

The Commission previously considered the idea of requiring funds to include historical individualized expense disclosure.[79] Although the Commission proposed requiring funds to disclose this expense information in shareholders' quarterly account statements, it ultimately determined that an individualized approach would be cost-prohibitive. The Commission also expressed concern about the logistical challenges involved in implementing this approach.[80]

The Commission ultimately concluded that the right approach was to require standardized expense disclosure in shareholder reports. It cited the importance of the balance between investors' need for information and the costs and burdens that would be associated with providing expense information

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[76] We are not recommending that the Commission require intermediaries to produce personalized expense information. Yet, the Commission must consider that most fund shares are held in omnibus accounts, and only the intermediary fully knows the actual individual account and transactional fees and/or allowable discounts that each of its customers pays. For example, intermediaries reduce or eliminate sales charges in some share classes depending on the investor's account type or size—individually or combined with members of the investor's household or family.

[77] *See* ICI, "The US Retirement Market, Second Quarter 2018," available at https://www.ici.org/research/stats/retirement. Nearly half of individual retirement account (IRA) assets are invested in mutual funds. Some intermediaries that hold IRA assets on behalf of customers are subject to Commission regulation (*e.g.,* broker-dealers) and others are not (*e.g.,* banks).

[78] For example, an investor most likely would not understand why a customized fee calculation is provided for his or her taxable mutual fund held directly with the mutual fund company, while no comparable calculation is provided for the same fund held in his or her 401(k) plan.

[79] The Commission was responding to GAO's report in 2000 suggesting that the Commission require mutual funds to provide each investor with an exact dollar figure for expenses paid in each quarterly account statement. *See* GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* (June 7, 2000), available at http://www.gao.gov/new.items/gg00126.pdf . Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, SEC Release Nos. 33-8164, 34-47023, IC-25870 (Dec. 18, 2002), available at http://www.sec.gov/rules/proposed/ic-25870.htm.

[80] *See* 2004 Release, *supra* note 3.

on an individualized basis.[81] The shareholder report instructs the shareholder how to use the information included in the shareholder report expense example to calculate the dollar amount of expenses paid during the period.[82] (Our recommended summary shareholder report would include this information.)

Given the many issues raised by funds providing individualized expense disclosure, we recommend that instead of requiring individualized expense disclosure, the Commission retain its current approach and consider providing prominent links on its website to tools investors can use to compare products, such as its mutual fund cost calculator or FINRA's Fund Analyzer.[83]

The Fund Analyzer provides a robust tool, which has been well-received by financial advisors and investors. The Commission itself has a public mutual fund cost calculator. Although the Commission's calculator needs to be substantially modernized and enhanced, there is a clear advantage to the Commission updating this tool and serving as a central resource for investors.

We also note that other calculators currently are available, including from intermediaries and others. Nevertheless, directing investors to tools that are publicly available at no cost from regulators can help support efforts to ensure investors understand the fees and expenses of their fund investments. The use of these existing tools is far superior and more efficient, particularly when considering the mutual fund market and range of intermediaries through which funds are accessed.[84] These tools directly address the Commission's concern about investors understanding the costs of a regulated fund, however accessed. These tools, however, would not address our broader concern that investors understand the expense of an investment whether a mutual fund or another investment product as well as any other expenses associated with the holding.

B. Transaction Cost Disclosure

The Commission asked whether to require funds to calculate their portfolio transaction costs. We do not support such disclosure and urge the Commission to retain current requirements. This topic—calculating a number for transaction costs—has been examined and rejected by the Commission for many compelling reasons. The serious risks of such an endeavor are well displayed in the European Union with new transaction cost disclosure requirements. The EU's experiences illustrate the

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[81] The final rule required funds to include two items in mutual fund shareholder reports (1) the cost in dollars associated with an investment of $1,000, based on the fund's actual expenses and return for the period; and (2) the cost in dollars associated with an investment of $1,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year. *See* 2004 Release.

[82] *See* Item 27(d)(1) of Form N-1A.

[83] The FINRA Fund Analyzer presents data in a layered and curated way and gives investors the ability to compare multiple funds.

[84] The 2017 ICI Annual Mutual Fund Shareholder Tracking Survey finds that 81 percent of mutual fund–owning households purchased their mutual funds through employer-sponsored retirement plans and 64 percent purchased mutual funds outside employer-sponsored retirement plans, with 50 percent using investment professionals and 36 percent going directly to mutual fund companies or discount brokers. See Holden, Bogdan, and Schrass (August 2018), *supra*.

complexity of calculating such a number and the dangerous, yet unintended, consequences of well-intentioned disclosure efforts.

Current requirements. Based on the Commission's evaluation and decision when it last considered this topic, today, a fund must disclose its portfolio turnover rate (the percentage of the portfolio the fund typically trades in one year) in both the prospectus and shareholder report.[85] The portfolio turnover rate is an effective indicator of the fund's transaction costs (*i.e.,* a higher portfolio turnover rate indicates higher transaction costs). Fund prospectuses provide brief disclosure regarding portfolio turnover immediately following the fee table expense example. In addition to providing a numerical rate for the most recent fiscal year, funds briefly explain the effect of portfolio turnover on transaction costs and fund performance.

Both the location of the disclosure (up front in the prospectus and summary prospectus) and the combination of narrative and numerical disclosure is sufficient. Transaction costs also are reflected in the fund's total return, meaning an investor comparing returns of different funds implicitly is considering the fund's transaction costs.[86] We supported the Commission's decision when it previously considered this topic and recommended retaining the current disclosure requirements.[87]

EU Experiences with Transaction Costs. Two pieces of EU legislation came into force at the start of 2018—the revised Market in Financial Instruments Directive (MiFID II) and the Packaged Retail and Insurance-based Investment Products (PRIIPs) regulation. Together these laws were intended, among other aims, to make the cost of investing in products, not just UCITS funds, transparent and comparable. For the first time, transaction costs involved in buying and selling the underlying securities inside a fund must be disclosed for investors.

While the regulatory intent of MiFID II and PRIIPs was to enable investors to see and understand fully the costs involved in investing in products, including investment products issued by banks and insurance companies, it has become clear that this approach has led to varying and counterintuitive results. It has caused confusing and misleading information for investors. Alarmingly, some funds

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[85] In 1995, the Commission adopted amendments to Form N-1A requiring funds to disclose in the financial highlights table adjacent to portfolio turnover the average commission rate paid on portfolio transactions. At that time, the Commission was concerned that funds may not provide adequate information to investors about transaction costs. *See* Payment for Investment Company Services with Brokerage Commissions, SEC Release Nos. 33-7197; IC-21221 (July 26, 1995). But just three years later, in 1998, the Commission eliminated the requirement for funds to disclose the average commission rate paid on portfolio transactions from the financial highlights table. Commenters and industry analysts indicated that the average commission rate paid disclosure was of little benefit. At that time, the Commission concluded that the prospectus was not the most appropriate document for disclosing average commission rate information. *See* 1998 Release, *supra* note 3.

[86] They are not included in the fund's expense ratio because they are not treated as fund expenses under generally accepted accounting principles. *See* FASB ASC 946-320-30-1. Transaction costs incurred on portfolio transactions increase purchase cost and reduce sale proceeds, reducing realized gain or increasing realized loss.

[87] *See* Item 3 of Form N-1A. Furthermore, the financial highlights table included in the shareholder report discloses portfolio turnover for the five most recent fiscal years so that a shareholder can see how portfolio turnover has changed over time.

have reported transaction costs of zero, or even *negative* numbers, while others have reported costs of up to 2 percent, leading to exceptionally confusing information.[88]

As noted by the UK Association of Investment Companies in its response to the UK Financial Conduct Authority's call for input on recent experience with PRIIPs, "*negative* costs suggest, counterintuitively, that the process of buying and selling investments does not result in reduction in the value of a product's assets. This simply does not make sense from a common-sense, consumer-orientated perspective of what a 'cost' is."[89] This recent example of regulatory action provides an unambiguous lesson in the need for extreme caution when requiring disclosure of transaction costs. We provide an overview of these European regulations and their resulting disclosures in Appendix C.

C. Investment Research Disclosure

The Commission also asks what disclosure, if any, funds should provide for the costs a fund pays for third-party broker-dealer research that an investment adviser uses in making investment decisions (*i.e.,* soft dollars). The Commission requires each mutual fund to disclose how it selects brokers, how the fund will evaluate the overall reasonableness of brokerage commissions paid, and, if a fund considers the receipt of research services in selecting the brokers, the nature of the services. In addition, a fund must disclose the aggregate dollar amount of brokerage commissions it paid during its three most recent fiscal years and explain if the amount has changed in the most recent fiscal year.[90] We believe the current disclosure is sufficient and urge the Commission to retain it as is.

D. Acquired Fund Fee and Expense Disclosure

ICI members have expressed concerns about the required fee table disclosure of "acquired fund fees and expenses" (AFFE") for funds' investments in business development companies ("BDCs"). The Commission required this disclosure as part of the fund of funds rule adopted in 2006. Because of the nature of their fundamental investment objectives, manner of operating, and associated expenses, we recommend that BDCs no longer be treated as "investment companies" for purposes of the AFFE disclosure requirement.[91]

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[88] *See* Chris Flood, "Slippage causes confusion in MiFID II fund rules row," *Financial Times* (Jan. 26, 2018), available at www.ft.com/content/7b37016a-00fc-11e8-9650-9c0ad2d7c5b5.

[89] *See* Comment Letter of the UK Association of Investment Companies to the UK Financial Conduct Authority's (FCA) Call for Input on experiences with the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation, available at https://www.theaic.co.uk (Sept. 18, 2018); *see also* FCA Call for Input: PRIIPs Regulation – initial experiences with the new requirements, available at https://www.fca.org.uk.

[90] *See* Item 21 of Form N-1A.

[91] The Commission could do so by granting the class exemption sought by the Coalition of Business Development, Apollo Investment Management, L.P., and Ares Capital Management LLC (Sept. 4, 2018), available at https://www.sec.gov/Archives/edgar/data/1449853/000147361218000002/a26449579_12xcsbgexemptive.htm.

A BDC is a closed-end investment company that Congress established for the purpose of making capital more readily available to certain types of companies. Under the Investment Company Act, a BDC must invest at least 70 percent of its assets in "eligible portfolio company," and certain other, securities. BDCs compete with various sources of capital, including private equity funds, hedge funds, and investment banks to provide financing to certain companies.[92]

Because of the nature of their business, BDCs typically have high expense ratios relative to traditional open-end and closed-end funds. For example, BDCs typically finance a substantial portion of their investment portfolio through borrowing and the interest paid is included in the expense ratio. In addition, the expense ratio is based on net assets (*i.e.*, the borrowed funds are a liability and are excluded from the asset base on which the expense ratio is calculated). For these reasons, a BDC's expenses are more like an operating company's expenses. Therefore, we recommend that the Commission permit funds to exclude BDCs from "acquired fund" for purposes of the required fee table presentation.

Our recommendation also has the benefit of causing the fee table expense presentation for funds investing in BDCs to better align with the expenses reported in their financial statements and shareholder reports. AFFE are not expenses under generally accepted accounting principles and are not reflected as expenses in the fund's statement of operations. As a result, the expense ratio included in the fund's financial highlights table and the shareholder report expense example do not reflect AFFE. [93]

E. Investing Related Expense Disclosure

The Commission requests comment on how to improve disclosure of a fund's fees and expenses. We recommend that the Commission require funds to disclose investing related expenses (*i.e.*, interest expense and dividends paid on short sales) in the fund's SAI (similar to information about brokerage costs) and financial statements rather than in the fee table. Our recommendation would focus the fee table on a fund's recurring operating expenses.

Item 3 of Form N-1A currently requires funds to disclose interest expense and dividends paid on short sales in the "other expenses" line item in the fee table and instructs that the amount depicted should be the same as the amount shown as expenses in the fund's statement of operations.[94] While interest paid on borrowings and dividends paid on short sales must be reported as expenses in a fund's statement of operations,[95] they can be viewed as the cost of a specific investing strategy. Funds already fold other costs of investing into their net returns without explicitly recognizing them as expenses (*e.g.*, brokerage commissions). Given that interest and dividend expenses essentially are

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[92] *See, e.g.*, Definition of Eligible Portfolio Company under the Investment Company Act of 1940, SEC Release No. IC-28266 (May 15, 2008) at 21, available at https://www.sec.gov/rules/final/2008/ic-28266.pdf.

[93] *See* Form N-1A, Item 27(d)(1).

[94] *See* Item 3 of Form N-1A, Instruction 3(c)(i) ("include all expenses not otherwise disclosed in the table that are deducted from the [f]und's assets or charged to all shareholder accounts. The amount of expenses deducted from the [f]und's assets are the amounts shown as expenses in the [f]und's statement of operations … .").

[95] *See* Fin. Accounting Standards Bd. Accounting Standards Codification 946-220-45-3.

costs of investing, allowing funds to exclude them from the fund's expense ratio would be consistent with the treatment of other costs of investing. Excluding these expenses also would provide investors a more stable measure of ongoing operating expenses, because interest and dividend expenses can vary significantly over time, depending on market conditions. Also, including these expenses in the fee table focuses investors on costs of these investing strategies without providing appropriate context (*i.e.*, that the strategy may lead to higher net returns for the fund).

Accordingly, we believe that interest and dividend expenses should be included in the SAI and in the financial statements, as of the historical period in time during which those expenses were incurred, rather than in the fee table.[96]

Any concern that investors may not be aware of interest and dividend expenses can be alleviated with appropriate disclosure. The Commission has proposed, as part of its ETF rulemaking, that Item 3 of Form N-1A be amended "to require a statement that investors may be subject to other fees not reflected in the fee table, such as brokerage commissions and fees to financial intermediaries."[97] Consistent with this general approach to transaction expenses, similar narrative disclosure should suffice with respect to interest and dividend expenses.

VI. Risk Disclosure

The Commission points out that it requires funds to highlight the principal risks associated with an investment in the fund. For example, a small-cap fund would discuss market risk as a general risk of investing in stocks and the specific risks of investing in small capitalization companies.[98] The Commission asks how risk disclosure could be enhanced and suggests a number of possible ways, discussing standardized risk measures or risk ratings such as that required by Canadian securities regulators and the European Union, as well as quantitative measures of risk (such as historic volatility, standard deviation, Sharpe ratio).

We strongly oppose the Commission mandating standardized risk measures or ratings primarily because none of these return volatility risk measures, whether alone or together, fully captures "risk" for an investor. We should note that it is important to distinguish between risk information that is permitted and provided voluntarily by funds (and that is still subject to meeting a general standard of not being misleading) versus Commission-required information. The latter has the Commission's *de facto* imprimatur and holds special status and weight (especially if it were required to be presented as a graphic), and therefore runs the real risk of taking on a heightened, or even singular, level of importance to investors.[99]

[96] The expense ratio included in the financial highlights table pursuant to item 13 of Form N-1A would continue to be based on the fund's total expenses under GAAP and would reflect any interest or dividend expense.

[97] *See* Exchange-Traded Funds, SEC Release Nos. 33-10515; IC-33140 (June 28, 2018).

[98] Release at 40–43.

[99] We also remind the Commission to consider potential costs if funds had to purchase a rating or license the methodology to produce a risk measure.

Third-party vendors and funds themselves already provide a wide range of risk measures for investors to consider, independently or in conjunction with their financial advisers. Forcing a standardized risk measure upon funds and investors is bound to confuse investors and be misleading. In fact, many of the same kinds of issues that arise in seeking to create uniform liquidity bucket ratings across funds would arise here: despite apparent "standardization" across funds, risk ratings will undoubtedly differ across funds because of nuances in how funds actually perform the calculations. To avoid such issues, the Commission would have to be highly specific in determining how the risk measures or ratings would be calculated, which as we show in other jurisdictions has led to outcomes that are highly sensitive to new data, and that focus investors too heavily on a single, very specific type of risk, rather than the wide range of risks they actually face.

This is not the first time the Commission has explored risk-based measures for investment companies. In its concept release issued in 1995, the SEC requested comment on how to improve risk disclosure for investment companies.[100] The SEC noted in 1998 that "[c]omments submitted in response to the Commission's Risk Concept Release asserted that investors have too wide a range of investment goals and ideas of what 'risk' means to be well served by a single quantitative risk measure.[101] Nothing has changed that affects this observation. Commenters also identified the significant danger arguing that, if the Commission mandated a risk measure, investors might rely on it as a definitive standard—essentially a government-approved assessment of risk—despite the lack of agreement on how to singularly measure risk."[102]

The Commission revisited the topic in 2014. At that time, the Commission requested comments on requiring standardized risk measures for target date funds.[103] ICI again voiced concerns that requiring funds to report standardized risk measures could for a number of reasons be misleading and confusing for investors.[104]

Many of the concerns we identified in 2014 about standardized risk measures for target date funds apply to all funds, not just target date funds. The concerns we have voiced when the Commission has raised this idea remain equally valid today. We strongly urge the Commission not to create standardized risk measures or risk ratings for the following reasons:

- Risk is inherently complex and multi-faceted—there is no single agreed-upon standard measure of risk. Rather, there are a wide array of risk measures, any one of which might be most appropriate for a given investor at a given time depending on his or her circumstances.
- Requiring funds to provide a standardized risk measure could be misleading, even harmful, for investors. Although risk measures, such as return volatility risk or standard deviation,

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[100] *See* Improving Descriptions of Risk by Mutual Funds and Other Investment Companies, SEC Release Nos. 33-7153; 34-35546; IC-20974 (Mar. 29, 1995) (Risk Concept Release).

[101] *See* 1998 Release.

[102] *Id.*

[103] *See* Investment Company Advertising: Target Date Retirement Fund Names and Marketing, SEC Release Nos. 33-9570; 34-71861; IC-31004 (Apr. 3, 2014), available at https://www.sec.gov/rules/proposed/2014/33-9570.pdf.

[104] *See* Letter from Dorothy M. Donohue, Acting General Counsel, ICI, to Kevin M. O'Neill, Deputy Secretary, SEC, dated June 9, 2014 (ICI 2014 Comment Letter) available at https://www.ici.org/pdf/28186.pdf.

can help investors understand risks, simplistic depictions are likely to be harmful, rather than helpful, for investors.

- There are widely identified weaknesses of mandated risk measures including the limitations of historical data on which they are based, the challenges of applying such data to a particular portfolio, and the inability of data to account sufficiently for market events with no historical precedent.
- The experiences of the EU and Canada provide object lessons in the hazards of regulators mandating standardized risk measures or ratings.

Defining Risk. Risk is an exceptionally multi-faceted concept, depending among other things on an investor's perspective and circumstances. The variance in investment returns for an investment (*e.g.,* standard deviation, a measure of variability around an investment's average returns) provides one measure of risk. Another concept, beta, measures the sensitivity of the return on an investment (or fund) to market returns. In layman's terms, these measures focus on the likelihood that an investment will go up and down in value (in the case of beta, up or down in value relative to a benchmark). There are other related measures, such as the Sharpe ratio (which the Commission asks about), semi-variance, Treynor's ratio, Jenson's alpha, tracking error, skewness, kurtosis, upside capture, downside capture, information ratio, and "batting average,"[105] all of which are reported in well-known fund databases such as Morningstar.

None of these return volatility risk measures, however, whether alone or together, fully captures "risk," for an investor, nor provides a kind of timeless snapshot of volatility. Risks change over time. Investors generally, and those saving for the long-term especially, must consider and plan for a wide range of risks, including inflation risk (*i.e.,* the risk that the purchasing power of one's assets will erode over time), longevity risks (*i.e.,* the risk of outliving one's assets), downside risks (*i.e.,* the risk of large losses), risk of inappropriate asset allocation (*e.g.,* investing heavily in real estate stocks if one is a realtor), and point-in-time risk (*e.g.*, risk of large losses at a critical point in one's life, such as if one were to fall ill and incur heavy medical expenses).

We also remain very concerned that requiring standardized risk measures could encourage investors to misapply the measures or make inappropriate comparisons between types of funds. For example, as we noted in our 2014 letter, the risks that target date fund investors face are inadequately captured by standard deviation. In fact, with a target date fund, standard deviation would evolve, being higher early on when the fund holds a larger portion of its assets in stocks or commodities, and falling as the fund shifts its portfolio composition more toward fixed-income securities.

[105] Batting average is a measure of a manager's ability to consistently beat the market. It is calculated by dividing the number of months in which the manager beat or matched an index by the total number of months in the period. The analogy to baseball is appropriate. Baseball fans know that batting average is a very useful measure of a player's offensive ability. But other measures also are very useful, such as slugging percentage, on-base percentage, batting average with runners in scoring position, home runs, and so forth. The point is that, as with statistics in baseball, no one risk measure captures the range of outcomes or is necessarily "best."

Below, we discuss the risk measures identified in the Release.[106] We also discuss some of the criticisms expressed regarding the various "risk-based" ratings adopted in other jurisdictions. The clear lesson learned is that, although risk measures are useful when investors understand their limitations, simplistic presentations of risk measures raise real and significant concerns.

Standard Deviation. The Release mentions standard deviation as an example of a quantitative risk measure that might be helpful to fund investors. Standard deviation is a measure of variability around an investment's average returns. Standard deviation can be used to calculate the probability under certain circumstances and assumptions that a fund's returns will fall within a range of its average returns approximately two-thirds of the time.[107] While some investors no doubt find this measure useful, many investors are not likely to understand the measure or appreciate its limitations with respect to predictability and precision.[108] For instance, a fund that consistently loses 10 percent annually would have a standard deviation of zero. Investors might mistakenly interpret a fund that reports a standard deviation of zero as having no risk, even though the fund's consistently negative return would subject the investor to inferior investment outcomes.

There are several fundamental challenges to the quality of standard deviation-based measures. We offer four, all of which are based on the fact that standard deviations, when actually calculated, are necessarily based on a limited set of historical data.

A first challenge is for funds that do not have sufficient history to calculate standard deviation over the prescribed period (in the case of the EU, five years). In the few foreign jurisdictions that have had to tackle this challenge, funds with too little history must "synthesize" missing data which tends to reduce the fidelity of results.

A second challenge, which arises even for funds with adequate histories, is that the regulatory approach implicitly assumes that risk measures are consistent over time. For example, the assumption seems implicit that if Fund A has a higher risk measure than Fund B at a given point in time, it will have a higher risk measure in subsequent periods. In fact, because the standard deviation is estimated over a limited sample, this implicit assumption is almost guaranteed to be wrong.

A third challenge is that investors may not understand how frequently returns may fall outside (or inside) one standard deviation. They may not appreciate that this frequency can in fact depend on a

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[106] For a discussion of other potential measures of risk and their related limitations, *see* Letter from Paul Schott Stevens, General Counsel, ICI, to Jonathan G. Katz, Secretary, SEC, dated July 28, 1995, available at www.ici.org/pdf/7147.pdf. We believe that these measures of risk are susceptible to the same fundamental limitations as standard deviation, as discussed below. For a discussion of value at risk (VaR) and its limitations, *see* Andreas Krause, "Exploring the Limitations of Value at Risk: How Good Is It in Practice?" *The Journal of Risk Finance* (Winter 2003), available at http://www.gravitascapital.com/Research/Risk/ValueAtRisk/VAR%20Limitations%20in%20Practice%20feb03.pdf.

[107] For example, if the average annual return of a fund were 15 percent and the standard deviation were 12 percent, there would be about a two-thirds chance that the annual return would be between 3 percent and 27 percent. There would be about a one-third chance that the annual return would be outside of this range.

[108] Indeed, the validity of standard deviation rests upon various conditions being satisfied. These conditions include constancy of the standard deviation, which history has shown to be highly variable, and a normal distribution of the fund's returns, which is generally not the case.

range of factors such as market conditions, changes in fund holdings, and the correlations in returns of those holdings.

Finally, standard deviation-based measures may be procyclical. In low volatility periods these estimates decline broadly for investments and may underrepresent risks to investors. Conversely, following large market corrections, these measures may overrepresent risk over the prescribed period for which standard deviation must be calculated. For example, the standard deviation of stock fund returns for the three-year period ending January 2018 would have been optically low, especially in light of the jump in market volatility that occurred in February 2018.

Historic Volatility. The release also mentions “historic volatility” as a potential standardized risk measure. Market participants and financial professionals generally would consider standard deviation and historic volatility to be the same concepts, and thus would be subject to the same criticisms.

But the Commission may have in mind other measures of “historic volatility,” such as average absolute deviation of returns around median returns, the largest one-month change in a fund’s return, or perhaps a fund’s tracking error. Whatever the case, these measures all would be backward-looking, and thus risk conveying to investors a prediction about the likely variability of future returns.

Sharpe ratio. The release also mentions Sharpe ratio as a possible standardized risk measure. The Sharpe ratio is calculated as the ratio of a fund’s average historical return relative to the risk-free return, all divided by the historical standard deviation of the fund’s return. A fund with a higher Sharpe ratio has a higher excess return per unit of risk.

The Sharpe ratio is a well-established tool for fund investors. But it is less a “risk measure” than a measure of risk-adjusted returns. All else equal, investors prefer funds with higher Sharpe ratios. But a fund with a high Sharpe ratio still may have a highly variable return (if it also has a high return to compensate for the extra variability). As a result, some investors might not recognize that a fund with a high Sharpe ratio could be quite “risky” in terms of return variability. Moreover, the Sharpe ratio can change not just because of a fund’s returns and return variability, but also because of the risk-free interest rate, which is itself procyclical. The Sharpe ratio, like standard deviation, is a backward-looking measure and may vary across market cycles. In short, although a useful tool for investors, the Sharpe ratio, as a standardized risk measure offers no clear advantage to standard deviation or other common risk measures (*e.g.,* beta or information ratio), but encompasses the limitations of other similar measures.

Other jurisdictions’ experiences with visual risk measures. The Commission asks whether visual presentations of risks could assist investors, pointing to the 5-point scale (Low, Low to Medium, Medium, Medium to High, and High) required for funds in Canada, and the 7-point scale required by the EU. Appendix D describes these approaches in some detail and gives examples of how they may confuse or mislead investors.

Although the desire of regulators to create standardized and easy-to-understand risk measures for investors is understandable, in practice mandated risk rating systems suffer from a range of problems. They tend to be opaque; risk misleading investors; are highly sensitive to fund returns;

may be based on highly prescriptive and rigid regulatory approaches for calculating risk ratings; and can lead to unusual outcomes despite good intentions.

Risk rating approaches are at root bucketing systems. The regulator selects one particular measure of fund risk, such as return volatility. Funds are required to calculate that risk measure, typically based on some window of historical data. Given the calculated risk measure, the regulator specifies a system for bucketing the risk measure into one of several categories (*e.g.*, 1 to 7). This approach introduces a number of fundamental and serious drawbacks.

One issue is that buckets are sharply delineated while risk measures (*e.g.*, standard deviation) are not. This risks giving investors false impressions about the variability of the fund's returns. Consider a risk rating system where the regulator has classified funds with return volatility of under 0.50 percent annually as in the lowest risk bucket (a rating of "1"). Suppose the next risk category (a risk rating of "2") captures funds with annual return variability 0.5 percent to under 5 percent. Now consider two funds. Funds A and B have historical return volatilities of 0.494 percent and 0.501 percent, respectively. Although the two funds have essentially identical variability based on history, Fund A receives a lower risk rating than Fund B (*i.e.*, 1 compared to 2). Moreover, Fund B is lumped into a risk rating category that includes funds (*e.g.*, Fund C) that have much more volatile returns, up to nearly 5 percent. In short, the risk rating approach conveys the misimpression that two funds (A and B) with very similar risk profiles are quite different, and that two funds with very dissimilar risk profiles (B and C) are very similar.

A related issue is that risk ratings for individual funds are likely to be highly sensitive to new data. For example, suppose over the next year the return of Fund B is slightly more stable than in the recent past. Its measured return volatility falls from 0.501 percent to 0.494 percent, causing its risk rating to fall from 2 to 1.

Another issue is that choice of the risk measure, which is arbitrary, must be selected or defined by the regulator, introducing subjectivity. Flaws in one risk measure may become apparent, tempting the regulator to change the approach in favor of a different risk measure, or perhaps changing the period of time for which the measure must be calculated (*e.g.*, shifting from a 3-year data window to a 5-year data window). If that happens, the risk rating of a particular fund could swing dramatically, jumping from a lower to higher risk bucket (or vice-versa), thus confusing investors.

The risk ratings for funds and their underlying methodologies mandated in the EU and Canada have many of the same flaws that affect risk measures generally, and exhibit the drawbacks just described, which are inherent in risk rating systems. In fact, a review of these risk rating systems and the criticisms they have drawn readily illuminates the pitfalls of attempting to identify and measure risk by using standardized numerical scores or labels. These risk rating systems are not appropriate for US-registered funds generally and would not be in the best interests of investors.

For instance, in 2009, the Committee of European Securities Regulators (CESR) required all UCITS funds to include the Synthetic Risk and Reward Indicator (SRRI) in certain fund documents made available at the time of purchase.[109] This measure ranges from 1 to 7, with 1 being the lowest risk/reward category and 7 the highest. Commentators expressed numerous concerns with the SRRI, including, for example, that different sources of risk are not captured by the measure;[110] that risk ratings may cause investors to place too much emphasis on volatility and forego the opportunity to benefit from higher returns;[111] and that, because similar types of funds tend to fall within just a couple of the risk categories (*i.e.*, "crowding"), the benefits of these comparative scores are limited.[112] In Hong Kong, fund risk indicators are not permitted in a fund's Key Facts Statement (KFS), which must follow a specific template.[113]

In an effort to correct these shortcomings, the European Securities Market Authority (ESMA), the successor to CESR, in 2016 revised how funds must calculate the 7-point scale, naming the new scale "Summary Risk Index" (SRI). The SRI is currently applied to PRIIPs products but is also slated to be applied to UCITS at the end of 2019. These changes, if in fact applied to UCITS, may simply compound the problems inherent in the earlier SRRI measure. For example, as Appendix D explains, the new SRI is complex, requiring calculations that are all but certain to be opaque and confusing to almost all investors. In fact, the calculations are in some cases so complex (involving highly specified synthetic data procedures that embed a statistical approach known as Principal Component Analyses, Monte Carlo simulations, and other complicated statistical procedures), that funds may turn to third-party vendors for assistance adding unnecessary costs for fund investors.

Canada requires fund managers to provide risk ratings (based on a 5-level scale ranging from "Low" to "High") for mutual funds. As Appendix D describes, Canada's risk rating approach,

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[109] *See* CESR, Annex to CESR's technical advice on the level 2 measures related to the format and content of Key Information Document disclosures for UCITS (Ref. CESR/09-949); methodology for the calculation of the synthetic risk and reward indicator" (Dec. 2009 Ref: CESR/09-1026), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/09_1026_final_kid_srri_methodology_for_publication.pdf.

[110] Paul D. Kaplan, PhD, Quantitative Research Director, Morningstar Europe, Ltd., What the Synthetic Risk Reward Indicator Doesn't Indicate About Risk or Reward (2011).

[111] Alex Hoctor-Duncan, Head of Retail in Europe, the Middle East and Africa for BlackRock, Crouching Tiger Hidden Danger, Strategic Solutions Magazine Q1-2 2012 issue.

[112] Ed Moisson, Head of UK & Cross-Border Research, Lipper, and Kevin Pollard, Research Analyst, Methodology, Lipper, SRRI European Overview (May 2012).

[113] *See* Hong Kong Securities and Futures Commission (SFC), Products Key Facts Statements, available at https://www.sfc.hk/web/EN/regulatory-functions/products/list-of-publicly-offered-investment-products/products-key-facts-statements.html. We note that in the case of UCITS distributed in Hong Kong that the UCITS key investor information document (or KIID, which includes a fund risk indicator) is not part of a Hong Kong fund's offering documents and not applicable to Hong Kong investors. To the extent a fund wants to provide a risk indicator in other materials, the materials would have to comply with the SFC's advertising guidelines. *See* SFC, Advertising Guidelines Applicable to Collective Investment Schemes Authorized under the Product Codes, available at https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/advertising-guidelines-applicable-to-collective-investment-schemes/Advertising%20Guidelines%20%20Applicable%20to%20Collective%20Investment%20Schemes%20Authorized%20under%20the%20Product%20Codes.pdf.

although much less complicated than the EU approach, may still be highly sensitive to either of a fund's most recent or more distant past returns, with funds potentially jumping between risk rating categories simply because a new month of data has been added to the calculation or an old month of data dropped.[114] In effect, by bucketing funds' return variabilities into five discrete categories, the regulator has created a system of knife-edges, where funds may jump from bucket to bucket on very small changes in their return profiles, rather than because of substantive changes in funds' risk profiles. Like the EU approach, the Canadian approach also lumps together in the highest risk rating category (category 5 in Canada's case) funds that have extremely different return variability profiles.

Despite these well-known problems, other countries have mandated standard risk ratings and suffered similar criticism. For example, Australia uses a Standard Risk Measure (SRM), based on a 7-level classification system, with risk labels ranging from "Very Low" to "Very High" for Australian superannuation funds.[115] Among other things, commentators have expressed concern that the SRM treats as the same any negative return regardless of magnitude, uses a subjective methodology, and creates an incentive to adopt a methodology resulting in a lower risk score.[116]

As noted earlier, this is not the first time the Commission has considered fund disclosure of a risk metric. When the Commission issued its 1995 Risk Concept Release, it received over 3,700 comment letters in response. After considering these comments, the Commission ultimately concluded that "commenters did not broadly support any one risk measure, and the Commission acknowledged that investors have a wide range of ideas of what 'risk' means." It then proposed that a fund's prospectus include a bar chart showing the fund's annual returns for 10 calendar years, and noted that over 75 percent of individual investors responding to the Risk Concept Release favored a bar chart presentation of fund risks.[117] The Commission subsequently adopted the bar chart requirement, which was intended to illustrate graphically the variability of a fund's returns and thus provide investors with some idea of the risk of an investment in the fund.[118] In addition, each fund must disclose its best and worst returns for a quarter during the 10-year period to make investors aware that fund shares may experience fluctuations over shorter periods in a straightforward manner.

We therefore do not support the Commission mandating a risk rating or measurement.

[114] *See* Canadian Securities Administrators (CSA) Notice 81-324 and Request for Comment—Proposed CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts.

[115] *See* ICI 2014 Comment Letter.

[116] *See* David Bell, "Is APRA's Standard Risk Measure Helpful?" Cuffelinks (Feb. 20, 2013), available at https://cuffelinks.com.au/is-apras-standard-risk-measure-helpful/.

[117] *See* Registration Form Used by Open-End Management Investment Companies, SEC Release Nos. 33-7398; 34-38436; IC-22528 (Feb. 27, 1997).

[118] *See* 1998 Release.

VII. Performance

The Commission requests comment on a number of issues related to funds' presentation of performance. We recommend below that:

- funds continue to be required to provide short-term performance along with medium-term and long-term performance;
- funds not be required to disclose how they determined that their benchmark is an appropriate broad-based securities market index;
- the Commission or its staff consider providing the industry with more clarity around their views on what constitutes an appropriate broad-based securities market index;
- the Commission consider permitting funds to use an index other than a broad-based securities market index as its primary benchmark;
- the Commission retain the current disclosure requirements related to portfolio managers; and
- the Commission not require funds to disclose comparisons of their fees or performance to other unaffiliated funds.

The Commission states that investors should consider performance information in light of a number of other factors and asks whether short-term performance periods (such as one-year) should be deemphasized and longer-term performance periods should be emphasized. The Commission currently requires the right mix of fund performance information for investors. Giving investors relevant information for short-, medium-, and long-term time periods allows them to choose which time period(s) is most relevant for them. Therefore, we do not believe short-term performance should be deemphasized. It should be provided along with medium and long-term performance to allow the investor to see how the fund performs over different time periods and the volatility in performance over that period.

Indeed, ICI's mid-2017 survey of mutual fund–owning households finds that more than nine out of ten mutual fund–owning households review historical performance when selecting a mutual fund, with half indicating the fund's historical performance was "very important" in their purchase decision (*see* Figure 5, *supra*). Almost nine out of ten mutual fund–owning households indicated they reviewed the fund's performance compared with an index.

The Commission notes that the performance table in the Risk/Return Summary must show the returns of an appropriate broad-based securities market index in addition to the performance of the fund. It then asks whether funds should disclose how they determined that their benchmark is an appropriate broad-based benchmark. Such a requirement would generate technical, boilerplate disclosure that investors would not find useful and therefore we do not support the Commission requiring funds to provide this information. In fact, this seems inconsistent with the Commission's goal to provide investors with clear and concise disclosure.[119]

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[119] We request that the Commission consider the continued appropriateness of requiring all funds to disclose returns of an appropriate broad-based securities market index as its primary benchmark. In the case of a sector-specific fund, permitting the fund to compare its performance to a sector-specific benchmark as its *primary* benchmark may convey a

In addition, Commission staff typically ask funds in the disclosure review process the basis for determining that an index other than the S&P 500 index is "broad-based." To streamline the disclosure process and limit these individual determinations and discussions, we recommend that the Commission/staff consider providing more clarity around their views on what constitutes an appropriate broad-based index. Relevant Commission statements indicate that the S&P 500 index is not the exclusive broad-based index. Rather, "a broad-based index is one that provides with a performance indicator of the overall *applicable* stock or bond markets, as appropriate" (emphasis added). In contrast, "[a]n index would not be considered to be broad-based if it is composed of securities of firms in a particular industry or group of related industries." [120] In particular, the Commission/staff should make what factors a fund should consider in determining what constitutes an applicable market—but must not, in doing so, drive funds to using a particular index provider.[121] We also ask the Commission to be mindful of, and sensitive to, the fees and costs associated with including this information in a fund's prospectus.

The Commission states that the investment decisions and trading strategies of a fund's portfolio manager(s) often drive fund performance and asks whether the current information about fund portfolio managers is sufficient, including disclosure regarding portfolio management teams. We believe the current disclosure requirements provide adequate information about portfolio managers.

The Commission requests comment on whether investors would prefer a graphical representation of fees like a fee meter (which is a graphic that shows how a fund's fees compares to other funds). Similarly, the Commission requests comment on whether investors would find useful a comparison between the fund's performance and that of a peer group of funds or to all funds with a similar investment strategy. The Commission also asks how it should define "peer group" to permit meaningful comparisons if it takes such an approach.

We adamantly oppose requiring a fund to provide comparisons its performance or fees to other unaffiliated funds. It is inappropriate, unnecessary, and unduly burdensome to impose such a requirement on each fund. How exactly would this work from a fund's perspective? Among other concerns, funds would have to assure themselves of the accuracy of another funds' performance and/or fees for disclosure purposes. There are obvious difficulties in determining appropriate "peer groups." What if unaffiliated funds objected to inclusion? The potential for liability that would accompany this type of presentation is high (and certain). Further, why should a fund's shareholders

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more apt comparison. Similarly, investors in multi-asset funds might find a comparison to a blended benchmark (e.g., 60 percent S&P 500 Index and 40 percent Bloomberg US Aggregate Bond Market Index) more useful than a comparison to a broad-based securities market index. The Commission therefore should consider providing funds with more flexibility to choose their primary benchmarks.

[120] *See* Disclosure of Mutual Fund Performance and Portfolio Managers, SEC Release Nos. 33-6988; IC-19382 (Apr. 6, 1993), available at https://www.sec.gov/rules/final/33-6988.pdf (where the Commission stated that "Item 5A(b) requires that a broad-based securities market index, *such as* the S&P 500, the Nikkei Index, or the Lehman Corporate Bond Index be used…" (emphasis added).

[121] Our recommended approach would be consistent with past Commission statements. *See* 1998 Release (where the Commission stated that the purpose of including return information for a broad-based securities market index was to provide investors with a basis for evaluating a fund's performance and risks relative to the market).

be responsible for paying for this disclosure? A fund's disclosure documents are designed to provide shareholders and investors with information about the fund, not other funds.

Further, third party vendors now track and aggregate data on thousands of mutual funds and organize and make this data available for public consumption.[122] Intermediaries provide this type of information and fund comparison tools. Investors are able to use this information to easily compare fund fees and performance (as well as other information about funds).

We therefore strongly urge the Commission to not consider requiring funds to compare their fees or performance with unaffiliated funds.

VIII. Management's Discussion of Fund Performance

The Commission asks a series of questions on how it might improve the MDFP.[123] In response, we recommend that:

- funds be permitted, but not required, to link the MDFP to an on-line video presentation;
- funds be required to include in semi-annual shareholder report's MDFP the 1-, 5-, and 10-year average annual return for the fund and its benchmark; and be permitted, but *not* required, to include the portfolio manager commentary and line graph in the semi-annual shareholder report; and
- the Commission continue to provide funds with flexibility to explain factors that materially affected their performance.

The Commission requests comment on how to improve the MDFP requirements, including for example, by linking the section to an online video presentation. The SEC should not dictate this, but rather permit funds to choose whether or not to link to an online video presentation. Our members are concerned that complying with such a requirement will be expensive both in the first instance and on an ongoing basis to keep it up-to-date. Designing, enhancing, and updating fund websites is expensive and decisions regarding them, including style and forms of presentation are best left with the funds who are often in contact with investors and others.

The Commission also notes that funds must include the MDFP in annual shareholder reports and asks if it also should be required in semi-annual reports. We understand that some funds voluntarily include a MDFP in semi-annual shareholder reports but others do not. This is an appropriate

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[122] In fact, the Commission recently took action to facilitate third-party aggregators' access to information even though it imposed additional costs on funds. *See* Inline XBRL Filing of Tagged Data, SEC Release Nos. 33-10514; 34-83551; and IC-33139 (June 28, 2018), available at https://www.sec.gov/rules/final/2018/33-10514.pdf. Moreover, when the Commission began requiring funds to tag risk/return information in XBRL, it was for the purpose of allowing investors to more easily compare funds to each other, not for funds to start pulling this information for other fund and disclosing the results of comparisons to investors.

[123] This is a section of a mutual fund or ETF's annual report in which fund managers discuss the factors, such as market conditions and investment strategies, that materially affected the fund's performance during its most recently completed fiscal year. Unlike the prospectus, which focuses on how a fund intends to invest, the MDFP describes how the fund actually invested in the prior year and why it performed as it did.

approach, and we are unaware of investors asking for this information to be included in semi-annual shareholder reports. As explained in Section I of this letter, members believe the performance commentary annual production schedule remains appropriate, given that drafting this disclosure requires significant time and effort of the fund's portfolio manager.

The Commission asks if the MDFP requirements should be in a standardized format, such as Q&A. The MDFP is a qualitative, subjective discussion of the investment operations and performance of a mutual fund that simply does not lend itself to standardization and it should not be forced.[124] It is important for funds to have the flexibility to explain factors that materially affected the fund's performance during the most recently completed fiscal year in order to generate meaningful disclosure. Therefore, the Commission should not require MDFPs to be standardized. For similar reasons, there should not be special requirements for different types of funds.[125] The current general directive provides funds, whatever their style, with the necessary and important flexibility to explain why the specific fund performed as it did over the relevant period.

IX. Fund Advertisements

The Commission asks a series of questions on how it might improve fund advertisements. In general, we believe that the Commission's current regulatory framework for advertisements works well and strikes an appropriate balance by allowing funds to provide useful information that is not misleading, yet is abbreviated, as compared to other fund regulatory documents. We explain:

- that it is unnecessary to enhance disclosure to better distinguish advertisements and prospectuses;
- there is no need to change requirements for risk and return disclosure;
- it is unnecessary to require new disclosures depending on fund type; and
- the Commission should incorporate changes that leverage technology to improve disclosure.

In addition, we identify four initiatives that the Commission could pursue to further promote an enhanced investor experience and more informed decision-making. We recommend that the Commission:

- encourage FINRA to permit broker-dealers to provide retail investors with "related performance information;"
- modernize the testimonial rule under the Investment Advisers Act and/or related guidance, to facilitate advisers' and funds' use of social media to communicate with investors;
- allow funds and advisers to calibrate the information provided in advertisements depending on the audience, recognizing that the information needs of retail and institutional investors differ; and

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[124] In particular, funds are required to discuss the factors that materially affected the fund's performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the fund's investment adviser.

[125] *See* Release at 53 (Question 96. Should there be special requirements for different types of funds?).

- encourage FINRA to amend FINRA Rule 2210 to permit streamlined expense information in fund advertisements.

A. The Current Regulatory Framework for Advertisements Works Well

It is not necessary for the Commission to amend its advertising rules to enhance disclosure to better distinguish advertisements and prospectuses. Rule 482 already requires fund advertisements to do so. Advertisements must alert investors to a source for obtaining a prospectus, must highlight the important information that prospectuses contain (*e.g.*, information about investment objectives, risks, and charges and expenses), and must advise the investor to read it carefully before investing.[126]

It also is unnecessary for the Commission to alter requirements for risk and return disclosure. To comply with Commission and FINRA requirements that advertisements not be misleading, funds include risk disclosures in advertisements. This general requirement is sufficient, and we urge the Commission not to require advertisements to include overly detailed or exhaustive risk disclosures. The prospectus (to which advertisements direct investors) is the proper location for fulsome risk disclosure. Lengthy risk disclosure would undermine the utility of advertisements for both investors (who may view lengthy risk disclosure as "boilerplate" to be skipped) and funds (which, depending on the medium, face space constraints in designing their advertisements). The existing regulatory framework rightly recognizes the different purposes of prospectuses and advertisements. Neither the Commission nor investors should view advertisements as "mini prospectuses" (or try to force them into such documents).

Moreover, fund investors receive or have ready access to a considerable amount of information from sources other than marketing materials, including prospectuses, shareholder reports, SAIs, and, soon, quarterly information contained in Form N-PORT filings. Advertisements are only one source of investor information, and should be viewed in the context of this larger mix of information. Given advances in technology, it is easier than ever for investors to access and review these other information sources. Finally, funds already are subject to strict, prescriptive rules regarding presentation of performance, or return, information.[127]

The Commission also should not amend the advertising rules to mandate new disclosures depending on fund type. The rules' principles-based requirements are preferable and "right-sized" for their purpose. They allow funds to respond to market demands and enable design of these documents with the information that investors need and seek in an advertisement.[128] If the Commission tried to

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[126] Rule 482(b)(1) under the Securities Act.

[127] Rule 482 under the Securities Act and Rule 34b-1 under the Investment Company Act contain detailed requirements for advertisements and sales literature that contain performance data; and FINRA Rule 2210 requires that advertisements containing performance data include and follow detailed fee, expense, and performance disclosure

[128] For instance, Rule 156 (Investment Company Sales Literature) under the Securities Act prohibits the use of sales literature that is materially misleading, *i.e.*, (i) contains an untrue statement of a material fact, or (ii) omits to state a material fact necessary in order to make a statement made, in the light of the circumstances of its use, not misleading.

identify a list of particular risks by fund type, it could become outdated and inappropriately lengthen advertisements with disclosure likely to be boilerplate, and thus less useful.

Finally, the Commission should continue to embrace technology and incorporate concepts such as layering (which include linking to more complete disclosures), incorporation by reference, and summary information into the advertising rules and, or its interpretations of them.

B. Encourage FINRA to Permit Funds to Provide Retail Investors with Related Performance Information

The Commission should encourage FINRA to permit funds to present related performance information in advertisements and sales literature. This would align FINRA's guidance with Commission staff guidance and allow funds to provide relevant information to retail investors.

Because of how fund shares are typically offered, fund advertisements are generally subject to both Commission and FINRA rules and guidance. In certain respects, the Commission staff's interpretations of its rules and guidance applicable to funds and advisers deviate from those of FINRA staff applicable to funds and broker-dealers. For instance, Commission staff conditionally permits a fund to include "related performance information" (*i.e.*, actual performance of all separate accounts and/or funds that have investment objectives, policies, and strategies substantially similar to those of the fund) in their prospectuses, SAIs, advertisements, and supplemental sales literature.[129] While in recent years FINRA staff has shown greater openness to funds' use of related performance in *institutional communications*, they prohibit the presentation of related performance information in communications used with retail investors, stating that it generally does not comply with FINRA Rule 2210(d).[130]

While a fund's *own* performance information is generally most germane to investors, certain related performance information also may be useful and relevant to institutional *and* retail investors as they evaluate funds. This is particularly true of funds with relatively short (or no) performance track records. To the extent that the adviser has managed similar funds and accounts with track records longer than that of the fund, that related performance information may provide an indication of the adviser's performance in a more diverse set of market conditions and over a longer period. The Commission staff rightly permits (rather than requires) this disclosure, subject to several conditions designed to put this information in proper context and ensure that it is not misleading. The Commission staff's guidance in this area is well-developed and properly oriented towards protecting investors. FINRA simply could adopt the Commission staff's guidance as its own, thereby allowing funds to provide retail investors with valuable information and streamlining the disparate internal compliance review procedures that many large complexes currently must employ.

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[129] *See, e.g.,* Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests, SEC Division of Investment Management Guidance Update 2013-05 (August 2013), *available at* www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf.

[130] Interpretive letter from Joseph P. Savage, FINRA to Joan E. Boros, Esq., Stradley Ronon Stevens & Young, LLP (April 16, 2018), available at www.finra.org/industry/interpretive-letters/april-16-2018-1200am.

C. Modernize Testimonial Rule to Facilitate Advisers' and Funds' Use of Social Media

The Commission should modernize Advisers Act Rule 206(4)-1(a)(1), referred to as the "testimonial rule," which contains a blanket prohibition on adviser advertisements that "refer[], directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser… ." This rule is horribly outdated, having been adopted more than 50 years ago, in 1961, and remaining unchanged since then.

As a general matter, we believe the policy of treating all testimonials as *per se* fraudulent is unnecessarily broad. While a *particular* testimonial certainly could be fraudulent (depending on the facts), this categorical treatment is unwarranted. Testimonials could very well be presented in a fair and balanced way that is not misleading, and convey useful information to investors. The Commission therefore should regulate testimonials by generally prohibiting untrue statements of a material fact or otherwise false or misleading statements. The recommended approach would place testimonials on par with other adviser disclosures in advertisements.[131] Advisers and funds are accustomed to applying these principles to disclosures generally, and this provision would suffice for policing the appropriateness of testimonials. If the SEC wishes to retain testimonial-specific provisions in the rule, we recommend that the SEC follow FINRA's permissive disclosure-based approach, which requires communications to alert investors to the limits of testimonials and whether fees in excess of $100 have been paid for the testimonial.[132]

The testimonial rule's severe limitations are particularly problematic in the context of social media. While "likes" are a common feature of the social media landscape, depending on the web of circumstances, "liking" an adviser's content could violate the rule. For instance, if an investment adviser representative on a social media platform links to an article unrelated to the investment adviser's products or services, and an unrelated person "likes" that content, one arguably could construe this as an impermissible testimonial. And while the rule ostensibly applies to testimonials about an *adviser*, there is some question whether regulators view endorsements or favorable opinions about a fund as also indirect endorsements of the fund's adviser. These types of attenuated and unsolicited third-party communications simply do not give rise to any legitimate policy concerns. The rule in its current form creates genuine communication barriers for advisers and funds and prevents them from engaging in ways in which *investors* are most comfortable.

We recognize that the staff has created carve-outs from the testimonial rule and has provided guidance regarding its connection to social media.[133] Still, the difficulty of applying this (often highly qualified) guidance to varied fact patterns and non-static forms of communication has proven

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[131] *See* Rule 206(4)-1(a)(5) under the Investment Advisers Act of 1940.

[132] FINRA Rule 2210(d)(6) permits testimonials, provided that (i) if any testimonial concerns a technical aspect of investing, the person making the testimonial must have the knowledge and experience to form a valid opinion, and (ii) retail communications or correspondence providing any testimonial must prominently disclose that the testimonial: may not be representative of the experience of other customers; is no guarantee of future performance or success; and more than $100 was paid for the testimonial, if applicable.

[133] *See, e.g.*, Guidance on the Testimonial Rule and Social Media, SEC Division of Investment Management Guidance Update 2014-04 (Mar. 2014), *available at* www.sec.gov/investment/im-guidance-2014-04.pdf.

challenging. The limited guidance, together with Commission's and staff's historically antithetical views towards testimonials, has caused advisers and funds to engage in this space, at most, in a limited and very tentative fashion.

We understand from the Commission's Fall 2018 regulatory flexibility agenda that the staff is considering recommending amendments to the rule "regarding marketing communications and practices by investment advisers." This is welcome news, and we strongly encourage the Commission to modernize these requirements in a way that both respects investor protection and reasonably allows advisers and funds to communicate with investors in their preferred channels.

D. Recognize the Differences Between Retail and Institutional Investors

Unlike the Commission's advertising rules' "one-size-fits-all" approach for funds and advisers, FINRA Rule 2210 distinguishes between "retail communications" and "institutional communications." More rigorous approval and review, filing, and content requirements apply to retail communications. We encourage the Commission and its staff to consider modifying Commission advertising rules and guidance to take a similar approach. For instance, in addition to its prohibition on testimonials, Rule 206(4)-1 severely limits advisers' ability to refer to past specific recommendations in advertisements. [134] We believe that presentations of past specific recommendations outside the rule's scope could be useful to institutional investors in particular, providing a more nuanced picture of the types of investments that advisers acquire for their clients and the process underlying their selection.[135] Discrete examples of an adviser's recommended investments may provide a valuable and understandable complement to more general information about an adviser's investment philosophy or strategies, or comprehensive lists of recommended investments.

Commission and staff could communicate through guidance that the manner in which funds and advisers fulfill their responsibilities under these Commission rules can take into account the audience, and the disclosures and protections that are necessary and appropriate for retail investors may not be so for institutional investors, depending on the facts and circumstances.[136]

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[134] Rule 206(4)-1(a)(2) permits inclusion of past specific recommendations in advertisements if they list *all* of the adviser's recommendations made within at least the prior one-year period and include certain specified information.

[135] We also believe that past specific recommendation information could be useful to retail investors. We acknowledge, however, that differences in presentation and disclosure could be appropriate for advertisements directed to retail investors, given that they may be less sophisticated than institutional investors.

[136] *See, e.g.*, SEC No-Action Letter to ICI (pub. avail. Sept. 23, 1988) (permitting advisers to provide certain prospective clients (*e.g.*, wealthy individuals, pension funds, universities and other institutions with sufficient assets) performance results for advisory accounts on a gross basis in a one-on-one presentation, and to consultants, subject to several conditions).

E. Encourage FINRA to Amend Rule 2210 to Streamline Expense Disclosure

Under FINRA Rule 2210(d)(5), retail communications and correspondence that present fund performance data must include, among other things, the fund's total annual fund operating expense ratio, gross of any fee waivers or expense reimbursements, as stated in the fee table of the fund's current prospectus. The SEC's Form N-1A in turn includes detailed requirements regarding how a fund must disclose annual fund operating expenses in its prospectus, and the instructions permit the fund to disclose its expenses net of expense reimbursements and fee waivers.[137] We understand from members that FINRA permits including both gross and net expense ratio information to be included in fund advertisements, but insists on the inclusion of detailed information about expense reimbursements and fee waivers.[138]

We recommend that the Commission encourage FINRA to modify Rule 2210(d)(5) (or its interpretation thereof) to permit funds to remove this detailed disclosure about expense reimbursements and fee waivers from advertisements. While such disclosure may be necessary and appropriate for a fund prospectus, it does not follow that it is equally necessary and appropriate for a fund advertisement. As mentioned above, advertisements are not "mini prospectuses" and should not be counted on to convey the same amount of information to investors. Including both gross and net expense information in an advertisement signals that expense ratios are not fixed and could in fact rise above the net figure. Furthermore, the rule's requirement that advertisements include the expense ratio figures from the current prospectus ensures that the numbers will be subject to updating at least once each year. If FINRA wants to continue to require additional disclosure about expense reimbursements and fee waivers in advertisements, a short statement directing investors to the fund prospectus should suffice (*e.g.*, "See the fund prospectus for more expense reimbursements and fee waiver information.").

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[137] *See* Instruction 3(e) to Item 3 of Form N-1A. The instruction states, "If the Fund provides this disclosure, also disclose the period for which the expense reimbursement or fee waiver arrangement is expected to continue, including the expected termination date, and briefly describe who can terminate the arrangement and under what circumstances." Funds with expense reimbursements or fee waivers typically include this required information in a footnote to the fee table.

[138] *See* NASD Notice to Members 06-48 (September 2006), available at www.finra.org/sites/default/files/NoticeDocument/p017302.pdf (setting forth the expectation that a member that presents a subsidized expense ratio along with the gross expense ratio also disclose in the sales material whether the fee waivers or expense reimbursements were voluntary or mandated by contract, and the time period during which the fee waiver or expense reimbursement obligation, if any, remains in effect).

X. Closed-End Funds

The Commission asks several questions related to closed-end funds. We describe below that:

- it is unnecessary for the Commission to develop a summary prospectus for non-continuously offered closed-end funds;[139]
- the Commission could require closed-end funds to provide an MDFP and improve the presentation of performance in shareholder reports; and
- the Commission should modernize the delivery of Section 19(a) notices.

A. Permitting Closed-End Funds to Use a Summary Prospectus

Unlike mutual funds and ETFs, most closed-end funds do not offer their shares continuously, and therefore do not provide investors with prospectuses continuously. Closed-end funds provide prospectuses during their initial public offering (typically during the first 40 days of an offering).[140] The Commission adopted the summary prospectus rule, in part, to provide mutual fund investors with ready access to key fund information. Closed-end funds provide shareholders with key information in shareholder reports, which are provided to shareholders semi-annually. As discussed at length in Section I above, we recommend that closed-end funds be permitted to provide their investors with key, yet streamlined, information via a summary shareholder report. Given the prominent disclosure role that shareholder reports play for closed-end fund shareholders, the Commission would better serve closed-end fund investors by pursuing our recommended initiative than pursuing a summary prospectus.

B. Closed-End Funds Providing Investors with an MDFP and Improved Performance Presentation in Shareholder Reports

Many closed-end funds provide MDFP-type information in annual shareholder reports despite not being required to do so. Members report that they provide this information voluntarily to assist investors with understanding fund performance and market conditions over the report's period. We therefore would not object to the Commission requiring closed-end funds to provide MDFPs in annual full-length shareholder reports.

We support the Commission requiring closed-end funds to show performance information in annual and semi-annual full-length shareholder reports in the same chart and table format required for

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[139] While the large majority of closed-end funds would not use a summary prospectus for the reasons described below, the Commission could consider tailoring a summary prospectus for continuously offered closed-end funds that provide updated prospectuses to investors. The benefits associated with a mutual fund summary prospectus would be applicable equally to shareholders in continuously offered closed-end funds.

[140] Further, we understand that the Commission staff is working on recommending proposed rules that would permit closed-end funds, under certain conditions, to meet final prospectus delivery obligations by providing investors with access to the prospectus. If this rulemaking is completed, closed-end fund shareholders would not experience anywhere near the cost savings that mutual fund shareholders experience from funds using summary prospectuses. *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 509 (Parity for Closed-End Companies Regarding Offering and Proxy Rules) (2018).

mutual funds.[141] Investors generally prefer information presented in some type of graphical format. Further, if the Commission requires closed-end funds to show performance in a chart and table format, we recommend requiring that performance to be based on market price consistent with a closed-end fund's financial highlights.[142]

C. Modernize Delivery of Section 19(a) Notices

Many ICI members have expressed concerns with the costs to deliver Section 19(a) notices to fund shareholders. We describe below an alternative approach to delivery to reduce costs.

Section 19(a) of the Investment Company Act generally prohibits a fund from making a distribution from any source other than the fund's net income, unless that payment is accompanied by a written statement that adequately discloses the source or sources of the payment. Rule 19a-1 specifies the information required to be disclosed in the written statement (Rule 19a-1 Notice). Rule 19a-1(a) also states that every written statement "shall be made on a separate paper." The Division of Investment Management issued guidance in 2013, stating that:

> Notwithstanding the rule's provision referencing "a separate paper," the staff believes that electronic delivery of a Rule 19a-1 Notice, consistent with the Commission's guidance [on electronic delivery], would satisfy the purposes and policies underlying Rule 19a-1. Moreover, electronic delivery may be a more efficient, effective and timely means of providing fund shareholders with the required information.[143]

This means that funds may deliver a Rule 19a-1 Notice in the form of an e-mail to the fund shareholder containing the Rule 19a-1 Notice or a document link to the Rule 19a-1 Notice, provided the shareholder has consented to e-delivery. Despite the step the staff took to modernize delivery, members report that costs associated with producing and delivering paper Rule 19a-1 Notices still can exceed one million dollars annually.[144]

The objective of Section 19(a) can be achieved by requiring funds to disseminate information about the sources of distributions required by Rule 19a-1 on the fund's or an affiliate's website within a

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[141]*See* Section I.F.

[142] Instruction 13 to Form N-2 Item 4.1. Of course, a closed-end fund should have the option of also showing performance based on net asset values. *See* Section 1.F.

[143] *See* Shareholder Notices of the Sources of Distribution – Electronic Delivery, SEC Division of Investment Management Guidance Update No. 2013-11 (November 2013), available at https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-11.pdf. *See also* SEC No-Action Letter to ICI (pub. avail. July 22, 1996) (permitting funds to inform shareholders of the source(s) of distributions on, or together with, quarterly account statements if the distributions are automatically reinvested in fund shares or are directed to a bank or brokerage account or to a third party or on a check stub for funds that pay distributions by check). Members have informed us that, as a practical matter, only direct-sold, not broker-sold funds, can take advantage of the 1996 no-action relief. Brokerage account statements have limited space, and it would be a lengthy and challenging process with an uncertain outcome for funds to work with brokers to modify the format of their statements. It similarly would be difficult to convince brokers to mail a separate Section 19(a) Notice together with brokerage statements.

[144] The costs include printing, mailing, processing fees, and filing fees.

reasonable amount of time after a distribution is made. Under our recommended approach, funds would be required to inform shareholders that distribution source information is available on a particular website. Specifically, funds would be required to disclose in each annual and semi-annual shareholder report that the distribution source information required by Rule 19a-1 is available at a specified website address.

To afford shareholders adequate notice that distribution source information will be transitioned from paper delivery to the internet, the Commission could require a one-year transition period similar to that we recommend with respect to the notice of availability of prospectuses. For example, the Commission could require fund shareholder reports to disclose for a specified period that the distribution source information will be available on a website (rather than in paper) after a specified period.[145] Also consistent with Rule 30e-3, this manner of delivery would be optional so that funds could continue to email Rule 19a-1 Notices to shareholders that have consented to that manner of delivery. We recommend that funds also be required to keep their Section 19(a) Notices on the website for 24 months.[146]

XI. Opportunities for Ongoing Assessment of Disclosure Effectiveness

The Commission seeks comment on opportunities it should consider to assess disclosure effectiveness on an ongoing basis. The Release recites various possible approaches, including enhanced investor testing, pilot programs to test potential disclosure alternatives suggested by fund professionals or investor advocacy groups, and the use of roundtables or committees as formats to engage investors and market participants on fund disclosure matters.

We support the Commission exploring enhanced investor testing, pilot programs to test potential disclosure alternatives, and the use of roundtables or committees to engage investors and market participants on fund disclosure matters. Results from small samples are not as reliable as a broader national survey. We therefore caution the Commission not to give the same weight to such a non-representative exercise as it would give to a such a survey.

We do strongly urge the Commission to act quickly to permit funds to provide notices in lieu of summary or full prospectuses to those shareholders who choose this manner of delivery, following the Rule 30e-3 model. This is one place that the Commission could act quickly to develop a proposal.

[145] Unlike mutual fund shareholders, closed-end fund shareholders that purchase shares in the secondary market do not receive the fund’s prospectus upon or closely following investment. Therefore, closed-end funds would disclose the availability of 19(a) notices through shareholder reports.

[146] Commission exemptive orders that permit closed-end funds to utilize managed distribution plans often require that funds maintain Rule 19a-1 Notices on their website for at least 24 months. Rule 19a-1 Notices provide estimated information for shareholders. Once a calendar year is complete, however, information on an shareholder’s Form1099 DIV supersedes any estimated information reported on the Rule 19a-1 Notices. The Form 1099 information could be quite different from the estimates provided in the Rule 19a-1 Notices and could cause confusion and improper tax reporting from investors if they incorrectly utilize the information within the Rule 19a-1 Notices. This could be addressed by disclosing on the fund’s website the relationship between the 19a-1 Notice and the Form 1099.

We appreciate the opportunity to provide comments in response to the SEC's request for comment on enhancing fund disclosure to improve the investor experience and to help investors make more informed investment decisions. If you have any questions, please contact me at (202-326-5813 or solson@ici.org) or Dorothy Donohue, Deputy General Counsel–Securities Regulation at (202-218-3563 or ddonohue@ici.org), or Sarah Holden, Senior Director of Retirement and Investor Research at (202-326-5915 or sholden@ici.org).

Sincerely,

/s/ Susan Olson

Susan Olson
General Counsel

cc: The Honorable Jay Clayton
The Honorable Kara M. Stein
The Honorable Robert J. Jackson Jr.
The Honorable Hester M. Peirce
The Honorable Elad Roisman

Dalia Blass
Director, Division of Investment Management

Appendix A

ICI Summary Shareholder Report Prototype

ABC FUNDS

Summary Annual Shareholder Report

JUNE 30, 2017

ABC EQUITY FUND

INVESTOR CLASS (ABCIX)

CLASS A (ABCAX)

CLASS R (ABCRX)

This summary annual shareholder report contains important information about ABC Equity Fund, including performance, expenses, and portfolio holdings. You may want to review the fund's annual shareholder report which contains more detailed information about the fund's portfolio holdings, financial statements, and other items.

You can obtain the fund's annual shareholder report online at **abcfunds.com** or by mail at no cost by calling **(800) 123-4567**. The fund's annual shareholder report for the period ended June 30, 2017 is incorporated by reference.

ABC Equity Fund

Summary Annual Shareholder Report

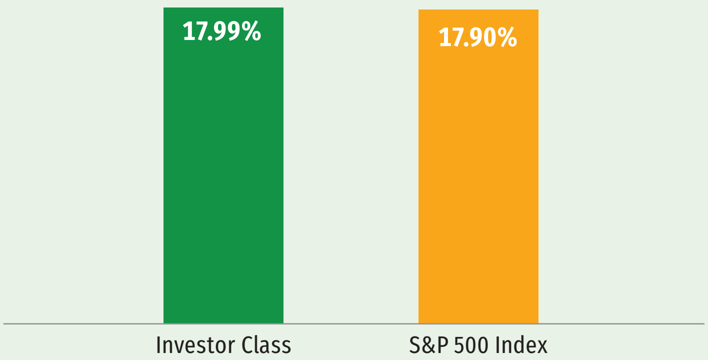
JUNE 30, 2017

PERFORMANCE HIGHLIGHTS

- The combination of accelerating global growth and robust corporate earnings fueled substantial gains for equity markets in the annual period ended June 30, 2017.
- ABC Equity Fund Investor Class returned 17.99% during the period, compared with the 17.90% return of its benchmark, the S&P 500 Index.
- The fund's overweight positions in information technology and healthcare relative to the benchmark benefited fund performance. The fund's overweight positions in consumer discretionary detracted from fund performance.
- Leading individual contributors to fund performance included Alphabet, Microsoft, Intel and UnitedHealth Group.
- Among the largest detractors to fund performance were Nike, McDonalds, and Williams-Sonoma.

TOTAL RETURN[1] AND EXPENSES

Year Ended June 30, 2017



Expense Ratio[2] 0.67%

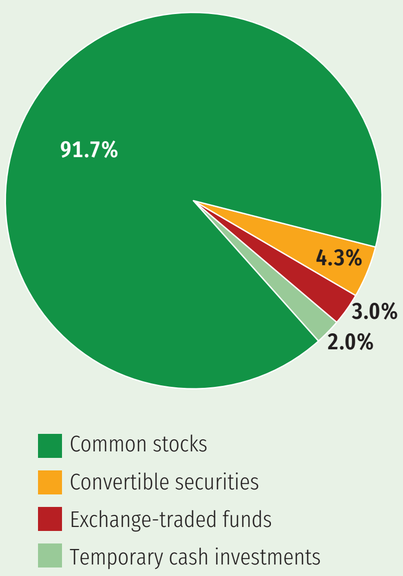
Performance and expense information for other share classes is available in the "Average Annual Compound Total Return" and "Fund Expense Example" tables below.

[1]Total return reflects the rate that an investor would have earned on an investment in the fund during each period, excluding the effects of any sales charges and assuming reinvestment of all distributions.

[2]The expense ratio is the annual percentage of average net assets used to pay fund expenses. The expense ratio reflects expense limitations, if any, and expenses may vary.

ASSET ALLOCATION

Percent of Net Assets, 6/30/17



INDUSTRY ALLOCATION

Percent of Net Assets, 6/30/17

Information technology	12.2%
Consumer discretionary	11.3
Biotechnology	10.4
Healthcare	9.5
Financials	8.6
Energy	7.8
Manufacturing	6.9
Consumer durables	5.2
Media and entertainment	4.3
Other	23.8
Total	**100.0%**

TEN LARGEST HOLDINGS

Percent of Net Assets, 6/30/17

Alphabet	3.3%
Apple	2.9
Microsoft	2.7
Amazon	2.6
Visa	2.3
UnitedHealth Group	2.1
Danaher	1.9
Intel	1.8
Cisco	1.7
Bank of America	1.4

AVERAGE ANNUAL COMPOUND TOTAL RETURN*

Period Ended June 30, 2017

	1 Year		5 Years		10 Years	
	without sales charge	with sales charge	without sales charge	with sales charge	without sales charge	with sales charge
Investor Class	17.99%	N/A	12.96%	N/A	6.22%	N/A
Class A	17.71	10.95%	12.68	11.35%	5.96	5.34%
Class R	17.37	N/A	12.39	N/A	5.69	N/A
S&P 500 Index	17.90	N/A	14.62	N/A	7.18	N/A

**Assumes reinvestment of all distributions and payment of the maximum applicable sales charge. Investment results reflect applicable fees and expenses. When applicable, investment results reflect expense waivers, without which results would have been lower.*

Returns do not reflect taxes that the shareholder may pay on fund distributions or the redemption of fund shares. Current performance may be higher or lower than the quoted past performance, which cannot guarantee future results. Updated performance information is available through abcfunds.com.

FUND EXPENSE EXAMPLE

The following example is intended to help you understand your ongoing costs (in dollars) of investing in the fund.[1] The example is based on an investment of $1,000 invested at the beginning of the most recent six-month period and held for the entire period.

	Beginning Account Value 1/01/17	Ending Account Value 6/30/17	Expenses Paid During Period[2] 1/01/17 to 6/30/17	Annualized Expense Ratio[3]
Investor Class	$1,000.00	$1,089.40	$3.47	0.67%
Class A (without sales charge)	1,000.00	1,088.20	4.76	0.92
Class R	1,000.00	1,086.60	6.05	1.17

[1] Expenses shown in the table highlight only ongoing costs and do not reflect any transaction costs, such as redemption fees or sales charges. To the extent a fund charges transaction costs, however, the total cost of owning that fund is higher.

[2] Expenses are equal to the class's annualized expense ratio for the 6-month period, multiplied by the average account value over the period, multiplied by the number of days in the most recent fiscal half year (181), and divided by the days in the year (365) to reflect the half-year period.

[3] The expense ratio is the annual percentage of average net assets used to pay fund expenses. The expense ratio reflects expense limitations, if any, and expenses may vary.

Appendix B

Comparison of Summary Shareholder Report to Current Shareholder Report Requirements

Summary Shareholder Report Content

1. **Cover Sheet with Legend**
    a. The summary report prototype includes a cover sheet with a catch-all legend, based on the summary prospectus legend, that points investors to the full report online. There is no comparable requirement currently for shareholder reports.
2. **Performance Highlights**—Form N-1A Item 27(b)(7)(i)
    a. Current requirement
        i. Discuss the factors that materially affected the fund's performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the fund's investment adviser.
        ii. Required only in the annual report, not in the semi-annual report.
    b. Summary report
        i. Includes a short summary of performance highlights, rather than the full discussion of performance, investment strategies, and techniques.
        ii. Includes those performance highlights only in the summary annual report.
3. **Total Return and Expense Ratio, Based on Financial Highlights**—Form N-1A Item 27(b)(2)
    a. Current requirement
        i. Provide information for the last 5 fiscal years of the fund ("per share" table): NAV at beginning and end of period, per share operating performance, net assets at end of period, ratio of expenses to average net assets, ratio of net income to average net assets, portfolio turnover rate, and total return.
        ii. Required in both the annual and semi-annual report.
    b. Summary report
        i. Includes only total return for most recent fiscal period and expense ratio in a bar chart, using only one share class in this chart—the same class that the fund selects for the summary prospectus's bar chart of annual total returns (per Form N-1A Item 4(b)(2)).
        ii. Also includes total return of the same appropriate broad-based securities market index that the fund selects for the line graph of performance in the annual shareholder report's MDFP (per Form N-1A Item 27(b)(7)(ii)(a) and Instruction 5).
        iii. The fund additionally may include total return for a more narrowly based index that reflects the market sector in which the fund invests (in addition to

the required broad-based securities market index), if the fund includes that additional index in the line graph of performance in the annual shareholder report's MDFP (per Form N-1A Item 27(b)(7)(ii)(a) and Instruction 6).

iv. We did not include the other items in the financial highlights table (*i.e.*, NAV at beginning and end of period, per share operating performance, net assets at end of period, ratio of net income to average net assets, and portfolio turnover rate) because we concluded that the average investor is unlikely to understand them, and they will be available online for any investor who wants to view this information.

4. **Graphical Representation of Holdings**—Form N-1A Item 27(d)(3)

a. Current requirement

i. Provide one or more tables, charts, or graphs depicting the portfolio holdings of the fund by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic regions, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of the presentation should be formatted in a manner reasonably designed to depict clearly the types of investments made by the fund, given its investment objectives.

ii. Required in both the annual and semi-annual report.

b. Summary report

i. Maintains existing flexibility to provide graphical representations of holdings in forms such as a table showing top ten holdings, asset allocation, style/capitalization box, geographical concentration, sector diversification, credit rating, maturity, etc.

ii. The equity fund prototype's graphical representations of holdings consist of the tables and charts labeled "Asset Allocation," "Industry Allocation," and "Ten Largest Holdings."

5. **Average Annual Total Returns Table**—Form N-1A Item 27(b)(7)(ii)(B)

a. Current requirement

i. Provide table of returns for 1-, 5-, and 10-year periods (provided for each class in a multi-class fund).

ii. Required only in the annual report, not in the semi-annual report.

b. Summary report

i. Includes table of returns (with and without sales charge, as applicable) for 1-, 5-, and 10-year periods along with index performance for the same periods.

1. We recommend adding index performance because our prototype otherwise would not include index performance. The current shareholder report includes a line graph of performance compared to an index, but we do not recommend including this item, as we explain in Item 10 below.

ii. Includes this table in both the annual and semi-annual summary report.

6. **Expense Example**—Form N-1A Item 27(d)(1)
    a. Current requirement
        i. Using a hypothetical $1,000 account, show expenses paid for the most recent fiscal half-year using actual returns and a hypothetical 5% return.
        ii. Required in both the annual and semi-annual report.
    b. Summary report
        i. Shows expenses paid for the most recent fiscal half-year using actual returns only. Does not include expenses paid using a hypothetical 5% return.
        ii. Adds annualized expense ratio from Financial Highlights.
7. **Liquidity Risk Management Program Narrative Disclosure –** Form N-1A Item 27(d)(7)(b)
    a. Current requirement

        Discuss the operation and effectiveness of the fund's liquidity risk management program over the past year if the board of directors reviewed the fund's liquidity risk management program pursuant to the liquidity risk management rule.
    b. Summary report
        i. A fund would include this information if relevant. We did not include it in the prototype because this disclosure requirement is not yet effective and, therefore, we had no disclosure to model.
8. **Discussion of Effect of Any Stable Distribution Policy**—Form N-1A Item 27(b)(7)(iii)
    a. Current requirement
        i. Discuss the effect of any policy or practice of maintaining a specified level of distributions to shareholders on the fund's investment strategies and per share net asset value during the last fiscal year. Also discuss the extent to which the fund's distribution policy resulted in distributions of capital.
    b. Summary report
        i. A fund would include this information if relevant. We did not include it in the prototype because mutual funds do not typically have stable distribution policies. This disclosure is more common for closed-end funds.
9. **Changes in and Disagreements with Accountants**—Form N-1A Item 27(b)(4)
    a. Current requirement
        i. Disclose changes in and disagreements with accountants in annual and semi-annual reports.
    b. Summary report
        i. A fund would include this information in the summary report if there is a change in or disagreement with its accountants. Changes in and disagreements with accountants are not common, so we did not include this item in the prototype.

We do not recommend including the following shareholder report items in the summary report:

10. **Line Graph of Performance Compared to Index**—Form N-1A Item 27(b)(7)(ii)(A)
    a. Current requirement
        i. Assuming an initial $10,000 investment, provide a line graph showing the change in account value over 10 years as compared to a broad-based index (typically provided only for the largest class in a multi-class fund).
        ii. Required only in the annual report, not in the semi-annual report.
    b. Summary report
        i. We have concerns that the graph could look misleading when compressed into the limited space available in the summary report.
        ii. Our recommended summary report instead includes index returns in the table of returns for 1-, 5-, and 10- year periods.

We did not include the items listed below because we concluded that they were of a more technical nature that a typical retail investor would not read or understand. In addition, these items would be available online for those who wish to access the full shareholder report.

11. **Financial Statements (Auditor's Opinion)** —Form N-1A Item 27(b)(1)
12. **Remuneration Paid to Directors, Officers, and Others**—Form N-1A Item 27(b)(3)
13. **Management Information**—Form N-1A Item 27(b)(5)
    a. Requires name, address, age, principal occupation during last five years, etc. for the fund's directors and officers. This information also appears in the SAI.
14. **Statement about Availability of Additional Information about Fund Directors in the SAI**—Form N-1A Item 27(b)(6)
15. **Statement Regarding Availability of Quarterly Portfolio Schedule**—Form N-1A Item 27(d)(4)
16. **Statement Regarding Availability of Proxy Voting Policies and Procedures**—Form N-1A Item 27(d)(5)
17. **Statement Regarding Availability of Proxy Voting Record**—Form N-1A Item 27(d)(6)
18. **Statement Regarding Basis for Approval of Investment Advisory Contract**—Form N-1A Item 27(d)(7)
19. **Disclosure About Matters Submitted for a Shareholder Vote**—Rule 30e-1(b) under the Investment Company Act

Appendix C

Recent European Experience with Disclosure of Actual Transaction Costs

Both the European Union's Regulation on Packaged Retail and Insurance-Based Investment Products (PRIIPs)[1] and the recast Markets in Financial Instruments Directive[2] and the Markets in Financial Instruments Regulation[3] (collectively, MiFID II) mandate that funds disclose "actual transaction costs," including implicit or indirect costs, to investors. Under PRIPPs and MiFID II, there are four types of costs that must now be disclosed separately on an investment fund, both before a fund is sold to an investor and on an ongoing basis: (i) one-off charges (e.g., sales charges, distribution fees, redemption fees); (ii) ongoing charges (e.g., annual management fee, operating and administration costs, securities lending cost); (iii) incidental costs (e.g., performance fees); and (iv) transaction costs.

There are different ways of evaluating and calculating a fund's transaction costs. The PRIIPs Regulation requires applicable fund disclosure documents to disclose "the cost associated with an investment in the PRIIP, comprising both direct and indirect costs to be borne by the retail investor, including one-off and recurring costs."[4] The PRIIPs Level II Delegated Regulation (the PRIIPs Delegated Regulation) provides a detailed methodology for calculating costs associated with investing in the PRIIP, which includes four possible methodologies for calculating transaction costs.[5]

Likewise, Article 24(4) of the MiFID II Directive requires that EU "investment firms" provide clients with information regarding "all costs and associated charges … relating to both investment and ancillary services."[6] Costs and charges information must be provided to all clients of EU "investment firm" distributors (*e.g.*, funds distributed through regulated EU distributors), which are obligated to provide an "all in" costs and charges figure to their clients. As further described in

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[1] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products ("PRIIPs Regulation"), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R1286.

[2] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ("MiFID II Directive"), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065.

[3] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R0600.

[4] Article 8(3)(f) of the PRIIPs Regulation.

[5] *See* Article 5 and Annex VI of Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R0653.

[6] Article 24(4) of the MiFID II Directive.

Article 50 of the MiFID II Level II Delegated Regulation, such information must be provided to prospective clients on an *ex ante* basis based upon good faith estimates and on an annual *ex post* basis based upon actual costs and charges data where the investment firm has or has had "an ongoing relationship with the client during the year."[7]

MiFID II costs and charges disclosures include both explicit and implicit costs and must be calculated using the PRIIPs methodology set forth in the PRIIPs Delegated Regulation.[8] Explicit costs include: broker commissions (to buy and sell securities), research costs or commission (where the asset manager passes these costs onto the investor), taxes and levies (such as stamp duty, regulatory and exchange levies), and securities lending (the cost of borrowing or the administration fee from lending for short selling activities).

The ability of an asset manager to use different methodologies to calculate estimates of transaction costs under the PRIIPs Regulation and MiFID II, which may be calculated under four possible methodologies, along with subjective inputs, for example related to implicit and indirect costs, has led to inconsistent, confusing, and misleading information for those investors seeking to understand it and compare products among providers.[9] As mentioned above, these funds have reported transaction costs of zero, and even negative numbers. Despite every best intention, the interests of investors obviously are disserved when the disclosures they receive are unintelligible, confusing, and misleading in this way.[10] These initiatives provide an unambiguous lesson in the need for caution when considering requiring personalized cost disclosure that is based upon complex methodologies with subjective inputs.

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[7] Article 50 of Commission Delegated Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive ("MiFID II Delegated Regulation"), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?toc=OJ:L:2017:087:TOC&uri=uriserv:OJ.L_.2017.087.01.0001.01.ENG.

[8] *See* Annex II of the MiFID II Delegated Regulation and the European MiFID Template. Answer 6 of the European Securities and Markets Authority's (ESMA) Level III guidance, Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics (6 June 2017 | ESMA 35-43-349), states that calculation of costs and charges under MiFID II should follow the PRIIPs calculation methodology, which requires detailed transaction cost calculations covering both explicit and implicit costs.

[9] *See, e.g.*, Chris Flood, "Slippage causes confusion in MiFID II fund rules row," *Financial Times* (Jan. 26, 2018), available at www.ft.com/content/7b37016a-00fc-11e8-9650-9c0ad2d7c5b5 (quoting industry sources regarding the confusion arising from MiFID II costs and charges calculation methodologies); Valentina Romeo, "Fool's gold: How MiFID II has revealed the true cost of funds," MONEY MARKETING (Jan. 26, 2018), available at www.moneymarketing.co.uk/mifidii-transaction-costs-funds/ (discussing industry fears that MiFID II costs and charges disclosure "will confuse and mislead investors and could ultimately defeat the goal of greater transparency"); Transtrend, Responsible Investing: Transaction costs according to PRIIPs (January 2018) (illustrating inconsistent results of application of PRIIPs methodology through various examples).

[10] Despite industry feedback, it is unclear whether further guidance will be forthcoming from regulatory authorities.

While the intent of European regulators was to provide investors with objective and comparable numbers, it has become clear that this regulatory approach has led to varying and counterintuitive results and thus confusing and misleading information for investors. In hindsight, MiFID II and PRIPs did not achieve the goal of EU regulators in allowing investors to compare the total cost of investing.

Appendix D

Recent Experiences of the European Union and Canada with Risk Ratings

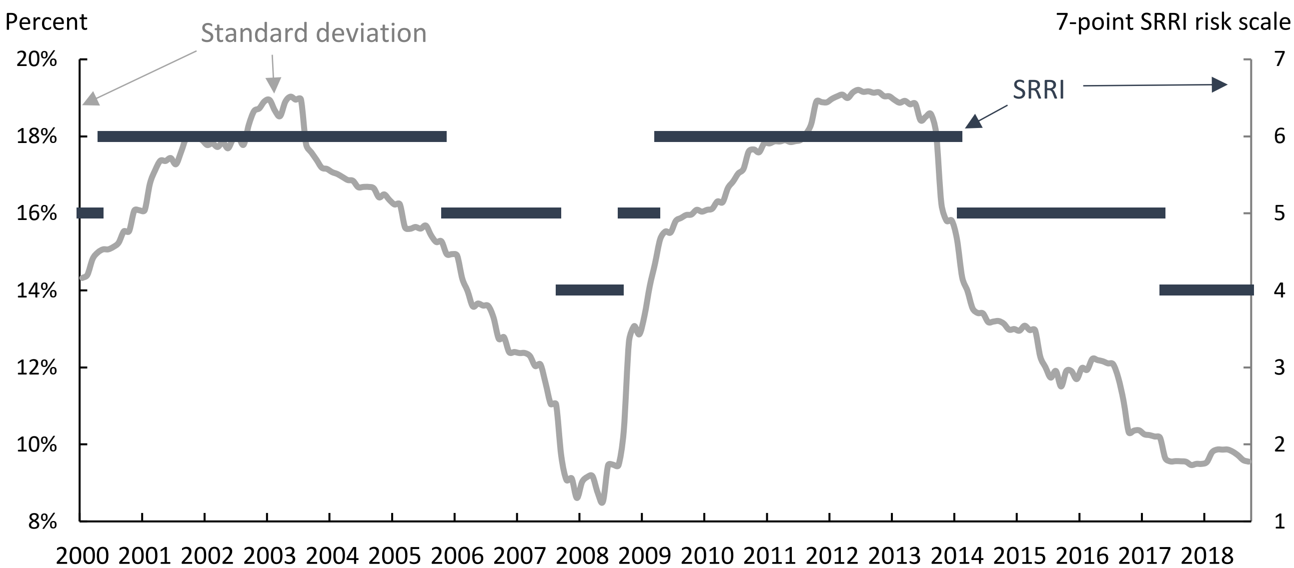
European Union

In 2009, the Committee of European Securities Regulators (CESR) required UCITS to include in certain fund documents a Synthetic Risk and Reward Indicator (SRRI). That measure was based on an annualized standard deviation approach. The approach generally required five years of data and cast results in terms of a 7-point scale. A five-year window was selected in part because newer funds might not have more years of returns available to calculate the risk rating. In fact, many funds must resort to "synthetic data" to backfill the required data window.[11]

Figure D.1

Small Changes in the "Data Window" Cause Risk Rating Scales to Jump

Example using EU 2009 SRRI measure for total returns from a hypothetical S&P 500 index fund



Note: The gray line (left axis) shows the "rolling" standard deviation of the monthly total returns on the S&P 500 using a data window comprising five years of monthly observations. The solid black horizontal bars (right scale) show how the rolling standard deviations translate into the EU's 2009 SRRI risk rating scale.
Sources: ICI, Bloomberg, and Standard & Poor's

As indicated in the body of our comment letter, one problem with risk ratings is that they tend to be procyclical and highly sensitive to changes in the data. Figure D.1 illustrates this problem using the EU's 2009 SRRI risk rating system as an example. Consider, for instance, the risk ratings a

[11] Morningstar estimates that about half of UCITS do not have the required five years of actual data needed to calculate the required volatility measures. Thus, many funds would need to synthetically estimate returns for at least some portion of the required five-year period. *See* Strazis, "KIID by the Numbers," Morningstar, available at https://corporate1.morningstar.com/uploadedFiles/UK/Products/Key_Investor_Information_Document_Services/Content/KIID_SRRI_ByTheNumbers.pdf.

hypothetical plain vanilla S&P 500 fund would receive. To calculate the risk rating, one first calculates the standard deviation of a fund's return. The solid gray line in the figure (left-hand scale) plots a "rolling" measure of standard deviation of total returns for the S&P 500 index, successively adding one new month of data and dropping the initial month of data, but always keeping a "data window" (i.e., a sample) that is five years (60 months) wide.

As seen in Figure D.1, the calculated standard deviation varies over time as new months of total returns data on the S&P 500 index are added and old observations are dropped. The solid horizontal bars (right scale) plot the SRRI risk ratings that would be calculated for the S&P 500 fund based on the EU 2009 approach. Problems are apparent. As time progresses, the risk rating jumps back and forth, cyclically, between ratings of 4 and 6. For example, from 2005 to 2008, in other words before and during the financial crisis, risk ratings on an S&P 500 index fund would dropped from 6 to 4, a peculiar result. Then, in mid-2009, just when the financial markets are recovering and thus presumably becoming less risky, the risk measure would jump to a 6, indicating that the fund is becoming *more* risky. In short, the timing of the changes in the risk ratings is out of synch with actual market risks, a feature that seems bound to confuse investors.

In sum, the 2009 SRRI approach, like other standard deviation-based approaches, is sensitive to the data window that regulators require. The wider the data window is (e.g., 5 years), the more backward-looking the rating will be and thus the more of a lagging indicator it will be for investors. The narrower the data window is (e.g., 2 months), the closer it will be to a contemporaneous indicator of volatility, but at the cost that the ratings will jump much more frequently, which risks confusing investors.

In part because of these kinds of concerns, and because commentators expressed concerns that the SRRI did not adequately capture certain sources of risk (e.g., currency risk),[12] the EU changed its risk rating approach as of 2016. These changes apply first for PRIIPS and, as currently proposed, beginning at the end of 2019 for UCITS.

The revised risk rating scale, determined by the European Securities Market Authority (ESMA), is called the Summary Risk Index (SRI). It is based on a meaningfully different method than the SRRI, and has two components: a Market Risk Measure (MRM) and a Credit Risk Measure (CRM). These two components are combined in a grid to determine a fund's overall risk rating (i.e., the fund's SRI).

Assuming that funds do in fact begin calculating and reporting the SRI measure in 2019, as current regulations require, the first step would be for a fund to calculate its MRM. ESMA provides a 35-page document of flow charts to help financial products (such as funds) determine which variant of the MRM applies to them.[13] Once a fund determines which MRM it should use, it would then follow a 29-step procedure specifying how to calculate the MRM. The document provides formulas

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[12] *See*, for example, Paul D. Kaplan, PhD, Quantitative Research Director, Morningstar Europe, Ltd., "What the Synthetic Risk Reward Indicator Doesn't Indicate About Risk or Reward" (2011).

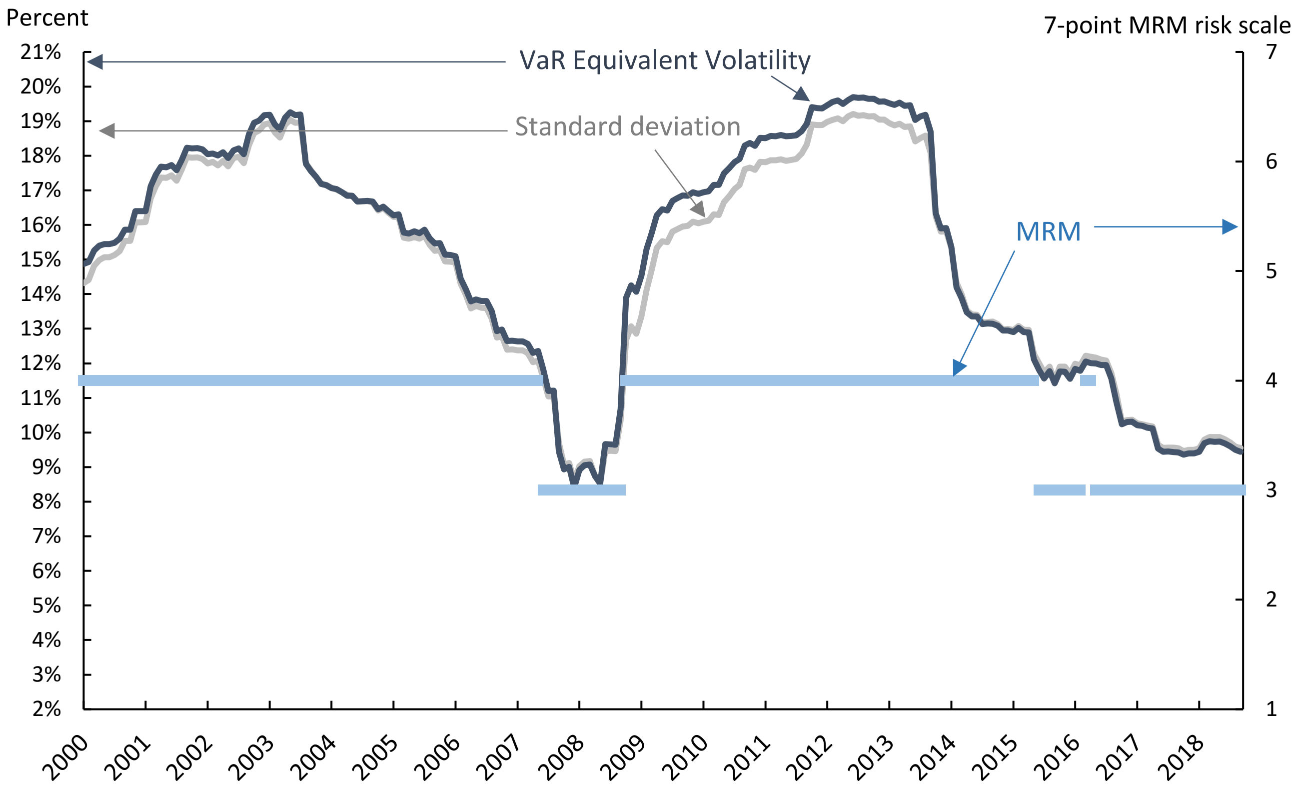
[13] *See* ESMA, "PRIIPs – Flow Diagram for the risk and reward calculations in the PRIIPs KID" (Aug. 16, 2017), available at https://esas-joint-committee.europa.eu/Publications/Technical%20Standards/JC%202017%2049%20%28PRIIPs_flow_diagram_risk_reward%29.pdf.

that funds must apply to compress the mean, variance, skewness and kurtosis of a fund's returns (or synthetic returns) over the previous five years into a single number, VaR Equivalent Volatility (VEV). The single output is then rescaled, as under the 2009 approach, to a 7-level "volatility scale" for MRM.

Figure D.2

The EU's 2016 Risk Rating Approach Compounds Problems Apparent in the 2009 Approach

Example comparing the EU's 2009 SRRI and 2016 MRM volatility for a S&P 500 index total returns fund



Note: The left-hand axis measures two separate series: The CESR rolling five-year measure of standard deviation, included from Figure D.1 as reference, along with the new ESMA measure of VaR Equivalent Volatility for total returns of the S&P 500 index. The right-hand axis shows the 7-point MRM scale. Horizontal bars show the risk ratings that we estimate this fund would report based on the 2016 ESMA methodology under an assumed minimum recommended holding period of five years (consistent with a 60-month data window).

Sources: ICI, Bloomberg, and Standard & Poor's

The 2016 MRM creates risk ratings that jump less, and less frequently than the 2009 SRRI approach. However, this is not because the 2016 approach is more complex and opaque. As seen in Figure D.2, the two approaches generate nearly identical volatility measures (compare the gray line to the black line). Instead what drives the difference between the 2016 and 2009 pattern of ratings is that the 2016 approach uses wider "risk buckets" to scale the volatility measures.

Figure D.3
Comparison of the EU 2009 SRRI and 2016 MRM Risk Scales

Risk Scale (1-7)	2009 SRRI Standard Deviation	2016 MRM VaR Equivalent Volatility
1	0.0% to <0.5%	Less than 0.5%
2	0.5% to <2.0%	0.5% to 5.0%
3	2.0% to <5.0%	5.0% to 12.0%
4	5.0% to <10.0%	12.0% to 20.0%
5	10.0% to <15.0%	20.0% to 30.0%
6	15.0% to <25.0%	30.0% to 80.0%
7	25.0% and above	Above 80.0%

Note: Threshold values, and treatment of threshold boundaries differ across the two approaches. Following the ESMA approach, the MRM thresholds do not overlap from scale readings of 1–2 and 6–7. However, VEV overlap occurs at intermediary boundaries (e.g.: a VEV of 30 percent describes the highest investment rated 5, and the lowest rated 6, simultaneously).
Sources: CESR 2009 and ESMA 2016 regulations

For example, Figure D.3 compares the bucket widths of the two approaches. Consider risk rating 3. Under the 2009 SRRI approach, that category captures standard deviations from 2.0 percent to less than 5 percent. Even though the volatility measures (i.e., standard deviation and VaR Equivalent Volatility) are essentially identical from 2016 on (Figure D.2), under the 2009 approach an S&P 500 fund would likely get a risk rating of 4 and under the 2016 approach a risk rating of 3 simply because the EU elected to widen the risk buckets (Figure D.3). What this suggests is that risk ratings are essentially arbitrary, depending on the bucket widths the regulator chooses.

The risk rating outcomes of the 2016 approach also depend on a recommended holding period for the investment, which a fund would be required to choose. The holding period is itself tied to the width of the data window. In fact, under 2016 methods, two funds that were for all intents and purposes identical might report different risk ratings simply because their fund advisers chose to apply different recommended holding periods. This risks confusing investors even further.

In an effort to create a risk rating system that encompasses both market volatility risk and volatility risk due to credit conditions, the second component of the 2016 EU rating system, the Credit Risk Measure (CRM), seeks to bring credit risk into the mix. Like the MRM, the CRM has peculiar features.

The CRM method would assign funds a rating of 1 to 6 based on a formulaic aggregation of credit ratings determined by credit rating agencies.[14] This approach raises the same issues as the MRM: the credit buckets 1 to 6 are assigned essentially arbitrarily by the regulator according to some formula; a fund could jump from rating bucket to rating bucket because of small changes in its data or changes in credit ratings assigned by credit rating agencies; and the highest CRM risk category (category 6) could comprise funds that have widely different credit risk profiles.

In any event, the next step combines the CRM and MRM categories to generate a final SRI risk rating number. Figure D.4 shows the results.[15]

Figure D.4
Combining the MRM and CRM Risk Measures into a Single SRI Risk Rating Blurs Important Distinctions Between Funds

	MRM						
CRM	1	2	3	4	5	6	7
1	1	2	3	4	5	6	7
2	1	2	3	4	5	6	7
3	3	3	3	4	5	6	7
4	5	5	5	5	5	6	7
5	5	5	5	5	5	6	7
6	6	6	6	6	6	6	7

SRI Matrix

Note: The MRM measure (top row), which runs from 1 to 7 would be calculated for a fund based on its calculated volatility measure under the 2016 approach, as illustrated in Figure D.2. The CRM measure (left column), which runs from 1 to 6, would be assigned based on a bucketing of a fund's credit risk, as determined according to credit rating agencies. The values within the table, which are the final SRI risk ratings, are then assigned by regulators according to some weighting of the values of the MRM and CRM.
Source: ESMA Final Draft Regulatory Technical Standards

Figure D.4 illustrates some unusual and puzzling outcomes. Suppose, for instance, that a fund receives a CRM of 3. Funds with MRM ratings of 1, 2, or 3, ratings that would capture funds with a wide range of return volatilities, all receive SRI ratings of 3. Only when the CRM is 4 or greater does the SRI change, jumping from 3 to 5. In fact, combining a CRM value of 4 with an MRM

[14] ESMA itself has questioned the wisdom of using credit ratings provided by credit rating agencies to create a risk rating system. stating that "In spite of the EU initiatives in progress to reduce the overreliance on credit ratings issued by credit rating agencies, it is surprising to see that the proposal considers that no suitable methodology other that the external rating has been found regarding credit risk assessment. It should be reminded that hundreds of insurance-based investment products´ manufacturers don´t have a credit rating issued by a credit rating agency. It should also be reminded that the cost of getting a rating by a credit rating agency is very high, especially for small and medium insurance undertakings, something that could distort competition. The proposal provides that if an insurer doesn't have a rating, it will be automatically allocated to CR3. According to the aggregation method proposed, this would mean that even if the insurer has a MR1, its final SRI would be 3. This is not a reasonable outcome, given that market risk is the most relevant factor for insurance-based investment products." *See* pages 167–168 in ESMA, "Final draft regulatory technical standards," available at https://www.esma.europa.eu/sites/default/files/library/jc_2016_21_final_draft_rts_priips_kid_report.pdf.

[15] *See* pages 39–40 in ESMA, "Final draft regulatory technical standards," *supra*.

value of 1, 2, 3, 4, or 5, results in an SRI of 5. As another example of an unusual outcome consider the diagonal pattern in SRI, notice that when MRM and CRM values are both 4, the SRI value is 5. Why this makes sense is unclear, seems arbitrary, and in any case is again likely to confuse investors. Perhaps not surprisingly, market participants have made similar points to ESMA about the SRI approach.[16]

Finally, it is worth noting that the EU risk rating approach will be computationally difficult for some, if not most, entities. Given these complexities, funds may well be forced to turn to third-party vendors who can undertake the calculations, much as US funds have been forced to turn to third-party vendors in order to report the new liquidity buckets required by the SEC under Rule 22e-4. For example, one third-party vendor, *Anevis,* markets services to build a fund KID for EU-registered funds, one component of which is to provide systems to calculate the SRI measure.[17] This is likely to add to fund costs, lowering investor returns, without obvious benefits for investors.

In sum, the EU approach should, if anything, serve as an object lesson for the Commission about why it should avoid adopting, or for that matter further investigating, risk rating measures. This conclusion is reinforced by Canada's experience.

Canada

Canadian fund managers are required to provide risk ratings for their mutual funds, based on a 5-level scale. A fund's annual return volatility is based on the annualized standard deviation of monthly returns over a 10-year period. The higher the number, the higher a fund's volatility has been historically. The lowest risk category (category 1) captures funds that have had a historical return standard deviation of 0 to less than 6 percent and are classified as having "low" risk. The next category (category 2), captures funds whose historical return standard deviation is 6 percent to less than 11 percent, which are then classified as having low to medium risk and so on until category 5, which captures all funds with an annualized return standard deviation of 20 percent or more. The first four categories are thus relatively narrow, while the fifth absorbs all remaining funds. Figure D.5 illustrates.[18]

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[16] In response to ESMAs question, "*Do you agree with the scales of the classes MRM, CRM and SRI? If not, please specify your alternative proposal and include your reasoning."* Responders addressing MRM have noted:

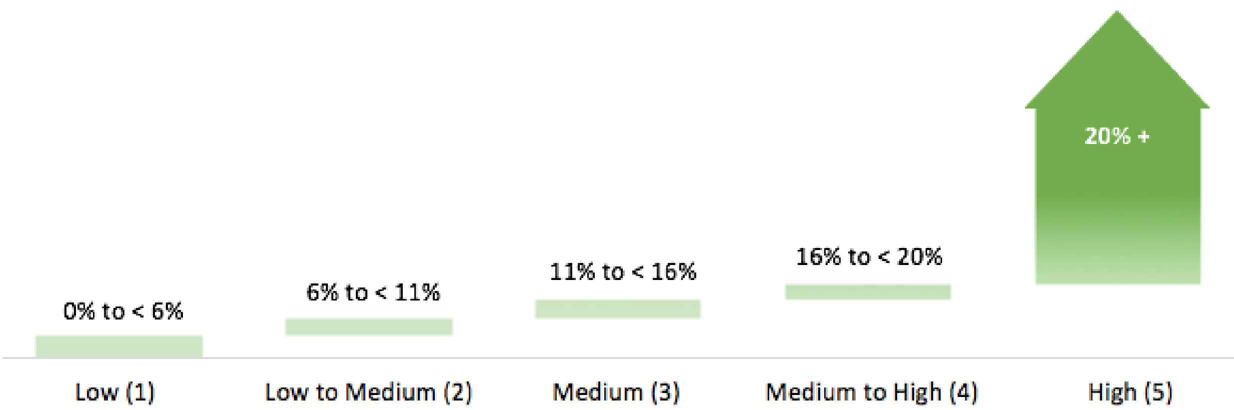
- Regarding MRM indicator: "The criteria in Category I 'up to 5 years', seems an artificial barrier…"
- Regarding CRM: "It may be questionable to base the credit risk assessment only on external ratings as a number of entities, particularly smaller entities and insurance-based investment products´ manufacturers, do not have a credit rating issued by an external credit rating agency. Also, cost implications of obtaining ratings for smaller entities are not negligible."
- Regarding SRI: "A SRI is not the best approach for the analysis of risks. As credit and market risk are not comparable, a separate analysis of both risks is recommended."

See page 176 in ESMA, "Final draft regulatory technical standards," *supra.*

[17] *See* the Anevis Solutions Reporting Suite, available at https://www.anevis-solutions.com/.

[18] *See* "Appendix F: Investment Risk Classification Methodology," in Canadian Securities Administrators (CSA"), "Chapter 5: Rules and Policies, 5.1.1 CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts – CSA Notice of Amendments to National Instrument 81-102 Investment Funds and Related Consequential Amendments" (Dec. 8, 2016), available at https://www.osc.gov.on.ca/documents/en/Securities-Category8/ni_20161208_81-101-81-102_csa-mutual-fund-risk.pdf.

Figure D.5
Canadian Five-Point Risk Rating Scale
Percentages are for a fund's annualized standard deviation of returns based on 10 years of monthly data



Source: CSA Mutual Fund Risk Classification Methodology for Use in Fund Facts and ETF Facts – CSA Notice of Amendments to National Instrument 81-102 Investment Funds and Related Consequential Amendments

The Canadian approach requires funds to calculate standard deviation over a 10-year window. Although based on a more straightforward calculation than the EU 2016 approach, it still results in risk classifications that are sensitive to new returns data. For example, any data window that captures the financial crisis is likely to push funds toward higher risk categorizations. As the financial crisis-era data roll out of the 10-year window, funds' volatility rankings will improve (move to the left in Figure D.5). In contrast, low historical volatility begets a low risk rating. This could encourage complacency among investors, if they are comforted by low volatility ratings. The problem, of course, is that low volatility does not last forever, as events in February 2018 demonstrate.

In sum, standardized risk measures that are prescribed by regulators have a range of significant drawbacks. Those drawbacks are compounded by risk rating systems by trying to make a complex issue—risk and how to define, measure, and control it—look deceptively simple.