

COMMENT LETTER

August 11, 1998

Institute Comments on Improving Shareholder Reports, August 1998

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Barry P. Barbash
Director
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: Improving Shareholder Reports

Dear Mr. Barbash:

The Investment Company Institute [1](#) is pleased to submit recommendations for changes to the current form of mutual fund shareholder reports to improve disclosures to investors. In recent years, the Commission has demonstrated its determination to make mutual fund disclosure more comprehensible, informative and useful to investors. In particular, we commend the Commission for its recent adoption of changes to Form N-1A and new rule changes allowing the use of fund profiles and requiring that certain portions of fund prospectuses, as well as fund profiles, be written in "plain English."[2](#) We believe that shareholder reports should similarly be drafted with plain English principles in mind.

We understand that one of the Commission's next disclosure reform initiatives will consider revising the requirements for annual and semi-annual reports provided to investment company shareholders. We encourage the Commission to undertake such an initiative as soon as possible. In doing so, the Commission should strive to achieve the same goals of making shareholder reports more comprehensible, informative and useful to the average investor that it sought to achieve in amending the requirements for fund prospectuses and permitting the use of fund profiles.

Our recommendations are set forth below.[3](#)

Streamlining the Schedule of Investments

We understand that the AICPA Investment Companies Committee (the "AICPA") has made specific recommendations to the Commission for simplifying investment company financial statements included in shareholder reports.[4](#) Separately, we understand that the AICPA will

soon propose changes to the Investment Company Audit Guide, which dictates generally accepted accounting principles ("GAAP") for investment companies. Regulation S-X requires an investment company to include in its shareholder reports a schedule listing all investments held by the fund as of the last day of the reporting period. The AICPA has proposed that Regulation S-X be amended to require, at a minimum, a fund to disclose the name and number of shares or principal amount of each investment constituting more than one percent of net assets (including all investments in any one issuer aggregating more than one percent of net assets). Funds also would require to disclose, at a minimum, the 50 largest holdings of the fund. The ICI supports this proposal.

The current requirement to disclose all fund investments generally is not helpful to most investors. Listing a minimum of a fund's top 50 holdings would enable an investor to focus on the fund's principal holdings in evaluating the fund's risk profile and investment strategy. Under the current standard, investors may have to sift through each of the fund's individual holdings, regardless of how small and immaterial those holdings may be, to determine the fund's most significant investments. Additionally, for funds with a large number of holdings, such as index funds, current requirements greatly increase the length and complexity of shareholder reports (thus increasing shareholders' costs of printing and mailing such reports) without providing corresponding benefits to shareholders.⁵ Accordingly, the requirement to disclose all fund holdings regardless of size should be eliminated.

We also recommend that money market funds be exempt from the requirement to list portfolio holdings. This information is of little or, in most cases, no relevance to investors. Rule 2a-7 under the Investment Company Act of 1940 strictly regulates money market funds' portfolios, and thus there is less need for disclosure of a money market fund's specific holdings. In addition, given the short-term nature of money market fund portfolio holdings, the information is likely to be stale.⁶

Any concerns that the Commission may have that either it or a fund's shareholders would not receive complete information regarding the fund's holdings can be easily addressed. First, the Commission should require a fund to file a complete listing of all securities held by the fund as of the last day of the reporting period covered by the shareholder report. Second, the Commission should require funds to provide to investors upon request and at no charge a complete schedule of the fund's holdings as of the last reporting period covered by the shareholder report.⁷ Thus, investors (as well as the Commission) still would have easy access to a complete list of a fund's holdings.

The proposed changes to the schedule of investments would benefit the majority of fund shareholders. These modifications would enable shareholders to discern those fund holdings that have the greatest impact on their fund's performance and risk profile, and reduce fund printing and mailing expenses, without sacrificing full disclosure of a fund's holdings for those shareholders or others that may be interested in obtaining a complete listing of the fund's portfolio securities.⁸

Graphic Presentation

The Commission should consider requiring that shareholder reports include a chart, table or graph breaking down a fund's investments by category as of the last day of the reporting period covered by the shareholder report.⁹ This would provide shareholders with additional information that shareholders currently may not receive. Presenting this information in a

graphic format would facilitate investor understanding of a fund's portfolio holdings.

In most cases, this graphic presentation would be in the form of a pie chart. Because of the diversity of investment strategies followed by mutual funds today, however, the Commission should not require a particular type of chart, table or graph that funds must provide. Rather, a fund should have the flexibility to include a chart, table or graph that it determines provides the most useful information to shareholders given the fund's investment objectives and limitations. It may be appropriate, however, for the Commission to provide examples of charts, tables or graphs for particular types of funds to assist funds in determining what type of graphic presentation is most appropriate. For example, a domestic equity fund could provide a pie chart that shows its portfolio investments by industry sector (e.g., energy, banking, telecommunications, etc.), and a corporate or municipal bond fund may wish to provide a table showing its holdings broken down by credit quality or maturity. Similarly, an international fund could provide a pie chart that shows portfolio securities by country or region.

Management's Discussion of Fund Performance

The Commission should consider requiring that the Management's Discussion of Fund Performance (which is currently required by Item 5 of Form N-1A) be included in a fund's annual report, regardless of whether it is also included in the fund's prospectus. Although funds currently have the option of including MDFP in the prospectus if it is not in the annual report, we do not believe that placing the MDFP in the prospectus without including it in the annual report is in investors' best interest. The MDFP represents a discussion of the fund's performance over the prior year, and thus fits naturally with other "backward looking" information regarding a fund's performance, such as the fund's financial statements.

Financial Highlights Table

We commend the Commission for making certain changes to the financial highlights table contained in a fund's prospectus as part of the amendments to Form N-1A.¹⁰ However, the Commission acknowledged in its release adopting the Form N-1A amendments that additional changes could improve the financial highlights table and stated that it intended to revisit this issue when considering changes to financial statements generally.¹¹

As an initial matter, we do not believe that the financial highlights table needs to appear in both the prospectus and shareholder reports. Thus, consistent with our comments on the proposed Form N-1A amendments, we recommend that the financial highlights table be deleted from the prospectus.¹² The financial highlights table contains information that is backward, rather than forward, looking, and thus is more appropriately placed in a shareholder report than in a prospectus. In addition, if a prospective investor is interested in the information contained in the financial highlights table, he or she can request a shareholder report.¹³

We have several suggestions for changes to the financial highlights table as it appears in shareholder reports. First, the net investment income ratio should be eliminated. Investors principally are interested in the fund's total return rather than a breakdown of the return by dividends and interest versus capital appreciation. Additionally, this ratio is meaningless for funds whose returns are primarily derived from appreciation in portfolio stock values. Moreover, the net investment income ratio is similar to the fund's SEC yield,¹⁴ which is generally available from the fund's distributor, frequently in a more up-to-date form. In

order to accommodate those investors that seek this information, shareholder reports should include disclosure providing the means (e.g., a toll-free telephone number) to obtain the fund's SEC yield.

Second, the two line items detailing distributions per share (i.e., distributions from net investment income and distributions from realized capital gains) for non-money market funds should be consolidated into one line item captioned "distributions." Providing two separate line items detailing distributions unnecessarily complicates the financial highlights table. In addition, tax basis distribution information provided to shareholders on IRS Form 1099-DIV may differ from that provided in the financial highlights table since short term capital gains are taxed as ordinary income when distributed to shareholders. Our recommendation to consolidate distribution per share information is consistent with the current draft of the AICPA Investment Company Audit Guide.

Third, the per share data should be eliminated for money market funds. Because all money market funds seek to maintain a stable net asset value of \$1.00 per share, this data is mostly meaningless and does not provide any useful information to investors. The remaining items in the table, with the exception of the net investment income ratio, should be retained. The net investment income ratio should be eliminated and, as discussed above, replaced with disclosure providing the means to obtain the fund's current seven-day yield.

A fund's current seven-day yield provides more up-to-date and useful performance information for investors than does the net investment income ratio (which is as of the last day of the reporting period for the shareholder report). Further, the total annual return for a money market fund is substantially the same as the net investment income ratio, rendering it duplicative and unnecessary.

Need to Coordinate with AICPA

We generally endorse the AICPA recommendations to the Commission for simplifying investment company financial statements included in shareholder reports, and in particular the reduction in the level of detail required to be provided in a fund's schedule of investments (as detailed above).¹⁵ The concurrent disclosure obligations placed upon investment company financial statements by Regulation S-X and GAAP necessitate close coordination between the Commission staff and the AICPA in order to ensure that any modifications to financial reporting requirements can be realized. This is particularly true to the extent that the AICPA Investment Company Audit Guide requires the shareholder reports financial highlights table under GAAP. We encourage the Commission staff to work closely with AICPA as it considers changes to investment company financial statements.

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The Institute appreciates the opportunity to provide suggested changes to the Commission's requirements for investment company shareholder reports. If you have any questions regarding our comments or need additional information, please contact me at (202) 326-5815, Greg Smith at (202) 326-5851, or Joe Savage at (202) 326-5819.

Sincerely,

Craig S. Tyle

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,301 open-end investment companies ("mutual funds"), 436 closed-end investment companies and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about \$5.097 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

2 See SEC Release Nos. 33-7512, 34-39748 and IC-23064 (Mar. 13, 1998), 63 Fed. Reg. 13916 (Mar. 23, 1998) (Form N-1A amendments) (the "Form N-1A Release"); SEC Release Nos. 33-7513 and IC-23065 (Mar. 13, 1998), 63 Fed. Reg. 13968 (Mar. 23, 1998) (allowing the use of fund profiles), SEC Release Nos. 33-7497, 34-39593 and IC-23011 (Jan. 28, 1998), 63 Fed. Reg. 6370 (Feb. 6, 1998) (requiring the use of "plain English").

3 These comments are primarily general in nature, and certain additional technical changes to the Commission's shareholder reports requirements may be necessary in order to implement these proposed changes. Accordingly, we may recommend such changes to future proposed amendments to the shareholder reports requirements in order to assist in their implementation.

4 See Letter from Steven E. Buller, Chair, AICPA Investment Companies Committee, to Lawrence A. Friend, Chief Accountant, Division of Investment Management (April 25, 1996).

5 For example, the schedule of investments contained in one large equity fund's annual report for the year ended March 31, 1998 is nineteen pages long and lists approximately 480 securities.

6 We understand that the Investment Company Audit Guide will make no special provision for money market funds, and accordingly, they will be required to disclose, at a minimum, their top 50 holdings. In order for the Institute's recommendation to be realized, the Investment Company Audit Guide will need to be modified from its current draft form.

7 A fund could satisfy this delivery requirement with respect to certain investors that have access to the Internet by posting the fund's schedule of investments as of the last day of the reporting period on its Internet web site, so long as it complies with the notice and consent requirements provided in Commission Release No. IC-21399 (Oct. 6, 1995).

8 The benefits to shareholders in certain funds, such as non-diversified or narrowly focused funds, may not outweigh the costs associated with preparing and handling two separate listings of portfolio securities (i.e., the abbreviated schedule listing the top 50 holdings and the full schedule of investments). Therefore, the decision to replace the full schedule of investments with the abbreviated schedule in shareholder reports should be left to the issuer, based on the nature and extent of its holdings.

9 This chart, table or graph could appear as part of the Management's Discussion of Fund Performance in annual reports, and as a separate item in semi-annual reports. In either case, however, the graphic presentation should not be part of the fund's audited financial statements.

10 In particular, the Commission changed the period covered by the financial highlights table from 10 to 5 years to parallel the period covered by financial information required to be contained in fund annual reports, and eliminated the required disclosure of average

commission rates.

11 Form N-1A Release at 85.

12 See Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (June 9, 1997).

13 Recently adopted amendments to Form N-1A requiring notice of the availability of shareholder reports combined with the three business day delivery requirement should ameliorate any concerns with removal of the financial highlights table from the prospectus. See item 1(b) (1) of Form N-1A.

14 The SEC yield refers to the 7-day yield (in the case of money market funds) or 30-day yield (in the case of non-money market funds) permitted to be included in advertising pursuant to SEC Rule 482 under the Securities Act of 1933, as calculated in accordance with the provisions of Item 21 of Form N-1A

15 The AICPA has recommended that the restricted securities disclosure required by Regulation S-X, Rule 12-12 be eliminated and replaced with footnote disclosure of the total value of securities priced at fair value. While we support elimination of restricted securities disclosures, we oppose disclosure of the total value of securities priced at fair value, for several reasons. First, we do not believe that providing the total value of such securities will be meaningful to most investors, since they will not understand the significance or meaning of this figure. Second, this figure could be misleading when comparing different funds, since fair valuation procedures are utilized only when there is no readily available market quotation for a security, and the determination of whether a readily available market quotation exists can be a subjective decision. Further, the presence or absence of market quotations for a particular security can change over time in response to market conditions and corporate developments. Thus, disclosure of this information in shareholder reports could present practical problems, and different fund families holding the same security could reach different results as to whether the security should be included as a fair valued security.