The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

March 24, 1997

Comment Letter on SEC Plain English Proposal, March 1997

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

Re: Plain English Disclosure; File No. S7-3-97

Dear Mr. Katz:

The Investment Company Institute[1] is pleased to comment on the SEC's "plain English" disclosure proposal and draft Plain English Handbook. We strongly support the Commission's objective in these initiatives—to improve communications with investors. We agree that investors must be able to understand disclosure to use it. The mutual fund industry benefits when investors are well-informed.[2]

The Commission proposes to do the following:

- require companies to use plain English principles in writing the front and back cover pages, summary, and risk factor sections of prospectuses;
- revise current requirements for highly technical information in the front of prospectuses; and
- revise the rule on the preparation of prospectuses to provide companies with more specific guidance on the clarity required of the entire document.

The proposal would apply to investment companies, but corporate issuers are its principal focus.[3] This is appropriate for several reasons. First, mutual funds are different from typical corporate issuers in that funds continuously offer their shares. Unlike an issuer doing a one-time offering, mutual funds must have "evergreen" prospectuses. Second, funds already are subject to requirements similar to those in the plain English proposal. Instruction G to Form N-1A (the registration form for mutual funds) states, in part, as follows:

The purpose of the prospectus is to provide essential information about the Registrant in a way that will assist investors in making informed decisions about whether to purchase the securities being offered. Because investors who rely on the prospectus may not be sophisticated in legal or financial matters, care should be taken that the information in the

prospectus is set forth in a clear, concise, and understandable manner. Extensive use of technical or legal terminology or complex language and the inclusion of excessive detail may make the prospectus difficult for many investors to understand and may, therefore, detract from its usefulness.

Finally, in recent years, mutual funds already have worked along with the SEC to reverse a trend toward longer, more complicated prospectuses that developed in the period following Form N-1A's 1983 adoption.4 Indeed, investment companies have been at the forefront of recent efforts to improve communications with investors. For example, the Institute has conducted significant empirical research on how to improve mutual fund prospectus disclosure.5 In addition, many investment company firms have dedicated substantial time and resources to making their disclosure documents more "user-friendly." Many investment company prospectuses have been recognized as models of clear, understandable disclosure.6 The SEC recently issued three additional proposals specifically focused on improving investment company disclosure still more.7 The plain English rule proposal and draft Handbook complement these ongoing efforts. As mutual funds continue to improve their prospectuses, widespread adherence to "plain English" principles will enhance the readability of fund disclosure documents.

Our specific comments on the proposal appear below. Our comments address the draft Plain English Handbook, the administration and enforcement of the plain English requirements, certain liability issues, the scope of the plain English rule proposal, a required cover page legend, and the proposal's effective date.

The Plain English Handbook

The draft Plain English Handbook contains "practical tips on how to create plain English documents." It will be a valuable resource for people who draft SEC disclosure documents. We appreciate the SEC's guidance on how to achieve clear, effective disclosure.

The draft Handbook properly emphasizes, however, that there is no single correct way to meet the goal of effective disclosure. For example, in the Introduction to the Handbook, SEC Chairman Arthur Levitt states that "[t]his handbook gives you some ideas on what has worked for others, but use whatever works for you."8 He adds that "[n]o matter what route you take to plain English, we want you to produce documents that fulfill the promise of our securities laws."9 In describing the purpose of the Handbook, Chairman Levitt observes, "Not all of the tips will apply to everyone or to every document. Pick and choose the ones that make sense for you."10

We strongly support this flexible, open-ended approach. In this spirit, we recommend two changes involving the examples in the draft Handbook, as discussed below.

The draft Handbook uses examples to illustrate the guidance it provides. While these examples may be helpful, the Handbook should make clear that they are intended merely to illustrate various principles of plain writing. The Handbook should state explicitly that the examples are not required—or even recommended—disclosure formulations for specific situations. Otherwise, the examples might evolve into standardized, boilerplate disclosures that are no longer meaningful. More importantly, the examples do not necessarily address all circumstances.11 Above all else, disclosure must be accurate.

In addition, we suggest that the SEC delete one example the draft Handbook cites in discussing use of the active voice. The example comes from a mutual fund prospectus. The

"before" example states: "The foregoing Fee Table is intended to assist investors in understanding the costs and expenses that a shareholder in the Fund will bear directly or indirectly."12 The draft Handbook advises its audience to "[d]ispense with the filler words, '. . . to assist investors in understanding. . .' to move your reader more quickly to the important points."13

Item 2(a) of Form N-1A sets forth the requirements for mutual fund fee tables. Instruction 1 to Item 2(a) states: "Immediately after the table, provide a brief narrative explaining that the purpose of the table is to assist the investor in understanding the various costs and expenses that an investor in the fund will bear directly or indirectly." (Emphasis added.) Thus, the "filler words" referred to in the draft Handbook originated with the SEC itself in Form N-1A.

Not only does the "before" example track Form N-1A, but also it is more accurate than the "after" example in the draft Handbook. The "after" example states: "This fee table shows the costs and expenses you would pay directly or indirectly if you invested in our fund."14 In fact, the fee table lists shareholder transaction expenses that do not necessarily apply to all investors.15 Thus, stating that all investors "would pay" all of the costs and expenses listed in the table would be misleading. In addition, because mutual funds continuously offer their shares, many funds regularly send prospectuses both to new investors and to existing shareholders. Characterizing the costs and expenses listed in the fee table as amounts that "you would pay . . . if you invested in our fund" fails to recognize that many prospectus recipients already have invested in the fund.

The proposed amendments to Form N-1A would replace the existing instruction with a required statement before the fee table that "[t]his table describes the fees and expenses you may pay in connection with an investment in the fund."16 Because of the shortcomings of the "after" example, and because the proposed amendments to Form N-1A contain specific required disclosure to describe the fee table, we recommend that the SEC delete the fee table example.

Administration and Enforcement of the Plain English Requirements

Proposed Rule 421(d)(1) would require investment companies to follow "plain English principles in the organization, language, and structure of the front and back cover pages, and the summary and risk factors sections, if any, included in the prospectus."17 The provision further states that "[a]t a minimum, the disclosure should substantially comply with" the following six principles: (1) active voice; (2) short sentences; (3) definite, concrete, everyday words; (4) tabular presentation or "bullet" list for complex material, whenever possible; (5) no legal jargon, or highly technical business terms; and (6) no multiple negatives.18 While we support the SEC's proposal, we urge the SEC and the staff to exercise care in administering and enforcing these requirements. As the proposing release states, "it is impossible to give a precise formula for clear writing . . . ."19

In particular, the staff should not rigidly or mechanically apply the plain English principles. For example, it would be inappropriate in most cases for the staff to second-guess particular phrasings and word choices in disclosure documents. This could cause undue delays in the registration process, and would not be a good use of staff resources.20 We agree wholeheartedly with Chairman Levitt's comment at the open meeting on the proposal that the SEC should not play the role of "grammatical police." Similarly, we strongly oppose

any efforts by the staff to develop "model," standardized disclosures. Such disclosures soon would become meaningless boilerplate, and would frustrate the goal of improving communications with investors.

The proposal also would amend Rule 461 to authorize the SEC to refuse to accelerate the effectiveness of a registration statement where the plain English requirements have not been met. This provision raises several concerns.

Read literally, the provision contemplates SEC refusal to accelerate effectiveness based, for example, on an issuer's use of the passive voice or failure to present information in a tabular format. In a particular case, this could prove to be a very harsh sanction for such "violations." Some of the enumerated plain English principles are, of course, highly subjective in their application. For instance, reasonable people may well disagree about what words are "everyday" words. Similarly, the draft Handbook advises, "Don't ban the passive voice, use it sparingly."21 The Handbook goes on to state that "[a]s with all the advice in this handbook, we are presenting guidelines, not hard and fast rules you must always follow. The passive [voice] may make sense when it's not important for the reader to know the person or thing performing the action."22

Thus, the draft Handbook contemplates a flexible application of the plain English principles. As a corollary proposition, the SEC staff should not be installed as an arbiter of plain English style. As Chairman Levitt candidly acknowledges in the Introduction to the draft Plain English Handbook, "the SEC has not cornered the market on plain English advice." Moreover, the SEC's larger goals suggest that the staff should not focus excessively on whether individual words or sentences comply with the plain English principles, but instead should concern itself with the overall readability of the prospectus.

As the proposing release notes, Rule 461 currently provides that the SEC can refuse to accelerate a registration statement "[w]here there has not been a bona fide effort to make the prospectus reasonably concise and readable, so as to facilitate an understanding of the information required or permitted to be contained in the prospectus." (Emphasis added.) This standard is designed to promote the same basic goals that the plain English initiative seeks to address, and we believe it remains appropriate for regulatory purposes. We recommend that, instead of adopting a new standard under which acceleration could turn solely on compliance with the plain English requirements, the SEC enforce its existing standard with the plain English principles in mind.

Liability Issues

The Institute agrees that the use of plain English should not increase an issuer's potential liability. To the contrary, straightforward disclosure should reduce potential liability because it makes it less likely that an investor will misunderstand the prospectus. By formalizing its policy to encourage plain English disclosure, the SEC also may help alleviate liability concerns.

For example, the release emphasizes that in using plain English, "you are not forced to choose between clarity and precision."23 The release further explains that "plain English does not mean ‘dumbing down' complex information. It means writing well so that it is not needlessly difficult to understand."24 The SEC should encourage the courts to take this policy into account when considering the adequacy of prospectus disclosure.25 This is particularly important in light of the complex nature of many investment company offerings and the tenor of recent litigation involving investment company disclosure.

According to the proposing release, the SEC knows of no case that has held anyone liable under Section 11 for clearly disclosing material information to investors. The release further states that "[t]he staff's review of the few reported cases finding Section 11 liability indicates that no case required the use of specific legal language or turned on the use of legal language."[26] The release does not mention cases where there was no finding of Section 11 liability. Yet, courts have relied on disclosures that would not necessarily meet the plain English principles of proposed Rule 421(d) when dismissing Section 11 claims involving investment company prospectuses.[27]

We do not suggest that issuers would have been liable in these cases if their disclosures had followed the plain English principles. As the Commission knows, however, investment companies are inherently complex and many of them pursue complicated investment strategies. Investment companies should be encouraged to communicate as effectively as possible with investors, and the SEC must permit them to do so in the manner that best suits each particular fund's own unique circumstances. At the end of the day, it is the issuer's responsibility—and not the SEC's—to provide adequate and appropriate disclosure to investors in keeping with the Commission's rules.

Scope of the Proposal

As proposed, the plain English requirements would apply to the front and back covers of an investment company prospectus, as well as to any summary.[28] Although we would not expect the remaining portions of investment company prospectuses to vary significantly from these parts in terms of their clarity, we support the scope of the requirements as proposed.[29] If the SEC decides to expand the scope of the requirements, it should continue to exclude the statement of additional information. This document typically has a much smaller and more sophisticated audience. The costs of imposing plain English requirements on SAIs at this time would far exceed the benefits.

Cover Page Legend

The proposal would amend Regulation S-K to require issuers to write certain legal warnings in clear and concise language. In general, this is a positive step and fully consistent with the overall purpose of the proposal. In one case, however, we recommend that the SEC eliminate a required legend altogether.

Specifically, proposed Item 501(b)(5) of Regulation S-K calls for disclosure on the front cover page of a prospectus "that indicates that the Securities and Exchange Commission has not approved the securities or passed upon the adequacy of the disclosures in the prospectus and that any contrary representation is a criminal offense." The provision also includes two sample disclosure formats.[30] Even when expressed in plain English, however, this legend is not meaningful to investors.

The premise for requiring the legend seems to be a concern that investors otherwise will assume the SEC has given a prospectus its stamp of approval. Whatever historical basis there may be for this disclosure requirement, we do not believe there is any contemporary basis for this concern as to investment company offerings. Further, to state that "any contrary representation is a criminal offense" is merely to restate the law. It does not help investors make an informed investment decision.[31] Accordingly, we suggest that the SEC delete proposed Item 501(b)(5).

Effective Date

If the SEC adopts the plain English requirements, it is essential that they become effective as to mutual funds at the same time as amendments to Form N-1A and approval of fund profiles. Each proposal will require major changes to fund prospectuses and, as discussed above, they greatly complement each other. We believe there is no justification for the burdens that disparate effective dates necessarily would impose.

We appreciate your requesting our views on the plain English initiatives. If you have questions about our comments or need any additional information, please call me at (202) 326-5810.

Sincerely,

Paul Schott Stevens
Senior Vice President
General Counsel

cc: The Honorable Arthur Levitt, Chairman
The Honorable Steven M.H. Wallman, Commissioner
The Honorable Isaac Hunt, Commissioner
The Honorable Norman Johnson, Commissioner
Nancy M. Smith, Director
Office of Investor Education and Assistance

Barry P. Barbash, Director
Division of Investment Management

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,220 open-end investment companies ("mutual funds"), 443 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3.483 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

2 As major investors in the securities markets, our member firms also expect to benefit from improvements in other issuers’ disclosure documents.

3 Some aspects of the proposal would not apply to investment companies. These include proposed amendments to Regulation S-K to clarify prospectus disclosure for corporate issuers.

4 The staff required additional disclosure through individual comments and positions expressed in industry-wide generic comment letters. State regulators also required additional disclosure. In some cases, fund counsel added disclosure in an effort to avoid liability under the securities laws.

5 See Investment Company Institute, Shareholder Assessment of Risk Disclosure Methods (Spring 1996).

6 See, e.g., J. Morgan, Mutual-Fund Risks, Plain and Simple, New York, NY Newsday (Sept.

22,1996) at F06; D. Rogers, Coming Soon: A Prospectus You Can Read, Investor's Business Daily (Nov. 5, 1996) at A1.

7 These include proposals to substantially revise Form N-1A to focus mutual fund prospectuses on essential fund information; to allow mutual funds to use a simplified "fund profile" that would provide investors with the option of purchasing shares or requesting the full prospectus; and to require any investment company whose name suggests that it focuses on a particular type of investment to have a fundamental policy requiring it to invest at least 80% of its assets accordingly.

8 Draft Handbook at p. 7.

9 Id. (emphasis added).

10 Draft Handbook at p. 9.

11 Our recommendation would make the draft Handbook consistent with the proposing release, which states as follows: "We provide examples of [the plain English] requirements to illustrate the plain English principle. You should make sure that your disclosure reflects the facts of your particular situation." Proposing release at p. 18.

12 Draft Handbook at p. 23.

13 Id.

14 Id. (emphasis added).

15 For example, funds must disclose their maximum sales charges in the fee table. Some categories of investors may be eligible to purchase shares at reduced charges or at net asset value. In addition, where a fund has a contingent deferred sales charge, whether any given investor will pay such a charge depends upon the investor's holding period.

16 See Investment Company Act Release No. 22528 (February 27, 1997) at p. 35.

17 Proposing release at p. 72.

18 Id.

19 Proposing release at p. 17.

20 Mechanical application of the principles also could impair precision and accuracy by eliminating important nuances. The fee table example in the draft Handbook, discussed above, demonstrates this possibility. This result would be highly inappropriate.

21 Draft Handbook at p. 24.

22 Id.

23 Proposing release at p. 13.

24 Id.

25 In addition, the proposed amendments to Form N-1A seek to focus fund prospectuses on essential information. The amendments would move some current prospectus disclosure to

the statement of additional information and eliminate other disclosure. If the SEC adopts the proposed amendments, they could substantially streamline fund prospectuses. The revised form also might help clarify what information fund prospectuses must include and what information they need not include.

26 Proposing release at p. 14, n. 45 (emphasis added).

27 See, e.g., Krouner v. The American Heritage Fund (S.D.N.Y. 1995); Sheppard v. TCW/DW Term Trust 2000 (S.D.N.Y. 1996); In re Alliance North American Government Income Trust, Inc. Securities Litigation, No. 95 Civ. 0330, 1996 U.S. Dist. LEXIS 14209 (S.D.N.Y. 1996).

28 In its recent releases proposing amendments to Form N-1A and proposing fund profiles, the SEC said that these requirements would apply to the proposed risk/return summary for mutual fund prospectuses, as well as to fund profiles in their entirety.

29 In addition, the proposed amendments to Form N-1A will help by streamlining the entire prospectus.

30 Although Item 501(b)(5) does not apply to investment company prospectuses, the SEC's release proposing amendments to Form N-1A would make conforming changes to Rule 481(b)(1) of Regulation C under the Securities Act (containing the same legend requirement for investment company prospectuses).

31 Indeed, inclusion of this legend seems inconsistent with the stated goal of the proposed amendments to Form N-1A: to focus the prospectus on essential information about a particular fund that would assist an investor in deciding whether to invest in that fund. See Investment Company Act Release No. 22528 (February 27, 1997) at p. 1. Notably, the SEC has not proposed to require the legend on the cover page of mutual fund profiles.
