

## COMMENT LETTER

July 17, 2001

# ICI Sends Letter Concerning Portfolio Holdings Disclosure, July 2001

July 17, 2001

Paul F. Roye  
Director, Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: Frequency of Mutual Fund Portfolio Holdings Disclosure

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Dear Mr. Roye:

The Investment Company Institute<sup>1</sup> is writing to share its views on issues related to the frequency with which mutual funds disclose their portfolio holdings. We understand that the staff is considering this matter in the context of developing a rulemaking proposal designed to improve disclosure in mutual fund shareholder reports. In addition, we are aware that several rulemaking petitions have been filed calling for the Commission to increase the frequency of mutual fund portfolio holdings disclosure beyond the current requirement of twice a year.<sup>2</sup>

The Institute strongly urges the staff to reject suggestions to increase the frequency of mutual fund portfolio holdings disclosure. As a preliminary matter, there is no compelling reason for the Commission to require more frequent disclosure. Notwithstanding the requests of certain financial intermediaries and third parties with business interests in this information, our members report virtually no demand for it from their shareholders. And for

those investors to whom it is important, there are numerous funds that do voluntarily disclose their portfolio holdings more frequently than semi-annually. There also is no evidence that disclosing mutual fund portfolio holdings more than twice a year would benefit mutual fund shareholders.

More importantly, there is substantial evidence, which we detail below, that requiring all funds to disclose their portfolio holdings more frequently would harm fund shareholders. It would facilitate the ability of professional traders and other opportunists to front run trades by mutual funds and to exploit fund research and proprietary investment strategies, all at the expense of fund shareholders. Indeed, abusive practices like these occur today. Requiring funds to disclose their portfolio holdings more frequently would only exacerbate this problem. Instead, we strongly urge the Commission to examine current reporting requirements for institutional investment managers and to take appropriate action to ensure that these reports cannot be used in a manner that harms fund shareholders.

We also wish to reiterate our support for changes that will improve the quality of the information that is presented in periodic reports. This, as opposed to increasing the frequency of what is at best marginally useful data, will best serve the interests of mutual fund shareholders.

## **I. Requiring More Frequent Portfolio Holdings Disclosure Will Not Help Mutual Fund Shareholders**

In considering any change to the current portfolio holdings disclosure requirements, the Commission, as a threshold matter, needs to establish that there is a valid policy basis for making such a change. To date, however, there has been no demonstration that requiring more frequent disclosure would significantly benefit mutual fund shareholders.<sup>3</sup>

### **A. Mutual Fund Shareholders Have Not Indicated That They Want More Frequent Portfolio Holdings Disclosure**

Notwithstanding the results of an investor survey of dubious value,<sup>4</sup> our members report that they have experienced virtually no demand from fund shareholders for more frequent portfolio holdings disclosure. Indeed, several of our members have informed us that they previously sent portfolio holdings information to shareholders in quarterly reports but have discontinued the practice and received no complaints from shareholders.

To the extent that an investor does desire more frequent disclosure of fund portfolio holdings, we note that many mutual funds voluntarily provide such information more often than semi-annually and that this disclosure is readily available to those shareholders who want it. The Institute recently conducted an informal [survey](#) of the portfolio holdings disclosure practices of the 100 largest mutual fund groups.<sup>5</sup> Fifty-seven fund groups responded to the survey (representing \$5.15 trillion, or 73.3 percent of total industry assets under management). (See [Appendix A](#) for survey results.) Of these, 24 fund groups, with respect to a total of 1,403 funds, reported that they disclose all fund holdings to shareholders more frequently than required under SEC rules. Moreover, 55 of the 57 fund groups responding to the survey reported that they disclose top fund holdings to all shareholders in between semi-annual reporting periods. Thus, investors for whom the frequency of portfolio holdings disclosure is an important consideration have ample choices under the existing regulatory requirements.

The fact that many funds currently disclose their portfolio holdings more frequently than is

required by law demonstrates that the current regulatory scheme provides funds with appropriate flexibility to adopt disclosure regimes that best serve their shareholders. Funds that do not disclose their portfolio holdings more frequently than semi-annually have made a determination that it is not in the best interests of their shareholders to do so.[6](#)

## **B. There Is No Evidence That Requiring More Frequent Portfolio Holdings Disclosure Would Help Fund Shareholders**

Forcing mutual funds to disclose their portfolio holdings more frequently would be particularly inappropriate given that more frequent disclosure would provide no meaningful benefits. In the case of shareholders of actively managed funds, a static "snapshot" of individual portfolio holdings as of a particular date is of limited value. More frequent "snapshots," in addition to raising the serious concerns discussed later in this letter, would focus undue attention on individual portfolio securities and could encourage a short-term investment perspective. These results would be wholly inconsistent with the basic nature and investment philosophy of most mutual funds. A mutual fund is not a pre-selected basket of specific securities, nor is it intended as a short-term trading vehicle. Rather, when investors purchase mutual fund shares, they are buying an interest in an investment pool that is professionally managed to meet specified investment objectives and is generally designed for long-term shareholders.

Some have asserted that the Commission should require funds to disclose their portfolio holdings more frequently than semi-annually because this would discourage abusive practices known as "window dressing" and "portfolio pumping." These assertions are misguided. To the extent that window dressing and portfolio pumping are practices that actually occur, the Commission has adequate authority to redress them.[7](#) You have previously indicated that a task force of the Commission's Office of Compliance Inspections and Examinations is looking into these practices by examining trading patterns of fund portfolio securities for possible violations of the securities laws.[8](#) We support this initiative and believe that such examinations are a much more appropriate and effective means to detect and deter any such practices.

## **II. Requiring More Frequent Portfolio Holdings Disclosure Would Harm Fund Shareholders**

Requiring more frequent disclosure of fund portfolio holdings not only would fail to benefit fund shareholders – it would facilitate practices that harm them. More frequent disclosure would expand opportunities for speculators and other professional traders to exploit the information in ways that are detrimental to fund shareholders. These practices include trading ahead of funds that are in the process of building or eliminating positions in stocks or other securities. Our members have developed their current policies concerning portfolio holdings disclosure with this in mind. Several of them have expressed serious concerns about their ability to protect shareholders' interests if portfolio holdings information is required to be disseminated more frequently.[9](#)

It should be noted that mutual fund firms are not the only ones expressing the concern that mandating more frequent portfolio disclosure will fuel trading practices that harm fund shareholders. For example, a well-known mutual fund columnist has cautioned fund investors that:

[I]f your fund starts telling everyone what it owns each month, Wall Street's sharp traders will be able to follow – far better than they already can – what your fund is doing. These

folks can profit by trading ahead of a big fund, buying whatever the fund is buying and selling what it's selling. That maneuvering by outside speculators will drive up the price your fund pays for stocks – and drive down the price it gets when it sells. As a result, higher trading costs will eat away at your returns.[10](#)

Indeed, even those petitioning the Commission to require more frequent portfolio holdings disclosure implicitly acknowledge the possibility that these adverse consequences may occur.[11](#)

## **A. There Is Strong Empirical Evidence That Requiring More Frequent Portfolio Holdings Disclosure Would Facilitate Practices That Harm Fund Shareholders**

In order to examine in a more rigorous fashion the harmful consequences of requiring more frequent portfolio holdings disclosure, the Institute retained Professor Russ Wermers (Department of Finance, Robert H. Smith School of Business, University of Maryland at College Park) to analyze the potential effects of more frequent portfolio disclosure on mutual fund performance. Drawn from existing research, Professor Wermers' study concludes that, if more frequent portfolio holdings disclosure were required, abusive activities would become more widespread and would adversely impact fund performance.[12](#) Professor Wermers' study, which is attached as [Appendix B](#), identifies and discusses specific examples of these activities. As a result of these activities, the study states, "the total return that shareholders receive from mutual fund investments would likely be lower than under the current disclosure standard."[13](#)

### **1. Fund Portfolio Disclosure and "Front Running"**

Professor Wermers' study finds that more frequent disclosure of portfolio holdings has the potential to raise fund trading costs by increasing the risk that outsiders would use the information to successfully anticipate fund trades and capture the price impact by trading ahead of funds. Such front running can result in higher prices for fund purchases of securities and lower prices for fund sales. Importantly, the study points out that front running likely would occur even if disclosure of portfolio holdings were made subject to a lag of 30 or 60 days, particularly in the case of large trades. Thus, claims that lag times would prevent front running, while possibly true in the case of smaller trades in more liquid securities, are, according to Professor Wermers, simply inaccurate in the case of larger trades or trades of less liquid securities that take longer to complete.

### **2. Fund Portfolio Disclosure and "Free Riding"**

According to the study, more frequent portfolio holdings disclosure also could facilitate the ability of outside investors to obtain for free the benefits of fund research and investment strategies that fund shareholders pay for. "Free riders" could duplicate fund holdings or portfolio strategies which, in turn, might prevent a fund from fully realizing the potential returns from its research efforts by moving security prices before the fund has a chance to fully implement its investment strategies. In this way, these "free riders" expropriate the results of proprietary research and strategies that fund shareholders pay for.

More frequent disclosure of portfolio holdings not only would facilitate direct mimicking of a fund's holdings but also it would facilitate "reverse engineering." The study explains that this form of free riding occurs when an outside investor applies statistical techniques to portfolio holdings information to infer a fund's stock-picking strategies, strategic choices, or even holdings of specific securities. The study notes that the feasibility and precision of

such inferences become greater as the frequency of portfolio holdings disclosure increases. It concludes that disclosing fund portfolio holdings more frequently than semi-annually, even with a 60-day lag, would substantially increase the potential for free riding because of the potential return that an outside investor could capture through such a strategy.

## **B. Professional Traders Already Are Exploiting Mutual Fund Portfolio Disclosures**

Professor Wermers' analysis provides strong support for the theory that requiring more frequent disclosure of fund portfolio holdings would be harmful to fund shareholders. Significantly, though, concerns about the adverse effects of more frequent portfolio holdings disclosure on fund shareholders are not just theoretical. Professional traders and others already exploit information about fund portfolio holdings that is currently available.

A review of financial websites on the Internet reveals a number of services that claim to provide clients with the ability to "piggyback" off of mutual fund research and investment strategies.<sup>14</sup> For example, one such service asks: "Why not pick the minds of the best money managers in the world to help build your portfolio?"<sup>15</sup> This service explains on its website that it draws on the research of professional money managers. "[The service] allows you to take advantage of the wealth of research conducted by institutional money managers [who] invest an enormous amount of time and money performing research and analysis."<sup>16</sup>

This service's website addresses the issue of whether the information provided is unreliable because it is stale:

Absolutely not. It is true that the data we are looking at is from information that the funds reported six to twelve weeks ago. However, funds usually make big commitments to particular holdings for a long-term investment; so it is unlikely that a fund will reverse a large buy in a short time frame. More importantly ... [m]omentum trends often result in upward price movement over many months or even years. Only four weeks after the close of each quarter, [the service] begins to identify stocks that institutions and mutual funds are accumulating on a large scale, stocks whose future the market is just beginning to discover.<sup>17</sup>

As set forth in [Appendix C](#), our initial scan of the Internet uncovered three services being offered to anyone who wants to trade stocks and other securities on the basis of information regarding the holdings of mutual funds and other institutional money managers. It seems reasonable to believe that this is a small sample of those who may be using this information in such a manner. To cite just one obvious example, there may be private money managers who use similar strategies but who do not publicly solicit clients.

Undoubtedly, these professional traders would welcome a requirement for more frequent disclosure of mutual fund portfolio holdings because such a requirement would enhance their ability to take advantage of the research and investment acumen that is meant to benefit the fund shareholders who are paying for it. It also likely would encourage still more speculators and opportunists to try to "piggyback" off the work of mutual fund managers.

What is more important is that the gains for those who would exploit this information will come at the direct expense of fund shareholders. For this reason, it seems apparent that requiring funds to disclose their portfolio holdings more frequently than semi-annually would contravene the Commission's investor protection mandate.

### **III. The Commission Should Review Current Reporting Requirements for Institutional Money Managers**

In addition to disclosing fund portfolio holdings semi-annually in shareholder reports, mutual fund managers generally must file quarterly reports on Form 13F ("13F Reports") with the Commission if they manage, in the aggregate, at least \$100 million in certain equity securities.<sup>18</sup> The information provided in 13F Reports differs from the schedule of investments required in fund shareholder reports in several respects. For example, 13F Reports disclose an investment manager's aggregate holdings of the securities required to be reported. The holdings of each individual mutual fund or other account over which the manager has investment discretion are not broken out separately. In addition, 13F Reports are limited to exchange-traded or Nasdaq-quoted equity securities included in a list published by the Commission. Thus, unlike the schedule of investments included in shareholder reports, 13F Reports do not include certain types of securities, such as foreign securities (unless they trade on a U.S. exchange) or fixed income securities.

Another important difference is that, when filing 13F Reports, investment managers are permitted to request confidential treatment of certain types of information, including information that would reveal an investment manager's program of acquisition or disposition that is ongoing both at the end of a reporting period and at the time of filing the Form 13F.<sup>19</sup>

As a result of the distinctions described above, the disclosures included in 13F Reports may not facilitate the same degree of harmful trading practices as disclosure of individual fund portfolio holdings. Nevertheless, like fund portfolio holdings disclosure, and especially when combined with such disclosure, 13F Reports likely facilitate front running and free riding practices that hurt fund shareholders. Indeed, the services referred to above and described in Appendix C to this letter clearly rely in significant part on information from 13F Reports.

For this reason, in addition to recommending against a requirement for more frequent disclosure of fund portfolio holdings, the Institute recommends that the Commission commence a review of the 13F reporting requirements. We note that one of the primary purposes behind the enactment of Section 13(f) of the 1934 Act in 1975 was to create a central depository of information about the investment activities of institutional investment managers in order to allow regulatory agencies to analyze their influence and impact on the securities markets. Since the enactment of Section 13(f), however, there is no evidence that the Commission has made extensive use of this information for the purposes intended by Congress or for any other reason.

In addition, while Section 13(f) also was intended to provide greater public disclosure of institutional holdings, Congress could not possibly have anticipated the technological advances since 1975 that have greatly increased the speed and ease with which the information in 13F Reports may be accessed and disseminated. A clearly unintended consequence of the accessibility of this information has been to support private firms' packaging the information to facilitate predatory securities trading practices, such as front running mutual fund trades or free riding on funds' investment research – practices which, as noted earlier, likely are harming mutual fund shareholders.

Thus, it appears that 13F Reports are not serving one of their primary purposes; yet, at the same time, they are being used for purposes not contemplated by Congress and in a manner that is directly contrary to the protection of investors. Based on these

developments, the Commission should conduct a review of the 13F requirements to determine what modifications (e.g., to the frequency of filing such reports) are needed to ensure that 13F Reports achieve their designated objectives without promoting activities that negatively impact mutual fund shareholders.[20](#)

## **IV. The SEC Should Propose Changes To Improve the Usefulness of Disclosures About Mutual Fund Portfolio Holdings**

Based on the serious potential for harm to fund shareholders, the Institute is hopeful that the staff agrees that it would be a grave error for the Commission to mandate more frequent portfolio holdings disclosure by all funds. The risks of harm to fund shareholders far outweigh any potential benefits.

Instead of increasing the frequency of portfolio holdings disclosure, the Commission should propose changes that would improve the usefulness of portfolio information in shareholder reports. For example, as the Institute previously recommended,[21](#) the Commission should streamline the schedule of investments to simplify the information contained in fund shareholder reports. More specifically, the current requirement to disclose all fund investments in shareholder reports generally is not helpful to most investors and should be revised to require disclosure of any holding constituting more than one percent of a fund's net assets and, at a minimum, the fund's 50 largest holdings.[22](#) The Commission could further require that a complete list of fund holdings be made available free of charge upon request.

In addition, the Commission should consider requiring graphic presentations of portfolio information, such as a pie chart showing different categories of securities held in a fund's portfolio (e.g., broken down by industry sector, credit quality, or other characteristic). Many funds already provide graphic presentations of the fund's investments. A Commission requirement to do so would extend this practice more broadly and facilitate investor understanding of a fund's portfolio holdings. Under any such requirement, funds should retain the flexibility to determine what type of chart, table or graph would provide the most useful information to shareholders given the fund's investment objectives and limitations.

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The Institute appreciates the opportunity to share its views on this important topic with the staff. We look forward to working with you and the Commission as you continue to consider ways to improve fund shareholder reports.

Sincerely,

Craig S. Tyle  
General Counsel

Attachments

cc: Laura S. Unger, Acting Chairman  
Isaac C. Hunt Jr., Commissioner  
Cynthia M. Fornelli, Deputy Director  
Susan Nash, Associate Director

## Division of Investment Management

### ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,598 open-end investment companies ("mutual funds"), 504 closed-end investment companies, and 7 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.991 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

2 See Letter and Supporting Memorandum from Mercer E. Bullard, Founder & CEO, Fund Democracy, LLC, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 28, 2000; Letter from Duane R. Thompson, Director of Government Relations, the Financial Planning Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 28, 2000; Letter from Consumer Federation of America, et al., to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated August 9, 2000; Letter from Kenneth S. Janke, President and CEO, National Association of Investors Corporation, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated October 9, 2000; Letter from Richard L. Trumka, Secretary-Treasurer, American Federation of Labor and Congress of Industrial Organizations, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated December 20, 2000.

3 Indeed, many of the proponents of more frequent portfolio holdings disclosure do not appear to represent the interests of fund shareholders generally. Rather, their own business or other interests would be served by having access to more frequent fund portfolio information. These are not the interests the Commission is charged with protecting when it promulgates regulations.

4 See MetaMarkets Press Release, "Do You Know What Stocks Are in Your Mutual Fund Today?" at [http://www.metamarkets.com/about/release\\_000710.jhtml](http://www.metamarkets.com/about/release_000710.jhtml) (describing the results of a June 2000 survey of mutual fund investors commissioned by MetaMarkets.com). Among other weaknesses, the survey failed to measure the respondents' current use of portfolio holdings information to provide a benchmark for assessing expected use of more frequent disclosure. In addition, in summarizing the survey results, MetaMarkets drew the unsupported conclusion that responses regarding investors' knowledge (or lack thereof) of their funds' current holdings indicated a strong demand for exact, current information on fund holdings. A more appropriate interpretation of the data is that investors do not know the current holdings of their mutual funds because they do not review the portfolio holdings information that is currently provided to them. Finally, the survey emphasizes more frequent disclosure without indicating any associated costs or risks to fund shareholders, which is unrealistic. It is predictable that investors would indicate a desire for more information if receiving it did not involve any associated costs or risks.

5 A summary of the survey results is set forth in [Appendix A](#) to this letter. The 100 largest mutual fund groups were identified based on assets under management as of March 31, 2001.

6 It is important to note that because any additional costs associated with a requirement to provide portfolio holdings disclosure more frequently would be passed through to shareholders, fund management companies derive no benefit from "holding back" portfolio information. Their only incentive in declining to provide the information more often is to protect the fund and its shareholders.

7 See SEC v. Friedlander, No. 01 Civ. 4658 (S.D.N.Y. filed May 31, 2001).

8 See, e.g., "The Challenge of Making Best Practice, Common Practice," Remarks by Paul Roye, Director, Division of Investment Management, U.S. Securities & Exchange Commission, 2000 ICI Securities Law Developments Conference (December 4, 2000) at 11.

9 See "Keep the Investment Boogeymen at Bay," Washington Post, Oct. 15, 2000 at H3.

10 Jason Zweig, "Why Your Fund Manager May Work Better in the Dark," Money, March 1998. This same columnist suggested to investors: "If your fund starts sending monthly updates, throw them in the garbage; a semiannual checkup is plenty." Id.

11 See, e.g., Letter from Consumer Federation of America, et al., to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated August 9, 2000, at 3 (suggesting that a 30-day lag time should be sufficient to address concerns about possible front-running of fund trades). As discussed further below, such a time lag would not effectively address these risks.

12 Russ Wermers, "The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance," Perspective, Vol. 7, No. 3, June 2001, Investment Company Institute. (Included as [Appendix B](#) to this letter.)

13 Id. at 1 (emphasis added).

14 Descriptions of several such services are included in [Appendix C](#) to this letter.

15 See [http://www.iDayo.com/qa\\_indicator.html#4](http://www.iDayo.com/qa_indicator.html#4).

16 See [http://www.iDayo.com/indicator\\_why.html](http://www.iDayo.com/indicator_why.html).

17 See [http://www.iDayo.com/qa\\_indicator.html#9](http://www.iDayo.com/qa_indicator.html#9) (emphasis in original).

18 Rule 13f-1(a) requires any institutional investment manager that exercises investment discretion with respect to accounts holding "Section 13(f) securities" having an aggregate fair market value on the last trading day of any month of any calendar year of at least \$100,000,000 to file a 13F Report with the Commission within 45 days after the last day of such calendar year and within 45 days after the last day of each of the first three calendar quarters of the subsequent calendar year. The reports are filed on the Commission's EDGAR system and can be accessed by the public over the Internet.

19 Although there is a provision that permits mutual funds to avoid identifying individual securities in the schedule of investments included in shareholder reports under certain circumstances (see Section 12-12 of Regulation S-X under the Securities Act of 1933 at n.1), it differs significantly from the confidential treatment provisions for 13F Reports. For example, it imposes a five percent limit on the total value of securities that may be listed as "miscellaneous securities" and not specifically identified. In addition, it does not extend to situations where a fund is either disposing of a position in a security or adding to an existing position if the securities have been held for a year or longer or have previously been reported by name.

20 We note that Section 13(f)(1) does not mandate quarterly reports. Rather, it authorizes the Commission to determine the frequency of reporting by institutional investment managers, subject to the proviso that in no event shall 13F Reports be filed for periods

longer than one year or shorter than one quarter.

21 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, dated August 11, 1998. A copy of the letter is attached as Appendix D to this letter.

22 Such a requirement would be consistent with generally accepted accounting principles ("GAAP") for investment companies, as set forth in the Investment Company Audit Guide.

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