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DISCLOSURE

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II. DISCLOSURE

PROF. HAAS: Our next panel is going to focus on two really heated issues in the industry. One, what disclosure do investors really need to make investment decisions? That is, when you are choosing between a mutual fund or deciding to buy a stock, what information is crucial to you? Two, is the industry doing enough to control fees and expenses? Of course I said that with a bias, suggesting the industry is not doing enough. I am sure there will be people who disagree with me on that. Moderating the panel is Dean Sargent.

DEAN SARGENT: Okay. I will start with some brief introductions. We have once again a spectacularly distinguished panel. To our right is Matthew Chambers, who is with Wilmer, Cutler & Pickering, and was formerly with the SEC Division of Investment Management for quite a while, so he can bring us both the practitioners' and the regulatory perspective. To my right, of course, is Professor Haas, who needs no introduction to this group, though I will point out that he is part of that small group of securities law scholars who is working in the '40 Act area. So he is doing important work. Next to him is Catherine Heron from the Capital Group Companies, Inc. She is an expert in the mysteries of ERISA, an area which securities lawyers do not dare touch, unless they are smart. We are glad to have her here to enlighten us. Next to her is Edward Rosenbaum, from Lipper Inc., which is of course a leading data source. To my far right is Jason Zweig, who is a columnist for Money Magazine. From his biography you see that he has a spectacularly diverse career and did all sorts of things before he ended up in this somewhat dreary area. His biography concludes by saying that he is no relation to money manager Martin Zweig, and I am thinking of adding to my biography a whole list of people to whom I have no relation. But in any event, that is our group.

We are going to start with a discussion of fund disclosure and we are going to focus on a couple of major issues that are very hot today, in particular, the question of legalese versus plain English. One aspect of the securities laws is the notion that you should disclose information to people which they can actually use; though, of course, securities disclosure really can be read as a memorandum to potential clients' lawyers. That is, you write securities disclosure in such a way that it can be summary judgment-proof, which is not necessarily consistent with disclosing information to people which they can actually use. The plain English movement has been an attempt to change this, and, to a certain extent, has been the development of the profile disclosure. We are going to start off with Matt Chambers and Catherine Heron who will be talking about these topics. One question that I would like them to address, and all the speakers to address at some point, is what information do investors really need to have. What is essential, what is sort of ground minimum? Let us begin with Matthew Chambers.

MR. CHAMBERS: Thank you. In the late Nineties, the SEC went through a period trying to get plain English into prospectuses of all issuers, but with particular focus on mutual funds. This effort culminated in mid-1998 with a new form for the prospectus for mutual funds, called Form N-1A. It supposedly is in plain English. It includes some bar charts, graphic depictions of investor return, and a portion called the risk/return summary, but it does not really tell you a whole lot about risk. This effort was preceded by a lot of ballyhoo from the agency saying that it made things better for investors. I think in fairness, now that we've had a year of experience with the new prospectuses, it has improved disclosure. But it certainly hasn't made prospectuses anything anybody wants to read.

Dean Sargent was saying the history of the securities laws and the point of prospectuses has been the subject of some debate. For those of you who are scholars, go back and read a law review article written in 1934 by a Yale law professor named William O. Douglas, who later went on to become SEC chairman. In his article on the Securities Act of 1933, which governs mutual fund prospectuses, he wrote that the point wasn't to make prospectuses something the average investor could understand.[1] It was, instead, to put a body of information into the marketplace through which experienced professionals, such as broker-dealers, financial advisors and others, could distill and provide to investors.[2] The SEC has gotten away from that concept in the last ten years or so. Whether that is good

1. *See* William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521 (1934).
2. *See id.*

or not, I don't know. You can make an argument that, in the mutual fund world, the distilling process doesn't work as well as it does in other areas, in part because many investors buy directly without seeking any advice from anybody else and, in part, because mutual funds are sold at net asset value and not at a market price that is established by people buying and selling in a market. The Agency has really decided it is not going to accept William Douglas's view of the Securities Act.[3] It is going to go to plain English.[4]

Now, back in the early Nineties, before I left the SEC, I was speaking at a conference here in New York[5] and somebody asked me what I thought about plain English efforts. I said, "Some days I can't even get my staff to write in plain English," and that "I was very skeptical of the SEC's ability to force mutual fund groups to write their prospectuses in plain English." I got back to my office the next day and somebody walked in and said, "So you don't think I can write, huh?" *USA Today* had quoted me.[6] I immediately sent an e-mail to everybody that I worked with saying what I really should have said was that many days I can't write in plain English. I didn't mean to take it out on my staff. I have the same problem.

Where I come out on the legalese-plain English issue is that it is all well and good for the Agency to try but, unless you give people more of an economic incentive to write in plain English, they are not going to do it. They would much rather have a court reviewing a very complex, lengthy disclosure document that gives them all sorts of protections in a lawsuit. There is where their economic incentives lie.

PROF. HAAS: I met with Arthur Levitt in his office about nine, ten months ago, and he asked me about plain English, and what I thought about plain English prospectuses. I said that I think, generally speaking, they are a very good thing, but it is been difficult

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3. *See* Chairman Levitt Announces Two Communications Initiatives in On-Going Public Education Campaign, SEC 94-145, 1994 WL 557715 (Oct. 13, 1994); *see also* SEC Adopts Rule Requiring Plain English in Prospectuses, SEC 98-10, *at* http://www.sec.gov/news/press/98-10.txt (Jan. 22, 1998).

4. *See, e.g.*, General Rules and Regulations, Securities Act of 1933, 17 C.F.R. § 230.421 (2000).

5. The speaker refers to a meeting of the 100% No-Load Mutual Fund Council, held on November 29, 1994.

6. Daniel Kadlec, *Oakmark Patiently Lets Acorns Grow*, USA TODAY, Nov. 30, 1994, at 3B.

for the SEC-oriented lawyers to start writing like that, particularly in things like asset-backed securitization deals. I said it would be nice also, since you are requiring us to write in plain English, if you rewrite all of the security regulations in plain English. He didn't find that very funny.

MR. CHAMBERS: Look at the legend they put in the prospectuses, and they try to make it look more like plain English, but the last sentence of the legend says, "It is a criminal offense to state otherwise."[7] I keep on trying to get my clients to strike out the words criminal offense and write crime. But they won't do it. They look at me like I am crazy. I keep saying, what is a criminal offense if not a crime? All the law students here can tell me what the answer is, because I don't know. The Agency did not even rewrite that.[8] In fact, it says it is a criminal offense. That is the passive voice. It should say, "stating otherwise is a crime." Therefore, the Agency has not been able to do it either.

DEAN SARGENT: Apropos of Jeff's point: one of the problems with plain English is that the underlying thing that you are describing has to be capable of description in plain English. I defy anyone here to describe an asset securitization in plain English.

PROF. HAAS: It is very, very difficult to do. I would be interested in hearing Matt and Catherine's view of this. We have, on one end of the continuum, language that is so technical and so boring that nobody ever wants to read it. On the other side of the continuum, we have language that is so cute that people really do not take it seriously. Take for example, the IPS Millennium Fund,[9] which is an Internet-related fund. They have taken plain English to a new level. I call that new level the hard truth, and they've made the following statements. I would like to hear what Cathy and Matt have to say about it.

They made this comment that they've sent to their investors and put on their website: "A stock fund gets clobbered in a reces-

7. Item 501(b)(7) of Regulation S-K.

8. *See id.*.

9. *See* IPS Advisory, Inc., IPS Millennium Fund, *at* http://www.ipsfunds.com/indexmf.html.

sion even if Gandhi, Jefferson, John Lennon, Jesus and the Apostles, Einstein, Merlin and Golda Meir all manage the thing."[10]

MS. HERON: Jeff, if it is the bottom line you are talking about, boy, that is really entertaining. But the truth of the matter is that the fund prospectus is indeed a legal document. Lawyers deal with it every day. It deals with the liability issues. Plain English is great. Plain English is motherhood and apple pie. But there has to be a balancing. This is, indeed, a legal document. What I would like to do, if asked the question about what disclosure people need most, is turn to what I consider the most fundamental, significant failure of our disclosure system. That is something that nobody has paid any attention to so far as I can tell. Mark gave me the great lead-in.

The real area where the disclosure system is failing us is in the retirement plan area. What we have seen over the past fifty years is a monumental shift in the nature of our retirement system. We have moved from defined benefit plans where employers choose the investments, and bear the risk of those investments, to plans which are essentially the reverse of that. In other words, you have employees choosing investments and participating in directed plans like 401(k)s. The employees bear the risk of that investment. Obviously, to where does the disclosure go? Not to the employees. There is no mandatory requirement that employees in retirement plans who are picking their investments receive disclosure of what those investments are.

Now, this is an area that to my mind is just an enormous problem. It is been going on for roughly fifty years now that we have seen a sea change in the retirement plan system, and yet nobody stepped up to really address it. It has fallen between the cracks of regulatory whatever, regulatory abandonment, I guess. That is an area in which somebody needs to step up to the plate. Should it be the SEC or the Department of Labor? It is not clear. But nobody is doing it.

MR. ZWEIG: Mark, I would like to jump in and just follow up on what Cathy was saying. First of all, I would like to address her comments about retirement plan disclosure, which is abysmal, if not non-existent. But also, being the lone panelist who will stand

10. IPS Advisory, Inc., Risks of Investing in IPS Millennium Fund, *at* http://www.ipsfunds.com/risks.html.

up in defense of the IPS Millennium Fund, I would like to point out two things. First of all, this disclosure is not part of the prospectus. This is simply a promotional window on their Web site,[11] and, frankly, I think it is fabulous. I think it is the optimal example of what the Internet can do for fund companies that most fund companies are ignoring. It does not replace the prospectus, supplant the prospectus, or contradict the prospectus. It supplements the prospectus in a way that the SAI,[12] and all the other worthless disclosure documents that funds are required to file, can never do.

Better yet, it reaches people in a way they can understand and to which they can relate. It contains an interesting comment that is apropos to what we are talking about here. I printed out the full text. The third paragraph of what they call the human language risk disclosure reads, and I quote:

> Aside from the mandatory boilerplate terrorizing above, there are risks that are specific to the IPS Millennium Fund you should understand better. Since most people don't read the Prospectus, (this isn't aimed at *you*, of course, just all those *other* investors), we thought we'd try a more innovative way to scare you.[13]

Can you possibly argue from a legal point of view that anyone who has actually read this document is unaware that this fund is risky? A sensible judge would throw out a plaintiff's case faster against a fund like this than one with a 175-page mumbo-jumbo prospectus.

PROF. HAAS: Jason, I think you make an excellent point. I just want to clarify that this language is not in the prospectus. This is sent as a supplement to investors and it is up on the website. I guess my only concern is, can we become too cute with the language to the point that people just kind of laugh it off? I'll give another example. The IPS website states, "Don't come crying to us if we lose all your money and you wind up a dumpster dude, or a basket lady rooting for aluminum cans in your old age."[14]

MR. CHAMBERS: If that was all it said, then I think it would be too cute. The lawyer's role is not only to make sure that it is not too cute, but also that there are valid warnings in there. It sounds like

11. *See* IPS Advisory, Inc., IPS Funds, *at* http://www.ipsfunds.com.
12. Statement of Additional Information, Form N-1A, Part B.
13. IPS Advisory, Inc., Risks of Investing in IPS Millennium Fund, *at* http://www.ipsfunds.com/risks.html.
14. *Id.*

there are. Jason, the article about this Millennium Fund said that their lawyers and the NASDR[15] had scotched some of their more amusing language.[16] I don't know why or in what context, but I can tell you that everybody in my practice group at Wilmer got an e-mail from the head of our practice group saying how wonderful this language was. I wish they were our client.

MS. HERON: You have to say it gets people's attention. If you are going to get through to them, this kind of language will do it.

MR. CHAMBERS: These days it may not be a bad marketing thing because so many investors think they want to take that risk and invest in technology funds. That is fine, as long as they understand the risk.

PROF. HAAS: Jason, what three pieces of information do you think investors need to really make an informed investment choice?

MR. ZWEIG: They need to know how much the fund costs. They need to know what it is likely to earn. And they need to know whether the performance that is being presented to them has any better than the negligible or non-existent predictive value it usually has. The third one is a real problem.

MR. CHAMBERS: How would they know that, Jason?

MR. ZWEIG: I don't have a solution to that.

DEAN SARGENT: Perhaps we could focus now on the question of the profile, which is a particular form of disclosure. Why don't we start with Matthew on that.

MR. CHAMBERS: Again in 1998, when the SEC adopted the so-called plain English mutual fund prospectus,[17] it also adopted something called a fund profile,[18] which is a shorter document from which mutual funds may directly sell without giving investors the full prospectus. Although the SEC doesn't like to admit it, the profile really grew out of something I worked on back in the early Nineties that we called an "off the page prospectus."[19] The idea was that you could have a piece of paper about $8^1/_2$" by 11", or maybe even smaller, that could appear as a newspaper ad, or before the days of the World Wide Web, in a mailing, and you could sell from that. We felt that almost everything you need to know about a mutual fund could be boiled down to one or two pages.

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15. Referring to the National Association of Securities Dealers Regulation, Inc. *See* NASD Regulation, Inc., A Resource for Investors and the Securities Industry, *at* http://www.nasdr.com.

16. *See Mutual Fund is Painfully Blunt*, ST. LOUIS DISPATCH, Feb. 8, 2000, at C7.

17. *See* General Rules and Regulations, Securities Act of 1933, 17 C.F.R. § 230.421 (2000).

18. *See* 17 C.F.R. § 230.498 (2000).

19. *See, e.g.*, Off-the-Page Prospectuses for Open-End Management Investment Companies, 58 Fed. Reg. 16141, at 16141-01 (proposed March 25, 1993).

There was great Sturm and Drang when we proposed this. People said we were trying to get rid of basic investor protections and that we were trying to help the fund industry market.[20] Actually, those of us who worked on it didn't feel that way at all. We really felt that, by focusing on a shorter document, you would get more plain English and convey more of the important facts, the two or three or five or six things investors really need to know. When the SEC adopted the profile prospectus in 1998, it said that it thought the profile would be particularly helpful in the defined contribution employee benefit plan market and on the Internet. When I read the Internet part, I thought, "Well, why?" When you go to the Internet, you can just go get the prospectus with the same click of the mouse with which you can get the profile. Why would you want only the shorter document? And from the fund companies' point of view, there is absolutely no savings on the Internet stemming from the delivery of a shorter document. There is plenty of bandwidth, for mutual fund prospectuses, at least. There does seem to be some theory that it might work in the defined contribution plan market. Thus far it has not been used that way, in part because, as Cathy said, the law just simply does not require that kind of disclosure. Cathy, what is your view on this proposal?

MS. HERON: That is exactly where a lot of fund companies thought that they could reap a substantial savings as well as provide a significant benefit by giving a short, concise disclosure document to participants of retirement plans. What they didn't want to have to do was to send out multiple copies of the prospectuses to thousands of participants of retirement plans. If the plan offers—say, ten or twelve investment options—the amount of paper involved in sending each participant ten or twelve full prospectuses, which they wouldn't read, seemed pretty outrageous. So, it really was heralded, I think, as something that would permit mutual funds to use a short, concise document that would give participants a quick, easy way to glance at what their options are.

The problem is, once again, that nobody thought through what the various legal requirements are, and it has been an abysmal failure, so far as I can tell, in the retirement plan market because it doesn't work. The reason it does not work is because there was not any coordination again between the SEC and the Department of Labor on this. The Department of Labor has some requirements under ERISA. These are contained within Section 404C of ERISA.[21] That is the pro-

20. *See, e.g.*, Peter D. Santori, *Selling Investment Company Shares Via an Off-The-Page Prospectus: "Leveling the Playing Field" or "Diminishing Investor Protection,"* 20 J. CORP. L. 245, 271-272 (1995).

21. *See* 26 U.S.C. § 404C (1994).

vision of ERISA that says an employer can be off the hook for liability and will not be responsible for its participants' investment decisions if they make them independently. In other words, if participants exercise independent control and make the investment decision, the employer is not going to be responsible.

404C has a requirement that you have to provide a prospectus as part of the concept of the employee exercising independent control and actually making the investment decision.[22] The problem is that the prospectus required under 404C cannot be a profile prospectus.[23] So, you are right back in the soup. It has got to be a full prospectus.[24] The Department of Labor would not permit profiles. So the profile, certainly in the retirement plan market, has not been adopted to any length at all. I guess that is where there was a sense that it would be a benefit to participants and a real cost savings to funds.

DEAN SARGENT: Anybody else want to pitch in on the profile?

PROF. HAAS: Is anyone using it?

MR. CHAMBERS: I don't know. Certainly none of our clients are. I have never gotten one because I do most of my mutual fund looking these days on the Internet. Again, I do not think there is any reason to put it there.

PROF. HAAS: Just a general comment that I have, and I don't mean to bash the SEC too badly on this, but I am going to do it. They always seem to be two or three years too late. I think if the profile had been adopted earlier then it actually might have been more useful. One of the reasons I like to talk about the delayed reaction of the SEC is that I remember two or three years ago talking with Brian Lane, Director of Corporation Finance, who now has left the SEC. He was waxing on about the SEC's EDGAR database,[25] which has all the company filings for public companies, except the filings are formatted in ASCII. Everyone heard of that? ASCII. It is very difficult.

MR. CHAMBERS: It is the ugliest text a computer can use.

PROF. HAAS: It is something from the Seventies. He was very proud about saying—maybe, Matt, you can update us on this—that by the year 2001 or 2002, that database will be in HTML,[26] which is slowly becoming history for the rest of the internet world. So the SEC is about to adopt a system, HTML, in the next couple of years, which no one will be using.

22. *See* 26 U.S.C. § 404c (1994).

23. *See id.*

24. *See id.*

25. *See* U.S. Securities and Exchange Commission, Edgar Database of corporate information, *at* http://www.sec.gov/edgarhp.html.

26. *See id.*

MR. CHAMBERS: One of my colleagues said he thought he had seen something about HTML being on Edgar this week, but I haven't bothered to go check. I don't use Edgar. I use some of the other sites, like Free Edgar,[27] where they put the things up in a format that is slightly more advanced, where you see a table that you can figure out what it was supposed to look like.

MR. ROSENBAUM: I just wanted to comment about the issue of the profile. One of the reasons the profile is not working is that mutual fund investors have gotten a lot smarter a lot faster than anybody ever expected them to get. So the consumers of mutual fund data are now—well, I don't know if they are reading the prospectus—

MR. CHAMBERS: They are not.

MR. ROSENBAUM: They sure as heck know what is going on in their funds, including, but not limited to expenses. They want to know, with a fair amount of specificity, about the investment policy, what choices are being made, and overlap between their funds and other funds in terms of stocks that are inside. The profile just simply won't do it and, frankly, neither will so-called plain English. The prospectus does not do it, either. However, as investors are grappling with the question about what they own, they are going to phenomenal lengths to try to find that out, and almost none of us are serving those needs.

DEAN SARGENT: That raises a really fascinating question. We are dependent, or seem to be dependent, upon a mandatory government disclosure system, but you are arguing that it doesn't work very well, that there is a tremendous appetite for private sources of information and that, of course, private providers have an incentive to provide such information.

MR. ROSENBAUM: I am not suggesting that the government system does not work very well. It serves its purpose. That is, it protects the fund against the kinds of liabilities from which they have to be protected, and that is an important function.

MR. CHAMBERS: It also puts a certain amount of information into the public marketplace, where people like you can get it. For example, they have to show you their portfolio holdings every six months, and that gives you a snapshot you would not otherwise have.

MR. ZWEIG: I think what Ed is driving at is that the current disclosure regime is ideal for a world in which only one mutual fund exists and every investor is considering buying that fund and no one owns any other mutual funds or any other securities and has no concern whatsoever as to how that particular fund might mesh with what she already owns. Unfortunately, that is not very much like the market-

27. See the Lipper Inc. corporate website at http://www.lipperweb.com.

place we are talking about. I find in my contacts with the readers of our magazine that the issues Ed is talking about are exactly what people care about. Virtually everyone who is eligible to buy a fund, given their investment minimums, already owns several of them. The key decision most people face is not which fund to buy, but often which fund to get rid of, or, in other words, where do I have a small hole and how can I fill in one fund without overlapping with what I already have.

I would not argue that this is something that mandatory government disclosure should address, but it is the kind of thing on which we see virtually nothing spontaneously from the industry. At this point it is being answered primarily through third parties, which is probably a shame. I do not see why a fund company would incur any sort of legal liability if it included in its official disclosure documents some basic discussions of where this particular investment fits in with an asset allocation program, what kind of risk contribution it might make to an overall portfolio, and some basic information about the asset class itself. It would be nice to see a common stock fund say, "Over the past seventy years stocks have done so and so in comparison to cash and bonds. However, from 1966 through 1982 they stunk. That could happen again." We do not see that anywhere.

PROF. HAAS: Is the problem with disclosure not with the people providing it, but with the people receiving it? I hearken back to Tobin's noise theory,[28] where he says there is a class of investor—I am often in that class myself, so I plead guilty—that doesn't trade on fundamentals. I do not buy stocks on fundamentals. I do not read the prospectus. I buy on tips that I hear at cocktail parties. I buy based on what I see in a chat room on the Internet. I chase performance. I see this fund is up 150 percent. I think going in with Tobin's noise theory, that is, people trading on non-fundamental information, plays perfectly with people chasing returns. "Well, this fund made 150 percent last year. Gosh darn, I got to get my money in it now."

MR. ZWEIG: My answer, Jeff, is that, as is so often the case in the securities industry, it is a devil's bargain. You have brokers, the brokerage community, the fund industry and the public all aiding and abetting each other's worst tendencies.

PROF. HAAS: I think that is fair.

MR. ZWEIG: That is a bull market phenomenon. In a bear market, all the relationships will be severed and the people in the fund industry and the brokerage business will be saying to the public, "We

28. *See* James Tobin, *A Proposal for International Monetary Reform*, 4 E. ECON. J. 153, 153-59 (1978).

have a relationship built on trust." The public will be saying, "I don't think so."

MR. ROSENBAUM: The public will hear, at a time like that, from the advisors, the third parties, and the fund managers, "We told you so. Look at this prospectus." The investing public will say two things; First, "I don't think so. You didn't tell me about this." They will be, in part, right about that. Second, all of the bonhomie we are facing now, while everything is going up, is going to collapse in a split second. It has happened before. Fourth quarter 1987 was no treat. There was a lot of finger pointing. This, in fact, could happen again and it will be accompanied by lawsuits. Investors clearly need more information than they are getting now. But they do not need the same kind of information in the same format that they have been getting. The industry and the investors know this. I know that because I used to be one. The systems that are used, both by the industry itself and by third parties such as ourselves and our competitors, try to go forward in order to get what it is that investors are really looking for. Because in all the legalese, it is easy to forget that this is their money. In some sense we have a quasi-fiduciary responsibility to see to it that they know what it is they are getting into.

PROF. HAAS: Maybe that is the reason why this hard-truth disclosure is particularly useful in the case of noise traders like myself. It rises up to the level of cocktail conversation, something you might see in a chat room. Someone describes, "Oh, no, that is a dog." I understand what that is. I am going to stay away from it. Jason, do you think there is anything in that?

MR. ZWEIG: I do. I would just close my usefulness to this part of the discussion by giving two simple observations. One is that fund companies get the customers they deserve, and fund investors get the returns they deserve. This does not happen in the short run but it happens in the long run. Anyone who is out there using disclosure as a minimalist tool to maximize cash flow into their investment products will get the customers they deserve. People who are using disclosure in creative, positive ways will also get the customers they deserve. The investors who are chasing performance, I hate to tell you this, Jeff, will ultimately get the returns they deserve. It may take a while.

PROF. HAAS: I'm getting them right now.

MR. ROSENBAUM: This month, anyway. This month has not been pretty for you.

DEAN SARGENT: Let us talk about a different type of information and one that is near and dear to Ed's heart, I think. That is the question of categorizing funds or classifying funds. You see a bewildering array of fund categories and fund classifications out there now. What do you think about all that?

MR. ROSENBAUM: Several things. The classification is confusing. Every time somebody introduces a new scheme it seems to get more confusing. Let me take you back a couple of years to describe the state of play at that point. At that point, the industry used eight categories to describe diversified equity mutual funds: small cap, large cap, growth, value, capital appreciation, growth and income, equity income, and mid cap. That is not counting the sectors and non-U.S.

The problem with that scheme is that it grew up over time. It started with growth when people were trying to discern what a mutual fund was. That became important. They had a system in which, frankly, nobody—by nobody, I mean even the portfolio managers managing the funds—could tell you the difference between growth and income and equity income. Even within a single category, say growth and income, you would find yields that would vary between four-tenths of a percent and four percent. Two portfolio managers from two separate companies would tell you they'd swear on a stack of Lipper reports that they are all doing the same thing. And they'd be right, which is the worst problem.

Investors in some sense, in some important sense, were not being served. Especially since some of these categories were not mutually exclusive. How could you call value different from small cap? So we had a state of affairs in which the emperor was buck naked and nobody was admitting it. The marketing guys had gotten locked into a set of categories in which practitioners did not really believe, but which were critically important in terms of making sure that cash flows into the funds were maintained. Remember that profitability in the mutual fund industry is leveraged not to performance but to net cash inflow, because fees are a percent of assets. Performance is a means to an end, not the end in itself.

MR. ZWEIG: For the advisor.

MR. ROSENBAUM: For the advisor. Actually, for the fund management company.

MR. ZWEIG: For everyone but the shareholder.

MR. ROSENBAUM: Exactly. One of the reasons that we rolled out a new system, because there was an important need out there that was not being met. Because Lipper bears particular responsibility as the third party reference of choice to the majority of the mutual fund companies in the U.S., we had to get it right. We spent a couple of years, actually more than a couple of years. This system was five years in gestation. We had a first pass, I would say it was our alpha test. That took about a year. We went through a review and commentary process not dissimilar to what regulations go through. We received a lot of very useful commentary, and what we came up with was a system which we hope has distinctions that matter to investors, that is simple, intuitive and that has some methodological rigor behind it. That is, you can tell why a fund is in one box versus another. We had a lot to leave out.

What we eventually settled on was growth and value as a signpost of investment style, with the center being growth at a reasonable price or, looked at another way, value with growth characteristics. That was one axis. If you will, that is the horizontal. The vertical was market cap size. For reasons which are mostly historical, the investment industry tends to care about whether an investment is large cap, mid cap or small cap.[29] We are willing to grant that, although I question the premise. We built systems that would differentiate by the cap size of the underlying stocks, and we built another category called multi-cap for people who don't and shouldn't care about the market cap of the mutual funds they have invest in. In this system we can classify diversified equity funds in a way which gives the investor a sense of what is inside. The most important thing about this classification system, by the way, is that it does not depend upon the prospectus language. Prospectuses, mostly used to cover the liabilities of mutual fund companies, have become purposely vague over time.

MR. CHAMBERS: Or to give their managers flexibility.

MR. ROSENBAUM: Same thing. So you can no longer tell from the prospectus what the investment charter of the system is. So we abandoned it. For U.S. diversified funds we look at the contents of the portfolio. Our system, which, thankfully, is automated, looks up at content and tells you whether these are growth or value stocks. Because that determination is important, our methodology is public. This is not a black box. The system is posted on the Web site.[30] Anybody who has access in the industry to commonly available data can replicate our classifications. So there is no question about ownership or rights or mystery. It is very simple to explain where a fund is. The problem is, as virtuous as this system is, it is yet another system. It is going to confuse people in the short run.

PROF. HAAS: I think one of the concerns I would have is that you hear people say from time to time that there is too much information. I can barely look at a prospectus. Now I have to figure out what your categories are. And there are 15,000 mutual funds out there. Pretty soon we are going to be so specialized that we are going to have the General Motors mutual fund. All they do is invest your money in Gen-

29. "Cap" refers to market capitalization. The market capitalization of a given company is determined by multiplying its stock price by the number of shares it has outstanding.

30. *See* REUTERS Limited, *The Home of Funds Data*, *at* http://www.lipper.reuters.com.

eral Motors. How do you respond to something like that? Too much information. Do you think that it is a timing thing?

MR. ROSENBAUM: It is not just a timing thing. It is an interesting comment to make in a setting in which we are talking about how the investors need more disclosure because it is the flip side of giving investors more information. On the one hand, we know that the current level of information is overwhelming and does not serve the investor. At the same time we also know that it is insufficient, in that the distinctions that it makes are not meaningful. So, we could continue on with the old system until it breaks down entirely. There is a risk to the mutual fund industry, namely that investors will, and have started to, vote with their feet away from mutual funds because, in fact, that is the reaction. The reaction is, "Why should I care about market cap? Why should I care about growth versus value?" So they say, "The heck with this. I am going to go buy some Yahoo." That is something that the mutual fund industry ought to, and does, fear. The only answer to the old problem was to come up with another system, because the old one could not be fixed. I do not know of another way, just from a common sense standpoint, to have approached this.

PROF. HAAS: How long do you think it is going to take for the investing public to embrace the system?

MR. ROSENBAUM: We have seen an incredible amount of success so far. In fact, one of the things on my agenda today is that we have mutual fund companies coming to us with mock portfolios, saying, "Well, what would a portfolio like this look like in your system?" That is something that did not happen in the old system. So, if you judge success by unrequested demand, the success is very, very strong. In fact, it is strong enough that it is an issue for us in terms of balancing work load. We've seen broad acceptance. We get calls from mutual fund companies, the departments that write prospectuses, asking what the proper usage is for the words. So that is the only way you can measure success. In three years, I suspect people will wonder why they ever accepted the old system because of its lack of rigor.

DEAN SARGENT: We have been talking about some fairly global disclosure issues: the philosophy of disclosure, the relationship between mandatory government disclosure and privately generated disclosure or reprocessing of information, for example. There are numerous specific disclosure issues that are constantly under discussion and re-evaluation. One of them is the question of after-tax disclosure. I am going to ask Catherine to speak on that issue.

MS. HERON: Mark, I think you can see in the overwhelming trend of disclosure that there are a lot of good, possibly meaningful, things out there that could be added to the prospectus. We go through these cycles whereby somebody says, "Boy, that is a good idea.

Let's put that in." Someone else says that sounds like a good idea, so we put that in. Then the SEC requires this to be put in and the disclosure, the prospectus builds up and up and up and when you look at it, you say, "My God, this is awful. Nobody can understand it." Then we strip it all down and start all over again. We see these cycles in prospectus disclosure. We went through a cleaning house just a few years ago and now we are in the building up stage again. Disclosure of after-tax returns is one more proposal that we are about to see in March that is clearly part of the building-up phase. The question is, how meaningful or relevant is it? Is it meaningful and important enough that it really ought to be in there? Why now? Mutual funds have been making taxable distributions since the 1920s. Why this great interest in after-tax return or tax efficiency now?

First, there has been much more emphasis on equity fund investing and, certainly, tax efficiency and after-tax return are much more important to equity funds. Second, there is a lot of media coverage of the industry and they talk about tax efficiency. Third, some funds have made large capital gain distributions at the same time as the value of the fund's portfolio has declined. It makes people scratch their heads and say, "Hmm, I am getting this back tax bill and yet the value of my fund is down. How did I get that wonderful treat?" Essentially we've had a great amount of discussion focusing on after-tax return recently. Even in Congress we've got Congressman Gilmore, who is introduced a bill, which says he wants the SEC to do something to help shareholders understand the importance of portfolio turnover and how that affects after-tax return. The problem is, as usual, that the Congressman did not quite get it right, and doesn't quite understand the whole picture. But that is Congress.

There are many factors that affect after-tax return. Portfolio turnover is one of them, but only a marginal one. In fact, you can have a fund with a large amount of portfolio turnover that does not negatively affect after-tax return. If you are offsetting gains and losses, that is fine.

MR. ROSENBAUM: What if they bought losing stocks? The stocks go down and then they sell them.

MS. HERON: Yes.

MR. ROSENBAUM: Then turnover is high, and guess what?

MS. HERON: That is right. Turnover is high and you don't have much after-tax return to worry about.

MR. ROSENBAUM: Exactly.

MS. HERON: You have other things to worry about, such as pretax return, which is probably not so good. Anyhow, the SEC has jumped into this and instead of waiting for Congressman Gilmore to tell them to do something they are going to do it on their own. In

March, there is going to be a proposal to require disclosure of after-tax return.[31] I think there is a recognition that there are many more things that affect a fund than portfolio composition. As I said, you have to look at expenses, capital loss carry-forwards that can eat up gains so the funds don't have to distribute them, investment strategies, and fiscal year ends. I am not going to go through all this, but there are many things that affect a fund's tax efficiency besides portfolio turnover. The real question is what is the goal here? What are we trying to achieve with this disclosure? I think there are two goals that are usually cited. The first is an apples to apples comparison. In other words, I want to stand one equity fund next to another equity fund and figure out which is best for me. I am a taxable investor and I want to know where I am going to be, which sounds like a reasonable objective. The second goal is to make sure that people understand the tax effects of investing in a mutual fund, which may be a little tougher.

The apples to apples comparison of two funds is, generally, a comparison that can be made using a standardized formula, which would crank all funds into the same formula and spit out numbers at the end so that you can tell which is best on an after-tax basis. The problem in developing any of these standardized formulas, though, is that it is an imprecise science and you have to think about a lot of things. Some of the things that would go into the formula are things like, whether, for example, a return is pre-liquidation or post-liquidation. Pre-liquidation refers to whether we should pretend that the shareholder is still holding his shares, and simply focus on what it is that the fund did. In other words, did the fund's portfolio produce tax results for the investors? Post-liquidation pretends that the shareholder sold his shares at the end of some measurement period and considers his tax situation there. The short answer seems to be that we may be in the situation where we have to provide both.

MR. CHAMBERS: There is actually at least one fund group that now does this on its website.

MS. HERON: Right. There are actually two major fund groups that do it, and they do pre-liquidation return.

MR. CHAMBERS: The one I went to this week had the investor choose whether you want to see the returns before—

MS. HERON: Before liquidation.

MR. CHAMBERS: —and the investor could also predict marginal tax rate.

31. This proposal was recently adopted by the SEC. *See* U.S. Securities and Exchange Commission, Disclosure of Mutual Fund After-Tax Returns, *at* http://www.sec.gov/rules/final/33-7941.htm.

MS. HERON: Yes, that is another factor that is rather important because, obviously, whatever marginal rate you put into the formula has got to be the same for everybody. Then the question is, what rate should I put in? I assume everybody pays the highest marginal tax rate, 39.6 percent. But we know a lot of shareholders don't pay the highest marginal tax rate. So will this number be meaningful for somebody who doesn't pay the highest marginal tax rate?

MR. CHAMBERS: What will you be paying when you liquidate?

MS. HERON: Right. The other question with respect to tax rates is what do you do about state tax rates. There are fifty different states all with different tax rates.

MR. CHAMBERS: What if George Bush becomes President?

MS. HERON: That is already an issue, because we have had tax rates that have changed over the years. So the question is, if you look back over, say, a one, five and ten year period, do you use the actual rate that has applied for the past ten years or do you use 39.6% ? You have to deal with all these issues when you are developing this standardized formula. You also have to figure out the period you measure. Are you looking at the calendar year or are you looking at the fund's fiscal year? If you want to do apples to apples, you probably ought to do the calendar year, because funds' fiscal years change. Right now, as you know, funds have to disclose their pre-tax return for the past one, five and ten years, annualized. I think they are going to add six more numbers: pre-tax and after-tax post-liquidation for one year, same for five, same for ten.

MR. CHAMBERS: This would be in an advertisement or in a prospectus?

MS. HERON: I am not the SEC staff so I don't know.

MR. CHAMBERS: People look at ads. They don't look at the prospectuses.

MS. HERON: I am assuming that it will be in the prospectus, along with the one, five and ten. But, of course, there is the question of whether this is really going to be helpful to shareholders. I do not pay taxes at the 39.6 percent rate, or I live in California. You didn't take into account California taxes, which are pretty significant. What if I have an IRA or I am in a 401(k)? I don't care at all about after-tax return. I only care about pre-tax return. What is this really going to tell me? The other thing is whether investors will understand some of the complexities, like the fact that you can have a fund with minus three pre-tax, minus 3.2 after tax pre-liquidation, and five percent positive return on post-liquidation. That is because if I redeemed my shares and they were at a loss, that is a tax benefit to me. So you can have the anomalous result of a fund that has got negative pre-tax return, negative pre-liquidation after-tax return, and positive after-tax post-liquidation return. Trying to explain that to an investor is going to involve explaining why it is a tax benefit to own a fund that just went down in value, assuming you sold it.

The other question is, obviously, as I said, about half of the investors in equity funds don't pay taxes. They don't care. Another big question asks to what funds would this apply? It is probably irrelevant to an aggressive growth fund, an equity fund where tax efficiency is important. What about a bond fund? What about situations where you are trying to get some taxable return? What about an equity income fund where, again, taxable income is part of your objective. Should it apply there?

MR. ROSENBAUM: What about a small cap fund which in order to stay small cap has to sell its winners?

MS. HERON: Another factor that can affect after-tax return are cash inflows and outflows. If you have money coming in, that reduces per share dividend distributions. So you can help your after-tax return. If you have money going out, shareholders leaving, you get killed. You have to sell portfolio securities and the per share distributions get bigger. There is nothing you can do. There is no great way, that I am aware of, to manage that situation.

MR. ZWEIG: Cathy, I have two thoughts. The first is that this whole project reminds me of Jeff's allusion before to the SEC and, in this case, also to Congress perennially fighting the last war. I think that we will find, as we go forward from here, that the Internet is going to take this whole issue away. I want mutual funds to set up interactive tax calculators for my readers, so that each current or prospective shareholder can input his own marginal tax rate, his state of residence, and the Web site will know his state or local tax rate immediately. He can enter whether he itemizes or not, and he will get a number, which would be vastly better than any number that he can get out of a standardized document. It will be his number, not the number for the median United States mutual fund shareholder. The second issue that concerns me is that this entire project is predicated upon the assumption that this number has predictive value, that this number, based on past performance and tax data, tells you something about what your future taxable experience in this fund will be. Unless it is an index fund, that is a false premise.

MR. CHAMBERS: Are you saying the past performance is not true or that the past tax efficiency is not true?

MR. ZWEIG: I am saying that the past tax efficiency is not highly likely to continue into the future.

MR. CHAMBERS: I've never heard that before.

MS. HERON: In fact, it is likely to reverse. It can be very tax efficient initially. It is likely to become much less tax efficient. Eventually, things are going to catch up with it.

MR. ZWEIG: If you are running the Chambers Aggressive Growth Fund and you are doing a good job, you will build up, over time, an increasing balance of unrealized capital gains. Your tax efficiency will rise over time until the point at which it crashes through the floor and you finally have to realize those gains.

MS. HERON: That is what post-liquidation return does. Post-liquidation return will unmask that. In other words, because that assumes that the shareholder redeems, it doesn't matter that it is unrealized expense. That is why post-liquidation return is a kind of leveler.

MR. CHAMBERS: I understand that tax efficiency will not necessarily stay constant, but I think it would have more predictive value than you are suggesting. Certainly, Morningstar rates funds on their tax efficiency and it gives you several years of tax efficiency numbers, and it seems to me that you do not see a lot of variation there.

MR. ZWEIG: That is because we have had seventeen years of a bull market.

MR. ROSENBAUM: Right. It is also because the underlying methodology has issues.

MR. ZWEIG: We also have positive cash flow.

MR. ROSENBAUM: The other issue that after-tax return raises, which concerns us, is comparability. Right now it is very easy. I grant you that total return numbers over time are a flawed way to look at your total personal return from mutual funds, but they have a very strong virtue, in that they are calculated all exactly the same way. What that means is that you can compare Fund A to Fund B in terms of its past performance. You can tell what the fund does, and what funds do relative to each other in different kinds of market environments. Once you begin to use taxability, once you begin to use different after-tax numbers for one fund versus another, you take away the possibility of comparing funds to each other for the purposes of selecting them. That is dangerous. That does not serve investors in the intermediate and long term. It, therefore, looks very important from our standpoint to make sure that whatever after-tax returns are disclosed, that simple total return—that is NAV[32] plus dividends calculated in a coherent fashion, comparable fashion—is also presented. When you take that away, the investor is very, very ill-served.

MS. HERON: Yes. There is a real concern that you could focus only on after-tax return, and not focus on pre-tax return. You are not

32. Net asset value.

going to have a great investment if you do not have good pre-tax return.

DEAN SARGENT: No conference on mutual fund issues would be complete without a discussion of fees and expenses. So we are going to once again turn to Jason, Matthew and Catherine for discussion on this.

MR. CHAMBERS: Mutual fund fees and expenses are like the weather. Everybody talks about it but nobody does anything about it. It is unclear why we should do anything about it. Mutual fund investors already know the fees and expenses they pay if they look in the prospectus. Despite my jokes about the prospectus earlier, there is a fee table right in the very front which I think most investors probably at least glance at. If they read Jason's magazine, they see comparisons of fund expenses. If they look at Lipper information or Morningstar they will see it. Investors in general, with the bull market going the way it is or has been for the last however many years, just don't care, because the expenses don't show up very highly, don't have much effect, given the tremendous gross returns most mutual funds have had. Maybe they should pay more attention. I certainly pay attention when I buy a fund. If the fund is paying higher than average expenses, you ought to ask yourself why you want this fund, and whether there is a good reason for those expenses. Perhaps it is a category of fund that requires more sophisticated investment analysis. Perhaps you are buying it through a broker who is being paid by the fees off the fund. In that case it is perfectly legitimate to pay more fees. I do not see anything the government needs to do to change this area at all. All the information is out there. If you regulate the fees any more than they already are, you will simply hurt the industry to the long-term detriment of investors.

MS. HERON: I will quote Jason from an earlier point, when he said investors get what they deserve. I guess they get the return that they deserve. Coming from a fund group that has fees among the lowest in the industry, I do think fees are important. It is important to have low fees, consistently low fees. With respect to incentive fees, I think, again, to a certain extent, this represents a bias in the media to focus only on equity funds and, indeed, high-flying equity funds. I think if you are going to talk about incentive fees, it depends on what kind of fund you are talking about. If you have a relatively conservative fund, there is nothing like an incentive fee to push the portfolio manager to take risks that maybe he should not take, that are not within the context of the fund's investment objectives. Whether or not to have incentive fees depends upon the type of fund and, maybe, we should leave that to the more high-flying type funds. But, having said that, fees are important. I think they are disclosed and investors get the return they deserve.

MR. ZWEIG: It is not a legal or regulatory issue at this point. If you work for a fund company or you are thinking of working for a fund company or you have a fund company as an outside client, it is a business issue. History suggests, very strongly to me, that if fund companies are unwilling to cut their fees now in a bull market, when it won't hurt them very badly, they should think about the prospect of what it is going to feel like when the public forces them to cut their fees in a bear market, when it will be extremely painful. That is almost certainly what we will see happen. There is a fairly good amount of historical data that suggests fees go up, on average, in a bull market and go down, on average, in a bear market. If I were running a fund company, I could cut them now or I could cut them later. I would rather cut them now.

It is a sad commentary on the fund industry that so few equity funds do use performance incentive fees. Fidelity, to its credit, does this. Vanguard does it in its actively managed funds. A handful of other fund companies do it. But it is very peculiar that in its advertising and marketing materials, as we have seen, the fund industry badgers the public to take the other side of the bet. The bet is whether our performance will continue. We are telling you, Mr. Investor, that it will. How would you like to take our bet? The problem is, the fund company is not taking the bet because the fund company gets paid whether the performance persists or not. That is the beauty of a performance incentive fee. If performance, relative to a benchmark, is poor, the fees are poor. Because they have to be symmetrical. I am not suggesting that every fund in every category should charge that way. If I were running a fund company, I would wonder why am I asking my customers to make a bet I am refusing to take?

MS. HERON: Asset-based fees are, by their nature, performance related to a certain extent. When assets go up and investors come in, gross fees in dollar terms go up. So there is a relationship between an asset-based fee and performance.

MR. ROSENBAUM: From an investor's standpoint, and this is going to sound a little heretical, I suspect it is cheap. Anybody who has ever tried to run a portfolio understands that it is not something that you can do on a Saturday afternoon. You are paying somebody a fee for delivering a service. That service is not having to worry excessively about how the stocks in your fund are doing Monday through Friday. I maintain that a lot of the fees that are being charged by mutual funds right now are not excessive. I would also argue that investors are in fact less stupid than we seem to be presuming. I do not know that they have to be protected from high fees as much as the fees need to be disclosed. There are an awful lot of investors out there who are voting with their dollars in the direction of fund companies whose fees are relatively high. Rather than saying that these guys are being duped, why not say that their behavior, in fact, has a lesson in it and we have to learn what the lesson is. Maybe they are not paying attention. Maybe fees are not being disclosed. Maybe they are getting perceived value from these fees. What is that value that they are getting? Maybe it is affiliational. That is, I want to belong to Fidelity. Maybe it is security. They have a feeling that a particular fund, Company "X," is not likely to go to Bermuda with their money. And that is worth a certain percent.

Fees do matter in the long run. This is Jack Bogle's argument,[33] that twenty basis points is an appropriate thing to pay to own the S&P Index Fund, because that is roughly what it costs to run. Think about it this way: What is twenty basis points of $100 billion? I do not know if an index fund costs that much to run. And those fees have not dropped a lot over the course of the past few years. What we are all saying is that fees are not sufficiently called out, that we as a group do not necessarily think that the mutual fund companies are disclosing fees enough to allow investors to make what we consider to be a well-informed decision.

PROF HAAS: I just have one point on fees, picking up on what Jason was saying. I don't think there is much discussion within a fund complex of how the fees of mutual funds compare to fees of alternative ways to invest. There is a lot of discussion that our fee for our mutual fund is either higher or lower than someone else's fund, which is very similar to our fund. But nobody is comparing it, that I am aware, to alternative ways to invest money, that is, the do-it-yourself investor who has the computer already, has the Internet connection, and is now trading for $7 a trade.

MR ROSENBAUM: I guarantee you, you are wrong. Because as the net inflows into mutual fund companies have leveled off over the course of the past couple of years, the strategic planning departments of the mutual fund complexes that have them are worrying every minute of every day about this. They perceive this to be a threat to the ongoing business.

MR. CHAMBERS: I would like to see the after-tax performance of the online traders.

MR. ROSENBAUM: Right, this is another thing. Remember survivorship bias. You hear somebody bragging about the one trade out

33. *See* The Vanguard Group, *Bogle Financial Markets Research Center*, *at* http://www.vanguard.com/bogle_site/bogle_home.html.

of thirty that happened to go up thirty percent. Trust me, everyone has dogs.

DEAN SARGENT: Okay, I think that wraps it up. Thank you very much.