HEALTHY MARKETS TRANSPARENCY & TRUST

Council of Institutional Investors® The voice of corporate governance

CFA Institute

November 6, 2020

Via Electronic Mail
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-09-20 -- Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements[1]

Dear Ms. Countryman:

The Healthy Markets Association, Council of Institutional Investors,[2] and CFA Institute write jointly to offer improvements to the above-referenced proposal to reform the disclosure obligations for investment funds.

The 646-page Fund Disclosure Proposal would dramatically revise what information open-end funds provide to investors, as well as the form and timing of those disclosures.

While each of our organizations may have views on various aspects of this significant proposal, we are focusing this joint comment letter narrowly on factors related to best execution and the costs of trading and research. Unfortunately, despite our June 2019 letter to Chairman Clayton urging the Commission to require disclosures related to trading and research costs,[3] the current proposed revisions would not make these

[1] *Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements*, SEC, Exch. Act Rel. No. 33-10814 (Aug. 5, 2020), *available at* https://www.sec.gov/rules/proposed/2020/33-10814.pdf ("Fund Disclosure Proposal").

[2] The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of US public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than 15 million participants – true "Main Street" investors through their pension funds. Our associate members include non-US asset owners with about $4 trillion in assets, and a range of asset managers with more than $35 trillion in assets under management. For more information about CII, including its board and members, please visit CII's website at http://www.cii.org.

[3] Letter from Tyler Gellasch, Healthy Markets Association, Jeff Mahoney, Council of Institutional Investors, and Kurt Schacht, CFA Institute, to Hon. Jay Clayton, SEC, June 26, 2019, *available at* https://www.sec.gov/comments/mifidii/cll5-5739221-186727.pdf ("2019 Joint Letter").

long-overdue reforms.

The Commission's failure to adopt clear disclosure requirements regarding transaction costs means that most investors don't know how much they are paying for trading or research, nor do they have the comfort that the research for which they are paying benefits them.

We urge you to modify the Fund Disclosure Proposal to require funds to disclose:

- detailed transaction costs (not just commissions), including separate line items for costs of investment research paid from fund assets, regardless of how it is funded; and
- their best execution policies, which should reflect efforts to ensure that fund transaction costs, including commission dollars generated by the fund, directly benefit the asset owners in the fund.

Put simply, investors should know how much they are paying for trading or research, and have the comfort that the research for which they are paying benefits them.

Proposal, Questions, and Initial Reactions

The Fund Disclosure Proposal would require the disclosure of an "Ongoing Annual Fee," which "generally would be the same figure that funds currently report as 'Total Annual Fund Operating Expenses' (i.e., the fund's expense ratio)."[4]

However, as the Fund Disclosure Proposal expressly acknowledges the "expense ratio does not currently reflect all or even most of the material performance expenses that similarly affect the fund's performance,"[5] such as securities lending costs and transaction costs.[6] These transaction costs, the release explains, "are the costs a fund incurs when it buys or sells portfolio investments," which "include commissions, spread costs, market impact costs, and opportunity costs."[7] Notably, included in the "commissions" portions of the missing costs might also be the costs associated with investment research.

The Fund Disclosure Proposal further explains that while these additional costs are not itemized and disclosed, they nevertheless show up in the performance disclosures in the fund prospectus and Statement of Additional Information ("SAI"), because the amounts are essentially directly taken from the fund assets.[8]

Further, the release notes:

> prospectuses provide a fund's portfolio turnover rate, and SAIs include the amount of brokerage commissions the fund

[4] Fund Disclosure Proposal, at 275.
[5] Fund Disclosure Proposal, at 275.
[6] Fund Disclosure Proposal, at 275-276.
[7] Fund Disclosure Proposal, at 276.
[8] Fund Disclosure Proposal, at 276.

> paid. This information can help investors understand how fund transaction costs may vary among different funds.[9]

Ultimately, despite acknowledging the significant effect of transaction costs on fund performance, the Fund Disclosure Proposal essentially continues to leave investors in the dark on those costs, and offers no meaningful reforms.

However, the Fund Disclosure Proposal does make a number of requests related to whether it should include more enhanced disclosures of fund costs. For example, the release asks "should the reported expense ratio include any performance expenses—such as securities lending costs or fund transaction costs—that it does not currently include?"[10] The answer is, of course, yes.

Similarly, the Fund Disclosure Proposal asks:

> If funds were to provide additional disclosure about securities lending costs or fund transaction costs in prospectuses, would this disclosure complement existing disclosure requirements in the prospectus, SAI, and Form N-CEN? Or should we remove or modify those existing disclosure requirements?[11]

Here, again, the answer should be obvious for those seeking to inform and protect investors. The disclosures are complementary. The Form N-CEN should include securities lending and enhanced trading cost disclosures, which should also be summarized with other expenses as a total cost number.

The Proposal also asks:

> [S]hould funds disclose these costs in connection with the prospectus's presentation of fund performance under Item 4 of Form N1A given they can detract from performance? If so, should they, for example, be required to disclose the top three—or some other number—types of costs that detracted from fund performance?[12]

Again, the answer is yes. All material costs should be quantified and disclosed. Not just the "top three."

Lastly, the Proposal asks:

> How would modifying prospectus disclosure to reflect securities lending costs, fund transaction costs, or other

[9] Fund Disclosure Proposal, at 277.
[10] Fund Disclosure Proposal, at 282.
[11] Fund Disclosure Proposal, at 284.
[12] Fund Disclosure Proposal, at 283.

> performance expenses of a fund's portfolio management activities affect investors? What disclosure modifications would help investors better understand these costs, and conversely, are there any disclosure modifications that would contribute to investor confusion or potential misinterpretation?[13]

Here, again, the answer is simple. Investors should know who is providing a better service, and be able to seek to negotiate different costs based upon their own priorities. Cost transparency gives rise to informed negotiations. In fact, some very large institutional investors have already been able to negotiate these types of disclosures. And with that information, many of them have reduced or entirely eliminated costs that had previously detracted from their performance.

Further, despite investment advisers' best execution obligations, the Fund Disclosure Proposal would not require them to disclose their best execution policies, practices, or other more qualitative information with which fund customers may identify the true total transactions and research costs incurred by the funds.

Background and Analysis

The question of whether and how the SEC should require funds to disclose more complete transaction costs is not new. Investors and their advocates have been urging for these disclosures for years. In fact, in 2003, the Commission released a Concept Release on potentially requiring more detailed disclosures of transaction costs.[14] Back then, commenters called for disclosure of these costs.

Today, best execution policies, including transaction cost analysis are widely adopted across the industry. Trading and research costs, and industry practices, have changed dramatically. Unfortunately, however, the Commission has nevertheless continued to fail to offer any rules or guidance for investment advisers' seeking to fulfill their best execution obligations.[15]

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[13] Fund Disclosure Proposal, at 284.

[14] *Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, SEC, Exch. Act Rel. No. 34-48952, (Dec. 19, 2003), *available at* https://www.sec.gov/rules/concept/conceptarchive/conceptarch2003.shtml.

[15] We note that the Commission has, to date, offered no rules related to minimum obligations related to "best execution" requirements for investment advisers. Nevertheless, the Commission's Office of Compliance, Inspections, and Examinations released a Risk Alert in 2018 that highlighted purported "deficiencies" in investment advisers' policies. *Compliance Issues Related to Best Execution by Investment Advisers*, Office of Compliance, Inspections and Examinations, SEC, July 11, 2018, *available at* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf. If the Commission is going to identify and potentially bring enforcement actions for purported deficiencies, it should first outline minimum expected obligations. The requirement that firms at least adopt "best execution" policies -- which have long been industry best practices -- would be a cautious, but effective first step. Interestingly, the only guidance offered by the Commission to date covers exclusively the application of a statutory safe harbor from claims related to use of commissions to pay for investment

Similarly, investors have been calling for enhanced disclosures of research costs for years. For example, in 1998, the Council of Institutional Investors instituted a policy that:

> [l]ike any other expense of the plan, trading costs need to be managed to minimize the cost and ensure that maximum value is received. But current brokerage industry practices of bundled pricing for services make it difficult to break out the exact costs of services (for trade execution, research or other things), may be antithetical to the fiduciary obligation of obtaining best execution, and hold too much potential for conflicts of interest and abuses.
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> We support and urge full unbundling of pricing for investment management, brokerage and research services, so that institutional investors can purchase and budget for these services as they do any other expense of the plan.[16]

Similarly, the CFA Institute has long had a policy that:

> [i]t is the duty of investment managers to seek best execution for their clients, to ensure that any benefits accruing from the payment of commission fees beyond execution costs belong to the clients, and to inform their clients about how the benefits derived from those execution costs are invested.[17]

As we explained in the 2019 Joint Letter,

> [o]ur members, who regularly work as fiduciaries for US retirement funds, endowments, foundations, and other asset owners, frequently do not know how much of their own assets are being used to pay for investment research, nor can they be confident that the research they are buying even benefits their funds. While other parts of the developed world have adopted research cost transparency (or gone further in

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research. See generally, Letter from Tyler Gellasch, Healthy Markets Association, to Hon. Jay Clayton, SEC, Apr. 2, 2018, *available at* https://healthymarkets.wpengine.com/wp-content/uploads/2018/05/04-02-18-HM-letter-Impact-on-Payments-for-Research.pdf; see also, *The Future of Research in the US After MiFID II*, CFA Institute, 2019, *available at* https://www.cfainstitute.org/-/media/documents/article/position-paper/future-research-us-after-mifid-ii.ashx.

[16] Council of Institutional Investors, *Policies on Other Issues, Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture*, Mar. 31, 1998, *available at* http://www.cii.org/policies_other_issues#principles_trading_commission_softdollar.

[17] CFA Institute, Investment Management Policies: Fair Dealing. *Accord*, CFA Institute, *Soft Dollar Standards: Guidance for Ethical Practices Involving Client Brokerage*, at 8, 2011.

> the name of protecting investors), the US regulatory regime has not changed in decades.
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> Correcting US policy to provide greater transparency and flexibility in the payments for research has never been more essential. With the implementation of MiFID II and the PRIIPS regimes in Europe, many European asset owners are no longer being asked to pay for research.[18] This trend appears to be spreading globally.
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> If a global adviser were to want to continue to use its clients' commissions to pay for research, it can. But that would now often include mostly (or only) US asset owners. Put simply, US retirement funds, endowments, foundations, and other asset owners are now at risk for subsidizing research for others around the world. And they generally have no transparency into those additional costs.

Investors in Europe are already protected by both of the requirements we are recommending. Notably, some of the largest investors in the United States have already been able to negotiate these types of disclosures from their investment advisers.

Unfortunately, there is a very disparate impact of this lack of required disclosures on investors within the US. In the US, many of the very largest asset owners have been able to compel their investment advisers and brokers to provide this detailed information, or to take other steps to protect their investments. By contrast, retail investors and other smaller institutional investors are unlikely to be able to obtain such disclosures or protections.

We again urge you to level the playing field to protect all US investors by requiring funds to disclose basic details regarding their trading costs (including research-related costs), as well as their best execution policies.

We also note that the SEC's Investor Advisory Committee urged the Commission to consider "whether fiduciaries relying on the Section 28(e) safe harbor should be required to provide greater transparency about any costs borne by clients in the form of higher commissions for Research."[19]

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[18] While MiFID II permits client funds to be used to pay for research through a Research Payment Account, we understand that the overwhelming majority of asset managers have declined to utilize this framework, and have instead elected to generally pay for investment research for their MiFID II-covered customers with adviser assets, often referred to as their "P&L."

[19] *Recommendation Submitted by the Market Structure Subcommittee of the SEC Investor Advisory Committee (IAC) for IAC Consideration and Approval, Structural Changes to the US Capital Markets Re Investment Research in a Post-MiFID II World*, Sec. and Exch. Comm'n, July 25, 2019, *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-market-structure-subcommittee-investment-research.pdf.

We urge the Commission to finally ensure that investors know research and trading costs that directly impact their investment returns.

Lastly, we note that some opponents to transparency of fund research spending costs have suggested that it could negatively impact overall levels, quality, or availability of investment research. At an initial level, we question how it is somehow better for investors to not know how much they are spending for research and other products and services. Typically, we -- and the Commission -- have found that transparency improves market efficiency. But more deeply, we have a ready experiment in Europe. There, the European Securities Markets Authority has conducted a thorough review of its far more prescriptive requirements regarding research cost transparency.[20] In summarizing the findings of that study, ESMA explained:

> In the past, concerns have been raised, based primarily on survey data, that the new rules could have detrimental effects on the availability and quality of company research in the EU. … [W]e examine a sample of 8,000 EU companies between 2006 and 2019, and do not find material evidence of harmful effects from these rules. The introduction of MiFID II has not led to a significant difference in the number of analysts producing Earnings per Share (EPS) estimates ("research intensity"). Recent increases in the number of firms no longer being covered by research analysts ("research coverage") appear to be a continuation of a long-term trend. The quality of research has been steadily improving in recent years. SMEs do not appear to be particularly affected in terms of research intensity, research coverage, and research quality. The descriptive findings in this article are consistent with the emerging data-based academic literature on the impact of the MiFID II research unbundling provisions and are complemented by a forthcoming ESMA econometric study.[21]

Put simply, transparency related to transaction and research costs, as well as related best execution policies, would provide investors with essential details to better protect themselves, including through permitting them to better evaluate and compare funds' trading and research payment practices.

[20] *ESMA Report on Trends, Risks and Vulnerabilities*, European Securities Markets Authority, ESMA-50-165-1287, Sept. 2, 2020, *available at* https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf ("ESMA Research Report).

[21] *ESMA Research Report, at 5-6.*

Conclusion

For decades, investors have been in the dark about how their assets are being used, and even whether their assets are being used to subsidize other funds. Investors deserve to know how their assets are being used.

Regulators around the world have adopted new rules to require asset managers to disclose their best execution policies, as well as their funds' detailed costs--including transactions costs. Many investment advisers in the US are already very familiar with these requirements, and if not compelled to follow them, have nevertheless adopted them as best practices.

Rather than continue the opaque regulatory regime in the US (which disproportionately harms smaller investors), we urge you to take the long overdue step of modernizing fund prospectus disclosures to include:

1. their best execution policies;
2. detailed total trading costs;
3. amounts paid for research from client assets (separate from trading costs); and
4. whether the fund has policies and procedures designed to ensure that all commission dollars generated by the fund benefit the asset owners in the fund, including commissions used to pay for investment research.

If you have any questions or would like to follow up with any of us, please feel free to contact Tyler Gellasch at ty@healthymarkets.org, Jeff Mahoney at jeff@cii.org, and Jim Allen at james.allen@cfainstitute.org.

Thank you for your consideration.

Sincerely,

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