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New Rules for Shareholder Reports?

Our comments on the good, but not great, proposed SEC rule S7-09-20

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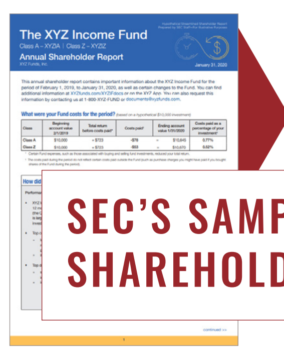
Back in September, the Securities and Exchange Commission (SEC) released some proposed new rules about mutual fund shareholder reports. The proposal is still in its comment period until January 4, but we think it's been out there enough now to make a few comments of our own.

If you haven't seen the proposal yet (and you could be forgiven for that slipping by in such a tumultuous year), the SEC is aiming to dramatically streamline the published shareholder report, encouraging "concise, layered disclosure" that is "visually appealing." A (very brief) summary of the (600+ page) proposal:

- The SEC wants to focus on the essentials of portfolio performance and portfolio statistics.
- The SEC recommends including a small number of regulatory disclosures and prospectus changes. As a result, firms would no longer be required to mail updated prospectuses to existing shareholders.
- Financials, disclosure and other supportive content can be filed separately, and can be published to a company's website. Investors may request a delivered version.

The SEC compiled a 3-page sample report to illustrate the rule. It includes little narrative discussion, instead focusing on data and exhibits that explain the ups and downs of the previous period's performance. Portfolio characteristics data will be allowed, though firms will have flexibility in choosing what they show.



SEC'S SAMPLE ANNUAL SHAREHOLDER REPORT

A (SORT OF) STEP IN THE RIGHT DIRECTION

With one glaring exception, we applaud the proposal. It replaces the current, unreadable tomes that often stretch to hundreds of pages. It consolidates existing disclosure mailings and reduces costs and publishing burdens for fund firms.

More importantly, it highlights research showing that too much report writing is too technical and is focused on the wrong audience — a complaint we've had for years. As the proposal puts it:

> ***"The majority of investors … expressed the view that funds' annual reports are written more for advanced investors, financial professionals, or regulators than for an average investor. [Other data] further support the conclusion that investors view funds' shareholder reports as too lengthy and complicated, and difficult for the average investor to use to effectively find information of interest."***

We also note that the proposed report has plenty of precedent. Experienced reporting pros and client service professionals will recognize the sample as being very akin to what is already being produced online by most firms on a quarterly basis, or to targeted communications designed for advisors and institutions.

THE GLARING EXCEPTION: PERFORMANCE WITHOUT CONTEXT

But it's not all good news. We identified a major problem with the proposed ruling: In eliminating discussions about portfolio positioning, it jettisons an essential tool asset managers need to build trust with their shareholders.

To shrink down the reports, the SEC wants to emphasize only contributors and detractors to performance during the period. A section of the report titled "How has the Fund changed?" will focus only on material changes in the prospectus. Because portfolio discussions in shareholder reports are often overly long, overly technical narratives, the SEC is suggesting eliminating all of it — or at least relegating it to "supplementary content" posted on the website, with a requirement that it be "less prominent" than the report itself.

We view this as a serious loss. It's true that investors don't want overly technical content. However, if investor comments on the proposed rule are any indication, that doesn't mean they don't want any information about the way strategies and risks are evolving in the portfolio. They just want that information to be short and to the point.

Contextual comments about changes in a fund's performance and risk profile don't just benefit shareholders. They also serve as critical protection for the fund firm itself. Setting clear expectations around anticipated changes in positioning or performance is essential to maintaining a long-term trust relationship with investors. It helps discourage short-term trading and keeps investors considering longer-term financial goals. In the most extreme cases, it also helps a firm prevent costly lawsuits from disgruntled or surprised investors.

> *In my comments on the rule, I advocated for the inclusion of content to provide context around portfolio activity. But I agree that asset managers need help being disciplined and clear in those comments. You can see Purcellcom's comments on the SEC website here.*

In fact, we would argue that it *should* be the company's responsibility to provide that insight, especially regarding risks. Morningstar's comments on the rule identified a similar concern, stating, "We believe that the proposed format of the shareholder report provides a comprehensive view of performance and costs but is less complete with regard to the discussion of risk."

And we know that most asset managers agree with us, because they already provide those types of comments on their websites without any regulation to require it.

GET READY

If the rules go through more or less as proposed, we think our clients could see some meaningful impacts. Here is what you'll want to plan for:

1. EVALUATE YOUR CONTENT DEVELOPMENT PROCESS AND GUIDELINES.	**Writing tight** and **writing to audience** — these are challenges we work on with our clients all the time. As the SEC has, we'd love to see more asset managers put their weight behind the idea that technical writing is inappropriate for a retail audience, regardless of whether comments appear in a report or in supplementary online content.
2. CONSIDER THE INVESTOR'S "LAYERED" EXPERIENCE.	The SEC wants to see more layering, providing **a range of content in different environments** for investors with different interests. Find an objective voice that can help you organize your content across platforms and build a straightforward user experience.
3. MAKE SURE YOUR DATA IS READY.	Any time a report gets reorganized, the flows of **data in and around your organization get reorganized as well**. Our experience managing large-scale report creation suggests that the SEC's proposal could reduce the extensive man-hours required to produce shareholder reports as they exist today, but you'll need to get your ducks in a row to capture the opportunity.

We want to know what you think about this proposed rule, or how your firm plans to implement it. Contact me at kpurcell@purcellcom.com to ask questions or to send us samples.