August 9, 2000

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Secretary Katz:

On behalf of the undersigned organizations, we hereby petition the Commission to take steps to improve disclosure of mutual fund portfolio holdings. Specifically, we petition the Commission to adopt rules:

- to prohibit the use of names that suggest a mutual fund invests in a particular type of security (e.g., government bonds, value stocks, growth stocks, junk bonds, etc.) unless the fund invests 85 percent or more of its assets in that type of security;

- to require funds to disclose their portfolio holdings on a monthly basis within 30 days after the end of each month and on random days throughout the year; and

- to require funds to post the disclosures on the Internet in an easily accessible, downloadable format and provide paper copies of the information upon request.

We also urge the Commission to study the extent to which prospectus disclosures of investment goals and investment strategies accurately and consistently reflect funds' portfolio holdings. Based on that study, the Commission should determine whether additional enforcement efforts are needed in this area.

As consumer groups, we represent average investors who have come increasingly to rely on mutual funds to invest for a variety of goals, such as building a retirement nest egg, providing income during retirement, or saving for short- and medium-term goals, such as buying a car or a house. The key advice that we and others offer such investors is that they develop an asset allocation plan based on the timing and risk characteristics of a particular goal and implement that plan through the purchase of an appropriate fund or basket of funds.

The current system of twice yearly portfolio disclosure does not provide investors who attempt to follow that strategy with adequate information to determine whether their funds are providing them with the asset allocation they seek. At a time when the typical actively managed fund turns over its entire portfolio in a single year, two separate snapshots of fund holdings cannot hope to provide an accurate portrait of those holdings or of the fund's investment strategies. Furthermore, evidence suggests that in between disclosures, some funds trade in and out of securities that are entirely unrelated to the fund name or its stated investment style.[1]

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[1] It is worth noting, for example, that the Commission's proposed rule on fund names

A primary motivation for funds in diverging from their stated investment style is to boost performance above other funds in the same class. The unfortunate fact is that investors rely heavily on fund performance and rankings of funds within particular fund categories in making their investment selections. This provides funds with a strong incentive to boost their performance numbers in any way they can, and the current system of twice yearly portfolio disclosure gives them the cover they need to hide those tactics. Research also strongly suggests that some fund managers use the cover provided by infrequent portfolio disclosure to engage in other highly questionable practices, such as window dressing and portfolio pumping.[2]

Portfolio pumping occurs when fund managers attempt to boost the fund's year-end performance results by buying more of a stock it already owns in order to drive up the price of that stock. Since funds frequently rely on year-end performance numbers in advertisements and prospectuses, and since managers' bonuses are generally based on those same performance numbers, they have a strong incentive to engage in this practice, even though the stock in question is likely to immediately drop in value on the first trading day of the new year.

Window dressing occurs when a fund buys or sells securities just before the date on which its holdings are disclosed to create the impression that the fund has made wise investment decisions. Specifically, fund managers have an incentive to sell shares (even at a very low price) of a stock whose price has taken a dive so that there is no evidence of the fund manager's mistaken judgement, or conversely to buy shares of a particularly successful stock (even at a high price) to create the appearance that the fund was in on that company's success.

Practices such as these make a travesty of the twice yearly disclosures, which as a result may fail to accurately reflect a fund's investment style or its holdings through much of the year. As noted above, we have proposed several steps to address these practices.

1. Curb the use of misleading fund names.

As a first step, the Commission should adopt proposed Rule 35d-1 with strengthening amendments. Under current SEC rules, a fund whose name implies it invests in a particular type of asset can hold fully a third of its assets in securities unrelated to the fund name, as long as that possibility is disclosed in the fund prospectus. As proposed, the rule would raise the bar, requiring funds to invest at least 80 percent of assets in the type of investment described by the fund name. We suggest two changes

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(which we believe should be adopted with strengthening amendments) grew out of a concern that funds describing themselves as U.S. Government Bond funds and describing their investment goals as preservation of capital were investing significant assets in highly volatile interest rate derivatives in order to boost their returns. A number of other examples of such practices are described in the *Memorandum in Support of Rulemaking Petition* prepared by Fund Democracy, LLC and submitted to the Commission June 28, 2000.

[2] Again, numerous examples are provided in the Fund Democracy *Memorandum*.

to the proposed rule: the standard should be raised to 85 percent, and, if an exception for "temporary investments" must be included, it should be strictly limited. In addition, the Commission should provide guidance on appropriate use of terms commonly found in fund names -- such as "growth," "value," "balanced," "index," and "small-," "mid-," and "large-capitalization" -- to ensure that they are not used in ways that may tend to mislead investors. Funds that desire more flexibility could simply avoid using fund names that imply they engage in a particular investment style.

2. Require more frequent portfolio disclosure.

Requiring more frequent portfolio disclosure would give investors a better picture of the on-going investment practices of a particular fund. Even investors who lack the expertise to evaluate fund holdings themselves would likely have access to this information, either through their financial advisers or through the financial press. This would enable them to select funds that consistently pursue a style compatible with the investor's goals.

More frequent portfolio disclosure would also make it more difficult for funds to engage in questionable practices, such as portfolio pumping, window dressing, and investing outside the fund category to artificially boost performance numbers. As long as portfolio holdings are disclosed only on dates known in advance, however, these practices will likely persist. We therefore also urge the Commission to adopt of a program of disclosure on randomly selected dates. Such a program would provide a real deterrent, since fund managers would never know when they might be "caught in the act."

Allowing a 30-day time delay for monthly and randomly timed disclosures should answer objections either on the grounds that more frequent disclosure would enable traders to front-run fund trades to the detriment of the fund and its shareholders or on the grounds that it would expose funds' proprietary trading strategies to their competitors. And requiring the information to be filed with the Commission only twice a year, in conjunction with semiannual reports, should minimize costs. On the other hand, the benefits to investors, as described above, would be substantial.

3. Require Internet posting of fund holdings and paper copies on request.

The simplest and most effective means of providing access to information about portfolio holdings is to require that it be posted on the Internet in an easily accessible, downloadable format. Not only will such an approach provide Internet savvy shareholders with access to the information, it will enable regulators, financial advisers, academicians, and members of the personal finance media to analyze the data. Knowing that the data will be subject to such careful scrutiny should further discourage fund managers from engaging in questionable or abusive practices.

Although the number of households with Internet access is growing, use of the Internet is still far from universal. According to data recently released by the Investment Company Institute, 68 percent of mutual fund shareholders have used the Internet, and 47 percent of those have visited the web site of a mutual fund company.[3] In order to ensure that those mutual fund shareholders who do not yet use the

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[3] "Mutual Fund Shareholders' Use of the Internet," *Fundamentals*, Vol. 9, No. 3, July 2000, Investment Company Institute, pg. 1 and 3.

Internet to monitor their holdings also have access to portfolio disclosure information, the Commission should require that fund companies provide paper copies of the data upon request through the fund company's customer service 800-number. The availability of the information and information on how to obtain it should be prominently disclosed in the prospectus, annual report, and semi-annual report.

4. Conduct a study of fund disclosure practices.

Armed with easily accessible and analyzable data on fund portfolio holdings, the Commission should conduct a study to determine the accuracy of prospectus statements regarding investment goals and strategies. If, as we suspect, the Commission finds that a significant number of funds describe these fund characteristics in ways that do not clearly or accurately reflect the fund's actual holdings, the Commission should consider additional steps, including enforcement actions, to improve prospectus disclosures.

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Mutual funds have offered investors of limited financial resources an effective means of achieving a diversified portfolio. However, investors' ability to manage that portfolio by selecting funds to provide a particular asset allocation is undermined if funds are free to trade outside their stated investment style without the investor's knowledge. Relying primarily on enhanced portfolio disclosure to address this concern would allow funds to retain full flexibility in selecting among a variety of investing styles -- including styles that allow the fund to trade in and out of a variety of securities -- while enabling investors to better select funds that fit with their particular investment goals. Thus, investors would benefit while imposing minimum burdens on industry.

Thank you for your consideration. If you have any questions about this letter or would like to discuss it further, please contact Barbara Roper, Director of Investor Protection for Consumer Federation of America at 719-543-9468.

Respectfully submitted,

Consumer Federation of America
Arizona Consumers Council
Consumer Action
Consumer Federation of California
Consumer Fraud Watch
Consumers Union
Democratic Processes Center
North Carolina Consumers Council
Pennsylvania Citizens Consumer Council
Virginia Citizens Consumer Council