

June 28, 2000

BY HAND

Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Re: Rulemaking Petition

Dear Mr. Katz:

On behalf of Fund Democracy, LLC, I hereby petition the Commission to adopt rules designed to improve the disclosure of portfolio holdings of mutual funds. Specifically, Fund Democracy petitions the Commission to adopt rules requiring that mutual funds: (1) use names suggesting that they invest in a particular type of security only if 85% of their assets are invested in that type of security; (2) publicly report their portfolio holdings on a monthly basis within 60 days after the end of each month, with exceptions granted by the Commission on a case-by-case basis, and (3) post portfolio holdings on the Internet in a format that is easy to download and analyze, and provide paper copies of this information upon request. Fund Democracy believes that the prompt adoption of these disclosure requirements is imperative for the financial security and protection of America's investors.

Background

Over the last twenty years, mutual funds have become this country's most popular investment vehicle. Between 1980 and 1999, the percentage of U.S. households investing in mutual funds grew from 6% to 47%.<sup>1</sup> Today, 83 million Americans in 48 million households own mutual fund shares.<sup>2</sup> Americans have invested 49% of their IRA assets and 45% of their 401(k) assets in mutual funds<sup>3</sup> and, more importantly, they make their own investment decisions for these accounts. Mutual funds have assumed a central role in ensuring the financial security of tens of millions of Americans.

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<sup>1</sup> Mutual Fund Fact Book, Investment Company Institute 45 (May 1999). Mutual fund shareholders represent a broad cross-section of Americans. The average mutual fund shareholder is 44 years old and of moderate financial means, and has \$25,000 in mutual fund investments. Id. at 44.

<sup>2</sup> Id. at 41.

<sup>3</sup> Id. at 51.

The importance of mutual funds to America's financial security has made it more important than ever to ensure that investors have the information they need to make informed investment decisions, and that they are adequately protected against fraudulent sales practices and other abuses. It therefore is critical that investors and their advisers know how mutual funds are actually investing their money so that they can assess whether fund investments are consistent with the risks that they have chosen to assume.

Under current law, however, mutual funds are required to disclose their portfolio holdings only twice each year. Although funds are free to disclose their holdings more frequently, few do so. In fact, 18 of the 25 largest fund complexes fully disclose their portfolio holdings only semiannually.<sup>4</sup> These 18 complexes represent more than 50% of mutual fund assets.

### Inadequate Information to Make Informed Investment Decisions

The paucity of fund portfolio information prevents investors and their advisers from making fully informed investment decisions. Even the most diligent investors cannot determine what they are buying when they invest in many mutual funds. Large cap funds regularly invest a large percentage of their assets in small cap companies, substantial positions in foreign stocks frequently find their way into domestic stock funds, and new age tech stocks often dominate blue chip portfolios. Existing portfolio disclosure requirements leave investors in the dark about how their money is being invested.

The disclosure of portfolio information is growing in importance as more investors seek to reduce risk by diversifying their investment portfolios. "Ten years ago, people simply shopped for outstanding returns; now, they pick funds to fill slots in a diversification plan."<sup>5</sup> Unfortunately, the limited availability of information about portfolio holdings makes it difficult to know whether a portfolio is truly diversified or dangerously concentrated, and thus exposes investors to significant risks. Funds' portfolios often do not reflect their stated investment style, and they frequently have substantially overlapping portfolios. To address these problems, the Commission should adopt rules requiring funds to publicly disclose their portfolio holdings on a monthly basis within 60 days. If certain funds can demonstrate that they may be harmed by disclosing their portfolios on a monthly basis, the Commission should exempt them from monthly disclosure requirements to the extent necessary to address their concerns.

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<sup>4</sup> David Dietz, What's the Big Secret About Mutual Fund Holdings? TheStreet.com (Apr. 26, 2000).

<sup>5</sup> Gregory Millman, First, Pop the Hood, U.S. News Online (Feb. 3, 1997) (paraphrasing John Rekenhalter, Research Director, Morningstar Inc.). In recent years, "more and more investors have invested in investment companies to meet their retirement goals. These investors typically place greater emphasis on allocating their investment company holdings in well-defined types of investments . . ." Investment Company Names, Investment Company Act Release No. 22530 (Feb. 27, 1997) ("Names Release").

## Limited Utility of Portfolio Information

Investors require portfolio information in a way that is easy to access and analyze. All too frequently, well-intended disclosure requirements are ineffective because consumers cannot use the resulting information to make better investment decisions. Electronic communications have virtually eliminated the cost of publicly disseminating data, the Internet has virtually eliminated the cost accessing it, and software technology has made sophisticated analysis of the significance of financial data feasible for millions of investors and their advisers.

The Commission therefore should require funds to post their portfolio holdings on a free Internet site in XML or other easily manipulated language, and attach to each holding the security's ticker symbol, cusip number, and security industry code. To accommodate investors who do not have Internet access, funds should be required to provide paper copies of portfolio information upon request. The Commission must ensure not only that critical information is publicly available, but also that the information can be used to serve its purposes: to enable investors to make informed investment decisions, and to protect investors against fraud.

## Portfolio Fraud

Of even greater concern is that current disclosure rules facilitate portfolio fraud by permitting fund managers to conceal fund portfolio holdings from shareholders and the investing public. Portfolio fraud includes:

- Deceptive Labeling and Promotion: Funds use misleading terms in their names that suggest that the fund is investing in a particular type of security, when in fact the funds often have no more than 65% of their assets invested in that type. Fund managers claim to invest according to a particular investment style or in a particular asset class, while actually timing the markets to improve their performance relative to their putative peer groups. This deception is exacerbated by the pervasive use of fund ratings, such as Morningstar's star rating system, in fund ads. As a result, shareholders often unwittingly assume substantial financial risks, with potentially dire consequences for all Americans' financial security.
- Window Dressing: Portfolio managers add high-performing stocks, and remove low-performing stocks, to and from fund portfolios just before the portfolios are publicly disclosed. This practice is intended to lead investors to believe that the managers picked winners and avoided losers during the preceding period.
- Portfolio Pumping: Portfolio managers buy stocks at the end of the quarter or the end of the year that their funds already hold in order to give their funds' performance a one-day boost. This manipulative practice inflates the fund's performance results, which under SEC regulations are calculated and advertised on a quarterly and annual basis. Portfolio pumping also may adversely affect

investment performance for 401k and other retirement plan participants, who frequently buy shares at the end of each quarter.

Portfolio fraud misleads investors regarding the true risks posed by their investments, imposes added costs on investors, and undermines investor confidence in the integrity of mutual funds and the financial markets. Anecdotal and empirical evidence of portfolio fraud is discussed in the attached memorandum, which is hereby incorporated by reference in this petition.

### An Entrenched Industry

The mutual fund industry has resisted all attempts to reform portfolio disclosure rules. Most recently, the Investment Company Institute, the leading trade organization for the fund management companies, reiterated its belief that current disclosure requirements “remain appropriate,” notwithstanding substantial evidence that investors do not have the information they need to make informed investment decisions, and that fund managers are using these requirements as a screen for portfolio fraud.<sup>6</sup>

Fund management companies generally have objected to reforming portfolio disclosure rules because there purportedly has been no market demand for more information about portfolio holdings, and additional portfolio disclosure would (1) be too costly, (2) enable traders to use information about fund trading activities to benefit themselves to the detriment of funds and their shareholders, and (3) expose funds’ proprietary trading strategies to their competitors.

Not only are these concerns greatly outweighed by the need for investors to be able to make informed investment decisions, and for the prevention of portfolio fraud, they also are factually incorrect and misguided. A 1999 poll of 2,500 online investors by the Montgomery funds found that 97% wanted more information about fund portfolio holdings.<sup>7</sup> Furthermore, even if investors were not actively interested in additional fund portfolio disclosure, this would be no excuse for failing to take steps to protect investors against portfolio fraud.

The practical problems cited by the industry also are without merit. Portfolio holdings can now be widely disseminated on the Internet at little cost. Requiring the actual filing of this information with the Commission only in conjunction with funds’ semiannual reports would minimize any added filing costs. Permitting funds to post their monthly portfolio holdings after a 60-day delay will prevent traders in almost all cases from exploiting a fund’s trading activity by frontrunning fund trades. Finally, there simply is no evidence that disclosure of holdings on monthly intervals after a 60-day

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<sup>6</sup> Letter from Matthew P. Fink, President, Investment Company Institute, to Donald L. Luskin, President & CEO, MetaMarkets Investments LLC, and H. Davis Nadig, Executive Vice President, MetaMarkets Investments LLC (May 11, 2000).

<sup>7</sup> Dawn Smith, Should Fund Portfolios Be Secret? SmartMoney.com (April 20, 2000).

delay would enable traders to determine as a matter of course fund managers' proprietary trading strategies. In the rare instance that a fund can show that it and its shareholders may be harmed by more frequent portfolio disclosure, the Commission can grant them relief from disclosure requirements on a case-by-case basis.

The ICI also has opposed the Commission's proposal to require any mutual fund with a name that suggests that it focuses on a particular type of investment (e.g., the ABC Stock Fund) to invest at least 80% of its assets in that type of investment.<sup>8</sup> The ICI argues that funds should be permitted to change their investment focus without shareholder approval, and to diverge from this focus to assume "temporary defensive positions."<sup>9</sup> These changes would, in effect, eviscerate the SEC's proposal. Funds that choose to advertise their investment focus in their names should be required to live up to their billing.

### Toward Trust in Mutual Fund Investing

The inadequacy of information about mutual fund portfolio holdings provided by existing portfolio disclosure rules deprives investors of the information they need to make informed investment decisions. Existing portfolio disclosure rules also help to conceal a wide variety of forms of portfolio manipulation. The format in which portfolio information is provided makes it difficult to access and analyze fund portfolio holdings.

It is critical to Americans' trust in mutual fund investing that funds invest shareholders' money consistent with their expectations. Improving trust in mutual fund investing lies not in private law suits or SEC enforcement actions, however. Rather, the path to improving trust in mutual fund investing lies in providing more information to the market coupled with limited substantive regulation.

More frequent public portfolio disclosure would allow the market to measure, judge and eliminate portfolio fraud through investment decisions by millions of investors. Enhanced disclosure would provide the best mechanism for determining when fund managers are operating outside of their purported investment styles or engaging in deceptive labeling and promotion, window dressing or portfolio pumping.

Limited substantive regulation, in the form of a prohibition against the use of misleading names, similarly will enable investors to make better informed investment decisions and improve confidence in mutual funds and the securities markets. Requiring that portfolio information be provided on the Internet in a format that is easy to access and analyze will further enable market forces to make the most efficient judgments about the existence and significance of fund portfolio manipulation.

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<sup>8</sup> Names Release, supra note 5. The Commission proposed the rule over four years ago, but has not taken final action on it.

<sup>9</sup> Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (June 9, 1997).

## Fund Democracy

Fund Democracy is a Maryland limited liability company formed on January 27, 2000. Fund Democracy's purpose is to serve as an advocate and information resource for mutual fund shareholders through a multi-faceted advocacy program.

Fund Democracy publishes articles that target mutual fund practices, policies and rules that are harmful to fund shareholders.<sup>10</sup> Fund Democracy also formulates advocacy initiatives and, in concert with diverse consumer, investor, employee and professional groups, seeks to effectuate reforms that will benefit mutual fund shareholders. These initiatives include submitting comment letters on rule proposals, asking for hearings on requests for exemptions from fund regulations, lobbying federal and state legislators, submitting rulemaking petitions, and participating in selected litigation on a pro bono basis.<sup>11</sup>

Finally, Fund Democracy will serve as an advocate and information resource through a professionally designed web site, which is currently under development. The web site will provide fund ratings, independent data and analysis, and a forum for shareholder activism.

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The recent leveling off of stock market returns supports predictions that mutual fund sales also will level off, and that increasing competition among fund companies lies ahead.<sup>12</sup> With increasing competition will come greater pressure on fund management to resort to abusive sales practices to sell fund shares, including various forms of portfolio fraud. In addition, the continued growth of self-directed retirement accounts, such as

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<sup>10</sup> See Your International Fund May have the "Arbs Welcome" Sign Out, TheStreet.com (June 10, 2000); Barbarians at the Gate, On Wall Street (June 2000) & Financial Planning Magazine (June 2000); As 401(k) Plans Spread, The Information Gap Becomes More Glaring, TheStreet.com (May 27, 2000); The Fund Prospectus: Yesterday's News, SmartMoney.com (May 11, 2000); Heads in the Sand, Barron's (April 10, 2000).

<sup>11</sup> Fund Democracy and the Consumer Federation of America recently asked the Commission to hold a hearing on a request by Barclays Global Fund Advisors to offer a series of exchange-traded funds. Fund Democracy and the CFA objected that exchange-traded funds had been widely portrayed as trading at prices that were very close to the fund's net asset value ("NAV"), when in fact many of these funds have traded at substantial and persistent discounts to their NAVs. This misleading impression was being reinforced by the limited public availability of information about the funds' trading history. In response to Fund Democracy's and the CFA's concerns, Barclays agreed to provide on its web site and in fund documents information regarding the trading history of their exchange-traded funds. For more information, see [http://www.funddemocracy.com/articles\\_and\\_advocacy.htm](http://www.funddemocracy.com/articles_and_advocacy.htm).

<sup>12</sup> See Dan Culloton, Boom Times May Be Over for Mutual Funds, Morningstar.com (May 19, 2000); Richard A. Oppel, Jr., After Long Run, Mutual Funds Begin to Slow, New York Times (Dec. 20, 1999).

401(k) plans and IRAs,<sup>13</sup> will magnify the importance of ensuring that investors have the information they need to make informed investment decisions.

As Chairman Levitt often has said, “The best time to fix the roof is when the sun is shining.” The time to require funds to provide the information about their investments that investors need, and to protect investors against portfolio fraud, is now.

Sincerely,

Mercer E. Bullard  
Founder & CEO

cc: The Honorable Arthur Levitt  
The Honorable Isaac C. Hunt, Jr.  
The Honorable Paul R. Carey  
The Honorable Laura S. Unger  
Paul F. Roye, Esq.

Enclosure

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<sup>13</sup> Frank Stanton, Self-Directed 401(k) Options on the Rise, Morningstar.com (May 25, 2000).