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Let's Make Disclosure Reform Serve Shareholders

By Dorothy Donohue

The October 12 meeting of the Investor Advisory Committee (IAC)—a group established by the Dodd-Frank Act to advise the Securities and Exchange Commission (SEC) on regulatory priorities and other issues—has breathed new life into a long-running debate over how US-registered funds can best provide essential information to their shareholders.

Though the debate remains far from over, fund shareholders can take heart from a positive turn in the conversation. At long last, those who believed shareholders were best served by the antiquated rules governing shareholder reports—including some members of the IAC—seemed to acknowledge that those rules no longer serve shareholder interests, and are in dire need of an overhaul.

That's a welcome development. But the rest of the story isn't so heartening. The IAC appears to be falling in line behind a self-serving proposal put forward by the firm that currently holds a monopoly on brokers' delivery of fund shareholder reports. That proposal is designed to preserve vendor fees. In fact, it may even *raise* vendor fees for fund shareholders. For that reason—among others—ICI does not support this proposal.

Instead, we support a modernized disclosure framework that aligns more effectively with shareholder preferences for information access than the current outdated system. That means effective, clear disclosure that is easy for investors to understand—delivered online, the way that most Americans, and the vast majority of fund shareholders, access financial information today. Just as important, any proposed approach to disclosure reform must permit investors to receive hardcopy disclosure if they so choose, while also creating direct and very material cost savings for fund shareholders.

And we call on the IAC—as the body created to advise the SEC on disclosure effectiveness and initiatives to protect investors' interests—to work to ensure that disclosure reform benefits investors, rather than the business model of a monopoly supplier.

An Expensive and Misaligned Model

This is a complicated issue, so let me give some background.

Under current rules, funds must mail paper reports—often hundreds of pages long—to every shareholder who does not affirmatively opt in to receiving reports by email. Each year, fund shareholders pay more than $340 million for the privilege of receiving these dense, novella-length documents, even as more and more of them prefer to access financial information online.

With costs that high, you'd think that any new proposal to modernize the delivery framework would aim to bring them down. Yet the "solution" recently showcased at the IAC—a one-page "enhanced notice" created by Broadridge Financial Solutions, the vendor delivering fund shareholder reports for nearly the entire broker-sold fund market—wouldn't save shareholders a dime in vendor fees.

In fact, if Broadridge was able to deliver its notice in place of a full shareholder report, fund shareholders would end up paying millions more in vendor fees than they do today. This key fact was conspicuously absent from the discussion at the IAC meeting.

The root of the problem is misaligned incentives exacerbated by the administration of a deeply troubling New York Stock Exchange (NYSE) fee schedule.

What do I mean by "misaligned incentives"? Federal securities laws require brokers to deliver annual and semiannual shareholder reports to their clients who are fund shareholders. Those laws, in turn, require funds to reimburse brokers for reasonable expenses incurred in delivering the reports. So—simply put—brokers choose the delivery vendor, and fund shareholders foot the bill.

The NYSE fee schedule and a single service provider complicate this further. The schedule provides maximum fees that a broker can charge a fund for delivering a shareholder report. But because brokers have no incentive to charge anything less than the maximum amount allowed, what was intended as a cap acts in practice as a uniform, nonnegotiable floor.

Here's how it works: on behalf of its broker-dealer clients, Broadridge bills funds for reimbursement of the maximum fees allowed by the NYSE fee schedule. However, the fees charged to large broker-dealer clients are sometimes less than those maximum fees that the funds pay. Broadridge then remits the surplus—essentially a kickback—to its broker-dealer client. In effect, this practice allows brokers to pocket shareholder money whenever the broker is able to negotiate a fee rate with Broadridge that is less than the NYSE fee schedule's maximum rate. It's a sweet deal for Broadridge and brokers—but not for fund shareholders.

FINRA Has a Role to Play

This abusive practice makes clear that the need for regulatory intervention could not be more urgent.

As soon as possible, the SEC must direct the Financial Industry Regulatory Authority (FINRA) to take responsibility for the rules governing fees for the delivery of fund materials. As the primary self-regulatory organization overseeing brokers—with investor protection as an integral part of its mandate—FINRA is uniquely equipped to scrutinize these fees, and to develop a fee schedule that allows fund shareholders to reimburse no more than a broker's "reasonable expenses."

Oversight by FINRA is particularly important because, in practice, Broadridge previously has interpreted the rules in a manner that increases its revenue. ICI's estimates of the costs to fund shareholders rely on information from Broadridge about how it plans to apply certain fees, and we therefore are concerned that actual costs ultimately could be significantly higher than what we have estimated.

The Commission also must take a hard look at all available options to improve the content and delivery of shareholder reports, as it works to bring funds' communications with their shareholders into the 21st century and to reform fund disclosure more broadly.

The Way Forward

Delivering shareholder reports online—while enabling those who still want paper reports to continue receiving them—is an option worth considering. So too is delivering a summary document incorporating key information and letting people know where to get the full report. ICI has supported this approach to disclosure for decades.

But the SEC must consciously choose how to move forward. That choice cannot be left in the hands of a single, monopolist firm looking to preserve its revenue stream on the backs of fund shareholders. A job this critical demands an objective analysis—one that only regulators, through the standard notice-and-comment process, are qualified to lead. ICI stands ready to work with both the SEC and FINRA to ensure that the job gets done right.

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