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SECURITIES AND EXCHANGE COMMISSION'S ENHANCED DISCLOSURE AND NEW PROSPECTUS DELIVERY OPTION FOR REGISTERED MUTUAL FUNDS

SARAH B. ZIMMER[†]

INTRODUCTION

“Never invest in a product that you don’t fully understand,” advises the Securities and Exchange Commission (“SEC”).¹ To ensure that investors make informed decisions, the SEC requires mutual funds to provide investment information in the form of a prospectus.² A mutual fund prospectus is a lengthy, comprehensive document that describes in detail a fund’s goals, fees, expenses, investment strategies, and risks.³ The SEC expects a mutual fund’s prospectus to be an investor’s primary source of information.⁴ It is no secret, however, that investors find mutual fund prospectuses to be cumbersome and difficult to understand.

Prospectuses have long been criticized for being overly legalistic and containing too much information. At the root of the problem is the tension that results from the prospectus functioning both as a document used to inform investors and as a document used to protect mutual fund companies from liability. Recognizing the inherent drawbacks of the prospectus as a user-friendly document, the SEC has recently adopted rules to

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¹ SEC, Invest Wisely: Advice from Your Securities Industry Regulators (Aug. 1, 2007), <http://www.sec.gov/investor/pubs/inws.htm>.

² INVESTMENT COMPANY INSTITUTE, A GUIDE TO UNDERSTANDING MUTUAL FUNDS 21 (2007), http://www.ici.org/pdf/bro_understanding_mfs_p.pdf.

³ *Id.*

⁴ See Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. 10,898, 10,900 (proposed Mar. 10, 1997) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274).

enhance the accessibility of the disclosures provided to mutual fund investors in the prospectus.⁵ The newly adopted rule grants mutual funds the option to satisfy prospectus delivery obligations under section 5(b)(2) of the Securities Act of 1933 ("Securities Act")⁶ by providing investors with a summary of key information (a "summary prospectus") while posting additional information—including the statutory prospectus—on the Internet.⁷ The summary prospectus is a streamlined disclosure document that contains key investment information in plain English, and in a standardized order.⁸ All mutual fund companies will be required to replace the current Risk/Return Summary located at the beginning of the statutory prospectus with the newly adopted summary prospectus.⁹ If funds choose to disseminate the summary prospectus as a stand-alone, preliminary disclosure document, the statutory prospectus must be made available on funds' websites and sent to investors upon their request.¹⁰

"With virtually every other household in the United States invested in mutual funds, effective and efficient regulation of the mutual fund industry must be a top national priority."¹¹ The SEC uses consumer investment in mutual funds as a measure of investor confidence.¹² Investor confidence is vital to the health of the nation's capital markets and without it, consumers will flee the market.¹³ Moreover, mutual funds represent the country's primary investment vehicle, and with over 8,000 funds to choose from, investors face the difficult task of choosing a fund that satisfies their personal investment goals.¹⁴ Smart investing

⁵ Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546 (Jan. 26, 2009) (to be codified at 17 C.F.R. pts. 230, 232, 239, 274) [hereinafter Enhanced Disclosure Rule].

⁶ 15 U.S.C. § 77e(b)(2) (2006).

⁷ Enhanced Disclosure Rule, *supra* note 5, at 4546.

⁸ *See id.* at 4548.

⁹ *Id.*

¹⁰ *Id.* A "statutory prospectus" is a prospectus that meets the requirements of section 10(a) of the Securities Act. 15 U.S.C. § 77j(a).

¹¹ Donna M. Nagy, *Regulating the Mutual Fund Industry*, 1 BROOK. J. CORP. FIN. & COM. L. 11, 44 (2006).

¹² Barbara Black, *Are Retail Investors Better Off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303, 304–05 (2008).

¹³ *Id.* at 304.

¹⁴ *See* INVESTMENT COMPANY INSTITUTE, 2009 INVESTMENT COMPANY FACT BOOK 114–15 tbl.5 (49th ed. 2009), available at <http://www.icifactbook.org> [hereinafter INVESTMENT COMPANY FACT BOOK]. These goals include providing for

requires consumers to believe that they hold the proper tools to make sound investment choices.¹⁵ Investors, however, cannot make sound investment decisions unless they have accurate, useful information presented in a clear manner. The statutory prospectus in its current form does not sufficiently provide ordinary investors with the ability to make these critical investment decisions. If investors are not supplied with adequate information to assess the risks of their investments, the results can be financially catastrophic.¹⁶

The SEC is optimistic that its new rule “has the potential to revolutionize the provision of information to the millions of investors who rely on mutual funds for their most basic financial needs.”¹⁷ While the SEC should be applauded for taking the initiative to ensure that investors receive the right information before investing in mutual funds, the final rule could benefit from further refinement and specification. In the context of examining the SEC’s final rule, this Note will highlight the tension that is created as a result of the dual function that a statutory prospectus currently serves: first, as a document that is intended to be informative and useful to the average investor; and second, as a document that is written to protect investment companies against liabilities imposed by the Securities Act of 1933 for misstatements or omissions.¹⁸ Only one of these functions is consistent with Congress’s intent in passing the Investment Company Act of 1940 (“1940 Act”)¹⁹—to instill investor confidence in mutual fund companies while protecting the public from the dangers of insufficient regulation of this new type of security.

retirement, education, and other everyday financial needs. *See* Black, *supra* note 12, at 305.

¹⁵ Black, *supra* note 12, at 306.

¹⁶ One only needs to look at today’s financial crisis to see what can occur when risk is not properly assessed. Investors can lose their homes, savings, and, ultimately, their financial security.

¹⁷ Enhanced Disclosure Rule, *supra* note 5, at 4577.

¹⁸ CLIFFORD E. KIRSCH ET AL., MUTUAL FUND REGULATION § 4:2.2 (Clifford E. Kirsch ed., 2d ed. 2005 & Supp. 2009); Shefali Anand, *It May Finally Hit the Market: A Prospectus You Can Read*, WALL ST. J., Apr. 3, 2008, at R1 (“A thick prospectus typically is a fund company’s first line of defense against litigation by investors who lose money; fund companies can point to risk factors and other details listed deep within.”).

¹⁹ Pub. L. No. 76-768, 54 Stat. 841 (1940); KIRSCH ET AL., *supra* note 18, § 1:1.

This Note suggests that facilitating a user-friendly approach to investing is preferable to the current disclosure regime. However, the SEC's plan does not go far enough. The SEC is sending a mixed message to investors by permitting mutual funds to utilize the summary prospectus as a disclosure piece while simultaneously requiring funds to produce a statutory prospectus. Providing investors with a summary prospectus while encouraging them to seek out additional information via the statutory prospectus does not provide investors with a streamlined approach to investing. This ultimately leads one to question whether the layered approach is really a meaningful improvement.

Part I of this Note provides a brief synopsis of mutual funds and the relevant bodies of regulation. It also offers a general overview of the SEC's enhanced disclosure and new delivery option requirements. Part II discusses the current regime of mutual fund disclosure and examines key aspects of the new rule, focusing on how the SEC intends to improve the current scheme of regulation. After each corresponding discussion of the newly adopted rule, this Note explores the pros and cons of the SEC's initiative utilizing the comment letters solicited by the SEC. Part III of this Note assesses the effectiveness of the SEC's rule in light of what is known about investor behavior and how investors are treated in New York when they bring a claim against their broker for fraud or misrepresentation. Part III also examines the policy considerations that underlie the rules and the regulatory environment of disclosure.

I. BACKGROUND

The first mutual fund was founded in Boston in 1924, and today, mutual funds comprise an astonishing thirteen trillion dollar industry.²⁰ The rise in popularity of mutual funds was a result of their ability to offer affordable, expert management, along with the capability to attain diversification with less money than is needed to diversify through individual ownership of

²⁰ INVESTMENT COMPANY FACT BOOK, *supra* note 14, at 171, 185 app. C.

securities.²¹ With nearly half of Americans invested in mutual funds—far more than those who own individual stocks and bonds—this market is prime for thorough regulation.²²

A mutual fund is an investment company that pools money from many investors and purchases a portfolio of securities selected by an investment adviser to meet a specified investment goal.²³ Functionally, a mutual fund company is “a shell, a pool of assets consisting of securities, belonging to the shareholders of the fund.”²⁴ Investors purchase shares of the mutual fund from the fund itself or through a broker rather than from other investors on secondary markets such as the New York Stock Exchange.²⁵ There are three basic types of mutual funds: open-end, closed-end, and unit investment trusts. This Note, however, only covers open-end mutual funds—that is, those that continuously issue new shares.²⁶

Four principal securities laws govern mutual funds: the Securities Act of 1933,²⁷ the Securities Exchange Act of 1934,²⁸ the Investment Advisers Act of 1940,²⁹ and the 1940 Investment Company Act.³⁰ These federal securities acts were enacted to

²¹ See Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 914 (2005).

²² INVESTMENT COMPANY FACT BOOK, *supra* note 14, at 72.

²³ SEC, Invest Wisely: An Introduction to Mutual Funds (July 2, 2008), <http://www.sec.gov/investor/pubs/inwsmf.htm> [hereinafter Invest Wisely].

²⁴ *Zell v. Intercapital Income Sec., Inc.*, 675 F.2d 1041, 1046 (9th Cir. 1982).

²⁵ Invest Wisely, *supra* note 23.

²⁶ *Id.* Closed-end funds are similar to individual stocks; a fixed number of shares are sold at one time in an initial public offering, and those shares then trade on the secondary markets. *Id.* Unit investment trusts (“UIT”) also make a “one-time public offering of . . . a specific, fixed number of redeemable securities.” *Id.* Those securities are referred to as “units” and will expire on a date specified when the UIT was created. *Id.*

²⁷ See 15 U.S.C. § 77a (2006).

²⁸ See *id.* § 78a.

²⁹ See *id.* § 80b-1.

³⁰ See *id.* § 80a-1. Additionally, the Financial Industry Regulatory Authority (“FINRA”) plays a role in regulating mutual funds. Nagy, *supra* note 11, at 16. Created in July 2007 by the merger of the National Association of Securities Dealers (“NASD”) and the regulatory arm of the New York Stock Exchange, FINRA is the principal regulator of broker-dealers in the United States. See About the Financial Industry Regulatory Authority, <http://www.finra.org/AboutFINRA/index.htm> (last visited Mar. 24, 2010). Broker-dealers who sell mutual funds must comply with FINRA’s regulations concerning advertising and sales practices, and they are subject to periodic inspections by FINRA. Nagy, *supra* note 11, at 16. Broker-dealers who

avoid the dangers of the “caveat emptor philosophy” by implementing a “philosophy of full disclosure.”³¹ The acts most relevant to mutual fund disclosure are the Securities Act and the 1940 Act. The Securities Act, enacted after the stock market crash of 1929 and the subsequent depression, had two objectives: first, to ensure that investors receive considerable information regarding publicly offered securities; and second, to prohibit misrepresentation and fraud in the sale of securities.³² The Securities Act also outlines the registration process for securities.³³ As mutual funds continuously offer and sell their shares to the public, they must comply with the Securities Act registration requirements.³⁴ Accordingly, mutual funds must register a public offering of their shares pursuant to the Securities Act.³⁵

The 1940 Act, a complex statutory scheme that governs investment companies and the mutual fund industry, was Congress’s response to the mismanagement and fraud that plagued the industry in the 1930s and caused investors to lose more than one billion dollars.³⁶ The SEC played a role in drafting the 1940 Act and sought to instill consumer confidence in the mutual fund industry by providing the public with enhanced protection.³⁷ The Act expressly sets forth the requirements with which SEC-registered funds must comply, and the SEC is responsible for ensuring funds’ compliance with those rules and regulations.³⁸ For example, the Act mandates that mutual funds register with the SEC and may not engage in any business in interstate commerce or use the mails to offer any security for sale until the fund is properly registered.³⁹ In

violate FINRA regulations or federal securities laws may face disciplinary action by FINRA. *Id.*

³¹ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

³² See *KIRSCH ET AL.*, *supra* note 18, § 1:1.

³³ *Id.* § 4:1.2.

³⁴ *Id.*

³⁵ See *id.*

³⁶ H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777, 780–81, 784 (2004).

³⁷ See, e.g., Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 957 (2008) (stating that the underlying premise of the 1940 Act was that “investors cannot fend for themselves”); see also Nagy, *supra* note 11, at 15–16.

³⁸ *KIRSCH ET AL.*, *supra* note 18, at § 4:1.1; Nagy, *supra* note 11, at 16.

³⁹ 15 U.S.C. § 80a-7 (2006).

addition to setting forth extensive disclosure requirements,⁴⁰ the Act also regulates substantive aspects of mutual funds' organization and structure.⁴¹

Finally, the offer and sale of securities by mutual funds is also subject to state securities laws—often referred to as blue sky laws—which require securities to be registered in the state in which they are offered for sale.⁴² For a fund that is widely distributed, this requires separate registration in all fifty states.⁴³ The state registration process “lends itself to an automated and clerical approach” and is, therefore, typically handled by a fund's administrative staff.⁴⁴

A. *General Overview of Prospectus Requirements Prior to the Enactment of the New Rule: Content and Delivery*

Mutual fund prospectus disclosures are made in the context of fund registration under both the Securities Act and the 1940 Act.⁴⁵ Form N-1A is the designated registration statement form for mutual funds that satisfies both the Securities Act and the 1940 Act.⁴⁶ “The purpose of the prospectus is to provide essential information about the Fund in a way that will help investors make informed decisions about whether to purchase the Fund's shares described in the prospectus.”⁴⁷ The information required

⁴⁰ *Id.* § 80a-29 (outlining the requirements for filing periodic reports with the SEC and disseminating reports to investors).

⁴¹ *See id.* § 80a-18(i) (relating to “capital structure of investment companies”); *see also id.* § 80a-25 (pertaining to the filing of reorganization plans for registered investment companies); *id.* § 80a-14 (establishing guidelines for the size of registered investment companies and requiring that such companies have net worths of at least \$100,000 before making a public offering of securities); *id.* § 80a-19 (establishing guidelines for the payment or distribution of dividends).

⁴² KIRSCH ET AL., *supra* note 18, § 4:1.4.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* § 4:1.

⁴⁶ *Id.* § 4:1.2.

⁴⁷ *Id.* § 4:3.2. Form N-1A provides guidelines for mutual funds for registering and creating a prospectus:

The prospectus disclosure requirements in Form N-1A are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters. The prospectus should help investors to evaluate the risks of an investment and to decide whether to invest in a Fund by providing a balanced disclosure of positive and negative factors. Disclosure in the prospectus should be designed to assist an investor in comparing and contrasting the Fund with other funds.

by Form N-1A must be provided “in a clear, concise and understandable manner” pursuant to the plain English requirements of rule 421 promulgated under the Securities Act.⁴⁸ This rule was adopted in 1998 to address concerns that fund disclosure documents were difficult for investors to understand.⁴⁹

Form N-1A is divided into three parts.⁵⁰ Part A includes information required by section 10(a) of the Securities Act.⁵¹ This consists of the Risk/Return Summary, which covers investments, risks, performance, and fees.⁵² Additionally, a fund’s investment objectives, principal investment strategy, related risks, and a disclosure of the portfolio holdings are detailed in this section.⁵³ Generally, a fund has little discretion in formulating Part A of a prospectus since Form N-1A explicitly lists the required information and in what order it must appear.⁵⁴ Part B includes the information required in a fund’s Statement of Additional Information (“SAI”).⁵⁵ The purpose of the SAI is to provide supplementary information about the particular fund that the SEC believes “is not necessary or appropriate in the public interest or for the protection of investors to be in the prospectus, but that some investors may find useful.”⁵⁶ The SAI is comprised of information such as the fund’s history,

SEC, REGISTRATION FORM FOR OPEN-END MANAGEMENT INVESTMENT COMPANIES 6 (2009), available at <http://sec.gov/about/forms/formn-1a.pdf>.

⁴⁸ 17 C.F.R. § 230.421 (2009). This rule requires that information in a fund’s prospectus must comply with four general standards: “(1) . . . [w]henver possible, use short, explanatory sentences and bullet lists; (2) [u]se descriptive headings and subheadings; (3) [a]void frequent reliance on glossaries or defined terms as the primary means of explaining information . . . ; (4) [a]void legal and highly technical business terminology.” *Id.*

⁴⁹ KIRSCH ET AL., *supra* note 18, § 4:2.2. Investors had difficulty understanding the documents because they were “written by lawyers primarily as documents to avoid potential fund liability under the securities laws, rather than to communicate clearly with the public.” *Id.*

⁵⁰ It is no wonder that mutual fund prospectuses are so long when the registration form alone is comprised of sixty-five pages.

⁵¹ See SEC, *supra* note 47, at 6.

⁵² See *id.* at 10, 13.

⁵³ *Id.* at 18.

⁵⁴ *Id.* at 9–26.

⁵⁵ KIRSCH ET AL., *supra* note 18, § 4:3.

⁵⁶ SEC, *supra* note 47, at 6.

management of the fund, portfolio managers, and taxation of the fund.⁵⁷ Finally, Part C contains “Other Information,” including location of accounts and records, principal underwriters, and indemnification.⁵⁸

Despite these extensive disclosure requirements—prior to the enactment of the SEC’s rule—a fund’s prospectus disclosed very little information regarding costs.⁵⁹ Costs, including ongoing yearly fees and transaction fees, can vary drastically from fund to fund, and investors understand very little with respect to how costs affect their investment portfolios.⁶⁰ It has been suggested that broker-dealers inadequately educate investors with respect to investing in funds, especially when it comes to costs.⁶¹ In addition, mutual funds often give incentives to broker-dealers as rewards for selling shares of their funds, resulting in potential conflicts of interest.⁶² In this type of environment, one must wonder if retail investors are being treated fairly.⁶³ If investors cannot efficiently gather key information from a fund’s prospectus or from broker-dealers, they face a very difficult task in choosing among thousands of available mutual funds.

Once the prospectus has been finalized and approved by the SEC, it must be delivered to each purchaser of a fund’s shares by no later than the time the investor has received confirmation of his or her initial purchase.⁶⁴ The federal securities laws do not prescribe a specific medium by which the prospectus must be provided to purchasers.⁶⁵ The SEC has indicated that delivery may be satisfied by electronic means.⁶⁶ Electronic delivery, however, is not valid without the purchaser’s prior consent to this method of delivery.⁶⁷

⁵⁷ *Id.* at 27, 29, 39, 43.

⁵⁸ *Id.* at 56–58.

⁵⁹ See Black, *supra* note 12, at 325–26.

⁶⁰ See *id.*

⁶¹ *Id.* at 326.

⁶² *Id.* at 325.

⁶³ *Id.*

⁶⁴ 15 U.S.C. § 77e(b)(2) (2006); KIRSCH ET AL., *supra* note 18, § 4:7.2.

⁶⁵ KIRSCH ET AL., *supra* note 18, § 4:8.

⁶⁶ *Id.*

⁶⁷ *Id.* § 4:8.1.

The registration process, particularly the requirements of Form N-1A, fuels the tension between creating a useful document for investors while shielding funds from liability imposed by the Securities Act. Investment companies have become accustomed to disclosing to consumers too much information—to protect themselves from liability—without carefully considering the drawbacks of this practice.⁶⁸ Former SEC Chairman Arthur Levitt said, “[t]oo much information can be as much a problem as too little” and “[m]ore disclosure does not always mean better disclosure.”⁶⁹ When investors are provided with too much information, they become overwhelmed, hindering their ability to make informed choices. This defeats the very purpose disclosure was intended to serve—to protect and inform investors.⁷⁰

II. SEC'S ENHANCED DISCLOSURE AND NEW DELIVERY OPTION SCHEME

Since investment in mutual funds gained momentum in the 1980s, the SEC has devoted significant attention to improving disclosure. In 1983, the SEC adopted a “two-part disclosure format” under which investors first receive the statutory prospectus, which provides them with essential information, then, upon request, receive the more detailed information in the form of the SAI.⁷¹ Additionally, Levitt began work on improving mutual fund disclosure in 1994 when he initiated a program to develop an efficient mutual fund disclosure document known as the “Profile Prospectus.”⁷² Then, in 1998, the SEC adopted a rule allowing mutual funds to sell shares via a “fund profile,” which

⁶⁸ See Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 146–47 (2006).

⁶⁹ *Id.* at 162 (quoting Arthur Levitt, *Corporate Finance in the Information Age*, INSIGHTS, Mar. 1997, at 19).

⁷⁰ *Id.*

⁷¹ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. 10,898, 10,899 (Mar. 10, 1997) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274); Letter from David Certner, Legislative Counsel and Director of Legislative Policy, AARP, to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n 2 (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-114.pdf>.

⁷² INVESTMENT COMPANY INSTITUTE, INVESTOR VIEWS ON THE U.S. SECURITIES AND EXCHANGE COMMISSION'S PROPOSED SUMMARY PROSPECTUS 1 (2008), http://www.ici.org/pdf/ppr_08_sum_mary_prospectus.pdf.

was not widely adopted by funds.⁷³ The SEC claims that the “fund profile” failed to catch on because it did not enable funds to incorporate information by reference, and thus funds had “little incentive to use it.”⁷⁴

The SEC’s most recent attempt to improve the disclosure regime is the summary prospectus. In November 2007, the SEC released a proposal to amend Form N-1A and to adopt a new rule permitting mutual funds to satisfy prospectus delivery requirements by sending a summary prospectus to investors.⁷⁵ One year later, the SEC voted unanimously to adopt these amendments, with a number of modifications, to take effect beginning March 31, 2009.⁷⁶ The SEC claims that this improved mutual fund disclosure framework will provide investors with information that is easier to use and more readily available, while retaining the substance of the information that is currently offered.⁷⁷ Furthermore, “[t]he new rule is intended to create a disclosure regime that is tailored to the unique needs of mutual fund investors in a manner that provides ready access to the information that investors need, want, and choose to review in connection with a mutual fund purchase decision.”⁷⁸

⁷³ *Id.*; see also New Disclosure Option for Open-End Management Investment Companies, SEC Release Nos. 33-7513, 63 Fed. Reg. 13,968, 13,968 (Mar. 23, 1998) (to be codified at 17 C.F.R. pts. 230, 270).

⁷⁴ Troy A. Paredes, Commissioner, SEC, Speech by Sec. & Exch. Comm’n Commissioner: Statement Regarding the Adoption of the Summary Prospectus Rules (Nov. 19, 2008) (transcript available at <http://www.sec.gov/news/speech/2008/sph111908tap.htm>). Other theories explaining why this initiative failed include rapid development of the Internet and mutual fund companies’ concern about legal liability. See Anand, *supra* note 18; Certner, *supra* note 71, at 2. It has been suggested that the streamlined prospectus is back because of increased Internet usage. Anand, *supra* note 18. With research showing that nearly eighty percent of fund investors use the Internet, the push for readily available information has gained significant momentum in recent years. *Id.*

⁷⁵ Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 72 Fed. Reg. 67,790 (Nov. 21, 2007) (to be codified at 17 C.F.R. pts. 230, 232, 239, 274) [hereinafter Proposal].

⁷⁶ Press Release, U.S. Securities and Exchange Commission, SEC Improves Disclosure for Mutual Fund Investors (Nov. 19, 2008), <http://sec.gov/news/press/2008/2008-275.htm>. The final version of the proposal contains amendments to rules 159A, 482, 485, 497, and 498 under the Securities Act of 1933 and rules 304 and 401 of Regulation S-T. Enhanced Disclosure Rule, *supra* note 5, at 4546. All initial registration statements on Form N-1A filed on or after January 1, 2010, must comply with the new rule; this provides mutual funds with a sufficient transition period following the effective date. *Id.* at 4574.

⁷⁷ See Enhanced Disclosure Rule, *supra* note 5, at 4549.

⁷⁸ *Id.* at 4560.

The SEC's new rule creates a distinct layered approach to disclosure whereby investors are given key information up front and later provided with more detailed information upon request.⁷⁹ The foundation of the initiative is the user-friendly, streamlined summary prospectus.⁸⁰ Every prospectus will be required to incorporate a summary section at the beginning of the document.⁸¹ It is important to note that at this time, mutual funds will not be required to create a separate summary prospectus; however, they must include the summary section in the beginning of the statutory prospectus.⁸² The summary section will contain information identified by the SEC as central to making an investment decision.⁸³ If a fund chooses to rely on a summary prospectus to meet its Securities Act prospectus delivery obligations, the amendments provide that the fund's current statutory prospectus, SAI, and most recent annual and semi-annual reports must be made available, free of charge, at a web address specified in the summary prospectus.⁸⁴ Moreover, mutual funds may satisfy delivery obligations under the Securities Act by sending "key information" to investors via a summary prospectus.⁸⁵ In theory, the summary prospectus is to be supported by the statutory prospectus, which must be available online and sent to investors upon their request.⁸⁶

A. *Summary Prospectus: Content and Format*

The SEC received approximately 160 comment letters on the enhanced disclosure and new prospectus delivery option proposal.⁸⁷ In the following Sections, particular areas of the rule that garnered significant criticism during the proposal stage are

⁷⁹ *Id.*

⁸⁰ *Id.* at 4546.

⁸¹ *Id.* at 4549.

⁸² *See id.* A summary prospectus meeting the requirements of the proposed rule would be deemed a prospectus under section 10(b) of the Securities Act and section 24(g) of the 1940 Act for the purposes of section 5(b)(1) of the Securities Act. *Id.* at 4563.

⁸³ *Id.* at 4546.

⁸⁴ *See* KIRSCH ET AL., *supra* note 18, § 4:5.

⁸⁵ *Id.*

⁸⁶ *See* Enhanced Disclosure Rule, *supra* note 5, at 4548.

⁸⁷ *See* SEC, Comments on Proposed Rule: Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, <http://sec.gov/comments/s7-28-07/s72807.shtml> (last visited Mar. 24, 2010).

highlighted, followed by a discussion of the pros and cons of those items as included in the final version. The substance of the comment letters is used in this discussion. These critiques are organized into two areas: the format and content of the summary prospectus and the rule's approach to delivery and the Internet.

The amendments to Form N-1A will alter the beginning section of the statutory prospectus in two significant ways. First, the rule requires that additional information be included as a summary section, intended to function as a comprehensive presentation of information.⁸⁸ Second, for prospectuses that cover multiple funds, summary information for each fund must be separately presented to enable investors to compare and contrast funds.⁸⁹ The SEC has made one exception to this rule.⁹⁰ In order to eliminate information that is duplicative and reduce the length of prospectuses, the SEC will permit integration of information that is uniform for multiple funds.⁹¹ Thus, a prospectus covering multiple funds will be permitted to integrate information pertaining to the purchase and sale of fund shares, tax information, and financial intermediary compensation if it is the same for all funds covered by the prospectus.⁹²

The summary prospectus builds on the old Risk/Return Summary, which was identified by the SEC as an effective way to convey key information to consumers.⁹³ The summary prospectus must contain the following information in this precise order: "(1) [i]nvestment objectives; (2) costs; (3) principal investment strategies, risks, and performance; (4) investment advisers and portfolio managers; (5) brief purchase and sale and tax information; and (6) financial intermediary compensation."⁹⁴ If

⁸⁸ See Enhanced Disclosure Rule, *supra* note 5, at 4549.

⁸⁹ *Id.* The basis for this requirement is the SEC's belief that "[m]ultiple fund prospectuses contribute substantially to prospectus length and complexity, which act as barriers to understanding. [The SEC has] concluded that requiring a self-contained summary section for each fund will significantly aid investors' ability to use multiple fund prospectuses effectively." *Id.* at 4549 n.35.

⁹⁰ *Id.* at 4550.

⁹¹ *Id.* at 4550-51.

⁹² *Id.*

⁹³ Proposal, *supra* note 75, at 67,792.

⁹⁴ Enhanced Disclosure Rule, *supra* note 5, at 4552. The current version of Form N-1A was adopted in 1998. Part A contains the items that must be included in a prospectus to meet the requirements of the Securities Act. Those items include investment objectives, investment strategies and risks, performance information, and a fee table. KIRSCH ET AL., *supra* note 18, § 4:3.1. Other than this required

a fund relies on rule 498⁹⁵ to meet its statutory prospectus delivery obligations, the information contained in the summary prospectus must be the same information as contained in the summary section of a fund's statutory prospectus.⁹⁶

Mutual fund companies will also be prohibited from including any additional information in the summary prospectus not specifically required in the amended General Instructions to Form N-1A.⁹⁷ The key summary information must be presented, in plain English, in a standardized order, in approximately three to four pages.⁹⁸

Additionally, the SEC has adopted, as proposed, a cover page to appear at the beginning of the summary prospectus that provides the following information: the fund's name and share classes covered by the summary prospectus; the exchange ticker symbol of the fund's securities; a statement informing investors that the document is a summary prospectus; and the approximate date of the summary prospectus's first use.⁹⁹ The cover page will also include a legend informing investors that they may want to review the fund's statutory prospectus before investing.¹⁰⁰ This legend also tells investors how and where they can obtain a copy of the fund's statutory prospectus.¹⁰¹

One noteworthy modification to the contents of the summary prospectus is the SEC's placement of cost information, including the fee table, in a more prominent position in order to alert

information, a mutual fund may currently organize its prospectus in any manner that will be "easy for investors to understand." *Id.*

⁹⁵ 17 C.F.R. § 230.498 (2009). Rule 498, adopted in 1998, permitted mutual funds to create a mutual fund profile, which summarized key fund information. Enhanced Disclosure Rule, *supra* note 5, at 4560 n.194. The final rule effectively eliminates the use of the profile. *Id.*

⁹⁶ Enhanced Disclosure Rule, *supra* note 5, at 4563.

⁹⁷ *See id.* at 4551. Funds will still be permitted to include additional information that is not required in the prospectus. *Id.*

⁹⁸ *Id.* at 4548. The indication of three to four pages is merely a guideline as no precise number has been designated.

⁹⁹ *Id.* at 4564.

¹⁰⁰ *Id.* The legend reads:

Before you invest, you may want to review the Fund's prospectus, which contains more information about the Fund and its risks. You can find the Fund's prospectus and other information about the Fund online at [_____]. You can also get this information at no cost by calling [_____] or by sending an e-mail request to [_____].

Id.

¹⁰¹ *Id.*

investors to its importance.¹⁰² Through its research, the SEC found that investors are not aware that they pay ongoing costs each year they are invested in a fund.¹⁰³ To address this concern, the SEC has revised the parenthetical following the heading, “Annual Fund Operating Expenses” to read “expenses that you pay each year as a percentage of the value of your investment” rather than “expenses that are deducted from Fund assets.”¹⁰⁴ The SEC is confident that this revision makes clear to investors that they pay fund operating expenses as a percentage of the total value of their fund investment.¹⁰⁵

Another improvement in the area of costs is the adoption of a narrative disclosure alerting investors to the availability of discounts on front-end sales charges for larger purchases, also known as “breakpoint discounts.”¹⁰⁶ The SEC believes that investors are not fully aware of the availability of these discounts, and thus has proposed a brief narrative disclosure to make this information more prominent and understandable.¹⁰⁷ Additionally, the rule requires the inclusion of a brief disclosure concerning portfolio turnover and its effects on transaction costs.¹⁰⁸ Directly following the fee table, mutual funds will be required to report their turnover rates for the previous fiscal year.¹⁰⁹ This information must be followed by an explanation of

¹⁰² *Id.* at 4553. For example, a one percent increase in annual fees can reduce an investor’s return by eighteen percent over a twenty-year period. *Id.* at 4553 n.87.

¹⁰³ *Id.* at 4554.

¹⁰⁴ *Id.* at 4553–54 (internal quotation marks omitted).

¹⁰⁵ *Id.* at 4554.

¹⁰⁶ *Id.* at 4553 (internal quotation marks omitted).

¹⁰⁷ *See id.* The narrative reads:

You may qualify for sales charge discounts if you and your family invest, or agree to invest in the future, at least \$[____] in [name of fund family] funds. More information about these and other discounts is available from your financial professional and in [identify section heading and page number] of the Fund’s prospectus and [identify section heading and page number] of the Fund’s statement of additional information.

Id. at 4590.

¹⁰⁸ *Id.* at 4554; SEC, Mutual Fund Investing: Look at More than a Fund’s Past Performance, <http://www.sec.gov/investor/pubs/mfperform.htm> (last visited Mar. 24, 2010) (revealing that a fund that frequently buys and sells securities may also generate higher capital gains taxes).

¹⁰⁹ *Id.*

the effect of portfolio turnover on costs and performance.¹¹⁰ The explanation also addresses the adverse tax consequences that may result from high turnover rates in taxable accounts.¹¹¹

Another significant item to be included in the summary section is entitled, "financial intermediary compensation."¹¹² This item is new to prospectuses and will force mutual funds to disclose compensation agreements with selling broker-dealers.¹¹³ This information is intended to alert investors about potential conflicts of interest that may arise as a result of broker-dealers being influenced by compensation arrangements to suggest one fund over another.¹¹⁴ Compensation relationships have the potential to affect the objectivity of advice given to investors from their financial intermediaries.¹¹⁵ To satisfy the concerns of commentators about the negative connotation associated with the blanket disclosure, the SEC modified its original proposal to allow funds to omit the disclosure if they do not pay financial intermediaries for the sale of fund shares or any related services.¹¹⁶

Finally, the SEC initially proposed requiring funds to include a list of their top ten holdings in the summary section but did not include this requirement in the adopted rule, finding the component had "limited utility."¹¹⁷ During the comment process, it was pointed out that the top ten holdings information had the potential to mislead investors because it may not accurately reflect a fund's overall holdings and may be stale by the time it reaches investors.¹¹⁸ Similarly, the SEC did not include the

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.* at 4552.

¹¹³ *Id.* at 4557. The summary section would conclude with the following statement:

If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information.

Id.

¹¹⁴ *Id.*

¹¹⁵ See Black, *supra* note 14, at 331–32.

¹¹⁶ Enhanced Disclosure Rule, *supra* note 5, at 4557.

¹¹⁷ *Id.* at 4552.

¹¹⁸ *Id.*

proposed quarterly performance update in the final rule because it was concerned that this information may confuse investors and discourage funds from using the summary prospectus.¹¹⁹ Requiring quarterly updating of performance in the summary prospectus could be potentially confusing to investors because the summary prospectus would be updated more frequently than the statutory prospectus; thus investors may be exposed to differing performance data.¹²⁰

B. Critique of Format and Content

The organization and substance of the summary prospectus outlined above received a significant number of critiques, both positive and negative, during the rule's proposal stages. As to the organization of the summary prospectus, commentators generally supported a standardized format to assist investors in side-by-side comparison of funds. Some argued, however, that the rule's format requirements are too rigid and could benefit from greater flexibility.¹²¹ AARP, a staunch supporter of user-friendly disclosure, suggested that the SEC broaden its parameters for compliance with the format and presentation of the summary prospectus.¹²² AARP suggested that mutual funds should be allowed to "use their creativity in designing a form that is truly investor friendly."¹²³ Ultimately, the SEC retained the strict organization format, noting that "[f]unds have complete flexibility to prepare and present comparative information to investors" in advertising and sales material.¹²⁴

The rule, as adopted, also includes requirements as to language, typography, style of graphs, and length. Many commentators believed that such aspects, especially length,

¹¹⁹ *Id.* at 4565.

¹²⁰ *Id.*

¹²¹ Letter from Jill Gross, Director, & Jay Yamamoto, Student Intern, John Jay Legal Servs., Inc., Investor Rights Clinic at Pace Univ. Sch. of Law, to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-83.pdf> ("[I]nstead of imposing a rigid page limit, prohibiting the scope of information and imposing formatting requirements may be more effective for funds to provide a concise summary.").

¹²² Certner, *supra* note 71, at 1-4.

¹²³ *Id.* at 4. AARP encouraged the SEC to make use of what mutual funds have created and use today on their own websites and on Morningstar and Yahoo! Finance as those sites do an excellent job of presenting information in a user-friendly format. *Id.*

¹²⁴ Enhanced Disclosure Rule, *supra* note 5, at 4550.

should be left to the mutual funds to decide.¹²⁵ The Assistant General Counsel of Janus Capital, a publicly owned asset management company, opined that a precise limitation on the number of pages in the summary prospectus was not necessary.¹²⁶ She argued that the SEC could accomplish its goal of providing streamlined disclosure by identifying the information that it considers important to investors without limiting the number of pages.¹²⁷ Janus's comment letter stated "that useful information should not be sacrificed for the sake of brevity."¹²⁸ Another commentator, however, cautioned the SEC that without a strict page limit, the summary prospectus will expand over time, undermining its utility.¹²⁹ The SEC ultimately decided to leave the page limit open though it suggested that the summary prospectus should be approximately three to four pages in length.¹³⁰

Commentators also disagreed as to whether the summary prospectus should be consistent for all funds or if the SEC should allow exceptions for greater flexibility for certain types of funds.¹³¹ Representatives from EQ Advisors Trust and AXA

¹²⁵ Letter from Michael P. Zimmer, President, Fluent Techs., to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n (Mar. 14, 2008), <http://sec.gov/comments/s7-28-07/s72807-128.pdf> ("This will encourage creativity, improve the industry's adoption rate for the new document and further support the intent of the regulation.").

¹²⁶ Letter from Stephanie Grauerholz-Lofton, Vice President and Assistant Gen. Counsel, Janus Capital Mgmt. LLC, to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n 1-2 (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-90.pdf>.

¹²⁷ *Id.*

¹²⁸ *Id.* at 2.

¹²⁹ Letter from Robert W. Uek, Chair, Indep. Dirs. Council, to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n 4 (Feb. 15, 2008), <http://sec.gov/comments/s7-28-07/s72807-51.pdf>. In addition, without a precise limit, summary sections may drastically vary from fund to fund, thus hindering investors' ability to compare between funds. See Letter from Josiah Fisk, Co-Founder and Director, Firehouse Fin. Commc'ns LLC, to Nancy Morris, Secretary, Sec. & Exch. Comm'n 3 (Feb. 29, 2008) <http://sec.gov/comments/s7-28-07/s72807-121.pdf>.

¹³⁰ Enhanced Disclosure Rule, *supra* note 5, at 4551.

¹³¹ Letter from Eric D. Roiter, Senior Vice President and Gen. Counsel, Fidelity Mgmt. & Research Co., to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n 5 (Feb. 28, 2008) <http://sec.gov/comments/s7-28-07/s72807-105.pdf>. Fidelity's comment letter suggested that "[t]he 'fund by fund' format in a summary prospectus, which precludes the grouping or consolidation of information for closely related funds, would in some cases impede, rather than promote, clear and concise disclosure to investors." *Id.* For example, Roiter, Fidelity's senior vice president and general counsel believes that an investor evaluating Fidelity's twelve Freedom Funds may prefer to view a summary of each fund in that product line rather than view twelve

Premier VIP Trust, registered open-end investment companies, suggested that the SEC's strict regulation of what material can be included in the summary prospectus is not practical for every mutual fund.¹³² The SEC took note of these suggestions and modified its original proposal to allow funds that are used as investment vehicles in retirement plans and variable insurance contracts to modify or eliminate particular items from the summary prospectus.¹³³ For example, these funds may modify or omit specific information pertaining to the purchase and sale of fund shares that is not relevant.¹³⁴

Commentators were also critical of moving cost information to a more prominent position in the summary prospectus because they believed it placed too great an emphasis on fees and costs. One critic argued that while cost is an important factor, it is not one of the most important factors, and thus should not be given such a prominent location in the summary prospectus.¹³⁵ Conversely, others believe that mutual funds are frequently sold primarily based on favorable past performance, with investors paying too little attention to a fund's fees and costs.¹³⁶ Many mutual funds, and the broker-dealers who sell funds to individual investors, inadequately inform investors about the significance of costs when purchasing mutual funds. When fees are not given the attention they require, investors tend to fervently chase past results while glossing over cost information.¹³⁷

separate summary prospectuses. *Id.* Therefore, Roiter requested that the SEC "modify the proposed rule to provide an exception to permit life cycle and target risk funds to integrate the presentation of summaries for multiple funds." *Id.*

¹³² Letter from Steven M. Joenk, Chair, Chief Executive Officer and President, EQ Advisors Trust, AXA Premier VIP Trust, to Nancy Morris, Secretary, Sec. & Exch. Comm'n 2 (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-102.pdf> ("[W]e believe that the Amendments, as currently proposed, do not contemplate basic disclosures for funds that . . . serve as investment vehicles of variable life insurance contracts and/or variable annuity certificates . . .").

¹³³ Enhanced Disclosure Rule, *supra* note 5, at 4551.

¹³⁴ *Id.*

¹³⁵ Zimmer, *supra* note 125.

¹³⁶ Black, *supra* note 12, at 326.

¹³⁷ *See id.*; Securities and Exchange Commission, Mutual Fund Investing: Look at More than a Fund's Past Performance, <http://www.sec.gov/investor/pubs/mfperform.htm> (last visited Mar. 24, 2010) (providing an example of the vast difference in returns between annual operating expenses of 1.5% and 0.5% over an investment period of twenty years).

One final area that garnered significant criticism concerned the legend informing investors of the location of the statutory prospectus; it was suggested that the legend be more prominently situated.¹³⁸ Moreover, after viewing the sample summary prospectus, it was also suggested that the legend should appear in larger type font and printed in boldface, stressing its importance to investors.¹³⁹ The legend should include language that makes it clear to investors that the summary prospectus does not contain all of the information one should consider when making an investment decision.¹⁴⁰ The SEC decided not to modify the legend and believes “that the legend, as adopted, is sufficient to alert investors to the existence and location of additional information about the fund.”¹⁴¹

C. *SEC's New Prospectus Delivery Requirements: A Layered Approach to Disclosure*

In addition to modifying the format and content of the prospectus, the rule modifies the prospectus delivery requirements. The rule replaced rule 498¹⁴² of the Securities Act and allows mutual fund companies to satisfy their prospectus delivery obligations under the Securities Act by sending or giving investors a summary prospectus and providing the statutory prospectus online.¹⁴³ The SEC does not intend the summary prospectus to be “a self-contained document, but rather one element in a layered disclosure regime that is intended to provide investors with better, more useable access to the information in the statutory prospectus, SAI, and shareholder reports than they have today.”¹⁴⁴ The rule permits mutual funds to satisfy their obligation under section 5(b)(2) of the Securities Act¹⁴⁵ to deliver a statutory prospectus in an offering registered on Form N-1A by

¹³⁸ Gross & Yamamoto, *supra* note 121, at 3.

¹³⁹ *Id.*

¹⁴⁰ *Id.* (“Due to the easy-to-follow format of the Summary Prospectus, investors may overestimate their knowledge of investment matters and prematurely make investment decisions.”).

¹⁴¹ Enhanced Disclosure Rule, *supra* note 5, at 4564.

¹⁴² 17 C.F.R. § 230.498 (2008) (valid through March 31, 2009).

¹⁴³ Enhanced Disclosure Rule, *supra* note 5, at 4560; 17 C.F.R. § 230.498 (2009).

¹⁴⁴ Enhanced Disclosure Rule, *supra* note 5, at 4572.

¹⁴⁵ 15 U.S.C. § 77e(b)(2) (2006). Section 5(b)(2) makes it unlawful “to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus.” *Id.*

sending or giving the summary prospectus to an investor no later than the time of delivery of the security.¹⁴⁶ If any other materials accompany the summary prospectus when it is given to the investor, the fund must ensure that the summary prospectus is given “greater prominence.”¹⁴⁷ For example, the summary prospectus must be placed on top of a stack of paper documents when provided to an investor.¹⁴⁸ The summary prospectus, however, is not required to be given more prominence than accompanying summary or statutory prospectuses.¹⁴⁹

In its original proposal, the SEC made the “greater prominence” standard a condition to satisfaction of delivery obligations under section 5(b)(2) of the Securities Act.¹⁵⁰ After further consideration, the SEC chose to make it a rule requirement only; thus, failing to comply with the rule will not result in as serious a violation as failing to meet the requirements of section 5(b)(2) of the Securities Act.¹⁵¹ The SEC did, however, adopt the “greater prominence” requirement that prohibits the “Summary Prospectus from being bound together with any other materials.”¹⁵² Though commentators were split on this element, the SEC “continue[s] to believe that it is important to prevent the Summary Prospectus from being obscured by accompanying sales and other materials and to highlight for investors the concise, balanced presentation of the Summary Prospectus.”¹⁵³

The SEC has also established specific delivery guidelines to allow mutual funds to take advantage of technology and the Internet. Under the rule, a “fund’s current summary prospectus, statutory prospectus, SAI, and most recent annual reports must

¹⁴⁶ Enhanced Disclosure Rule, *supra* note 5, at 4561.

¹⁴⁷ *Id.* at 4562.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.* The SEC stated:

While we continue to believe that the ‘greater prominence’ requirement is important to prevent the Summary Prospectus from being obscured by accompanying sales and other materials . . . we are persuaded by commenters that the consequences of failure to meet the condition—a Section 5 violation—is not needed to achieve our goal.

Id.

¹⁵² *Id.*

¹⁵³ *Id.* at 4562–63. The only instance where the SEC will allow the binding of a summary prospectus with other materials is in the case of a variable annuity or variable life insurance contract. *Id.* at 4563.

be provided, free of charge, at the Web site address specified on the cover or at the beginning of the summary prospectus.”¹⁵⁴ These documents must be accessible prior to or at the time the summary prospectus is provided to the investor, and current versions of these documents must remain on funds’ websites for at least ninety days after the date that the mutual fund security is delivered.¹⁵⁵ These documents must “be presented in a format that is human-readable and capable of being printed on paper in human-readable format.”¹⁵⁶ The SEC did not, however, make the formatting requirement a condition to satisfying delivery obligations under section 5(b)(2) of the Securities Act.¹⁵⁷ In other words, a fund that fails to comply with the requirement that the statutory prospectus be presented in a format that is “convenient for both reading online and printing on paper” will face a violation of the SEC’s rule but will not be deemed to have violated section 5(b)(2) of the Securities Act.¹⁵⁸

The rule also contains requirements for linking back and forth among the summary prospectus, statutory prospectus, and the SAI on a fund’s website.¹⁵⁹ Investors accessing the statutory prospectus or SAI online must “be able to move directly back and forth between each section heading in a table of contents of the document and the section of the document referenced in that section heading.”¹⁶⁰ Moreover, investors accessing the summary prospectus online must be able to navigate back and forth between related sections of the statutory prospectus and SAI that

¹⁵⁴ *Id.* at 4566.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* The rule as proposed would have required the documents to be “presented in a format that is convenient for both reading online and printing on paper” as a condition to complying with relevant securities regulations. *Id.* In response to commentators’ suggestions, the SEC has modified this portion of the rule. *Id.* However, the SEC decided not to specify a particular format such as HTML or PDF as constituting a convenient format. *Id.* at 4567. The SEC states that it is “concerned that the Commission’s endorsement of any particular format could result in the use of that format to the exclusion of other formats that are in existence today or that may be developed in the future and that are more user-friendly.” *Id.*

¹⁵⁷ *Id.* at 4566–67. It is also not a condition to satisfying section 2(a)(10) of the Securities Act. *Id.*

¹⁵⁸ *Id.* at 4566. A cause of action under section 5(b)(2) of the Securities Act may provide a purchaser of securities with remedies of rescission or damages. See Ferdinand S. Tinio, Annotation, *What Constitutes Violation of § 5(b)(2) of Securities Act of 1933 (15 U.S.C.A. § 77e(b)(2)), Requiring Security To Be Accompanied or Preceded by Prospectus*, 28 A.L.R. FED. 811, § 2(b) (1976).

¹⁵⁹ Enhanced Disclosure Rule, *supra* note 5, at 4567.

¹⁶⁰ *Id.*

provide additional information concerning items mentioned in the summary prospectus.¹⁶¹ The purpose of these requirements is to provide investors with online information in a “more useable format than the same information when provided in paper”—enhancing its overall goal of more accessible disclosure.¹⁶²

The SEC has recognized that due to system outages or other technological problems, a fund may temporarily not be in compliance with the rule’s Internet posting requirements.¹⁶³ Therefore, it has included a “safe harbor” provision that will protect mutual funds from liability provided they have “reasonable procedures in place to ensure that those materials are available in the required manner.”¹⁶⁴ In addition, a fund is required to take prompt action to ensure that the materials are available “as soon as practicable following the earlier of the time at which the fund knows or reasonably should have known that the documents are not available in the manner required.”¹⁶⁵

Finally, the new rule permits the summary prospectus to incorporate by reference additional information contained in a fund’s statutory prospectus, SAI, and shareholder reports.¹⁶⁶ A fund, however, may not incorporate by reference information from any other source.¹⁶⁷ Additionally, a fund may not incorporate by reference any of the information that is required to be provided in the summary prospectus.¹⁶⁸ The SEC believes that permitting funds to incorporate by reference information contained in these lengthier disclosure documents—the statutory prospectus, SAI, and shareholder reports—“further[s] [its] goal of creating an improved mutual fund disclosure framework for the benefit of investors.”¹⁶⁹ The SEC is confident that by allowing funds to take advantage of incorporation by reference, a significant number of funds and intermediaries will be more

¹⁶¹ *See id.* at 4567–68.

¹⁶² *Id.*

¹⁶³ *Id.* at 4569.

¹⁶⁴ *Id.* The SEC did not elaborate on what would constitute “reasonable procedures.”

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* If a fund chooses to incorporate information by reference, the summary prospectus must specify, in the legend, what type of document is being referenced—for example, the statutory prospectus—and the date of the document must be provided. *Id.* at 4570.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

likely to utilize the summary prospectus.¹⁷⁰ According to the SEC, permitting incorporation by reference furthers its goals of encouraging mutual funds to use the summary prospectus and providing investors with a user-friendly approach to disclosure.¹⁷¹ It is, however, contestable whether permitting incorporation by reference truly benefits the investor or whether it simply alleviates mutual funds' concerns over liability. The SEC's current approach to incorporation by reference in the summary prospectus goes too far. Allowing mutual fund companies to incorporate information from multiple documents is confusing for investors and its use should be severely limited.¹⁷²

D. Critique of the Newly Adopted Delivery Requirements

The new delivery requirements and the layered approach to disclosure received a great deal of attention from commentators during the proposal stage. Commentators expressed concerns with the leniency of the "greater prominence" requirement. One commentator suggested that the SEC should take greater steps to prevent this "lightweight" summary prospectus, which contains crucial information, from being lost among marketing materials that have more lenient standards than those contained in rule 10(b)(5) of the Securities Exchange Act of 1934.¹⁷³ During the comment period, it was suggested that the SEC incorporate a legend in the summary prospectus that reads, "Promotional Materials: Except [for] the above documents, the Fund may send you additional materials promotional in nature. The law permits more freedom in preparing them. The promotional materials

¹⁷⁰ *Id.* at 4571. The SEC credits the low usage rates of the late nineties' fund profile—discussed above—to concerns about possible liability for omission of facts from the profile that were contained in the statutory prospectus or SAI. *Id.*; see also Certner, *supra* note 71, at 2 (stating that liability concerns relating to the use of the fund profile contributed to its lack of use among mutual funds); Letter from Joseph A. Franco, Professor, Suffolk Univ. Law Sch., to Sec. & Exch. Comm'n 6 (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-113.pdf> (stating that the fund profile was "overly restrictive" in terms of what it permitted to be incorporated by reference, contributing to its limited use).

¹⁷¹ Enhanced Disclosure Rule, *supra* note 5, at 4570–71.

¹⁷² One commentator suggested that the SEC modify the rule only to allow incorporation by reference to the statutory prospectus. See Franco, *supra* note 170, at 6.

¹⁷³ See Letter from Bo Li, Esq., to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-110.pdf>; 17 C.F.R. § 240.10b-5 (2009).

may be less reliable.”¹⁷⁴ It was argued that this additional warning combined with the requirement that the summary prospectus be the first document sent to investors, would ensure that investors give the summary prospectus the attention it deserves.¹⁷⁵

Commentators also expressed concern over the role of the Internet in the rule’s disclosure and delivery regime. For example, AARP cautioned the SEC to be careful in its reliance on the Internet in conjunction with the expectation that investors will proactively seek out a fund’s statutory prospectus.¹⁷⁶ Thus, AARP strongly encouraged the SEC to require that investors receive timely access to a hard copy of the summary prospectus and to make certain that “access does not equal delivery,” as some commentators proposed.¹⁷⁷ Research conducted by AARP revealed older investors’ strong preference to receive information regarding their investments via regular mail rather than by electronic delivery.¹⁷⁸ Thus, the SEC maintained the requirement that mutual funds send or give investors a hard copy of the summary prospectus while providing the additional disclosure documents online.¹⁷⁹

¹⁷⁴ Li, *supra* note 173.

¹⁷⁵ *See id.*

¹⁷⁶ *See* Certner, *supra* note 71, at 3.

¹⁷⁷ Letter from David Certner, Legislative Counsel and Director of Legislative Policy, AARP, to Nancy M. Morris, Secretary, Sec. & Exch. Comm’n 1–2 (June 16, 2008), <http://sec.gov/comments/s7-28-07/s72807-140.pdf> (supplementing AARP’s Feb. 28, 2008 letter). AARP cautioned against some commentators’ suggestion that the SEC include an “access equals delivery” provision for the summary prospectus, eliminating the requirement to send a hard copy except when requested by an investor. *Id.*

¹⁷⁸ *Id.* When asked how they prefer to receive investment-related information, eighty-one percent of respondents aged fifty to sixty-nine expressed a preference for regular mail. ELIZABETH WILLIS & S. KATHI BROWN, STRATEGIC ISSUES RESEARCH, AARP, VIEWS OF THE INDIVIDUAL INVESTOR TOWARD INTERNET-BASED DELIVERY OF COMPANY PROXY MATERIALS 28 (2006), available at http://assets.aarp.org/rgcenter/general/investor_proxy.pdf. Another study funded by the NASD Investor Education Foundation that examined fund purchase practices found that a majority of respondents aged sixty-five and older said they would not use the Internet to conduct research related to investments. BARBARA ROPER & STEPHEN BROBECK, CONSUMER FEDERAL OF AMERICA, MUTUAL FUND PURCHASE PRACTICES: AN ANALYSIS OF SURVEY RESULTS 3, http://www.consumerfed.org/pdfs/mutual_fund_survey_report.pdf.

¹⁷⁹ Enhanced Disclosure Rule, *supra* note 5, at 4560. AARP believes that “requiring investors to take steps to obtain a summary prospectus would likely dampen access to the key information contained in it.” Certner, *supra* note 177.

Additionally, commentators disagreed as to whether providing investors with a summary prospectus while telling them that more information is available online was the most effective way to improve disclosure. For example, one commentator stated that this method might lead investors to conclude that the summary prospectus is the only thing they need to review before making an investment decision.¹⁸⁰ To solve this problem, this commentator suggested that investors should only receive notice that information is available on the fund's website and nothing more; this radical approach would avoid the risk of liability that the summary prospectus will inevitably create due to its minimalist approach to dispensing information.¹⁸¹ "No matter what rules the Commission adopts, plaintiffs will always contend that the mutual fund misled investors by hiding 'key' information in the statutory prospectus rather than including it in the summary prospectus that was actually delivered to the investor."¹⁸² This commentator argued that the SEC should rely on the market to transform investor information into user-friendly formats—a "survival of the fittest" type of approach.¹⁸³ He stated, "[t]here is no reason to suppose that the market is any less efficient in disseminating information about mutual funds" than it is in disseminating information about other types of investments.¹⁸⁴

Finally the majority of mutual fund companies that responded to the SEC's request for comments suggested that the SEC do away with the proposed back-and-forth linking requirement between documents on a fund's website. These companies suggested that the cost of complying with the proposal is enormous and may force some funds to completely rebuild their website infrastructure.¹⁸⁵ For example, representatives from Janus estimated that the redesigning of its website in order to comply with the proposed amendments would be its largest expenditure in complying with the proposal.¹⁸⁶ Oppenheimer Funds's general counsel agreed and suggested that the SEC do

¹⁸⁰ Letter from Stephen A. Keen, to Nancy M. Morris, Secretary, Sec. & Exch. Comm'n 3-4 (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-106.pdf>.

¹⁸¹ *Id.* at 3.

¹⁸² *Id.* at 4.

¹⁸³ *See id.* at 3.

¹⁸⁴ *Id.*

¹⁸⁵ Grauerholz-Lofton, *supra* note 126.

¹⁸⁶ *Id.*

away with the back-and-forth linking requirement due to the significant resources and enormous cost this complex undertaking would require.¹⁸⁷ Although the SEC retained the back-and-forth linking requirements between the summary prospectus and the statutory prospectus in its final rule, it modified the proposal in order to offer more flexibility for funds.¹⁸⁸ The SEC reduced the number of links that would be necessary to link between the summary prospectus and the tables of contents of the statutory prospectus and SAI by “requir[ing] either links located at both the beginning and end of the Summary Prospectus, or links that remain continuously visible to persons accessing the Summary Prospectus, perhaps in a separate panel or frame.”¹⁸⁹ Though the SEC has reduced the number of links available in these documents, the requirement that they “remain continuously visible” ensures that they will be readily accessible to investors, promoting the SEC’s overall goal of effective disclosure.¹⁹⁰

III. WILL INVESTORS BE BETTER OFF WITH THE SEC’S NEW RULE?

While the SEC’s initiative has improved upon the current disclosure regime, many areas of the new rule could use further refinement and development. The summary prospectus is admittedly an improvement over the statutory prospectus, but the SEC has fallen short of its ultimate goal of revolutionizing

¹⁸⁷ Letter from Robert G. Zack, Executive Vice President and Gen. Counsel, Oppenheimer Funds, to Nancy M. Morris, Secretary, Sec. & Exch. Comm’n 12–13 (Feb. 28, 2008), <http://sec.gov/comments/s7-28-07/s72807-120.pdf>.

¹⁸⁸ See Enhanced Disclosure Rule, *supra* note 5, at 4567–68. The modifications include a clarification that the linking between the table of contents of the statutory prospectus and the summary prospectus “may be outside the document, e.g., in a separate frame or panel of the computer screen and need not be the table of contents that is contained within the document itself.” *Id.* at 4567. The SEC stated, “[t]his modification is intended to provide flexibility to use linking technologies other than hyperlinking within the document itself. Permitted technologies would include . . . the use of ‘bookmarks’ that replicate the document’s table of contents, but are displayed in a separate panel from the document itself.” *Id.* In addition, the SEC provided additional clarification in the final rule by stating that “the links must permit movement directly back and forth between each section heading in a table of contents and the particular section of the document referenced in that section heading.” *Id.*

¹⁸⁹ *Id.* at 4568.

¹⁹⁰ *Id.* This alteration responds to commentators’ concerns that too many links would result in a confusing and cluttered presentation of the summary prospectus. *Id.*

disclosure. The tension fueled by the statutory prospectus's role as both an informative document and one that shields funds from liability must be taken into account when examining the intended function of the new summary prospectus. Requiring mutual funds to continue to produce a statutory prospectus does not relieve this tension that has bogged down the disclosure environment for so long. Given the proposed execution of the summary prospectus and the corresponding delivery requirements, the rule sends a mixed message to investors regarding whether or not they can rely solely on the summary prospectus when making an investment decision. In addition, the delivery option places an unnecessary, added burden on investors.

It is doubtful that the SEC's new rule alone will foster the degree of change needed to heighten investor confidence and protection. A more beneficial approach would include streamlining the statutory prospectus into one user-friendly document that expands upon the summary prospectus so that an investor need not seek out additional information. In addition to streamlining disclosure, substantive regulations that directly govern mutual fund advisers' conduct are needed to heighten investor protection.

A. *Critical Examination of the Summary Prospectus and the Underlying Policy Concerns*

The SEC's rule is based on certain presumptions that demand closer scrutiny. Generally, the summary prospectus is a significant improvement over the current statutory prospectus. If read and understood by investors, the summary prospectus has the potential to provide them with a helpful starting point. However, there are particular areas that need further modification to meaningfully enhance protection for investors. These areas include, and are not limited to, providing stricter guidelines concerning the formatting of the summary prospectus; imposing a bright-line rule to ensure that marketing materials are not confused with the summary prospectus; and enhancing the legend informing investors that the summary prospectus, as currently adopted, does not contain all pertinent information concerning the particular fund.

“In order for a disclosure system to be effective, not only must the information . . . be disclosed completely, clearly, and accurately, but it must also be read and comprehended by the consumer.”¹⁹¹ The current disclosure regime is overly complex and ineffective yet “[s]ecurities regulation is motivated by the assumption that more information is better than less.”¹⁹² The philosophy behind the new rule—improving disclosure by providing investors with a streamlined disclosure piece—appears to take aim at this critique; yet merely adding another layer of disclosure is not the proper solution. Investors should either be able to rely on the summary prospectus to make an investment decision or the length of the statutory prospectus should be significantly reduced so that it is the only disclosure document provided to investors. Parceling the disclosure process into a series of “layers” does not meaningfully streamline disclosure; in fact, it arguably generates confusion on the part of investors who do not know what information to rely on when making an investment decision.

With regard to the content and organization of the prospectus, the SEC should mandate a standardized format for all funds that specifies font type, font size, and use of color and graphics. Strict formatting guidelines should be developed to ensure that the summary prospectus is not easily confused with marketing materials. Some critics are concerned that a short summary may make it difficult for investors to tell the difference between a marketing pitch and SEC-mandated disclosure.¹⁹³ This concern cannot be alleviated until more stringent formatting regulations are adopted. Just as there should be strict guidelines regulating the formatting of these documents, the SEC should specify a particular format for the online posting of the documents, such as PDF. Allowing too much discretion in this area will result in presentations that vary significantly from fund to fund, thus inhibiting investors’ ability to compare and contrast funds effectively.

The SEC properly disposed of the proposed top ten holdings requirement, as it was not a meaningful addition to the prospectus. As one critic pointed out, it is merely a snapshot of

¹⁹¹ Ripken, *supra* note 68, at 146.

¹⁹² *Id.* at 147.

¹⁹³ Anand, *supra* note 18.

the portfolio on a given day.¹⁹⁴ The SEC also decided not to incorporate the quarterly updating performance requirement in its final rule. It mandates, however, that funds that supply this information elsewhere must indicate—in the summary section—where it can be found.¹⁹⁵ Requiring funds to inform investors where they can locate performance information is a valid compromise especially given concerns over investors' tendency to chase past returns when making investment decisions. Moreover, it is equally important for investors to understand the costs associated with investing in a particular fund. The SEC justifiably moved cost information to a more prominent position. Considering the significance investors place on past performance, anything the SEC can do to educate investors about fees and how they impact returns is advantageous.

The “layered approach” to delivery consists of a fund sending investors the summary prospectus while providing the statutory prospectus online. If funds choose to satisfy their delivery obligations in this manner, they are providing investors with simply one more document that may be ignored. Considering that investors are also receiving marketing materials from multiple funds, how are they to know that the summary prospectus is of greater importance? The SEC’s “greater prominence” rule does not provide an adequate solution to this dilemma. To solve this problem and the possible confusion with marketing materials, the SEC should impose a bright-line rule ensuring that no other materials will accompany the summary prospectus. The SEC should then set up a time frame for when mutual fund companies may begin sending investors marketing materials. Marketing materials usually precede the prospectus, which is typically not sent to an investor until confirmation of an initial purchase.¹⁹⁶ If the summary prospectus were to become the first document received by an investor, there would be less confusion as to its importance. It is vital that marketing materials, which typically gloss over important items like fees and risk, do not overshadow the summary prospectus.

While it has made some improvements in the area of fund disclosure by streamlining preliminary disclosure documents, the SEC is sending a mixed message to investors with its layered

¹⁹⁴ See Joenk, *supra* note 132, at 3.

¹⁹⁵ Enhanced Disclosure Rule, *supra* note 5, at 4566.

¹⁹⁶ See 15 U.S.C. § 77e(b)(2) (2006).

approach to disclosure. Authorizing the use of a summary prospectus that theoretically contains everything an investor needs to know while stamping a disclosure on it telling an investor that he *may* want to read the statutory prospectus before investing, sends a conflicting message. The SEC stated that it does not “intend the Summary Prospectus to be a self-contained document, but rather one element in a layered disclosure regime that results in the simultaneous provision of information to investors through multiple means.”¹⁹⁷ It is unrealistic to expect investors to take the additional step of reviewing the statutory prospectus—a document that is inherently difficult to understand—before making an investment decision. In fact, a study conducted by the Investment Company Institute found that only thirty-four percent of investors polled said that they looked at a fund’s prospectus before investing.¹⁹⁸ If most investors are not currently reading statutory prospectuses when they receive hard copies, it is impractical to expect investors to read them when the SEC’s new rule is implemented. Compounding the problem is that the legend in its current form¹⁹⁹ does not adequately encourage investors to seek out the statutory prospectus. If the SEC believes that the statutory prospectus is still a vital tool for investors, the language used in the legend should be far more compelling.

Finally, the rule will burden investors who bring suit against brokers for fraud or misrepresentation. In a jurisdiction such as New York where courts apply the “Prospectus Rule”—which provides that “a written prospectus bars most claims against conflicting oral misstatements”—the brokerage industry has a distinct advantage over investors.²⁰⁰ Investors are charged with constructive knowledge of the information contained in a fund’s statutory prospectus regardless of whether they read it or understood it. Rather than reading the prospectus, some investors choose to rely on their brokers’ oral statements. But ultimately the onus is on the investor in the event of a financial

¹⁹⁷ Proposal, *supra* note 75, at 67,805.

¹⁹⁸ INVESTMENT COMPANY INSTITUTE, UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 4 (2006), available at http://ici.org/pdf/rpt_06_inv_prefs_full.pdf.

¹⁹⁹ See *supra* note 100.

²⁰⁰ Kenneth B. Gorton, *When Words Collide: Arbitrating Securities Claims When Oral Misrepresentations by a Broker Contradict a Written Prospectus*. PIABA B.J. 24, 25 (Spring 2006).

adviser's misstatement.²⁰¹ This is a troubling realization considering professional advisers are the most common source of information sought out by mutual fund investors.²⁰² Therefore, it is critical that the system of disclosure encourages readership of prospectus materials while providing investors with a heightened level of protection.

Compare the standard in New York and the Second Circuit with California's more lenient federal case-law standard, which holds that an investor's receipt of a prospectus does not constitute constructive knowledge for common law fraud and other related actions.²⁰³ Given the increased responsibility investors will have in obtaining information under the new rule, it would certainly be fairer to investors if the New York courts moved in the direction of California's system. This concern

²⁰¹ See *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031-32 (2d Cir. 1993) ("An investor may not justifiably rely on a [broker's] misrepresentation if, through minimal diligence, the investor should have discovered the truth."), *superseded by statute*, Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737; see also *Marlow v. Gold*, No. 89 Civ. 8589, 1991 WL 107268, at *9 (S.D.N.Y. June 13, 1991) (holding that an investor recklessly disregarded written warnings when he relied on assurances from his accountant); *Treacy v. Simmons*, No. 89 Civ. 7052, 1991 WL 67474, at *6 (S.D.N.Y. Apr. 23, 1991) (finding that it was unreasonable for an investor to rely on broker's oral statements in lieu of reading the risks disclosed in the prospectus). The state courts in New York have applied the prospectus rule with even more force than the federal courts. *Gorton*, *supra* note 200, at 16; see *Yang v. Morgan Stanley Dean Witter (In re Dean Witter Managed Futures Ltd. P'ship Litig.)*, 282 A.D.2d 271, 271, 724 N.Y.S.2d 149, 150 (1st Dep't 2001) ("[Plaintiffs'] causes of action for fraud and negligent misrepresentation are barred by the prospectuses . . . Such disclosures in the written offering materials rendered any reliance on alleged contradictory oral representations unjustifiable as a matter of law . . ." (citations omitted)).

²⁰² INVESTMENT COMPANY INSTITUTE, *supra* note 198, at 4.

²⁰³ See *Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989) (holding that the district court erred in granting summary judgment "against the [plaintiffs] on the ground they had constructive notice the alleged misrepresentations were not true"); *Luksch v. Latham*, 675 F. Supp. 1198, 1199 (N.D. Cal. 1987) (concluding that "knowledge of the information contained in offering memoranda . . . should not be legally imputed to investors"); *Acebey v. Shearson Lehman Bros., Inc.*, No. CV 92-5926-WMB, 1993 U.S. Dist. LEXIS 19659, at *37 n.17 (C.D. Cal. June 4, 1993) (interpreting *Luksch* as "requir[ing] proof that each investor charged with constructive notice of his claims had read the prospectus and appreciated the importance of the fact that the prospectus contradicted other representations that defendants had made"), *aff'd*, 62 F.3d 1423 (9th Cir. 1995).

becomes even more paramount in light of the possibility that mutual funds may bury less appealing information in the statutory prospectus.²⁰⁴

It is unlikely, however, that the New York courts will discontinue their application of the “Prospectus Rule” given the way in which the SEC has presented the summary prospectus. Because the SEC has presented it as a preliminary disclosure document complete with a disclaimer encouraging investors to seek out the statutory prospectus before investing, the courts will likely continue to place the burden on investors to seek out additional information in the face of conflicting statements by a broker.²⁰⁵ It is also unreasonable for investors to be charged with constructive notice of what is contained in the statutory prospectus. This is especially inequitable for investors when a fund can satisfy its delivery obligations by simply sending a summary prospectus to the investor while posting the statutory prospectus online. The new delivery option places too high a burden on consumers given that it will be consumers’ responsibility to locate the statutory prospectus on the fund’s website or take the initiative to call the fund and request one. This “burden-shifting” policy does not coincide with the purpose of either the Securities Act or the 1940 Act, which were enacted to eliminate the caveat emptor component of investing.²⁰⁶

Another way in which the burden may be shifted back onto the consumer is in the form of fees. “Distribution or Service Fees”—commonly referred to as “12b-1 fees”—are fees paid by the fund out of its assets to pay for the costs of marketing and selling fund shares to consumers.²⁰⁷ Distribution fees pay for

²⁰⁴ This worry is enhanced given the fact that instead of two layers of disclosure—comprised of the statutory prospectus and the SAI—there will now be three layers, with the summary prospectus comprising the first.

²⁰⁵ See *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 351 (2d Cir. 1993) (holding that “a plaintiff [cannot] rely on misleading oral statements to establish an unsuitability claim when the offering materials contradict the oral assurances”). The court in *Dodds* also held that issuers of prospectuses cannot be expected to predict “the risk averseness of each potential investor.” *Id.*; see also *Addeo v. Braver*, 956 F. Supp. 443, 450 (S.D.N.Y. 1997) (holding in an action for fraud, that plaintiffs had “a duty to inquire into the reliability of defendant’s investment advice.” If plaintiffs were unsuccessful in doing so, “they must be held to [have] had constructive knowledge not merely of those facts directly implicated on the face of the materials available to them, but also of any information that would have come to light during the course of a reasonable investigation”).

²⁰⁶ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

²⁰⁷ Invest Wisely, *supra* note 23.

compensating those who sell shares of the fund and for the printing and mailing of prospectuses and sales literature.²⁰⁸ The SEC does not address whether investors will be effectually “footing the bill” for its newly adopted rule in the form of increased 12b-1 fees. If investors will be paying for the rule’s implementation, they should be given a greater say in how this information is presented and delivered.²⁰⁹

B. *Is Disclosure Enough?*

Given how complicated the current disclosure regime is, one must inquire whether disclosure alone provides investors with adequate protection. The academic community has painted a dismal picture of average investors, describing them as “generally uninformed and financially unsophisticated.”²¹⁰ Empirical studies of investor behavior show that investors suffer from cognitive biases that mask their ability to make rational investment decisions.²¹¹ Such cognitive biases include chasing past returns and the “home bias,” or the tendency to buy domestic assets while underweighting foreign assets.²¹² Still other academic studies have revealed investors’ lack of understanding of risk and their apparent indifference to it.²¹³ Some argue, “until the [SEC] faces the cognitive biases and investment limitations that most fund investors face, further streamlining of fund disclosures is unlikely to help.”²¹⁴

²⁰⁸ *Id.*

²⁰⁹ For a detailed estimate of the costs associated with the SEC’s proposal, review Enhanced Disclosure Rule, *supra* note 5, at 4580–81.

²¹⁰ Palmiter & Taha, *supra* note 37, at 936.

²¹¹ *See id.* at 938–39; *see also* Ripken, *supra* note 68, at 158–60.

²¹² *See* Palmiter & Taha, *supra* note 37, at 994, 1002. Other biases include the “overconfidence bias,” which “facilitates an enhanced sense of ability to control events and risks;” the “optimism bias,” which leads people to “believe that they are far more likely than others to experience positive life outcomes;” and the “confirmation bias,” which may lead investors to “look for information that affirms, rather than undermines, their beliefs, and they may be slow to change their beliefs in the face of new evidence,” such as poor returns. Ripken, *supra* note 68, at 163–76.

²¹³ Palmiter & Taha, *supra* note 37, at 978.

²¹⁴ Letter from Alan Palmiter and Ahmed Taha, Professors of Law, Wake Forest Univ. Sch. of Law, to Nancy M. Morris, Secretary, Sec. & Exch. Comm’n (Mar. 4, 2008), <http://sec.gov/comments/s7-28-07/s72807-125.pdf>.

“The SEC’s belief that fund investors can fend for themselves, once armed with adequate disclosure, fails to appreciate the extent of investors’ limitations.”²¹⁵ Perhaps the problem originated with the passage of the 1940 Act, as illustrated by the following passage:

The Investment Company Act of 1940 (the “1940 Act”), passed by Congress to regulate the disclosure and management of mutual funds, assumes that mutual fund investors cannot adequately fend for themselves. Nonetheless, despite doubts about the capabilities of fund investors, the 1940 Act also assumes (somewhat inconsistently) that fund investors can make basic asset-allocation and fund-selection decisions. The 1940 Act thus adopts a blurred policy between regulatory paternalism and market liberalism, with a significant portion of industry oversight left not to regulation but to fund investors themselves.²¹⁶

This “blurred policy” of protecting investors, on the one hand, while allowing them to fend for themselves, on the other, is prevalent in our current disclosure system. We cannot assume that by providing investors with multiple disclosure documents, they will automatically be transformed into savvy decisionmakers.

Perhaps improving disclosure, without more, is not enough.²¹⁷ Instead, rules that regulate the conduct of investment companies more directly and substantively may be more effective than attempts to streamline disclosure.²¹⁸ It is, however, easy to recognize why disclosure is such a popular means of regulation for the government—it is “the least controversial way of trying to get corporations to behave properly.”²¹⁹ Substantive legislation that directly affects economic behavior rather than demanding disclosure would be more effective in protecting investors

²¹⁵ Palmiter & Taha, *supra* note 37, at 936.

²¹⁶ *Id.* at 937.

²¹⁷ Ripken, *supra* note 68, at 190.

²¹⁸ *Id.*

²¹⁹ *Id.* at 189; *see also id.* (stating that “[d]isclosure has always seemed to be the most palatable form of regulation because it constitutes a compromise: requiring disclosure is better than doing nothing at all, but it does not go so far as to regulate substantive conduct directly.”).

and instilling consumer confidence in the capital markets.²²⁰ Substantive regulation would command favorable corporate conduct while prohibiting behavior that is improper or unfair.²²¹

Substantive securities regulation that prohibits improper behavior by corporations can be effective in stimulating investor trust and promoting investor protection.²²² "Investors might not trust in the corporate insiders themselves, but they rely on the efficacy of strong regulation of the corporate insiders."²²³ The merits of substantive regulation require far more analysis and thought, but the proposal provides an interesting take on disclosure alternatives.²²⁴ Rather than responding to every corporate scandal that tests investor confidence by adding more layers of disclosure, perhaps it is time to examine viable alternatives.²²⁵

The SEC has responded with substantive regulation of mutual funds in the past.²²⁶ Trading abuses known as "market timing, in which traders buy and sell fund shares based on movements in stock prices that aren't yet reflected in the pricing of those fund shares"²²⁷ and "late trading," which occurs when funds are bought and sold at closing price past the four p.m. deadline,²²⁸ were brought to light in 2003 by New York Attorney General Eliot Spitzer and the SEC.²²⁹ In response, the SEC's Office of Compliance Inspections and Examinations prepared a

²²⁰ *Id.* at 190.

²²¹ *Id.* For example, rather than requiring companies to disclose certain "related-party transactions," it makes more sense to prohibit these kinds of transactions altogether. *Id.* at 192. The author uses the example of Regulation S-K, which requires that directors of a corporation who have a material interest in transactions with the corporation exceeding \$60,000 must publicly disclose the nature of the transaction and what their interest in that transaction is. *Id.* at 191.

²²² *Id.* at 204.

²²³ *Id.* at 195.

²²⁴ *Id.* at 204.

²²⁵ *Id.*

²²⁶ See Memorandum from Lori A. Richards, Office of Compliance Inspections and Examinations, Sec. & Exch. Comm'n, to Chairman William H. Donaldson, Sec. & Exch. Comm'n 2 (Mar. 10, 2004), <http://www.sec.gov/news/extra/apx-ts031004lar.pdf> [hereinafter Inspection Memorandum].

²²⁷ Tom Lauricella, Deborah Solomon & Gregory Zuckerman, *Mutual Funds Face Overhaul as Spitzer and SEC Fight for Turf*, WALL ST. J., Oct. 31, 2003, at A1 (internal quotation marks omitted).

²²⁸ Arden Dale, *Public Pension Funds React to Probe: Some States Have Fired Investment Managers; Others Wait and Watch*, WALL ST. J., Nov. 5, 2003, at D9.

²²⁹ Deborah Solomon, *SEC Plans Makeover of Trading Rules for Mutual Funds*, WALL ST. J., Oct. 10, 2003, at C1.

report, which described the changes the SEC was instituting in response to abusive market timing and late trading activities.²³⁰ These changes were premised on enhancements to the examination procedures to address “market timing” and “late trading.”²³¹ The enhancements, which are becoming a mandatory procedure in routine examinations, incorporate “review[s of] trading in the fund’s shares,” “a daily summary of net sales and redemptions,” and the sampling of internal e-mail correspondence.²³² In addition, in December 2003, the SEC adopted a rule requiring funds to implement and maintain written compliance procedures designed to prevent violations like the ones mentioned above from occurring.²³³

CONCLUSION

An approach that combines improved disclosure with substantive securities regulation is the most effective way to enhance investor confidence and protection. Instead of relying on a system of layered disclosure, the SEC should implement one disclosure document that investors may wholly rely upon when making an investment decision. Understandably, it would not be as lightweight as the summary prospectus, but placing limits on its length and content will prevent the document from evolving into today’s burdensome statutory prospectus.

Investors will experience greater confidence in knowing that they can adequately arm themselves with information contained in one easy-to-understand document, without having to seek out additional information in documents like the statutory prospectus and the SAI. Enhancing investor confidence will also be realized when investors observe the SEC placing greater substantive regulations on mutual funds and corporate executives. This combination approach would strengthen the SEC’s efforts to improve disclosure in a meaningful way rather than merely approaching the problem with another layer of disclosure—an approach that has not been successful thus far.

When examining the current state of mutual fund disclosure, one thing is certain—the statutory prospectus in its current form does not properly equip investors with the knowledge required to

²³⁰ Inspection Memorandum, *supra* note 226, at 2.

²³¹ *Id.* at 9.

²³² *Id.*

²³³ *Id.* at 13.

make important financial planning decisions. The SEC should be commended for taking the initiative to craft a more user-friendly document that will aid investors in making these important decisions. However, the newly adopted rule does not provide the necessary framework to implement such a feat. In addition to enhancing the value of the summary prospectus, the SEC should consider available alternatives for improving investor confidence and, ultimately, the overall health of the financial markets.