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The Profile: Designer Disclosure for Mutual Funds

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THE PROFILE: DESIGNER DISCLOSURE FOR MUTUAL FUNDS*

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The country is experiencing a series of inversions. In the stock market, new era thinking dominates the old ideas, with market price setting the standards for value rather than standards for value determining market price.[1] From academia comes a call for replacing the country's widely acclaimed regulation of the equities markets to protect investors with a market-oriented approach of competitive federalism, whereby issuers select the nature of regulation to which they will be subject, with states and the federal government competing for business.[2]

Now, coming to what this Author proposes to discuss, the SEC has taken unprecedented steps to dilute the time-honored principle of mandatory disclosure by encouraging the use by investors of a short-form prospectus—the "Profile"—in the selection of mutual funds.

In the discussion which follows, this Author will try to convince you that Rule 498–the Profile Rule–constitutes a large mistake by the SEC–a large mistake because, in adopting this rule, the SEC has:

1) required investors to define for themselves the amount of information they need to make an investment decision;

2) encouraged the impression that the Profile contains all the information investors need;

3) with seeming inconsistency, retained the notion that the full prospectus is "the primary disclosure document

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[1] Gretchen Morgenson, *A Time to Value Words of Wisdom*, N.Y. TIMES, Aug. 16, 1998, at § 3 (Money & Business) at 1.

[2] Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation* 100 YALE L.J. 2359, 2361-63 (1998).

contemplated under the federal securities laws" and amended it in many useful respects to focus disclosure "on essential information" about a mutual fund, knowing that much of that "essential information" will never be seen by investors opting to look only at the Profile;[3]

4) based the rule on focus group reactions to pilot profiles, which may have established that prospectuses in current use were hard to comprehend but did not prove that investors preferred the simplified disclosure of the pilot to a well-written prospectus containing all material information;

5) determined for itself what can, and what cannot, be included in the Profile, thereby preventing mutual funds from including in the Profile information that they consider material to investor choice but that is not covered by one of the nine specific items of information required to be included; and

6) excluded from what is includable in the Profile a large number of items of information clearly material to prudent investor choice.

Each of these items is unprecedented. Taken together they represent a major shift by the SEC away from its long espousal of mandatory disclosure of all material facts in favor of enhanced readability for average investors through brevity and simplicity of expression. This well-intentioned effort is misguided. It is a Faustian bargain that begins by short-changing the public investor and, predictably, will end by impairing the SEC's reputation and independence.

I. WHAT RULE 498 DOES

Rule 498 gives investors a choice. Thus, at the outset, the Profile Release[4] states:

> A fund that offers a Profile will be able to give investors a choice of the amount of information that they wish to consider before making a decision about investing in the fund; investors will have the option

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[3] Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 33-7512, 66 SEC Docket 1629, 1998 WL 107729, at *1, *4 (Mar. 13, 1998) [hereinafter Form N-1A Release].

[4] New Disclosure Option for Open-End Management Investment Companies, Securities Act Release No. 33-7513, 66 SEC Docket 1703, 1998 WL 107724 (Mar. 13, 1998) [hereinafter Profile Release].

of purchasing the fund's shares after reviewing the information in the Profile or after requesting and reviewing the fund's prospectus (and other information).

An investor deciding to purchase fund shares on the basis of the Profile will receive the fund's prospectus with confirmation of the purchase. Under the Securities Act, the Profile is a summary disclosure document permitted under Section 10(b) while the prospectus meets the disclosure requirements of Section 10(a). Of course, it is highly unlikely that any significant number of investors who base their investment decision on the Profile will read the prospectus when it arrives. The ICI Profile Survey[5] found that, even without the Profile, only half of fund shareholders ever consult a prospectus before investing.

As addressed in more detail later, the Profile's content is limited by rule to nine items, thereby omitting by design matters of materiality to investors. The legend required on the cover page of the Profile states (emphasis added): "This profile summarizes *key* information about a fund that is included in the fund's prospectus." However, it is perfectly clear that the SEC recognizes that the Profile's "key" information will not encompass all that is material to informed investor choice since it has declared that a prospectus meeting the requirements of recently amended Form N-1A will contain only "essential" information. The Form N-1A Release explains the Commission's objective in amending the disclosure requirements for the prospectus as follows: "The amendments to Form N-1A seek to make the prospectus, which will remain a fund's primary disclosure document, a more effective tool by focusing its contents on information that is *essential* to an investment in the fund."[6]

II. THE COMMISSION'S NEW IDEA OF CHOICE

This principle of choice for investors, starting with a document acknowledged to contain less than all information "essential" for informed investor choice, is both unprecedented and deeply troubling. To grasp the magnitude of choice an investor

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[5] Form N-1A Release, *supra* note 3, at *2 n.5.

[6] Form N-1A Release, *supra* note 3, at *4 (emphasis added). The term "essential" appears to be new to the securities laws; its meaning remains obscure.

seeking the whole story about a fund would have to exercise, consider that even the prospectus omits information material to an investment decision. Beyond the prospectus, there are two other documents an investor can request: the fund's statement of additional information ("SAI") and the fund's annual or semi-annual report. The Profile's legend is required to state: "You may obtain the prospectus *and other information about the Fund* at no cost by calling _____ ."[7] Of course, it would take a sophisticated investor to know enough to ask for these documents, which are not referred to by name in the Profile and contain material information not otherwise available. The shareholder reports are not only the sole source of portfolio holdings but typically contain the required discussion by the fund's management of the fund's performance ("MDFP"). The MDFP is the mutual fund's analog to the management's discussion and analysis ("MD&A") section of a commercial company's prospectus. It is likely to be one of the most important and revealing bodies of information about the manager's thinking and methodology as can be found anywhere in the various disclosure documents.

In 1983, when the SEC adopted the SAI concept to allow a shortened prospectus to be used with the offer to supply additional information through the SAI upon request, it permitted incorporation of the SAI by reference in the prospectus.[8] Aware of the risk that, under Section 12(a)(2) of the Securities Act, a court could impose liability if information in the SAI included material facts necessary to make the statements in the prospectus not misleading,[9] and that mandatory incorporation by reference might be construed as an admission that, without the SAI, the prospectus lacked information necessary to meet the Section 12(a)(2) standard, the SEC made incorporation by reference voluntary. Moreover, it specifically found that the prospectus, standing alone, met the disclosure stan-

[7] Profile Release, *supra* note 4, at *11 (footnote omitted) (emphasis added).

[8] *See* Registration Form Used by Open-End Management Investment Companies, Proposed Guidelines, Release No. 33-6447, 26 SEC Docket 1500, 1982 WL 35958 (Dec. 27, 1982) [hereinafter SAI Proposing Release]; Registration Form Used by Open-End Management Investment Companies, Guidelines, Release No. 33-6479, 28 SEC Docket 682, 1983 WL 35814 (Aug. 12, 1983) [hereinafter SAI Adopting Release].

[9] SAI Proposing Release, *supra* note 8, at *9.

dard of Section 10(a) of the Securities Act in that it contained all information "'necessary or appropriate in the public interest or for the protection of investors.'"[10]

III. THE PROFILE FAILS TO PROTECT INVESTORS

Whatever the merits of the SEC's claim that the prospectus, without the SAI, meets the disclosure requirements for a Section 10(a) prospectus under the Securities Act, it is clear the Profile does not. The SEC resisted industry demands to allow the prospectus to be incorporated by reference in the Profile, arguing that to do so would be inconsistent with the idea that the Profile is a self-contained document on the basis of which an investor could decide to invest.[11]

To allow the Profile to be used as the Commission intends, a finding had to be made under Section 10(b) of the Securities Act that the use of the Profile as a "summary prospectus" was "necessary or appropriate in the public interest or for the protection of investors."[12] Given the likely effect of the Profile to reduce sharply the numbers of investors who will read the prospectus, and the fact that the Profile admittedly omits information essential to informed investor choice, it is difficult to understand how the SEC could find the Profile either "'necessary or appropriate . . . for the protection of investors.'"[13] Indeed, a well developed argument might be advanced that Rule 498 is sufficiently "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law" as to be beyond the SEC's discretionary powers to adopt.[14]

The SEC points to its experience with the SAI as support for peeling away from the Profile essential information contained in the prospectus. However, this experience is inapposite because, in the case of the prospectus, the SEC made a finding that, standing alone, it met the disclosure require-

[10] SAI Adopting Release, *supra* note 8, at *5.

[11] Profile Release, *supra* note 4, at *6 (footnote omitted).

[12] Securities Act of 1933, § 10(b), 15 U.S.C. § 77b(a)(10) (1997).

[13] The Commission's stated explanation appears in the Profile Release, *supra* note 4, at *4 (footnote omitted).

[14] 5 U.S.C. § 706(2)(A) (1998); *see, e.g.*, Checkosky v. SEC, 139 F.3d 221 (D.C. Cir. 1998); Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

ments of a Section 10(a) prospectus after the SAI information had been removed. No such finding has been made in the case of the Profile, nor could it.

IV. SOME OF THE MATERIAL FACTS OMITTED FROM THE PROFILE

Unlike the prospectus, which may contain information not specifically required by Form N-1A,[15] the Profile may contain only the items specified or expressly permitted by Rule 498.[16] Thus, the Profile may not contain a listing of the fund's top ten portfolio holdings, a very important disclosure item only available to an investor who is considering a fund if she knows enough to ask for an annual or semi-annual report to shareholders, where such information can be found, or is a subscriber to Morningstar. There is no need in the Profile to indicate the size of companies (large cap or small), or whether they express a value or growth style, or whether they number in the hundreds or fewer than 30. Further, there may not be an investment style box, also found in Morningstar, which gives the investor an easy-to-understand grasp of the riskiness of the fund and the relative size of the stocks being used. Nor may there be included such modern portfolio theory measures of risk as Alpha, Beta, the Sharp Ratio, R-Squared or Standard Deviation, each of which is found in Morningstar.

The only risk-related disclosure actually specified in Profile instructions is to the effect that "loss of money is a risk of investing in the fund."[17] As Roger Lowenstein wrote in the Wall Street Journal, "a more serious problem relates to the narrative discussion of risk—supposedly the heart of the new Profiles . . . samples offered by fund companies are generalized to the point of irrelevancy."[18]

Financial highlights may not be included nor may a discussion of the market conditions and investment strategies that significantly affected the fund's performance in the past

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[15] Form N-1A, General Instructions, C(3)(b).

[16] Securities Act of 1933, Rule 498(b), 17 C.F.R. § 230.498(b) (1998).

[17] Form N-1A, Pt. A, Item 2(c)(1)(i).

[18] Roger Lowenstein, *Intrinsic Value: Time for Straight Talk from Mutual Funds*, WALL ST. J., Jan. 9, 1997, at C1.

year. Turnover may not be included. Return adjusted for risk and adjusted for taxes may not be included nor may the imbedded capital appreciation of a fund be shown. Although the fund's performance must be compared to a "broad-based securities market index,"[19] its portfolio may not be broken down by industry sectors and compared with the sector weightings in that index. Moreover, the fund's performance may not be compared to the performance of other funds, an item of information at least as important as the comparison to an index, and included in Morningstar.

If three or more individuals are responsible for day-to-day portfolio management, none need be identified by name and through length of service with the past performance achieved by the fund. Of course, it is crucial to informed investor choice to be able to identify as best one can what individual or group of individuals "owns" a fund's past performance. The way Rule 498 appears to be written, if one person had been chiefly responsible for, say, a brilliant ten year record and had died, the fund could avoid disclosure of this crucial fact by making three or more managers jointly responsible for the fund's portfolio.[20]

Such useful financial data as the portfolio's average P/E ratio, P/B ratio, five-year earnings growth, return on assets and debt to capital ratio, compared to the measuring market index averages, may not be included.

Permitted as an option, but not required, is disclosure about the types of investors for whom the fund is intended and the types of investment goals that may be consistent with an investment in the fund.[21] How a particular fund might fit into an investor's overall financial plan and portfolio is one of the most important factors to consider in making choices among funds. Not only should this disclosure item be required, but an effort should be made in Profile instructions to assure a thorough texturing of the response keyed to the particular investment style and goals of the fund. Here a big opportunity for investor education and sound counseling is being missed.

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[19] Form N-1A, Pt. A, Item 2(c)(2)(iii)(2).

[20] Securities Act of 1933, Rule 498(c)(2)(v)(C), 17 C.F.R. § 230.498(c)(2)(v)(C) (1998).

[21] Securities Act of 1933, Rule 498(c)(2)(iii), 17 C.F.R. § 230.498(c)(2)(iii) (incorporating Item 2(c)(1)(i) of Form N-1A). Such disclosure is also optional in the prospectus. *See* Form N-1A, Pt. A, Item 2(c)(1)(c).

In addition to the above, there may not be disclosure as to the manager's investment stake in the fund, an item at least as important as the ownership by business directors of the stock of the companies on whose boards they sit.

The Profile may only contain a summary of the fund's principal investment strategies and principal risks. This leaves out non-principal, yet highly material, strategies and risks, which in each case could be important to both investor choice and investment return.

In considering the omissions of material fact that result from using the Profile, one should bear in mind the level of disclosure demanded of investment managers by institutional investors. Since the original idea behind the securities laws was for a governmental agency to mandate disclosure of all material facts for the benefit of those unable to demand such disclosure for themselves, one useful benchmark for measuring how well the agency is performing this task would be to examine the items of disclosure used by institutional investors in picking investment managers. This process at the institutional level is directly analogous to a retail investor's search for the appropriate mutual fund or funds.

The use of manager questionnaires by institutions has become commonplace. Aided sometimes by selection managers, the questionnaires in use today are very similar to one another and call for a large amount of information considered relevant to manager choice. Without itemizing all the data typically adduced in this process, it is safe to say that only a tiny fraction of it would appear in the Profile. Among the important items covered by a typical questionnaire, for example, are firm changes over the past five years, ownership structure, litigation, third party arrangements for marketing, professional turnover over the past five years, incentive compensation arrangements for employees, clients gained and lost over the past three years, investment style and impact of size on style effectiveness, nature of investment decision-making process, buy and sell discipline, risk control techniques, portfolio characteristics, trading process and costs, performance details over the past ten years (*e.g.*, for equity only and equity plus cash) and key personnel data (background, years with firm, portfolios managed, other responsibilities).

These questionnaires make the investment manager the principal focus of inquiry. The Profile does not follow suit, nor does the prospectus, SAI or annual reports, in itself a failing of the SEC's mandatory disclosure system, which focuses principally on the mutual fund rather than the investment adviser controlling its operations. The point here is not to urge the SEC to mandate a disclosure document equivalent to the standard questionnaire used by institutions. The questionnaires should, however, be used by the SEC to obtain a valuable list of items generally considered material to the most sophisticated investors in the land. From such a list, the SEC might develop a list of its own, tailored to meet the needs of retail investors.

The information contained in the Profile is so far removed from the information covered in these questionnaires that one is tempted to conclude the connection between the two has yet to be treated with importance by the SEC.

V. THE PROFILE RAISES QUESTIONS OF LIABILITY

It has occurred to many that use of the Profile may expose a fund to liability for material misstatements or omissions under Section 12(a)(2) of the Securities Act.[22] This paper will not study that question except to note that the Profile Release seems correct in stating that potential liability would arise if a Profile contained a material misstatement or omitted a statement necessary to make the disclosure in the Profile not materially misleading.[23] The question remains whether a document encouraged by the SEC to provide the basis for an investment decision that omits information deemed by the SEC to be "essential" to informed investor choice renders the information included in that document materially misleading. There is at least a plausible case for this result. Moreover, the SEC's reliance on the advertisement rule (Rule 434d) to suggest that liability would not be found in regard to the Profile is misplaced. Investors are not permitted to rely on an advertisement to pur-

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[22] *See, e.g.*, STUART M. STRAUSS & JON D. KAPLON, NEW DISCLOSURE RULES AND OPTIONS FOR MUTUAL FUNDS: DO THEY OPEN THE DOOR TO LITIGATION AND LIABILITY? 273 (PLI Corporate Law & Practice Course Handbook Series No. B0-002C, 1998).

[23] Profile Release, *supra* note 4, at *6.

chase.[24] In the case of the Profile, the SEC allows, indeed, encourages, reliance solely on the Profile. This being so, it is puzzling to find the SEC inviting comparison between the Profile and Rule 434d advertisements.[25]

VI. THE PROFILE AS INVITATION TO WAIVER

In a sense what the SEC has done in allowing investors to choose the kind of disclosure they want is to effect for them a waiver of the protection intended for investors under the Securities Act. Section 14 of the Securities Act flatly prohibits a waiver of rights by investors. In approving the Profile, the SEC is blessing a *de facto* waiver by an investor of its statutory right to consider an offer of fund shares only through a prospectus. The Profile turns mandatory disclosure on its head. Those investors least sophisticated are the ones who most need the protection of the law's mandate for full disclosure. Yet, it is those same investors—referred to in the N-1A release as "average or typical"—who are most likely to rely solely on the Profile, being too uninformed to know that material information about the fund has been deleted from the Profile and is sprinkled through at least three other documents available only upon request.

VII. WHAT IS THE GOAL OF A MANDATORY DISCLOSURE SYSTEM?

In defending its action against critics of the Profile, who pressed the SEC to work on improving the prospectus rather than promoting an abbreviated disclosure document that, standing alone, would inadequately inform investors, the SEC declared the critics' viewpoint "inconsistent with the sentiments of fund investors."[26] One need not challenge the SEC's

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[24] STRAUSS & KAPLON, *supra* note 22, at 301.

[25] Don Phillips, head of Morningstar, the mutual fund information provider, compared the Profile to a sales document. *See* Don Phillips, *Open Letter to the SEC* (May 2, 1997) <http://www.morningstar.net/cgi-bin/GetNews.exe?NewsStory=MS/OpEd/LetterToSEC1/lettertosec.1.html>.

[26] Profile Release, *supra* note 4, at *4.

reading of the focus group polls to argue against the use of so ethereal a premise as "investor sentiment" to ground the elements of disclosure in a mandatory system.

What, then, is the standard for mandatory disclosure under the Securities Act?

This Author has always believed that a prospectus for the sale of securities should, as a bedrock minimum, contain enough information to enable a reasonable investor, who may be equated with a fiduciary acting with legally sufficient care, to determine whether or not to invest. This standard should not be understood to mean that there could be no additional information outside the prospectus that in the exercise of reasonableness, an investor would wish to have. It is simply to say that the prospectus should seek to provide the minimum necessary to enable a reasonable investor to make an investment choice. Short of that level of disclosure, it is difficult to see why Congress would have bothered to mandate disclosure at all.[27]

Outside the mutual fund arena, this standard has certainly been met. The idea of including all material information permeates the Securities Act, the cases that have interpreted it and the disclosure forms developed by the Division of Corporation Finance. In fact, Rule 408 goes beyond the specific items of disclosure elicited by the forms to require disclosure of "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." Given the dramatic trend among investors to prefer mutual funds to direct investment in the markets, it is all the more remarkable to find the SEC encouraging a large reduction in the quality and quantity of information required to be furnished to fund investors—a reduction from a level of disclosure already significantly below that required for other kinds of business entities.

The reasonable investor standard for disclosure follows from the case law determining when a misrepresentation or omission in the prospectus is material and, accordingly, gives

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[27] In *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953), the Supreme Court said that the federal securities laws exist "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."

rise to liability. As the Supreme Court ruled in *Basic, Inc. v. Levison*, an omission will be judged material only if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available."[28] This "reasonable" investor can properly be equated with a fiduciary who invests through the exercise of due care; that is, a reasonable investor is a fiduciary acting non-negligently, or, in other words, "reasonably," under the circumstances.

This standard for disclosure is also supported by the fiduciary duty imposed by the Securities Act on directors and officers to use care in assuring that the prospectus contains no material misrepresentations or omissions.[29]

The large reduction in scope and quality of information in the Profile below that provided to investors in other kinds of business entities cannot be explained by a claim that mutual funds are easy to understand. The SEC has long been of the opinion that the ability of investors to evaluate the risks of investing in managed pools requires a higher degree of sophistication than is required to evaluate the risks of investing in ordinary business entities.[30] It was for this reason that the "qualified purchaser" exception in Section 3(c)(7) of the Investment Company Act of 1940, added by the Securities Markets Improvement Act of 1996, rejected the accredited investor standard for unregistered offerings under the Securities Act in favor of a much higher standard of presumed sophistication, requiring of a natural person at least $5 million in investments.

Regardless of the correctness of the SEC's view on the relative levels of sophistication required for these different kinds of investments, it is all the more surprising to find the SEC embracing the Profile's reductionist approach to disclosure in light of its strongly held view on the matter and its success in selling that view to Congress.

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[28] 485 U.S. 224, 231-32 (1988) (citation omitted).

[29] Securities Act of 1933, § 11(c), 15 U.S.C. § 77(k) (1997).

[30] DIV. OF INV. MANAGEMENT, SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 113 (May 1992). The authors of this Report provide no basis for this conclusion.

VIII. THE DESIGNER APPROACH TO DISCLOSURE

In its profile and N-1A releases, the SEC announces a new standard of disclosure. Nowhere does the goal of putting in the hands of investors all information material to investor choice appear. To the contrary, as the Profile Release states, "[t]he Commission's strongly held belief is that the principal goal of fund disclosure . . . should be to provide investors with useful and relevant information."[31] The priority for funds is to "*design* disclosure documents . . . first and foremost, to communicate information to investors effectively."[32] In the case of the Profile, this meant short, summary disclosure of only the information specified by the nine items in Rule 498. As to other material information in the prospectus, SAI or report to shareholders, the SEC declared that "an investor who believes that he or she needs more information before making [a purchase] decision has the option of obtaining additional information by requesting the fund's prospectus or other disclosure materials."[33] Translated, these statements imply that the SEC considers even average fund investors capable of "fending for themselves," a standard heretofore reserved for institutional and other sophisticated investors who did not need the protections of the Securities Act.

The SEC has defended the Profile's approach to disclosure by observing that most retail investors do not read the prospectus or SAI, due to their length, complexity and lack of information useful in the selection of mutual funds. Investors rely instead on magazines, mutual fund reviews, employer screens and word of mouth.

The solution to a form of prospectus that no one reads is not a slimmed down document omitting material information. If we are going to have a mandatory system to afford protection to investors, recognizing we can only expect to make protection available, not guarantee its use, then the answer to non-use cannot be to lower the level of protection afforded. It must be, instead, to afford the necessary protection (all material information) in a form that is as comprehensible to the aver-

[31] Profile Release, *supra* note 4, at *5.
[32] Form N-1A Release, *supra* note 3, at *5 (emphasis added).
[33] Profile Release, *supra* note 4, at *9 (footnote omitted).

age investor as humanly possible. Vanguard's materials and those of the College Retirement Equities Fund[34] are striving to meet this challenge. Surely it can be done, and may be done, in time without SEC help. How much faster and more certain of result would the evolution be, however, were the SEC to provide leadership.

As to reliance on third party materials, they are not subject to the principles of complete disclosure that underlie an SEC-mandated system. Indeed, were one to conclude that reliance on such materials was sufficient, it would seriously undermine any logical basis for imposing mandatory disclosure.

The SEC's instincts for greater, rather than less, disclosure, deeply ingrained from more than six decades of service to investors, are bound to continue but with difficulty because of the Profile initiative. A current example will illustrate this point. The SEC will soon release a report on the use of "soft dollars" by fund managers in effecting transactions through broker-dealers. At a minimum, the SEC is likely to demand greater disclosure to fund shareholders of "soft dollar" practices, how those practices impact fund expenses and performance, what effect they have on the duty to obtain "best execution" and other related matters. However, where can this disclosure be placed so that investors are informed? Certainly not in the Profile. Indeed, given the plain English directive, on the one hand, and the hideously complex and ambiguous nature of the practices represented by the innocuous and opaque terms "soft dollars" and "best execution," on the other hand, it is difficult to see how useful disclosure could appear in any of the other documents required to be made available to investors.

IX. EMH Inapplicable to Mutual Funds

Another important aspect to disclosure in the case of mutual funds deserves mention. The efficient market hypothesis ("EMH"), which claims that stock prices in an active marketplace will reflect all publicly available information, supports the idea that an investor need not know the contents of an issuer's disclosure documents to get a fair price. The market

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[34] In the interest of full disclosure, the Author is a member of the Board of Trustees of College Retirement Equities Fund and of its mutual funds.

sets a fair price regardless. By relying on this hypothesis, the SEC was able to justify allowing a seasoned issuer to incorporate by reference in its prospectus the extensive information on file with the SEC in its annual report on Form 10-K.[35]

EMH has no application to mutual funds because there is no active trading market for mutual fund shares, which are always redeemable by the fund at net asset value. Thus, no pricing mechanism can be claimed the vicarious champion of an investor who is not furnished all material information about a fund. This fact makes the argument for full disclosure to mutual fund investors significantly more powerful than in the case of other kinds of equity products. When Michael Price announced his retirement as chief investment strategist for the Mutual Series of mutual funds, the net asset value of those funds changed not a bit as a result. Yet, for a fund investor, Price's decision was supremely important. Almost none of the highly material facts about a mutual fund (and, most importantly, its investment adviser) will affect net asset value, or, as a result, the price at which investors can access or exit the fund.

X. THE PROFILE IS A MISTAKE WITH POTENTIALLY LARGE CONSEQUENCES

It was a very serious mistake for the SEC to accede to the view that investing is such a simple process that one can do it knowing just the information responding to those nine items in the Profile. When a sharp market adjustment occurs, or a prolonged decline, it will be the SEC to whom questions from investors, the press and the Congress will be addressed, not the Investment Company Institute, the mutual fund trade association that lobbied hard and successfully for the Profile. Moreover, regardless of correlations between investor loss and the Profile's dumbing-down simplicity, the SEC will be blamed for failing adequately to warn investors that picking funds carefully is important and requires digesting a lot of information beyond what is available in the Profile.

[35] *See* SECURITY ACT RULES 6331, 23 SEC Docket 288, 290-291 (1981); SECURITY ACT RULES 6383, 24 SEC Docket 1262, 1267 (1982).

The stakes here are large. Since 1933, U.S. securities regulation has succeeded brilliantly in large measure because it was rooted in mandatory disclosure, enforced by an agency renowned for its independence and vigor. More than any other administrative agency, the SEC was successful in resisting capture by either politicians or the industries it regulated. This relatively non-intrusive form of regulation, from which the nation has benefitted so much, including, especially, the mutual fund industry, will be at profound risk should the markets cause widespread losses to individuals whose rising expectations have been abetted, not corrected, by SEC endorsement of the Profile.

The severity of risk results from two additional features of today's marketplace. First, since adoption of the Profile, the shape of our stock market grew daily more bubble-like. Despite the third quarter decline in 1998, the bubble has grown apace to unprecedented levels.[36] If, when, and how large a market correction there will be is anyone's guess. Clearly, it could be very large. Second, individuals are increasingly being put in charge of investing for their retirement through defined contribution plans such as 401(k)s. If the market regresses to the mean, as it did in the mid-70s, the pain will be felt by a very broad segment of society. Congress, feeling that pain vicariously, will look for scapegoats. The Profile will point the way to the SEC and the disclosure-based system of regulation it diluted. The result could be far more intrusive regulation, mandated by a Congress under pressure to "do something." Embattled and defensive, the SEC would lack the influence to block such a move.

XI. IS THERE AN ALTERNATIVE?

There is an alternative to dumbing-down disclosure in response to investor dissatisfaction with the turgidity of documents currently in use. The success of Morningstar is convincing proof that investor demand exists for material information that is unavailable through SEC-mandated disclosure. Moreover, the ICI's research report, "Understanding Shareholders'

[36] *See, e.g.*, MORGAN STANLEY DEAN WITTER, INVESTMENT PERSPECTIVES 1-2 (Feb. 16, 1999) (comment of Barton M. Biggs).

Use of Information and Advisers," contains the finding that 72 percent of those surveyed expressed an interest in learning more about mutual funds. Rather than experiment with a vastly less useful document to sell mutual fund shares, one that, standing alone, will impair the SEC's reputation as protector of investor interests, the SEC should encourage industry leaders to compete in the development of selling documents that would provide all reasonably material information in language comprehensible to the non-professional investor. The SEC would have to loosen up the requirements of the prospectus and SAI enough to make such an experiment possible. Given the high quality of this industry's leadership, and its long record of effectiveness in pursuing its self-interest, this Author is confident such an experiment would quickly lead to the establishment of "guild standards" far superior in their capacity to inform than almost anything currently in use.