
MUTUAL FUND POINT OF SALE DISCLOSURE
INVESTOR RESEARCH FINDINGS

PREPARED FOR

NASD

BY

APPLIED RESEARCH & CONSULTING LLC

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BACKGROUND & OBJECTIVES

In 2004, the SEC retained Siegel & Gale and Gelb Consulting Group to design and test forms for broker/dealers' disclosure of mutual fund sales fees to investors. The design process was conducted iteratively, with changes made to the forms after each round of research.

NASD engaged the services of Applied Research & Consulting (ARC) to conduct a further round of research to:

- Evaluate the usability of an alternative form designed by NASD;
- Understand how the effectiveness of NASD's alternative form compares to the effectiveness of the SEC's proposed form; and,
- Gather in-depth investor feed-back on a few specific design components of NASD's form.

METHODOLOGY

In order to achieve the research objectives, ARC conducted in-depth, in-person interviews with individual investors in White Plains, NY; Alexandria, VA; and Bethesda, MD. Respondents were screened to ensure eligibility on several criteria, including:

- Having sole or shared responsibility for making decisions regarding purchases of investments;
- Having recently purchased at least one of the following categories of investment through a broker:
 - o “loaded” mutual funds,
 - o variable annuities, or
 - o 529 plans where the underlying investment are mutual funds;
- Having total investments of at least \$2,000 and less than \$500,000; and,
- Being a high school or college graduate (excluding persons with graduate degrees).

In all three research locations, the NASD document was presented on a laptop computer as a PDF file with active online links to the underlying prospectus. The SEC forms were presented in hard-copy paper format.

All interviews began with a brief discussion of the respondents’ general approach to investing (including the type of investments they make and the ways in which they use brokers) to provide a context for their responses to the document. Following the introductory section, respondents were asked to evaluate the relevance and utility of the NASD prototypes and in Alexandria and Bethesda to compare them to the most recent version of the SEC form, as noted in the table below. Respondents were not told that one form was designed by NASD and the other by the SEC.

White Plains February 22, 2005 7 interviews	Alexandria, VA February 24, 2005 5 interviews	Bethesda, MD March 16, 2005 8 interviews
NASD Disclosure Form	NASD Disclosure Form	Revised NASD Disclosure Form
	SEC Disclosure Form (v3 pos class A, 11.10.04 from Gelb/Siegel & Gale research)	Revised SEC Disclosure Form (as of 3.16.05)

RESEARCH FINDINGS – DAYS 1 AND 2 (WHITE PLAINS, NY AND ALEXANDRIA, VA)

Overall, the research yielded consistent results: respondents welcomed the information provided on the NASD Disclosure Form and generally reported that the two-page document is easy-to-understand, relevant, and informative. The document achieved its purpose of informing individual investors about the various sales charges and other fees, as well as brokers' potential conflicts of interest.

However, while respondents reported that they understood the main points of the document, they evidenced confusion in two areas:

- 1) On page two, some of the language and the order in which information was presented decreased the clarity of the message.
- 2) Respondents' understanding of the material occasionally decreased when they "clicked through" to the fund prospectus.

Other key findings include the following:

- Most of the respondents indicated that they preferred to receive the information online, instead of by mail or having their broker read the information over the phone.
- All respondents appreciated the information that was provided on page one regarding the fund's investment approach, risks, yearly performance and average performance.
- While respondents indicated that they are unlikely to read all the "fine print" included in the underlying fund prospectus, they valued having the ability to "click here for more information" without requesting a mailed prospectus or having to go to an online version of a prospectus.
- Following are the specific research findings about the document, organized by the same evaluative criteria used in the Gelb/Siegel & Gale report for the SEC:
 - o Utility
 - o Navigational Ease
 - o Relevance
 - o Clarity, and

o Educational Value

Utility

The document created by NASD is organized into two pages. The first page provides “big picture” information to the investor about the fund’s investment approach, principal risks, and performance history.

- Investment Objective
- How We Invest
- Risks to You
- Year-by-Year Performance
- Average Performance

The second page details the fees, other charges and potential conflicts of interest a broker may have when recommending/selling the fund (i.e., revenue-sharing issues).

- Fees and Expenses
 - o Sales Charges – Paid Directly By You
 - o Annual Fund Expenses – Deducted from Fund Assets
 - o Portfolio Turnover
- Potential Conflicts of Interest
 - o Does the Fund or its affiliates pay us extra to promote this fund over other Funds?
 - o Do we pay our personnel more for selling this Fund than for selling other funds we offer?

Findings:

Page One: The information provided on page one was familiar to respondents, and they all indicated that this is the kind of information that they would expect to receive from their broker when considering an investment in a mutual fund. They liked having this information summarized for them and did not indicate any impatience or boredom in receiving the basic fund specifications, even if they were to receive similar information from other sources. On the contrary, several respondents indicated that they want even more in-depth data: specifically, a percentage breakdown of the kinds of industries that the fund invests in, with representative companies listed.

“This is good. It’s common knowledge (i.e., volatility), but it’s scary to see it.” – White Plains

“I think the risk factors are explained well.” – Alexandria

“I think they need to tell you that there is a risk. No surprises there. I would expect this information.” – White Plains

“I wish there was more information about what’s in the fund.” – Alexandria

Page Two: Respondents reported that the information on page two was not information that they typically receive before making an investment. While some respondents asserted that such fees and financial incentives are to be expected and would not change how they work with their broker, others indicated that the disclosure would prompt them to inquire more closely why their broker was recommending this particular fund over another.

“That’s interesting. That seems like a lot of money. . . It’s direct, it’s clear. I’ve never seen the conflicts of interest spelled out before, but I suspected that they were there.” – Alexandria

“It breaks it down into layman’s terms. Normally it’s not like this. You never see numbers like this – I’ve never seen a dollar fee before.” – White Plains

Navigational Ease

Respondents viewed the document as a PDF file on a laptop computer. Links to the additional information were “live” and brought the respondents to a website.

Each of the two pages was organized in vertical columns with horizontal heading breaks.

Findings:

Computer Literacy: All the respondents reported considerable experience with reviewing investment information online and demonstrated ease and comfort navigating through a computer-based document. In addition, no one demonstrated any problems with accessing more information by means of the “click-through” prompts.

“It is much easier to navigate online than to sit down and read. If I need to I can print it, but a big package mailed to me with all that stuff is too much.” – White Plains

Delivery Mode: When asked what method of delivery they preferred, the majority indicated a strong preference for online delivery. A small number of respondents were less firm in their preference, stating that either online or mail would be fine. No one indicated a preference for disclosure by phone.

“The less paper I get the better. I think e-mail is the way to go.” – Alexandria

“It’s better to read it for yourself, and online is much better. Waiting for mail is archaic.” – White Plains

“The more I think about it, the more I’d like to have it online. I’d like to receive an e-mail and then go to the website. Then I can look at the stuff I want to see.” – Alexandria

Layout: While most respondents reported no difficulties with the document set-up and layout, two respondents indicated that they prefer a horizontal orientation to a vertical one. One of those respondents also indicated a preference that the information be presented as hyperlink headlines (like the online *Wall Street Journal*), so that he can quickly assess all the topics and then click only on the ones that interest him.

“This is easy to focus on section-by-section. I like that.” – White Plains

“I don’t see why there are two columns like this with a tall section on one side (i.e., Fees and Expenses) and short on the other (i.e., Potential Conflicts of Interest). I’m more into balance.” – White Plains

Relevance

Respondents demonstrated a very high degree of enthusiasm for the content of the NASD Disclosure Form. They asserted that if they were asked by their broker to read this document, they would do so, and that the information provided would be valuable in helping make investment decisions.

“If someone I trusted sent it and said I should read it, I would.” – Alexandria

“All of this is basic, but you need to read it. . . But I still need to talk to someone – I would call [my broker] and ask what’s going on.” – White Plains

“I’ve never seen an upfront acknowledgement of getting paid more for promoting certain funds.” – Alexandria

“From what I’m hearing I’m constantly giving somebody money. . . I’m complaining, but it’s good for me to understand. For the most part, you’re telling me what I need to hear.” – White Plains

However, not surprisingly, respondents generally demonstrated a great deal of trust toward their brokers – such trust being part of a successful, ongoing relationship. Respondents reported that the disclosure information might lead them to ask additional questions of their brokers about the merit of the fund, but implied that – given the underlying trust of the relationship – it probably would not lead to a strong movement away from their brokers’ initial recommendations.

“The bottom line is that it’s not enough of an incentive for the broker to push it. I would have a problem if they’re pushing crap, but if [two funds are equivalent], I’m comfortable with what my broker recommends. He was referred by my father.” – White Plains

“As long as it doesn’t cost me more, that’s o.k. But it would make me wonder – is the fund not doing well if they’re trying to get the broker to push it more?” – White Plains

Clarity

All the respondents reported that the information provided on the two-page disclosure document was clear and understandable. However, when asked to explain to the interviewer what each section meant, respondents often “read back” incorrect information. The mis-readings seemed to stem from a combination of unclear language (e.g., the use of indefinite pronouns), a misleading hierarchy of information, and individual respondents’ inability to understand the meaning of the text.

Furthermore, as indicated above, clicking for more information sometimes actually increased misunderstanding. Because the NASD is not currently engaged in changing formats or specifications for investment prospectuses, ARC will only focus on text that the NASD can immediately make improvements upon (i.e., the two-page disclosure document and the “Message from XYX Broker”).

Findings

Sales Charges – Paid Directly By You: Although there is a general understanding among respondents that brokers receive compensation for executing a mutual fund sale, respondents report that the exact amount of that fee is rarely – if ever – explicitly disclosed. Respondents liked to see the actual fee in dollars for each \$1,000 investment and reported that they clearly understood what the fee represented. One respondent, however, misunderstood the term “Sales Charge” to mean a fee he would pay when he sells the fund. Others demonstrated a lack of understanding that the fee is a one-time charge.

- Therefore, ARC recommends that the section be re-titled “One-Time Sales Charges – Paid Directly By You.”

In addition, the sentence immediately preceding the section referring to break-point fee reductions caused respondents to be distracted from the key point about the sales charge.

- ARC recommends that the sentence be moved after the Sales Charges disclosure and that it be re-written as follows for greater clarity:

“If you and your family invest at least ~~\$25,000~~ \$50,000 (NB: the dollar amount should match chart in the click-through) in the John Doe Family of Funds, then you may be eligible for a fee reduction in this charge.”

“I want to know what a fee reduction is . . . [After click-through]. It’s not what I expected. . . I’m a little confused with this page. As a Class A shareholder, I might be eligible for a fee reduction, but I clicked on it and didn’t see anything.” – White Plains

When they compared the NASD document to the SEC document, respondents indicated that they liked the SEC chart that presented three examples under the following column headings: “Contribution amount,” “Up front fee you pay,” “Your net investment value,” “Up front fee %.” Respondents were attracted by the easy interactivity of the bold fill-in boxes – and they assumed that if the document were online, the fees they would actually pay would be automatically calculated.

- ARC recommends at least providing additional examples of fees in a chart form, as well as an auto-calculation function, if feasible.

“Do I have to pay 25 times \$57.50 if I were investing \$25,000?” – White Plains

Only one respondent in Alexandria explicitly noted that he/she valued the fee comparative scale provided on the SEC document. This seemed to be a feature that was less necessary than others, but because of the small number of interviews, the findings on this feature are inconclusive.

Annual Fund Expenses:

While respondents claimed to understand this section, not all of them actually grasped that the fees are charged annually.

- Therefore, ARC recommends altering the heading to “Annual Fund Expenses – Deducted from Fund Assets Each Year.”
- ARC also suggests that the parenthetical phrase “(per \$1,000 investment ~~over 12 months~~)” be edited as indicated and, for consistency, suggests it be moved below the phrase “Total Fund Operating Expenses.”
- To help respondents fully understand that they themselves will be paying these operating costs, it is recommended that “Total Fund Operating Expenses” be changed to “Estimated Annual Fee You Pay.”
- As with the “Sales Charges” section, respondents appreciated the SEC version, which featured a small chart of examples, as well as fill-in boxes that automatically calculate the annual fees they would pay.

Respondents did not find the detailed breakdown of Annual Fund Expenses (available by “clicking” for more information) either clear or useful. Several respondents observed that only the total amount was relevant to them as individual investors. Furthermore, respondents found the breakdown categories to be vague.

“It adds up to 1.38%. I already knew that from before. Why should I care about this? It won’t affect how much I’m paying.” – Alexandria

“What is this ‘other expenses?’ That doesn’t tell me anything.” – White Plains

Portfolio Turnover:

This section seemed to be the source of the most confusion. Many respondents did not fully understand the implications of portfolio transaction costs. And a few even thought that the turnover percentage of 47% indicated the return on investment.

“Turnover of 47% – I could use more of an example.” – White Plains

“47%. That’s high. That’s good. Remember, they lost money in 2002.” – White Plains

“47%. That sounds like profit to me.” – White Plains

However, research indicated that the wording was clear for most respondents and need not be changed.

Potential Conflicts of Interest:

Most respondents volunteered that they liked the question-answer format of the Conflicts of Interest Section. A majority of the respondents understood that this section revealed that their broker might not be working in the investor’s best interest by recommending this fund over funds with similar investment objectives and performance.

“It’s telling you that they get more if they end up selling the fund, which I look at somewhat negatively, because it’s not in my best interest.” – Alexandria

“To think that there’s a conflict of interest is interesting. It’s good that you’re being told up front – it’s not so sleazy.” – White Plains

“That’s interesting information – not information I’d expect to see. I can see why the SEC would want us to know that.” – White Plains

“As long as they pay, I don’t care.” – White Plains

The greatest misunderstanding in this section stemmed from the use of indefinite pronouns instead of proper nouns. The two main bullet points would be easier for respondents to understand if they were edited as follows:

- Does the John Doe Small Cap Fund or its affiliates pay ~~us~~ XYZ Brokerage Firm extra to promote ~~this~~ the John Doe Small Cap Fund over other funds?
Yes
- ~~Do we pay our~~ Does XYZ Brokerage Firm pay its own personnel more for selling this Fund than for selling other funds ~~we~~ XYZ Brokerage Firm offers? **Yes**

In addition, the first sentence in the section (“Of the \$57.50 in sales charges, XYZ Broker receives \$50.”) misdirects investors from the main point of the Conflicts of Interest section: namely that the brokerage firm receives additional payments from the Fund, over and above the sales charges paid by the investor.

- ARC strongly recommends that this sentence be moved to the Sales Charges section: 1) to prevent a misunderstanding that the investor is paying for revenue sharing and 2) to focus investors on the potential conflict of interest, itself.

A Message From XYZ Broker: One of the biggest differences between the SEC form and the NASD form is the NASD’s “Message From the Broker” document. Investors expressed great appreciation for the additional information provided in this “click-through” document. However, respondents also demonstrated a wide range of interpretations of the document. In some cases, the language served to obfuscate – rather than clarify – the payments made by the Fund family to the Brokerage Firm and the incentives paid by the Brokerage Firm to its own registered sales reps. The greatest misunderstanding seemed to stem from the chart of fees: the headings were confusing to respondents and some respondents did not understand the rankings provided in parentheses.

“It’s their ranking according to the best. . . Because it’s so popular, they [the broker] are getting more money.” – White Plains

“They’re comparing their fees to others?. . . This is confusing to me. . . And I don’t know what this 5, 3, 2 means.” – White Plains

- It is also recommended that the table heading “Annual Asset Fees” be re-titled “Fees Paid Annually By John Doe Small Cap Fund to XYZ Brokerage Firm” and “Sales Fees” be retitled “One-Time Fees Paid by John Doe Small Cap Fund to XYZ Brokerage Firm.” In addition, ARC suggests that the columns be switched to reflect the progression of fee payments.

Educational Value

Most respondents were demonstrably surprised to learn the specifics of the purchase fees and on-going charges they pay when purchasing a mutual fund through a broker. Their comments often focused on their perceptions that the fees seem high, and that this is information that is important for them to know.

“On top of sales charges, the fund has an operating expense. I think it’s pretty high. It’s good to know this information up front.” – White Plains

“It’s good. I like that it tells what the fund invests in, the risk, and the performance. How much it would cost per year. Right now, with my broker, I don’t really see that too often – it’s been kind of nebulous. It’s good to know that up front.” – Alexandria

Overall, the five respondents in Alexandria preferred the NASD Disclosure Form to the SEC form for two main reasons:

- 1) the ease of reading and working with an online document, including the convenience of the “click-through” options, and
- 2) the inclusion of investment objectives, approach, risks and performance on page one.

The greatest relative advantage of the SEC version over the NASD alternative seemed to be the examples of the fees for varying investment amounts and bold fill-in boxes.

“There’s more information on the NASD version, because of page one. Often prospectuses leave you wondering what you’re looking at. The NASD version gives me enough to make a decision – the SEC form would require me to look for more [information]. I’d go with the NASD, except possibly for the fees broken out by dollar amounts.” – Alexandria

RESEARCH FINDINGS – DAY 3 (BETHESDA, MD)

The reactions from respondents were consistent with those of the first two days of research. In this final day of research, investors responded favorably to “Page One” of the NASD prototype and typically preferred the SEC’s format to the NASD’s “Page Two.” As before, most respondents indicated a preference for electronic delivery, citing the benefits of instant access, ease of comparing the information to other investment options, and reduced paper clutter.

Page One

Respondents indicated that they value the first page of the NASD form, and they noted its absence from the SEC version. One respondent pointed out that the “Page One” material addresses the aspects of mutual funds that are of greatest interest to investors, suggesting that the inclusion of that information will increase the likelihood of the document being read. Some respondents stated that the performance information provides an essential context for evaluating the fees and other disclosed data. Everyone agreed that the “Risks to You” column was relevant, clear and helpful.

“This was informative. I think it’s really smart. I think it’s good that it’s the first page. Immediately you’re grounded.” – Bethesda

“[The SEC form] is missing a couple of key features. I would add the performance and risk information [to the SEC form], and the other basic information about the kind of fund.” – Bethesda

“There isn’t any fund performance stuff [on the SEC form]. That’s the only advantage [of the NASD form] that I see.” – Bethesda

“It’s well-written, brief and to the point. The first word I see is ‘Risk.’” – Bethesda

“I like this [the SEC version]. But [‘Page One’] is important to know. If you forget about [the risks], you could be in a world of trouble.” – Bethesda

Page Two

Almost all respondents thought that the SEC's presentation of the sales fee information was superior to the NASD version.

- o **Introductory Language:** Several respondents mentioned and appreciated that the SEC form included an "Ask before you buy" section at the top of the form, which made clear that the primary purpose of the document was the disclosure of fees and conflicts.

"It's good. Right up top, it warns you upfront: we are required to tell you about fees and conflicts. 'Ask before you buy.'" – Bethesda

"'Ask before you buy' is at the top of the page. This seems like a much more straightforward presentation." – Bethesda

- o **Section Titles:** Most respondents preferred the SEC's language to the NASD's language for the two fee sections: "You pay when you buy" and "You also pay each year." These two labels were considered to be perfectly clear and user-friendly.

"I like the wording – 'You pay when you buy.'" – Bethesda

"This is easier to understand. 'You pay when you buy.' It shows you exactly how much you're investing. The percentage is nice to see – it shows that the more you invest, the lower the fee you pay." – Bethesda

"Here it makes it clear that it's going to be every year. It slaps you in the face." – Bethesda

- o **Layout of Sales Fee Disclosure:** Investors appreciated the four-column approach of the SEC document: "Total payment amount," "Estimated upfront fee you pay," "Your investment amount," and "Upfront fee as % of your investment amount."

"This is shorter, more concise [than the NASD version]. It has both numbers and percentages." – Bethesda

"This is considerably more user-friendly. It's got the percentages." – Bethesda

"It immediately shows you what you have to invest and what's being taken off the top. It's very clear. I think that's good." – Bethesda

- o **Fill-In Boxes:** The blank boxes received mixed reactions. Some investors found the interactivity to be appealing and the (inferred) automatic calculation helpful. Others found the presentation of the boxes to be condescending.

“I’d use this on a website.” – Bethesda

“I like the blocks that let you put in the amount you’re going to invest.” – Bethesda

“What do you need that for?” – Bethesda

“I think it’s a gimmick. I always feel that they treat me like a half-wit.” – Bethesda

- o **Annual Fund Expenses:** Some respondents were misled by the use of a fixed dollar amount rather than a percentage in the annual fee section of the NASD form. The table of examples in the SEC document was puzzling to some because the percentage did not change. A simple statement of the percentage would be less likely to confuse investors.

“I guess I’d like to see a percentage. That’s typical.” – Bethesda

“I read it as \$13.80 coming out every year as a flat amount. [After respondent clicked through for additional information] It’s a percent. Not a flat amount. The 1.38% is helpful.” – Bethesda

“It expresses [the fee] in dollars that the average layman understands. I deal in percentages. Maybe it could do both – it wouldn’t hurt.” – Bethesda

“It’s always good to have the percentage.” – Bethesda

“Why are you showing four different figures? It’s the same percentage.” – Bethesda

“Get rid of the blank boxes [in the SEC form] because that’s just more confusion. . . The fee is a percentage of the value.” – Bethesda

- o **Account Fee:** The annual account fee was noticed by a few respondents and was seen as being a relevant disclosure that was missing from the NASD form.

- o **SEC's Annual Fee Breakdown:** Most respondents considered the breakdown of the annual fee to be unnecessary and unhelpful. When they tried to interpret the fee sub-categories (distribution, management, and other), they were unable to do so.

"I guess I don't care. These fees are used to fund the company. They're not all going to one person." – Bethesda

"'Other' – whatever the hell that means. Just call these management fees and give the total." – Bethesda

"This is what it's going to cost. Whether you call it a management fee – what does it matter to me? It doesn't help any." – Bethesda

"This is where I tune out. It's just gobbledygook." – Bethesda

- o **Portfolio Turnover:** The turnover section was very confusing to many respondents, especially because it appears in a document that focuses on disclosing the fees being charged to investors. In several cases, respondents assumed that "transaction costs" referred to would be charged directly to them, which made them question the validity and meaning of the annual fee disclosures they had just finished reading.

"I don't know if turnover is relevant. I think it's excess information." – Bethesda

"They put [that information] there to tell me they're aggressive. . . It's an impressive number if things are going well." – Bethesda

"Why are you charging me transaction fees if I'm already paying an operating expense?" – Bethesda

"I think the average layman would be upset by this. . . They can charge anything they darn well please. Why are you charging me more?" – Bethesda

"Maybe it's [included] so that when they sell a stock they used to own when I bought the fund, I won't complain . . . But what are these transaction costs you're going to hit me with? Boy, this is really getting confusing now." – Bethesda

Delivery Mode

Consistent with the first round of research, most respondents said they would prefer to receive these disclosures electronically through some combination of e-mail and online access. They cited the following reasons for this preference: instant access; ease of comparing the information to other investment options; reduced paper clutter; and the ability to print part – or all – of the document, if desired. Seniors are more likely than younger investors to indicate a preference for hardcopy over electronic delivery.

“I’d like it by e-mail, where I can go to the web and read it.” – Bethesda

“I prefer a piece of paper.” – Bethesda

“Just send it to me in an email. In the email, not an attachment. . . [A website] would be nice. Those kind of links are good.” – Bethesda

“I don’t want it over the phone. Email or mail. Email now is a pretty secure thing.” – Bethesda

“Probably mailed would be better. . . It would be interesting if it was on a web page where you could enter in an amount and it would calculate for you.” – Bethesda

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