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Report to Congressional Committees

July 2011

MUTUAL FUND ADVERTISING

Improving How Regulators Communicate New Rule Interpretations to Industry Would Further Protect Investors

U.S. Government Accountability Office

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GAO-11-697

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Highlights

Highlights of GAO-11-697, a report to congressional committees

July 2011

MUTUAL FUND ADVERTISING

Improving How Regulators Communicate New Rule Interpretations to Industry Would Further Protect Investors

Why GAO Did This Study

Mutual funds are one of the most widely held investment products by Americans and advertising is one method by which investors may obtain information on funds. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires GAO to conduct a review of mutual fund advertising, focusing on the advertising of past performance information. This report examines (1) what is known about the impact of fund advertisements on investors, (2) the extent to which performance information is included in advertisements, and (3) the regulatory requirements for fund advertisements and how they are administered and enforced. To address these objectives, GAO reviewed existing and proposed Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) rules, conducted a literature review of studies related to mutual fund advertising's impact on investors, and reviewed a random sample of 300 fund advertisements. GAO also met with regulators, fund companies, academics, and industry and investor protection groups.

What GAO Recommends

To help ensure investors are better protected from misleading advertisements, SEC should take steps to ensure FINRA develops sufficient mechanisms to notify all fund companies about changes in rule interpretations for fund advertising. Both SEC and FINRA agreed with the recommendation.

View GAO-11-697.
For more information, contact Alicia Puente Cackley at (202) 512-8678 or cackleya@gao.gov.

What GAO Found

While some academic studies and others have suggested that advertisements that emphasize a fund's past performance can influence investors to make inappropriate investments, the evidence that investors are harmed by these advertisements is mixed. Some academics believe that because research has shown that past performance generally does not persist and is not predictive of future performance, performance advertisements are inherently misleading. However, some studies illustrate that investors who are influenced by performance advertising may still achieve returns that exceed market indexes or other funds. In addition, the extent to which investors rely on performance advertisements is unclear. Industry surveys show that investors are increasingly relying on information from financial advisors and other sources and use a variety of information—beyond performance information—when making investment decisions.

GAO's review of a random sample of mutual fund advertisements also revealed that advertising focusing on performance is generally not common. Of the six different advertising methods we included in our review—brochures, press releases, print media, the Internet, radio, and television—we estimate that 9 percent emphasized a fund's performance and 35 percent contained some type of performance information. For example, many of these included the standardized presentation of the fund's performance over a 1-, 5-, and 10-year period, and others presented information on a fund's performance ranking relative to other funds. Fund company staff noted that, although performance information is not the focus of most advertisements, investors can still seek it out from required disclosure documents or public Web sites.

Another factor that helps limit the potential for investors to be misled by fund advertising is an established regulatory review process of fund advertisements used by broker-dealers intended to be seen by the public at the time of first use. FINRA reviews all advertisements intended to be seen by the public and provides comment letters to fund companies that can require changes that must be made to advertisements or can prohibit advertisements from being used entirely. FINRA, which is overseen by SEC, also conducts special reviews on emerging industry issues at firms selling mutual funds that can help to identify potentially misleading advertisements. However, fund company representatives expressed concerns that FINRA does not always effectively communicate changes in advertising rule interpretations that arise when the regulatory staff identify concerns about new material being advertised by fund companies. Because FINRA communicates some new interpretative positions initially by making comments on advertisements submitted for its review, only those firms that submit new advertisements learn of new interpretations of existing rules. As a result, they may be competitively disadvantaged if other firms attract additional investments by continuing to use previously approved advertisements that do not comply with the new position. In addition, this uneven method of communicating changes in rule interpretations can result in investors being exposed to advertising that does meet current standards and may be considered misleading.

Contents

Figures

Abbreviations

AREF	Advertising Regulation Electronic Files
DOL	Department of Labor
ETF	exchange-traded funds
FINRA	Financial Industry Regulatory Authority
NAV	net asset value
SEC	Securities and Exchange Commission

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United States Government Accountability Office
Washington, DC 20548

July 26, 2011

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

Mutual funds are companies that pool money from many investors and invest it in stocks, bonds, and other securities or assets. They are a popular investment product, with about 90 million Americans owning shares in them in 2010. For many, mutual funds play an important role in saving for retirement. Thus, ensuring that investors are knowledgeable about the factors to consider when purchasing mutual funds and clearly understand the risks associated with their investments is important. According to some academic studies, investors can be overly influenced by a fund's past performance and advertising that emphasizes superior past returns—that exceed those of similar funds or market indexes—which can lead them to make poor choices or experience lower returns later.

Advertisements are one method by which investors can obtain information about mutual funds. While advertisements can include different kinds of information about mutual funds, including performance, some advertisements focus mainly on a fund's performance. Both the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA)—a self-regulatory organization—have specific rules that govern the content of mutual fund advertisements, including rules on the calculation and presentation of performance information.[1]

This report responds to Section 918 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which requires GAO to conduct a study on mutual fund advertising.[2] Our objectives are to examine (1) what is known about the impact of mutual fund advertisements on investors, (2) the extent to which performance information is included in mutual fund advertisements, and (3) the regulatory requirements that exist for mutual fund advertisements and how they are administered and enforced.

In addition to mutual funds, we included exchange-traded funds (ETF) in our review. ETFs are similar to mutual funds in that they are most commonly structured as open-end investment companies and offer investors a proportionate share in a pool of stocks, bonds, and other assets.[3] We included ETFs because of their increasing popularity as investment vehicles. Throughout this report, we use the term “fund advertisements” to refer to mutual fund and ETF advertisements. To examine what is known about the impact of fund advertisements on investors, we conducted a literature review of existing studies and reports that included explorations of investors’ usage of past performance information in fund purchases; the persistence of fund past performance; the effectiveness of existing regulatory disclosures; and the importance of

[1]FINRA was established in 2007 through the consolidation of NASD and the member firm regulation, enforcement and arbitration functions of the New York Stock Exchange. FINRA defines six different types of “communications with the public” by fund companies: advertisements, sales literature, correspondence, institutional sales material, public appearances, and independently prepared reprints. Throughout the report, we use “advertisement” to include advertisements and sales literature. The remaining four types of communications with the public were excluded from our review.

[2]Pub. L. No. 111-203, Title IX, § 918, 124 Stat. 1376, 1837 (2010).

[3]ETFs can be registered with SEC as investment companies under the Investment Company Act of 1940. According to industry data, about 90 percent of ETF assets are in funds registered as investment companies under that act. The remaining 10 percent of ETF assets, which are generally commodity-based, are held in ETFs that are not registered with or regulated by SEC under the Investment Company Act of 1940. The Commodity Futures Trading Commission regulates commodity-based ETFs that invest in commodity futures, while SEC regulates those that invest solely in physical commodities under the Securities Act of 1933. ETFs that are not registered as investment companies are currently not required to submit advertisements and sales materials to FINRA for review; therefore, we have excluded them from our review.

various information sources, including advertisements, in investors' selection of funds. We also met with academics, representatives of industry and investor protection groups, and fund companies to discuss the impact of performance advertising on investors. To determine the extent to which fund advertisements contain performance information, we selected and reviewed a random sample of 300 mutual fund and ETF advertising materials—including brochures, press releases, public Web site content pieces, print advertisements, radio, and television advertisements—out of the universe of about 71,000 individual pieces that were reviewed and deemed compliant with applicable standards by FINRA during calendar years 2006—2010, which was the period for which data was available. For each of these advertisements, we collected information on whether the advertisements contained performance information and, if so, what kind, as well as other types of information. We based the selection of the 6 delivery methods on our initial review of about 200 advertisements submitted for FINRA review in 2010 in which all 21 delivery methods were represented.[4] For each delivery method, we reviewed the different types of information contained in the materials and selected the six methods that retail investors would be more likely to encounter in their daily activities—such as advertisements that appear in print media or on the Internet. All estimates from the sample in this report have a margin of error of plus or minus 10 percentage points or less. We performed a data reliability assessment for data used in our generalizable sample and determined that the data were sufficiently reliable to perform our review and project our results to the six delivery methods in our population of advertisements. Additionally, we selected and interviewed a nongeneralizable sample of 18 fund companies on the advertising practices they currently used. We included the 10 companies that had filed the most mutual fund advertisements for review with FINRA in 2009,

[4]FINRA classifies advertisements and sales materials that they review into 21 delivery methods: account statement-related communications; articles and third-party reprints; material for broker-dealer use only; brochure; audio/video tapes (CDs and DVDs); electronic messages (e-mail, instant messages, and text); fund fact sheets (fund-specific information sheets); handouts (flyers and other hand-delivered material); mailings; performance reports (periodic and other performance reports such as an annual report); telephone (telemarketing and other telephone scripts); press releases; print advertisements, posters and signs; radio advertisements and broadcasts; research reports (equity and debt research); seminar-related communications; software output and tools; stationery; television advertisements and broadcasts; Web site information–password protected; and Web site information-publicly accessible (Internet advertisements and materials posted to fund company Web sites).

as well as the 5 companies that had filed the most ETF advertisements.[5] We also selected three fund companies (two offering mutual funds and one that offered ETFs) that filed fewer numbers of advertisements in 2009. Finally, we also interviewed three companies from a list of five that the Investment Company Institute—the mutual fund industry's trade organization—had identified as likely to have relevant perspectives on this issue. To describe the regulatory requirements for fund advertisements and how they are administered and enforced, we reviewed the rules and requirements related to fund advertisements, including proposed SEC and FINRA rules and public comments received on those rules. We met with SEC and FINRA officials to discuss the methods used to enforce these requirements and the process FINRA uses to review fund advertisements. For a more detailed discussion of our scope and methodology, see appendix I.

We conducted our work from September 2010 to July 2011 in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The percentage of U.S. households owning mutual funds has grown from about 6 percent in 1980 to about 44 percent in 2010 with about 90 million individual investors owning mutual fund shares.[6] Most mutual funds continuously offer new shares to investors, and investors purchase and redeem shares directly from the fund. The price per share is known as the net asset value (NAV), which represents the difference between the market value of the fund's assets and its accrued liabilities divided by the number of outstanding shares. NAVs are calculated at least once each

[5]Because some companies file both mutual fund and ETF advertisements, 12 companies represented both the 10 most frequent mutual fund filers and the 5 most frequent ETF filers.

[6]In 2010, 62 percent of households that own mutual funds own them inside tax-deferred accounts—such as 401(k) and other defined contribution plans, individual retirement accounts, and variable annuities. Another 28 percent of households own mutual funds both inside and outside tax-deferred accounts, and only 9 percent of households own mutual funds only outside of tax-deferred accounts.

trading day—usually at 4:00 p.m. Mutual funds are “forward priced,” meaning, for example, that for a fund with a 4:00 p.m. cut off time, orders to sell or redeem mutual fund shares received prior to 4:00 p.m. receive the price determined that same day at 4:00 p.m. Investors pay mutual fund fees including, among others, operating expenses, which cover the day-to-day costs of running a fund. These expenses are accrued daily, and generally paid monthly, from overall fund assets rather than from individual investor accounts. Generally shown as a percentage of the fund’s average net assets, the annual total operating fee amount is referred to as the fund’s operating expense ratio.

Over the past decade, demand for a new type of investment company product known as ETFs has grown significantly both as an institutional and retail product. An ETF is an investment company whose shares, unlike those of mutual funds, are traded throughout the day on stock exchanges at market-determined prices that constantly fluctuate. Investors may buy or sell ETF shares through a broker just as they would the shares of any publicly traded company. Many ETFs aim to achieve the same return as a particular market index, such as the S&P 500 index, while others invest in a unique mix of assets to meet a particular investment objective.

Mutual Funds Overseen by Securities Regulators and Various Requirements Apply to Fund Advertising

As the primary regulators of mutual fund advertising, SEC and FINRA have cooperated in carrying out their respective roles, with SEC generally setting the regulations for mutual fund advertising and FINRA generally enforcing those regulations, although FINRA also has adopted rules of its own. SEC regulates mutual funds under the Investment Company Act of 1940 (Investment Company Act), the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934. The Investment Company Act was passed specifically to regulate mutual funds and other types of investment companies.[7] Under the Investment Company Act, mutual funds are required to register with SEC, subjecting their activities to SEC regulation. The Securities Act requires that

[7]The Investment Advisers Act requires mutual fund advisers to register with SEC, imposes reporting requirements on them, and prohibits them from engaging in fraudulent, deceptive, or manipulative practices. The Securities Act requires fund shares offered to the public to be registered with SEC and regulates mutual fund advertising. The Securities Exchange Act, among other things, regulates how funds are sold and requires persons distributing funds or executing fund transactions to be registered with SEC as broker-dealers.

investors receive adequate and accurate information about mutual funds. FINRA is a self regulatory organization that has primary responsibility, under the Securities Exchange Act, for regulating its member broker-dealers, including their mutual fund sales practices, subject to SEC oversight.[8] Because virtually all firms that market and sell fund shares are FINRA members, FINRA is an important source of information and guidance on advertising for mutual funds.

Key rules that apply to mutual fund and ETF advertisements include:

- **Securities Act, SEC Rule 482.** Includes specific performance presentation and calculation standards, such as the requirement that performance information be presented as the average annual return for 1-, 5-, and 10-year periods. This rule also contains disclosure requirements, including, among others, alerting investors to consider the investment objectives, risks, charges, and expenses of mutual funds and stating that past performance does not guarantee future results. Finally, the rule also contains presentation standards on the type size, type style, prominence, and proximity that must be used in materials. For example, among other things, disclosure statements must be presented in a type size at least as large as that used in the major portion of the advertisement and required disclosures must be presented in close proximity to the performance data contained in an advertisement.

- **Investment Company Act, SEC Rule 34b-1.** Applies the standardized performance requirements of Rule 482 to advertising materials that are preceded or accompanied by the fund's prospectus.

- **Securities Act, SEC Rule 156.** Provides general guidance on how fund advertising may be determined to be materially false or misleading. Advertising is materially misleading if it contains an untrue statement of a material fact or it omits a material fact that is necessary in order to make it not misleading.

- **NASD Rule 2210.** Entitled "Communications with the Public," this rule provides content requirements and prohibits misleading advertisements by broker-dealers. It directs that, among other things,

[8]Self-regulatory organizations are private organizations with statutory responsibility to regulate their own members through the adoption and enforcement of rules of conduct.

communications with the public must be fair and balanced; may not omit material facts; must not contain false or exaggerated statements; and may not predict or project performance or imply that the past performance will recur. In addition to these general standards, the rule has specific disclosure requirements in a number of areas, such as communications with the public that contain testimonials and comparative information such as rankings.

SEC, the Department of Labor (DOL), and FINRA also have proposed new rules concerning the advertising materials of funds:

- **SEC Target-Date Fund Rule.** In June 2010, SEC issued proposed regulations that addressed the advertising and naming of target-date funds (also known as life-cycle funds).[9] Target-date funds take into account an individual's age or retirement date and its investments generally are designed to become more conservative as an investor approaches retirement. The proposed rule would, among other things, require a target date fund that includes the target date in its name to disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in advertising materials and require advertising materials to include a table, chart, or graph depicting the fund's asset allocation over time, together with a statement that would highlight the fund's final asset allocation. The public comment period for the rule closed in August 2010, but as of July 2011, the rule has not yet been finalized.

- **DOL Target Date Disclosure Rule.** In November 2010, DOL also released proposed regulations on target-date fund disclosures.[10] DOL has designated target date funds as one of the types of qualified default investment alternatives, which are investments into which retirement plans can automatically place participants and obtain limited fiduciary relief if the participants do not choose their own investments. The proposed rule would require specific disclosures to be made for target date funds that are used as qualified default investment alternatives. For example, target date fund disclosures would require, among other things, an explanation of how the fund's

[9] *Investment Company Advertising: Target Date Retirement Fund Names and Marketing*, 75 Fed. Reg. 35,920 (June 23, 2010) (to be codified at 17 C.F.R. parts 230 and 270).

[10] *Target Date Disclosure*, 75 Fed. Reg. 73,987 (Nov. 30, 2010) (to be codified at 29 C.F.R. part 2550). The comment period for the proposed regulation closed on January 14, 2011.

asset allocation will change over time, and the point in time when it will reach its most conservative position; a table, chart, or graph that illustrates how the fund's asset allocation will change over time; and for a target date fund that refers to a particular date (for example, "Retirement 2050 Fund"), an explanation of the relevance of the date. Both SEC and DOL proposed rules contain some similar provisions that, if finalized, would help ensure that investors generally obtain more accurate information about target date funds, but differences do exist in the two agencies' proposed regulations. The public comment period for the rule ended in January 2011, but as of July 2011, the rule has not yet been finalized.

- **FINRA Communications with the Public.** In September 2009, FINRA issued a regulatory notice proposing new rules governing broker-dealer communications with the public.[11] The rules would employ new communications categories and require filing for certain types of communications currently not covered by existing filing requirements; for example, communications regarding ETFs that are not registered investment companies. Communications that currently qualify as advertisements under FINRA rules generally could fall under the new communications category, "retail communications," which would include any written (including electronic) communication that is distributed or made available to more than 25 retail investors. FINRA officials stated that they have submitted a draft of the proposed rule to SEC, but did not know when the final rule would be issued.

[11]FINRA Regulatory Notice 09-55, *Communications with the Public* (September 2009).

Although Academics and Others Argue That Investors Could Be Harmed by Performance Advertisements, Evidence of Impact Is Mixed

Some academics and representatives of investor protection organizations expressed concerns that mutual funds that advertise superior performance—exceeding those of similar funds or market indexes—can adversely affect investors. Academics and regulators consider a mutual fund's past performance not to be a reliable indicator of future performance because any superior performance by funds generally does not persist for long periods of time. As part of conducting a search for literature relating to mutual funds' performance, we identified various papers that examined whether mutual funds can consistently exhibit superior performance. We also reviewed studies that these papers frequently cited as also addressing this topic. Many of these studies generally concluded that funds that exhibited superior performance were not able to persistently sustain their performance over long periods.[12] For example, one study examined the performance records of about 1,900 equity mutual funds during 1962 through 1993. The author of this study compiled the gross investment returns—those that include expense ratios—of these funds and ranked the funds by their return for 1 year and then compared each funds' ranking in the year following the initial ranking. The author concluded from this analysis that funds that have superior returns (winners) are somewhat more likely to continue to perform well in the following year and funds that have poor returns (losers) are more likely to continue such performance or cease operations. However, the funds in the top 10 percent of returns differ substantially each year, with these top-performing funds frequently becoming the next year's worst performers and vice versa. Additionally, the study also examined 2- to 5-year returns and found that funds with superior returns in 1 year generally did not continue to experience these returns over the longer period.[13] Academic research also generally reports that funds are unable to continue superior performance because

[12] Michael C. Jensen, "The Performance of Mutual Funds in the Period 1945-1964," *The Journal of Finance* Vol. 23, No. 2 (May 1968): 389-416; Christopher R. Blake, Edwin. J. Elton, and Martin J. Gruber, "The Performance of Bond Mutual Funds," *The Journal of Business*, Vol. 66, No. 3 (July 1993): 371-403; Jonathan B. Berk and Richard C. Green, "Mutual Fund Flows and Performance in Rational Markets," *The Journal of Political Economy,* Vol. 112, No. 6 (December 2004): 1269-1295; Burton G. Malkiel, "Returns from Investing in Equity Mutual Funds 1971 to 1991," *The Journal of Finance*, Vol. 50, No. 2 (June 1995): 549-572; Mark M. Carhart, "On Persistence in Mutual Fund Performance," *The Journal of Finance*, Vol. 52, No. 1 (March 1997): 57-82; and Nicolas P. B. Bollen and Jeffrey A. Busse, "Short-Term Persistence in Mutual Fund Performance," *The Review of Financial Studies*, Vol. 18, No. 2 (Summer 2005): 569-597.

[13] Carhart (1997).

their returns are likely the result of chance rather than the skill of the fund manager. For example, because there are a large number of mutual funds, by chance alone, some will outperform market indexes regardless of the fund manager's asset-selection ability. Three papers we reviewed found that chance accounted for almost all of the funds that had superior returns.[14] For example, the authors of one of these studies used monthly returns of 2,076 actively managed U.S. domestic equity mutual funds that existed at any time between 1975 and 2006. The authors explained that, by chance alone, a certain expected percentage of these funds will achieve levels of returns significant enough to cover their trading costs and expenses (including fees). They applied a statistical technique designed to determine if the returns observed for the 2,076 funds were significantly different from those that would be expected from chance. After conducting their analysis, the authors estimated that the majority—about 75 percent of the 2,076 funds they examined—had managers with stock-picking skills such that their incremental returns were just sufficient to cover their trading costs and other expenses, and more than 24 percent exhibited no skill and thus were unable to produce additional returns sufficient to overcome their trading costs and expenses. Although the authors found that about 0.6 percent of managers of all funds overall appeared to exhibit skill in investment selection sufficient to produce returns beyond the level needed to cover their expenses, this proportion was not significantly different than zero.[15]

Because of the inability of most mutual funds to continually maintain superior returns, some academics told us that allowing mutual funds to advertise past performance information is inherently misleading to investors because if they invest in funds with superior past performance, they are not likely to experience similar results. Some academics note that mutual fund firms are likely to advertise those funds that do have superior performance to attract investor fund flows and studies done on this issue confirmed that mutual fund firms choose their highest-performing funds to advertise. For example, these studies found that

[14]Laurent Barras, Olivier Scaillet, and Russ Wermers, "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas," *The Journal of Finance*, Vol. LXV, No. 1 (February 2010); Eugene F. Fama and Kenneth R. French, "Luck versus Skill in the Cross-Section of Mutual Fund Returns," *The Journal of Finance*, Vol. LXV, No. 5 (October 2010); and Gary E. Porter and Jack W. Trifts, "Performance Persistence of Experienced Mutual Fund Managers," *Financial Services Review*, Vol. 7, No. 1 (1998): 57-68.

[15]Barras, Scaillet, and Wermers (2010).

advertised mutual funds are typically some of the highest-performing funds for fund families and also have significantly superior performance compared with other mutual funds.[16] One study that we reviewed found that the 1-year performance records before funds are advertised were much higher than nonadvertised funds. For example, the study found that advertised funds' 1-year returns averaged about 26 percent, compared with about 6 percent for funds that were similar, but not advertised. Additionally, it found that 1 year after the advertisement, the funds did not exhibit superior performance relative to various benchmarks.[17] Therefore, investors influenced by advertisements that tout superior past performance and that base their purchase decisions on these advertisements are unlikely to experience similar levels of returns. One consumer advocate with whom we spoke stated that she hears complaints from investors when they lose money after purchasing funds based on their superior performance levels and the performance levels are not sustained. Representatives of some mutual fund firms with whom we spoke confirmed that they choose which funds to advertise based on the fund's performance level or rankings by industry research organizations such as Lipper and Morningstar, Inc., which periodically issue comparative ratings and rankings of funds' performance over different time periods.[18] For example, one service has developed a rating system that categorizes funds by "stars." A fund that receives a "5 star" rating is a fund that achieved returns that fell within the top 10 percent of its peers for a set period of time.

While much of the literature we reviewed finds that past performance does not persist over the long-term and superior returns are the result of chance, some literature contradicts these findings and other literature provides mixed evidence of the actual harm to investors from performance advertising. For example, we reviewed studies that found

[16]Jonathan J. Koehler and Molly Mercer, "Selection Neglect in Mutual Fund Advertisements," *Management Science*, Vol. 55, No. 7 (July 2009): 1107-1121; and Prem C. Jain and Joanna Shuang Wu, "Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows," *The Journal of Finance*, Vol. 55, No. 2 (April 2000): 937-958.

[17]Jain and Wu.

[18]Morningstar, Inc., provides data on investment offerings including mutual funds and ETFs. Lipper supplies mutual fund information, analytical tools, and commentary. Both Morningstar and Lipper's benchmarking and classifications are widely recognized as industry standards.

that some funds did exhibit some superior performance persistence over various short-term periods.[19] For example, one study that reviewed no-load growth-oriented mutual funds during 1975-1988, found that those that had superior performance in the most recent year continued to be superior performers in the following 1 to 8 quarters.[20] Another study found superior performance persistence over 1- and 2-year intervals from 1976 to 1994 and another found it over 5-year periods from 1974 to 1984.[21]

Additionally, other studies illustrate that investors who are influenced by funds advertising superior performance may not always be harmed as a result of such reliance. For example, even if a fund's advertised superior performance is not replicated in subsequent periods, such funds still may continue to have positive returns, including those that exceed the returns on market indexes, similar funds, or other alternative investments. Research by one mutual fund company showed that persistent superior performance by a fund is difficult to achieve, with only 21 percent of funds that were in the highest quintile of performance over the 5-year period ending December 1997 achieving performance that ranked them in the highest quintile in the following 5-year period.[22] However, although this same research showed that about 34 percent of the top performing funds in the first 5-year period ended up in the lowest 2 quintiles in the next 5-year period, 41 percent of the top performing funds were at least in the top 2 quintiles in that subsequent 5-year period. Although this is about the proportion that would be expected to perform that way if returns are completely the result of chance, nevertheless, investors who bought in the first period as a result of any advertised performance by those funds

[19]For examples of these studies, see William N. Goetzmann and Roger G. Ibbotson, "Do Winners Repeat?" *The Journal of Portfolio Management*, Vol. 20, No. 2 (1994): 9-18; Mark Grinblatt and Sheridan Titman, "The Persistence of Mutual Fund Performance," *The Journal of Finance* Vol. 47, No. 5 (December 1992): 1977-1984; and, Darryll Hendricks, Jayendu Patel, and Richard Zeckhauser, "Hot Hands in Mutual Funds: Short-Run Persistence of Relative Performance, 1974-1988," *The Journal of Finance*, Vol. 48, No. 1 (March 1993): 93-130; and Russ Wermers, "Is Money Really "Smart"? New Evidence on the Relation Between Mutual Fund Flows, Manager Behavior, and Performance Persistence," working paper (November 2003).

[20]Hendricks, Patel, and Zeckhauser (1993).

[21]Wermers (2003) and Grinblatt and Titman (1992), respectively.

[22]The Vanguard Group, *We Believe #4: Consistently Outperforming the Financial Markets Is Extremely Difficult* (Valley Forge, Pa., 2006).

and held their investment throughout the second period would still have been in a fund that performed better relative to a majority of other funds.

Finally, some academics expressed concerns about the advertising of performance information for “incubated” funds.[23] Mutual fund incubation is a strategy that some fund families use to develop new funds and involves a fund company creating a number of start-up funds, seeded with the company’s or other private money, which are not marketed to the public.[24] Academics argue that incubated funds generate investor protection concerns because any superior performance returns likely would not be continued. One study that analyzed returns from about 1,000 new U.S. domestic equity funds from 1996 to 2005 found that the new funds that were incubated outperformed the nonincubated funds annually by 3.5 percent on a risk-adjusted basis. However, in the post-incubation period, the funds that had been incubated did not exhibit superior performance relative to nonincubated funds.[25] The superior performance of an incubated fund may not be sustainable for several reasons. First, some academics have noted that fund companies may

[23]Some academics also expressed concerns over mergers between funds. According to one paper that analyzed fund mergers, the funds that fund companies merged into other funds within their fund family were more likely to be those that had exhibited significant underperformance. Although some concerns existed over whether investors might be misled if the newly merged fund advertises different performance than the previously separated funds, SEC staff generally expects that fund companies will determine whether a new fund resulting from a reorganization may use the historical performance of one of several predecessor funds by comparing the attributes of the new fund with the predecessor funds to determine which of the predecessor funds most closely resembles the new merged fund and is therefore considered to be the survivor fund. Although allowing the performance of the survivor fund to be presented as the performance of the merged fund implies that the merged fund’s performance going forward should be similar, this study found that the merged funds often had reduced performance after merging, resulting in a transfer of wealth between the existing shareholders of the survivor fund and the shareholders of the fund that was merged. See N. Jayaraman, A. Khorana, and E. Nelling, “An Analysis of the Determinants and Shareholder Wealth Effects of Mutual Fund Mergers,” *Journal of Finance,* Vol. LVII, No. 3 (June 2002): 1521-1551.

[24]A fund company could register a new fund immediately but not actively market it (to build a performance record for a fund it may wish to advertise later). Some academics noted that indications that a fund company is incubating a registered fund include delays in obtaining a trading ticker symbol, which is a unique set of characters used to identify the shares of publicly traded companies and mutual funds, or the company’s providing data on the new fund to the third-party investment monitoring firms.

[25]Richard B. Evans, “Mutual Fund Incubation,” *The Journal of Finance*, Vol. LXV, No. 4 (August 2010): 1581-1611.

provide various advantages to the fund that will not be available later, such as granting the fund large portions of shares from "hot" initial public offerings that are more likely to rise quickly in price.[26] Because incubator funds generally are small, even a small allocation of hot IPO shares can significantly boost returns. However, during the post-incubation phase when the fund is marketed to the public and more investors purchase it, the fund's larger size makes it more difficult for the fund manager to achieve the same level of returns because identifying sufficient numbers of assets with good return prospects becomes more challenging. Second, these academics believe that incubated funds are misleading to investors if companies publicly registered and marketed only the most successful ones without disclosing the number of incubated funds that did not produce superior returns. This would make the fund manager appear to have had special asset-picking abilities when, instead, the fund's returns were more a matter of chance.

Performance Advertising May Lead Investors to Purchase Funds at Inopportune Times

Investors who purchase shares of funds that advertise superior past performance also may be harmed by buying at disadvantageous times compared with other investors. Many academics warn that most investors lack the ability to recognize the most appropriate time to make investments, and thus they discourage investors from attempting to "time the markets" with their purchases. These academics find that many investors invest when markets have risen and sell when they have declined and thus too often miss the best returns compared with investors who practice a strategy known as "buy and hold," in which investors purchase funds, hold them for extended periods, and are not influenced by short-term movements in price. To avoid adverse investment returns that can result from poor market timing, others advocate dollar-cost averaging, in which investors regularly contribute the same amount of money to their investment accounts. This strategy helps to smooth out the effects of market fluctuations because investors are able to purchase more shares when the price is low and fewer shares when the price is high and lessens the risk of making a larger lump-sum purchase when the price is high.

[26]Alan R. Palmiter and Ahmed E. Taha, "Star Creation: The Incubation of Mutual Funds," *Vanderbilt Law Review* Vol. 62 (October 2009): 1485.

Academics and others noted that investors who continually purchase shares of funds that advertise superior performance are more likely to experience lower returns as a result of poor market timing of such investments. Some studies have found that this strategy results in underperformance by investors relative to investors who use a buy-and-hold strategy.[27] For example, one study found that between 1991 and 2004 equity fund investors' timing decisions reduced their average returns by about 1.6 percent annually.[28] Furthermore, agency officials and representatives of mutual fund companies with whom we spoke, as well as some researchers, said that more advertisements showing superior past returns for mutual funds appear after the market has performed well. However, investors who are influenced by these advertisements generally are purchasing the funds as their performance is beginning to decline and will be more adversely affected than if they had used dollar-cost averaging to invest.

Evidence on the Impact of Advertising Is Mixed

The extent to which investors are influenced to make investments by mutual fund performance advertising is mixed. Various academic studies have been published that find that performance advertising does influence investors' decisions. First, multiple studies have found that investors place more attention on a fund's past performance than on other fund characteristics.[29] For example, one study that tested investors' reactions to the inclusion of fund expense ratios in performance advertisements found that, despite the prominent presence of fund expense information, investors overwhelmingly continued to use past

[27]Stephen L. Nesbitt, "Buy High, Sell Low: Timing Errors in Mutual Fund Allocations," *The Journal of Portfolio Management*, Vol. 22 (1995): 57-60; Geoffrey C. Friesen and Travis R. A. Sapp, "Mutual Fund Flows and Investor Returns: An Empirical Examination of Fund Investor Timing Ability," *Journal of Banking and Finance*, Vol. 31 (April 2007): 2796-2816; Oded Braverman, Shmuel Kandel, and Avi Wohl, "The (Bad?) Timing of Mutual Fund Investors," working paper (August 2005); and Mercer Bullard, Geoff Friesen, and Travis Sapp, "Investor Timing and Fund Distribution Channels," working paper (June 2008).

[28]Friesen and Sapp (2007).

[29]Beth A. Pontari, Andre J. S. Stanaland, and Tom Smythe, "Regulating Information Disclosure in Mutual Fund Advertising in the United States: Will Consumers Utilize Cost Information?" *Journal of Consumer Policy*, Vol. 32 (2009): 333-351; Noel Capon, Gavan J. Fitzsimons, and Russ Alan Prince, "An Individual Level Analysis of the Mutual Fund Investment Decision," *Journal of Financial Services Research*, Vol. 10 (1996): 59-82; and Richard T. Wilcox, "Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds," *The Journal of Business*, Vol. 76, No. 4 (October 2003): 645-663.

performance information when forming preferences for mutual funds.[30] Additionally, a survey of mutual fund investors conducted by an industry trade group found that about 70 percent considered past performance before their most recent fund purchase.[31]

Multiple studies also have found that funds with superior performance tend to attract larger investment inflows.[32] Studies we reviewed examined fund performance between 1969 and 2001 and found that new investments into funds are related to funds' performance levels, with funds that have superior performance levels receiving more new investments. For example, one study found that investor inflows depend both on a fund's industry rank within its market segment and its performance compared with funds offered by the same fund company.[33] The study reviewed U.S. equity funds between 1993 and 2001 and found that funds in the top quintile of their industry segment received larger inflows than funds in lower quintiles. Additionally, only funds with the highest returns within a particular fund companies' offerings received large additional inflows. Because past performance drives new fund investments, one study we reviewed found that fund companies that utilize performance advertising receive the highest levels of new investments in advertised funds, showing that performance advertising does have some impact on investors' mutual fund purchase decisions. For example, it found that inflows to advertised funds were about 20 percent larger than those for nonadvertised funds with similar characteristics.[34] Another study found that Morningstar ratings—which are based on a fund's performance record—also have a significant impact on mutual fund flows. Funds that moved from a 4-star to a 5-star rating

[30]Pontari, Stanaland, and Smythe (2009).

[31]Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (Washington, D.C., 2006).

[32]Erik R. Sirri and Peter Tufano, "Costly Search and Mutual Fund Flows," *The Journal of Finance*, Vol. 53, No. 5 (October 1998): 1589-1622; Alexander Kempf and Stefan Ruenzi, "Family Matters: Rankings within Fund Families and Fund Inflows," *Journal of Business Finance & Accounting*, Vol. 35, Nos. 1 and 2 (January/March 2008): 177-199; Berk and Green (2004); and Diane Del Guercio and Paula A. Tkac, "The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds vs. Pension Funds," *The Journal of Financial and Quantitative Analysis*, Vol. 37, No. 4 (December 2002): 523-557.

[33]Kempf and Ruenzi (2008).

[34]Jain and Wu (2000).

(the highest rating) often experienced the largest increase in investor fund flows in the 6 months following the upgrade, with these funds receiving about 35 percent above normal expected flow.[35]

However, other evidence indicates that fund advertising may not overly influence investors' fund investment decisions. Some studies have found that investors do not use fund advertisements as an important information source in their fund purchase decision. One investor survey that surveyed a representative sample of about 2,000 Americans—both those that invest in mutual funds and those that do not—in September 2005 found that the vast majority regarded advertisements as either "not very" or "not at all" influential. The survey included mutual fund investors who purchase most of their mutual funds directly from the fund company or through a discount broker or fund supermarket; purchase most of their funds through a financial services professional, such as a broker or financial planner; and purchase most of their funds through a workplace-based retirement plan.[36] Some studies have shown that although investors use performance information when making mutual fund purchase decisions, they also utilize a variety of other information. For example, one study found that before purchasing a mutual fund, investors review, on average, nine pieces of fund information including fees and expenses, risks, and price per share.[37]

Further, investors have access to a great deal of information regarding mutual funds beyond the information contained in advertisements. Numerous mutual fund information sources exist including required disclosure documents—fund prospectuses and statements of additional information—that contain information on funds' investment objectives, risks, fees and expenses, and past performance; Web sites provided by industry research organizations; investment periodicals; and financial advisers. Additionally, investors' usage of the Internet also has grown over time, which has made access to performance and other fund

[35]Diane Del Guercio and Paula A. Tkac, "Star Power: The Effect of Morningstar Ratings on Mutual Fund Flows," Federal Reserve Bank of Atlanta, working paper 2001-15 (August 2001).

[36]Consumer Federation of America, *Mutual Fund Purchase Practices* (Washington, D.C., 2006).

[37]Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information*.

information easier. A survey by an industry trade group of 4,200 U.S. households—both those that own and do not own mutual funds—found that 9 of 10 households that own mutual funds have Internet access in 2010 and that almost 60 percent use it to obtain investment information.[38] Many mutual fund investors also use advice from financial advisers as an important source of information when considering which mutual funds to purchase. An industry survey showed that in 2006, 73 percent of recent mutual fund investors consulted a financial adviser before purchasing a fund. Another survey revealed that in 2010, about half of all mutual fund-owning households had used or had an ongoing relationship with, a financial adviser.[39]

Information from regulators also provides another indication that investors are not encountering misleading advertisements. We asked SEC and FINRA staff to review the complaints or inquiries each organization had received between November 2009 and April 29, 2011, to identify complaints or inquiries from investors or others on fund advertisements. Although these regulators had received over 50,000 complaints or inquiries during this 17-month period, they identified just 25 complaints or inquiries as possibly relating to misleading mutual fund or ETF advertisements during the period we reviewed, and after discussing the details of these complaints or inquiries with regulators, we determined that only 3 complaints appeared to involve misleading fund advertisements.[40]

Regulators Have Taken Steps to Address Some Critics' Concerns Related to Performance Advertising

Because of the concerns that have surrounded mutual fund performance advertising over time, SEC and FINRA have issued various mutual fund performance advertising rules and have amended them as new concerns have arisen. For example, SEC requires that all fund companies that use performance advertising use a standardized process for calculating performance and that, if a fund company chooses to advertise a fund's

[38]Investment Company Institute, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010* (Washington, D.C., 2010).

[39]Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* and Investment Company Institute, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010*, respectively.

[40]We reviewed complaints received by SEC between November 16, 2009, and April 29, 2011, and complaints received by FINRA between January 1, 2010, and March 31, 2011.

standardized performance, it must include the fund's 1-, 5-, and 10-year returns calculated as of the most recently ended calendar quarter. This rule facilitates the ability of investors to have consistent information for comparing returns among funds. In the late 1990s and early 2000s, the stock market experienced extraordinary returns but then dropped significantly. After seeing funds advertising returns reflecting only the period during which the market had risen, SEC staff became concerned that such advertising was misleading because it was using older performance data that did not always take into account recent market changes. To address this concern, SEC amended Rule 482 in 2003 to require that, among other things, fund companies provide investors access to more current information (the most recent month-end returns) through a toll-free number or a Web site. It also requires additional disclosures in advertisements that alert investors that a fund's past performance does not guarantee future results and that its current performance may be higher or lower than the performance being advertised. SEC also required that fund advertisements include a disclosure directing investors' attention to a fund's investment objectives, risks, and charges and expenses to address concerns that other fund information was being overshadowed by past performance information. In 2006, SEC approved amendments to NASD Rule 2210 to require that advertisements by broker-dealers containing performance information also include the fund's sales charges and annual operating expense ratio to help ensure that investors most interested in past performance information receive other important fund information. FINRA staff noted that helping to ensure that investors were aware of the funds' expense ratio was important because a fund's total annual operating expenses would affect its performance for as long as an investor held shares in the fund.

In addition to having detailed requirements about the content of fund advertisements, SEC and FINRA undertake investor education initiatives to help ensure that investors consider other factors besides past performance as part of their investment decisions. Both agencies maintain Web sites and issue publications aimed at educating investors about mutual funds.[41] Officials from both agencies stated that these materials include information about how past performance is not predictive of future performance. Both agencies also issue investor alerts

[41]See www.investor.gov and www.finra.org/investors/index.htm.

on topics that arise for which particular concerns may exist. Moreover, they also noted that they participate in numerous speaking engagements in which they reinforce the message that past performance is not predictive of future performance and that investors should consider other fund characteristics before purchasing a fund.

Limited Use of Performance Information in Advertising also May Limit Its Influence on Investors

The potential for investor harm also may be limited because advertising materials for mutual fund companies largely focus on issues other than performance. To determine the extent to which mutual funds were advertising performance, we selected and reviewed a random sample of 300 mutual fund and ETF advertising materials—including brochures, press releases, public Web site content pieces, print advertisements, radio, and television advertisements—out of the universe of about 71,000 individual pieces of such materials that FINRA determined to be compliant with applicable standards from calendar years 2006 through 2010. Because market conditions fluctuate, the results of our review of advertisements are not generalizable to periods other than 2006 through 2010. Based on this review, we estimate that 9 percent of the advertisements intended to be seen by the public had a primary focus on fund performance.[42] The advertisements that focused on performance used one or more types of performance-related information to try to persuade investors to purchase the product. For example, some highlighted the fund's positive performance by presenting the SEC standardized performance information for the past 1-, 5-, and 10-year periods. Other advertisements compared fund performance data with an industry benchmark. For example, one of these advertisements compared a fund's returns to the S&P 500 index and used language describing a fund as "ahead of the pack" while another advertisement stated that it "out-performed its primary benchmark" to focus attention on the fund's superior performance. Some advertisements also used ratings or rankings compiled by industry third-party data providers to illustrate the funds' superior performance compared with competitors. For example, such advertisements used language such as "our growth fund received a

[42]Because these estimates are based on a probability sample, they are subject to sampling error. All estimates from the sample in this report have a margin of error of plus or minus 10 percentage points or less. We selected the six delivery methods that investors might encounter without specifically seeking such information to include traditional methods of advertising. Appendix I contains a complete description of the methodology we used for the random sample.

4 out of 5-star Morningstar rating" or "our small cap fund was ranked number 1 by Lipper." Representatives from 7 of the 18 fund companies we interviewed explained that they were increasingly using fund rankings and ratings rather than presenting a fund's SEC standardized return to emphasize performance. Some of them explained that they believe investors want this type of information. In addition, the fund company representatives noted that presenting rankings allows them to illustrate the superior performance of a fund or group of funds relative to competitors' funds even during periods with declining market conditions.

Representatives from many of the fund companies we interviewed indicated that most of their advertising has not focused on performance information. Representatives from many of these companies explained that rather than focusing their advertisements on performance information, they instead are using advertisements more generally to educate investors about the types of products available. For example, rather than using advertisements with fund-specific content, their advertisements would explain how ETFs worked or describe the advantages and disadvantages of different products. Although performance may not be the primary focus of most fund company advertisements, fund company representatives stated that performance information is available to investors through a variety of materials, such as required disclosure documents and the Internet.

Based on our review, we estimate that 35 percent of all advertisements submitted to FINRA during 2006 through 2010 contained at least some performance information (for example, SEC standardized performance information, a rating or ranking, or a general description of a fund's performance).[43] Table 1 shows that the various ways in which performance was presented in these advertisements varied. For example, we estimated that of the 35 percent, 76 percent of these materials compared performance information with an industry benchmark and 70 percent contained SEC standardized performance information. Additionally, 31 percent presented rankings or ratings from third-party analysis services, and 27 percent used a graphic to display the performance information. For example, many used graphs depicting a line or bar showing a fund's returns over time as compared to a line or bar

[43]This estimated 35 percent of advertisements that contains at least some performance information includes the estimated 9 percent of advertisements for which fund performance was the primary focus.

depicting the return of a benchmark over that same period. Finally, 20 percent of the advertisements provided the information related to performance in more than one way. For example, an advertisement could include a rating, a ranking, and SEC standardized performance information.

Table 1: Ways in Which Performance Was Presented in Advertisements That Included Any Performance Information, 2006 through 2010

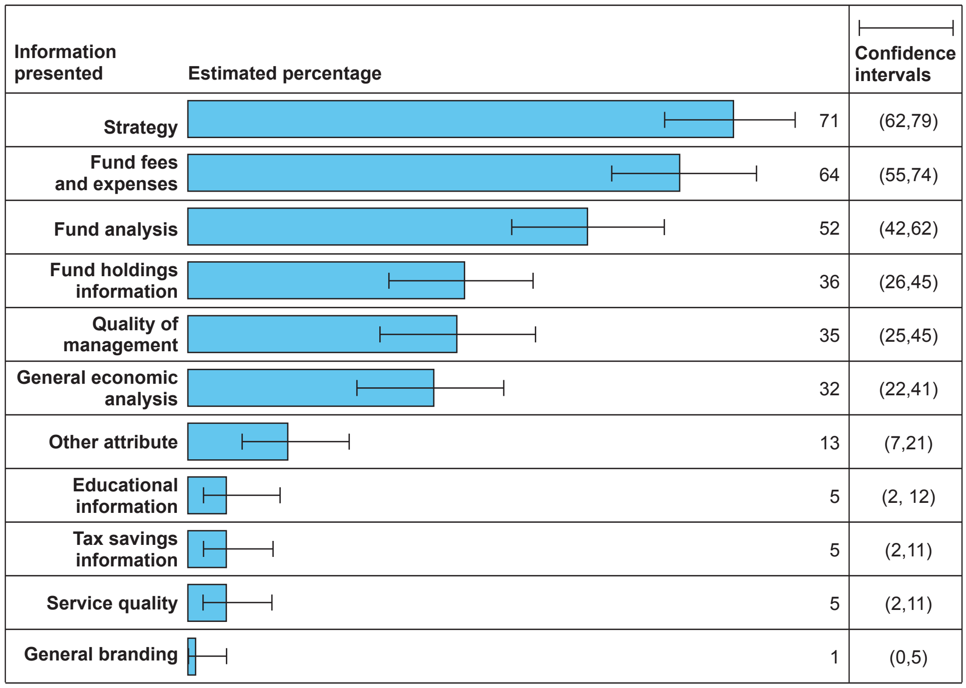
How performance was presented or illustrated in advertisements	Estimated percentage	Confidence intervals (percentage)
Performance benchmark	76	(66, 84)
SEC standardized performance information	70	(60, 79)
Ranking or rating	31	(22, 41)
Performance graphic	27	(19, 37)

Source: GAO analysis.

Note: These estimates are based upon a random sample. The percentages represent point estimates and the two-sided, 95 percent confidence interval.

Advertisements in our review that included performance information often also contained information on other fund attributes. For example, based on our review an estimated 71 percent of advertisements that included performance information also included information on the strategy of the fund. About two-thirds of the advertisements that included performance information also contained information on the fund’s fees and expenses such as the fund’s expense ratio. Advertisements that contained performance information also often explained factors that contributed to the fund’s returns (52 percent) and sometimes provided information on the fund’s portfolio holdings (36 percent). Figure 1 summarizes the other fund attributes found in advertisements that contain performance information.

Figure 1: The Prevalence of Types of Information Included in Advertisements with Performance Information, 2006 through 2010

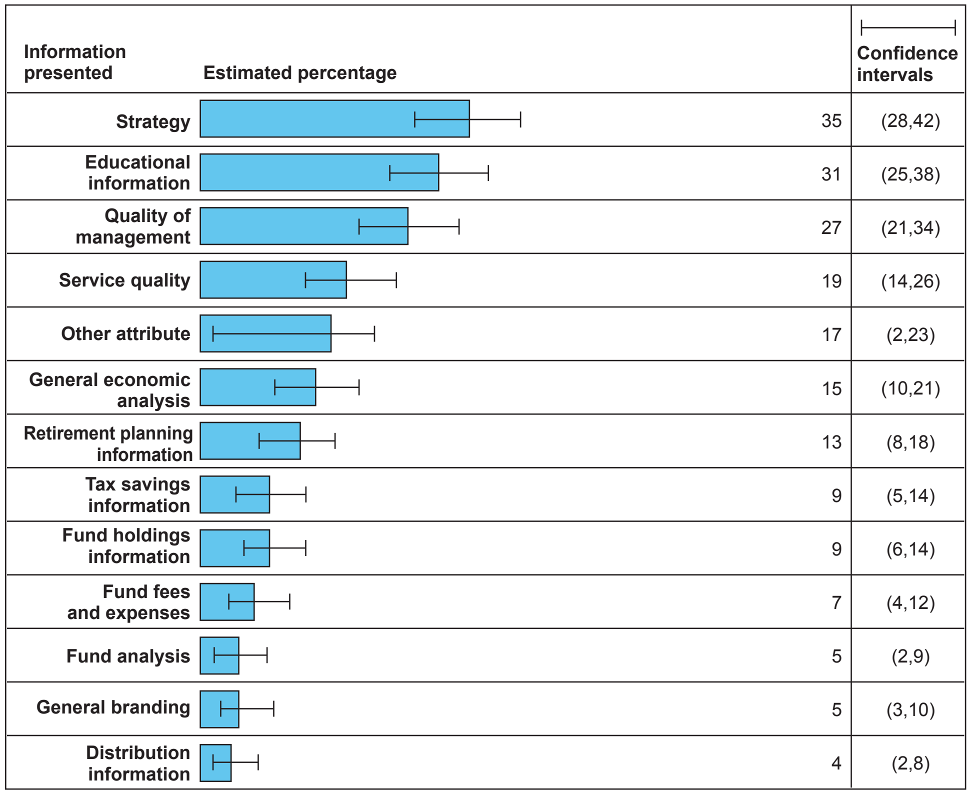


Source: GAO analysis.

Note: These estimates are based upon a random sample. The percentages represent point estimates and the two-sided, 95 percent confidence interval.

The remaining 65 percent of advertisements that we reviewed that did not contain performance information often emphasized other attributes related to the fund or the fund company. For example, about 35 percent focused on explaining the investment strategy for the fund. An estimated 31 percent provided general educational information, such as explaining recommended investment strategies and options for retirement saving. About 27 percent promoted the quality of the fund's managers. An estimated 19 percent emphasized fund company characteristics such as the quality of service or the wide variety of products offered. In addition, advertisements that did not include performance information sometimes provided general economic analysis (15 percent), such as the factors that influence the direction of the stock market or interest rates. Figure 2 summarizes the attributes of advertisements that do not include performance information.

Figure 2: The Prevalence of Types of Information Included in Advertisements without Performance Information, 2006 through 2010



Source: GAO analysis.

Note: These estimates are based upon a random sample. The percentages represent point estimates and the two-sided, 95 percent confidence interval.

Some Have Called for Changes in Required Disclosures in Advertisements and Others Expressed Concerns That Such Disclosures Have Become Too Complicated

Concerns exist among some academics that the current SEC-mandated disclosures, which are aimed at dissuading investors from focusing on past performance, are not effective. For example, one academic study tested the effectiveness of the disclosure that must be made in advertisements under Rule 482, which requires, among other things, firms to include in the text of the advertisement that: (1) "past performance does not guarantee future results; (2) the investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost; and (3) current performance may be lower or higher than the performance data quoted."[44] To determine whether potential investors were sufficiently influenced by this required disclosure or whether other versions of such information were more effective, the study tested about 550 participants by showing them different versions of mock performance advertisements in which the disclosure statements varied in content and prominence. After viewing different versions of the disclosure, participants were then asked about their beliefs about the fund's future performance and their willingness to invest in the fund. The results indicated that the current disclosure required by SEC neither reduced participants' expectations about the fund's future performance nor their willingness to invest in the fund. However, the study found that participants who viewed a more strongly worded disclosure—one that informs investors that high fund returns generally do not persist—were more likely to disregard the advertised performance data. An official from FINRA's Office of Investor Education explained that the office has been considering conducting research to determine if disclosures can be used to encourage investors not to overly rely on past performance information. He added that such research could help inform regulatory changes.

Because of the concerns over the effectiveness of disclosures required to be made in advertisements containing performance information, some academics and others have called for various changes. To prevent investors from inappropriately investing in funds that advertise high performance that is not likely to be repeated, some academics with whom we spoke instead would prohibit fund companies from showing performance information in advertisements. According to these academics, the current disclosures that warn investors that past performance is no guarantee of future performance are not enough to fully ensure investors are adequately protected from timing investments poorly. While recognizing that performance information still would be available to investors through other sources such as fund prospectuses and third-party research providers, they argue that at least some investors who use performance advertisements no longer would be aware of a fund's high performance if performance advertising were prohibited. Additionally, they argue that, although SEC requires past performance in the prospectus, that document is different from a performance

[44]Molly Mercer, Alan R. Palmiter, and Ahmed E. Taha, "Worthless Warnings? Testing the Effectiveness of Disclaimers in Mutual Fund Advertisements," *Journal of Empirical Legal Studies*, Vol. 7, No. 3 (September 2010): 429-459.

advertisement because, in addition to performance information, a prospectus contains various other fund details so that an investor can make an informed decision. They also argue that investors who read prospectuses are likely to be more sophisticated than those who might decide to invest in a particular fund based solely on a performance advertisement. Another researcher told us that SEC's standardized performance requirement—which requires that fund companies that choose to advertise specific returns for their funds show the 1-, 5-, and 10-year returns—should not include the 1-year return. He explained that the shorter the performance period, the higher the risk the returns are outliers and, therefore, not meaningful information for investors. He suggested replacing the currently mandated 1-year returns with 3-year returns.

Representatives from some fund companies expressed concerns that adding different or more disclosures would not help investors. For example, some indicated that current disclosures already were voluminous. A representative from one fund company told us that as regulatory changes have occurred, additional disclosure requirements were added for advertisements. However, none were removed, resulting in advertisements with so much information that investors are distracted by the information provided. For example, based on our review, we estimate that performance advertisements contain an average of 31 sentences of disclosure. One performance advertisement we reviewed had 102 disclosure sentences. Representatives from some fund companies told us that keeping disclosure requirements simple was important for preventing investors from ignoring the information entirely. While performance advertisements are required to disclose key information about a fund, representatives from some firms argued that fund advertisements should not be considered the primary or only source of information available to investors for a fund and need not contain as much information as currently is required. Representatives from many firms also told us that the number of required disclosures affected their decisions on what types of advertisements to develop because of space restrictions or readability. One fund company representative told us that for certain performance advertisements, additional content might be appropriate; however, they were prevented from including it due to the amount of space required for the disclosures.

Although the Regulatory Review Process Limits Potential for Misleading Advertisements, Communication of Rule Interpretation Changes Has Been Uneven

FINRA Reviews Fund Advertisements Intended for Public

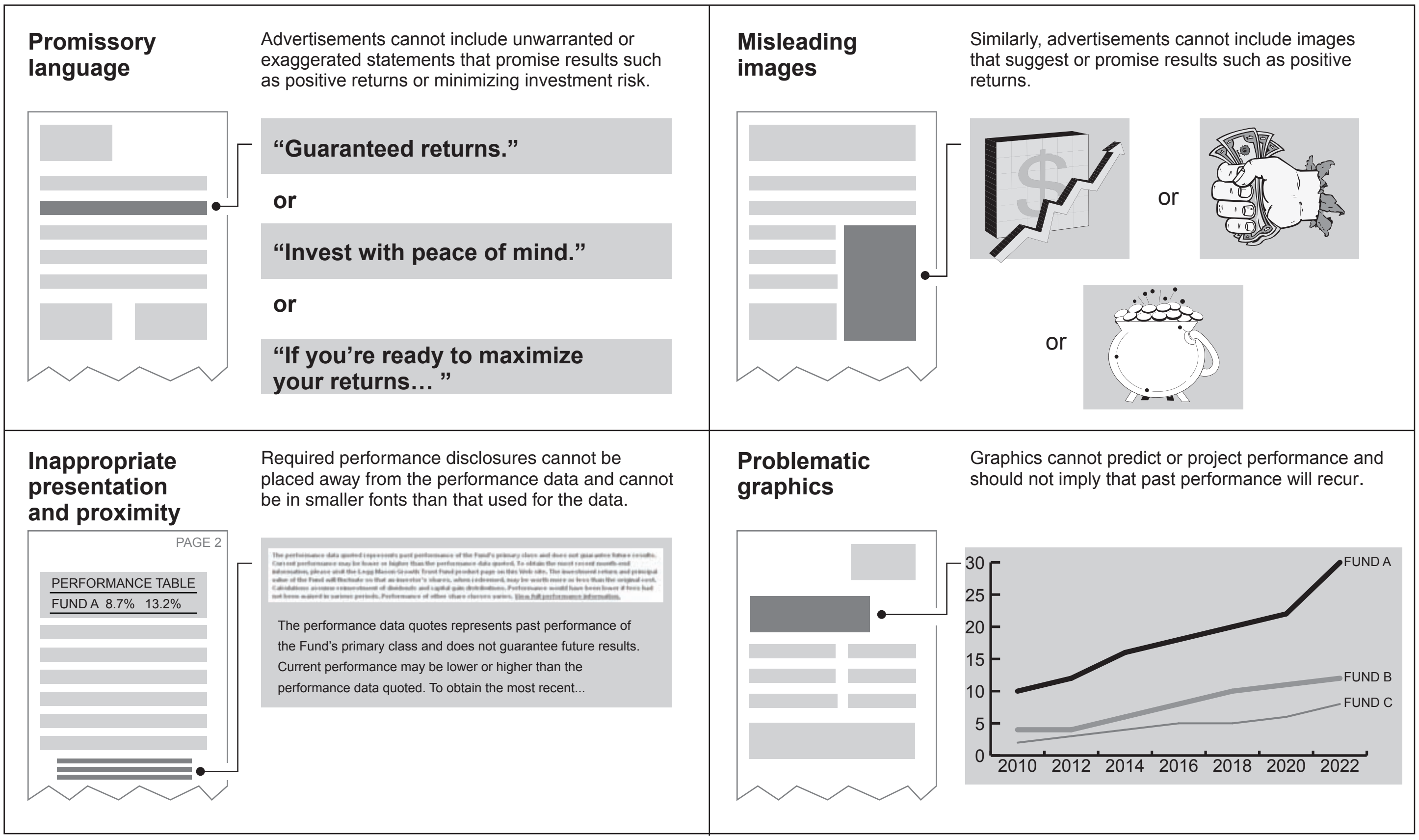
As part of its investor protection responsibilities, FINRA reviews advertisements seen by the public or provided to potential investors by broker-dealers. Under NASD Rule 2210, broker-dealers—including those that distribute mutual fund shares—must generally submit fund advertisements to FINRA for review within 10 business days of first use. Although this allows such firms to provide fund advertisements after they have been seen by the public or broker-dealers' customers, many firms file such materials before using them as a business practice.[45] Representatives from several firms with whom we spoke said that they pre-filed fund advertisements because the broker-dealers and financial advisors that sell their funds wanted documentation that FINRA reviewed their materials for compliance with applicable standards. Some mutual fund firm representatives whose firms did not always file all fund advertisements before first use told us that they instead pre-filed fund advertisements that were more costly to create, such as television commercials or new print ad campaigns. They did so to ensure that these materials would receive regulatory review before they were finalized and to avoid having to make costly changes later.

[45]Among other types of materials, institutional sales materials—or materials intended to be used only with institutional investors, such as broker-dealers registered with FINRA or qualified employee benefit plans—are not required to be filed with FINRA for review. Firms that have been members of FINRA for less than 1 year must file all advertisements 10 days prior to first use. According to FINRA guidance to its members, a review takes about 3 weeks.

To conduct the fund advertisement reviews, FINRA's Advertising Regulation Department has a centralized and standard process for reviewing all fund advertisements that are filed. In 2010, FINRA reviewed more than 77,000 fund advertisements and other materials relating to mutual funds and ETFs. As of June 2011, FINRA's Advertising Regulation Department consists of about 65 staff persons, with about 25 analysts and 11 supervisory staff dedicated to conducting reviews. On average, each analyst reviews between 250 and 300 pieces per month. The majority of firms submit their materials electronically through FINRA's Web-based system, although FINRA also accepts hard copies of materials.[46] FINRA analysts review materials filed to see if they comply with SEC and FINRA advertising regulations and to help prevent the use of misleading fund advertisements, including those that misuse performance information. For example, analysts review fund advertisements to ensure that all required disclosures are present and that prohibited features (such as language that promises positive returns) or images or charts that are misleading (such as a hypothetical illustration that projects positive performance of a fund) are not included. Because firms must submit filings that present the performance of a fund to SEC as part of other regulatory requirements, FINRA officials stated that they rely on the performance information provided by firms and that they do not recalculate performance figures. However, analysts do verify that any mutual fund rankings and ratings presented in the fund advertisements, such as those provided by industry third-party data providers, are accurate. Figure 3 illustrates the types of information FINRA examines when conducting its review.

[46]Firms must pay a $100 fee for filing advertisements (for up to 10 pages) or $500 fee (for up to 10 pages) for an expedited review, in which FINRA generally will provide a review letter within 3 to 4 business days.

Figure 3: Examples of Components of Advertisements That Would Not Be Found Compliant with Applicable Standards



Source: GAO; Art Explosion.

After completing a review of fund advertisements, FINRA analysts transmit a letter to the submitting firm generally indicating either that the material appears to be consistent with applicable standards or it needs revisions to be compliant.[47] If a submission is found not to be compliant, the FINRA analyst will provide comments in the review letter identifying which rules the material violates and whether it can be revised or should

[47]Firms can currently receive four other types of determinations in review letters: (1) FINRA has a minor comment, but the advertisement does not require revisions; (2) FINRA does not have jurisdiction over the firm or product and therefore is not able to provide a review; (3) FINRA needs more information before it can provide its review; and (4) FINRA tells a firm to not use an advertisement—for pieces that contain significant problems–and requires the firm to respond in writing how they plan to address the situation.

not be used at all. According to FINRA data, from 2006 through 2010, only about 14 percent of materials required revisions and less than 1 percent were not approved for use. A FINRA official explained that the percentages of noncompliant materials were low because firms have been required to submit materials for many years and have gained experience in what is required and what should not be included in materials. In addition, firms are required to have internal approval on any material prior to use and submission to FINRA, which also serves to help ensure that most materials are compliant with applicable rules. This approval must be completed by a fund company's registered principal—generally an officer of the fund company who has passed examinations administered by FINRA demonstrating competence in federal securities laws, rules, and regulations. Additionally, representatives from many of the firms with whom we spoke told us that before they submit materials for official review they frequently call to discuss issues with FINRA staff, such as when they are uncertain if the information they want to use in an advertisement complies with rules and regulations. FINRA officials stated that firms and their representatives can face significant repercussions for not complying with FINRA comment letters that require revisions, including fines and being barred from the industry.[48]

Although FINRA Has Controls in Place for Advertising Reviews, Some Firms Expressed Concerns about the Consistency of Some Reviews

Although representatives of the mutual fund firms with whom we spoke were generally satisfied with their interactions with FINRA staff, some noted concerns related to the reviews of advertising materials by FINRA analysts. Over three-quarters of the 18 fund company representatives with whom we spoke generally were satisfied with their interactions with FINRA—with some fund companies stating that FINRA analysts were open to discussing their comments or willing to answer questions when firms were developing new materials. Three of the firms added that, when needed, they were able to discuss issues with higher-level management in FINRA's Advertising Regulation Department. Furthermore, some fund company representatives specifically stated that they were pleased with the overall review process.

Representatives from many firms told us that they sometimes received inconsistent comments from FINRA on materials. They explained that in

[48]Representatives of firms—including principals—are generally registered with SEC and FINRA. Representatives who are barred from the industry receive a permanent expulsion from associating with a FINRA member firm in any or all capacities.

some cases when they made minor updates to materials that had been previously filed and deemed compliant and re-filed it with FINRA, they subsequently received comments on portions of the material that had not been changed. In some cases, the representatives stated that this occurred when there had been a change in the FINRA analyst to whom they were assigned. Some firm representatives acknowledged that part of the inconsistency might result from the subjective nature of the advertising rules. For example, FINRA rules set general content standards that advertisements must be fair, balanced, and not misleading. However, because the rules do not prescribe what is considered fair, balanced, and not misleading, what one FINRA analyst interprets as meeting these standards may be different than what another analyst deems appropriate. For example, an industry representative stated that FINRA interprets what constitutes a fair and balanced advertisement on a case-by-case basis, which sometimes can lead to problems because one firm's material may be deemed compliant, while another firm's may not.

FINRA acknowledges the challenge of consistency in its reviews and has developed quality control procedures to improve the level of consistency in the application of rules. Due to the volume of materials reviewed, FINRA supervisors reviewed the work of their analyst staff on an average of about 12 percent of materials in 2009 and 2010. To compensate for this low level of supervisory review, FINRA has other quality controls in place, including supervisory review of all new analysts' work. Additionally, supervisors conduct monthly checks of each analyst's work to assess whether the analysts are appropriately and consistently applying the rules. FINRA also has developed a standard checklist that contains step-by-step instructions and lists all requirements and rules that analysts can use as they conduct their reviews. Moreover, FINRA also maintains and regularly updates a "watch list" of topics of industry concern that it is following. If an advertisement contains an item that is listed on the watch list, FINRA requires that analysts bring the material to their supervisor for additional review and approval before the review letter can be released to the firm. Nearly all staff have industry certifications and all new staff, regardless of their level of industry experience, go through a standard training course and receive ongoing training on emerging issues. Finally, FINRA's Advertising Regulation Department has regular staff meetings and issues memoranda and other communications that discuss consistency issues management has identified.

In addition to the Advertising Regulation Department's quality control procedures, FINRA's Office of Internal Audit and SEC review the department's operations. For example, the Office of Internal Audit conducts a comprehensive review of the Advertising Regulation Department about every 3 years—most recently in 2005 and 2008—which includes a review of department processes and procedures, general operations, and its Web-based system and database. SEC also oversees FINRA's efforts by conducting periodic oversight examinations, the most recent in 2006. During these examinations, SEC reviews policies, procedures, and staffing resources and also reviews a sample of fund advertisements to help ensure that FINRA is appropriately and consistently enforcing advertising rules and regulations.

FINRA Lacks Sufficient Mechanisms for Communicating New Rule Interpretations to Industry

Based on information we collected, FINRA lacks sufficient mechanisms for ensuring that new interpretations of existing rules are communicated evenly to all fund companies. The mutual fund firms we interviewed expressed concerns about the evenness of how FINRA communicates changes in interpretations of advertising rules. Currently FINRA communicates such changes to fund companies in a variety of ways. First, it can issue new rules, which are legal changes to existing requirements. New rules go through an official proposal and review process in which public comments are made and then considered as part of finalizing the rule. Second, FINRA publishes regulatory notices to provide guidance to firms. For example, notices have provided information on new advertising requirements or the usage of social media in advertising. Third, FINRA officials state that they orally alert the industry to new rules and requirements or changes in rule interpretations through various public speaking arrangements and annual FINRA conferences. For example, FINRA's Advertising Regulation Department holds an annual conference during which it dedicates one session to discuss regulatory developments that have occurred throughout the year. Representatives from some firms with whom we spoke said they thought that this conference was useful because it gave them an opportunity to learn about new issues, rules, and requirements. FINRA officials also told us that they offered a number of industry training events, including online learning courses, Web casts, and pod casts.

Finally, a FINRA official and representatives from many firms with which we spoke told us that FINRA also uses individual firm comment letters from its advertising review process to communicate recent interpretive positions. For example, FINRA staff recently identified concerns about mutual fund firms that would start a new fund and then create hypothetical returns by comparing the fund's investment strategy with historical data to show how the fund would have performed had it been in existence. The FINRA staff decided that such information—known as hypothetical back-tested data—was misleading because investors might believe that the hypothetical returns represented actual fund performance and likely would recur. However, in this and other instances in which FINRA changed how it interpreted the advertising rules, it did not publicly disseminate any written guidance about these interpretive positions. Instead, FINRA began alerting firms and implementing the change through individual comment letters.

However, relying on comment letters to communicate such new rule interpretations could increase the potential for investors to be exposed to misleading advertisements. FINRA is responsible for helping to ensure that its rules are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors.[49] The review of fund advertisements fulfils a part of this responsibility and is intended to assist in preventing misleading advertisements from becoming available in the marketplace. However, many firms expressed concern with the unevenness that results from FINRA communicating changes to rule interpretations using the comment letter process. For example, firms that submitted advertisements for FINRA review that contained unacceptable information, based on a new interpretation would receive a comment letter explaining the new interpretation and would have to revise their materials. However, firms that were using older, previously reviewed advertisements containing information in conflict with the new interpretation would not be aware of the change and could continue using it. This uneven method of communicating new rule interpretations can result in investors being exposed to advertising that does not meet current interpretations and may be considered misleading.

In addition, this uneven mechanism for communicating new rule interpretations can also lead to competitive advantages or disadvantages for firms. Because only firms submitting materials after the FINRA staff develop their new rule interpretation may learn of it through comment letters, other firms that have submitted materials previously may be continuing to use advertisements with material that now would not be considered acceptable under the new interpretation. As a result, these firms might have a competitive advantage over firms required to comply

[49] Section 15A(b)(6) of the Securities Exchange Act.

with the new interpretation because investors might choose the funds being advertised using older content that other firms have been prohibited from using. Additionally, by not making all firms aware of new rule interpretations more broadly, some firms might incur additional expenses when they developed and submitted materials without knowledge of the new changes. The firms then would have to make revisions after finding out these materials no longer complied with the new interpretations.

FINRA officials noted that rule interpretation changes arise because while the advertising rules were developed many years ago, the industry is constantly changing and developing new products and new ways to market them. They noted that when they see new concerns arise, they believe the most efficient way to address them is to alert the firm directly in the comment letter. However, by not taking steps to more fully ensure that all industry members are concurrently aware of new interpretative positions, other firms may be continuing to use advertisements with information that FINRA now considers as potentially misleading to investors. In fact, representatives from some firms with whom we spoke told us they were not aware of some new interpretative positions and learned of them, not through FINRA, but through other firms, industry connections, or the media.

FINRA and SEC Conduct Additional Oversight and Enforcement of Fund Advertisements

FINRA and SEC also conduct additional oversight activities to help identify advertising concerns that may not be caught during FINRA's advertising review process. For example, the Advertising Regulation Department conducts sweeps, which are targeted examinations that focus on specific emerging issues. In June 2010, FINRA conducted a sweep on 19 firms that sell products similar to ETFs, but unlike most ETFs, are not registered as investment companies. During this sweep, FINRA requested and reviewed advertising materials for these products and found that the advertisements did not adequately balance information about risks and potential benefits of these products under FINRA rules.[50] For example, a commodity ETF that invests in gold must identify that precious metals are subject to volatile price changes. An advertisement that did not explain this risk and discussed only the potential benefits of

[50]The examination is now closed and the department made one referral to pursue disciplinary action. In September 2009, FINRA issued Regulatory Notice 09-55, which, among other things, proposes that communications on these types of products be filed with FINRA.

gold would be considered misleading. FINRA addresses concerns found during sweeps by issuing new requirements or guidance, if necessary.

Additionally, FINRA conducts routine risk-based examinations of broker-dealers through the member regulation program to determine if firms are in compliance with federal securities laws, rules, and regulations. These examinations may include a review of a firm's advertising material, if deemed appropriate. FINRA also investigates allegations of wrongdoing by investigating customer complaints, tips, or other indications of rule violations.

When necessary, FINRA undertakes disciplinary actions against firms and individuals for violations of FINRA rules; federal securities laws, rules, and regulations; and other related securities rules. According to FINRA officials, during 2006 through 2010, 34 formal disciplinary actions were taken against FINRA regulated member firms that advertised funds (32 concerning mutual funds and 2 concerning ETFs) for advertising materials. For example, one company that was alleged to have misleading and exaggerated advertising claims and to have omitted material information including rankings criteria in television and Web site advertisements agreed to a settlement without admitting or denying the allegations and, among other things, was fined $20,000.

In addition to FINRA's oversight, SEC also conducts activities related to the review of fund advertisements. For example, SEC conducts risk-based examinations of mutual fund companies during which advertisements may be reviewed. SEC officials told us that if during the scoping of an examination they found that a mutual fund was advertising unusually high returns, they might include a review of advertising in the examination. SEC also may decide to review advertising during an examination if its staff notice unusual practices in a firm's advertisements, if concerns are raised during an examination of another fund company, or if it receives a referral from FINRA. If advertising violations are found during an examination, SEC can take enforcement actions. Officials told us that between 2000 and early 2011, they took five formal enforcement actions related to fund advertisements.

Conclusions

Because tens of millions of Americans invest in the shares of mutual funds, ensuring that they receive fair and objective information and are not misled by the advertising for such funds is an important regulatory goal. Some academics have suggested that the use of performance information in fund advertisements could overly influence investor choices. However, evidence from existing academic research was mixed regarding the extent to which fund performance persisted and the extent to which investors relied on performance information. In addition, the potential for investors to be harmed by performance advertisements also appears reduced by other factors. First, relatively few advertisements tend to focus primarily on performance information. Second, as more fund information is available on the Internet and more investors access it, investors increasingly have other sources beyond advertisements to consider as part of making fund purchase decisions. Third, securities regulators have continued to refine rules to help ensure that advertisements do not include misleading information and employ an established review process for advertisements.

Although mutual fund companies generally were satisfied with their interactions with FINRA review staff, FINRA has not, in all cases, effectively communicated its new interpretations of existing rules to the industry. Over time as new advertising practices or concerns arise in the marketplace, FINRA staff expectations of what content should be excluded or how it should be presented can change. However, when communicating these rule interpretation changes through formal comment letters only to the individual companies that submitted affected materials, awareness and compliance with new interpretations could be limited. By developing additional ways to better ensure that all fund companies are notified of new interpretative positions for advertising material, FINRA could help decrease the potential for some fund companies to have an unfair competitive advantage over others by using inappropriate advertisements. Moreover, the effective communication of such information across the industry also would decrease the potential for investors to be misled.

Recommendation for Executive Action

To help ensure that investors are better protected from potentially misleading advertisements, the Chairman, SEC, should take steps to ensure FINRA develops sufficient mechanisms to notify all fund companies of new interpretations of existing rules that arise during the course of FINRA's regulatory reviews of advertisements.

Agency Comments and Our Evaluation

We provided a draft of this report to DOL, FINRA, and SEC. DOL did not provide written comments. FINRA and SEC provided written responses, which are reprinted in appendixes II and III, respectively. DOL, FINRA, and SEC also provided technical comments, which we have incorporated where appropriate. In her letter, the SEC Chairman noted that because millions of Americans invest in mutual funds, an important regulatory goal is to ensure that investors receive fair and objective information and are not misled by fund advertisements. She stated that she remains committed to considering changes to SEC's advertising regulations, such as its target date retirement funds proposal, in order to reduce the potential for investors to be misled by fund advertisements and ensure that fund advertisements appropriately communicate information to potential investors. She also stated that she believes that uniform dissemination of regulatory positions tends to enhance compliance, thereby furthering investor protection. She plans to request that FINRA review its methods for disseminating new interpretations of its fund advertising rules and has asked SEC staff to work with FINRA, as needed, in developing mechanisms to enhance transparency in this area and to consider our findings as part of SEC's ongoing oversight of FINRA.

The executive vice president of FINRA's Regulatory Policy department noted that FINRA has begun to take steps to address the points in our report. First, FINRA intends to publish, through a *Notice* or other means, any significant new interpretation of the advertising rules that affects a broad section of the industry. Next, FINRA will develop mechanisms to provide regular summaries of advertising issues and its interpretation of advertising rules to industry. His letter noted that these mechanisms may include regular letters or webinars to advertising compliance contacts at firms. Additionally, he stated that during regular Advertising Regulation Department manager meetings, FINRA managers will pay particular attention to whether interpretive issues affect a broad section of the industry and determine if a *Notice* or other industry guidance should be issued. He also stated that these steps will help to ensure that firms are aware of their compliance requirements, further investor protection, and reduce the possibility of competitive advantage to firms that continue to use inadvertently noncompliant materials.

We are sending copies of this report to the Chairman, SEC; Chairman and Chief Executive Officer, FINRA; the Secretary of Labor; and interested congressional committees. The report also is available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or cackleya@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

Alicia Puente Cackley
Director, Financial Markets
and Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives were to examine (1) what is known about the impact of mutual fund advertisements on investors, (2) the extent to which performance information is included in mutual fund advertisements, and (3) the regulatory requirements that exist for mutual fund advertising and how they are administered and enforced. Our review included mutual funds and exchanged-traded funds (ETF), which are investment companies whose shares, unlike those of mutual funds, are traded throughout the day on stock exchanges at market-determined prices that constantly fluctuate. We included ETFs in our review because of their increasing popularity as investment vehicles.

To examine what is known about the impact of fund advertisements on investors, we conducted a literature review of existing studies and reports, including those related to:

- investors' use of past performance information in fund purchases;
- the persistence of fund performance;
- the flow of funds into mutual funds with high returns;
- the impact on investors' returns from purchasing recent high-performing mutual funds;
- the effectiveness of existing regulatory disclosures; and
- the importance of various information sources, including advertisements, in investors' selection of funds.

To identify existing studies and reports, we first conducted focused Internet searches. We also conducted searches of several databases of business and financial academic research, including Proquest, EconLit, Gale Group, BAMP, and SciSearch, using key words to link advertisements, mutual funds, performance data, regulations, impact, and investor protection concepts for studies generally between the 1970s and 2010. We then reviewed the bibliographies of reports obtained to identify additional material. Furthermore, we asked for recommendations for studies, reports, and articles from academic experts and from representatives of organizations that address issues related to mutual fund advertising. We limited our review to only those studies that were conducted in the United States, to ensure that the funds were subject to the same mutual fund and advertising laws, rules, and regulations. Each of the documentary sources cited in our report was reviewed for methodological strength and reliability and we ultimately determined 50 studies were sufficiently reliable for our purposes. We performed our searches from October 2010 to May 2011. We also interviewed representatives and gathered documents from federal agencies, academics, representatives of industry investor protection groups, and fund companies about the impact of performance advertising on investors.

To assess the extent to which performance information is used in advertising, we first reviewed a nongeneralizable sample of 201 mutual fund and ETF advertisements submitted to the Financial Industry Regulatory Authority (FINRA) between January and November 2010 to understand the different types and formats of advertising material. Our sample consisted of a selection of five advertisements from each of the 21 FINRA-classified advertising delivery methods for both mutual funds and ETF advertisements.[1] For each advertisement, we collected information on whether the advertising materials contained performance information and identified the other types of information they contained. From this review, we then identified 6 of the 21 delivery methods classified by FINRA—brochures, press releases, public Web site content pieces, print advertisements, radio, and television advertisements—that generally contained performance information and that retail investors were more likely to encounter in their daily activities. Next, we selected a stratified random sample of 300 fund advertisements (out of a population of 71,087) that were deemed compliant with applicable standards by FINRA during calendar years 2006 through 2010, which was the period for which FINRA data was available. We stratified the population into five strata based on the year the advertisement was submitted to FINRA and

[1]For some delivery methods, five advertisements were not available because fund companies had not submitted advertisements to FINRA for review for each of the 21 categories in 2010. FINRA classifies advertisements and sales materials that they review into 21 delivery methods: account statement-related communications; articles and third-party reprints; material for broker-dealer use only; brochure; audio/video tapes (CDs and DVDs); electronic messages (e-mail, instant messages, and text); fund fact sheets (fund-specific information sheets); handouts (flyers and other hand-delivered material); mailings; performance reports (periodic and other performance reports such as an annual report); telephone (telemarketing and other telephone scripts); press releases; print advertisements, posters and signs; radio advertisements and broadcasts; research reports (equity and debt research); seminar-related communications; software output and tools; stationery; television advertisements and broadcasts; Web site information–password protected; and Web site information-publicly accessible (Internet advertisements and materials posted to fund company Web sites).

selected a sample of 60 advertisements within each stratum. Because market conditions fluctuate, the results of our review of advertisements are not generalizable to periods other than 2006 through 2010. Table 2 provides a description of the strata sample sizes and the distribution of the sample across the six chosen delivery methods.

Table 2: Stratified Population of Advertisements Submitted to FINRA and Sample Sizes of GAO Review

Year	Population size	Brochure	Press release	Print ad	Radio	Television	Web site	Sample size
2006	10,551	23	2	3	0	0	32	60
2007	10,989	22	4	4	0	0	30	60
2008	14,660	17	0	2	0	0	41	60
2009	15,576	13	1	2	1	1	42	60
2010	19,311	12	1	3	0	0	44	60
Total	**71,087**	**87**	**8**	**14**	**1**	**1**	**189**	**300**

Source: GAO analysis of FINRA data.

For each of these advertisements, we determined whether the advertisements contained performance information, whether performance or some other characteristic was the primary information being emphasized in the advertisement, how performance information and disclosures were presented, and what other types of information were contained in fund advertisements. We considered an advertisement to have had any type of performance information if it included general statements about the fund's returns (such as if the fund had a positive performance in a quarter); standard performance data showing the fund's returns for 1-, 5-, and 10-year periods; and independent third-party data providers' ratings or rankings.[2] We considered performance to be the emphasis of an advertisement if it was the predominant focus of the accompanying text and the graphics. For example, an advertisement containing information only on a fund's third-party rating or presenting its 1-, 5-, and 10-year Securities and Exchange Commission (SEC) standardized return. We do not report information on the type of mutual fund (for example, stock, bond, money market, or balanced) or ETF that was being advertised in the advertisements we reviewed because FINRA's Advertising Regulation Electronic Files (AREF) system does not maintain this level of detail on advertisements. Therefore, we would have

[2]The Securities and Exchange Commission requires standard performance to be in the format of average annual total returns for 1-, 5-, and 10-year periods.

been unable to determine a stratified random sample based on the type of fund being advertised. Had we been able to collect this type of information, we may have found that different patterns of performance information or other attributes existed by type of fund.

The results of the sample are only generalizable to the 71,087 advertisements for the six delivery methods we included in our universe. Because we treated our review as a stratified random sample, we assumed our sample was only one of a large number that could have been drawn. Because each sample could have provided different estimates, we expressed our confidence in the precision of our particular sample's results as a 95-percent confidence interval. This is the interval that would contain the actual population value for 95 percent of the samples we could have drawn. As a result, we are 95 percent confident that each of the confidence intervals based on the advertisement review includes the true values in the sample population. All estimates from the sample in this report have a margin of error of plus or minus 10 percentage points or less.

We performed data reliability assessments for data used in our generalizable sample of the six advertising delivery methods. For example, we interviewed knowledgeable officials and conducted a "walk-through" of FINRA's AREF system, which maintains data on the advertisements reviewed by FINRA, to understand how data are entered and captured, what types of edit checks are included in the system, and the overall data reliability of the system. We also performed electronic testing and verified there were no duplicates in the full universe of advertisement data received for 2006 to 2010 on the six selected advertising delivery methods to ensure that the data were complete and consistent with previous summary data provided to us by FINRA. We discussed with FINRA officials reasons for any inconsistencies we found. To ensure that advertisements were properly classified by investment product and other advertisement attributes, we also compared FINRA's coding of data in its AREF system to the advertisements we reviewed in our nongeneralizable sample. We determined that the data were sufficiently reliable to perform our review and project our results to the six delivery methods in our population of advertisements.

Additionally, we selected and interviewed a nongeneralizable sample of 18 fund companies on the advertising practices they currently used, including performance advertising. Our selection of fund companies included the 10 companies that had filed the most mutual fund advertisements for review with FINRA in 2009, as well as the 5 companies that had filed the most ETF advertisements.[3] We also chose three fund companies (two offering mutual funds and one that offered ETFs) that filed lesser numbers of advertisements in 2009. Finally, we selected and interviewed three of five fund companies that were provided to us by the Investment Company Institute—the mutual fund industry's trade organization—which it had identified as likely to have relevant perspectives on this issue.

To address our third objective, we reviewed regulatory rules and requirements related to fund advertisements, including proposed Department of Labor, SEC, and FINRA rules and public comments received on those rules. We also interviewed SEC and FINRA officials to discuss the methods used to enforce advertising requirements and the process FINRA uses to review fund advertisements. We participated in a "walk-through" of FINRA's AREF system in which officials explained to us the processes in which advertisements are submitted to FINRA and how FINRA staff review and provide comments on advertisements to fund companies. We also attended the FINRA Advertising Regulation Conference in November 2010 to learn of new issues related to mutual fund advertising and observe how information is disseminated. Furthermore, we reviewed notices and other documents FINRA and SEC provided to fund companies and materials both agencies publish related to mutual funds and ETFs. Additionally, we interviewed fund companies to gather their opinions on existing regulatory requirements and experiences with FINRA's advertising review process. Finally, we spoke with SEC and FINRA officials on the types of enforcement actions taken and the number of complaints or inquiries they received related to mutual fund advertising.

We conducted our work from September 2010 to July 2011 in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[3]Because some companies file both mutual fund and ETF advertisements, 12 companies represented both the 10 most frequent mutual fund filers and the 5 most frequent ETF filers.

Appendix II: Comments from the Financial Industry Regulatory Authority

FINRA

Financial Industry Regulatory Authority

Thomas M. Selman
Executive Vice President
Regulatory Policy

July 11, 2011

Alicia Puente Cackley
Director
Financial Markets and Community Investment
United States Government Accountability Office
Washington, D.C. 20548

Dear Ms. Cackley:

Thank you for the opportunity to comment on the Government Accountability Office's (GAO) draft report concerning mutual fund advertising and regulatory requirements that apply to such advertising. The report provides a comprehensive overview of the uses of fund advertising, the academic studies concerning performance advertising, the extent to which investors rely upon performance advertising and the regulatory oversight of mutual fund advertising, particularly FINRA's advertising review program. As the report states, FINRA's review of mutual fund advertisements has helped to limit the potential for investors to be misled by mutual fund advertising.

The report identifies the SEC and FINRA as the primary regulators of mutual fund advertising and states that they have cooperated in carrying out their respective roles. The report noted the relatively small number of complaints received by both organizations related to mutual fund advertising. Additionally, the report indicates that the mutual fund firms contacted by GAO staff were generally satisfied with their interactions with FINRA staff.

Based on discussions with those firms, the report recommends that the SEC take steps to ensure FINRA develops mechanisms to notify all fund companies about new interpretations of existing rules. The report also states that some firms have complained that FINRA analysts have commented on portions of material that had been previously filed and deemed compliant. The report lists some of the quality controls that have enabled FINRA's Advertising Regulation Department to maintain an acceptable level of consistency in its review program. In addition to these quality controls, and in light of our conversations with GAO staff, FINRA has already taken the following steps to address these points:

- FINRA intends to publish, through a *Notice* to firms or by other means, any significant new interpretation of the advertising rules that affects a broad section of the industry. This approach will help us achieve the objectives in your report, such as ensuring that firms are aware of their compliance requirements, furthering investor protection and reducing the possibility of a competitive advantage to firms that continue using inadvertently noncompliant material. Pending the development of this publication or *Notice*, FINRA will apply any significant new interpretations of the advertising rules in our regular filings program.

Investor protection. Market integrity.

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www.finra.org

Alicia Puente Cackley
July 11, 2011
Page 2 of 2

- FINRA also will develop one or more mechanisms to provide a regular summary of advertising issues and its interpretation of the application of the advertising rules to these issues. For example, these mechanisms would include a regular letter to advertising compliance contacts in the industry and regularly scheduled webinars for these contacts.

- As the report indicates, FINRA's Advertising Regulation managers meet regularly to discuss important matters, including novel interpretive issues. Going forward, the managers will pay particular attention to the question of whether any of these issues affect a broad section of the industry and, if so, whether FINRA should issue a *Notice* or other guidance to the industry. We will also remind firms of their ability within the existing advertising filing system to alert their analyst about similar, previously filed material. This approach should help address the point raised by some firms about receiving comments on material that was previously deemed compliant.

We appreciate the constructive comments in the report, and we believe these actions will help address the important concerns that GAO has raised. We appreciate your review of these issues and the recommendations for how we can strengthen our advertising review program. If you have any questions, please do not hesitate to contact me at (202) 728-6977.

Sincerely,

Thomas M. Selman
Executive Vice President
Regulatory Policy

Appendix III: Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

July 15, 2011

Ms. Alicia Puente Cackley
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Ms. Cackley:

Thank you for the opportunity to comment on the draft report entitled *Mutual Funds: Improving How Regulators Communicate New Rule Interpretations to Industry Would Further Protect Investors*. The draft report responds to Section 918 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires the Government Accountability Office to conduct a study on mutual fund advertising.

The draft report examines what is known about the impact of fund advertisements on investors, the extent to which performance information is included in fund advertisements, and the regulatory requirements for fund advertisements and how they are administered and enforced. In preparing the draft report, GAO reviewed existing and proposed Commission and Financial Industry Regulatory Authority rules and requirements, conducted a literature review of existing studies and reports, and reviewed a random sample of 300 fund advertisements. GAO also met with regulators, fund companies, academics, and industry and investor protection groups.

As GAO observes in the draft report, because millions of Americans invest in mutual funds, it is an important regulatory goal that investors receive fair and objective information and are not misled by fund advertisements. The GAO found that, while some academic studies and others have suggested that fund advertisements that emphasize past performance can influence investors to make inappropriate investments, the evidence that investors are harmed by these advertisements is mixed. GAO noted, as a factor that reduces the potential for investor harm, the fact that securities regulators have continued to refine their rules to help ensure that advertisements do not include misleading information and employ an established review process for advertisements. I remain committed to considering changes to the Commission's advertising regulations, such as the Commission's target date retirement funds proposal, in order to reduce the potential for investors to be misled by fund advertisements and assure that fund advertisements appropriately communicate information to potential investors.

In its review, GAO also found that FINRA sometimes communicates new interpretations of existing advertising rules through formal comment letters to individual fund companies and that this practice could limit awareness of, and compliance with, new interpretations. To address this finding, the draft report recommends that the Chairman of the Commission take steps to

Ms. Alicia Puente Cackley
Page 2

ensure that FINRA develops mechanisms to notify the entire fund industry of new interpretations that arise during the course of regulatory reviews of fund advertisements.

Like GAO, I believe that the uniform dissemination of regulatory positions tends to enhance compliance, thereby furthering investor protection. The development by FINRA of additional mechanisms to notify the entire fund industry of new interpretations could decrease the potential for investors to be misled by advertisements. Therefore, I plan to request that FINRA review its methods for disseminating new interpretations of its fund advertising rules with a view to enhancing transparency of those interpretations. In addition, I have asked the Commission staff to work with FINRA, as needed, in developing mechanisms to enhance transparency in this area and to consider the GAO's findings as part of the staff's ongoing oversight of FINRA.

Thank you again for the opportunity to comment on this report.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Chairman

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Alicia Puente Cackley, (202) 512-8678, or cackleya@gao.gov

Staff Acknowledgments

In addition to the individual named above, Cody Goebel, Assistant Director; James Ashley; Tania Calhoun; Barbara Chapman; Christine Houle; Thomas McCool; Marc Molino; Barbara Roesmann; Kelly Rubin; Andrew Stavisky; Verginie Tarpinian; and Frank Todisco made key contributions to this report.

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