

Recommendation on Disclosure Effectiveness

As approved by Investor as Purchaser Subcommittee 4.6.20

Our securities laws rely extensively on disclosure to inform and protect investors. For example, public companies provide comprehensive information about their operations and finances so that investors, analysts, and other market participants can fairly value their shares. Mutual funds provide both summary and detailed information on their investment goals and strategies, costs, risks, performance history and more. Disclosures by investment advisers, and soon broker-dealers, describe the nature of their services and the terms on which those services are offered. Together, these and other required disclosures create the transparency on which our competitive securities markets depend, assist regulators in providing effective market oversight, and provide investors with the information needed to make sound decisions about both investments and investment professionals. Yet questions have repeatedly been raised over the years about the effectiveness of those disclosures, particularly disclosures that are aimed at and relied upon by retail investors, in conveying the information needed to support informed choice.

SEC Faces Considerable Challenges in Designing Effective Disclosures for Retail Investors

The problem of developing clear disclosures that consumers can understand is common across the financial services industry.¹ The Securities and Exchange Commission (SEC) faces a particularly daunting challenge in developing effective disclosures. The simple fact is that investment decisions are often complex.² The options available to investors are virtually limitless. Whether the investor is selecting a financial adviser or selecting an investment product, the factors to consider in an effort to identify the best or most appropriate option can be numerous and difficult to analyze.³ Legal requirements and liabilities exacerbate the problem, causing registrants, their lawyers and the SEC staff to add more detail to disclosures for the sake of completeness, even though the additional information may not always be relevant or helpful to the investor.

This is true even when the investor is selecting among fairly straightforward products and services. To select a mutual fund, for example, experts are nearly unanimous in recommending that investors consider the fund's investment objectives and strategies, risks, fees and expenses, past performance, including the volatility of that performance, the reputation of the fund manager, tax implications of an investment in the fund, and information about such account

¹ Angela A. Hung, Min Gong, and Jeremy Burke, Effective Disclosures in Financial Decisionmaking, RAND Research Report, July 2015, <http://bit.ly/2wbY000>.

² See, for example, Chater, Nick; Huck, Steffen; Inderst, Roman; and Goethe, Johann Wolfgang, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*, November 2010 (Coordinated by Decision Technology Ltd with participation by Online Interactive Research Ltd.) for a discussion of the vast choices and complex factors investors must weigh in making those choices.

³ See, for example, SEC 913 Study and RAND Study for a discussion of investors' inability to distinguish between brokers and investment advisers, the services they offer, and the legal duty they owe clients.

features as investment minimums.⁴ That is a daunting task, made more difficult by the fact that some of these factors – such as investment strategy and risk – can be difficult to convey in clear language that the investor is likely to understand. In recent years, more complex products and services have entered the retail marketplace, further complicating those choices. The more complex the product, the more difficult it becomes to convey the relevant information clearly.

Further complicating the SEC’s task is the fact that many investors lack relevant knowledge needed to fully understand the disclosures designed to help them make investment decisions. For example, a review of studies and surveys on investor knowledge, prepared by the Library of Congress for the SEC, found that many investors do not understand key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns.⁵ In 2008, RAND Corporation researchers studying the regulatory landscape for broker-dealers and investment advisers found that most investors who responded to their survey and participated in their focus groups, including those who had employed financial professionals for years, did not “have a clear understanding of the boundaries between investment advisers and broker-dealers.”⁶ In addition, surveys demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those with lower education levels, have an even greater lack of investment knowledge than the average person in the general population.⁷

In a white paper on retirement, Merrill Lynch describes the problem this way: “People find the language of finance confusing: Sixty-five percent of Americans say that most of the language used by the finance industry is not user-friendly. The world of financial instruments and strategies can be complicated, and many people’s ‘financial IQ’ isn’t high. Only six in ten of Americans age 50+ say they clearly understand the two terms most associated with saving for retirement—IRA and 401(k). Far fewer understand the process of asset decumulation or the problem of 401(k) leakage.”⁸ In short, the challenge the SEC faces is a daunting one: designing comprehensible disclosures about complex topics for individuals who lack expertise in the topic and are uncomfortable with the vocabulary of finance.

Many Investors Struggle to Understand Disclosures

The SEC has devoted considerable time and effort over the years to a good faith effort aimed at developing more investor-friendly disclosures. Despite those efforts, however, evidence suggests that many investors still struggle to understand the disclosures they receive about investments and investment professionals. Perhaps the most comprehensive study of this issue

⁴ Roper, Barbara, *Mutual Fund Essential Knowledge: What Do Investors Need to Know and What is the Best Way to Provide that Information?* (2005).

⁵ Seth L. Elan, Financial Literacy Among Retail Investors in the United States, A Report Prepared by the Federal Research Division, Library of Congress under an Interagency Agreement with the SEC, December 30, 2011, <http://bit.ly/2eK31CA>. See, also, FINRA Investor Education Foundation, *Investors in the United States 2016*, Dec. 2016, <http://bit.ly/2hMrppX> (“FINRA Survey”).

⁶ Angela A. Hung, et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*. Santa Monica, CA: RAND Corporation, 2008, <http://bit.ly/1OrrZ3v>.

⁷ Elan, *Financial Literacy Among Retail Investors*.

⁸ *Finances in Retirement: New Challenges, New Solutions*, A Merrill Lynch Retirement Study, conducted in partnership with Age Wave 2017 <https://bit.ly/34hJeD7>.

was conducted in 2012 on behalf of the SEC.⁹ That study included a number of questions designed to test investors' ability to understand a variety of common disclosures. The online surveys conducted for the study found, for example:

- Among survey respondents who reviewed a sample ADV Form, fewer than three in ten (28.9 percent) were able to correctly identify the likely amount they would be charged, based on the information presented in the exhibit they reviewed.¹⁰
- Among survey respondents who reviewed a sample confirmation for a mutual fund transaction, less than two-thirds (57.9 percent) could correctly identify the type of investment, and only 12.7 percent recognized that the financial firm was acting as a dual agent.¹¹
- Having reviewed a sample disclosure that begins as follows, “In addition to sales loads and 12b-1 fees described in the prospectus, we receive other compensation...,” just over half (54.8 percent) correctly answered a question about whether the firm gets compensation other than sales loads and 12b-1 fees.¹²
- After reviewing a sample chart providing information on additional payments the firm receives from mutual fund companies, only 31.8 percent indicated they definitely knew what the term “annual asset fees” meant, and another 46.2 percent indicated they thought they knew what it meant.¹³ Survey respondents were generally unable to determine the significance of the information provided.¹⁴

These findings are consistent with other research conducted on behalf of the SEC to test individual disclosures. In 2005, for example, focus group tests conducted by Siegel & Gale LLC of a proposed disclosure for fee-based brokerage accounts concluded that the proposed disclosure left investors “confused as to the differences between accounts and the implications of those differences to their investment choices.”¹⁵ More recently, RAND Corporation testing of the proposed Customer Relationship Summary (CRS) for broker-dealers and investment advisers found that, while investors generally viewed the disclosures favorably, many investors failed to understand key information that would help them determine whether a brokerage or advisory account would best suit their needs even after a careful reading of the CRS.¹⁶

⁹ Siegel + Gale, Investor Research Report, Submitted to the U.S. Securities and Exchange Commission, July 26, 2012 <https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part3.pdf>.

¹⁰ SEC Investor Research Report, page 89 and 91.

¹¹ Ibid, page 134.

¹² Ibid, page 172.

¹³ Ibid, page 277.

¹⁴ Ibid, page 278.

¹⁵ Siegel and Gale, LLC, and Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures: Report to the Securities and Exchange Commission, March 10, 2005, <http://bit.ly/2wXS331>.

¹⁶ Angela A. Hung et. al., Investor Testing of Form CRS Relationship Summary, prepared by the RAND Corporation for the Securities and Exchange Commission, Nov. 2018, <https://bit.ly/2QxcRfj> (“RAND 2018”). See, also, Letter from AARP, CFA, and the Financial Planning Coalition to SEC Chairman Jay Clayton, September 12, 2018, <https://bit.ly/2CXfz6W>.

Despite Improvements, Current Disclosures Often Fail to Match Investor Needs and Preferences

As the SEC financial literacy study and other research has shown, investors want disclosures that are brief, readable and delivered before they have to make an investment decision. The SEC study found, for example, that:

- Investors “favor summary documents containing key information about the investment product.”¹⁷
- Investors “prefer that disclosures be written in clear, concise, understandable language, using bullet points, tables, charts, and/or graphs.”
- Investors “prefer to receive disclosures before making a decision on whether to engage a financial intermediary or purchase an investment product or service,” ideally receiving that information far enough in advance to think about it before making a decision.

The Commission has adopted numerous improvements over decades of effort, including summary prospectuses for mutual funds, plain English requirements and comparison tools intended to address these concerns. However, investors still often receive long, densely worded documents – documents written by lawyers to comply with legal requirements – after they have already made the investment decision and, sometimes, after the transaction has already been completed.

For example, mutual fund prospectuses, fund shareholder reports, and ADV forms can all be dozens of pages long, and sometimes top 100 pages. Prospectuses for variable products are typically even longer. As a result, investors may end up feeling overwhelmed by the volume and complexity of the information they receive, and that may translate into confusion regarding the choices they face. According to a 2012 survey of investor sentiments, for example, 40 percent of investors believe investment products are “overly complex,” and 34 percent feel “overwhelmed” by the investment choices available to them.¹⁸

This directly undermines disclosure effectiveness, as research in the decision-making literature suggests that “consumers tend to reduce the amount of effort they expend when decisions become more complex.”¹⁹ Similarly, another study of the insurance market finds that, “More information may deflect attention from what is really important. A pervasive finding ... is that cue competition occurs: more salient cues weaken the effects of less salient ones, and the presence of irrelevant cues causes subjects to make less use of relevant cues. Introducing

¹⁷ Researchers who have tested disclosure documents with investors have reached similar findings. See, for example, Greenwald, Mathew, *Report on Consumer and Financial Advisor Reaction to Annuity Disclosure Documents: A Report on Seven Focus Groups and Four In-depth Interviews*, prepared for ACLI by Mathew Greenwald & Associates; also, ICI, *Investor Views*.

¹⁸ MFS Investments news release, “Complexity of Investment Products Overwhelming Investors” (May 7, 2012).

¹⁹ Agnew, Julie R.; Anderson, Lisa R.; Gerlach, Jeffrey R.; and Szykman, Lisa R., *An Experimental Study of Annuity Choice* (June 2008)

additional accurate information may therefore lead to worse outcomes.”²⁰ In other words, providing more information, even when that information is accurate and relevant, may actually cause investors to make less use of the information.

This creates a tension between the various purposes served by disclosure. Market transparency, accountability, and regulatory oversight depend on the full and fair disclosure of all material information that has characterized the Commission’s traditional approach. Moreover, investors may benefit from disclosures they do not read, if, for example, independent analysts and reporting services digest and summarize the material, thereby enabling investors to focus on key insights they might have otherwise missed. In some cases, the information required to be disclosed causes entities to avoid conduct that would be embarrassing if revealed. Similarly, comprehensive 10(k) disclosures by issuers lead to more accurate pricing of their securities, benefiting even those investors who do not review the 10(k).

But designing effective disclosures to assist retail investors in choosing a mutual fund or a financial professional may require a different approach. To address this concern, the Commission has experimented with the creation of summary disclosures in areas most important to retail investors in order to supplement the longer disclosure documents. The mutual fund summary and the CRS are two such examples. Most recently, the Commission adopted proposed rule to create a summary disclosure for variable products. Even where the Commission makes a good faith effort to create a plain English summary disclosure, however, better outcomes would be possible if the Commission were to incorporate basic principles of effective disclosure design into the development of these disclosures.²¹

Improving the Quality of SEC’s Retail Disclosures is an Achievable Goal

Designing effective disclosures for individuals who are not comfortable with the language of finance poses significant challenges. And there are limitations to what one should expect to achieve through disclosure alone.²² On the other hand, disclosure experts have learned a lot in recent years about how to design disclosures to increase the likelihood both that they will be read and that they will be understood. The IAC heard presentations on how to design effective disclosures from experts in the field at its September 19, 2019 meeting.²³ Although the panelists approached the topic from very different perspectives, there was broad agreement that it is possible to design clear disclosures of complex topics for a non-expert audience. There was also

²⁰ De Meza, David; Irlenbusch, Bernd; Reyniers, Diane; *Disclosure, Trust and Persuasion in Insurance Markets*, Institute for the Study of Labor (IZA), Discussion Paper No. 5060 (July 2010)

²¹ See, e.g., Hypothetical Initial Summary Prospectus for a Variable Annuity Contract, prepared by SEC Staff to illustrate its rule proposal, <https://www.sec.gov/rules/proposed/2018/33-10569-appendix-a.pdf>.

²² McCabe Curwood, Disclosure is Not Enough, Oct. 19, 2019 <https://mccabecurwood.com.au/disclosure-not-enough/>.

²³ We heard from the following panelists: Brenda J. Cude, Professor, Department of Financial Planning, Housing and Consumer Economics, University of Georgia; Billy Kingsland, Group Director, Brand Communication, Siegel+Gale; Dan Silverman, Rondthaler Professor of Economics, Arizona State University, Research Associate, NBER; Yuhgo Yamaguchi, VP, Design Strategy, Fidelity Labs, Fidelity Investments. Meeting webcast available here: https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac091919. Susan Kleimann also addressed this topic during an earlier panel discussion on the SEC’s proposed Form CRS June 24, 2018. The slides from her presentation are available here: <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac061418-slides-by-susan-kleimann.pdf>.

broad agreement, however, that improved disclosure design is only likely to be achieved if basic principles of effective disclosure are built in on the front end. The following are among the most important of these principles, as identified by the panelists:

- Disclosures need to be designed with a clear understanding of the end user. Research, in the form of surveys and focus groups, can help to clarify investors’ needs and wants. However, “human-centered design” is “not just about asking people what they want and delivering it. It’s about understanding people, what they mean, what they value beyond what they can articulate in a focus group or a survey.”²⁴
- Disclosures also need to be designed with a clear understanding of the purpose the disclosure is intended to achieve. They are most likely to be effective if they are based on a consumer empowerment goal. Toward that end, those designing the disclosures should ask themselves, “What are you trying to enable investors to do as a result of these disclosures?”²⁵
- One key purpose of disclosures is to support investor decision-making. Enabling clear comparisons and highlighting key differences in the disclosure is important, because “comparing things is how we make decisions.”²⁶ Moreover, presenting disclosures in a question-and-answer format can help to guide them through that decision-making process.
- Experts in disclosure design should be involved in the disclosure development process from the beginning, working hand-in-hand with legal experts. Relevant disclosure design expertise includes how to choose and create content, design the disclosure, and determine when and how best to deliver the disclosure.
- Consumer testing is necessary to understand how the disclosures are likely to be used and understood and whether they achieve their intended goal. One-on-one cognitive interviews are a useful technique to help demonstrate what consumers want to know about a topic, what they think the disclosure is telling them, and whether they’ll use it and how.²⁷ Another useful technique is A/B testing, which allows comparison of different approaches and how consumers respond to those approaches.²⁸
- The results of that testing should be used to refine the disclosure design. Disclosures are most likely to be effective if they are developed through an iterative process that incorporates research, design, testing, revision, and retesting.

²⁴ See remarks of Yuhgo Yamaguchi. This point was also emphasized by Billy Kingsland.

²⁵ See remarks of Brenda Cude.

²⁶ See remarks of Yuhgo Yamaguchi.

²⁷ For online disclosures, heat mapping can help to demonstrate how users interact with a disclosure. See, e.g., <https://www.crazyegg.com/blog/understanding-using-heatmaps-studies/>. “A heat map uses a warm-to-cool color spectrum to show you your site analytics, namely which parts of a page receive the most attention.”

²⁸ See remarks of Billy Kingsland.

- Disclosure timing is important. Disclosures that arrive after the investor has made their decision are less likely to be read or, if read, to influence investor behavior.²⁹
- Technological advances allow for non-traditional approaches to disclosure, such as the use of videos and info-graphics. Similarly, electronic delivery (either online or through mobile apps) allows for just-in-time delivery of disclosures. However, not everyone has access to these technologies. Moreover, as technology lowers the cost of disclosure, it can lead to the disclosure of more and more information, which can distort investors' choices.³⁰
- Standardization of disclosures can benefit investors, by making comparisons easier, and companies, who do not each have to reinvent the wheel in responding to a new disclosure mandate.³¹ These potential benefits of standardization have to be balanced against concerns about one-size-does-not-fit-all disclosures. One option is for the regulator to give companies a template, and a clear sense of how they fill that in, but with the ability to adjust it to fit their particular situation.³²
- Layering of disclosures offers a key way to resolve the tension between the demand for comprehensive information (to inform the market and more sophisticated users, to comply with legal obligations, and to address liability concerns) and the need to communicate clearly to retail investors. Instead of thinking of layering in binary terms, where one layer consists of a brief summary and a second layer consists of the full prospectus, disclosures can be designed as a decision-tree to help walk the user through a complex process or as a spectrum of information, delivered in bite-size pieces.³³

One point that was emphasized throughout the panel was the importance of using an iterative process to research, design, test, and refine disclosures. As Kingsland said, "Culturally within the SEC we would just encourage that that become your go-to process." Similarly, Yamaguchi stated, "That's an important process to follow, because if we just start with our hypotheses and then put them in the market wholesale, then we're in a sense just guessing, and we don't want to do that." Panelists also emphasized the importance of including design experts in the process from the outset, working with the legal experts. "Where we see things go awry," Kingsland said, "is either legal is the only department holding the baton or legal gets passed the baton at the very end of the process and they've not been involved from the beginning and necessarily it undoes all the work that came before."

While the Commission has increasingly incorporated consumer research into its development of disclosures, and has looked to layered disclosures as a way to develop more investor-friendly disclosures, it has not typically used the kind of iterative process identified by panelists as critical to the development of effective disclosures. This suggests that procedural

²⁹ See remarks of Brenda Cude.

³⁰ See remarks of Dan Silverman.

³¹ See remarks of Dan Silverman.

³² See remarks of Brenda Cude.

³³ See remarks of Brenda Cude and Yuhgo Yamaguchi.

changes in the Commission's approach to disclosure development could result in significant improvements in the effectiveness of its mandated disclosures.

Recommendation

In order to enhance the effectiveness of disclosures that are aimed at and relied on primarily by retail investors, the IAC makes the following recommendations:

- In developing new disclosures intended primarily for retail investors, the SEC should, to the extent possible, adopt an iterative process that includes research, design, testing, and refinement of proposed disclosures. In addition to incorporating this process into its own work, the Commission could provide incentives to registrants who employ these best practices in their disclosure development.
- Disclosure design experts should work hand-in-hand with legal experts throughout the disclosure development process to provide input into decisions about content, language, presentation, and delivery. In developing disclosures, they should seek to balance the benefits of standardization against the risks of one-size-fits-none disclosures.
- In addition to using this process for development of new disclosures, the Commission should, as resources allow, review existing retail disclosures (such as various mutual fund disclosures, the new variable product summary, the CRS and ADV, and possibly IAPD and BrokerCheck reports) to determine their effectiveness and, as necessary, make improvements.
- In deciding which disclosures to review, the Commission should prioritize those disclosures or sections of disclosures that its research shows are of greatest significance to retail investors and/or least likely to be read or understood by such investors. The Office of Investor Advocate can play a valuable role in helping to set those priorities.
- The Commission should continue to explore the potential for alternative disclosure formats (e.g., online, video, mobile app) to improve investor engagement and comprehension, providing registrants appropriate regulatory relief that may be necessary to encourage those innovations. Of course, the Commission should preserve easy access to paper documents for those who prefer that delivery method.
- Regardless of whether the Commission develops in-house expertise in this area, relies on outside consultants, or some combination of the two, it will require an appropriate allocation of resources. Congress should provide the agency with the personnel and resources necessary to support this effort.

The IAC believes that adopting these changes can meaningfully improve the effectiveness of investor disclosures, with potential benefits for investors, financial firms, and the market as a whole.