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Request for Comments on Measures To Improve Disclosure of Mutual Fund Transaction Costs; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release Nos. 33–8349; 34–48952; IC–26313; File No. S7–29–03]

RIN 3235–AI94

Request for Comments on Measures To Improve Disclosure of Mutual Fund Transaction Costs

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comments.

SUMMARY: The Securities and Exchange Commission is seeking public comment on a number of issues related to the disclosure of mutual fund transaction costs. We seek comment on, among other things, whether mutual funds should be required to quantify and disclose to investors the amount of transaction costs they incur, include transaction costs in their expense ratios and fee tables, or provide additional quantitative or narrative disclosure about their transaction costs. We also seek comment on whether mutual funds should be required to record some or all of their transaction costs as an expense in their financial statements. The Commission requests comment from investors, investment companies, investment advisers, the financial services industry, academics, regulators, and the public generally on the issues summarized in this release, the specific questions located in Sections III (Alternatives for Quantifying Transaction Costs), IV (Accounting Issues), V (Alternatives that Provide Additional Information About the Level of Transaction Costs), and VI (Review of Transaction Costs by Fund Directors) of the release, and on any other issues that commenters believe relevant.

DATES: Comments must be received by February 23, 2004.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or electronic mail, but not by both methods.

Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following E-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. S7–29–03; this file number should be included in the subject line if electronic mail is used. All comments received will be posted on the Commission's Internet Web site (*http://www.sec.gov*) and made available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.[1]

FOR FURTHER INFORMATION CONTACT: Paul Goldman, Assistant Director, or Jacquelyn Rivas, Staff Accountant, Office of Financial Analysis, Division of Investment Management, (202) 942–0510, at the Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION:

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I. Introduction

The Securities and Exchange Commission ("Commission") is considering various alternatives designed to improve the information that mutual funds disclose about their portfolio transaction costs. Mutual funds incur transaction costs when they buy or sell portfolio securities. Transaction costs are significant for two reasons. First, for many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions and spreads alone cost the average equity fund as much as 75 basis points.[2] Second, fund managers are subject to a number of conflicts. Commissions, which are paid out of fund assets, may, for example, be used to pay for research or trading support functions (brokerage services) that might otherwise be paid for by the fund's investment adviser (soft dollar commissions).[3]

Fund directors play a pivotal role in monitoring these conflicts. As explained in further detail below, transaction costs are not readily apparent to investors. These costs, however, must be disclosed to a fund's board of directors where such costs bear on the reasonableness of the fund's payments to the fund manager or its affiliates. Thus, it is imperative that the fund's directors both understand and heavily scrutinize the payment of such costs by the fund. The fund's board should demand, and the fund's adviser should provide, all information needed to undergo this review process. In the absence of vigilant oversight by the fund's boards, transaction costs may include payment for services that benefit the fund's adviser at the expense of the fund.

Although transaction costs are taken into account in computing a fund's total return, they are not included in a fund's expense ratio because under generally accepted accounting principles they are either included as part of the cost basis of securities purchased or subtracted from the net proceeds of securities sold and ultimately are reflected as changes in the realized and unrealized gain or loss on portfolio securities in the fund's financial statements. As a result, current disclosure requirements focus on providing fund investors with information about two items that are related to transaction costs—portfolio turnover rate and dollar amount of brokerage commissions. All mutual funds (except money market funds) are required to disclose in their prospectuses the annual rate of portfolio turnover that they have incurred during the last five fiscal years. Investors can compare turnover rates to obtain an indication of how transaction costs are likely to vary among different funds. Funds (with the exception of money market funds) also must disclose in the Statement of Additional Information ("SAI") the actual dollar amount of

[1] We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

[2] John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, *Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management*, Aug. 30, 2001, at 10 (available at *http://finance.wharton.upenn.edu/edelen/PDFs/MF_tradexpenses.pdf*). These estimates omit the effect of market impact and opportunity costs, the magnitude of which may exceed commissions and spreads.

[3] *But see* NASD Rule 2839 (K).

brokerage commissions that they have paid during their three most recent fiscal years.[4] The Commission is concerned that the current disclosure requirements do not directly address a fund's overall transaction costs or elicit sufficient information about these costs.

Some investors and financial industry observers have expressed similar concerns. For example, at hearings held on March 12 and November 4, 2003 by the U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, and on November 3, 2003 by the Senate Subcommittee on Financial Management, the Budget and International Security, a number of witnesses testified that inadequate information about portfolio transaction costs makes it difficult for mutual fund shareholders to know the overall cost of their investment.[5]

The Commission is aware of the need for transparency of mutual fund fees and expenses and committed to improving disclosure of the costs that are borne by mutual fund investors; but it is mindful of the complexities associated with identifying, measuring, and accounting for transaction costs. Thus, the Commission is considering how mutual fund transaction cost disclosure requirements should be revised to provide more meaningful information to fund investors. In particular, the Commission is considering whether mutual funds should be required among other things to (1) quantify in some meaningful way and disclose some or all of their portfolio transaction costs without including these costs in their expense ratios and fee tables; (2) quantify some or all transaction costs and include them in expense ratios and fee tables; (3) provide other quantitative information about the level of transaction costs, or (4) some combination of the above. The Commission also seeks comment on whether mutual funds should be required to treat transaction costs, or a portion thereof, as an expense in their financial statements.

This release invites comment on both the general topic of how to improve the disclosure of mutual fund transaction costs and a number of specific questions. For ''yes or no'' questions, please explain the reasons for your response. For questions with respect to alternatives for disclosing some or all transaction costs in fund expense ratios, fee tables or in other numerical formats, please be as specific as possible about how these alternatives may be accomplished, or why these alternatives are not feasible. Discussion is encouraged with respect to specific formulas that should be used, and specific recordkeeping and operational procedures that should be required in order to implement numerical disclosures.

The remainder of this release examines a number of major issues with respect to disclosure of portfolio transaction costs. Section II describes the different types of portfolio transaction costs and estimates their magnitude. Section III identifies and discusses various proposals for additional quantitative disclosures. Section IV discusses issues related to how funds account for transaction costs and report them in their financial statements. Section V explains the current requirements with respect to disclosure and identifies and requests comment on possible new disclosures related to the level of transaction costs. Section VI discusses the review of transaction costs by fund directors.

II. Background

A. Types of Transaction Costs

Broadly defined, a mutual fund's transaction costs include all of its costs that are associated with trading portfolio securities.[6] Transaction costs include commissions, spreads, market impact costs and opportunity costs.

1. Commissions

Commissions generally refer to charges that a broker collects to act as agent for a customer in the process of executing and clearing a trade. Commissions are the only type of transaction cost that can be measured directly. Measurement is easy because the commission is separately stated on the transaction confirmation and is paid directly from fund assets.[7] Trades for which commissions are paid generally involve equity securities traded on the exchanges. Equity securities are also traded on NASDAQ and through dealers. Although historically NASDAQ trading has been effected primarily on a spread basis, more and more equity trades are being done as single price riskless principal trades,[8] and the cost of these trades is now more frequently charged and identified as a commission equivalent.[9] Consequently, it appears that quantification of commission-type fees on equities has become easier. In fact, the commission on the average NASDAQ trade (almost 16 basis points) now approaches the commission on the average NYSE trade (18 basis points).[10]

2. Spread Costs

Spread costs are incurred indirectly when a fund buys a security from a dealer at the ''asked'' price (slightly above current value) or sells a security to a dealer at the ''bid'' price (slightly below current value). The difference between the bid price and the asked price is known as the ''spread.'' Spread costs include both an imputed commission on the trade and any market impact cost associated with the trade as discussed below.[11]

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[4] All funds are required to provide their SAI to investors upon request. In addition, the SAI of any fund may also be accessed via the Commission's Web site (*http://www.sec.gov*) and frequently on a fund's or a fund sponsor's Web site.

[5] The House of Representatives recently passed legislation entitled the ''Mutual Funds Integrity and Fee Transparency Act of 2003'' (HR 2420) that would, among other things, mandate a new document in which mutual funds would disclose their fees to investors and directed the Commission to issue a concept release on issues related to mutual fund transaction cost disclosure. H.R. 2420, 108th Cong. (2003). HR 2420 would also require funds to disclose their portfolio turnover rate in the new fee disclosure document and provide a textual explanation of the impact of high portfolio turnover rates on fund expenses and performance. Additionally, the Commission has proposed that fund shareholder reports be required to include, among other things, the costs in dollars associated with an investment of $10,000, based on a fund's actual expenses and return for the period. Investment Company Act Release No. 25870 (Dec. 18, 2002). The Commission is also today proposing to enhance disclosure regarding breakpoint discounts on front-end sales loads.

[6] *See* Larry Harris, *Trading and Exchanges: Market Microstructure for Practitioners* (2003) at 420–441 (discussing the components of transaction costs, including explicit and implicit costs, as well as alternative methods for estimating the magnitude of transaction costs).

[7] Stephen A Berkowitz and Dennis E. Logue, *Transaction Costs: Much ado about everything*, Journal of Portfolio Management (Winter 2001) at 68.

[8] *See* Harold Bradley, Senior Vice President, American Century Investment Management, Statement Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (Mar. 12, 2003).

[9] The Commission has recognized that money managers opting for certain riskless principal transactions would now be informed of the entire amount of the market maker's charge for effecting the trade. *See* Exchange Act Release No. 45194 (Dec. 27, 2001).

[10] Justin Schack, *Trading Places*, Institutional Investor (Nov. 2003) at 32.

[11] Funds incur spread costs on trades that are made on a principal basis (*e.g.*, NASDAQ trades executed from dealer inventory). Dealer spreads compensate brokers and broker-dealers for maintaining a market's trading infrastructure (*i.e.*, price discovery and execution services) and may also reflect the impact of large orders on the prices of securities. The proportion of these two components varies among different trades. The market impact cost component of dealer spreads reflects dealers' inventory management costs. These costs have a significant impact on the spread between the dealer's bid (buy price) and ask (sell price). Although spread costs cannot be directly calculated, they can be estimated with data collected some time after the trade is executed. See Berkowitz and Logue, *supra* note at 65–68.

3. Market Impact Costs

Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security.[12] Stated formally, market impacts are the price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction.[13]

Market impact cost cannot be calculated directly. It can be roughly estimated by comparing the actual price at which a trade was executed to prices that were present in the market at or near the time of the trade.[14] Impact cost may be reduced by stretching out a trade over a long time period. The benefit of reduced impact cost may be reduced or eliminated by an increase in opportunity cost.

4. Opportunity Costs

Opportunity cost is the cost of missed trades.[15] The longer it takes to complete a trade, the greater the likelihood that someone else will decide to buy (or sell) the security and, by doing so, drive up (or down) the price.[16]

Opportunity cost cannot be measured directly. The joint effect of market impact and opportunity cost can be estimated by comparing market prices at the time that the transaction was conceived to the price at which the transaction was actually executed. Consulting firms have developed quantitative tools that attempt to estimate these costs for their clients.[17]

5. Magnitude of Transaction Costs

Although estimates of the magnitude of transaction cost and its components vary, the following estimates are representative. For the average stock fund, commission costs have been estimated at almost .30% of net assets [18] (an amount equal to approximately 20% of the 1.42% expense ratio of the average long-term mutual fund in 2002); and spread costs have been estimated at approximately .45% of net assets [19] (approximately 30% of the average expense ratio.)[20] Market impact cost and opportunity cost are more difficult to measure. One study estimates that total transactions costs (including market impact and opportunity costs) for large capitalization equity transactions range from 0.18% to as much as 1% of the principal amount of the transaction.[21] Another study estimates that for institutional investors, under relatively stable market conditions, opportunity costs may amount to 0.20% of value.[22]

To summarize, commissions are explicit costs, readily identifiable and quantifiable. Spread, impact, and opportunity costs are implicit costs. Because the implicit costs, which are difficult to identify and quantify, can greatly exceed the explicit costs, there is no generally agreed-upon method to calculate securities transaction costs.[23]

III. Proposals To Quantify Transaction Costs

During recent years, a number of commentators have argued that although transaction costs represent a significant portion of the overall expenses incurred by a mutual fund, current disclosure requirements fail to provide investors with adequate information about these costs. Most recently, during hearings held on March 12, 2003 by the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, and on November 3, 2003 by the Senate Committee on Governmental Affairs, Subcommittee on Financial Management, the Budget, and International Security, several witnesses testified about the opacity of portfolio trading costs and made suggestions for additional narrative and quantitative disclosure. Suggested improvements tend to fall into three broad alternatives that would require funds to: (1) Quantify and disclose their commission costs; (2) quantify and disclose all of their transaction costs; or (3) provide other information related to the level of transaction costs. In this section of the release, we describe in more detail the alternatives for quantifying transaction costs and request comment on the alternatives. Alternatives for providing additional information about the level of transaction costs are described and comment is requested in Section V of this release.

A. Quantify Commission Costs Only

The dollar amount of commissions paid is easily determined. As previously indicated, the commission appears on the confirmation of each transaction and funds already report in their SAIs the aggregate dollar amounts of commissions paid.

Some commentators have proposed that mutual funds be required to disclose the commissions they pay to effect securities transactions and include the result in their expense ratios and fee tables.[24] They argue that disclosing portfolio commissions would provide additional information about the amount of transaction costs that funds incur, thus permitting investors to make better informed investment decisions. The average commission paid by institutional investors is about 5 to 6 cents per share, but can range from 1 cent to 12 cents per share.[25] A portion

[12] *See* Harris, *supra* note 6 at 421. The average trade on the New York Stock Exchange and on NASDAQ is approximately 1,700 shares. The average order placed by institutions (including mutual funds) is 44,600 shares, according to an estimate from Plexus, Inc. *See* Wayne H. Wagner, Chairman, Plexus Group and Senior Vice President, Chase JPMorgan Chase Co., Statement Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services (Mar. 12, 2003). Basic economics dictate that, if the supply of a good or service is held steady, increased demand drives up the price. Large trades have an impact on price. They ''move the market'' (drive the price up if the fund is buying; down if the fund is selling.)

[13] *See* Berkowitz and Logue, *supra* note 7 at 67.

[14] *See* Harris *supra* note 6 at 422–423. Theory suggests comparing the actual price paid or received to what would have prevailed had the order never been placed. In practice, however, only the market prices and bids and offers near the time of the trade can be observed.

[15] *See* Harris, *supra* note 6 at 421.

[16] An opportunity cost is incurred when three conditions hold: (1) The price of a stock rises (falls) after an investor decides to buy (sell) it, but before he or she is actually able to do so; (2) the price change is independent of the investor's decision; and (3) the price change is ''permanent''—*i.e.*, it is caused by the dissemination of information relevant to the valuation of the asset. Other factors may influence the price of an asset, such as temporary liquidity imbalances, but they do not generate opportunity costs. *See* Robert A. Schwartz and Benn Steil, *Controlling Institutional Transactions Costs*, The Journal of Portfolio Management (Spring 2002) at 43.

[17] *See* Berkowitz and Logue, *supra* note 7 at 70.

[18] Miles Livingston and Edward O'Neal, *Mutual Fund Brokerage Commissions*, Journal of Financial Research, Vol. XIX, No. 2 (Summer 1996) at 280. *See also*, Chalmers, Edelin, and Kadlec, *supra* note 2 at 2; Rich Fortin and Stuart Michelson, *Mutual Fund Trading Costs*, Journal of Investing, Vol. 7, No. 1 (Spring 1998) at 67.

[19] *See* Chalmers, Edelen, and Kadlec, *supra* note 2 at 10.

[20] Morningstar Principia Pro Database, Apr. 2003 edition.

[21] *See* Berkowitz and Logue, *supra* note 7 at 67.

[22] *See* Schwartz and Steil, *supra* note 16 at 43–44.

[23] ''Transaction cost measurement is as much an art as a science. It's very difficult to accurately measure implicit trading costs. Not all companies use the same methodology, and there's no commonly accepted standards as to how to measure price impact.'' *See* Alison Sahoo, *SEC Weighs Trading Cost Rule, Seeks Industry Input, Ignites.com* (July 22, 2003) (quoting Ananth Madhavan, managing director of ITG, a provider of equity-trading services and transaction research to institutional investors and brokers).

[24] *See* John Montgomery, President, Bridgeway Funds, and Gary Gensler, Former Undersecretary of the Treasury for Domestic Finance and Author of *The Great Mutual Fund Trap,* Statements Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (Mar. 12, 2003).

[25] *See* Harris, *supra* note 6 at 151. In 1998, the Commission's Office of Compliance Inspections and Examinations (OCIE) conducted limited scope on-site inspections of the soft dollar activities of 75 broker dealers and 280 investment advisers and investment companies. OCIE found the average cost

of these commissions may be used to obtain soft dollar benefits (*i.e.*, research and other services as permitted by section 28(e) of the Securities Exchange Act of 1934) that may benefit the manager. The limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services.

B. Quantify All Transaction Costs

Some commentators have suggested that mutual funds be required to quantify and disclose all of the transaction costs that they incur.[26] This alternative would provide the advantages associated with the previous alternative (including commissions in the expense ratio) while eliminating any disadvantages associated with quantifying some, but not all transaction costs.[27]

This alternative raises the issue of the difficulty of quantifying spreads, market impacts, and opportunity costs. Consultants and academics derive transaction cost estimates that include spreads and market impact costs by using a variety of algorithms to compare the actual price that was paid in each transaction with the market price that prevailed at some time before[28] or after[29] the transaction was completed. Perhaps the most all-inclusive way to measure transaction cost is another method called ''implementation shortfall.'' Implementation shortfall measures the transaction cost of each trade as the difference between the price of all trades you intend to make (trades actually made plus intended trades that fail to execute) and the price that prevailed in the market *when each decision to trade was made.*[30]

With respect to the before trade and after trade methods, a common standard would need to be chosen from among the wide variety of estimation techniques that are used, opportunity costs would remain unaccounted for, and some measures in this category may be vulnerable to being ''gamed.''[31]

The advantages of the implementation shortfall method are that it includes all trading costs and is not vulnerable to being gamed. However, there is no generally accepted manner to calculate a portfolio's implementation shortfall. To monitor performance and comply with their best execution responsibilities, many fund advisers already gather a substantial amount of data about transaction costs and execution quality.[32] Of course, there may be substantial differences in the types of data that fund advisers currently gather that would require changes to their systems. However, there may be a fair amount of uniformity, at least on the general types of information (*e.g.*, trade decision time, time orders are given to brokers, trade execution time and price, *etc.*) that fund advisers maintain.

C. Quantify the Effect of Daily Decisions to Trade

Another, more inclusive alternative for measuring transaction costs would capture the combined effect of transaction costs and gains and losses from short term trading. This ''trade effect'' measure would reflect the annual average daily difference between the actual value of the portfolio as of the close of each trading day and the hypothetical value of the portfolio if no trades had been made that day.

Trade effect is easy to measure in practice. It is equal to the total mark-to-market profits or losses on the security purchases and sales made by the fund. For a purchase, the mark-to-market profits or losses are computed by multiplying the total quantity traded in the security times the difference between the volume-weighted average fill price and the price at the end of the period over which the profits or losses are measured. For a sale, it is the negative of this quantity.[33]

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of soft dollar executions was 6 cents per share. *See* Office of Compliance Inspections and Examination, SEC, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998) (available at *http://www.sec.gov/news/studies/softdolr.htm) (''Inspection Report'').*

[26] *See* John C. Bogle, Founder and Former Chief Executive, Vanguard Group and President, Bogle Financial Markets Research Center, Statement Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (Mar. 12, 2003); and Mercer Bullard, Founder and President, Fund Democracy, Inc., Statement Before the Senate Subcommittee on Financial Management, the Budget, and International Security (Nov. 3, 2003).

[27] ''The ability to figure out trading costs is there. When these companies want internal efficiencies to reduce expenses or improve sales there's no shortage of money to do that. But as soon as someone asks them to spend money on what they are charging shareholders, they bellyache. Trading costs are paid out of shareholders' money. They should decide what they pay.'' *See* Sahoo, *supra* note 23 (quoting Max Rottersman of fundexpenses.com, a website that monitors mutual fund costs and expenses).

[28] A ''before trade'' measure compares the actual price of each trade with the price that prevailed in the market before the transaction was completed. *See* Andre F. Perold, *The Implementation Shortfall: Paper vs. Reality,* Journal of Portfolio Management (Spring 1988) at 8.

[29] In an ''after trade'' measure, the market price might be today's closing price, tomorrow's closing price, some other price in effect after the fund completed the trade, the average of the high and the low for the day, or a weighted average of all prices at which market participants transacted on that day. *See* Perold, *supra* note 28 at 7.

[30] The concept of ''implementation shortfall'' was introduced by Treynor in 1981. *See* Jack L. Treynor, *What Does it Take to Win the Trading Game?*, Financial Analysts Journal (Jan.–Feb. 1981). at 55–60; *see also* Perold, *supra* note 28 at 8. Implementation shortfall is defined as a measure of the degree to which execution, market impact and opportunity costs prevent the investor from taking advantage of his or her stock selection skills. *See* Perold, *supra* note 28 at 5–6. Implementation shortfall can be interpreted as the difference in value between an actual portfolio and a corresponding paper portfolio. A paper portfolio is an imaginary portfolio that is constructed on paper to see what would happen if certain trades were actually made. To measure transaction costs, a trader must specify a benchmark price at which he buys or sells securities for his paper portfolio. The difference in value between the actual portfolio and the corresponding paper portfolio measures the trader's cost of implementing trading decisions relative to this benchmark. Since implementation is generally accomplished at a cost, paper portfolios typically earn better returns than the corresponding actual portfolios. Harris, *supra* note 6 at 426. Leinweber illustrates the implementation shortfall concept by noting that from 1979 to 1991 stocks classified as ''Group 1'' by Value Line had an annualized return of 26.3% while the Value Line mutual fund that contained the same stocks returned only 16.1%. The difference between the paper return and the actual portfolio return is the cost of trading. David J. Leinweber, *Using Information from Trading in Trading and Portfolio Management,* 4 Journal of Investing, No. 1 (1995) at 40.

[31] For example, because a before trade measure compares the actual price of each trade with the market price in effect before the transaction was completed, the market price is known in advance. A trader working on behalf of a fund could ''manufacture'' low transaction costs if, after each decision to trade is made, the trader would wait to take action on the order list, implement only the buy orders for which prices have fallen since the receipt of the order, implement only the sell orders for which the prices have risen, and dismiss the rest of the orders as ''too expensive'' to execute. *See* Perold, *supra* note 28 at 7–8.

[32] ''Virtually all the major institutions have a transaction-cost measuring system in place. They compare their actual execution costs to pre-trade benchmarks from models or peer comparisons from different firms. That puts pressure on the trading desks to control costs. So the guys who aren't doing it are being left behind.'' Sahoo, *supra* note 23 (quoting Ananth Madhavan). ''* * * [M]ore pension funds and investment managers are measuring transaction costs—either by using proprietary systems or third party services * * *. Since the wrenching bear market of 2000–'02, institutions have learned that transaction costs can be a significant drag on performance, and they have begun managing them as intently as they research stocks.'' Schack, *supra* note 10, at 32.

[33] For example, a mutual fund purchases 500 shares of ABC Company at a volume-weighted average fill price of $19. The price of the security at the end of the measurement period is $20. The mark-to-market profit or loss associated with this trade would be the difference between the fill price and the measurement price (−$1) times the number of shares transacted (500), or −$500. Alternatively, a mutual fund sells 500 shares of XYZ Company at a volume-weighted average fill price of $15. The price of the security at the end of the measurement period is $17. The mark-to-market profit or loss associated with this trade would be the negative of the difference between the fill price and the measurement price (+$2) times the number of shares transacted (500), or $1,000. In this example, the cost of trading—the trade effect—would be $500 (−$500 + $1,000), indicating that the trading was

Continued

For disclosure purposes, each fund could be asked to sum these mark-to-market profits and losses across all trades on a given day. Funds would divide this sum by total assets for that day and report on an annual basis the average of this ratio across all trading days.

Trade effect includes all realized costs of trading—commission, spread and price impacts—plus any short-term trading profits or losses incurred as a result of the timing of the trade. Funds produce short-term trading profits if they can successfully capitalize on short-term price changes, for example, when they buy before prices rise. They incur short-term trading losses when they poorly time their trades, for example, when they buy before prices fall.

Investors may benefit from disclosure of short-term trading impact information because it would allow them to better understand the benefits and costs associated with fund portfolio trading. This information may particularly help investors interpret fund turnover. Although high turnover generally is correlated with poor performance due to excessive transaction costs and poor timing, high turnover may be desirable for funds that can implement profitable short-term trading strategies. Presently, investors lack the information necessary to meaningfully discriminate among funds on this basis. Trade effect disclosure may allow investors to determine the extent to which fund performance—for better or worse—is due to its trading activities.

If the Commission were to mandate trade effect disclosure, it would have to determine the period over which funds would measure their trade effect mark-to-market profits and losses. It might seem most natural to measure trade effect over the trading day on which each trade occurred by comparing trade prices to trade day closing prices. However, this comparison could cause some managers to shift their trading towards the end of the trading day to minimize their reported trade effect. To reduce such incentives, trade effect could be measured by comparing trade prices to closing prices on the next trading day.[34]

D. Sell-Side Alternatives

Thus far, the discussion in this release has focused primarily on the disclosure by mutual funds of their transaction costs and execution quality. The Commission also wishes to request comment on whether disclosure by markets or broker-dealers of their execution quality for large, institutional orders would be helpful to funds in evaluating execution costs. For example, broker-dealers handling large orders potentially could be required to disclose statistics that compare the prices at which their orders are executed with the quotes for a security at the time they received the order. To enhance their comparability, the statistics could be divided into categories based on the size of the order compared to the average daily trading volume in the security. Similar disclosure could be required of other venues that directly receive and execute institutional orders, such as floor brokers, specialists, and electronic trading venues. Such sell-side disclosure could represent one part of a comprehensive approach that attempted to measure transaction costs throughout the trading cycle. Standardized market statistics, which would encompass orders from many different institutions, potentially could provide benchmarks for execution quality that might assist fund managers and their boards in evaluating the execution quality obtained from different broker-dealers. For example, such statistics might be helpful in evaluating the execution quality obtained from affiliated or related broker-dealers compared to that obtained from those that are independent of the fund.[35]

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General Questions About Quantifying Transaction Costs

1. Is investor decision-making harmed because investors lack numerical information about mutual fund transaction costs?

2. What would be the best way to provide investors with additional numerical information about the amount of transaction costs that mutual funds incur? Would the information most appropriately be located in the prospectus, the SAI, or in another disclosure document?

Questions About Quantifying Commissions and Spreads

3. Would a requirement to quantify (express as a percentage) and disclose brokerage commissions, but not other transaction costs provide useful information to fund investors? If funds are required to quantify and disclose their brokerage commissions, should the number be included in fund expense ratios and fee tables?

4. Does the increased use of riskless principal trades on NASDAQ make it easier to quantify the cost of NASDAQ trades? What proportion of NASDAQ trades are subject to commission-equivalent fees?

5. Would quantifying commissions mislead investors because it would result in a number that includes some transaction costs and excludes others? Please explain the reasons for your answer.

6. If the answer to question 5 is yes, would the concern be alleviated if funds were required to quantify commissions and provide investors with disclosure that details the portion of trades that are performed on a commission basis; spread basis; or some other basis (*e.g.*, directly from an issuer)?

7. What effect, if any, would a requirement to quantify commissions have on the incentives of fund managers with respect to (1) use of principal versus agency transactions; and (2) use of soft dollar transactions?

8. Could any possible adverse effects identified in questions 5 and 6 be mitigated or eliminated by requiring funds, in addition to reporting their commission costs, to estimate the spread cost of their principal trades (for example, by imputing to principal trades the fund's average commission rate on agency trades)? If yes, should this number be included in fund expense ratios and fee tables?

9. Alternatively, can the portion of spread cost that represents payment for executing a trade be measured separately from the portion of the spread that represents the market impact cost associated with that trade? If yes, should this number be included in fund expense ratios and fee tables?

Questions About Quantifying All Transaction Costs

10. Would a requirement to quantify *all* transaction costs provide useful information to fund investors? Would a requirement to quantify *all transaction costs, except opportunity costs* be a better alternative? If you advocate that we mandate either of these alternatives, please explain as specifically as possible, how the alternative should be

not beneficial. If assets for the measurement period were $100,000, the trade effect would be 0.5%.

[34] As noted above, trade effect measures the combined effect of transaction costs and short-term trading profits (or losses). The use of next day closing prices instead of same day closing prices would increase the importance of the short-term trading profits in the determination of the trade effect measure. Although variation in trade effect due to unpredictable market fluctuations would increase, averaging over many securities and over all days in the year would largely eliminate the impact of such fluctuations. Moreover, since most funds simultaneously buy and sell when effecting portfolio adjustments, the effects of unpredictable market fluctuations on the mark-to-market profits for buy and sell trades often would offset each other.

[35] For a fuller discussion of fund director's review of transaction costs, see Section VI of this Release, ''Review of Transaction Costs by Fund Directors.''

implemented. Please discuss the specific algorithms, formulas, definitions, recordkeeping requirements, and internal control requirements that should be used. Commenters are encouraged to address the following specific topics:

A. How should funds measure their spread costs?

B. How should funds measure their market impact costs?

C. How should funds measure their opportunity costs?

D. Should spread, market impact and opportunity costs be measured trade-by-trade or for all transactions?

E. Should spread, market impact and opportunity costs be measured absolutely or relative to a benchmark?

F. Should this number be included in fund expense ratios and fee tables?

11. Would the trade effect measure provide useful information to investors, and if so, should we require its disclosure? If the Commission mandated trade effect disclosure, should trade effect be measured with respect to same day closing prices or next day closing prices?

12. More generally, if the Commission were to choose to require disclosure of only one transaction cost measure, which measure should it be?

* * * * *

IV. Accounting Issues

Under generally accepted accounting principals, most portfolio transaction costs are either included as part of the cost basis of securities purchased or subtracted from the net proceeds of securities sold and ultimately are reflected as changes in the realized and unrealized gain or loss on portfolio securities in the fund's financial statements.[36] Unfortunately, this accounting treatment provides a mutual fund shareholder with an opaque view of portfolio transaction costs in a fund's financial statements.[37] One effect of this lack of transparency is that it has impaired the ability of investors to evaluate the use of fund assets to obtain research services (as that term is defined in section 28(e) of the Securities Exchange Act of 1934) that are paid for through commissions or spreads.

The component of commissions that represent execution and clearing costs are the equivalent of acquisition or disposition costs incurred on physical assets and current accounting principles dictate that they be included in the cost basis of securities purchased or in the net proceeds from securities sold.[38] However, the component of commissions that represent the costs of services is conceptually an operating expense of a fund and should not be included in the cost basis of securities purchased or in the net proceeds from securities sold.[39]

We have attempted to improve the transparency of financial reporting when reliable information is available. For example, the aggregate value of all fund operating expenses paid for by brokers in brokerage offset arrangements are identifiable and measurable, even if the brokerage offset credits cannot be allocated to individual trades. Accordingly, we adopted a rule under Regulation S–X in 1995 that requires a mutual fund to record the value of services received under brokerage-offset arrangements as an expense.[40] The practical result is that the portion of commission or spread cost that can be reliably identified and measured and that also represents operating expenses of the fund is reflected in the expense ratio and in fund expenses.[41]

We are considering whether all transaction costs can be and should be captured in fund expense ratios and fee tables contained in a fund's prospectus. We also are considering whether the cost information obtained would be reliable and relevant for financial reporting purposes or whether alternatively, some subset of transaction costs (*e.g.*, all non-execution and clearing costs) can be reliably measured and expensed for financial reporting purposes. We may conclude that the standard for including these costs in the fee table is different than the standard for including these costs in the fund financial statements thereby creating a discrepancy between the two measures. If we conclude transaction costs or some subset of transaction costs should be included in fund financial statements, those statements would not be comparable to other similar entities, such as pension funds, hedge funds, and other investment vehicles. We are interested in the perspectives of fund investors and fund financial statement preparers on the desire for and feasibility of including some or all of this information in the prospectus and the fund financial statements.

* * * * *

Questions About Accounting Issues

13. Would it be appropriate to include some or all transaction costs in fund expense ratios and fee tables without accounting for these items as an expense in fund financial statements?

14. Would it be feasible to account for some or all transaction costs as an expense in fund financial statements? If it is not feasible to reliably measure market impact and opportunity costs, should we still require that commission costs be expensed? If yes, should the requirement apply to all commission costs or only those commission and spread costs that do not relate to the execution and clearing of a portfolio transaction (*i.e.*, soft dollars)? If it is not feasible to reliably measure all research costs, should we still expense those costs that can be reliably measured (*i.e.*, payments to third parties for research)?

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[36] For example, if a mutual fund purchases 1 share of XYZ Company at a price of $10 with a commission of 5 cents, the mutual fund will record the cost of that security as $10.05. However, the mutual fund will record the security on its statement of assets and liabilities at its market value, for example, $10.03. The fund will then record the difference between the cost basis ($10.05) and the market value ($10.03) as unrealized gain or loss, in this case, an unrealized loss of 2 cents. Therefore, the portfolio transaction costs are not reflected directly as expenses of the fund, but are reflected in the statement of operations as changes in the realized or unrealized gain or loss on portfolio securities. *See* AICPA Audit and Accounting Guide for Investment Companies, paragraph 2.40 (May 1, 2002).

[37] Regardless of whether transaction costs are included in the costs basis/settlement proceeds of securities transactions or separately identified as operating expenses of the fund, the total return of the fund remains the same. Total return is calculated based on the net asset value of the fund, which would not be impacted by the alternatives in recognizing transaction costs. *See* Item 9 of Form N–1A. Form N–1A is the registration form used by open-end investment companies to register under the Investment Company Act of 1940 and to offer their shares under the Securities Act of 1933 [15 U.S.C. 77a].

[38] *See* Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

[39] *See* Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

[40] *See* Rule 6–07(2)(g) of Regulation S–X [17 C.F.R. 210.6–07(2)(g)]. Prior to adoption of this rule, funds would report fund expenses, such as expenses for transfer agency, custody, and other services net of direct payments made by brokerage firms on behalf of funds under brokerage offset arrangements. Rule 6–07(2)(g) requires these fund expenses reflect the total amounts paid to fund service providers whether directly paid by the fund or by another entity on its behalf. The fund is allowed to show after total fund expenses the amount of those expenses paid by the brokerage firms. This presentation results in a gross-up of income and expenses in the statement of operations; however, it provides transparency to shareholders on the impact of these arrangements on the fund's financial statements. Additionally, this presentation allows the expense ratio to properly reflect a component of commission/spread costs as an expense.

[41] When we adopted this requirement, we also requested comment on whether the cost of research services provided by broker-dealers should be expensed. Many commentators pointed out the difficulty of allocating research received by an adviser among accounts when the brokerage of those accounts is used to acquire the research. Some commentators, however, supported the additional disclosure of research soft dollar practices. *See* Investment Company Act Release No. 21221 (July 21, 1995).

15. Are mutual funds and their managers better able than they were in the past to track the portion of commission costs that purchase research services from brokers? Has the improvement been sufficient to make it feasible for us to require funds to expense these items in their financial statements? Since soft dollars are earned based on complex-wide trading activity, how should research and other non-execution costs be allocated among funds? Can soft dollars be traced to individual portfolio transactions? (This would entail adjusting the basis of the securities purchased in those transactions for the portion of the commission cost that was used to purchase research services.) Alternatively, should an aggregate adjustment (not specified to a particular portfolio transaction) be made to realized and unrealized gain or loss? If funds and their managers are not yet capable of tracking the portion of commission costs that purchase research services from brokers, what factors continue to prevent funds and managers from developing this capability?

* * * * *

V. Alternatives That Provide Additional Information About the Level of Transaction Costs

A. Existing Disclosure Requirements

1. Portfolio Turnover

All mutual funds (except money market funds) provide investors with information about two items that are related to transaction costs ''portfolio turnover rate and dollar amount of brokerage commissions.[42] Funds disclose in their prospectuses the annual rate of portfolio turnover that they have incurred during the last five fiscal years.[43] Portfolio turnover rate measures the average length of time that a security remains in a fund's portfolio.[44] The requirement to disclose portfolio turnover rate is premised on the observation that a fund's transaction costs tend to be highly correlated with its turnover rate, other factors held equal.[45] Thus, by comparing turnover rates, investors can obtain an indication of how transaction costs are likely to vary among different funds. The advantage that turnover rate (an indirect indicator of fund transaction costs) has over the dollar amount of brokerage costs (a more direct measure) is that turnover rate is less affected by the asset size of a fund. For example, a fund with assets of $1 billion is likely to pay many more dollars of brokerage commissions than a fund with assets of $100 million, even if their turnover rates are identical.

2. Dollar Amount of Commissions Paid

In addition to providing their portfolio turnover rates, funds are required to disclose in their prospectus whether they may engage in active and frequent trading of portfolio securities to achieve their investment strategies. If so, funds must explain the tax consequences to shareholders of the increased portfolio turnover, and how the trading costs and tax consequences may affect investment performance.[46]

Funds (with the exception of money market funds) also must disclose in their SAIs the dollar amount of brokerage commissions that they have paid during their three most recent fiscal years.[47] Brokerage commission amounts, although they must be interpreted carefully, can nevertheless provide useful information to fund investors. This disclosure informs investors of the magnitude of the fund's overall assets that are expended on commissions.

B. Improving Disclosure Related to the Level of Transaction Costs

Another set of alternatives for improving mutual fund transaction cost disclosure consists of approaches aimed at improving current transaction cost related disclosures or adding new types of disclosure that would provide information that is more meaningful and understandable to the average investor.

1. Disclose Transaction Costs in Terms of Rated Categories

One commentator has suggested transaction costs (including commissions, spreads, and market impact costs) could be disclosed in terms of rated categories, instead of as part of the expense ratio or as a stand-alone ratio. The commentator suggested funds would categorize their trading costs as either very high, high, average, low or very low. The commentator acknowledged this disclosure might be a rough estimate, but a ''rough estimate was better than no estimate at all.'' [48]

Each fund would be compared to an industry standard. In order for such a comparison to be made, a transaction cost measure would have to be developed. In addition, we would have to determine whether any comparison should be against other funds generally or only against similar funds. For example, the transaction costs of an equity fund are likely not comparable to transaction costs of a fixed-income or money market fund.

2. Portfolio Turnover

Another possible approach would be to require funds to give greater prominence to the portfolio turnover ratio.[49] Portfolio turnover can be calculated easily by all funds. The ratio is simple and easy to understand and readily comparable among funds. If portfolio turnover is highly correlated with transaction costs, then the portfolio turnover ratio may be a good proxy for these costs.[50] The advantages of being able to easily calculate, understand, and compare portfolio turnover rates may justify any imprecision in their correlation to transaction costs.

3. Information About Average Net Flows

Another approach to providing information about transaction costs is to provide additional information about the sale and redemption of fund shares. The sale and redemption of fund shares often generates portfolio transaction costs that all fund investors must bear. Sales of fund shares often lead to security purchases as new monies are invested in the fund's portfolio. Redemptions often lead to security sales to raise money to pay for redemptions. To the extent that sales and redemptions do not offset each other, the net difference ultimately will generate portfolio transactions. These transactions usually incur transaction costs that all investors (in the case of net sales) or all remaining investors (in the case of net redemptions) must bear.

Investors therefore may be interested in the average level of net flows into and out of funds. The disclosure of average daily net flow, measured as a fraction of total assets, therefore might help investors predict the losses that they

[42] Money market funds purchase and sell securities on a principal basis. Transaction costs for these securities are embedded in the purchase price or sale proceeds and are not separately stated.

[43] *See* Item 9 of Form N–1A.

[44] For example, a fund that has a portfolio turnover rate of 100% holds its securities for one year, on average. A fund with a portfolio turnover rate of 200% holds its securities for six months, on average.

[45] *See, e.g.*, Livingston and O'Neal, *supra* note 18 at 283; Fortin and Michelson, *supra* note at 67. *But see*, Chalmers, Edelen, and Kadlec, *supra* note 2 at 2 (''Turnover is likely to be an unreliable proxy for funds trading expenses because it does not account for heterogeneity in the per-unit costs of trading an asset. For example, an uninformed manager that frequently trades assets with a low cost-per-trade may incur lower trading expenses than an uninformed manager who infrequently trades assets with high cost-per-trade.'')

[46] *See* Instruction 7 to Item 4(b) of Form N–1A.

[47] *See* Item 16(a) of Form N–1A.

[48] *See* Statement of Wayne H. Wagner, *supra* note 12.

[49] HR 2420 would require funds to disclose their portfolio turnover rate in a new document in which mutual funds would disclose their fees to investors.

[50] *See supra* note 45.

will bear when holding funds that other traders trade. This measure may provide investors with information about whether the other shareholders in the fund tend to be long-term or short-term investors, and may allow them to gauge the portfolio transaction costs generated by short-term investors. This measure also would help investors understand the extent to which a fund is used by other investors for short-term trading—*i.e.*, market timing.

4. Other Narrative Disclosures

Another possible approach is to require a discussion of transaction costs and portfolio turnover in the prospectus, the report to shareholders, or in another disclosure document. Currently, funds are required to discuss the impact of active and frequent portfolio trading, which results in a higher portfolio turnover ratio, if it is a principal investment strategy. The Commission could require that all funds discuss the impact that their management style would have on portfolio turnover. Funds also could be required to discuss the impact on portfolio transaction costs by: trading in various types of securities in which the fund will invest; markets in which they will invest (*e.g.*, on an exchange or through over-the-counter transactions, or in foreign or domestic markets); and the portfolio management strategies that a fund's adviser will employ. In addition, the Commission could require a fund to disclose the portfolio turnover rate that the fund would not expect to exceed.

5. Brokerage Costs and Average Commission Rate per Share

The Commission could require that the information on brokerage costs that is currently included in the SAI be moved to the fund prospectus and prominently displayed with the portfolio turnover information to give shareholders a more complete understanding of the underlying transaction costs of the fund. Another possibility would be to reinstate some form of average commission rate per share disclosure,[51] with appropriate revisions to make it more meaningful than the previously eliminated disclosures of such information in the fund's financial highlights table.

6. Disclosure of Gross Returns

Up to this point in the release, we have described the many sources of costs incurred by fund investors. We could require an alternative disclosure that captures indirectly the total cost of investing in funds. Funds could report the return on their investments prior to all identifiable costs along with the investment return after such costs have been deducted. By reporting both measures side by side, investors could get a reasonable idea of how much they are paying for the return they receive.

Current Commission regulations mandate the disclosure of the returns that funds generate after fees and expenses (standardized returns).[52] These standardized returns differ from the gross returns generated by the fund's portfolio manager.[53] Gross returns are the returns that investment managers produce while standardized returns are the returns that are available to shareholders.

Gross returns are generally higher than standardized returns because the standardized returns reflect the loads, fees, expenses, and other charges that shareholders pay to obtain and maintain their investments. Dilution due to market timing may also cause standardized returns to be lower than the associated gross returns.

If gross returns were disclosed to investors, they could compare the returns produced by their managers with the standardized returns. Investors would be able to evaluate the efficiency of fund management by examining the difference between these two returns. In particular, they would be able to determine how much of the portfolio return they will actually receive on a net basis.

The disclosure of gross returns would also allow investors to compare the performance of investment managers on an equivalent basis. Such comparisons now require that investors take into account differences across funds, such as loads, fees, expenses, and dilution. Although loads, fees, and expenses are now disclosed, dilution caused by portfolio trading is not. Accordingly, investors cannot now compare investment managers on a completely equivalent basis.

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Questions About Improving Disclosure Related to the Level of Transaction Costs

16. Are there ways to provide a rough estimate of transaction costs, or develop a scheme to categorize these costs (for example, ''very high,'' ''high,'' ''average,'' ''low,'' or ''very low'') under general guidelines set by the Commission that would mitigate the difficulties involved in coming up with a more precise measure, and yet still provide useful information to investors? Could such an approach produce results that are consistent enough to permit meaningful comparison among funds? If yes, please provide specific suggestions.

17. In general, do the current disclosure requirements relating to transaction costs described in this section of the release provide investors with adequate information? If not, what additional information should funds provide? Would one or more of the alternatives described in this section provide useful information to investors, or would the alternatives lengthen the prospectus while providing no real benefit? If one or more of these alternatives would provide meaningful information, would the information most appropriately be located in the prospectus, the SAI, the report to shareholders, or in another disclosure document?

18. Does existing portfolio turnover disclosure provide useful information about transaction costs? If additional narrative disclosure concerning portfolio turnover and its relationship to transaction cost is needed, what information should be required?

19. Does the existing requirement to disclose the dollar amount of commissions paid provide investors with meaningful information about transaction costs? How can the existing requirement be improved?

20. Would an average daily net flow measure provide useful information to investors?

21. Should the Commission consider policies to encourage funds to charge purchasers and redeemers of fund shares a fee payable to the funds to compensate existing and remaining investors for the costs they bear when their funds accommodate the purchases and redemptions of other investors? If yes, should the Commission consider requiring funds to disclose how they compute these fees, if they require them; and why they do not require these fees, if they do not?

[51] In 1995 the Commission amended Form N–1A to require funds to disclose in the financial highlights table their average commission rate per share. *See* Investment Company Act Release No. 21221 (July 21, 1995). This amount was calculated by dividing the total dollar amount of commissions paid during the fiscal year by the total number of shares purchased and sold during the fiscal year for which commissions were charged. In 1998 the Commission eliminated this requirement in the belief that the fund prospectus is not the most appropriate document through which to make this information public. *See* Investment Company Act Release No. 23064, (Mar. 13, 1998). The Commission noted that industry analysts had informed the staff that average commission rate information is only of marginal benefit to them and to typical fund investors, and that the analysts support the view that these rates are technical information that typical investors are unable to understand.

[52] *See* Item 21(b)(1) of Form N–1A.

[53] Gross return refers to the aggregate performance of the holdings of a portfolio.

22. Should the requirement to disclose average commission rate per share be reinstated, in either its original form or in a revised form? If you advocate that it be reinstated in a revised form, please provide specific suggestions.

23. Is ''transaction costs'' as described in this release a useful concept, or would it be more useful for investors to see the effect of all costs combined, for example, by showing the following:

- Gross or ''pure'' portfolio return;
- Net return to shareholders; and
- The resulting difference?

24. If it would be useful for investors to see the effect of all costs combined, could funds calculate and report the gross or ''pure'' portfolio return, net return to shareholders and the resulting difference on an annual basis?

25. Should the Commission require disclosure of gross returns? If so, what definition would be most useful? Of what benefit would these returns be to investors? How expensive would it be for funds to compute these returns?

26. Would the disclosure of gross returns allow investors to better identify dilution due to market timers?

27. If portfolio returns are to be disclosed, how should the returns be adjusted for fund flows into and out of the portfolio? Should they be computed using internal rate of return methods; time-weighted average methods; or should other methods be used?

28. If portfolio returns are to be disclosed, should these returns only be disclosed, or should the differences between these returns and the shareholder returns be disclosed?

29. Where should these returns or return differences be disclosed, and how should they be described?

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VI. Review of Transaction Costs by Fund Directors

Although a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost. The adviser's obligation is to seek to obtain the most favorable terms for a transaction reasonably available under the circumstances.[54] Given the fact that portfolio transactions costs can be substantial and that they involve the use of fund assets, portfolio transaction costs must be a significant issue for consideration by fund directors. The transaction costs incurred by a mutual fund are also generally reviewed by the fund's board of directors because section 15(c) of the Investment Company Act requires a fund's board to request and review such information as may reasonably be necessary to evaluate the terms of the advisory contract between the adviser and the fund. Even if the investment adviser obtains best execution, research, distribution, and other services purchased by the adviser with the fund's brokerage bear on the reasonableness of the fund's management fee because the research, distribution and other services may otherwise have to be purchased by the adviser itself, resulting in higher expenses and lower profitability for the adviser. Therefore, for example, mutual fund advisers that have soft dollar arrangements provide their funds' boards with information regarding their soft dollar practices.[55]

In evaluating the use of commissions, fund directors also consider the appropriateness of entering directed brokerage arrangements. Under a directed brokerage arrangement, the fund asks the investment adviser to direct securities transactions to a particular broker that has agreed to provide services, pay for services provided by others, or make cash rebates to the fund. Funds typically enter into directed brokerage arrangements to offset fund expenses, such as audit, legal, and custodial fees. Although directed brokerage does not involve the conflicts posed by soft dollars, it does raise issues related to how a fund's assets are being expended and other issues, including disclosure.[56]

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Questions About Board Review of Transaction Costs

30. Are existing requirements for board review of transaction costs adequate? If they are not adequate, how can they be improved?

31. Should boards be required to receive reports with mandated information regarding soft dollars and directed brokerage payments? Should investors be provided periodically with a summary of these reports?

32. One problem in evaluating execution cost measurements is in identifying a standard of comparison. It may be difficult for fund directors to assess the fund's execution performance statistics in a vacuum, without comparison with other funds' statistics. Should the Commission or other independent body collect these statistics from similar funds and make available aggregate statistics for comparison purposes?

33. Should fund advisers be required to provide fund boards with an internal allocation of their uses of brokerage commissions, indicating the amounts and percentage used by the adviser to obtain execution services and soft dollar benefits, specifically detailing the types and amounts of the various kinds of benefits? Should there be separate allocations among types of research, such as research produced by underwriters, or other broker-dealer affiliates?

* * * * *

In conclusion, the Commission believes that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund. As outlined above, the Commission intends to examine what steps can be taken to improve the disclosure of transaction costs in order to make the information more useful and understandable to the average investor.

By the Commission.

Dated: December 18, 2003.

Margaret H. McFarland,

Deputy Secretary.

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[54] *See* Securities Exchange Act Release No. 23170 (Apr. 23, 1986).

[55] *See* Section 15(c) of the 1940 Act. *See also,* Inspection Report, *supra* note 25.

[56] All advisers, including the investment advisers of mutual funds, have an obligation to act in the best interests of their clients and to place client interests before their own. They also have an affirmative duty of full and fair disclosure of all material facts to their clients. *See* 15 U.S.C. 80b–6 (2000) (Section 206 of the Investment Advisers Act of 1940); *S.E.C.* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963). Some of the funds that engage in directed brokerage disclose the practice in the prospectus, the SAI, and/or the annual report to shareholders. Others use the footnotes to the financial statements to make the disclosure. In 1995, the Commission adopted accounting rules which require funds to report all expenses gross of off-sets or reimbursements pursuant to a directed brokerage arrangement. *See supra* note 40. HR 2420 would create a specific fiduciary duty for fund boards to review soft dollar and directed brokerage arrangements, as well as require an annual report to the board on soft dollar and directed brokerage payments, as well as summary disclosure in annual reports to shareholders regarding the report to the board in these areas.