MEMO# 17130

February 24, 2004

INSTITUTE LETTER ON SEC CONCEPT RELEASE ON MEASURES TO IMPROVE DISCLOSURE OF MUTUAL FUND TRANSACTION COSTS

[17130] February 24, 2004 TO: ACCOUNTING/TREASURERS MEMBERS No. 9-04 EQUITY MARKETS ADVISORY COMMITTEE No. 4-04 SEC RULES MEMBERS No. 28-04 SMALL FUNDS MEMBERS No. 22-04 RE: INSTITUTE LETTER ON SEC CONCEPT RELEASE ON MEASURES TO IMPROVE DISCLOSURE OF MUTUAL FUND TRANSACTION COSTS The Institute has filed a comment letter with the Securities and Exchange Commission on its concept release relating to the disclosure of mutual fund transaction costs.1 The most significant aspects of the letter are summarized below and a copy of the letter is attached. I. Institute Recommendations The comment letter recommends that the Commission take the following actions. • Require new disclosure in the financial highlights table of brokerage commissions paid by a fund (1) as a percentage of average net assets and (2) as a percentage of the principal amount of transactions. To ensure that these disclosures are meaningful to investors, the letter recommends that they be accompanied by disclosure stating the portion of trades that were executed on a commission basis, spread basis, or some other basis as well as the explanation of the factors and variables that affect commission rates. • Require new disclosure in the financial highlights table of a fund's gross inflows and outflows as a percentage of average net assets. The letter states that the disclosure of gross flows would be a better indicator of the transaction costs generated by fund flows than the average level of net flows into and out of funds, as suggested by the Concept Release. Specifically, the letter states that this measure would address situations that may arise where the disclosure of net flows could be misleading, e.g., where the inflows and outflows of a fund actively traded by shareholders offset each other over the period, resulting in an average net flow close to zero. 1 SEC Release Nos. 33-8349, 34-48952 and IC-26313 (December 18, 2003), 68 FR 74820 (December 24, 2003) ("Concept Release"). 2 • Require expanded and more prominent disclosure in a fund's prospectus relating to portfolio turnover rate. Specifically, the letter recommends that funds be required to include in the section of a fund's prospectus discussing its principal investment strategies the portfolio turnover rate for the five most recent fiscal years, as well as narrative disclosure explaining the meaning of portfolio turnover and its relationship to portfolio transaction costs, the impact that a fund's management style would have on portfolio turnover and transaction costs, and a description of portfolio transaction costs associated with the principal types of securities, or markets, in which the fund will invest. The letter also recommends that funds be required to add a standardized legend immediately subsequent to the fee table portion of the risk-return summary to alert

investors that the figures in the table do not include transaction costs and to reference the section of the prospectus that includes the discussion of the fund's portfolio turnover rate. Finally, the letter recommends that the Management's Discussion of Fund Performance in annual shareholder reports be required to describe the factors affecting portfolio turnover for the most recently completed period. • Require fund prospectuses to include narrative disclosure of a fund's policies and procedures for monitoring transaction costs and brokerage allocation that is currently required to be disclosed in Statements of Additional Information. The letter states that this recommendation is intended to give greater prominence to this information by moving it to the prospectus. The letter also recommends that funds be required to provide narrative disclosure of information about a fund's soft dollar arrangements, including the general types of products and services received, how the fund's adviser utilizes such products and services, whether or not they are unsolicited and what role, if any, they play in selecting brokers. • Require fund boards to approve the fund's policies and procedures of the fund's adviser for reviewing transaction costs, and require advisers to provide boards with reports on a periodic basis (e.g., annually) containing certain information about the fund's transaction costs. The letter states that such information could include an internal allocation of the adviser's use of brokerage commissions, indicating the amounts paid by the adviser to brokers for execution-only services and the amounts paid to brokers to obtain execution services and research and products under Section 28(e) of the Securities Exchange Act of 1934. II. Proposals to Quantify All Transaction Costs The Concept Release requests comment on the feasibility of attempting to quantify all transaction-related costs incurred by funds and requiring funds to disclose such a measure. The letter states that it would be inappropriate for the Commission to take this step. First, there is no single agreed-upon measure of transaction costs. The letter notes that market participants, academics and others utilize various different measures of transaction costs and that consulting firms also have developed various quantitative tools that attempt to estimate transaction costs using a variety and combination of approaches. Nevertheless, the letter states that to the best of our knowledge, there is no single generally-accepted method or product that has been developed to capture all the necessary and relevant data from a fund and generate objective and consistent measurements. 3 Second, each of the existing measurements of transaction costs has significant limitations. Specifically, several of the methods would include some, but not all, of the components of transaction costs, thereby presenting an incomplete picture of these costs to investors. In addition, the manner in which a trader executes an order may bias transaction cost measurements under these methods. Because of these limitations, the letter states that several of the measures are open to being "gamed" and therefore could encourage the execution of transactions in a manner that is intended to minimize transaction costs, potentially at the expense of what may be the best overall trade for a fund. Finally, mandating the use of any of the measures to quantify and disclose transaction costs would place an enormous burden on funds in terms of recordkeeping and operational requirements. The letter notes that while many fund advisers have systems in place to record the time at which a trader receives an order, others lack systems to record the applicable market data at that point in time. Therefore, requiring funds to quantify and disclose transaction costs could be extremely costly, especially for small and midsize fund complexes. For all of these reasons, the letter strongly opposes requiring funds to measure and disclose their total transaction costs utilizing any of the methodologies set forth in the Concept Release. The letter therefore states that the recommendations for additional quantitative and narrative disclosure, as well as enhanced board oversight, would be far more beneficial to investors, and would avoid the potential adverse effects of quantifying and disclosing a measure of all transaction costs. III. Accounting Issues The Concept Release also requests comment on whether it would be feasible to account for some or all transaction costs as an expense in fund financial statements or appropriate to include some or all of these costs in a fund's expense ratio and fee table without accounting for these items as an expense in the fund's financial statements. The letter states that commissions paid should not be reflected as an expense in fund financial statements as doing so would understate net investment income and overstate unrealized/realized gains as well as cause "book-tax differences" necessitating additional recordkeeping efforts by fund managers. The letter also does not support including commission costs that do not relate to execution and clearing (i.e., soft dollars) as an expense in fund financial statements. The letter states that it is difficult if not impossible to break out commissions paid for proprietary research and points out that Commission staff has previously noted that where the purchase or sale price of a security includes transaction costs that have been incurred for other reasons, but are difficult to separately identify and remove from the overall purchase or sales price, accounting theory recognizes that it would be neither feasible nor practical to account for these costs as a fund expense. Finally, the letter states that other types of transaction costs (e.g., spread costs, market impact costs, opportunity costs) also should not be included as expenses in fund financial statements as these costs cannot be reliably measured with the degree of precision necessary to include them in financial statements and because these costs – like commissions – constitute 4 acquisition and disposition costs, which are included in the cost basis of securities purchased or reduce the proceeds of sales. Ari Burstein Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 17130, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17130.
