

MEMO# 16919

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SEC ISSUES CONCEPT RELEASE SEEKING COMMENT ON MEASURES TO IMPROVE DISCLOSURE OF MUTUAL FUND TRANSACTION COSTS

[16919] December 24, 2003 TO: ACCOUNTING/TREASURERS COMMITTEE No. 39-03 EQUITY MARKETS ADVISORY COMMITTEE No. 41-03 RESEARCH COMMITTEE No. 24-03 SEC RULES COMMITTEE No. 107-03 SMALL FUNDS COMMITTEE No. 36-03 RE: SEC ISSUES CONCEPT RELEASE SEEKING COMMENT ON MEASURES TO IMPROVE DISCLOSURE OF MUTUAL FUND TRANSACTION COSTS The Securities and Exchange Commission has issued a concept release seeking comment on measures to improve disclosure of mutual fund transactions costs.¹ As discussed in more detail below, the Commission seeks comment on whether mutual funds should be required to: quantify and disclose to investors the amount of transaction costs they incur;² include transaction costs in their expense ratios and fee tables; or provide additional quantitative or narrative disclosure about their transaction costs. Additionally, the Commission seeks comment on whether mutual funds should be required to record some or all of their transaction costs as an expense in their financial statements. Comments must be filed with the Commission no later than Monday, February 23, 2004. The Institute plans to schedule a conference call with members in the near future to discuss the issues raised in the Concept Release. Once the call is scheduled, members will be notified of the call details via e-mail.

I. BACKGROUND Under current law, funds must provide investors with information about two items that are related to transaction costs – portfolio turnover rate and dollar amount of brokerage commissions. The Commission is concerned, however, that these requirements do not directly 1 See SEC Release Nos. 33-8349, 34-48952, and IC-26313 (Dec. 22, 2003) (the “Concept Release”). A copy of the Concept Release is available on the SEC’s website at: <http://www.sec.gov/rules/concept/33-8349.htm>. 2 As discussed in detail in the Concept Release, a mutual fund’s transaction costs include all of its costs that are associated with trading portfolio securities, including: commissions, spreads, market impact costs, and opportunity costs. The Concept Release acknowledges that, of these, commissions are explicit costs that are readily identifiable and quantifiable whereas spread, impact, and opportunity costs are implicit costs that cannot be measured or calculated directly. 2 address a fund’s overall transaction costs or elicit sufficient information about these costs. Accordingly, the Commission is considering how mutual fund transaction cost disclosure requirements should be revised to provide more meaningful information to investors. In particular, the Commission is considering whether it should require funds to:

- 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;
- Quantify some or all

transaction costs and include them in expense ratios and fee tables; • Provide other quantitative information about the level of transaction costs, or • Some combination of the above.³ As discussed in more detail below, the Commission seeks comment on each of these alternatives. Also, to the extent the Commission determines to provide investors with additional numerical information about the amount of transaction costs that mutual funds incur, the Commission seeks comment on whether this information would most appropriately be located in the prospectus, the statement of additional information, or in another disclosure document.

II. PROPOSALS TO QUANTIFY TRANSACTION COSTS

While the Concept Release generally seeks comment on what would be the best way to provide investors with additional numeric information about the amount of transaction costs that mutual funds incur, it notes that suggestions to improve the opacity of portfolio trading costs and provide investors adequate information about these costs tend to fall into three broad alternatives.⁴ These three alternatives, and some of the specific issues on which the Commission seeks comment, are as follows:

A. Quantify Commission Costs Only

Under this alternative, mutual funds would be required to disclose the commissions they pay to effect securities transactions and include the result in their expense ratios and fee tables. While this approach would provide investors additional information about the amount of transaction costs that funds incur, thus enabling them to make better informed investment decisions, it would not include all transaction costs.⁵ Accordingly, among other issues, the Commission seeks comment on whether quantifying only brokerage commissions would provide useful information to investors or whether, alternatively, such disclosure might mislead investors because it would not include all transaction costs.

B. Quantify All Transaction Costs

This alternative, which would require mutual funds to quantify and disclose all of the transaction costs they incur, would provide the advantages associated with quantifying commission costs only, while eliminating any ³ According to the Concept Release, in considering these alternatives, the Commission is mindful of the complexities associated with identifying, measuring, and accounting for transaction costs. ⁴ If the Commission were to choose to require disclosure of only one transaction cost measure, the Commission is also interested in comment on which measure it should be. ⁵ Also, according to the Concept Release, the limited transparency of soft dollar commissions that might result from this approach “may provide incentives for managers to misuse soft dollar services.” ³ disadvantages associated with quantifying some, but not all transaction costs. This alternative, however, raises the issue of the difficulty of quantifying spread, market impact, and opportunity costs.⁶ As with the previous alternative, the Commission seeks comment on whether this alternative would provide fund investors with useful information. For persons supportive of this alternative, the Commission seeks comment on how to implement it, including specific algorithms, formulas, definitions, recordkeeping requirements and internal controls that should be used. Comment is also sought on how funds should measure the spread, market impact, and opportunity costs that would be included in quantifying all of a fund’s transaction costs.

C. Quantify the Effect of Daily Decisions to Trade

Another alternative suggested to measure transaction costs is the “trade effect” measure, which would capture the combined effect of transaction costs and gains and losses from short term trading and 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. According to the Concept Release, trade effect is easy to measure in practice and includes all realized costs of trading – commission, spread, and price impacts – plus any short-term trading profits or losses incurring as a result of the timing of the trade.⁷ While the Concept Release notes that 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, comment is sought on whether this alternative would provide useful

information to investors.⁸ In addition to seeking comment on the above alternatives, the Commission seeks comment on whether disclosure by markets or broker-dealers (i.e., sell-side disclosure) of their execution quality for large, institutional orders would be helpful to funds in evaluating their execution costs.⁹

III. ACCOUNTING ISSUES

6 The Concept Release

notes that, perhaps the most all-inclusive way to measure transaction costs is through “implementation shortfall,” which measures the transaction cost of each trade as the difference between the price of all trades the fund intends 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. Concept Release at p. 6 and n.30.

7 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 (e.g., should they compare trade day prices to trade day closing prices or trade prices to closing prices on the next trading day).

8 The Concept Release notes that, because investors currently lack the information necessary to meaningfully discriminate among funds on the basis of the benefits and costs associate with fund portfolio trading, trade effect disclosure may allow investors to determine the extent to which fund performance – for better or worse – is due to the fund’s trading activities.

9 According to the Concept Release, an example of this would be requiring broker-dealers handling large orders 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.

4 The Concept Release notes that 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. This treatment, however, provides a mutual fund shareholder with an opaque view of portfolio transaction costs in a fund’s financial statements, which may impair the investor’s ability to evaluate a fund’s use of soft dollars. Accordingly, the Commission is considering whether: (1) all transaction costs can be and should be captured in the expense ratios and fee tables in a fund’s prospectus; and (2) 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. The Commission seeks comment on whether it would 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. It also seeks comment on whether it would be feasible to account for some or all transaction costs as an expense in fund financial statements.

IV. IMPROVING DISCLOSURE RELATED TO THE LEVEL OF TRANSACTION COSTS

The Concept Release also seeks comment on whether the current disclosure requirements relating to transaction costs provide investors with adequate information.¹⁰ If not, comment is sought on what additional information funds should provide to investors. In particular, comment is sought on the following set of disclosure alternatives that would either improve current disclosures or add new types of disclosure:

A. Disclose Transaction Costs in Terms of Rated Categories

– This alternative proposes that transaction costs be disclosed in terms of rated categories, instead of as part of the expense ratio or as a stand-alone ratio. So, for example, funds would categorize their trading costs as either very high, high, average, low, or very low. Each fund could then be compared to an industry standard but, in order for such a comparison to be made, a transaction cost measure would have to be developed.

B. Portfolio Turnover

– Another approach would be to require funds to give greater prominence to the portfolio turnover rate. According to the Concept Release, if portfolio turnover is highly correlated with transaction costs, the portfolio turnover ratio may be a “good proxy” for these costs.

C. Information about Average Net Flows

– This approach would involve providing investors additional information about the sale and

redemption of fund shares. The disclosure of average net flow, measured as a fraction of total assets might help investors predict the losses they will bear when holding funds that other traders trade. It may also help investors understand the extent to which a fund is used by other investors for short-term trading. 10 Under current law, all mutual funds, except money market funds, must disclose in their prospectuses the annual rate of portfolio turnover that they have incurred during the last five fiscal years. They must also disclose in their SAs the dollar amount of brokerage commissions that they have paid during their three most recent fiscal years. 5 D. Other Narrative Disclosure – Under this approach, a fund would be required to discuss its transaction costs and portfolio turnover in either its prospectus, report to shareholders, or another disclosure document. The Commission could require that this discussion include the impact that the fund’s management style would have on portfolio turnover and the impact on portfolio transaction costs by: trading in various types of securities in which the fund will invest; markets in which it will invest; and the portfolio management strategies that the fund’s adviser will employ. The Commission might also require a fund to disclose the portfolio turnover rate that the fund would not expect to exceed. E. Brokerage Costs and Average Commission Rate Per Share – The Commission could require that the information on brokerage costs that is currently included in the SA be moved to the fund prospectus and prominently displayed with the portfolio turnover information in order to provide investors a more complete understanding of the underlying transaction costs of the fund. Alternatively, the Commission could require funds to reinstate some form of average commission rate per share disclosure, with appropriate revisions to make it more meaningful than the previously eliminated disclosures of such information in the fund’s financial highlights table. F. Disclosure of Gross Returns – Under this approach, funds would 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, thereby indirectly capturing the total cost of investing in funds. V. REVIEW OF TRANSACTION COSTS BY FUND DIRECTORS The Concept Release discusses the “pivotal role” fund directors play in monitoring the conflicts that arise in connection with transaction costs. According to the Concept Release, 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.” 11 In evaluating the use of commissions, fund directors also consider the appropriateness of entering into directed brokerage arrangements. The Commission seeks comment on whether existing requirements for board review of transaction costs are adequate and, if not, how they might be improved. Comment is also sought on: whether boards should be required to receive reports with mandated information regarding soft dollars and directed brokerage payments;12 and whether fund advisers should 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. Tamara K. Salmon Senior Associate Counsel 11 Moreover, “it is imperative that the fund’s directors both understand and heavily scrutinize the payment of [transaction] 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.” 12 Comment is also sought on whether investors should be provided periodically with a summary of such reports.