

MEMO# 6137

August 16, 1994

SEC PROPOSAL ON REPORTING OF FUND EXPENSES PAID FOR THROUGH DIRECTED BROKERAGE ARRANGEMENTS

August 16, 1994 TO: ACCOUNTING/TREASURERS MEMBERS NO. 24-94 BOARD OF GOVERNORS NO. 78-94 SEC RULES MEMBERS NO. 56-94 RE: SEC PROPOSAL ON REPORTING OF FUND EXPENSES PAID FOR THROUGH DIRECTED BROKERAGE ARRANGEMENTS

The Securities and Exchange Commission has proposed amendments to enhance disclosure by investment companies of expenses paid by broker-dealers in connection with the allocation of a company's brokerage transactions to a broker-dealer ("brokerage/service arrangements"). The amendments are designed to enhance the information provided to investors so that they may better evaluate the expenses of a fund that pays for services with commission dollars and accurately compare expenses and yields among funds. The amendments would require that fund expenses paid in this manner be reflected in the fund's statement of operations, fee table, financial highlights table and yield quotations. Comments are due to the SEC on the proposed amendments by October 17, 1994. The significant aspects of the proposed amendments are summarized below, and a copy of the proposing release is attached. A. General In the release, the Commission notes that under a typical brokerage/service arrangement, a broker agrees to pay certain expenses of the fund (e.g., custodian fees, transfer agency fees) and, in exchange the fund agrees to direct a minimum amount of brokerage to the broker. The release states that, unlike research soft-dollar arrangements under which an adviser uses client commission dollars to obtain research services, brokerage/service arrangements involve the use of a fund's commission dollars to obtain services that directly and exclusively benefit the fund. Thus, brokerage/service arrangements generally do not present the same conflict of interest concerns addressed by the safe harbor under Section 28(e) of the Securities Exchange Act of 1934. The Commission stated in note 1, however, that the "receipt by a fund's adviser of any direct or indirect economic benefit as the result of these arrangements [which could arise if, for example, a 2reduction in fee expenses affects the amount of any expenses waiver or reimbursement by the adviser] would almost certainly violate Section 17(e)(1) of the [Investment Company Act of 1940], unless the benefit received fell within the safe harbor provided by Section 28(e)." B. Proposed Amendments 1. Regulation S-X - The proposal would amend Rule 6-07 of Regulation S-X to require that the amounts of the various expenses listed in a fund's statement of operations be adjusted, or "grossed-up," to include amounts paid with commission dollars. The required adjustments to the statement of operations would be made at the time financial statements are prepared, and no daily expense accruals for services paid for with commission dollars would be required. The amendments would specifically except research services, as defined in Section 28(e) of the

1934 Act. The Commission, however, requested comment on whether such services should be included and, if so, how they should be valued and how the value should be allocated among the adviser's clients. As an alternative to the proposed accounting changes noted above, funds could be required to allocate each commission paid between execution cost and payment for fund services and to present their financial statements based upon those allocations. This method would require separating commissions into brokerage and expense components, and reflecting the expense component as an expense in the financial statements. The Commission has solicited comment (a) on the ability of funds to account for amounts paid with commission dollars by the allocation method, (b) whether the proposed gross-up method adequately reflects the economic nature of these arrangements, and (c) on the costs of each of these accounting methods compared to their benefits to investors.

2. Fee Table and Financial Highlights Table - Amendments have been proposed to Form N-1A and Form N-2 to require that (a) the expense percentages included in a fund's fee table be based upon total expenses (i.e., that the percentages include amounts paid with commission dollars) and (b) the "ratio of expenses to average net assets" in a fund's financial highlights table reflect expenses paid with commission dollars.

3. Performance Information - The Commission has proposed to amend the instructions to the yield formulas for funds (other than money market funds) to require that the costs of services paid for with brokerage commissions be reflected in quotations of yield in a fund's registration statement, and, as a result, in its advertisements.

3The proposed amendments would not revise the money market fund yield formula because it is based upon the net change in the value of a hypothetical account, and any spread or mark-up paid by a fund would be amortized and reflected in that change in value. Therefore, requiring money market funds to include fees paid with commission dollars in the calculation of yield would result in those fees being counted twice. Comment has been solicited, however, on whether the money market fund yield formula should be revised to reflect the cost of services paid for with commission dollars as expenses when they are incurred.

C. Related Arrangements The release describes certain other arrangements that, like brokerage/service arrangements, have the effect of reducing reported fund expenses. For example, some funds have "compensating balance" arrangements with their custodians under which their custodian fees are reduced if they maintain cash on deposit with the custodians in a non-interest bearing account. Comment has been requested on whether an adjustment to fund expenses similar to that being proposed for brokerage/service arrangements should be required for these expense offset arrangements, or whether these arrangements should be addressed in footnotes to the financial statements.

D. Average Commission Rates The Commission has proposed to require that the average commission rate paid by a fund (in cents per share) be disclosed in the financial highlights table next to the portfolio turnover rate. This proposal is designed to address the Commission's concern that adequate information about brokerage commissions and other costs incurred in the execution of a fund's portfolio transactions is currently not being provided to investors.

Amy B.R.
Lancellotta Associate Counsel Gregory M. Smith Director - Operations/ Compliance & Fund Accounting Attachment