

MEMO# 17090

February 10, 2004

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

[17090] February 10, 2004 TO: ACCOUNTING/TREASURERS COMMITTEE No. 6-04 EQUITY MARKETS ADVISORY COMMITTEE No. 3-04 SEC RULES COMMITTEE No. 16-04 SMALL FUNDS COMMITTEE No. 12-04 RE: DRAFT INSTITUTE LETTER ON SEC CONCEPT RELEASE ON MEASURES TO IMPROVE DISCLOSURE OF MUTUAL FUND TRANSACTION COSTS As we previously informed you,¹ the Securities and Exchange Commission has published for comment a concept release on issues relating to the disclosure of mutual fund transaction costs.² The Institute has prepared a draft comment letter on the Concept Release. The most significant aspects of the draft letter are summarized below and a copy of the draft letter is attached. Comments on the proposal must be received by the SEC no later than February 23. We have scheduled a conference call for Friday, February 13, at 2:30 pm Eastern to discuss the proposal and the Institute's comment letter. The dial-in number for the call will be 888-625- 1617 and the passcode for the call will be 11664. If you plan to participate on the call, please contact Monica Carter Johnson by phone at 202-326-5823 or by e-mail at mcarter@ici.org. In the meantime, if you have any comments on the Institute's draft letter, please contact the undersigned by phone at 202-371-5408 or by e-mail at aburstein@ici.org.

I. Institute Recommendations The draft letter expresses support for improving investor awareness and understanding of fund transaction costs and states that enhanced disclosure could improve investor understanding of these costs. The draft letter, however, acknowledges that there is no broad consensus on how to quantify fund transaction costs.

1 Memorandum to SEC Rules Committee No. 107-03, Accounting/Treasurers Committee No. 39-03, Equity Markets Advisory Committee No. 41-03, Research Committee No. 24-03, and Small Funds Committee No. 36-03, dated December 24, 2003 [16919]. 2 SEC Release Nos. 33-8349, 34-48952 and IC-26313 (December 18, 2003), 68 FR 74820 (December 24, 2003) ("Concept Release").

2 After further internal and ICI Board discussion on the issues presented in the Concept Release, the draft letter recommends that the Commission take the following actions:

- Portfolio Turnover Rate: Require funds to disclose the portfolio turnover rate for the five most recent fiscal years, immediately subsequent to the fee table portion of the prospectus risk-return summary, accompanied by a standardized legend explaining the meaning of portfolio turnover and its relationship to portfolio transaction costs. The draft letter states that additional disclosure regarding a fund's portfolio turnover would help investors gain a better understanding of a fund's transaction costs. The draft letter notes that while portfolio

turnover rate is not a perfect proxy for fund trading costs, it is generally viewed as being highly correlated with transaction costs, and can be easily calculated by funds, easily understood by investors and readily comparable among funds.

- **Narrative Disclosure Regarding Portfolio Turnover and Brokerage Allocation:** Enhance prospectus disclosure relating to transaction costs by requiring narrative disclosure on a fund's portfolio turnover rate, including factors that may affect the fund's portfolio turnover, and a fund's policies and procedures for monitoring brokerage allocation and transaction costs, including how funds will select brokers to effect securities transactions and how the fund will evaluate the overall reasonableness of brokerage commissions paid, including the factors that the fund will consider in making those determinations.
- **Soft Dollars:** Enhance disclosure regarding a fund's soft dollar practices. Specifically, the draft letter recommends that disclosure concerning soft dollar practices should include the percentage of brokerage commissions paid that relate to specific products and services obtained from brokers, as well as narrative disclosure of the general types of products and services received, how the funds' advisers utilize such products and services, whether or not they are unsolicited and what role, if any, they play in selecting brokers.
- **Disclosure of Brokerage Commissions Paid:** Require, as line items in the financial highlights table, disclosure of brokerage commissions paid by a fund as a percentage of average net assets and average commission rate paid per share on portfolio transactions. These measures would be disclosed for each of the five most recent fiscal years. In order to make these disclosures more meaningful to investors, the draft letter recommends that these disclosures be accompanied by an explanation of the factors and variables that affect commission rates. Specifically, disclosure could be made regarding the impact on costs of executing a trade in a particular security and/or in a particular market. In addition, disclosure could be made regarding the portion of trades that are executed on a commission basis, spread basis, or some other basis. The draft letter also recommends that the Management's Discussion of Fund Performance in annual shareholder reports be required to include a discussion of the fund's portfolio turnover during the period.
- **Board Oversight:** Enhance board oversight of transaction costs by requiring boards to approve the fund's policies and procedures for monitoring brokerage allocation and portfolio transaction costs and requiring boards to receive reports of the fund's transaction costs on a periodic basis (e.g., quarterly), including an internal allocation of the adviser's use of brokerage commissions, indicating the amounts and percentage used by the adviser to obtain execution services and soft dollar benefits and specifically detailing the types and amounts of the various kinds of benefits.

Do members agree with the recommended enhanced disclosures? Are there any other disclosures that members recommend including in the comment letter or that should be taken out of the comment letter? The Concept Release requests comment on whether the SEC should require the disclosure of "gross returns." Do members believe such disclosure would be beneficial to investors? How would funds compute these returns? Should funds be required to disclose additional information about the average level of net flows into and out of funds? What benefit would such disclosure provide investors?

II. Proposals to Quantify Transaction Costs

The draft letter states that the Institute would not support a requirement to include portfolio transaction costs in fund expense ratios and fee tables nor would it support quantitative disclosure of transaction costs elsewhere in fund prospectuses or shareholder reports. Most significantly, the draft letter notes that there is no single agreed-upon method to capture all the necessary and relevant data from a fund and generate objective and consistent measurements and disclosing transaction costs would result in funds disclosing measurements that would be imperfect, at best, and that could mislead investors. Moreover, in contrast to the expense components currently included in fund expense ratios, transaction costs are variable and their effect on future costs and returns are uncertain. The Concept Release describes several different alternatives for quantifying and disclosing

transaction costs. The draft letter discusses the difficulties associated with each of these alternatives. In particular, the draft letter states that 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, several of the alternatives are open to being “gamed” and could encourage the execution of transactions in a manner that is intended to minimize disclosed costs, potentially at the expense of what may be the best overall trade for a fund. Several other factors also may bias transaction cost measurements under these methods, such as when traders fill a large order in multiple parts, when a trader pursues momentum or contrarian trading strategies, or when a trader is well informed about future price changes. The draft letter includes several examples of how applying standard industry trade cost measurements and benchmarks to a typical trade in an attempt to quantify all transaction costs yields a wide range of transaction costs, depending on the particular measurement and benchmark chosen. What procedures/audit processes do members have in place now to record when, for example, orders are submitted by portfolio managers to traders and/or from traders to brokers? If the SEC were to require that transaction costs be quantified and disclosed, how difficult would it be to implement the necessary recordkeeping procedures? What impact would this have on small fund complexes? 4 Do members have examples/arguments why the “trade effect” measure should not be used as a measure of a fund’s transaction costs? III. Accounting Issues The Concept Release requests comment on whether it would be feasible to account for some or all transaction costs as an expense in fund financial statements. The draft letter states that these costs should not be accounted for in this manner. The draft letter discusses that commission costs are the equivalent of acquisition or disposition costs incurred on physical assets and generally accepted accounting principles dictate that they be included in the cost basis of securities purchased or deducted from the proceeds of securities sold. Causing commissions paid to be treated as fund expenses would understate net investment income and overstate unrealized/realized gains. In addition, the draft letter states that other types of transaction costs should not be included as expenses in fund financial statements, most significantly because these costs cannot be reliably measured with the degree of precision necessary to include them in financial statements. The draft letter states that even if they could be reliably measured, they are more similar to acquisition and disposition costs, which are included in the cost basis of securities purchased or reduce the proceeds of sales. In addition, the Release requests comment on whether soft dollars should be included as an expense in fund financial statements or expense ratios. The draft letter states that, to the extent a fund pays for research through soft dollar commissions, it could be argued that those commissions should be included as expenses in fund financial statements. The draft letter notes, however, that the SEC has previously stated 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. The draft letter states that this reasoning may be applied to soft dollar commissions. Ari Burstein Associate Counsel Attachment (in .pdf format)

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