

## COMMENT LETTER

February 23, 2004

# Institute Comments on SEC Measures to Improve Disclosure of Mutual Fund Transaction Costs (pdf)

February 23, 2004 Mr. Jonathan G. Katz Secretary Securities and Exchange Commission 450 Fifth Street, N.W. Washington, DC 20549-0609 Re: Commission Request For Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs (File No. S7-29-03) Dear Mr. Katz: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's concept release on issues relating to the disclosure of mutual fund transaction costs.<sup>2</sup> The Institute strongly supports improving investor awareness and understanding of fund fees and expenses and recognizes the importance of improving disclosure concerning fund transaction costs and their effect on fund performance. We therefore commend the Commission for requesting comment on possible measures to improve information disclosed to investors about these costs. As a preliminary matter, we note that the Concept Release pertains only to the disclosure of costs associated with the trading of securities by mutual funds. If the purpose of the Concept Release is to identify methods to improve the disclosure of information to assist investors in understanding the costs of their investments, we believe it would benefit investors if the transaction costs associated with other types of investment vehicles, e.g., hedge funds and wrap accounts, also are disclosed. We therefore recommend that the Commission extend any proposals in this area to investment vehicles other than mutual funds. 1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,668 open-end investment companies ("mutual funds"), 611 closed-end investment companies, 111 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.456 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households. 2 SEC Release Nos. 33-8349, 34-48952 and IC-26313 (December 18, 2003), 68 FR 74820 (December 24, 2003) ("Concept Release"). Mr. Jonathan G. Katz February 23, 2004 Page 2 of 13 I. Summary of Institute Recommendations The Commission and the industry have long sought ways to improve the disclosure provided to investors about fund fees and expenses generally.<sup>3</sup> Recently, there has been an increased focus on ways to improve investor understanding of fund portfolio transaction costs.<sup>4</sup> There appears to be a lack of consensus, however, as to the best approach for doing so. Based on a thorough consideration of various approaches for improving portfolio transaction cost disclosure, we recommend 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, and require accompanying disclosure stating the portion of trades that were executed on a commission basis, spread basis, or some other basis. • Require new disclosure in the financial highlights table of a fund's gross inflows and outflows as a percentage of average net assets. • Require expanded and more prominent disclosure in a fund's prospectus relating to portfolio turnover rate. • Require fund prospectuses to include narrative disclosure of a fund's policies and procedures for monitoring transaction costs and brokerage allocation, including soft dollar practices. • Require fund boards to approve the fund's policies and procedures for monitoring brokerage allocation and portfolio transaction costs, and require boards to receive reports of the fund's transaction costs on a periodic basis (e.g., annually). Taken together, these new requirements would both significantly improve investor understanding of a fund's transaction costs and also enhance investor protection by formalizing board oversight of those costs. While the Institute supports enhanced disclosure of commission costs, we do not believe these costs should be included in fund fee tables or expense ratios, as doing so would diminish the ability of investors to use this information to compare the costs of different funds. We also do not believe it would be in the best interests of investors to require funds to disclose an "all-

3 See, e.g., Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated February 14, 2003 (supporting a Commission proposal to require funds to provide enhanced disclosure about their fees and expenses in shareholder reports). 4 See, e.g., H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," as passed by the U.S. House of Representatives on November 19, 2003, and S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," as introduced by Senators Corzine (D-NJ) and Dodd (D-CT) on November 25, 2003. Mr. Jonathan G. Katz February 23, 2004 Page 3 of 13 in" measure of all types of transaction costs. There is currently no single, agreed-upon measure of such costs and each of the alternatives discussed in the Concept Release has significant shortcomings. In this regard, it is important to note that all fund transaction costs are reflected in a fund's total return. The performance information included in the risk-return summary portion of fund prospectuses and in fund performance advertisements is calculated pursuant to a formula prescribed by the Commission, which requires that it be net of all fees and expenses.<sup>5</sup> As a result, when investors view this data, they are indirectly taking a fund's fees and expenses, including transaction costs, into account. Our recommendations and specific comments on the Concept Release are discussed more fully below.

## II. Enhanced Disclosure

### A. Disclosure of Brokerage Commissions Paid

As the Concept Release notes, the commissions paid by a fund are the only type of transaction cost that can be measured directly. The commission paid for each transaction appears on that trade's confirmation statement and all mutual funds (with the exception of money market funds) are currently required to disclose in their Statements of Additional Information the dollar amount of brokerage commissions that they have paid during their three most recent fiscal years.<sup>6</sup> The Institute believes that enhanced disclosure regarding brokerage commissions would improve an investor's overall ability to evaluate and compare fund brokerage costs. We therefore recommend that the Commission require funds to disclose certain information about brokerage commissions paid<sup>7</sup> in the financial highlights table. In particular, funds should be required to disclose brokerage commissions paid (1) as a percentage of average net assets and (2) as a percentage of the principal amount of transactions.<sup>8</sup> Including this information in the financial highlights table will allow investors to evaluate the commissions in the appropriate context (i.e., backward-looking information on the fund's returns and expenses).

<sup>5</sup> See Item 21 of Form N-1A (Calculation of Performance Data); Rule 482 under the Securities Act of 1933. <sup>6</sup> See Item 16(a) of Form N-1A (Brokerage Allocation and Other Practices). <sup>7</sup> For purposes of these

disclosures, “brokerage commissions paid” should be defined to include explicit commissions paid for executing trades in exchange-listed securities as well as “commission equivalents” and similar transaction costs paid in connection with riskless principal transactions. See SEC Release No. 34-45194 (December 27, 2001).<sup>8</sup> In 1995, the Commission amended Form N-1A to require funds to disclose in the financial highlights table their average commission rate per share. SEC Release No. IC-21221 (July 21, 1995). The Commission later eliminated this requirement in the belief that the fund prospectus was not the most appropriate document through which to make this information public. SEC Release No. IC-23064 (March 13, 1998). The Concept Release requests comment on whether this requirement should be reinstated. We believe that disclosing commissions as a percentage of the principal amount of transactions would be more meaningful to investors. This measurement, among other things, would facilitate the disclosure of commissions in foreign securities, where commissions are typically expressed in terms of a percentage of the value of the trade rather than as a fixed currency amount per share. Mr. Jonathan G. Katz February 23, 2004 Page 4 of 13 To ensure that these disclosures are meaningful to investors, we recommend that they be accompanied by an explanation of the factors and variables that affect commission rates. For example, disclosure could be made regarding the types and levels of transaction costs associated with different types of securities in which a fund invests. (For example, a fixed-income fund could disclose that trades in its securities typically do not include a commission, but rather a mark-up or mark-down. An international fund could discuss levels of commissions in the principal markets in which it invests.) In addition, disclosure should be made regarding the portion of trades that are executed on a commission basis, spread basis, or some other basis. This disclosure would clarify that the information about the fund’s commissions may relate only to a subset of the fund’s portfolio transactions. We believe that these recommendations would significantly enhance investor understanding of commission costs. We further believe that this approach is preferable to one that would require commissions to be included in the expense ratio and fee table. In contrast to the expense components currently included in fund expense ratios, transaction costs tend to vary from year-to-year. Consequently, their effect on future costs and returns is uncertain. Transaction costs can fluctuate as a result of a number of factors (e.g., market conditions, fund flows, portfolio manager changes). This volatility, which would not necessarily reflect changes in the cost of providing fund services to investors, could create significant confusion with respect to future fund expenses if transaction costs were included in the expense ratio and fee table. Indeed, the volatility in transaction costs is one of the reasons why an advocate for greater fund fee and expense disclosure has expressed opposition to including brokerage costs in expense ratios.<sup>9</sup> In addition, because commissions may be the primary type of transaction cost for some types of funds, but not others, including commission costs in the expense ratio would destroy its ability to provide “apples-to-apples” comparisons. In short, while enhanced disclosure of commission costs would be a positive step, including these costs in the expense ratio and fee table is not the way to do so.<sup>10</sup>

**B. Disclosure of Gross Inflows and Outflows** The Concept Release suggests that another approach to providing information about transaction costs would be for funds to provide additional information about the average level of net flows into and out of funds, specifically, the average daily net flow measured as a fraction of total assets. The Institute believes that providing additional information about the sale and 9 In explaining why he did not believe that brokerage costs should be included in expense ratios, John C. Bogle stated that, “The expense ratio is going to have a lot of stationary qualities. It’s not going to be to different from one year to the next.” See Richard Teitelbaum, Investing; Know a Fund’s Cost? Look Deeper, NEW YORK TIMES, February 9, 2003, at Section 3, p.7. 10 We also believe that including commissions in expense ratios would be inappropriate from a financial accounting standpoint, as is discussed further

below. Mr. Jonathan G. Katz February 23, 2004 Page 5 of 13 redemption of fund shares could be beneficial to investors in assessing portfolio transaction costs that may be generated as a result of investor activity. It also could be useful in informing investors about the level of short-term trading in a fund, which could include market timing. We therefore support additional disclosure along these lines. However, we believe that disclosure of a fund's gross inflows and outflows would be a better indicator of the transaction costs generated by fund flows.<sup>11</sup> Situations 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. We therefore recommend that funds be required to disclose their gross inflows and outflows as a percentage of a fund's average net assets, and suggest that this information be included in the financial highlights table.<sup>12</sup>

C. Portfolio Turnover All mutual funds (with the exception of 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.<sup>13</sup> The Concept Release requests comment on whether additional narrative disclosure concerning portfolio turnover and its relationship to transaction costs should be required. We believe that such additional disclosure would help investors gain a better understanding of a fund's transaction costs. While portfolio turnover rate is not a perfect proxy for fund trading costs,<sup>14</sup> it is generally viewed as being highly correlated with transaction costs. In addition, it can be easily calculated by funds, and is easily understood by investors and readily comparable among funds. We believe that these advantages outweigh any imprecision of a portfolio turnover rate's correlation to trading costs. For these reasons, we recommend that a fund's portfolio turnover rate be given greater prominence in a fund's prospectus. Specifically, we recommend that a fund's portfolio turnover rate for each of the five most recently completed fiscal years<sup>15</sup> be disclosed in the section of a fund's prospectus discussing its principal investment strategies.<sup>16</sup>

11 Funds are already required to disclose similar information in their financial statements. Specifically, Rule 6-09 of Regulation S-X requires disclosure of the gross dollar amount of purchases into and out of the fund over the reporting period. 12 The Concept Release discusses disclosing fund flows as a fraction of a fund's total assets. We believe that it would be more appropriate to reflect this information as a percentage of a fund's net assets. This approach would be consistent with the disclosure of other financial information in the prospectus and, therefore, would facilitate investor understanding. 13 Item 9 of Form N-1A (Financial Highlights Information). 14 For example, a fund that frequently trades securities on a low cost-per-trade basis may incur lower overall transaction costs than a fund that trades infrequently but on a high cost-per-trade basis. 15 We believe it is important to disclose portfolio turnover over a multi-year period to illustrate that portfolio turnover, and related transaction costs, change from year to year depending on various factors. 16 See Item 4 of Form N-1A (Investment Objectives, Principal Investment Strategies, and Related Risks). If the Commission determines that the portfolio turnover rate should be given even greater prominence, it might be appropriate to include the portfolio turnover rate for each of the five most recently completed fiscal years immediately subsequent to the fee table portion of the risk-return summary accompanied by a standardized legend.

Mr. Jonathan G. Katz February 23, 2004 Page 6 of 13 Such disclosure should be accompanied by 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;<sup>17</sup> and a description of portfolio transaction costs associated with the principal types of securities, or markets, in which the fund will invest. In addition, we recommend that funds be required to include a standardized legend immediately subsequent to the fee table (1) to alert investors that the figures in the table do not include transaction costs and (2) to reference the section of the prospectus that includes the discussion of the fund's portfolio

turnover rate recommended above. This legend would highlight for investors that the fund's transaction costs are not reflected in the figures in the fee table and advise them where they can obtain information about the fund's portfolio turnover rate, which may be viewed as an indirect indicator of those costs. Finally, we recommend that the Management's Discussion of Fund Performance (MDFP) in annual shareholder reports be required to describe the factors affecting portfolio turnover for the most recently completed period. We believe that including a discussion of a fund's portfolio turnover rate in the context of the MDFP would help investors gain a better understanding of a fund's transaction costs and the impact that they may have on the fund's performance.

18 D. Policies Relating to Transaction Costs, Brokerage Allocation and Soft Dollars The Institute further recommends that funds be required to include in their prospectus disclosure regarding their policies and procedures for monitoring portfolio transaction costs and brokerage allocation that is currently required to be disclosed in Statements of Additional Information.<sup>19</sup> The required disclosure would describe how a fund will select brokers to effect securities transactions and how it will evaluate the overall reasonableness of brokerage commissions paid, including the factors that the fund will consider in making those determinations. Our recommendation is intended to give greater prominence to this information by moving it to the fund's prospectus, explaining the meaning of portfolio turnover and its relationship to portfolio transaction costs. Our other recommended narrative disclosures relating to portfolio turnover would remain the same.

17 Currently, funds are required to disclose whether they may engage in active and frequent trading of portfolio securities to achieve their principal investment strategies. If so, funds must explain the tax consequences to shareholders of increased portfolio turnover, and how the tax consequences of, or trading costs associated with a fund's portfolio turnover may affect investment performance. See Instruction 7 to Item 4(b) of Form N-1A (Investment Objectives, Principal Investment Strategies, and Related Risks). Our recommendation would broaden the current requirement.

18 The Institute would oppose, however, the approach raised in the Concept Release of requiring a fund to disclose the portfolio turnover rate that the fund would not expect to exceed. Such disclosure would have to be a broad estimate at best, or be set at such a high level to ensure that funds would not exceed such a level. In addition, as noted above, a fund's portfolio turnover rate can be highly variable and stating a specific rate that the fund could not exceed could tie the hands of the portfolio manager in determining the best opportunities for the fund.

19 See Item 16(c) of Form N-1A (Brokerage Allocation and Other Practices). Mr. Jonathan G. Katz February 23, 2004 Page 7 of 13 The Concept Release discusses the relationship between soft dollars and transaction costs and requests comment on the impact of soft dollar arrangements on a fund's overall transaction costs.<sup>20</sup> We believe that investors would benefit by receiving information about a fund's soft dollar arrangements. We therefore recommend that funds be required to provide narrative disclosure of 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. This information would enable investors to assess their funds' soft dollar policies and the extent to which fund brokerage is used to obtain research services.

III. Review of Transaction Costs by Fund Directors The Concept Release discusses the role of fund boards in reviewing the fund's portfolio transaction costs and requests comment on several issues relating to the board's review. In describing the board's role, the Concept Release states that, because transaction costs are not readily available to investors, it is imperative that directors both understand and heavily scrutinize the payment of transaction costs by the fund and that the fund's board demand all relevant information that is needed to undertake this review process. As the Release notes, the transaction costs incurred by a mutual fund are generally reviewed by the fund's board because Section 15(c) of the Investment Company Act of 1940 requires a 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.<sup>21</sup> In addition, our members report that boards currently receive a large amount of information concerning transaction costs and that many boards have separate committees established to review brokerage issues. Nevertheless, we believe the requirements for board review of transaction costs can be improved. One suggestion would be to require boards to approve the policies and procedures of the fund's adviser for reviewing transaction costs. We also recommend that advisers be required to provide boards with reports on a periodic basis (e.g., annually) containing certain information about the fund's transaction costs.<sup>22</sup> For example, 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 20 Recently, the Institute recommended that the Commission adopt a revised interpretation under Section 28(e) of the Securities Exchange Act of 1934 to exclude certain products and services from the scope of that section's safe harbor. See Letter from Matthew P. Fink, President, Investment Company Institute, to William H. Donaldson, Chairman, Securities and Exchange Commission, dated December 16, 2003. The Institute's recommendation would significantly limit the products and services that a fund's adviser could receive under Section 28(e), thereby eliminating many of the concerns relating to the impact of soft dollar arrangements on a fund's overall transaction costs. 21 For example, mutual fund advisers that have soft dollar arrangements provide their funds' boards with information regarding those arrangements. 22 We believe that it is appropriate to provide boards with this information notwithstanding our concerns, discussed below, over attempts to quantify all transaction costs. In the context of a board meeting, the limitations of any particular measure or measures can be fully explained and there is opportunity for the adviser to address any questions the directors may have, which would not be the case in the context of prospectus disclosure. Mr. Jonathan G. Katz February 23, 2004 Page 8 of 13 amounts paid to brokers to obtain execution services and research and products under Section 28(e) of the Exchange Act.<sup>23</sup> 23 We do not believe, however, as the Concept Release suggests, that the Commission (or other independent body) should collect execution performance statistics from funds and make available aggregate statistics in order to facilitate directors' review of such performance. While the Commission requires broker-dealers and exchanges to disclose aggregate execution quality statistics, these statistics are not based on implicit costs, such as would be required for disclosure of statistics relating to a fund's transaction costs. See Rules 11Ac1-5 and 11Ac1-6 under the Securities Exchange Act. In addition, it is likely that proprietary systems would have to be developed, or third party services would have to be used, in order to evaluate the aggregate statistics and place them in a format that would be of benefit to directors, which could be very costly to funds. Mr. Jonathan G. Katz February 23, 2004 Page 9 of 13 IV. 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.<sup>24</sup> For the reasons set forth below, we do not believe that it would be appropriate for the Commission to take this step. A. There is No Single Agreed-Upon Measure of Transaction Costs Market participants, academics and others utilize various different measures of transaction costs. The Concept Release discusses a few of these approaches, including comparing the actual price that was paid in each transaction with the market price at some time before or after the transaction was completed ("before trade" or "after trade" measurements),<sup>25</sup> and using the "implementation shortfall" method.<sup>26</sup> In addition to these approaches, funds employ several other measures and benchmarks to estimate their transaction costs, including utilizing the volume weighted average price ("VWAP"). Consulting firms also have developed various quantitative tools that attempt to estimate transaction costs using a

variety and combination of these approaches. Nevertheless, 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.<sup>27</sup> Because of this lack of a single standard, funds currently utilize various measurement alternatives to monitor and evaluate their portfolio transaction costs.<sup>28</sup> Different funds use 24 As described in the Concept Release, this measure would include, in addition to commissions, both spread costs and market impact costs. The Concept Release requests comment on whether any such measure should also reflect “opportunity costs,” i.e., the cost of missed trades, as a component of transaction costs. We question whether opportunity cost is truly a transaction “cost” and whether, in any event, the “transaction” aspect of this “cost” can meaningfully be disaggregated from the impact of a fund’s investment strategies or ideas. 25 A “before trade” measure compares the actual price of each trade with a price that prevailed in the market before the transaction was completed. Concept Release at n.28. The benchmark used to determine the price that prevailed in the market could be, among other things, a price some time before the trade was executed (e.g., five minutes), the opening price, or the previous day’s closing price. In an “after trade” measure, the actual price of each trade may be compared with, among other things, the same day’s closing price, the next day’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. Concept Release at n.29. 26 The “implementation shortfall” method measures the transaction cost of each trade as the difference between the price of each trade that was actually made and the price that prevailed in the market when each decision to trade was made. 27 “[T]rying to fully quantify brokerage costs in total and given every trading scenario is similar to attempting to nail Jell-O to a wall.” Testimony of Jeffrey C. Kiel, Vice President – Global Fiduciary Review, Lipper, Inc, before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, United States Senate, January 27, 2004. 28 It is important to bear in mind that funds measure their transaction costs for internal purposes only, e.g., to evaluate traders, to make comparative decisions about the use of brokers, or to determine trading strategies. They do not attempt to measure transaction costs in order to disclose them to investors, given the imperfect nature of these measurements. Mr. Jonathan G. Katz February 23, 2004 Page 10 of 13 different measures for a variety of reasons, including, for example, the size of the fund complex, availability of resources, a fund’s investment objectives and strategies (e.g., index funds, momentum funds and international funds may all utilize different measurements), and the markets in which their portfolio securities trade. We further note that it is generally not feasible to measure portfolio transaction costs of fixed-income securities using the existing alternatives because of the lack of reliable market data in the fixed-income securities markets. B. Existing Measures Have Significant Limitations Each of the existing measurements of transaction costs has significant limitations. 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. The manner in which a trader executes an order also may bias transaction cost measurements under these methods, such as when traders fill a large order in multiple parts or when a trader pursues momentum or contrarian trading strategies.<sup>29</sup> Because of these limitations, 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. For example, assume that a buy order for a stock with an opening price of \$20.00 is received by a fund’s trading desk at 11:00 a.m., when the market price of the stock is \$21.10. If a “before trade” measurement is used and the benchmark is the opening price of the stock, the fund would have an

incentive to wait to execute the order hoping the price will drop below \$20.00. If the stock does not reach that price point, however, the order may not be executed that day or may be executed at a price even higher than the 11:00 am price, to the detriment of the fund's shareholders. Conversely, if an "after trade" measurement is used and the benchmark is the closing price of the stock, the fund would have an incentive to wait to trade until close to the end of the day, in order to ensure that its transaction costs will not stray too much above or below the closing price. The execution price for the stock, however, may be higher at that time than it would have been earlier in the day. Using VWAP to measure transaction costs raises similar concerns, as a fund would have an incentive to execute orders later in the day, once it has an indication of what a security's VWAP will be. This could cause the fund, however, to pay a higher execution price or forego an investment opportunity. The implementation shortfall method also has its limitations. Most notably, there is no generally accepted method to calculate a portfolio's implementation shortfall. Using the example discussed above, if an order were submitted at or before the open and the stock was executed at 2:00 p.m. at a price of \$21.25, the implementation shortfall cost would be \$1.25 (the difference between the execution price of \$21.25 and the opening price of \$20.00). If the order were submitted at 11:00 a.m., the transaction cost would be \$.15 (the difference between the 29 Traders who use momentum trading strategies buy after prices rise and sell after prices fall while traders who utilize contrarian trading strategies do the opposite. See Larry Harris, *Trading and Exchanges: Market Microstructure for Practitioners* (2003) at 429. Mr. Jonathan G. Katz February 23, 2004 Page 11 of 13 execution price of \$21.25 and the market price at 11:00 am of \$21.10). Therefore, two different transaction costs would result (\$1.25 or \$.15) depending on when the order was submitted, even though the same execution price for the stock was obtained. Consequently, if two funds each bought this stock but submitted their orders at the specified times above, one fund would report higher transaction costs even though the effect on both funds' total return would be identical. Finally, the Concept Release requests comment on the "trade effect" measure, which, according to the Release, 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. The primary problem with "trade effect" is that this method not only measures a fund's transaction costs but also the fund's short term trading profits and losses and therefore is not a "pure" measure of transaction costs. In addition, as the Concept Release notes, while it might seem most natural to measure trade effect over the trading day on which each trade occurred, this could cause some funds to shift their trading towards the end of the day to minimize reported trade costs, to the possible detriment of the fund's shareholders. In response, the Concept Release suggests using the next day's closing price as the benchmark to address this problem. The use of that benchmark, however, may be problematic because it is not clear that the potential variability due to unpredictable market fluctuations can be fully eliminated. 30 C. Recordkeeping and Operational Burdens Would Be Significant Mandating the use of any of the measures discussed above to quantify and disclose transaction costs would place an enormous burden on funds in terms of recordkeeping and operational requirements. Funds would need to collect and examine data whenever a decision is made that affects the outcome of a trade by the portfolio manager, the trader and the broker (e.g., the time horizon, target price and quantity elements of each trade) as well as determine when a trading decision has actually been made, when that decision has been modified, and determine the market price of the security at each of these times. 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 the above reasons, we would strongly oppose requiring funds to measure and disclose their total transaction costs utilizing any of the methodologies set forth in the Concept 30 The Concept Release requests comment on whether there are ways to provide a rough estimate of transaction costs, or develop a scheme to categorize these costs, such as in terms of rated categories (e.g., "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. The Commission, however, would still have to develop an industry standard in order to allow a comparison of funds to be made under this approach and would have to determine against whom this comparison would be made (e.g., as compared to all funds or funds with the same investment objective). In addition, these rough estimates would be just that, an estimate, and we question whether these results would be consistent enough to permit meaningful comparison among funds. We therefore would oppose such an approach. Mr. Jonathan G. Katz February 23, 2004 Page 12 of 13 Release. We believe, instead, that the suggestions set forth earlier in our letter – which include both 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 noted above.

V. 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. We do not believe that commissions paid should be reflected as an expense in fund financial statements. 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.<sup>31</sup> Causing commissions paid to be treated as fund expenses would understate net investment income and overstate unrealized/realized gains. It would also cause "book-tax differences" (i.e., financial accounting income and capital gains would be different than taxable income and capital gains) necessitating additional recordkeeping efforts by fund managers, the costs of which would likely be passed on to fund shareholders. Moreover, inasmuch as certain portfolio transactions are conducted on a net basis with no explicit commission, expensing commissions paid would diminish investors' ability to compare expenses between funds. The Concept Release also requests comment on whether commission costs that do not relate to execution and clearing (i.e., soft dollars) should be included as an expense in fund financial statements or expense ratios. We would not support such a requirement. It is difficult if not impossible to break out commissions paid for proprietary research. As Commission staff has previously noted, 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.<sup>32</sup> 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. For the reasons discussed above, we do not believe that these costs can be reliably measured with the degree of precision necessary to include them in financial statements. Moreover, these costs – like commissions – constitute acquisition and disposition costs, which, as described above, are

31 See FASB Concept Statement No. 2 and AICPA Audit and Accounting Guide for Investment Companies. 32 See Memorandum from Paul F. Royce, Director, Division of Investment Management, Securities and Exchange Commission to William H. Donaldson, Chairman, Securities and Exchange Commission, regarding correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (June

9, 2003). Mr. Jonathan G. Katz February 23, 2004 Page 13 of 13 included in the cost basis of securities purchased or reduce the proceeds of sales.<sup>33</sup> In addition, it is likely that they would not be considered to be expenses for financial accounting purposes.<sup>34</sup> Finally, if these transaction costs are required to be separately recognized in fund financial statements (as either acquisition/disposition costs or as expenses), fund officers would likely have difficulty certifying the accuracy of financial statements and independent accountants would likely qualify their audit opinions. \* \* \* \* \* The Institute appreciates the opportunity to provide comments on the Concept Release. If you have any questions regarding our comments, or would like any additional information, please contact me at (202) 326-5824 or Ari Burstein at (202) 371-5408. Sincerely, Amy B.R. Lancellotta Senior Counsel cc: The Honorable William H. Donaldson The Honorable Paul S. Atkins The Honorable Roel C. Campos The Honorable Cynthia A. Glassman The Honorable Harvey J. Goldschmid Paul F. Roye, Director Paul Goldman, Assistant Director Division of Investment Management

<sup>33</sup> We note that securities transactions are recorded on the fund's books net of transaction costs (e.g., market impact costs, spread costs). Thus, if these costs were to be reported as expenses, securities transactions would need to be reported on a gross basis (i.e., before transaction costs) in order to avoid double counting.

<sup>34</sup> FASB Concept Statement No. 6 describes expenses as outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. Further, expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the entity's ongoing operations.

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