

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release Nos. 33–8349; 34–48952; IC–26313; File No. S7–29–03]

RIN 3235–A194

Request for Comments on Measures To Improve Disclosure of Mutual Fund Transaction Costs

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comments.

SUMMARY: The Securities and Exchange Commission is seeking public comment on a number of issues related to the disclosure of mutual fund transaction costs. We seek comment on, among other things, whether mutual funds should be required to quantify and disclose to investors the amount of transaction costs they incur, include transaction costs in their expense ratios and fee tables, or provide additional quantitative or narrative disclosure about their transaction costs. We also seek comment on whether mutual funds should be required to record some or all of their transaction costs as an expense in their financial statements. The Commission requests comment from investors, investment companies, investment advisers, the financial services industry, academics, regulators, and the public generally on the issues summarized in this release, the specific questions located in Sections III (Alternatives for Quantifying Transaction Costs), IV (Accounting Issues), V (Alternatives that Provide Additional Information About the Level of Transaction Costs), and VI (Review of Transaction Costs by Fund Directors) of the release, and on any other issues that commenters believe relevant.

DATES: Comments must be received by February 23, 2004.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or electronic mail, but not by both methods.

Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–29–03; this file number should be included in the subject line if electronic mail is used. All comments received

will be posted on the Commission's Internet Web site (<http://www.sec.gov>) and made available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.¹

FOR FURTHER INFORMATION CONTACT: Paul Goldman, Assistant Director, or Jacquelyn Rivas, Staff Accountant, Office of Financial Analysis, Division of Investment Management, (202) 942–0510, at the Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION:

Table of Contents

- I. Introduction
- II. Background
 - A. Types of Transaction Costs
 - 1. Commissions
 - 2. Spread Costs
 - 3. Market Impact Costs
 - 4. Opportunity Costs
 - 5. Magnitude of Transaction Costs
- III. Proposals to Quantify Transaction Costs
 - A. Quantify Commission Costs Only
 - B. Quantify All Transaction Costs
 - C. Quantify the Effect of Daily Decisions to Trade
 - D. Sell-Side Alternatives
- IV. Accounting Issues
- V. Alternatives that Provide Additional Information about the Level of Transaction Costs
 - A. Existing Disclosure Requirements
 - 1. Portfolio Turnover
 - 2. Dollar Amount of Commissions Paid
 - B. Improving Disclosure Related to the Level of Transaction Costs
 - 1. Disclose Transaction Costs in Terms of Rated Categories
 - 2. Portfolio Turnover
 - 3. Information about Average Net Flows
 - 4. Other Narrative Disclosures
 - 5. Brokerage Costs and Average Commission Rate per Share
 - 6. Disclosure of Gross Returns
- VI. Review of Transaction Costs by Fund Directors

I. Introduction

The Securities and Exchange Commission ("Commission") is considering various alternatives designed to improve the information that mutual funds disclose about their portfolio transaction costs. Mutual funds incur transaction costs when they buy or sell portfolio securities. Transaction costs are significant for two reasons. First, for many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions and spreads alone cost the average equity

fund as much as 75 basis points.² Second, fund managers are subject to a number of conflicts. Commissions, which are paid out of fund assets, may, for example, be used to pay for research or trading support functions (brokerage services) that might otherwise be paid for by the fund's investment adviser (soft dollar commissions).³

Fund directors play a pivotal role in monitoring these conflicts. As explained in further detail below, transaction costs are not readily apparent to investors. These costs, however, must be disclosed to a fund's board of directors where such costs bear on the reasonableness of the fund's payments to the fund manager or its affiliates. Thus, it is imperative that the fund's directors both understand and heavily scrutinize the payment of such 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. In the absence of vigilant oversight by the fund's boards, transaction costs may include payment for services that benefit the fund's adviser at the expense of the fund.

Although transaction costs are taken into account in computing a fund's total return, they are not included in a fund's expense ratio because under generally accepted accounting principles they 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. As a result, current disclosure requirements focus on providing fund investors with information about two items that are related to transaction costs—portfolio turnover rate and dollar amount of brokerage commissions. All mutual funds (except 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. Investors can compare turnover rates to obtain an indication of how transaction costs are likely to vary among different funds. Funds (with the exception of money market funds) also must disclose in the Statement of Additional Information ("SAI") the actual dollar amount of

² John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, *Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management*, Aug. 30, 2001, at 10 (available at http://finance.wharton.upenn.edu/edelen/PDFs/MF_tradexpenses.pdf). These estimates omit the effect of market impact and opportunity costs, the magnitude of which may exceed commissions and spreads.

³ But see NASD Rule 2839 (K).

¹ We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.