

brokerage commissions that they have paid during their three most recent fiscal years.<sup>4</sup> The Commission is concerned that the current disclosure requirements do not directly address a fund's overall transaction costs or elicit sufficient information about these costs.

Some investors and financial industry observers have expressed similar concerns. For example, at hearings held on March 12 and November 4, 2003 by the U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, and on November 3, 2003 by the Senate Subcommittee on Financial Management, the Budget and International Security, a number of witnesses testified that inadequate information about portfolio transaction costs makes it difficult for mutual fund shareholders to know the overall cost of their investment.<sup>5</sup>

The Commission is aware of the need for transparency of mutual fund fees and expenses and committed to improving disclosure of the costs that are borne by mutual fund investors; but it is mindful of the complexities associated with identifying, measuring, and accounting for transaction costs. Thus, the Commission is considering how mutual fund transaction cost disclosure requirements should be revised to provide more meaningful information to fund investors. In particular, the Commission is considering whether mutual funds should be required among other things to (1) 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; (2) quantify some or all transaction costs and include them in expense ratios and fee tables;

(3) provide other quantitative information about the level of transaction costs, or (4) some combination of the above. The Commission also seeks comment on whether mutual funds should be required to treat transaction costs, or a portion thereof, as an expense in their financial statements.

This release invites comment on both the general topic of how to improve the disclosure of mutual fund transaction costs and a number of specific questions. For "yes or no" questions, please explain the reasons for your response. For questions with respect to alternatives for disclosing some or all transaction costs in fund expense ratios, fee tables or in other numerical formats, please be as specific as possible about how these alternatives may be accomplished, or why these alternatives are not feasible. Discussion is encouraged with respect to specific formulas that should be used, and specific recordkeeping and operational procedures that should be required in order to implement numerical disclosures.

The remainder of this release examines a number of major issues with respect to disclosure of portfolio transaction costs. Section II describes the different types of portfolio transaction costs and estimates their magnitude. Section III identifies and discusses various proposals for additional quantitative disclosures. Section IV discusses issues related to how funds account for transaction costs and report them in their financial statements. Section V explains the current requirements with respect to disclosure and identifies and requests comment on possible new disclosures related to the level of transaction costs. Section VI discusses the review of transaction costs by fund directors.

## II. Background

### A. Types of Transaction Costs

Broadly defined, a mutual fund's transaction costs include all of its costs that are associated with trading portfolio securities.<sup>6</sup> Transaction costs include commissions, spreads, market impact costs and opportunity costs.

#### 1. Commissions

Commissions generally refer to charges that a broker collects to act as agent for a customer in the process of

executing and clearing a trade. Commissions are the only type of transaction cost that can be measured directly. Measurement is easy because the commission is separately stated on the transaction confirmation and is paid directly from fund assets.<sup>7</sup> Trades for which commissions are paid generally involve equity securities traded on the exchanges. Equity securities are also traded on NASDAQ and through dealers. Although historically NASDAQ trading has been effected primarily on a spread basis, more and more equity trades are being done as single price riskless principal trades,<sup>8</sup> and the cost of these trades is now more frequently charged and identified as a commission equivalent.<sup>9</sup> Consequently, it appears that quantification of commission-type fees on equities has become easier. In fact, the commission on the average NASDAQ trade (almost 16 basis points) now approaches the commission on the average NYSE trade (18 basis points).<sup>10</sup>

#### 2. Spread Costs

Spread costs are incurred indirectly when a fund buys a security from a dealer at the "asked" price (slightly above current value) or sells a security to a dealer at the "bid" price (slightly below current value). The difference between the bid price and the asked price is known as the "spread." Spread costs include both an imputed commission on the trade and any market impact cost associated with the trade as discussed below.<sup>11</sup>

<sup>7</sup> Stephen A Berkowitz and Dennis E. Logue, *Transaction Costs: Much ado about everything*, Journal of Portfolio Management (Winter 2001) at 68.

<sup>8</sup> See Harold Bradley, Senior Vice President, American Century Investment Management, Statement Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (Mar. 12, 2003).

<sup>9</sup> The Commission has recognized that money managers opting for certain riskless principal transactions would now be informed of the entire amount of the market maker's charge for effecting the trade. See Exchange Act Release No. 45194 (Dec. 27, 2001).

<sup>10</sup> Justin Schack, *Trading Places*, Institutional Investor (Nov. 2003) at 32.

<sup>11</sup> Funds incur spread costs on trades that are made on a principal basis (e.g., NASDAQ trades executed from dealer inventory). Dealer spreads compensate brokers and broker-dealers for maintaining a market's trading infrastructure (i.e., price discovery and execution services) and may also reflect the impact of large orders on the prices of securities. The proportion of these two components varies among different trades. The market impact cost component of dealer spreads reflects dealers' inventory management costs. These costs have a significant impact on the spread between the dealer's bid (buy price) and ask (sell price). Although spread costs cannot be directly calculated, they can be estimated with data collected some time after the trade is executed. See Berkowitz and Logue, *supra* note at 65-68.

<sup>4</sup> All funds are required to provide their SAI to investors upon request. In addition, the SAI of any fund may also be accessed via the Commission's Web site (<http://www.sec.gov>) and frequently on a fund's or a fund sponsor's Web site.

<sup>5</sup> The House of Representatives recently passed legislation entitled the "Mutual Funds Integrity and Fee Transparency Act of 2003" (HR 2420) that would, among other things, mandate a new document in which mutual funds would disclose their fees to investors and directed the Commission to issue a concept release on issues related to mutual fund transaction cost disclosure. H.R. 2420, 108th Cong. (2003). HR 2420 would also require funds to disclose their portfolio turnover rate in the new fee disclosure document and provide a textual explanation of the impact of high portfolio turnover rates on fund expenses and performance. Additionally, the Commission has proposed that fund shareholder reports be required to include, among other things, the costs in dollars associated with an investment of \$10,000, based on a fund's actual expenses and return for the period. Investment Company Act Release No. 25870 (Dec. 18, 2002). The Commission is also today proposing to enhance disclosure regarding breakpoint discounts on front-end sales loads.

<sup>6</sup> See Larry Harris, *Trading and Exchanges: Market Microstructure for Practitioners* (2003) at 420-441 (discussing the components of transaction costs, including explicit and implicit costs, as well as alternative methods for estimating the magnitude of transaction costs).