

For disclosure purposes, each fund could be asked to sum these mark-to-market profits and losses across all trades on a given day. Funds would divide this sum by total assets for that day and report on an annual basis the average of this ratio across all trading days.

Trade effect includes all realized costs of trading—commission, spread and price impacts—plus any short-term trading profits or losses incurred as a result of the timing of the trade. Funds produce short-term trading profits if they can successfully capitalize on short-term price changes, for example, when they buy before prices rise. They incur short-term trading losses when they poorly time their trades, for example, when they buy before prices fall.

Investors may benefit from disclosure of short-term trading impact information because it would allow them to better understand the benefits and costs associated with fund portfolio trading. This information may particularly help investors interpret fund turnover. Although high turnover generally is correlated with poor performance due to excessive transaction costs and poor timing, high turnover may be desirable for funds that can implement profitable short-term trading strategies. Presently, investors lack the information necessary to meaningfully discriminate among funds on this basis. Trade effect disclosure may allow investors to determine the extent to which fund performance—for better or worse—is due to its trading activities.

If the Commission were to mandate trade effect disclosure, it would have to determine the period over which funds would measure their trade effect mark-to-market profits and losses. It might seem most natural to measure trade effect over the trading day on which each trade occurred by comparing trade prices to trade day closing prices. However, this comparison could cause some managers to shift their trading towards the end of the trading day to minimize their reported trade effect. To reduce such incentives, trade effect could be measured by comparing trade prices to closing prices on the next trading day.³⁴

not beneficial. If assets for the measurement period were \$100,000, the trade effect would be 0.5%.

³⁴ As noted above, trade effect measures the combined effect of transaction costs and short-term trading profits (or losses). The use of next day closing prices instead of same day closing prices would increase the importance of the short-term trading profits in the determination of the trade effect measure. Although variation in trade effect due to unpredictable market fluctuations would increase, averaging over many securities and over all days in the year would largely eliminate the

D. Sell-Side Alternatives

Thus far, the discussion in this release has focused primarily on the disclosure by mutual funds of their transaction costs and execution quality. The Commission also wishes to request comment on whether disclosure by markets or broker-dealers of their execution quality for large, institutional orders would be helpful to funds in evaluating execution costs. For example, broker-dealers handling large orders potentially could be required to disclose statistics that compare the prices at which their orders are executed with the quotes for a security at the time they received the order. To enhance their comparability, the statistics could be divided into categories based on the size of the order compared to the average daily trading volume in the security. Similar disclosure could be required of other venues that directly receive and execute institutional orders, such as floor brokers, specialists, and electronic trading venues. Such sell-side disclosure could represent one part of a comprehensive approach that attempted to measure transaction costs throughout the trading cycle. Standardized market statistics, which would encompass orders from many different institutions, potentially could provide benchmarks for execution quality that might assist fund managers and their boards in evaluating the execution quality obtained from different broker-dealers. For example, such statistics might be helpful in evaluating the execution quality obtained from affiliated or related broker-dealers compared to that obtained from those that are independent of the fund.³⁵

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General Questions About Quantifying Transaction Costs

1. Is investor decision-making harmed because investors lack numerical information about mutual fund transaction costs?

2. What would be the best way to provide investors with additional numerical information about the amount of transaction costs that mutual funds incur? Would the information most appropriately be located in the prospectus, the SAI, or in another disclosure document?

impact of such fluctuations. Moreover, since most funds simultaneously buy and sell when effecting portfolio adjustments, the effects of unpredictable market fluctuations on the mark-to-market profits for buy and sell trades often would offset each other.

³⁵ For a fuller discussion of fund director's review of transaction costs, see Section VI of this Release, "Review of Transaction Costs by Fund Directors."

Questions About Quantifying Commissions and Spreads

3. Would a requirement to quantify (express as a percentage) and disclose brokerage commissions, but not other transaction costs provide useful information to fund investors? If funds are required to quantify and disclose their brokerage commissions, should the number be included in fund expense ratios and fee tables?

4. Does the increased use of riskless principal trades on NASDAQ make it easier to quantify the cost of NASDAQ trades? What proportion of NASDAQ trades are subject to commission-equivalent fees?

5. Would quantifying commissions mislead investors because it would result in a number that includes some transaction costs and excludes others? Please explain the reasons for your answer.

6. If the answer to question 5 is yes, would the concern be alleviated if funds were required to quantify commissions and provide investors with disclosure that details the portion of trades that are performed on a commission basis; spread basis; or some other basis (e.g., directly from an issuer)?

7. What effect, if any, would a requirement to quantify commissions have on the incentives of fund managers with respect to (1) use of principal versus agency transactions; and (2) use of soft dollar transactions?

8. Could any possible adverse effects identified in questions 5 and 6 be mitigated or eliminated by requiring funds, in addition to reporting their commission costs, to estimate the spread cost of their principal trades (for example, by imputing to principal trades the fund's average commission rate on agency trades)? If yes, should this number be included in fund expense ratios and fee tables?

9. Alternatively, can the portion of spread cost that represents payment for executing a trade be measured separately from the portion of the spread that represents the market impact cost associated with that trade? If yes, should this number be included in fund expense ratios and fee tables?

Questions About Quantifying All Transaction Costs

10. Would a requirement to quantify all transaction costs provide useful information to fund investors? Would a requirement to quantify *all transaction costs, except opportunity costs* be a better alternative? If you advocate that we mandate either of these alternatives, please explain as specifically as possible, how the alternative should be