

implemented. Please discuss the specific algorithms, formulas, definitions, recordkeeping requirements, and internal control requirements that should be used. Commenters are encouraged to address the following specific topics:

A. How should funds measure their spread costs?

B. How should funds measure their market impact costs?

C. How should funds measure their opportunity costs?

D. Should spread, market impact and opportunity costs be measured trade-by-trade or for all transactions?

E. Should spread, market impact and opportunity costs be measured absolutely or relative to a benchmark?

F. Should this number be included in fund expense ratios and fee tables?

11. Would the trade effect measure provide useful information to investors, and if so, should we require its disclosure? If the Commission mandated trade effect disclosure, should trade effect be measured with respect to same day closing prices or next day closing prices?

12. More generally, if the Commission were to choose to require disclosure of only one transaction cost measure, which measure should it be?

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IV. Accounting Issues

Under generally accepted accounting principals, most portfolio transaction costs 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.³⁶ Unfortunately, this accounting treatment provides a mutual fund shareholder with an opaque view of portfolio transaction costs in a fund's financial statements.³⁷ One effect of this

lack of transparency is that it has impaired the ability of investors to evaluate the use of fund assets to obtain research services (as that term is defined in section 28(e) of the Securities Exchange Act of 1934) that are paid for through commissions or spreads.

The component of commissions that represent execution and clearing costs are the equivalent of acquisition or disposition costs incurred on physical assets and current accounting principles dictate that they be included in the cost basis of securities purchased or in the net proceeds from securities sold.³⁸ However, the component of commissions that represent the costs of services is conceptually an operating expense of a fund and should not be included in the cost basis of securities purchased or in the net proceeds from securities sold.³⁹

We have attempted to improve the transparency of financial reporting when reliable information is available. For example, the aggregate value of all fund operating expenses paid for by brokers in brokerage offset arrangements are identifiable and measurable, even if the brokerage offset credits cannot be allocated to individual trades. Accordingly, we adopted a rule under Regulation S-X in 1995 that requires a mutual fund to record the value of services received under brokerage-offset arrangements as an expense.⁴⁰ The practical result is that the portion of commission or spread cost that can be

calculated based on the net asset value of the fund, which would not be impacted by the alternatives in recognizing transaction costs. See Item 9 of Form N-1A. Form N-1A is the registration form used by open-end investment companies to register under the Investment Company Act of 1940 and to offer their shares under the Securities Act of 1933 [15 U.S.C. 77a].

³⁸ See Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

³⁹ See Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

⁴⁰ See Rule 6-07(2)(g) of Regulation S-X [17 C.F.R. 210.6-07(2)(g)]. Prior to adoption of this rule, funds would report fund expenses, such as expenses for transfer agency, custody, and other services net of direct payments made by brokerage firms on behalf of funds under brokerage offset arrangements. Rule 6-07(2)(g) requires these fund expenses reflect the total amounts paid to fund service providers whether directly paid by the fund or by another entity on its behalf. The fund is allowed to show after total fund expenses the amount of those expenses paid by the brokerage firms. This presentation results in a gross-up of income and expenses in the statement of operations; however, it provides transparency to shareholders on the impact of these arrangements on the fund's financial statements. Additionally, this presentation allows the expense ratio to properly reflect a component of commission/spread costs as an expense.

reliably identified and measured and that also represents operating expenses of the fund is reflected in the expense ratio and in fund expenses.⁴¹

We are considering whether all transaction costs can be and should be captured in fund expense ratios and fee tables contained in a fund's prospectus. We also are considering whether the cost information obtained would be reliable and relevant for financial reporting purposes or whether alternatively, some subset of transaction costs (e.g., all non-execution and clearing costs) can be reliably measured and expensed for financial reporting purposes. We may conclude that the standard for including these costs in the fee table is different than the standard for including these costs in the fund financial statements thereby creating a discrepancy between the two measures. If we conclude transaction costs or some subset of transaction costs should be included in fund financial statements, those statements would not be comparable to other similar entities, such as pension funds, hedge funds, and other investment vehicles. We are interested in the perspectives of fund investors and fund financial statement preparers on the desire for and feasibility of including some or all of this information in the prospectus and the fund financial statements.

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Questions About Accounting Issues

13. Would it be appropriate to include some or all transaction costs in fund expense ratios and fee tables without accounting for these items as an expense in fund financial statements?

14. Would it be feasible to account for some or all transaction costs as an expense in fund financial statements? If it is not feasible to reliably measure market impact and opportunity costs, should we still require that commission costs be expensed? If yes, should the requirement apply to all commission costs or only those commission and spread costs that do not relate to the execution and clearing of a portfolio transaction (i.e., soft dollars)? If it is not feasible to reliably measure all research costs, should we still expense those costs that can be reliably measured (i.e., payments to third parties for research)?

⁴¹ When we adopted this requirement, we also requested comment on whether the cost of research services provided by broker-dealers should be expensed. Many commentators pointed out the difficulty of allocating research received by an adviser among accounts when the brokerage of those accounts is used to acquire the research. Some commentators, however, supported the additional disclosure of research soft dollar practices. See Investment Company Act Release No. 21221 (July 21, 1995).

³⁶ For example, if a mutual fund purchases 1 share of XYZ Company at a price of \$10 with a commission of 5 cents, the mutual fund will record the cost of that security as \$10.05. However, the mutual fund will record the security on its statement of assets and liabilities at its market value, for example, \$10.03. The fund will then record the difference between the cost basis (\$10.05) and the market value (\$10.03) as unrealized gain or loss, in this case, an unrealized loss of 2 cents. Therefore, the portfolio transaction costs are not reflected directly as expenses of the fund, but are reflected in the statement of operations as changes in the realized or unrealized gain or loss on portfolio securities. See AICPA Audit and Accounting Guide for Investment Companies, paragraph 2.40 (May 1, 2002).

³⁷ Regardless of whether transaction costs are included in the costs basis/settlement proceeds of securities transactions or separately identified as operating expenses of the fund, the total return of the fund remains the same. Total return is