

15. Are mutual funds and their managers better able than they were in the past to track the portion of commission costs that purchase research services from brokers? Has the improvement been sufficient to make it feasible for us to require funds to expense these items in their financial statements? Since soft dollars are earned based on complex-wide trading activity, how should research and other non-execution costs be allocated among funds? Can soft dollars be traced to individual portfolio transactions? (This would entail adjusting the basis of the securities purchased in those transactions for the portion of the commission cost that was used to purchase research services.) Alternatively, should an aggregate adjustment (not specified to a particular portfolio transaction) be made to realized and unrealized gain or loss? If funds and their managers are not yet capable of tracking the portion of commission costs that purchase research services from brokers, what factors continue to prevent funds and managers from developing this capability?

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V. Alternatives That Provide Additional Information About the Level of Transaction Costs

A. Existing Disclosure Requirements

1. Portfolio Turnover

All mutual funds (except money market funds) provide investors with information about two items that are related to transaction costs "portfolio turnover rate and dollar amount of brokerage commissions.⁴² Funds disclose in their prospectuses the annual rate of portfolio turnover that they have incurred during the last five fiscal years.⁴³ Portfolio turnover rate measures the average length of time that a security remains in a fund's portfolio.⁴⁴ The requirement to disclose portfolio turnover rate is premised on the observation that a fund's transaction costs tend to be highly correlated with its turnover rate, other factors held equal.⁴⁵ Thus, by comparing turnover

rates, investors can obtain an indication of how transaction costs are likely to vary among different funds. The advantage that turnover rate (an indirect indicator of fund transaction costs) has over the dollar amount of brokerage costs (a more direct measure) is that turnover rate is less affected by the asset size of a fund. For example, a fund with assets of \$1 billion is likely to pay many more dollars of brokerage commissions than a fund with assets of \$100 million, even if their turnover rates are identical.

2. Dollar Amount of Commissions Paid

In addition to providing their portfolio turnover rates, funds are required to disclose in their prospectus whether they may engage in active and frequent trading of portfolio securities to achieve their investment strategies. If so, funds must explain the tax consequences to shareholders of the increased portfolio turnover, and how the trading costs and tax consequences may affect investment performance.⁴⁶

Funds (with the exception of money market funds) also must disclose in their SAIs the dollar amount of brokerage commissions that they have paid during their three most recent fiscal years.⁴⁷ Brokerage commission amounts, although they must be interpreted carefully, can nevertheless provide useful information to fund investors. This disclosure informs investors of the magnitude of the fund's overall assets that are expended on commissions.

B. Improving Disclosure Related to the Level of Transaction Costs

Another set of alternatives for improving mutual fund transaction cost disclosure consists of approaches aimed at improving current transaction cost related disclosures or adding new types of disclosure that would provide information that is more meaningful and understandable to the average investor.

1. Disclose Transaction Costs in Terms of Rated Categories

One commentator has suggested transaction costs (including commissions, spreads, and market impact costs) could be disclosed in terms of rated categories, instead of as part of the expense ratio or as a stand-alone ratio. The commentator suggested

funds trading expenses because it does not account for heterogeneity in the per-unit costs of trading an asset. For example, an uninformed manager that frequently trades assets with a low cost-per-trade may incur lower trading expenses than an uninformed manager who infrequently trades assets with high cost-per-trade.")

⁴⁶ See Instruction 7 to Item 4(b) of Form N-1A.

⁴⁷ See Item 16(a) of Form N-1A.

funds would categorize their trading costs as either very high, high, average, low or very low. The commentator acknowledged this disclosure might be a rough estimate, but a "rough estimate was better than no estimate at all."⁴⁸

Each fund would be compared to an industry standard. In order for such a comparison to be made, a transaction cost measure would have to be developed. In addition, we would have to determine whether any comparison should be against other funds generally or only against similar funds. For example, the transaction costs of an equity fund are likely not comparable to transaction costs of a fixed-income or money market fund.

2. Portfolio Turnover

Another possible approach would be to require funds to give greater prominence to the portfolio turnover ratio.⁴⁹ Portfolio turnover can be calculated easily by all funds. The ratio is simple and easy to understand and readily comparable among funds. If portfolio turnover is highly correlated with transaction costs, then the portfolio turnover ratio may be a good proxy for these costs.⁵⁰ The advantages of being able to easily calculate, understand, and compare portfolio turnover rates may justify any imprecision in their correlation to transaction costs.

3. Information About Average Net Flows

Another approach to providing information about transaction costs is to provide additional information about the sale and redemption of fund shares. The sale and redemption of fund shares often generates portfolio transaction costs that all fund investors must bear. Sales of fund shares often lead to security purchases as new monies are invested in the fund's portfolio. Redemptions often lead to security sales to raise money to pay for redemptions. To the extent that sales and redemptions do not offset each other, the net difference ultimately will generate portfolio transactions. These transactions usually incur transaction costs that all investors (in the case of net sales) or all remaining investors (in the case of net redemptions) must bear.

Investors therefore may be interested in the average level of net flows into and out of funds. The disclosure of average daily net flow, measured as a fraction of total assets, therefore might help investors predict the losses that they

⁴⁸ See Statement of Wayne H. Wagner, *supra* note 12.

⁴⁹ HR 2420 would require funds to disclose their portfolio turnover rate in a new document in which mutual funds would disclose their fees to investors.

⁵⁰ See *supra* note 45.

⁴² Money market funds purchase and sell securities on a principal basis. Transaction costs for these securities are embedded in the purchase price or sale proceeds and are not separately stated.

⁴³ See Item 9 of Form N-1A.

⁴⁴ For example, a fund that has a portfolio turnover rate of 100% holds its securities for one year, on average. A fund with a portfolio turnover rate of 200% holds its securities for six months, on average.

⁴⁵ See, e.g., Livingston and O'Neal, *supra* note 18 at 283; Fortin and Michelson, *supra* note at 67. *But see*, Chalmers, Edelen, and Kadlec, *supra* note 2 at 2 ("Turnover is likely to be an unreliable proxy for