

will bear when holding funds that other traders trade. This measure may provide investors with information about whether the other shareholders in the fund tend to be long-term or short-term investors, and may allow them to gauge the portfolio transaction costs generated by short-term investors. This measure also would help investors understand the extent to which a fund is used by other investors for short-term trading—*i.e.*, market timing.

#### 4. Other Narrative Disclosures

Another possible approach is to require a discussion of transaction costs and portfolio turnover in the prospectus, the report to shareholders, or in another disclosure document. Currently, funds are required to discuss the impact of active and frequent portfolio trading, which results in a higher portfolio turnover ratio, if it is a principal investment strategy. The Commission could require that all funds discuss the impact that their management style would have on portfolio turnover. Funds also could be required to discuss the impact on portfolio transaction costs by: trading in various types of securities in which the fund will invest; markets in which they will invest (*e.g.*, on an exchange or through over-the-counter transactions, or in foreign or domestic markets); and the portfolio management strategies that a fund's adviser will employ. In addition, the Commission could require a fund to disclose the portfolio turnover rate that the fund would not expect to exceed.

#### 5. Brokerage Costs and Average Commission Rate per Share

The Commission could require that the information on brokerage costs that is currently included in the SAI be moved to the fund prospectus and prominently displayed with the portfolio turnover information to give shareholders a more complete understanding of the underlying transaction costs of the fund. Another possibility would be to reinstate some form of average commission rate per share disclosure,<sup>51</sup> with appropriate

revisions to make it more meaningful than the previously eliminated disclosures of such information in the fund's financial highlights table.

#### 6. Disclosure of Gross Returns

Up to this point in the release, we have described the many sources of costs incurred by fund investors. We could require an alternative disclosure that captures indirectly the total cost of investing in funds. Funds could report the return on their investments prior to all identifiable costs along with the investment return after such costs have been deducted. By reporting both measures side by side, investors could get a reasonable idea of how much they are paying for the return they receive.

Current Commission regulations mandate the disclosure of the returns that funds generate after fees and expenses (standardized returns).<sup>52</sup> These standardized returns differ from the gross returns generated by the fund's portfolio manager.<sup>53</sup> Gross returns are the returns that investment managers produce while standardized returns are the returns that are available to shareholders.

Gross returns are generally higher than standardized returns because the standardized returns reflect the loads, fees, expenses, and other charges that shareholders pay to obtain and maintain their investments. Dilution due to market timing may also cause standardized returns to be lower than the associated gross returns.

If gross returns were disclosed to investors, they could compare the returns produced by their managers with the standardized returns. Investors would be able to evaluate the efficiency of fund management by examining the difference between these two returns. In particular, they would be able to determine how much of the portfolio return they will actually receive on a net basis.

The disclosure of gross returns would also allow investors to compare the performance of investment managers on an equivalent basis. Such comparisons now require that investors take into account differences across funds, such as loads, fees, expenses, and dilution. Although loads, fees, and expenses are now disclosed, dilution caused by portfolio trading is not. Accordingly,

informed the staff that average commission rate information is only of marginal benefit to them and to typical fund investors, and that the analysts support the view that these rates are technical information that typical investors are unable to understand.

<sup>52</sup> See Item 21(b)(1) of Form N-1A.

<sup>53</sup> Gross return refers to the aggregate performance of the holdings of a portfolio.

investors cannot now compare investment managers on a completely equivalent basis.

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#### *Questions About Improving Disclosure Related to the Level of Transaction Costs*

16. Are there ways to provide a rough estimate of transaction costs, or develop a scheme to categorize these costs (for example, "very high," "high," "average," "low," or "very low") under general guidelines set by the Commission that would mitigate the difficulties involved in coming up with a more precise measure, and yet still provide useful information to investors? Could such an approach produce results that are consistent enough to permit meaningful comparison among funds? If yes, please provide specific suggestions.

17. In general, do the current disclosure requirements relating to transaction costs described in this section of the release provide investors with adequate information? If not, what additional information should funds provide? Would one or more of the alternatives described in this section provide useful information to investors, or would the alternatives lengthen the prospectus while providing no real benefit? If one or more of these alternatives would provide meaningful information, would the information most appropriately be located in the prospectus, the SAI, the report to shareholders, or in another disclosure document?

18. Does existing portfolio turnover disclosure provide useful information about transaction costs? If additional narrative disclosure concerning portfolio turnover and its relationship to transaction cost is needed, what information should be required?

19. Does the existing requirement to disclose the dollar amount of commissions paid provide investors with meaningful information about transaction costs? How can the existing requirement be improved?

20. Would an average daily net flow measure provide useful information to investors?

21. Should the Commission consider policies to encourage funds to charge purchasers and redeemers of fund shares a fee payable to the funds to compensate existing and remaining investors for the costs they bear when their funds accommodate the purchases and redemptions of other investors? If yes, should the Commission consider requiring funds to disclose how they compute these fees, if they require them; and why they do not require these fees, if they do not?

<sup>51</sup> In 1995 the Commission amended Form N-1A to require funds to disclose in the financial highlights table their average commission rate per share. See Investment Company Act Release No. 21221 (July 21, 1995). This amount was calculated by dividing the total dollar amount of commissions paid during the fiscal year by the total number of shares purchased and sold during the fiscal year for which commissions were charged. In 1998 the Commission eliminated this requirement in the belief that the fund prospectus is not the most appropriate document through which to make this information public. See Investment Company Act Release No. 23064, (Mar. 13, 1998). The Commission noted that industry analysts had