

22. Should the requirement to disclose average commission rate per share be reinstated, in either its original form or in a revised form? If you advocate that it be reinstated in a revised form, please provide specific suggestions.

23. Is "transaction costs" as described in this release a useful concept, or would it be more useful for investors to see the effect of all costs combined, for example, by showing the following:

- Gross or "pure" portfolio return;
- Net return to shareholders; and
- The resulting difference?

24. If it would be useful for investors to see the effect of all costs combined, could funds calculate and report the gross or "pure" portfolio return, net return to shareholders and the resulting difference on an annual basis?

25. Should the Commission require disclosure of gross returns? If so, what definition would be most useful? Of what benefit would these returns be to investors? How expensive would it be for funds to compute these returns?

26. Would the disclosure of gross returns allow investors to better identify dilution due to market timers?

27. If portfolio returns are to be disclosed, how should the returns be adjusted for fund flows into and out of the portfolio? Should they be computed using internal rate of return methods; time-weighted average methods; or should other methods be used?

28. If portfolio returns are to be disclosed, should these returns only be disclosed, or should the differences between these returns and the shareholder returns be disclosed?

29. Where should these returns or return differences be disclosed, and how should they be described?

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VI. Review of Transaction Costs by Fund Directors

Although a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost. The adviser's obligation is to seek to obtain the most favorable terms for a transaction reasonably available under the circumstances.⁵⁴ Given the fact that portfolio transactions costs can be substantial and that they involve the use

of fund assets, portfolio transaction costs must be a significant issue for consideration by fund directors. The transaction costs incurred by a mutual fund are also generally reviewed by the fund's board of directors because section 15(c) of the Investment Company Act requires a fund's board to request and review such information as may reasonably be necessary to evaluate the terms of the advisory contract between the adviser and the fund. Even if the investment adviser obtains best execution, research, distribution, and other services purchased by the adviser with the fund's brokerage bear on the reasonableness of the fund's management fee because the research, distribution and other services may otherwise have to be purchased by the adviser itself, resulting in higher expenses and lower profitability for the adviser. Therefore, for example, mutual fund advisers that have soft dollar arrangements provide their funds' boards with information regarding their soft dollar practices.⁵⁵

In evaluating the use of commissions, fund directors also consider the appropriateness of entering directed brokerage arrangements. Under a directed brokerage arrangement, the fund asks the investment adviser to direct securities transactions to a particular broker that has agreed to provide services, pay for services provided by others, or make cash rebates to the fund. Funds typically enter into directed brokerage arrangements to offset fund expenses, such as audit, legal, and custodial fees. Although directed brokerage does not involve the conflicts posed by soft dollars, it does raise issues related to how a fund's assets are being expended and other issues, including disclosure.⁵⁶

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⁵⁵ See Section 15(c) of the 1940 Act. See also, Inspection Report, *supra* note 25.

⁵⁶ All advisers, including the investment advisers of mutual funds, have an obligation to act in the best interests of their clients and to place client interests before their own. They also have an affirmative duty of full and fair disclosure of all material facts to their clients. See 15 U.S.C. 80b-6 (2000) (Section 206 of the Investment Advisers Act of 1940); *S.E.C. v. Capital Gains Research Bureau*, 375 U.S. 180 (1963). Some of the funds that engage in directed brokerage disclose the practice in the prospectus, the SAI, and/or the annual report to shareholders. Others use the footnotes to the financial statements to make the disclosure. In 1995, the Commission adopted accounting rules which require funds to report all expenses gross of off-sets or reimbursements pursuant to a directed brokerage arrangement. See *supra* note 40. HR 2420

Questions About Board Review of Transaction Costs

30. Are existing requirements for board review of transaction costs adequate? If they are not adequate, how can they be improved?

31. Should boards be required to receive reports with mandated information regarding soft dollars and directed brokerage payments? Should investors be provided periodically with a summary of these reports?

32. One problem in evaluating execution cost measurements is in identifying a standard of comparison. It may be difficult for fund directors to assess the fund's execution performance statistics in a vacuum, without comparison with other funds' statistics. Should the Commission or other independent body collect these statistics from similar funds and make available aggregate statistics for comparison purposes?

33. Should fund advisers be required to provide fund boards with an internal allocation of their uses of brokerage commissions, indicating the amounts and percentage used by the adviser to obtain execution services and soft dollar benefits, specifically detailing the types and amounts of the various kinds of benefits? Should there be separate allocations among types of research, such as research produced by underwriters, or other broker-dealer affiliates?

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In conclusion, the Commission believes that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund. As outlined above, the Commission intends to examine what steps can be taken to improve the disclosure of transaction costs in order to make the information more useful and understandable to the average investor.

By the Commission.

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Margaret H. McFarland,
Deputy Secretary.

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would create a specific fiduciary duty for fund boards to review soft dollar and directed brokerage arrangements, as well as require an annual report to the board on soft dollar and directed brokerage payments, as well as summary disclosure in annual reports to shareholders regarding the report to the board in these areas.

⁵⁴ See Securities Exchange Act Release No. 23170 (Apr. 23, 1986).