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February 20, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

Re: Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs; File No. S7-29-03

Dear Mr. Katz:

The Investment Company Committee of the Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on the above-referenced concept release (the "Concept Release") issued by the Securities and Exchange Commission ("SEC" or "Commission").[2] The Concept Release is one of many recent regulatory and legislative initiatives designed to enhance the transparency of information, particularly with respect to fees and expenses, available to mutual fund investors. During hearings conducted last year by the House Financial Services Capital Markets Subcommittee, witnesses raised concerns about the level and transparency of mutual fund fees and expenses. In particular, several witnesses testified about the opacity of portfolio trading costs. According to the Concept Release, the Commission is considering various alternatives designed to improve the information that mutual funds disclose about their portfolio transaction costs.[3]

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[1] The Securities Industry Association ("SIA"), established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $142 billion in domestic revenue and $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

[2] Securities and Exchange Commission Release Nos. 33-8349; 34-48952; IC-26313; File No. S7-29-03, (December 18, 2003), 68 FR 74820.

[3] Unlike investment advisory fees and other operating expenses, the costs of effecting a fund's portfolio transactions are included as part of the cost basis of securities purchased or subtracted from the net proceeds of securities sold, and eventually are reflected as changes in the realized and unrealized gain or loss on portfolio securities in the fund's financial statements. Although transaction costs are taken into account in computing a fund's total return, the exact amount is not discernible to investors because they are not included in a fund's expense ratio.

I. Overview

The Concept Release states that the Commission is aware of the need for transparency of mutual fund fees and expenses and is committed to improving disclosure of the costs borne by mutual fund investors. In connection with this broad effort, the Commission is considering how mutual fund transaction cost disclosure requirements should be revised to provide more meaningful information to fund investors. Specifically, the Commission is considering whether mutual funds should be required to (1) quantify in some meaningful way and disclose some or all of their portfolio transaction costs without including these costs in their expense ratios and fee tables; (2) quantify some or all transaction costs and include them in expense ratios and fee tables; (3) provide other quantitative information about the level of transaction costs, or (4) some combination of the above. The Commission also seeks comment on whether mutual funds should be required to treat transaction costs, or a portion thereof, as an expense in their financial statements. Notably, the Commission acknowledges the complexities associated with identifying, measuring, and accounting for transaction costs.[4]

The Committee believes that appropriate disclosure promotes competition among different investment products and helps investors make informed decisions about which mutual fund is most appropriate for them. Thus, in general, we support the Commission's efforts to enhance investor understanding of the costs borne by mutual fund shareholders. In order for information to be useful to investors, it must be accurate, accessible, comprehensible, and comparable. Numerical disclosure of mutual fund transaction costs, due to the complexity and ambiguity involved in developing the data, does not advance these goals. Nevertheless, the Committee believes there are steps the Commission can take to ensure that investors are better informed about the level of transaction costs a fund incurs.

As the Commission notes in the Concept Release, transaction costs are difficult to quantify. Commissions alone, although explicit and easy to understand, do not fully reflect the overall cost associated with trading portfolio securities. In fact, actual transaction costs are difficult to measure because they include implicit costs such as market impact and opportunity costs, which cannot be measured directly but must be considered in attempting to determine the total cost of executing a trade.[5] Additionally, when trading on a principal basis, the transaction-based compensation, market impact and opportunity costs are reflected in the spread, *i.e.,* the difference between the bid price and the asked price. Thus, for dealer markets, these costs cannot be observed directly.

Although various equations have been developed for *estimating* transaction costs, no standardized method has emerged. Indeed, any effort to measure and report overall transaction

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[4] *Supra* note 2 at 74822.

[5] Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security. Opportunity cost is the cost of missed trades.

costs may cause investors to conclude that execution quality should be assessed based on quantitative factors alone when, in fact, qualitative factors are of equal or greater importance. As discussed in more detail below, due to the complexity of these issues, it is our view that the duty to evaluate transaction costs incurred by a mutual fund should continue to reside with fund directors, who have a fiduciary duty to understand and monitor all fund expenses, including transaction costs.

Nevertheless, the Commission can take steps to ensure that investors are better informed about the level of transaction costs a fund incurs. Information currently available to investors can serve as a proxy for transaction costs and the Committee supports more prominent disclosure of this information.[6] Also, the Commission has adopted rules requiring disclosure of more quantifiable fund expenses that we believe will increase investor awareness and spur cost competition within the industry.[7] We urge the Commission to evaluate the effectiveness of these measures, which will benefit investors by being easy to calculate, understand and compare, before causing investors to rely on complex calculations that may yield imprecise (and potentially misleading) results. Furthermore, mandating the more complicated structure will undoubtedly involve significant new data collection and new operational requirements at a material expense to the mutual fund industry, which expense will ultimately be borne by the individual investor through reduced performance, perhaps without providing the type of meaningful comparative information that the Commission is seeking to make available.

II. Transaction Costs Are Difficult to Quantify

Quantifying transaction costs is a complex and inexact process. Commissions on agency trades are reflected on the confirmation and therefore are easily measurable, but other costs that may be material are not as evident or as easily measured. For example, in a dealer market where trading is done on a principal basis, transaction costs are incurred when a fund buys a security at the asked price or sells a security at the bid price. Due to an efficient market, the spread includes imputed transaction-based compensation as well as any market impact and opportunity cost associated with the trade. In addition, institutional orders of significant size may have the effect of attracting other buyers and sellers, as the case may be, causing a change in price before the entire block is executed. These market impact and opportunity costs in many cases can exceed the commission or spread.

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[6] Information regarding portfolio turnover rates and dollar amounts of brokerage commissions could be disclosed in semi-annual and annual shareholder reports, for example. This is discussed further below.

[7] *See* Securities and Exchange Commission, Press Release 2004-16, February 11, 2004 reporting that the Commission adopted amendments to its rules requiring disclosure in a fund's semi-annual and annual report of a dollar example of the fees an investor would have paid on a hypothetical $1,000 investment, using the actual expenses incurred by the fund and the actual return that would have been achieved by the fund assuming a 5% return over the period, so funds can be compared against each other.

To demonstrate, consider a fund manager who wants to buy stock at $10 per share and asks his trader to buy 100,000 shares. If the trader is able to buy all the shares at $10 and pays a commission of $.04 per share, the fund will pay $1,000,000 for the shares and $4,000 in commissions. On the other hand, the trader may execute in a different market with lower transaction costs and get 10,000 shares at $10, paying only $.02 per share. By the time he has executed the entire trade, the share price has risen to $12 and the average per share price ends up being $11. He has paid $1,100,000 for the shares and $2,000 in commissions. The trader's explicit costs are half as much, however, the cost to the fund is $100,000 in market impact and opportunity costs. This example illustrates how potentially misleading (in terms of attempting to assess actual transaction costs) a straightforward comparison of actual commission costs or average commission rates can be.

As the Commission notes, there are ways to measure transaction costs that include implicit costs. Such methodologies employ a wide variety of estimation techniques and lack uniformity. A growing industry of consultants and academics derive transaction cost estimates using a wide variety of algorithms to compare the actual price that was paid in each transaction with the market price that prevailed at some time before or after the transaction was completed.[8] Such measurements involve judgment and calculation methodologies that differ from one consultant to another and, in most cases, the methodologies are considered proprietary information. This absence of uniformity and baseline measurements will not serve to facilitate comparisons among funds and, therefore, would be of limited use to investors.

Assuming the industry could decide on the specific formula that would yield the most accurate results, the Committee fears that it would nonetheless be susceptible to "gaming."[9] In addition, fund companies would be required to collect and analyze large quantities of data throughout the trading process. The recordkeeping and operational requirements as well as the expense to implement such numerical disclosures could be out of proportion to the potential benefits to investors. Moreover, such additional fund expense will serve to erode fund performance. The Committee, therefore, questions whether it is prudent or desirable to construct a complex (and potentially arbitrary) transaction cost measure.

Despite the fact that there is no generally accepted computation method, investment managers routinely employ proprietary systems or third party services to measure transaction costs, both to monitor performance and to comply with their best execution obligations. Fund managers are required to evaluate quality of execution performance periodically and systematically, and to make changes as necessary to improve performance.[10] All of this

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[8] *See, e.g.,* discussion of implementation shortfall, *supra* note 2 at 74823.

[9] A trader could lower transaction costs by simply delaying and executing only those buy orders where prices have fallen since the decision to trade was made, or only those sell orders for which prices have risen.

[10] Investment advisers are not obligated to obtain the lowest possible commission cost in order to meet their best execution obligation to the fund. Rather, the investment adviser must seek to obtain the most favorable terms for a transaction reasonably available under the circumstances. A money manager should consider the full range and quality of a broker's services in placing brokerage, including, among other things, the value of research provided as

information can, and in many cases is, used by fund directors in their oversight of the fund. Although it may not be apparent to mutual fund investors, mutual fund transaction costs are closely monitored by both those with fiduciary obligations to the fund company and to fund investors.

III. Directors' Duty To Monitor Transaction Costs

Monitoring fees and expenses to evaluate investment performance and to determine whether costs are competitive with other funds in the industry is a duty owed by fund directors in carrying out their fiduciary responsibility to act in the best interest of the fund company. At quarterly meetings and as otherwise requested, fund directors are provided with data and other information that enables them to evaluate these and other factors in connection with overseeing the activities of various service providers to a fund. Amid the recent improprieties involving the mutual fund industry and regulators' heightened attention to management issues, the vigilance of mutual fund directors is higher than ever. In order to effectively carry out their fiduciary responsibilities, mutual fund directors must be provided with adequate data regarding transaction costs.

Portfolio transaction costs have always been a significant issue for consideration by fund directors. Section 15(c) of the Investment Company Act of 1940 requires a fund's board of directors 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.[11] There are a number of practical steps that fund directors can take when evaluating a fund manager's transaction costs. Investment managers should be required to report to directors how trading decisions are made on a daily basis, including how investment decisions on behalf of a portfolio are made and how the related transactions are directed for execution. Those reporting to the board can use outside sources such as those discussed above to help analyze trading costs[12] or they can track trading costs internally. The process should identify appropriate benchmarks and compare the fund's performance, fee structures, and expenses to funds of comparable size and investment objective. We suggest that the active engagement of fund directors in issues related to fund fees and expenses, including the types of information available and the sources that can be used to

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well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager. *See* Securities Exchange Act Release No. 23170 (April 23, 1986), 51 FR 16004.

[11] Proposed amendments to Rule 31a-2 of the Investment Company Act of 1940 would require funds to retain copies of the written materials that directors consider in approving an advisory contract under Section 15. *See* Investment Company Act Release No. 26323 (January 15, 2004), 69 FR 3472. Another recent rule proposal would require a mutual fund company to provide disclosure in its reports to shareholders regarding the basis for the board of directors' approval of an investment advisory contract. *See* Securities and Exchange Commission Release Nos. 33-8364, 34-49219, IC-26350; File No. S7-08-04 (February 11, 2004), 69 FR 7852.

[12] Abel/Noser, Elkins/McSherry, and Plexus, Inc. are well-established providers of information and analysis of trading costs.

evaluate the information that they receive, will serve to protect the interests of individual investors.

IV. More Prominent Disclosure of Available Information

Although responsibility for monitoring and evaluating fund costs is most appropriately with those who have fiduciary obligations to the fund and its shareholders, the Committee recognizes that fund investors may want more information regarding fund fees and expenses. Accordingly, information regarding those transaction costs that are measurable (*i.e.*, brokerage costs), as well as information that may serve as a proxy for transaction costs, may be meaningful to investors and we believe disclosure of such costs can be improved.

In connection with transaction costs, mutual funds (except money market funds) disclose in their prospectus portfolio turnover ratios—a measure of a manager's trading frequency—which correlate highly with transaction costs. Moreover, funds are required to disclose the dollar amount of brokerage commissions. This information, however, generally appears in the Statement of Additional Information ("SAI"), which receives little attention from investors. Mutual funds also disclose information about their investment strategies, specifically whether they engage in active and frequent trading of portfolio securities to achieve their investment strategies. Unlike hedge funds, for example, which generally don't publicly discuss their strategies, there is much information available to investors that would enable them to measure the level of trading activity in a particular fund.

Brokerage commissions can provide useful information to fund investors. Because commissions can be used to purchase research services as permitted under Section 28(e) of the Securities Exchange Act of 1934, and because funds may also use brokerage commissions to pay certain fund operating expenses under directed brokerage arrangements,[13] greater availability of information on brokerage costs may help an investor evaluate whether the board is fulfilling its responsibilities in connection with its oversight of soft dollar practices and directed brokerage activity.

The Committee supports moving information on brokerage commissions from the SAI to semi-annual and annual shareholder reports. Likewise, the Committee supports including portfolio turnover ratios in shareholder reports as well. Improving investor access to information currently available will help investors to estimate the level of transaction costs for a particular fund. We believe such disclosure would be enhanced if it were accompanied by a narrative discussion of transaction costs, including the impact on portfolio transaction costs of various

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[13] In a directed brokerage arrangement, a fund will earn credits for directing a certain volume of trading to a particular broker-dealer. The broker-dealer agrees to pay the fund's custody, transfer agent, or other expenses. *But see* Securities and Exchange Commission, Press Release 2004-16, February 11, 2004 announcing that the Commission has proposed rules to prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares.

trading strategies and trading in various markets, as well as a general statement about implicit costs associated with portfolio trading.

V. Transaction Costs Should Not be Treated as an Expense for Financial Reporting Purposes

The Committee believes it would be inappropriate to account for portfolio transaction costs as a fund expense for the same reasons that disclosure of such costs is difficult. Specifically, explicit transaction-based compensation is the only type of transaction cost that can be measured directly. Other transaction costs – market impact and opportunity costs – are implicit and not easily quantified. To expense transaction-based compensation and not the other costs provides incomplete reporting on such costs. Funds that execute trades on an agency basis, paying a commission or commission equivalent, would appear to have higher costs than funds that execute trades on a principal basis, where the transaction cost is embedded in the price of the transaction. Moreover, as discussed above, market impact and opportunity costs can be considerable. As demonstrated in the example above, low commissions or spreads with a less favorable execution price may be less beneficial than transactions with higher commissions and spreads but more favorable execution prices.

Although commissions are identifiable and measurable, a portion of the commission may be used to purchase research services or to pay certain fund operating expenses under directed brokerage arrangements. Only that portion of the commission that represents the cost of such services is legitimately an operating expense of the fund, which should be reflected in fund expense ratios and fee tables contained in the fund's prospectus.[14] For the same reasons it is difficult to calculate transaction costs generally, the Committee believes it would be inadvisable to require apportioning such costs.

The other portion of the commission, consistent with generally accepted accounting principles, is the equivalent of acquisition or disposition costs, which are generally capitalized (*i.e.,* added to the cost basis of securities purchased or subtracted from the net proceeds of securities sold). Consequently, the Committee believes that any enhanced disclosure requirements the Commission might adopt should not impact the fund's financial statements. For the same reason, and because the Commission has worked extremely hard to achieve uniformity in the area of disclosure of fees and expenses, the Committee does not believe transaction costs should be reflected in the fee table.

VII. Conclusion

[14] Because the aggregate value of such operating expenses paid for by broker-dealers is identifiable and measurable, Regulation S-X requires a mutual fund to record as an expense the value of services received under a directed brokerage arrangement.

We thank the Commission for the opportunity to provide our views on ways the Commission can improve disclosure of mutual fund transaction costs. We note that Commission staff previously has considered whether it is feasible to quantify and record spreads, market impact, and opportunity costs as a fund expense or for reporting these costs in fund disclosure documents and has concluded it is not.[15] We agree. Both readily measurable and the less quantifiable costs are reflected already in fund performance. Any effort to measure such costs for purposes of disclosure will be imprecise and likely to confuse, rather than help, investors. We do, however, believe that more prominent disclosure of information that is currently available would make the information more useful to investors.

We hope that our comments are helpful. If you have any questions or would like to discuss our comments further, please contact the undersigned or Michael Udoff, SIA Vice President, Associate General Counsel and Secretary, at 212-618-0509.

Sincerely,

Stuart R. Strachan
Chairman
Investment Company Committee

CC: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Cynthia A. Glassman
The Honorable Harvey Goldschmid
The Honorable Roel Campos
Paul F. Roye, Director, Division of Investment Management
Paul Goldman, Assistant Director, Division of Investment Management
Jacquelyn Rivas, Staff Accountant, Division of Investment Management

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[15] *See* Memorandum from Paul F. Roye, Division of Investment Management, to Chairman William H. Donaldson, SEC, regarding Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, dated June 9, 2003.