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SEC Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs

The Securities and Exchange Commission (the "SEC") has announced a concept release that seeks public comment on issues related to the disclosure of mutual fund transaction costs (the "Release").[1] The Release indicates that the SEC is considering proposing new rules under the Securities Act of 1933, as amended (the "Securities Act"), the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the Investment Company Act of 1940, as amended (the "1940 Act"). Comments must be submitted to the SEC by February 23, 2004. This memorandum outlines the SEC's proposals in the Release.

A. Introduction

Open-end management investment companies ("mutual funds") currently are required to disclose to shareholders limited information on their portfolio transaction costs.[2] Under current regulations, mutual funds are required to disclose, in their Statement of Additional Information ("SAI"), the fund's portfolio turnover ratio and the dollar amount of portfolio brokerage commissions.[3] Portfolio turnover rate is a calculation of how long, on average, the portfolio holds securities; it is essentially an indirect indicator of the level of a fund's portfolio transaction costs.[4] Most information on transaction costs is not disclosed by funds, although the information is arguably incorporated into a fund's total return.[5]

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1 Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs; Release Nos. 33-8349, 34-48952, IC-26313, File No. S7-29-03: RIN 3235-AI94 (December 18, 2003).

2 Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section I.

3 Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section I.

4 *Id.* at Section V.A.1.

5 *Id.* at Section I.

Generally, portfolio transaction costs include commissions, spread costs, market impact costs and opportunity costs:[6]

- commissions: the fees that brokers are paid for executing trades for funds;
- spread costs: the implicit costs that funds pay if they purchase or sell a security at a price above or below current value;[7]
- market impact costs: the implicit costs incurred when a security's prices shift as a result of the fund's efforts to sell or purchase the security;[8] and
- opportunity costs: the implicit costs of missed trades, whereby failure to purchase or sell a security in a timely fashion results in a greater likelihood that the price of the security will increase or decrease.

In its Release, the SEC principally focuses on improving disclosure of these portfolio transaction costs. However, the SEC also discusses addressing the potential conflicts of interests between shareholders and fund managers with respect to the use of the portfolio commissions[9] and the future role of mutual fund directors in providing oversight for both the transaction costs and the conflicts.[10] The Release cites a study that estimates portfolio transaction costs lower the annual return to investors in an average equity fund by 75 basis

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6 *Id.* at Section II.

7 The "asked" or "offered" price of a security is slightly above current value, the "bid" price is slightly below current value; funds incur an indirect cost if they purchase a security at the "asked" or "offered" price and if they sell a security at the "bid" price.

8 The Release notes that these costs are reduced the longer a trade takes to complete.

9 As the SEC notes, fund managers often use portfolio commissions to obtain research and other services under "soft-dollar arrangements", which are permitted under Section 28(e) of the Exchange Act. Two key questions regarding the use of the commissions, and soft dollar arrangements generally, are whether fund managers are obtaining best execution for trades and whether the managers are properly using assets that belong to fund shareholders.

10 Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section I.

points.[11] Since the SEC is concerned about the transparency of these costs, the Release offers several proposals for increasing funds' disclosures to shareholders.

B. Quantifying Transaction Costs

The Release presents four proposals for using quantification and disclosure to make portfolio transaction costs more transparent. The first would be to require funds to include portfolio commissions in the disclosed expense ratio.[12] Currently, funds are not required to do this, but the Release states that this proposal fails to address the additional implicit transaction costs previously mentioned.

The second and third proposals would attempt to calculate and disclose all portfolio transaction costs, albeit with different methods. In the second proposal, the SEC expresses a favorable opinion about a method of measuring transaction costs called "implementation shortfall."[13] In essence, implementation shortfall calculates portfolio transaction costs as the difference between the prices for all trades intended for execution – whether actually executed or not – and the then-current prices when those trade decisions were reached.[14] The SEC notes however that there is no universally accepted manner of calculating implementation shortfall.

While the third alternative also would seek to measure and disclose all portfolio transaction costs, the focus for this proposal is on daily activity. The SEC here expresses a favorable opinion for a measuring method called "trade effect".[15] In essence, trade effect is a

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11 John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, "Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management", Aug. 2003, 2001 at 10, available at http://finance.wharton.upenn.edu/~edelen/PDFs/MF_tradexpenses.pdf.

12 Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section III.A.

13 *Id.* at Section III.B. The SEC also refers to additional methods of quantifying spread costs and market impact costs, but notes that these algorithms do not include opportunity costs and can be "gamed" or manipulated by the fund managers.

14 Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section III.B.

15 *Id.* at Section III.C.

daily mark-to-marketing, whereby the disclosed portfolio transaction costs would equal the annual average daily difference between the actual value of portfolio securities at the close of the day and the hypothetical value of the portfolio if no trades had been made that day.[16] The SEC notes approvingly that trade effect would be relatively simplistic and easy for funds to calculate.

The fourth and final alternative focuses on disclosures by parties other than mutual funds such as markets, specialists, electronic trading venues and broker-dealers.[17] The SEC proposes that these entities could report on the differences between the prices when the funds' orders are received and the prices when the trades are executed.[18] The Release notes that such disclosures could be part of a larger system that measured all transaction costs.

C. New Accounting Treatment

In the Release, the SEC states that it is considering whether portfolio transaction costs could be disaggregated for financial reporting purposes and possible inclusion in funds' expense ratios and fee tables.[19] Philosophically, the SEC here seeks to distinguish transaction costs that is attributable to trade execution and clearing services from transaction costs that are attributable to other services provided by financial intermediaries, most often under soft dollar arrangements.[20] Generally, soft dollar arrangements involve fund managers using portfolio commissions to obtain research and other services from financial intermediaries, and are permitted usually under the federal securities laws.[21]

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16 *Id.*

17 *Id.* at Section III.D.

18 *Id.*

19 *Id.* at Section IV.

20 *Id.*

21 Section 28(e) of the Exchange Act.

The SEC believes however that the portion of commissions, or other transaction costs, that is attributable to financial intermediaries providing research and other services (i.e., non-execution and clearing costs) is more accurately considered an operating expense of the fund, and therefore should be reported in fund expense ratios and fee tables.[22] Currently, for example, portfolio commissions are either included in the cost basis of purchased securities or reflected in the aggregate gains or losses of the portfolio after subtraction from the net proceeds of a security sale.[23] In considering this issue, the SEC notes the potential difficulty in reconciling this proposal with certain generally accepted accounting principles.

D. <u>Alternatives to Improve Disclosure of Transaction Costs</u>

As previously mentioned, mutual funds currently are required to disclose their portfolio turnover rate and the dollar amount of portfolio commissions that were paid in the three previous fiscal years.[24] The SEC's Release discusses six possible additions to these two requirements to improve disclosure of portfolio transaction costs.

The first would require mutual funds to rate the level of their portfolio transaction costs against an industry standard (e.g., high, average, low).[25] Another proposal would require funds to disclose portfolio turnover rates more prominently.[26] The SEC notes that portfolio turnover rates can be a good substitute for a comparison of the level of actual portfolio transaction costs in different mutual funds.

A third alternative focuses on improving information on average net flows into and out of fund shares.[27] The SEC notes that redemptions of fund shares often force fund

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[22] Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section IV.

[23] *Id.*

[24] *Id.* at Section V.A.

[25] *Id.* at Section V.B.1.

[26] *Id.* at Section V.B.2.

[27] *Id.* at Section V.B.3.

managers to sell portfolio securities, and therefore, net flows can be an indicator for estimating the level of a fund's portfolio transaction costs.[28]

The SEC's fourth proposal would require mutual funds to provide a detailed narrative discussion for shareholders on transaction costs.[29] This proposal could involve discussions on the impact of portfolio costs and management strategy.[30] The fifth proposal would involve moving information on brokerage costs from the SAI to the fund's prospectus.[31] Interestingly, the SEC also notes that it is considering reviving the requirement to disclose average commission rates per share, which was previously eliminated.[32]

The final SEC proposal, which the Release describes at length, would require funds to disclose to their shareholders both the gross returns and the standardized returns of the fund's portfolio.[33] Standardized returns, which funds are currently required to disclose, are the fund's returns after fees and expenses.[34] Gross returns are the aggregate performance of the portfolio's securities before considering fees, expenses, loads, and dilution from portfolio trading.[35] The SEC notes approvingly that this proposal would assist investors in comparing investment managers on a completely equivalent basis.[36]

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28 *Id.* The SEC also approvingly notes that such enhanced disclosures would alert investors to market timing activity.

29 Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section V.B.4.

30 *Id.*

31 *Id.* at Section V.B.5.

32 *Id.* The SEC abolished this requirement in 1998: Investment Company Act Release No. 23064, (Mar. 13, 1998).

33 Concept Release, Release Nos. 33-8349, 34-48952, IC-26313 at Section V.B.6.

34 *Id.*

35 *Id.* at Section V.B.6, n. 53.

36 *Id.* at Section V.B.6.

E. Review of Transaction Costs by Fund Directors

In the last part of the Release, the SEC asks whether fund directors should be required to receive and review additional information regarding portfolio transaction costs.[37] Fund directors currently consider, as part of their review of the fund's advisory contract, the fund's portfolio transaction costs as well as the adviser's directed brokerage and soft dollar arrangements.[38] The Release thus questions whether the SEC should require fund boards to receive reports from advisers with more extensive information on soft dollar and directed brokerage practices.[39]

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If you have any questions regarding the Release, or would like to consider submitting a comment on any part of the Release to the SEC, please do not hesitate to contact us.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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[37] *Id.* at Section VI.

[38] *Id.*

[39] *Id.*