THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 1, 2003

The Honorable Joseph I. Lieberman
Ranking Member
Committee on Governmental Affairs
United States Senate
340 Dirksen Senate Office Building
Washington, DC 20510-6250

Dear Senator Lieberman:

Thank you for your letter of November 3, 2003 regarding your concerns about the mutual fund industry in general and late trading and market timing abuses in particular. We applaud your efforts to focus on this important issue and explore ways to help mutual fund investors ensure that they receive the fundamental rights to which they are entitled.

In your letter, you raised a number of questions regarding the Commission's examination and enforcement programs, the prevention of trading abuses, and transparency of mutual fund expenses and transaction costs. I share your interest in these matters and how they impact mutual fund investors. At my request, Stephen Cutler and Paul Roye, the Directors of the Divisions of Enforcement and Investment Management, respectively, and Lori Richards, the Director of our Office of Compliance Inspections and Examinations, have prepared the enclosed memorandum that provides the analysis you requested in your letter regarding these and other issues.

I hope this memorandum is helpful to you. As with other issues involving the protection of investors, I welcome the opportunity to share our views on these matters. If you have additional questions or comments, please do not hesitate to contact me directly at 202/942-0100 or to contact Steve (202/942-4500), Paul (202/942-0720) or Lori (202/942-7400).

Sincerely,

William H. Donaldson

Enclosure

cc: The Honorable Susan Collins, Chairman

MEMORANDUM

December 1, 2003

TO: William H. Donaldson, Chairman

FROM: Division of Enforcement
Division of Investment Management
Office of Compliance Inspections and Examinations

RE: Correspondence from Senator Lieberman

In correspondence addressed to you dated November 3, 2003, Senator Joseph Lieberman expressed concerns regarding the Commission's handling of issues relating to mutual funds, and posed a number of specific questions on the subject. The following are responses prepared by the Divisions of Enforcement and Investment Management, and the Office of Compliance Inspections and Examinations.

1. **What did the SEC do, if anything, in response to Mr. Scannell's tip in March?**

Answer:

The staff of the SEC's Boston District Office (BDO) was initially contacted by an attorney representing Mr. Scannell early in 2003. The attorney explained that she had a client, employed at a mutual fund complex, who had been beaten up, he believed because he reported to his employer that union members were engaging in improper trading through their mutual fund retirement accounts. The attorney would not identify her client or the mutual fund complex involved. Over the next several weeks, the SEC staff had several calls with the attorney during which the staff tried to convince the attorney to identify her client and the fund complex.

In approximately March or early April, another lawyer, representing the same client, contacted the BDO staff and indicated she wanted to speak to the SEC about her client's situation. On April 14, the BDO staff met with the new attorney, who did not bring her client to the meeting, and would not identify him or his employer (the fund complex) by name. At the initial meeting, the attorney described her client's allegations of market timing in union member retirement accounts, and his complaint that he was not permitted to engage in similar trading. She indicated that, according to her client, he had been assaulted by a person wearing clothing bearing the union's name, and he believed this had occurred because he had brought the union members' excessive trading to the attention of the fund complex. She advised the staff that her client was out of work on disability, that he could not return to work at the fund complex, and that he had been diagnosed with post traumatic stress disorder following the alleged assault. She also

reported that her client had two objectives – he wanted the union members' market timing stopped, and he wanted a remedy for himself from his employer. At the urging of the BDO staff, she agreed to bring her client, Mr. Scannell, to a future meeting with the staff. In a subsequent telephone call, prior to the BDO staff's meeting with Mr. Scannell, the attorney identified Putnam as the fund complex involved in her client's allegations.

Two weeks later, on April 28, the BDO staff met with Mr. Scannell, accompanied by his attorney. Mr. Scannell reported that members of a local chapter of the Boilermakers Union were being permitted by Putnam to day trade in their retirement accounts, and that Putnam was not imposing fees on their accounts for engaging in this conduct. Mr. Scannell expressed unhappiness that he was not permitted by Putnam to conduct similar trades, and that when he had attempted to do so, Putnam had told him he could not. He further reported that when he pointed out to his supervisor at the Putnam call center that members of a Boilermakers Union local were market timing, he was told not to worry about it. Mr. Scannell also indicated that he had been beaten up by someone wearing a Boilermakers jacket or t-shirt while sitting in his car in South Boston, and that he believed this was related to the concerns he raised at Putnam about the union members' trades. During the meeting, Mr. Scannell provided the BDO staff with documents, including a spreadsheet showing the union trading, Putnam intranet printouts, prospectus pages, and emails.

Following the meeting with Mr. Scannell and his attorney, the BDO staff reviewed the documents Mr. Scannell had supplied and the relevant Putnam fund prospectuses. The prospectus disclosures indicated that no redemption fees would be imposed on 401(k) accounts. The staff also discussed possible legal theories under which the alleged conduct by Putnam would be illegal.

In September, after the New York Attorney General's Office filed its complaint against Canary Capital, the BDO staff sought to renew contact with Mr. Scannell through his lawyer. Although Mr. Scannell has declined to speak with the BDO staff, the staff is continuing to investigate a number of matters involving Putnam, including Putnam's actions in relation to market timing or excessive short term trading by non-employees.

Subsequently, on October 28, the BDO staff filed an enforcement action against Putnam and two of its portfolio managers alleging that the portfolio managers had engaged in market timing of the funds they managed in their personal accounts. This investigation was not based on Mr. Scannell's allegations, but on a tip received by Enforcement Director Cutler on September 8.

2. If the SEC did not open an investigation based on Mr. Scannell's tip, why did it fail to do so?

Answer:

As described in response to question 1, the Boston District Office (BDO) staff took a number of steps to follow up on Mr. Scannell's allegations. Although the BDO staff did not formally open an inquiry at that time, the steps they took were consistent with the steps taken in the early stages of an SEC inquiry. In addition, the staff is currently investigating a number of matters involving Putnam (in addition to the employee trading at issue in the SEC's recently-filed case against Putnam), including Putnam's actions in relation to market timing or excessive short term trading by non-employees.

3. When did the SEC open the investigation that culminated in the action announced on October 28, 2003?

Answer:

The Boston District Office opened the investigation that led to the filing of the October 28 action involving Putnam on September 12, 2003. As noted, this investigation was not based on Mr. Scannell's allegations, but on a tip received by Enforcement Director Cutler on September 8.

4. Director of Enforcement Cutler reportedly acknowledged that he received another tip alerting him to personal trading by Putnam executives. When did this tip come in? Has the SEC reviewed its files to see if it received any other tips of mutual fund wrongdoing by Putnam or others? If not, why not? If so, what did the SEC find? Please provide specifics relating to each call received and what the SEC did to follow up.

Answer:

Mr. Cutler received the tip concerning personal trading in Putnam funds by portfolio managers on the evening of September 8, 2003, and on the following day, asked the staff of the Boston District Office to commence an investigation. As noted in response to question 3, the related investigation was formally opened on September 12.

The Enforcement Division has reviewed available logs of correspondence received by the Division headquarters office during the last few years for additional communications relating to mutual fund misconduct, and is reassessing relevant correspondence identified by this means. None of this correspondence related to alleged wrongdoing by Putnam. We understand that the Office of Investor Education and Assistance, which receives hundreds of communications from the public each day, is in the process of identifying and reviewing past investor communications concerning Putnam. Prior to September 23, the Division did not maintain a log of telephone calls

received from the public so we are unable to provide information on the handling of each call received.

5. **Has the SEC taken any action to make sure that future tips will be handled better than Mr. Scannell's? If so, please specify what the SEC has done. If not, please explain why not.**

Answer:

The Division of Enforcement has taken a number of steps to increase the effectiveness of its complaint handling process. Specifically, the process of receiving, analyzing, and responding to all public tips received by the Division has been streamlined, and oversight of the process has been strengthened. Critical information concerning all enforcement-related tips and complaints, whether in the form of telephone calls, correspondence, email, or in-person, is reported to and maintained by a dedicated group within the Home Office staff. That group creates a centralized log of all complaints and tips received by Enforcement staff in all of the SEC's offices. The log identifies, among other things, the date of the complaint or tip, the name and address of the complainant, and the nature of the complaint. It also includes a summary of the action taken by the staff in response to the complaint or tip (e.g., referred for further investigation; referred to other agency; no follow up necessary). Senior management reviews the log on a regular and frequent basis, at least monthly, to confirm that each complaint or tip was appropriately disposed of by the staff. In addition, the Chairman has ordered an agency-wide reassessment of the Commission's policies and procedures on handling tips to be sure that there is appropriate follow through on this type of information and that tips are given expedited treatment.

6. **What specific aspects of the current reporting requirements for mutual funds are useful for helping to uncover improper or fraudulent practices? Would any additional reporting requirements provide an additional mechanism for catching such improper behavior?**

Answer:

There are several filings that assist the staff in uncovering improper and fraudulent practices. Specifically, mutual funds must (1) file and update annually their registration statement;[1] (2) file copies of their semi-annual and annual reports to shareholders, including the certifications required under the Sarbanes Oxley Act of

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[1] Mutual funds initially file a combined registration statement to register under the Investment Company Act 1940 and to register their securities under the Securities Act of 1933. *See* Section 8(b) of the Investment Company Act of 1940 and Section 6(a) of the Securities Act of 1933. Annually, thereafter, funds are required to update their registration statements under the Investment Company Act. *See* Rule 8b-16 under the Investment Company Act of 1940. In addition, if they continue to sell securities, they must also update their registration statements under the Securities Act. *See* Rule 10(a)(3) under the Securities Act of 1933.

2002;[2] (3) file semi-annual and annual reports on Form N-SAR containing information that we use for various regulatory purposes, including to tailor our inspection process;[3] and (4) submit reports on the internal controls prepared by their independent accountants.[4]

A mutual fund's registration statement provides the staff with important information on how a fund is organized and how it intends to operate.[5] The registration statement consists of two parts: the prospectus and the statement of additional information. Among other things, the prospectus contains disclosure concerning the fund's objectives, investment policies, investment strategies, past performance, investment adviser and portfolio manager, distribution arrangements, and procedures for purchasing and redeeming shares. The statement of additional information contains more detailed information about the operations of the fund including information about the fund's management and its service providers, rule 12b-1 expenditures, code of ethics, brokerage expenses and selection of brokers to execute trades, control persons and principal holders of its securities. Registration statement information provides the staff with not only an overview of the fund's operations and its investment risk profile, but also helps the staff identify high-risk areas, potential conflicts of interest, and details of fund operations that are unusual or potentially problematic. The information, however, is designed primarily to provide disclosure to investors, and does not, in and of itself reveal fraudulent practices. Nonetheless, it does help immensely in understanding the operations of the fund and areas that our inspection staff may need to examine to uncover improper or fraudulent behavior.

Every six-months a fund must file with the Commission its semi-annual and annual report to shareholders.[6] The filings contain the fund's financial statements and certifications by management on the preparation of the financial statements and the effectiveness of the fund's disclosure controls and procedures, including internal controls over financial reporting.[7] In addition, the annual filing contains an independent accountant's opinion on the financial statements, and a discussion of the mutual fund's performance over the relevant period.[8] From the financial statements the staff can calculate various analytical measures to identify abnormalities in the fund's results that are symptomatic of improper activity. In addition, anything other than an unqualified audit opinion from the independent accountant would immediately alert the staff that there might be potential problems in the fund's operations or financial reporting. Lastly,

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2 The annual and semi-annual reports required by Section 30(e) of the Investment Company Act of 1940 and Rule 30e-1 thereunder, must be filed on Form N-CSR and certified by the principal executive officer and the principal financial officer, or persons performing similar functions. *See* Item 1 of Form N-CSR and Rule 30(a)-2(a) under the Investment Company Act of 1940.

3 *See* Rule 30b1-1 under the Investment Company Act of 1940.

4 Item 77K of Form N-SAR.

5 *See* Form N-1A.

6 *See supra* note 2.

7 Item 10 of Form N-CSR.

8 Item 5 of Form N-1A

management's certification provides the staff with valuable information on changes in the fund's disclosure controls and significant deficiencies or material weaknesses in those controls. Such deficiencies or weaknesses can be an early indicator of improper behavior, requiring examination by the inspection staff.

Mutual funds also are required to file semi-annual reports on Form N-SAR.[9] These reports are designed to provide information to the Commission that helps support our regulatory functions. The reports provide, among other things, information on broker commissions and other compensation paid by the fund to its brokers, sales loads and other fee information, 12b-1 plan arrangements, legal proceedings, changes or disagreements with its auditors, and the acquisition of portfolio securities from affiliated brokers. The Commission staff uses N-SAR data about the operation of investment companies to support program activities such as reviewing disclosure documents, rulemaking, inspections, providing interpretive advice, and evaluating applications for exemption from regulatory requirements. For example, the Division of Investment Management compares mutual fund portfolios to peer companies or to the industry as a whole with respect to returns, expenses, portfolio activity, and other criteria. This capability enables the Division to target companies for review of their disclosure documents or to recommend an on-site inspection based on a systematic assessment of their portfolio and operational risk characteristics. The inspection staff also uses this information to identify heightened areas of risk, trends in fund and industry activities, and as early warnings from litigants and auditors of potential problems in the fund's operations or financial reporting. The staff is currently engaged in a review of the scope and types of information collected on Form N-SAR in order to increase the utility of N-SAR data for purposes of supporting Commission's fund oversight program.

As part of the audit process, the independent accountant is required to issue a report on the internal controls of a mutual fund, and the fund is required to submit the report to the Commission.[10] These reports are designed to identify material weaknesses in the internal control structure of a fund that were noticed as part of the audit process.[11] A material weakness is a serious void in the control procedures designed to prevent and detect improper conduct. Although typically a report does not identify any material weaknesses in a fund, when it does, the staff will generally institute an immediate cause examination of the fund's operations.

When used in conjunction with each other, the registration statement, the semi-annual and annual reports, and the report on internal controls can assist the staff in identifying areas of heightened risk that require greater attention by the inspection staff.

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[9] *See* Form N-SAR.

[10] This report is an exhibit to the N-SAR report. *See* Item 77K of Form N-SAR.

[11] *See* American Institute of Certified Public Accountants, *Audit and Accounting Guide: Audits of Investment Companies §11.13 (200).* Internal control reports on material weaknesses are less in scope than specific engagements to review the internal controls of an organization. *See* American Institute of Certified Public Accountants, Statement on Auditing Standards (SAS) No. 70, *Service Organizations.*

However, these documents are largely designed to provide disclosure to investors and generally provide more of a basis for establishing liability once improper or fraudulent practices have been discovered than helping to initially identify the undesirable behavior.

The staff continues to evaluate how reporting requirements can be improved, not only to assist the staff in identifying potential instances of improper or fraudulent conduct, but also for the communication of essential information to investors. Recently, for instance, the Commission instituted a reporting requirement that makes the fund's proxy voting record publicly available.[12] This disclosure may help identify situations where the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting. For example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund, a fund's adviser may have an incentive to support management recommendations to further its business interests.

Regardless of the reporting mechanisms that the Commission has or may require mutual funds to comply with, the Commission's ability to detect improper or fraudulent practices significantly depends on the record keeping requirements for registrants and the frequent inspection of those records by the examination staff. As discussed below, the examination process is designed to detect improper or fraudulent activity whereas the current reporting requirements generally are designed for disclosure and informational purposes. Nevertheless, the staff is currently evaluating recent events and whether, existing disclosure requirements should be amended to improve our ability to specifically detect improper or fraudulent conduct.

7. **What specific aspects of the audit and examination process are designed to help root out wrongful conduct? Is the SEC reviewing how it can enhance the audit and examination process in any way to facilitate detection of these practices?**

Answer:

The primary objective of all work undertaken during examinations is to identify wrongful conduct. Such conduct may involve violations of substantive provisions of a statute or regulation, or it may involve activities that are inconsistent with or contrary to disclosures that have been made to fund shareholders or boards of directors. Another goal of examinations is to identify weaknesses in internal controls and supervision that if uncorrected, could lead to wrongful violations.

During examinations, the staff uses techniques and procedures to scrutinize and probe selected transactions, arrangements and control processes of funds and their service providers (such as investment advisers, distributors, administrators and transfer agents). The staff reviews fund records as well as records of their service providers, and conducts

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[12] *See* Investment Company Act Release No. 25922 (Jan. 31, 2003) Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies.

interviews with fund and adviser personnel. Our techniques and procedures must evolve to try to keep up with the constant changes in the fund industry. Indeed, one of the attributes of the industry is its continual evolution, in growth of assets, the introduction of new products and services, changes in methods of operations and fluid organizational relationships. We are critically assessing ways we can enhance examination oversight of the industry.

No regulator has sufficient resources to be able to scrutinize every transaction, arrangement and control at each of its regulated entities. At the SEC, our past staffing for inspections has been about 350, to inspect an industry of about 8,000 funds and 7,000 advisers. Thus, every examination has to key in on those areas that have been identified as posing risks to investors. Examinations of funds and advisers focus on areas where past problems have been identified at other firms, as well as on risk areas that are specific to the particular firm being examined. Thus, examinations focus on reviewing universal risk areas along with targeted risk areas in order to analyze and probe those activities for violations. Particular areas of focus in recent examinations have included performance claims by advisers, allocations of securities among accounts, new privacy rules, pricing procedures and controls, supervision, anti-money laundering, "best execution" and use of brokerage, contingency planning and corporate governance, among other compliance areas. As detailed work gets underway, examiners may modify the initial plan based on actual findings and the evaluation of such work.

Additional staffing made available for fund inspections this year will allow us to inspect fund firms more frequently. In past years, the average frequency was once every five years for every fund and adviser. With new staffing, we will move towards a more risk-tailored inspection frequency of every two years for large fund complexes and fund complexes with weak internal controls, and every four to five years for other fund complexes and advisers. As we hire, train and deploy this additional staff, the Commission will be considering whether this level of oversight should be further enhanced.

The focus of examinations also changes as information comes to light about new kinds of wrongful conduct and the ways in which such wrongful conduct can be identified. Examiners use this information to update the examination planning process and improve the procedures employed to look for and analyze such conduct. As a result of findings of late trading and market timing, in addition to changes in Commission rules that will make this conduct less likely to occur in the future, examiners are making significant improvements in their inspection approach and use of technology, which are outlined below.

In the past, examiners did not review email files as part of the routine inspection process. It appears that many of the secret arrangements involving market timing were negotiated via email, and more broadly, that significant communications occur increasingly via email. Going forward, review of selected email files will be a standard part of all routine inspections. Email files maintained by funds and their service providers are often voluminous, however, so examiners must be able to sort quickly

through the hundreds of thousands, and even millions, of emails maintained by a fund and hone in on those that are critical in revealing whether wrongful conduct may be underway. To assist examiners in probing email files and other textual documents, the SEC recently acquired a powerful software tool that will be rolled out to the entire examination staff.

We also are actively evaluating additional period or macro-information that examiners could analyze as part of every inspection. Such information, including data on fund inflows and outflows, is intended to assist examiners in identifying the presence of patterns of transactions or sets of data that may be materially out of line with norms or peer group funds and that warrant further detailed scrutiny during the examination.

We also are planning to implement a program of special examinations that are intended to "benchmark" our inspection procedures. These examinations will exhaustively evaluate each of a selected firm's activities. These detailed examinations will be used as a means of searching for the existence of wrongful conduct that might not ordinarily be found by using a risk-based examination approach alone, and to identify additional or new examination steps that should be deployed.

More broadly, as part of an agency-wide initiative, we are taking steps to identify emerging risk areas sooner, and to deploy resources earlier on areas of emerging risk. Attached is an excerpt from the Chairman's November 18th testimony before the Senate Banking Committee that more fully describes this effort, which entails greater use of information and intelligence gathering about funds, advisers, and the securities industry.

8. & 9. Is the SEC considering changing the current rule to set a hard deadline for trades to be into the mutual fund by a time certain? What options is the SEC considering? Does the SEC have an alternative plan to prevent these practices?

Answer:

As Chairman Donaldson recently testified, on December 3, 2003, the Commission will consider proposed rule amendments that would require a fund (or designated agents) — rather than an intermediary such as a broker-dealer or other unregulated third party — receive a purchase or redemption order before the time the fund prices its shares (typically 4:00 p.m.) for an investor to receive that day's price.[13] This "hard" 4:00 cut-off would effectively eliminate the potential for late trading through intermediaries that sell fund shares. The proposing release likely will request comment on alternatives to address the late trading issue.

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[13] Testimony of William H. Donaldson, Chairman, Securities and Exchange Commission, Testimony Concerning Regulatory Reforms to Protect our Nation's Mutual Fund Investors, *available at* http://www.sec.gov/news/testimony/ts111803whd.htm.

10. The Definition of independence. Former SEC Chairman Levitt was recently quoted as saying, "Sadly," one of the most effective checks to these [mutual fund] abuses, I think needs fixing, and that's the independent directors." Under the current definition of independence, an independent director could be a board member of a fund who retired as an executive for that fund or a director who has served the fund for decades and sits on the boards of dozens of other funds within that mutual fund company. Will the SEC strengthen the definition of independence for mutual fund directors to avoid entrenchment and entanglement with management? If so, what is the timeline for doing so?

Answer:

Section 2(a)(19) of the 1940 Act defines the term "interested person" to include the fund's investment adviser, principal underwriter, and certain other persons (including their employees, officers or directors) who have a significant relationship with the fund, its investment adviser or principal underwriter.[14] It also encompasses a broader category of persons having business relationships with the fund or its investment adviser, including certain broker-dealers and persons who have served as counsel to the fund, its investment adviser, or principal underwriter within the last two fiscal years of the fund.[15] Finally, section 2(a)(19) provides the Commission authority to issue an order deeming a natural person to be an "interested person" as a result of certain material business relationships occurring within the last two fiscal years of the fund.[16]

Section 2(a)(19) contains gaps that have permitted persons to serve as independent directors despite relationships that suggest a lack of independence from fund management. For example, the statute permits a former executive of the fund's adviser to serve as an independent director two years after the person has retired from his position. This permits an adviser to use board positions as a retirement benefit for its employees. The statute also permits relatives of fund managers to serve as independent directors as long as they are not members of the "immediate family" of affiliated persons of the fund. In one case, the uncle of the fund's portfolio manager served as an independent director of the fund.[17]

The Commission has supported legislation that would amend section 2(a)(19) to give the Commission rulemaking authority to fill gaps in the statute that have permitted

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14 Section 2(a)(19)(A)(i)-(iii).

15 Section 2(a)(19)(A)(iv)-(vi).

16 Section 2(a)(19)(vii). In 1999 the Commission published a release discussing, among other things, the types of professional and business relationships that may be considered to be material for purposes of section 2(a)(19). Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999).

17 *See* Aaron Lucchetti, *SEC Backs Uncle's Role as Director*, Wall St. J., Nov. 11, 1999 at C1.

persons to serve as independent directors despite relationships that suggest a lack of independence.[18]

11. **Overcommitted Directors. According to Edward Regan, President of Baruch College and a corporate governance expert, "There are plenty of fund family directors who have 80 or 90 funds. That seems too many." Indeed, this appears to have been the case at the fund families involved in the Canary Partners scandal: The chairman of Bank of America's Nations Funds sits on the boards of 85 funds; the chairman at Janus sits on 113 fund boards. While many funds have similar structures and approaches, warranting some "economy of scale" in this regard, it is hard to see how anyone can effectively monitor activity in so many different entities. Will the SEC issue guidelines for mutual funds to follow in deciding how much is too much?**

Answer:

We share your concerns about overextended directors. The difficulty, of course, is in determining just how many funds is too many, and whether the same standard should be applied across all funds and all fund groups. In his November 18 testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Chairman Donaldson suggested one way to address this concern was to require directors to perform an annual self-evaluation of their effectiveness, including consideration of the number of funds they oversee and the board's committee structure.[19] We would expect the Commission to consider rule amendments requiring directors to engage in an annual self-evaluation in January of next year.

12. **More Independent Directors. While the SEC, as noted above, has required a majority of directors to be independent, the widespread abuses and the lax oversight that allows them suggest that we must have fewer insiders running the funds. Investors need more voices of authority challenging management. Has the SEC considered requiring that a significantly larger percentage of mutual fund directors be independent in order for those funds to qualify for certain basic exemptions? If not, why not?**

Answer:

On November 18, 2003, Chairman Donaldson testified that the problems that recently have come to light underscore the need for enhanced effectiveness of directors in carrying out their responsibilities.[20] The ideas he offered for reform included increasing the percentage of independent directors on fund boards from fifty percent to seventy-five percent. We expect the Commission to consider in January of next year rule amendments

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[18] Section 103(b) of H.R. 2420 contains statutory language that would provide the Commission with the appropriate authority.

[19] Testimony of Chairman. Donaldson, *supra* note 13.

[20] Testimony of Chairman Donaldson, *supra,* note 13.

requiring independent directors to constitute no less than seventy-five percent of the boards of funds relying on certain exemptive rules.

13. Compliance officers reporting directly to the Board. In order to reinforce the importance of matters of compliance, what are the SEC's views on requiring, as a qualifying condition for certain exemptions, that funds hire a compliance officer who reports directly to an independent compliance committee of the board of directors?

Answer:

In February of this year, the Commission proposed a new rule that would require funds to adopt policies and procedures designed to prevent the fund (or its investment adviser) from violating the federal securities laws, and to designate a chief compliance officer to administer these policies and procedures.[21] The Commission issued the proposal because it believes these measures are critical to an effective fund compliance program. Under the proposal, the chief compliance officer must be approved by the fund's board, including a majority of the independent directors, and would report directly to the board. On December 3, 2003, the Commission will be considering staff's recommendation to adopt this new rule.

14. Comparative Expense Information. A recent study commissioned by Fund Democracy and Consumer Federation of America and conducted by Morningstar, Inc. looked at index funds and money market funds – funds that are not actively managed and that would therefore be expected to have relatively low expenses. The study found that there was a huge variation in fees charged by these funds, with some investors paying expense ratios as much as 9 times higher than others.

a) In light of these findings, do you believe that it would be helpful to investors to require funds to provide information on how their fees compare to those of similar funds?

b) Has the SEC previously considered requiring such information?

c) Is there a particular benchmark – an average or range, for example – that you believe would be particularly useful as a point of comparison?

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[21] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25925 (Feb. 5, 2003) [68 Fed. Reg. 7038 (Feb. 11, 2003)] (proposing new rule 38a-1 under the Investment Company Act). The Commission also proposed to require SEC-registered investment advisers to adopt compliance policies and procedures, and designate a chief compliance officer.

Answer:

The Commission has taken a number of steps to enable investors to compare fees and expenses of different mutual funds when making investment decisions. The Division of Investment Management anticipates recommending additional fee disclosure requirements to the Commission early next year to better enable investors to make cost comparisons among funds. At present, the Division does not recommend requiring mutual funds to provide information on how their fees compare to those of a benchmark.

Currently, prospective fund investors receive significant disclosure about fund fees and expenses in a format that enables comparison between funds. Since 1988, Form N-1A, the form used by mutual funds to register their shares under the Securities Act of 1933, has required every mutual fund prospectus to include a fee table. The fee table requires a uniform, tabular presentation of all fees and expenses associated with a mutual fund investment. The fee table is accompanied by a numerical example that illustrates the total dollar amounts, including both transactional costs paid directly by a shareholder and ongoing asset-based expenses, that an investor could expect to pay on a $10,000 investment if the fund achieved a 5% annual return and the investor remained invested in the fund for 1-, 3-, 5-, and 10-year periods. This example is intended to enable investors to estimate the total dollar costs associated with a fund investment. The fee table and example together provide fund investors with fee and cost disclosure in a standardized format that is intended to facilitate cost comparisons among funds.

In December 2002, the Commission proposed additional disclosure requirements to increase investors' understanding of the expenses that they incur when they invest in a fund, in particular, ongoing expenses. Specifically, the Commission proposed to require mutual funds to disclose in their annual and semi-annual reports to shareholders fund expenses borne by shareholders during the reporting period. Under the Commission's proposal, fund shareholder reports would be required to include: (i) the cost in dollars, associated with an investment of $10,000, based on the fund's actual expenses and return for the period; and (ii) the cost in dollars, associated with an investment of $10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year. This second figure is intended to provide investors with a basis for comparing the level of current period expenses at different funds, while the first figure is intended to permit investors to estimate the actual cost, in dollars, that they bore over the reporting period.

In addition to requiring cost disclosure in a manner that facilitates comparison, the Commission has undertaken efforts to educate investors about the significance of the costs that they pay in connection with mutual fund investments. Most notably, in 1999, the Commission introduced the Mutual Fund Cost Calculator, an Internet-based tool available on the Commission's web site that enables investors to compare the costs of owning different mutual funds over a selected period. Like the prospectus example, the costs shown by the Cost Calculator include transactional costs paid directly by a shareholder and ongoing asset-based expenses. In addition, the costs shown by the Cost Calculator include earnings foregone on fees and expenses paid. To use the Cost

Calculator, an investor enters the time period that he or she expects to hold the investment, the dollar amount of the investment, and an assumed annual rate of return, as well as the fund's fees and expenses, which are set forth in the prospectus fee table.

At this time, the Division of Investment Management does not recommend requiring mutual funds to provide information on how their fees compare to those of a benchmark. Requiring funds to compare their fees to a benchmark would involve the difficulty of determining an appropriate benchmark (such as an average or range) for each fund to serve as a point of comparison. To do so would either require the Commission to categorize mutual funds for this purpose, or require funds to determine how to categorize themselves. Either approach would present practical difficulties, given the variation in asset sizes and investment strategies among funds, and could create incentives for funds to try to manipulate the criteria used in order to fall within the most favorable category of comparison. The Division believes that the better approach is to help investors who are selecting among different funds to make their own informed cost comparisons among the particular funds they are considering, by requiring all funds to provide information relating to their costs in a standardized format.

15. Consumer Research

a) **How, if at all, has the SEC used consumer research, either qualitative or quantitative, to determine how the information or disclosures required in mutual fund advertising or in prospectuses or other documents provided to investors are understood by those investors?**

b) **If the SEC has not made use of consumer research, please explain why not. Do you believe it would be useful to conduct such research to determine and design disclosure requirements in the future as a way of ensuring that information is provided to investors in a meaningful, useful and comprehensible way?**

Answer:

The Commission has used focus groups and investor surveys as part of its efforts to determine how the information provided to investors is understood by them. For instance, in 1995, the Commission used focus groups to compare investors' reactions to the mutual fund prospectus and to a fund profile providing a summary of key information about a fund. These focus groups were useful in understanding both the information and the formats that are helpful to investors. In 1996, the Commission jointly sponsored a nationwide telephone survey of 2,000 randomly selected mutual fund investors with the Office of the Comptroller of the Currency. This survey examined, among other things, mutual fund investors' familiarity with the costs and investment risks associated with mutual funds, the information sources used to learn about these costs and risks, and the overall level of investor financial literacy. The Commission considered the information derived from the focus groups and investor survey in 1997 when it proposed comprehensive revisions to the mutual fund prospectus.

The Division of Investment Management believes that information from consumer research can help the Commission to understand what information mutual fund investors find useful and what formats are more readily understood. Consumer research can be a useful supplement to the other input the Commission receives from individual investors and investor advocates, such as comment letters on proposed rules and other investor letters. Subject to budgetary constraints, the Division will consider using consumer research in the future in appropriate circumstances to help determine how to provide information to investors in a meaningful, useful, and comprehensible manner.

16. Individualized Fee Information

a) Does the Commission continue to believe that mutual funds should not disclose the expenses an investor paid in that investor's quarterly or monthly statements? Please explain why or why not.

b) How do the recent scandals in the mutual fund industry affect your analysis of this issue? Does the resulting need for increased transparency and trust in the industry alter your assessment of the costs and benefits of requiring clearer disclosure?

c) What is the status of the December 2002 proposed rule?

Answer:

The expense disclosure that the Commission has proposed to require in shareholder reports is designed to increase investors' understanding of the fees that they pay on an ongoing basis for investing in a fund and enhance cost competition among funds. As an alternative to this proposed approach, the Commission also considered the recommendation of the U.S. General Accounting Office ("GAO") that the Commission require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement.[22] While the Commission has not yet made a final decision, the Division of Investment Management believes that the Commission's proposal may strike a more appropriate balance between investors' need for increased information about fund expenses and the costs and burdens that would be associated with providing this information.

The GAO's alternative would have the benefit of providing fund shareholders with personalized information, expressed as a dollar amount, about the fees and expenses that they paid and of presenting that information together with the investor's account value. The Commission's proposed approach, however, effectively permits an investor to estimate his or her personalized expenses by multiplying the cost shown for a $10,000 investment by the investor's account value and, in addition, has significant advantages compared to the GAO's alternative. Disclosure of the dollar amount of fees and expenses

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22 See GAO, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION (June 7, 2000).

paid by investors in a fund's shareholder reports would enable investors to evaluate this information alongside other key information about the fund's operating results, including management's discussion of the fund's performance. In effect, shareholders would be able to evaluate the costs they pay against the services they receive. By contrast, expense disclosure in quarterly account statements would not provide an effective context for investors to assess the expenses shown.

In addition, the Commission's proposed disclosure of the cost in dollars associated with an investment of $10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year, would provide investors with expense information in a standardized manner that would facilitate comparison of ongoing costs among funds, as noted in the response to Question 14. By contrast, personalized expense disclosure in quarterly account statements would not assist investors in making comparisons among funds because it would be based on different investment amounts and different rates of return.

In addition to the advantages of the Commission's proposed approach in contributing to greater investor understanding of the costs that they pay, this approach also avoids certain costs and logistical complexity that the GAO's alternative might entail. Mutual fund expenses are charged against fund assets and are not currently accounted for on an individual account basis. Therefore, implementation of the GAO's recommendation would require systems changes to provide for expense accounting on an individual account basis. Moreover, in many cases fund shares are held by broker-dealers, financial advisers, and other third-party intermediaries, who must prepare accurate and timely customer account statements by integrating data supplied by many unrelated fund groups. In addition to any systems changes necessary for the fund itself, these financial intermediaries would need to implement new systems in order to calculate and report personalized expense information for each fund held in an account each quarter.

The recent allegations of abusive practices in the mutual fund industry are not directly related to the issue of how best to provide investors with increased information about the ongoing expenses they bear. With respect to the abuses alleged, the Commission is taking steps to address the alleged misconduct through its enforcement efforts. Moreover, the Division of Investment Management expects to recommend new rulemaking initiatives to the Commission shortly to directly address market timing and late trading abuses. The Division is also continuing to work on other initiatives intended to improve the transparency of mutual fund disclosure, including the Commission's proposal to improve expense disclosure in fund shareholder reports. The Division believes that by increasing investors' understanding of fund fees and facilitating cost comparisons among funds, the proposal may contribute to rebuilding investor confidence in the wake of the current allegations. The Division expects to recommend final action to the Commission on the proposal early next year.

17. **Trading Costs and Other Non-Disclosed Expenses.**

a) **What, if any, of these expenses do you believe should be disclosed directly to investors? For any that you do not, please explain why not.**

b) **To the extent such expenses are required to be disclosed to investors, what do you believe is the best manner in which to disclose them? Should they be included in expense ratios or should they be disclosed separately?**

Answer:

We agree that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund, but believe that quantitative disclosure of trading costs is problematic. Although some trading costs components can be quantified easily and precisely, others can be quantified only with great difficulty, using one of a variety of estimation methods. As a result, we are concerned that additional numerical disclosure of trading costs could result either in a number that would be comparable and verifiable, but incomplete, or a number that would be complete but not comparable because it would be based on estimates and assumptions that would vary from fund to fund.

If these difficulties can be overcome, we believe that trading cost information should be included in fund prospectuses along with the fund's fee table and expense ratio to facilitate an understanding of the magnitude of total fund expenses both before and after taking into account portfolio transaction costs. It may also be appropriate to include a trading cost number in the annual report to shareholders so that it can be viewed along with management discussion of the fund's performance, which may include a discussion of unusual portfolio turnover. As discussed below, the staff plans to recommend that the Commission issue a concept release to explore these issues further.

A. Types of transaction costs incurred by mutual funds

Broadly defined, a mutual fund's trading costs are the overall costs of implementing the fund's trading strategy.[23] Trading costs include commissions, spreads, market impact costs and opportunity costs.

Commissions are per share charges that a broker collects to act as agent for a customer in the process of executing and clearing a trade. Commissions are the only type of trading cost that can be measured directly. Measurement is easy because the

[23] John M.R. Chalmers, Roger M. Edelin, Gregory B. Kadlec, *Mutual Fund Trading Costs*, University of Pennsylvania, Rodney L. White Center for Financial Research, Working Paper 027-99, Nov. 2, 1999 at 1.

commission is separately stated as a per share charge on the transaction confirmation and is paid directly from fund assets.[24]

Spread costs are incurred indirectly when a fund buys a security from a dealer at the "asked" price (slightly above current value) or sells a security to a dealer at the "bid" price (slightly below current value). The variance between the bid price and the asked price is known as the "spread." [25] Spread costs include both an imputed commission on the trade and any market impact cost associated with the trade as discussed below.

Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security.[26] Stated formally, market impacts are the price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction.[27]

Market impact cost cannot be calculated directly. It can be roughly estimated by comparing the actual price at which a trade was executed to prices that were present in the market at or near the time of the trade. [28] Impact cost can be reduced by stretching out a trade over a long time period. The benefit of reduced impact cost may be reduced or eliminated by an increase in opportunity cost.

Opportunity cost is the cost of delayed or missed trades. The longer it takes to complete a trade, the greater the likelihood that someone else will decide to buy the stock and, by doing so, drive up the price. [29]

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24 Stephan A. Berkowitz and Dennis E. Logue, *Transaction Costs: Much ado about everything*, JOURNAL OF PORTFOLIO MANAGEMENT (Winter 2001) at 67-68.

25 Funds incur spread costs on trades that are made on a principal basis (trades executed from dealer inventory). The "commission" is the unstated increase to the buy price or reduction in the sell price at which the trade is executed. Although these markups and markdowns cannot be directly calculated, they can be estimated, but only with data collected with much difficulty some days after the trade is executed. (*See* Berkowitz and Logue, *supra* note 24 at 68.)

26 The average trade on the New York Stock Exchange and on NASDAQ is approximately 1,700 shares. The average order placed by institutions (including mutual funds) is 44,600 shares, according to an estimate from the consulting firm Plexus, Inc. Basic economics dictate that, if the supply of a good or service is held steady, increased demand drives up the price. Large trades have on impact on price. They "move the market" (drive the price up if the fund is buying; down if the fund is selling.)

27 Berkowitz and Logue, *supra* note 24 at 67.

28 Berkowitz and Logue, *supra* note 24 at 68. Theory suggests comparing the actual price paid or received to what would have prevailed had the order never been placed. In practice we can observe only actual market prices and the contemporaneous bids and offers to trade.

29 An opportunity cost is incurred when three conditions hold: (1) the price of a stock rises (falls) after an investor decides to buy (sell) it, but before she is actually able to do so; (2) the price change is independent of the investor's decision; and (3) the price change is "permanent" – *i.e.*, it is caused by the dissemination of information relevant to the valuation of the asset. Other factors

Opportunity cost cannot be measured directly. The joint effect of market impact and opportunity cost can be estimated by comparing market prices at the time the transaction is conceived to the price at which the transaction was actually executed. Consulting firms have developed quantitative tools that attempt to estimate these costs for their clients.[30]

In summary, commission costs can be easily determined, but spread, impact, and opportunity costs can only be roughly estimated. As a result, because of the varying factors involved, there is no generally agreed upon method to calculate transaction costs.

B. Analysis of Alternatives for Additional Transaction Cost Disclosure

Some industry observers have proposed that mutual fund transaction costs be quantified and disclosed as an expense. For commissions, this would be easy. As previously indicated, the per-share commission appears on the confirmation of each transaction and funds already report in their Statements of Additional Information the aggregate dollar amount of commissions paid.

The staff has considered the matter informally on several occasions and continues to believe that it would be inappropriate to treat commissions as a fund expense unless spreads, and possibly impact and opportunity costs, were treated in a similar manner.

First, although estimates of the magnitude of transaction cost and its components vary, brokerage commissions represent a relatively small portion of the overall transaction costs incurred by many funds. As a result, a transaction cost measure that includes only brokerage commissions may be misleading.[31]

Second, commissions and spreads pay for similar services. Expensing commissions and not spreads would cause funds that execute their trades on an agency basis (and pay commissions) to report higher expenses than funds that execute their trades on a principal basis (and incur the cost of the bid-asked spread).[32] This disparity

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may influence the price of an asset, such as temporary liquidity imbalances, but they do not generate opportunity costs. Robert A. Schwartz and Benn Steil, *Controlling Institutional Transaction Costs*, THE JOURNAL OF PORTFOLIO MANAGEMENT (Spring 2002) at 43.

30 *See* Berkowitz and Logue, *supra* note 24 at 70.

31 The chairman of a leading transaction cost consulting firm estimates that aggregate transaction costs for a typical mutual fund or pension fund are roughly ten times the commission cost. Testimony of Wayne H. Wagner, March 12, 2003 before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives.

32 The Commission has recognized that money managers opting for certain riskless principal transactions on Nasdaq would now be informed of the entire amount of a market maker's charge for effecting the trade. *See* Securities Exchange Act Release No. 45194 (Dec. 27, 2001). In this release, the Commission also recognized that fees on other riskless principal transactions can include an undisclosed fee (reflecting a dealer's profit on the difference in price between the first

would likely encourage funds to shift their trading activity from securities exchanges to NASDAQ and the over-the-counter markets in order to appear less costly, even if better execution prices could be obtained on an exchange.

Furthermore, a transaction cost number that included commissions and spreads, but not market impact and opportunity costs would still be problematic because funds that are more costly from an overall transaction cost standpoint might appear to be less costly if only commission and spread costs were disclosed.[33] An investor who evaluates whether a fund is getting best execution needs to consider not only commissions and spreads, but also the prices at which security purchases and sales are executed. Transactions with low commissions or spreads and a less favorable execution price may be less beneficial than transactions with higher commissions or spreads and more favorable execution prices.

This brings us to the question of whether it is feasible to quantify spreads, market impacts, and opportunity costs. We believe that it is not currently feasible to quantify these costs in a manner that would be suitable for disclosure documents that must be attested to by fund management and external auditors.

Today, consultants and academics derive transaction cost estimates that include spreads and market impact costs by using a variety of algorithms to compare the actual price that was paid in each transaction with the market price that prevailed at some time before [34] or after [35] the transaction was completed.

Perhaps the most all-inclusive way to measure transaction cost is "implementation shortfall." Implementation shortfall measures transaction cost as the difference between the price of all trades you intend to make (trades actually made plus intended trades that fail to execute) and the price that prevailed in the market *when each decision to trade was made*.[36]

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and second legs of the transaction), and that fees on traditional principal transactions also can include an undisclosed fee based on some portion of the spread.

33 *See* Testimony of Wayne H. Wagner and John Bogle, March 12, 2003 before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives.

34 A "before trade" measure compares the actual price of each trade with the price that prevailed in the market at the time that the decision to trade was made. *See* Perold, Andre F. *The Implementation Shortfall: Paper vs. Reality*, JOURNAL OF PORTFOLIO MANAGEMENT (Spring 1988) at 7-8.

35 In an "after trade" measure, the market price might be today's closing price, tomorrow's closing price, some other price in effect after the fund completed the trade, the average of the high and the low for the day, or a weighted average of all prices at which market participants transacted on that day. *See* Perold, *supra* note 34, at 7.

36 The term "implementation shortfall" was introduced by Perold in 1988. Implementation shortfall is defined as a measure of the degree to which execution, market impact and opportunity costs prevent the investor from taking advantage of his or her stock selection skills. See Perold, *supra*

Although the transaction cost estimates described above may provide valuable information to funds, their boards of directors, and researchers we do not believe that these estimates, as currently formulated, would provide an appropriate basis for reporting transaction costs as an expense in fund financial statements, or reporting these costs separately in fund disclosure documents.

With respect to the before trade and after trade methods, a common standard would need to be chosen from among the wide variety of estimation techniques that are used, opportunity costs would remain unaccounted for, and some measures in this category would be vulnerable to being "gamed." [37]

The advantages of the implementation shortfall method are that it includes all trading costs and may be less vulnerable to being gamed. However, because implementation shortfall compares prices of actual and intended trades to prices in effect when trading decisions were made, numerous practical difficulties would need to be resolved before this method could be mandated. Funds would need to collect and analyze enormous quantities of information throughout the trading process – from the portfolio manager, the trader, and the broker, whenever each makes a decision that affects the outcome of the trade – including the time, price, and quantity outcomes for each decision in the process of filling an order. [38] Objective and verifiable criteria would need to be developed for determining when a trading decision has actually been made, determining when the decision has been modified or revised, and selecting the figure that represents a security's market price at each of these times. These criteria would need to be mandated for use by all funds. Determining the extent to which the fund's actual trading activity has varied from its intention would be difficult, even if additional record keeping requirements were mandated concerning the motivations for the trade, such as investment objective, target price, and time horizon.[39] Because of the issues described above, the staff is planning to recommend that the Commission issue a concept release that would ask investors, the fund industry, consultants, academics, and others to comment on the

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note 34 at 5-6. Leinwebber illustrates the concept by noting that from 1979 to 1991 stocks classified as "Group 1" by Value Line had an annualized return of 26.3% while the Value Line mutual fund that contained the same stocks returned only 16.1%. The difference between the paper return and the actual portfolio return is the cost of trading. David J. Leinwebber, *Using Information from Trading in Trading and Portfolio Management*, 4 JOURNAL OF INVESTING, No. 1 (1995) at 40.

[37] For example, because a before trade measure compares the actual price of each trade with the market price in effect when the decision to trade was made, the market price is known in advance. A trader working on behalf of a fund could "manufacture" low transaction costs if, after each decision to trade is made, the trader would wait to take action on the order list, implement only the buy orders for which prices have fallen since the receipt of the order, implement only the sell orders for which the prices have risen, and dismiss the rest of the orders as "too expensive" to execute. *See* Perold, *supra* note 34 at 7-8.

[38] See Berkowitz and Logue, *supra* note 24 at 70-73.

[39] Donald B. Keim and Ananth Madhavan, *The Cost of Institutional Equity Trades*, FINANCIAL ANALYSTS JOURNAL (July/August 1998) at 54-55.

feasibility of requiring mutual funds to provide quantitative disclosure of their transaction costs.

Although the consultant reports' complexity and reliance on numerous assumptions make them an inappropriate vehicle for disclosure to investors, these reports are especially useful to fund directors in meeting their responsibilities under the Investment Company Act. Section 15(c) of the Act requires fund boards 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. Research and other services purchased by the adviser with the fund's brokerage bear on the reasonableness of the advisory fee because the research and other services would otherwise have to be purchased by the adviser itself, resulting in higher expenses and lower profitability for the adviser. Fund directors may find detailed information about the fund's overall transaction costs to be useful as they consider the nature and quality of the execution, research, and other services purchased by the adviser with the fund's brokerage, and how these services bear on the reasonableness of the advisory fee.

C. Accounting Treatment of Transaction Costs

An additional issue associated with treating fund trading costs as an expense in disclosure documents is that it would be inconsistent with way in which trading costs are treated in the fund's financial statements.

Under generally accepted accounting principles, portfolio transaction costs are generally capitalized (added to the cost basis of securities purchased or subtracted from the net proceeds of securities sold) rather than treated as a fund expense. [40] Consequently, each additional dollar of transaction cost produces a one-dollar decrease in total return, if other factors are held equal.

Transaction costs are capitalized for two reasons. First, accounting theory considers transaction costs that represent payments for execution and clearing services to be part of the cost of buying or selling a security. Accounting theory dictates that security acquisition and disposition costs be capitalized into the price at which a security is purchased or sold. [41] Second, to the extent that the purchase or sale price includes transaction costs that have been incurred for other reasons, but are difficult to separately identify and strip out of the overall purchase or sales price, accounting theory recognizes that it would be neither feasible nor practical to account for these costs as a fund expense. [42]

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[40] Federal tax law requires transaction costs to be handled in the same manner. *See* AICPA Audit and Accounting Guide for Investment Companies, Paragraph 2.40.

[41] *See* FASB Concept Statement No. 2 and AICPA Audit and Accounting Guide for Investment Companies.

[42] *See* FASB Concept Statement No. 2 and 5. This reasoning may be applied, for example, to spread, market impact, and opportunity costs, as well as to certain "soft dollar" commission costs.

Clearly, in considering whether to require mutual funds to quantify some or all of their transaction costs, one focus needs to be the effect of any resultant disparity between the transaction cost numbers that are reported in fund disclosure documents and the numbers that are reported in fund financial statements.

D. Soft Dollar Arrangements

The term "soft dollars" typically refers to arrangements under which an investment adviser directs client brokerage transactions to a broker and, in exchange, obtains research products or services in addition to brokerage services from or through a broker. Section 28(e) of the Securities Exchange Act of 1934 creates a safe harbor permitting money managers (including fund advisers) to pay more than the lowest available commission if the money manager determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. This section only excludes paying more than the lowest available commission and does not shield a person who exercises investment discretion from charges of violations of the antifraud.

The Commission has on several occasions expressed concern about soft dollar arrangements because of the conflicts they may present to money managers, including fund advisers, who would otherwise be required to pay for the research out of their own pockets.[43] If soft dollar practices were eliminated, the cost of this research would not likely be reflected as a separate fund expense but rather would be absorbed by the adviser and thus reflected as part of the advisory fee.

Nonetheless, some have suggested that it would be appropriate to reflect the implicit cost of soft dollar arrangements in the fund expense ratio, which would involve somehow quantifying the value of research, or the portion of brokerage commissions attributable to the costs of soft dollar benefits. The Commission twice has proposed to require advisers to give clients periodic quantitative information about the use of client brokerage and the research and services advisers obtain from brokers.[44] Both times the rules were not adopted because of intractable problems in valuing the research and services that advisers receive for soft dollars, tracing the allocation of those benefits to

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In contrast, the value of services received by mutual funds under certain brokerage service arrangements is accounted for as an expense. In a typical directed brokerage arrangement, a fund will earn a credit for a certain level of trading volume placed with a broker. The broker agrees to use that credit to pay a fund's custody, transfer agent, or other expenses. The aggregate value of all fund operating expenses paid for by brokers under these arrangements is identifiable and measurable, even if the payments cannot be allocated to individual trades. *See* Regulation S-X, Article 6-07(2)(g).

43 *See* Investment Advisers Act Release No. 1862 (Apr. 5, 2000).

44 As discussed earlier, section 28(e)(2) of the 1934 Act authorizes the Commission to require this disclosure.

clients' accounts, and quantifying the effect of the benefits on the accounts' performance.[45]

E. Conclusion

Our view is that it would be very difficult to include transaction costs in mutual fund expense ratios or to report them separately in fund disclosure documents. Although proposals to quantify transaction costs are attractive in theory, it is not clear they are feasible in practice. We believe it would be inappropriate to treat commissions as a fund expense unless spreads, and possibly impact and opportunity costs, were treated in a similar manner. Although transaction cost data that include some or all spread, impact and opportunity costs are available in consultant reports, we believe these data would be unsuitable for inclusion in disclosure documents unless significant modifications were made. For example, objective and verifiable criteria would need to be developed with respect to the trading decision and valuation issues identified above. We do not have sufficient information to evaluate whether methodologies designed to provide estimates for internal analytical purposes or academic research can feasibly be redesigned to provide transaction cost figures that are suitable for disclosure documents that must be attested to by fund management and external auditors.

To further explore these issues, the staff of the Division of Investment Management is planning to recommend that the Commission issue a concept release that would ask investors, the fund industry, consultants, academics, and others to comment on the feasibility of requiring mutual funds to provide quantitative disclosure of their transaction costs. We hope the concept release will elicit useful information and suggestions for addressing the issues associated disclosure of fund transaction costs.

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[45] Securities Exchange Act Release No. 13024 (Nov. 30, 1976); Investment Advisers Act Release No. 1469 (Feb. 14, 1995).

Attachment A

Excerpt From:

Testimony Concerning
Regulatory Reforms To Protect
Our Nation's Mutual Fund Investors

by William H. Donaldson
Chairman, U.S. Securities & Exchange Commission

Before the Senate Committee on Banking, Housing and Urban Affairs

November 18, 2003

SEC Risk Management Initiative

For too long, the Commission has found itself in a position of reacting to market problems, rather than anticipating them. There are countless reasons for this - not the least of which include historically lagging resources and structural and organizational roadblocks. The time for excuses has long passed.

Since coming to the Commission in February, one of my top priorities has been to reevaluate and determine how the Commission deals with risk. Part of this evaluation has been a thorough review of the Commission's internal structures. The results of our work form a new risk management initiative that will better enable the Commission to anticipate, identify, and manage emerging risks and market trends that stand to threaten the Commission's ability to fulfill its mission.

This critical initiative - the first of its kind at the Commission - will enable us to analyze risks across divisional boundaries, focusing on early identification of new or resurgent forms of fraudulent, illegal or questionable behavior or products. Operating under the "Doctrine of No Surprises," this initiative seeks to ensure that senior management at the Commission has the information necessary to make better, more informed decisions.

The new initiative will be housed within a newly created Office of Risk Assessment, and will be headed by a director who reports directly to the Chairman. The director will coordinate and manage risk assessment activities across the agency, and will oversee a staff of five professionals, who will focus on the key programmatic areas of the agency's mission.

The duties of the Office of Risk Assessment will be focused on the following areas:

- Gathering and maintaining data on new trends and risks from a variety of sources - including external experts, domestic and foreign agencies, surveys, focus groups, and other market data, including both buy-side and sell-side research.

- Analyzing data to identify and assess new areas of concern across professions, companies, industries and markets.

- Preparing assessments and forecasts on the agency's risk environment.

The work of the Office of Risk Assessment will be complemented by a Risk Management Committee, whose primary responsibility will be to review the implications of identified risks and recommend an appropriate course of action. Additionally, each Division and major Office will have one-to-two risk assessment professionals on staff, who will work closely with the Division Director or Office head as part of risk management teams to conduct risk assessment activities within each division.

I believe this important initiative will fundamentally change the way the Commission assesses risk and will enable us to head off major problems before they occur.