Fund Democracy
Consumer Federation of America
Consumers Union
Consumer Action

March 16, 2004

BY ELECTRONIC AND U.S. MAIL

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. S7-12-03

Dear Mr. Katz:

We are writing on behalf of Fund Democracy,[1] Consumer Federation of America,[2] Consumers Union[3] and Consumer Action[4] to respond to the Securities and Exchange Commission's request for comments on measures to improve the disclosure of mutual fund transaction costs.[5]

We share the Commission's concern regarding the disclosure of fund costs and applaud this initiative to address the problem of portfolio transaction costs disclosure. As the Commission has stated, fund fees "can have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years."[6] Notwithstanding the importance of fees, "the degree to

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[1] Fund Democracy is a nonprofit advocacy group for mutual fund shareholders. It was founded in 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments.

[2] The Consumer Federation of America (CFA) is a nonprofit association of 300 national, state, and local consumer groups, which in turn represent approximately 50 million Americans. CFA was established in 1968 to advance the consumer interest through research, education, and advocacy.

[3] Consumers Union, publisher of *Consumer Reports* magazine, is an independent nonprofit testing, educational and information organization serving only the consumer.

[4] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 6,500 community based organizations.

[5] Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Release No. 26313 (Dec. 18, 2003) ("Concept Release").

[6] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 25870, Part I.B (Dec. 18, 2002).

which investors understand mutual fund fees and expenses remains a significant source of concern."[7]

We also share the Commission's concern that investors' lack of understanding of fees is exacerbated by the inadequacy of disclosure about fund portfolio transaction costs. As the Commission has stated, "for many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions and spreads alone cost the average equity fund as much as 75 basis points."[8] A recent study commissioned by the Zero Alpha Group, a nationwide network of fee-only investment advisory firms, found that commissions and spread costs for large equity funds, the expenses and turnover of which are well below average, exceeded 43% of the funds' expense ratios.[9] A recent survey by Lipper identified at least 86 equity funds for which the total amount paid in commissions alone exceeded the fund's total expense ratio, in some cases my more than 500%.[10]

Because portfolio transaction costs constitute such a significant expense for fund shareholders, it is imperative that the Commission take prompt action to require full and effective disclosure of these costs. With total assets approaching $8 trillion, mutual funds have become Americans' investment vehicle of choice. Without improved disclosure of funds' portfolio transaction costs, investors will not be able to make fully informed investment decisions, as they will continue to be misled by the current, partial expense ratio. Price competition in the fund industry will continue to be suppressed. The payment of non-execution services with fund commissions will continue to distort fund managers' incentives and harm fund shareholders.

We strongly recommend that the Commission follow two principles in evaluating portfolio transaction cost disclosure. First, the Commission should require that such disclosure capture as much of the cost of portfolio transactions as is reasonably possible. This goal should not be compromised merely because, as with any quantitative financial

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[7] Id. (citing a joint report of the Commission and the Office of the Comptroller of the Currency that "found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns").

[8] Concept Release at Part I (citing John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management, at 10 (Aug. 30, 2001) (available at http://finance.wharton.upenn.edu/~edelen/PDFs/MF_tradexpenses.pdf). "These estimates ***omit the effect of market impact and opportunity costs***, the magnitude of which may exceed commissions and spreads." Id. (emphasis added).

[9] See Jason Karceski, Miles Livingston & Edward O'Neal, Mutual Fund Brokerage Commissions at 9 (Jan. 2004) (available at http://www.zeroalphagroup.com/headlines/ZAG_mutual_fund_true_cost_study.pdf).

[10] See Sara Hansard, Lipper Data Miffs Some Firms, Investment News at 3 (Feb. 23, 2004) (173 funds paid commissions in excess of 0.99% of net assets, which is the dollar-weighted average expense ratio for equity funds).

measure, there may be more than one way to calculate various components of portfolio transaction costs.

Second, the Commission should require that portfolio transaction costs be disclosed in the manner that will best facilitate price competition in the fund industry. If the Commission finds that it is possible to reasonably calculate a component of portfolio transaction costs, then it should adopt a method of disclosure that will give as much prominence to that cost component as any other component of a fund's costs. We believe that this necessarily means incorporating portfolio transaction costs in a fund's expense ratio along with other fund expenses. Any approach short of including quantifiable portfolio transaction costs in a total expense ratio will continue to permit disclosure that understates the true costs of fund ownership, suppresses price competition, distorts fund managers' incentives, and misleads investors.

Calculation of Portfolio Transaction Costs

As explained by the Commission, portfolio transaction costs can be divided into four categories: commissions, spread costs, market impact and opportunity costs.[11] The Commission acknowledges that commissions are readily calculable. Indeed, the Commission has already recognized the appropriateness of disclosing the dollar amount of commissions by requiring their disclosure in the Statement of Additional Information ("SAI").

The Commission also recognizes that other components of portfolio transaction costs can be measured, and that, "[t]o monitor performance and comply with their best execution responsibilities, many fund advisers already gather a substantial amount of data about transaction costs and execution quality."[12] Many third-party firms provide fund boards with data regarding portfolio transaction costs, and fund directors use it to evaluate the fund manager's performance.

Thus, the issue before the Commission is not whether portfolio transaction costs can be calculated, but whether the value of such calculations are fatally undermined because (1) they may misrepresent the actual amount of that category of portfolio transaction costs, or (2) they encourage strategic behavior that would be harmful to fund shareholders.

We do not believe either of these potential concerns could rise to the level necessary to justify depriving investors of such important information about fund costs. In the past, the Commission has considered similar proposals to require the disclosure of standardized information. In each case the Commission has adopted standardized formulas for calculating performance, fees and other information notwithstanding objections that there was no objective way to measure these values.

[11] See Concept Release at Part II.A.

[12] Concept Release at Part III.B.

Prior debates about the standardization of money market yields and funds' total returns were characterized by disagreements about different ways to calculate these figures.[13] For example, when the Commission decided to require that funds use standardized performance information, it noted that investment returns in fund advertisements were "often computed differently and/or presented over different time periods."[14] Notwithstanding that yield and total return could be calculated in a variety of ways, the Commission was able to decide on a single, standardized approach for each that has served investors well.

The fact that there may be more than one way to calculate a type of portfolio transaction cost by itself tells us nothing about whether a standardized calculation should be required to be disclosed. The only factors that would militate in favor of nondisclosure are that the calculation was so inherently misleading so as to misrepresent the actual amount of the costs, or that disclosure would cause funds to act in ways that are materially detrimental to shareholders. Otherwise, the Commission must respect the capacity of the marketplace to evaluate portfolio transaction cost information, rather than reject the disclosure of that information.

Presentation of Portfolio Transaction Cost Disclosure

To the extent that the Commission concludes that one or more components of portfolio transaction costs can be calculated, and it seems that this would necessarily be the Commission's conclusion at least regarding commissions, these costs should be afforded the same prominence as all fund costs. In short, they should be included in the fee table in the prospectus and incorporated into a fund's expense ratio.

It is especially critical that commissions and other quantifiable portfolio transaction costs be included in an expense ratio. The purpose of fee disclosure is to inform investors about fees in a way that promotes awareness of fees and price competition. The disclosure must be in an expense ratio because that is how fund costs are typically presented in resources that investors use to make investment decisions (e.g., Morningstar, personal finance magazines). These resources choose to use the current expense ratio to depict costs in the apparent belief that this is how investors want to see the information.

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[13] See Advertising by Investment Companies, Investment Company Act Release Nos. 15315 (Sep. 17, 1986) (proposing) & 16245 (Feb. 10, 1988) (adopting); Inclusion of a Standardized Yield Computation in Prospectuses, Investment Company Act Release Nos. 11028 (Jan. 28, 1980) (proposing) & 11379 (Oct. 9, 1980) (adopting); see also Improving Descriptions of Risk by Mutual Funds and Other Investment Companies, Investment Company Act Release No. 20974 (Mar. 29, 1995) (concept release on risk disclosure) and Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release Nos. 22528 (Feb. 27, 1997) (proposing to require bar chart illustrate variability of fund returns) & 23064 (Mar. 13, 1998) (adopting bar chart requirement).

[14] Advertising by Investment Companies, Investment Company Act Release No. 16245, at Part II.8 (Feb. 10, 1988).

Requiring only that portfolio transaction costs be disclosed separately from the partial expense ratio is inconsistent with the way that the market tells us investors choose to evaluate fund costs. Information providers publish a single number – the current expense ratio – because that is what investors want. They do not publish fund commissions, although they could easily do so both as a dollar amount and/or a percentage of assets. We believe investors would benefit if these information providers presented such information (along with other neglected information about funds), but we do not expect information providers to do so. Their purpose is to provide customers what they want -- a single, standardized expense ratio -- not to preach to investors about what they need.

The Commission must consider how information providers and investors actually publish and use information when deciding how quantifiable portfolio transaction costs should be presented. This means that for such disclosure to be effective it must be offered as part of a total expense ratio. This does not mean that the partial expense ratio must be eliminated. Rather, the Commission should offer the marketplace the choice between the partial and total expense ratios, and let information providers and investors decide which one they want to use.

If critics of our concept of a total expense ratio are correct, then the market will choose the partial expense ratio.[15] Third party service providers, such as Morningstar and personal finance magazines, have an interest in providing investors with the most useful information about funds. If they choose to provide a single standardized expense ratio, why should the Commission effectively force them to use the partial expense ratio? These third parties should not be forced to choose between an SEC-approved partial expense ratio, and a non-approved total expense ratio. The Commission should not favor only the partial expense ratio with its imprimatur; it should instead allow information providers a choice between two acceptable standardized measures. We have no doubt that they will choose the total expense ratio as the best reflection of the true cost of fund ownership.

The Partial Expense Ratio is Misleading

The partial expense ratio is misleading because it impliedly represents, in conjunction with other shareholder expenses listed in the fee table, the total cost of fund ownership. In fact, as the Commission recognizes, the partial expense ratio omits funds' portfolio transaction costs, which alone can be 5 times the amount of a fund's other expenses combined.[16]

Fund managers have exploited the misleading nature of the partial expense ratio by expressly suggesting that it reflects the total cost of fund ownership. For example, the most recent, well-publicized fee study conducted by the Investment Company Institute

[15] See Section 210 of the Mutual Fund Reform Act of 2004 (requiring the Commission to adopt rules that provide for disclosure of (partial) expense ratio, transaction cost ratio, and total expense ratio).

[16] See supra discussion at note 10.

purports to measure the "total shareholder costs," yet the study entirely ignores portfolio transaction costs.[17] In contrast, in the ICI's response to the SEC's concept release, it acknowledges that a fund's fees and expenses includ[e] transaction costs."[18]

The Commission should require funds to provide an alternative to the partial expense ratio that actually reflects "total shareholder costs." At a minimum, the Commission should prohibit fund managers and their proxies from misrepresenting the partial expense ratio as reflecting "total shareholder costs."

The Partial Expense Ratio Suppresses Price Competition in the Fund Industry

The Commission should require fee disclosure that enables the market to differentiate funds' cost models and make judgments about which models to reward with investments. Studies of mutual fund transaction costs demonstrate not only that these costs can be substantial, but also that they vary widely across different funds.

By excluding portfolio transaction costs, the partial expense ratio effectively prevents that market from judging the relative value of activities that lead to higher or lower portfolio transaction costs. This suppresses price competition because it removes an important incentive for fund managers to consider the price disadvantage of high portfolio transaction costs.

In criticizing a recent settlement in which a fund manager agreed to reduce its fees, the Commission asserted that "the best way to ensure [fair and reasonable fees] is a marketplace of vigorous, independent, and diligent mutual fund boards coupled with fully-informed investors who are armed with complete, easy-to-digest disclosure about the fees paid and the services rendered."[19]

We agree that the market should be the primary regulator of fund fees and that the market can only function effectively with complete, easy-to-digest disclosure. The partial expense ratio is not complete disclosure. Its exclusion of portfolio transaction costs prevents market regulation of fund fees by removing a substantial component of fund costs from consideration by the market.

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[17] See The Cost of Buying and Owning Mutual Funds, Investment Company Institute, 13 Fundamentals (Feb. 2004).

[18] Letter from Amy Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan Katz, Secretary, Securities and Exchange Commission, at Part I (Feb. 23, 2004) (available at http://www.ici.org/statements/cmltr/04_sec_port_disclose_com.html#TopOfPage).

[19] Statement of the Commission Regarding the Enforcement Action Against Alliance Capital Management, L.P. (Dec. 18, 2003) (available at http://www.sec.gov/news/press/2003-176.htm) (responding to New York Attorney General's settlement with Alliance).

The Partial Expense Ratio Distorts Fund Manager Behavior to the Detriment of Shareholders

The partial expense ratio distorts fund managers' incentives by rewarding them for paying for non-execution fund expenses with fund brokerage. Fund managers use commissions (and – because of a recent Commission position expanding the soft dollar safe harbor to principal trades – mark-ups and mark-downs) to pay for research and other services covered by the soft dollar safe harbor and for the sale of fund shares.[20] These are services that would otherwise be paid by the fund manager out of the management fee or by the fund out of the 12b-1 fee.[21]

By paying for these non-execution services with commissions, fund managers effectively move these costs out of the fee table where they belong. This enables the fund that pays for these non-execution services with commissions to present a lower partial expense ratio than a fund that does not – even if the fund managers use identical services and have identical operating expenses. As noted by the Commission, "[t]he limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services."[22]

To illustrate, consider two managers of two same-size funds that purchase research reports from Research Inc., and the cost of those reports is 0.05% of assets. If the fund managers pay for the reports out of the management fee, their funds' partial expense ratios will be 1.00%. If one fund manager pays for the reports with soft dollars, that is, with the fund's commissions, then that fund's partial expense ratio can be reduced to 0.95%.[23] Simply by shifting the cost of the reports from being paid for out of the management fee to being paid for with soft dollars, the fund manager can reduce the partial expense ratio 0.05%, and fund shareholders are none the wiser.[24]

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[20] We recognize that the Commission has proposed to ban the use of commissions to pay for sales of fund shares, which is known as directed brokerage. See Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356 (Feb. 24, 2004) ("Directed Brokerage Release").

[21] For example, the Commission "staff estimates that brokerage commissions may compose approximately twenty percent of annual expenditures for fund distribution." Id. at Part I.

[22] Concept Release at Part III.A.

[23] It may be more likely that the fund manager would pocket the additional 0.05% in fees, thereby leaving the expense ratio unchanged but effectively increasing the fund's total expenses by 0.05% once the additional transaction costs are considered.

[24] See generally Directed Brokerage Release at Part II ("Moreover, that brokerage commissions could instead be used to offset other fund costs rebuts the notion that the use of fund brokerage to finance distribution imposes no additional costs on the fund. Foregoing an opportunity to seek lower commission rates, to use brokerage to pay custodial, transfer agency and other fund expenses, or to obtain any available cash rebates, is a real and meaningful cost to fund shareholders." (footnote omitted))

The partial expense ratio creates an incentive for fund managers to shift non-execution costs that should be included in that expense ratio to a different category of expenses – so-called portfolio transaction costs – and thereby appear to reduce the total costs of the fund. This incentive will exist even if portfolio transaction costs are presented in a format apart from the partial expense ratio, because fund managers will continue to have an incentive to shift non-execution expenses out of the partial expense ratio to give the appearance that their costs are lower than they actually are.

Furthermore, the nondisclosure of portfolio transaction costs exacerbates the conflict of interest that is inherent in paying for non-executive services with commissions. As the Commission has recognized,

> "[s]oft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers."[25]

We have previously recommended that this conflict be addressed by banning soft dollars, which would necessitate legislative action.[26] We recognize that the agency does not have the authority to impose such a ban. What the agency can and should at a minimum do is ensure that the marketplace is informed in a meaningful way about the cost of this conflict. The continued concealment of portfolio transaction costs permits the soft dollar conflict to operate virtually unchecked by market forces, whereas including portfolio transaction costs in a total expense ratio would, at least, permit the marketplace to judge the efficacy of soft dollar arrangements.

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[25] Memorandum from Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission to William H. Donaldson, Chairman, Securities and Exchange Commission, at 36 (June 3, 2003) (available at http://financialservices.house.gov/media/pdf/02-14-70%20memo.pdf). Regarding directed brokerage, the Commission recently stated: "We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders." Directed Brokerage Release at Part II.

[26] Mercer Bullard and Barbara Roper, A Pro-Investor Blueprint for Mutual Fund Reform at Part 6.B (Nov. 25, 2003) (available at http://www.funddemocracy.com/mfblueprint2.pdf).

V. Conclusion

We commend the Commission for requesting comment on ways to improve the disclosure of fund portfolio transaction costs. Portfolio transaction costs have for too long been hidden from investors. We look forward to working with the Commission on its forthcoming proposal.

Sincerely,

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