CMFI
Coalition of Mutual Fund Investors

August 18, 2016

Investor Advisory Committee
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Subject: Mutual Fund Cost Disclosures

Dear Committee Members:

The Coalition of Mutual Fund Investors ("CMFI")[1] supports the recommendation of the Investor Advisory Committee ("Committee"), adopted on April 14, 2016, that the Securities and Exchange Commission ("SEC") explore ways to improve mutual fund cost disclosures.[2]

CMFI has two specific recommendations for both the Committee and the SEC to improve the disclosure of fund costs to individual investors. First, the SEC should adopt a requirement that fund costs be disclosed as an individualized estimate in dollar amounts on annual shareholder statements. Second, and over the longer term, the SEC should consider developing a standardized transaction cost ratio. Both of these recommendations are discussed below.

Individualized Cost Disclosures in Dollar Amounts on Annual Shareholder Statements

CMFI supports the concept advocated by the Committee that the SEC consider requiring the disclosure of individualized dollar costs on annual shareholder statements. If this cost is disclosed and explained as an estimate only, then it can done very simply and in an inexpensive manner on annual statements.

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[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors on public policy and regulatory issues. More information about the Coalition and its activities can be obtained at www.investorscoalition.com.

[2] *See* SEC Investor Advisory Committee, Recommendation of the Investor as Purchaser Subcommittee Regarding Mutual Fund Cost Disclosure, at 2, undated, *available a*t https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-041416-recommendation-investor-as-purchaser.pdf (hereinafter "IAC Recommendation").

This type of individualized cost disclosure would be more meaningful to the typical mutual fund investor than the current hypothetical cost disclosure that assumes a $1,000 or a $10,000 investment and a 5% rate of return.

For example, a shareholder with a $12,000 balance at the end of the year would have to make an individualized calculation of what his or her exact cost is now—or could be in the future—based on the assumptions in the hypothetical cost disclosure. However, it would be much more relevant to a shareholder to have an annual estimate of the dollar amount of mutual fund operating expenses incurred by that particular shareholder's account.

This cost estimate can be derived quite simply by multiplying each shareholder's annual account balance by either: (1) the fund's most recent expense ratio; or (2) a reasonable estimate by the fund adviser of the projected expense ratio for the upcoming year.[3] A footnote in the shareholder statement can be used to explain the methodology used to make this calculation. The footnote should also explain that a shareholder's costs would be different if his or her holding period is less than one (1) year.

Using the example above, if a shareholder has a year-end account balance of $12,000 in a fund with a 1.4% expense ratio, the annual shareholder statement would disclose that this shareholder's portion of the fund's annual operating expenses was $168.[4]

Dollar disclosure of this type will help educate investors about the true cost of owning a particular mutual fund, as long as the methodology used is common to all funds and it is implemented in a standardized manner that will facilitate comparisons among funds. Requiring a simple calculation using account balances and a fund's expense ratio should not be expensive to implement, although this concept would be more complicated to carry out for shareholders in omnibus accounts, as these investors receive account statements and balances from a broker-dealer or other financial intermediary.[5]

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[3] CMFI advocated this proposal in testimony submitted to Congress in 2004. *See* Coalition of Mutual Fund Investors, Statement of Niels C. Holch, Executive Director, before the U.S. Senate Committee on Governmental Affairs, Subcommittee on Financial Management, the Budget and International Security, Hearing entitled "Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors," January 27, 2004, *available at* http://www.investorscoalition.com/sites/default/files/StatementBeforeSenateGovernmentalAffairs.pdf.

[4] $12,000 multiplied by 1.4% equals $168.

[5] For numerous reasons, CMFI has advocated for more than a decade that broker-dealers and other intermediaries be required to provide mutual funds with full transparency at the investor-level within omnibus accounts. Same-day transparency into these accounts would solve a number of regulatory problems and would also make the type of individualized cost disclosure discussed above easier to implement. For more information about omnibus accounts, click on this link to the CMFI website: http://www.investorscoalition.com/regulatory-tracker/hidden_omnibus_accounts.

Improved Disclosure of Portfolio Transaction Costs

CMFI also supports the Committee's recommendation that the SEC consider additional disclosure changes to improve investors' understanding of fund costs.[5]

Since brokerage commissions and other portfolio transaction costs are the largest expense to investors that is *not* reflected in the expense ratio, CMFI supports more transparent and standardized disclosure of these costs. Under current SEC and GAAP accounting rules, the actual brokerage commissions paid by a fund are not disclosed in the expense ratio of a mutual fund. Instead, the cash amount paid for brokerage commissions is disclosed annually in a mutual fund's Statement of Additional Information.

Unfortunately, the disclosure of this cash amount has little value to an investor unless it is compared to the average net assets of the mutual fund and converted into a percentage ratio.

This disclosure problem is further complicated by the fact that mutual funds do not always pay a cash commission to transact in portfolio securities. Many securities—such as over-the-counter equities and most bonds—are traded via a bid/ask spread, with brokers on both sides of the transaction being compensated by the difference between the price offered to the buyer (the "ask") and the price offered to the seller (the "bid"). This spread "cost" is not considered a cash commission payment and so it is not included in the annual disclosure required in the Statement of Additional Information. Instead, the higher price paid by the buyer and the lower price received by the seller are reflected in a fund's capital returns (and performance) over time.

A further dilemma is how best to evaluate the other indirect costs incurred in portfolio trading. For example, a mutual fund that seeks to purchase a large block of an illiquid security may have a "market impact" cost if its own actions raise the price of that security as it accumulates a position. Similarly, a mutual fund that expects to have a certain level of redemptions in its shares may need to retain a larger cash balance, creating an "opportunity cost" for this un-invested amount.

The SEC started to tackle these issues in 2003, by issuing a Concept Release to gather information and ideas.[6] However, there are many facets to calculating portfolio transaction costs and the SEC has not followed up with a rulemaking in more than 12 years.

CMFI acknowledges that calculating market impact costs and opportunity costs will take many years and an army of economists to figure out. However, investors should not have to wait around for a perfect solution. It may be better to provide investors with more information in the

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[5] *IAC Recommendation* at 6.

[6] Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, 68 Fed. Reg. 74,820, December 24, 2003, *available at* https://www.gpo.gov/fdsys/pkg/FR-2003-12-24/pdf/03-31695.pdf.

short-term, while the SEC continues its evaluation of the more difficult aspects of portfolio transaction costs.

CMFI believes that the SEC could immediately enhance investor understanding of transaction costs by simply standardizing the disclosure of actual brokerage commissions that are paid each year and disclosed in the Statement of Additional Information. In order to compare these amounts with other funds, this figure should be converted into a *transaction cost ratio*.

To calculate such a transaction cost ratio, a fund should take the aggregate amount of brokerage commissions paid each year and divide this amount by the average net assets of the fund over the same period. This ratio should be provided on an annual basis and it would be separate from the expense ratio for comparison purposes. And a fund should be able to explain in a footnote why this number could be higher or lower because of other portfolio transactions using bid/ask spreads, or as a result of other unique cost issues.

If the SEC is interested in including portfolio transactions that involve a bid/ask spread in this type of transaction cost ratio, CMFI proposed several methods for how this could be accomplished in a 2004 comment letter to the SEC, which is attached. CMFI believes that an approach can be developed that includes the estimated cost of these portfolio transactions in a transaction cost ratio, with footnotes to explain any unique circumstances that a fund wants to explain to its shareholders.

There are ample reasons why the SEC should explore combining the actual costs of brokerage commissions with the estimated costs of spread transactions and converting these amounts into a transaction cost ratio. This ratio would greatly improve an investor's understanding of the approximate portfolio trading costs of his or her fund investment and would provide comparability across funds. Excluding market impact and other more theoretical costs will not detract from the value of this new cost ratio and can be explained in a footnote or a paragraph accompanying this disclosure.

The SEC should not wait another decade to develop a more comprehensive transaction cost ratio. Otherwise, "the perfect [will be] the enemy of the good," to quote Voltaire.

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CMFI appreciates the opportunity to comment on the Committee's recommendation to the SEC regarding better disclosures of mutual fund costs. Please contact CMFI if you would like to discuss any of these suggestions in more detail. I can be reached at [redacted] and via email at [redacted].

Sincerely,

Niels Holch

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

Attachment

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
Rick A. Fleming, Investor Advocate

Coalition of Mutual Fund Investors

February 23, 2004

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

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

Dear Mr. Katz:

The Coalition of Mutual Fund Investors ("CMFI" or "Coalition") is pleased to submit the following comments regarding the Concept Release issued by the Securities and Exchange Commission ("SEC" or "Commission") on December 18, 2003, proposing measures to improve disclosure of mutual fund transaction costs.

CMFI is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is based in Washington, D.C., with a Web site that can be accessed at www.investorscoalition.com.

The Coalition applauds the Commission for attempting to improve investor disclosure of these costs. As the Commission notes in its explanatory materials accompanying this Release, current disclosure requirements do not provide adequate information about an investor's overall transaction costs.

This issue must be addressed because brokerage commissions and other portfolio transaction costs are the *largest expense not reflected in the expense ratio* of a mutual fund. For these reasons, CMFI strongly supports more transparent disclosure of these costs.

400 North Capitol Street, N.W. ■ Suite 585 ■ Washington, D.C. 20001
Telephone 202-783-5300 ■ Fax 202-393-5218 ■ www.investorscoalition.com

Under current SEC rules and Generally Accepted Accounting Principles ("GAAP"), the brokerage commissions actually paid by a mutual fund are not disclosed as an operating expense or in the expense ratio calculation provided to investors. Instead, the cash amount paid for brokerage commissions is disclosed annually in the fund's Statement of Additional Information ("SAI"). Unfortunately, this number has little value to an investor unless it is compared to the average net assets of the mutual fund and converted into a percentage ratio.

The difficulty of properly measuring transaction costs is further complicated by the fact that mutual funds do not always pay a cash commission to transact in portfolio securities. For example, stocks purchased on the NASDAQ exchange and many bonds are commonly traded via a bid/ask spread, with brokers and other transaction intermediaries being compensated by the difference between the price offered by the buyer (the "ask") and the price offered by the seller (the "bid"). This price spread "cost" is not considered a cash commission payment and so it is not disclosed in the Statement of Additional Information. Instead, the higher price paid by the buyer and the lower price received by the seller are reflected in a fund's capital returns over time.

Another measurement problem in this area is how to evaluate the indirect costs of portfolio trading. For example, a mutual fund which seeks to purchase a large block of an illiquid security may have a "market impact" cost if its own actions raise the price of the security, as it accumulates its position. Similarly, a mutual fund which expects to have a certain level of redemptions in its shares may need to retain a larger cash balance, creating an "opportunity" cost for this uninvested amount. And this "opportunity" cost will be higher for those funds with excessive market timing activities, thereby reducing the returns of longer-term shareholders.

As a goal, it is important that the SEC develop a standardized transaction cost measure that is accurate, comparable, and not overly burdensome for mutual funds. *However, this process may take several years to complete and, in the interim, something should be done to improve the disclosures that investors now receive of portfolio transaction costs.*

The Coalition urges the Commission to act immediately to require improved investor disclosure of the actual brokerage commissions paid in cash by each mutual fund, a dollar figure which, as noted above, is currently disclosed in a fund's Statement of Additional Information. For comparison with other funds, this figure should be converted into a percentage of average net assets of the fund and disclosed to investors as a *transaction cost ratio*.

Since transaction costs are not a GAAP expense and are not included in the expense ratio of a fund, CMFI believes that the simplest approach for the SEC to consider is to present these costs as a separate ratio.

To calculate this proposed transaction cost ratio, a fund would take the amount of aggregate brokerage commissions paid each year and divide this amount by the average net assets of the fund over the same one-year time period. In presenting this new cost ratio, a mutual fund would be able to explain in a footnote why the actual cost of securities transactions could be higher or lower, because of the purchase of over-the-counter ("OTC") equities, bonds, and other portfolio transactions purchased on a spread basis.

An obvious flaw in the calculation of this proposed ratio is the fact that it does not include these bid/ask spread transactions. To address this issue, the Coalition recommends that the SEC consider the following additional steps:

1. For those securities in which the exact "spread cost" is currently allocated to the buyer and the seller (e.g. NASDAQ National Market transactions), the SEC should require that this amount be recorded on the fund's brokerage confirmation statement. This "cost" to the fund can then be summed over the same one-year period as cash brokerage commissions, divided by net average assets, and added to the proposed transaction ratio proposed above.

2. For those securities in which a "spread cost" is not specifically allocated to the buyer and the seller in a transaction (e.g. certain OTC equities and bonds), CMFI recommends that the "spread cost" be defined as a exact dollar amount, allocated evenly between the buyer and the seller, and recorded on a fund's brokerage confirmation statement. This "cost" can be summed over the same one-year period as cash brokerage commissions and any other spread costs, divided by net average assets, and added to the proposed transaction ratio figure. As an alternative, mutual funds could be required to estimate their spread cost for these trades using average commission rates or some other comparable measure.

If the Commission agrees to adopt a transaction cost ratio which includes bid/ask spread transactions, a footnote or legend should be added to any disclosure of this figure, stating that this calculation is presented to provide investors with an *estimate* of direct brokerage costs for the period involved. A further notation should be made that this ratio does not include other indirect investor transaction costs, including market impact and opportunity costs.

The SEC should continue its efforts to develop a methodology to calculate and present market impact and opportunity costs in a standardized and comparable manner. Once an acceptable measure is developed to calculate and compare these costs, the amounts can be added to the proposed transaction cost ratio in the future. However, it will take some time to develop the methodology for such a measure; investors should not have to wait until a more perfect formulation of transaction costs is developed.

As legendary investor Warren Buffett is fond of saying: "It is better to be approximately right than precisely wrong". Mr. Buffet was referring to the inadequacies of "beta" as a financial measure in this quote, but the analogy is quite appropriate when applied to the issue of trying to measure portfolio transaction costs.

Most of the information required to calculate commission and spread costs is available today, with current technology and trading practices. The Commission should work to develop a transaction cost ratio that includes this information, recognizing that the ratio will be an estimate of the *direct* costs, and it will not include, for the present, an accurate measure of the *indirect* costs, such as market impact or opportunity costs.

CMFI believes that this proposal strikes the proper balance between the need for additional investor transparency of transaction costs and the complexity involved in identifying and measuring *all* transaction costs.

If a transaction cost ratio is developed by the SEC, CMFI advocates that this new ratio be disclosed in the same manner and the same location as the expense ratio, with qualifying language that informs an investor of the measurement strengths and weaknesses of the ratio.

Regarding other issues presented in the Concept Release, CMFI provides the following comments:

1. <u>Accounting Issues</u>. CMFI does not currently advocate a change to the accounting treatment of transaction costs. This area of accounting is quite complex and many of the proposals for change may have unintended consequences. In CMFI's view, the best mechanism to improve investor disclosure and awareness about transaction costs is to create a transaction cost ratio which captures as much information as can be measured under current standards and practices.

2. <u>Portfolio Turnover</u>. Many industry commentators maintain that portfolio turnover information serves as a proxy for fund transaction costs. While CMFI supports this notion generally, a requirement to provide more visibility of portfolio turnover information in investor disclosure documents should not be the only action taken by the

Commission to address this issue. In other words, portfolio turnover information is helpful to an investor, but it is not going to provide a complete solution.

3. Average Net Flows Information. CMFI supports disclosure of additional information about the sale and redemption of a fund's shares. Specifically, CMFI supports the disclosure of average daily net flow as an additional tool for investor evaluation of trading activity and costs.

4. Disclosure of Gross Returns. CMFI supports the Commission proposal to disclose gross investment returns of mutual funds. Among other benefits, this additional disclosure will help investors develop a more accurate side-by-side comparison of fund performance against the performance of unmanaged indexes. This comparison is currently an "apples to oranges" comparison since fund performance is presented on a net basis, while index performance is reported on a gross basis.

Thank you for providing CMFI with the opportunity to present its views on these issues. If you or any member of the Commission staff have any questions or need additional information from CMFI, please contact me at 202-783-5300.

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors