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February 18, 2004

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:

Your concept release on the disclosure of mutual fund transaction costs raises some important issues. The following sets forth my views on specific proposals of this release and my more general views on protecting the less informed investor.

The Target Audience

Mutual funds already disclose a great deal of information, and some investors may even feel that there is an information overload. When presented with a multi-page document, some investors may give up and not read the document at all. Thus, before the SEC asks mutual funds to disclose even more, the SEC should carefully examine how investors currently utilize current fund documents, such as annual reports, prospectuses, and statements of additional information (SAIs).

At one extreme are investors who have very little knowledge about investing; at the other extreme are experienced and fully informed investors who read and comprehend all the information in fund documents. Most investors fall between these two extremes with some but still limited investment experience.

The standards for disclosure, as well as the method of disclosure, should vary with the target audience. Some investors, particularly those with limited investment experience, may find little value in increased disclosure, as they may not have even absorbed what is currently disclosed. For such investors, the SEC should focus on a limited number of key disclosures that are critical in allowing these typical investors to make informed investment decisions. Just as importantly, the SEC should then determine the best format in which to present these key disclosures.

In my view, typical investors would be well served if they understood the on-going costs of a mutual fund, the distribution costs that they pay, and the suitability of the investment style of a particular mutual fund to their needs.

How best to disclose these factors is, however, not straightforward. For instance, the following statements have the same literal meaning to an investor with $100,000: (1) The expense ratio is 0.98 percent per year. (2) The expense ratio is 98 basis points per year. (3) The expenses are $98 per $1000 of investment per year. (4) The expenses for your investment are $9,800 per year.

Does it matter which one of these statements is used? Does one statement communicate the level of expenses better than another? What is the best way to disclose distribution costs? What is the best way to indicate suitability? The SEC is currently devoting resources to investor education and assistance, and I encourage this effort. In designing disclosure requirements, it is critical that the SEC take into account the target audience and format the disclosures so as to communicate effectively with that audience.

Disclosure of Turnover

The current concept release discusses various ways to disclose the effects of turnover on the performance of funds. The SEC has proposed a menu of possible disclosures. One is to adjust the reported expense ratio upwards by the commissions incurred in trading.[1] Another is to adjust the reported expense ratio upwards by the soft dollar component of commissions. Still another is to adjust the expense ratio upwards by some measure of total execution cost. It is possible that the adjustment for total execution costs could be negative: for instance, if a fund followed a patient trading strategy of buying at the bid and selling at the offer.

Total commission costs are well defined, but omit a significant portion of trading costs. Specifying the component of commissions that is attributable to soft dollars is well defined when research is purchased from a third party; it is not well defined when research is purchased from the same broker-dealer that provides the research, as there is no third-party payment. Specifying total trading costs is fraught with difficulties, as there is no agreed upon method to measure such costs.

The SEC recognizes that all of these approaches can be "gamed." For instance, an investment advisor could minimize commissions by switching from agency to principal trades. An investment advisor could minimize the reporting of soft dollars by avoiding third-party payments. And I am sure that a clever investment advisor could exploit any

[1] To correspond with the tax law, the recorded values of securities in a fund's balance and income statements would presumably have to be adjusted upwards or downwards by commissions.

predetermined formula for measuring total trading cost so as to minimize reported trading costs (and even make them negative.)

Thus, I oppose mandating any reporting requirement for total trading costs. The question then is whether the expense ratio should include commissions or the soft dollar component of commissions. The answer to this question depends upon the target audience.

For informed and knowledgeable investors, the current level of disclosure is adequate. A high turnover rate is a red flag that a fund may be incurring unwarranted trading costs. Total commissions are disclosed, so that such investors can easily adjust an expense ratio upwards for these commissions. Knowing the portion of these commissions attributable to soft dollars is not likely to provide much additional information except for possible conflicts of interest.

What would be most valuable to informed and knowledgeable investors is the disclosure of mutual fund holdings on a monthly basis. With such data, such investors could undertake a complete attribution analysis of the realized returns of a fund.[2] With these data, investors could perform their own versions of attribution systems.

The story is different for a less informed investor. The question is how to communicate most effectively the impact of trading costs on investment performance. One possibility is to publish the turnover rate along with the range of turnover rates of comparable funds, much like fuel usage is displayed on new automobiles. Another possibility is to adjust the expense ratios upwards by commissions and then compare these ratios to other similar funds.

The key question is whether it makes any difference to a less informed investor. Until it can be shown empirically that adjusting expense ratios upwards for commissions alters investor behavior, it would be premature for the SEC to require any change in the reporting of the expense ratios. I strongly recommend that the SEC use every device that it can to determine the best way to communicate with investors so as to help them in making informed decisions. I do not believe that one can determine in advance what disclosures and what forms of disclosures will best inform investors of the merits of a particular investment.

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[2] Quarterly holdings do not provide sufficient information for an attribution analysis for a fund with a high turnover rate of say 75 percent or more per year.

Prohibition of Certain Practices

The Investment Company Institute reported that in 2001 only 15 percent of households purchased mutual funds directly or through discount brokers/supermarkets. The remaining 85 percent relied on financial professionals and the materials provided through retirement plans. No one knows the proportion of households that have actually read the disclosure material prepared by the mutual funds themselves, but I suspect that the proportion is small.

These households need protection. Disclosure is probably not doing it. What we need is an alternative approach to protect these less informed investors. There are some practices by mutual funds that the SEC should simply prohibit. Practices that the SEC should consider prohibiting have three characteristics: (1) Everyone agrees that the practice has the potential for mischief. (2) It is difficult, even for an informed individual including a director or regulator, to determine whether mischief took place. (3) There is no obvious harm to a beneficiary from such a prohibition.

Such prohibitions have worked well for pension funds subject to ERISA. The Department of Labor publishes a list of prohibited transactions. An example is a loan from a pension plan to the parent company for the purchase of plant and equipment. The potential for mischief is obvious. Determining whether mischief occurred is difficult. A prohibition of this transaction does not harm the pension fund, as it can always make a loan to another company.

For mutual funds, the SEC should consider prohibiting soft dollars. Everyone agrees that transactions involving soft dollars have the potential for mischief. It is difficult for persons other than the investment advisor to determine whether mischief occurred. Prohibiting soft dollars is not likely to hurt the owner of a mutual fund. Necessary research can always be purchased with hard dollars. Purchasing research with hard dollars may lead to an increase in expense ratios, but such an increase in reported expense ratios is exactly what the SEC has proposed except now it would be determined by market forces and not by disclosure requirements.

A direct way to prohibit the use of soft dollars by investment advisors of mutual funds is to repeal Section 28(e) of the Securities Exchange Act of 1934. The SEC has argued that Section 17(e)(1) of the Investment Company Act of 1940 prohibits soft dollars but for the exception in Section 28(e). Repealing Section 28(e) would thus have the effect of prohibiting the use of soft dollars by investment advisors of mutual funds.[3]

[3] Cf. Memo from Paul F. Roye to William H. Donaldson, dated June 9, 2003, p. 38. Additionally, the repeal of Section 28(e) would also prohibit investment managers of ERISA-regulated plans from using soft dollars.

There are other practices that the SEC should considering prohibiting. One practice is directed commissions. Another practice is trading through an affiliated broker-dealer. A final practice is revenue sharing between an investment advisor and a distributor of its mutual funds. Such revenue sharing should be reported as part of a fund's expense ratio, in the form of a 12(b)1 fee.

Some may oppose the SEC's prohibiting specific activities on the part of investment managers of mutual funds as unwarranted interference in the affairs of the private sector. There would be some truth to this assertion if all investors were fully informed about all aspects of investing, including the detailed workings of the mutual fund industry. In fact, many investors have only limited knowledge of mutual funds. A requirement that mutual funds disclose these potential conflicts of interest is likely to have minimal effect on these less informed investors. To protect these types of investors, the best course for the SEC is to simply prohibit the activities that generate these conflicts, unless there is convincing evidence that such prohibitions will harm investors.

Disclosure of Net Daily Inflows

In another question, the SEC asks whether it would be valuable to provide information on average daily net flows into and out of a fund as a percent of total assets.[4] The rationale is that if this number is large, the fund may be incurring additional trading costs and the fund may be exposed to the dilution effects of market timers.

Since there is already information about the annual flows into and out of a mutual fund, it is my opinion that this additional disclosure, although it would provide some additional information, does not provide sufficient additional information to warrant its requirement.

To illustrate, one of the funds that the SEC alleged to have been subject to market timing reported in its annual report that it had an average asset value in 2002 of 7.4 billion dollars, inflows to its Class A shares of 17.0 billion dollars, and outflows of 17.8 billion dollars. In contrast, a fund with similar objectives that has not been mentioned by the SEC had average assets in 2002 of 560 million dollars, inflows of 262 million dollars, and outflows of 223 million dollars. The differences between the relative magnitudes of the inflows to and outflows from these two funds are obvious. In the past, knowledgeable investors might have skipped these numbers, but with the high publicity given to market timing, I would expect knowledgeable investors in the future to examine them. Further disclosure is not necessary.

[4] As an aside, if the SEC goes ahead with this requirement, it should consider expressing the daily number as an annual number to make it comparable to turnover ratios.

Summary

In summary, the SEC should define disclosure requirements in terms of the end user. The typical investor who has only a limited knowledge of investment products requires a different type of disclosure than a highly knowledgeable investor. It is unlikely that the same set of documents will satisfy both types of investors.

The typical investor may not fully understand nor be able to evaluate disclosures about conflicts of interests involving complicated institutional arrangements, such as soft dollars or directed commissions. To serve these investors well, the SEC should consider prohibiting investment practices that involve these three characteristics: (1) They are prone to mischief. (2) It is difficult for an outsider, even a regulator, to determine whether mischief took place. (3) Prohibition will cause no discernable harm to the investor.

Thank you for the opportunity to comment on these important issues.

Yours very truly,

Marshall E. Blume

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