E*TRADE FINANCIAL

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February 20, 2004

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OFFICE OF THE SECRETARY

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

Dear Mr Katz,

Re: File No. S7-29-03 - Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs (the "Concept Release")

E*TRADE Financial Corporation welcomes this opportunity to comment on the Commission's Concept Release on proposed measures to improve disclosure of mutual fund transaction costs.

E*TRADE's response is given from the perspective of an independent broker-dealer. E*TRADE offers both proprietary and non-proprietary mutual funds to retail investors and, through our institutional brokerage operation, transacts securities business for domestic and international fund managers globally. In addition, our institutional brokerage operation has been a leading provider of soft dollar services to fund managers since 1989. E*TRADE is ably placed to comment on matters which pertain to the soft dollar industry. It is also important to note that E*TRADE does not produce proprietary research or engage in investment banking activities.

Mutual fund investors need information in order to make appropriate decisions. They deserve complete and accurate information about the costs incurred by the funds in which

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they invest and the uses to which their assets are put. Greater transparency of fund costs could help investors make better comparisons between funds. It also could help ensure that fund managers meet their responsibilities to use fund assets for the benefit of fund shareholders.

Brokerage commissions and investment research costs are two examples of costs incurred by mutual funds. Investment advisers need both trade executions and investment research in order to serve their clients. Section 28(e) of the Securities Exchange Act of 1934 permits fund managers to obtain research and related services together with execution services and pay for both through commission dollars. These practices are known as "soft dollar" arrangements.

E*TRADE believes soft dollar arrangements benefit investors by increasing the level of competition in the financial services industry. Soft dollar arrangements enhance the ability of smaller brokers and independent research providers to compete with large, diversified firms. They also enhance the ability of smaller investment advisors, which depend on third-party research, to compete with larger counterparts. Finally, soft dollar arrangements help promote the distribution of independent research.

E*TRADE supports transparency of soft dollar arrangements. Brokerage commissions for mutual fund portfolio transactions are paid for out of fund assets. Mutual fund directors and investors deserve to know how fund assets are being spent, what services are obtained with those assets, and the degree to which those services serve the interests of fund shareholders.

It is crucial that this transparency apply equally to specialist soft dollar brokers, who may provide third-party research, and to traditional brokers, who may provide proprietary research. E*TRADE believes that traditional brokers can and should allocate the cost of trade execution and the cost of other services provided in their "bundled" brokerage services to institutional clients. Failure to apply the same disclosure requirements to all brokerage services would create an incentive for fund managers to use the least transparent offerings. This economic distortion would both unfairly skew competition among brokers (which would inevitably favour the large traditional brokers) and result in a less competitive market, less expense information being available to mutual fund shareholders and therefore less transparency. Ultimately the loser is the investor.

To ensure that investors are not misled by disclosure, E*TRADE believes that all fund transaction costs should be disclosed. Disclosing brokerage commissions alone might make comparisons between funds more difficult, as other transaction costs such as spreads would remain opaque. With respect to brokerage costs, actual execution costs should be broken out, as well as any portion of commissions used to pay for soft dollar services. The disclosure also should include whether research is received from an independent third-party or is proprietary to the brokerage firm.

Finally, E*TRADE wishes to emphasize that fund return remains the most important information to investors. The majority of fund investors focus on the overall performance of a fund. Costs, including transaction costs, are just one factor that has an impact on return. The Commission should be mindful of the risk that investors will be misled if they place too much emphasis on costs, as a fund with relatively high costs may still outperform a fund with relatively low costs.

Attached please find an Appendix which lists our responses to some of the specific questions posed in the Concept Release. Kindly note that we have not addressed questions which directly affect the administration of mutual funds and in relation to which we have no specific view.

Sincerely,

Jarrett Lilien
President and Chief Operating Officer
E*TRADE Financial Corporation

APPENDIX

General Questions About Quantifying Transaction Costs

1. Is investor decision-making harmed because investors lack numerical information about mutual fund transaction costs?

In our experience, it is not necessarily the case that investor decision-making is harmed because investors lack numerical information about mutual fund transaction costs. Transaction costs alone are not the key factor in determining fund performance. A fund may have relatively low transaction costs and yet may not give a better return than a fund which has relatively higher transaction costs. The average investor will be most concerned by the overall performance of a fund once all costs, not just transaction costs, have been deducted. The danger with imposing complex or time-consuming procedures designed to enhance disclosure is that, unless investors genuinely understand the information being disclosed and know how to use it, it does not necessarily improve investor knowledge. In fact, a negative result might occur – namely, investors may become confused or even misled. If the cost of providing this information proves high and the corresponding benefit to investors is not achieved, then the investor is ultimately the loser as overall costs to the fund increase.

2. What would be the best way to provide investors with additional numerical information about the amount of transaction costs that mutual funds incur? Would the information most appropriately be located in the prospectus, the SAI, or in another disclosure document?

We would suggest that this information should be included in a prospectus or a quarterly or semi-annual report to shareholders. The SAI is not generally provided to shareholders.

Questions About Quantifying Commissions and Spreads

3. Would a requirement to quantify (express as a percentage) and disclose brokerage commissions, but not other transaction costs provide useful information to fund investors? If funds are required to quantify and disclose their brokerage commissions, should the number be included in fund expense ratios and fee tables?

This is useful information provided *all* transaction costs, and not just brokerage commissions, are broken out. The problem with disclosing brokerage commissions alone is that it does not give a complete picture of the fund's performance and therefore may be misleading to an investor. As we have stated above, the fund with the lowest commission costs is not necessarily the best performing fund.

If this type of disclosure is ultimately introduced, then all constituent elements of transaction costs should be disclosed, including brokerage commissions, implied and actual spreads, and market impact costs.

Furthermore, if brokerage commissions are to be disclosed, we strongly urge the Commission to require that brokerage commissions be broken out between actual execution costs and that portion of commissions used to pay for soft dollar services (whether research or execution related services), and whether provided by specialist soft dollar brokers such as ourselves, or by traditional full-service brokers who produce proprietary in-house research. This would compel traditional brokers, who typically charge a "bundled" commission rate to customers, to allocate a specific cost to each product/service that they provide, particularly with respect to their proprietary research. Such disclosure would improve cost transparency for investors, increase significantly the accountability of brokers and fund managers to investors, and create a more level playing field for market participants.

4. Does the increased use of riskless principal trades on NASDAQ make it easier to quantify the cost of NASDAQ trades? What proportions of NASDAQ trades are subject to commission-equivalent fees?

Riskless principal trading is inherently more transparent than traditional principal trading – however this increased transparency is not necessarily available to the investor, rather to direct market participants. Agency trading by its nature will always be the most transparent form of trading so far as an investor is concerned. In this regard, whilst we cannot quote specific figures, our US trading desk has noticed a constant and growing increase in commission-equivalent fees in NASDAQ trading.

5. Would quantifying commissions mislead investors because it would result in a number that includes some transaction costs and excludes other? Please explain the reason for your answer.

Yes, it could potentially mislead investors. Please refer to our response to question 3 above.

6. If the answer to question 5 is yes, would the concern be alleviated if funds were required to quantify commissions and provide investors with disclosure that details the portion of trades that are performed on a commission basis; spread basis; or some other basis (e.g. directly from an issuer)?

Yes. Please refer to our response to question 3 above.

7. What effect, if any, would a requirement to quantify commissions have on the incentives of fund managers with respect to (1) use of principal versus agency transactions; and (2) use of soft dollar transactions?

Any new disclosure rules that are overly burdensome could lead to a result which is the opposite of that intended, in this case, less transparency rather than more. For instance, significantly increased disclosure requirements could cause certain fund managers to increase principal transactions so as to avoid the disclosure associated with agency trades. This could potentially be at the expense of the investor. In the case of mutual funds, however, this could be overcome by requiring all their trading to be on an agency basis, or as suggested in question 8 below, by having mutual funds estimate the spread costs of their principal trades.

New disclosure rules could also cause fund managers to use soft dollars less, particularly if the disclosure requirements do not clearly extend to traditional brokerage firms providing proprietary in-house research. The Commission should not underestimate the importance of soft dollars in nurturing and promoting the growth of the independent research industry. Soft dollars are a significant payment mechanism for the independent research industry. Uneven disclosure requirements would create a disincentive for fund managers to use brokers that soft independent research and in turn call the viability of independent third party research into question.

Furthermore, the current disclosure required for soft dollar arrangements provides a good model for disclosure generally because the value of research and/or other services and execution is clearly broken out. This is not the case with traditional research produced by full-service brokerage firms.

<u>8. Could any possible adverse effects identified in questions 5 and 6 be mitigated or eliminated by requiring funds, in addition to reporting their commission costs, to estimate the spread cost of their principal trades (for example, by imputing to principal trades the fund's average commission rate on agency trades)? If yes, should this number be included in fund expense ratios and tables?</u>

Yes, but please also refer to our response to question 3 above. In addition, we would stress again that problems may arise if the investor does not understand the new information provided or how to use it. A further concern is that the cost of compliance with such new requirements may outweigh the benefits that it is sought to achieve.

9. Alternatively, can the portion of the spread cost that represents payment for executing a trade be measured separately from the portion of the spread that represents the market impact cost associated with that trade? If yes, should this number be included in fund expense ratios and fee tables?

We do not have any specific view on this question.

Questions About Quantifying All Transaction Costs

10. Would a requirement to quantify *all* transaction costs provide useful information to fund investors? Would a requirement to quantify *all transaction costs, except opportunity costs* be a better alternative? If you advocate that we mandate either of these alternatives, please explain as specifically as possible, how the alternative should be implemented. Please discuss the specific algorithms, formulas, definitions, recordkeeping requirements, and internal control requirements that should be used.

In our opinion, if transaction costs are to be quantified, then this should extend to all transaction costs, rather than just to some. However, in considering whether or not to introduce such a requirement, one must also take into account the costs of compliance and whether the perceived benefits justify the inevitable increase in costs. The danger is that investors are overwhelmed with information that they may or may not understand, and ultimately end up paying for the increased disclosure without obtaining any real benefits.

11. Would the trade effect measure provide useful information to investors, and if so, should we require its disclosure? If the Commission mandated trade effect disclosure, should trade effect be measured with respect to same day closing prices or next day closing prices?

Please refer to our response to question 10 above.

12. More generally, if the Commission were to choose to require disclosure of only one transaction cost measure, which measure should it be?

If the Commission were to require disclosure of only one transaction cost measure, then we would advocate disclosure of brokerage commissions, provided these costs were broken up between execution costs versus research/services costs.

Questions About Accounting Issues

13. Would it be appropriate to include some or all transaction costs in fund expense ratios and fee tables without accounting for these items as an expense in fund financial statements?

We do not have any specific view on this question.

14. Would it be feasible to account for some or all transaction costs as an expense in fund financial statements? If it is not feasible to reliably measure market impact and opportunity costs, should we still require that commission costs be expensed? If yes, should the requirement apply to all commission costs or only those commission and spread costs that do not relate to the execution and clearing of a portfolio transaction (i.e. soft dollars)? If it is not feasible to reliably measure all research costs, should we still expense those costs that can be reliably measured (i.e., payments to third parties for research)?

We consider that commissions and all other transaction costs should be made direct expenses to the fund management company. If this were required, it would solve the problem of transparency as all expenses would be included in the management fee. The only item requiring disclosure would be fund management fee and, as a result, investors could better compare and evaluate the performance of different funds.

We also consider that it is feasible to measure all research costs. There is no logical reason to treat in-house research differently from independent research. Independent third party research providers price their research according to market forces and this provides an arm's length standard of the commercial price for research. Brokers who produce in-house research should also be required to price their proprietary research. If this happens and brokers identify exactly what they charge for execution and what they charge for research, then fund managers can readily determine what they are paying for and can better disclose to their investors how much they pay for each service.

<u>15. Are mutual funds and their managers better able than they were in the past to track the portion of commission costs that purchase research services from brokers? Has the improvement been sufficient to make it feasible for us to require funds to expense these items in their financial statements? Since soft dollars are earned based on complex-wide trading activity, how should research and other non-execution costs be allocated among funds? Can soft dollars be traced to individual portfolio transactions? (This would entail adjusting the basis of the securities purchased in those transactions for the portion of the commission cost that was used to purchase research services.) Alternatively, should an aggregate adjustment (not specified to a particular portfolio transaction) be made to realized and unrealized gain or loss? If funds and their managers are not yet capable of tracking the portion of commission costs that purchase research services from brokers, what factors continue to prevent funds and managers from developing this capability?</u>

The technology to track commission charges and the portion used to pay for research services and to allocate these charges appropriately has existed for over a decade. E*TRADE's institutional brokerage operation has been a leader in the development of soft dollar administration systems. The current system developed by our firm can break down in the greatest detail every dollar spent by a fund manager on individual services/products. Charges can be allocated by trade and across funds. Statements can be customised to suit managers' individual needs and reporting requirements.

Traditional brokerages offering "bundled" arrangements have necessarily been lacking transparency because full service houses have not had the ability or the desire to attribute specific prices to their research analysis and ad hoc investment advice to clients. If they were required to provide the same level of information to fund managers that soft dollars brokers do, then there would be a significant increase in transparency and accountability.

Questions About Improving Disclosure Related to the Level of Transaction Costs

16. Are there ways to provide a rough estimate of transaction costs, or develop a scheme to categorize these costs (for example, "very high," "high," "average," "low," or "very low,") under general guidelines set by the Commission that would mitigate the difficulties involved in coming up with a more precise measure, and yet still provide useful information to investors? Could such an approach produce results that are consistent enough to permit meaningful?

We are very reluctant to endorse such an approach. The danger with providing "rough estimates" is that one might too readily conclude that high costs mean a badly-performing fund. Funds which deal in less liquid stocks or which require more research or which deal in markets with higher execution/clearing costs will look as if they are poor performers.

17. In general, do the current disclosure requirements relating to transaction costs described in this section of the release provide investors with adequate information? In not, what additional information should funds provide? Would one or more of the alternatives described in his section provide useful information to investors, or would the alternatives lengthen the prospectus while providing no real benefit? If one or more of these alternatives would provide meaningful information, would the information most appropriately be located in the prospectus, the SAI, the report to shareholders, or in another disclosure document?

We do not have any specific view on this question.

<u>18. Does existing portfolio turnover disclosure provide useful information about transaction costs? If additional narrative disclosure concerning portfolio turnover and its relationship to transaction cost is needed, what information should be required?</u>

We do not have any specific view on this question.

<u>19. Does the existing requirement to disclose the dollar amount of commissions paid provide investors with meaningful information about transaction costs? How can the existing requirement be improved?</u>

Real benefits would come from eliminating the differences in treatment of research provided by third parties and that provided via traditional brokerages. As we have discussed above, all commission charges should be broken down into their constituent parts, including the portion allocated to research and other services. It would also be beneficial for total execution costs to be expressed as a percentage of total turnover of the fund. This coupled with disclosure as to the research and other services purchased by the fund would give a meaningful picture of a fund's transaction costs.

<u>20. Would an average daily net flow measure provide useful information to investors?</u>

We do not have any specific view on this question.

<u>21. Should the Commission consider policies to encourage funds to charge purchasers and redeemers of fund shares a fee payable to the funds to compensate existing and remaining investors for the costs they bear when their funds accommodate the purchases and redemptions of other investors? If yes, should the Commission consider requiring funds to disclose how they compute these fees, if they require them; and why they do not require these fees, if they do not?</u>

We do not have any specific view on this question.

22. Should the requirement to disclose average commission rate per share be reinstated, in either its original form or in a revised from? If you advocate that it be reinstated in a revised from, please provide specific suggestions.

We do not support the reinstatement of the requirement to disclose average commission rate per share. For the reasons discussed elsewhere, this figure can lead to erroneous conclusions about a fund's performance. The lowest average commission rate does not necessarily guarantee the best performing fund. We see no benefit in disclosure of such information.

23. Is "transaction costs" as described in this release a useful concept, or would it be more useful for investors to see the effect of all costs combined, for example, by showing the following:

- Gross or "pure" portfolio return;
- Net return to shareholders; and
- The resulting difference?

We consider that it would be more useful for investors to see the effect of all costs combined. By providing information on the three measures listed above, an investor can see where performance, or the lack of it, is coming from.

24. If it would be useful for investors to see the effect of all costs combined, could funds calculate and report the gross or "pure" portfolio return, net return to shareholders and the resulting difference on an annual basis?

We do not have any specific view on this question.

25. Should the Commission require disclosure of gross returns? If so, what definition would be most useful? Of what benefit would these returns be to investors? How expensive would it be for funds to compute these returns?

We do not have any specific view on this question.

26. Would the disclosure of gross returns allow investors to better identify dilution due to market timers?

We do not have any specific view on this question.

27. If portfolio returns are to be disclosed, how should the returns be adjusted for fund flows into and out of the portfolio? Should they be computed using internal rate of return methods; time-weighted average methods; or should other methods be used?

We do not have any specific view on this question.

28. If portfolio returns are to be disclosed, should these returns only be disclosed, or should the differences between these returns and the shareholder returns be disclosed?
29. Where should these returns or return differences be disclosed, and how should they be described?

We do not have any specific view on this question.

Questions About Board Review of Transaction Costs

30. Are existing requirements for board review of transaction costs adequate? If they are not adequate, how can they be improved?

We do not have any specific view on this question.

31. Should boards be required to receive reports with mandated information regarding soft dollars and directed brokerage payment? Should investors be provided periodically with a summary of these reports?

We do not have any specific view on this question.

32. One problem in evaluating execution cost measurements is in identifying a standard of comparison. It may be difficult for fund directors to assess the fund's execution performance statistics in a vacuum without comparison with other funds' statistics. Should the Commission or other independent body collects these statistics from similar funds and make available aggregate statistics for comparison purposes?

We do not have any specific view on this question.

33. Should fund advisers be required to provide fund boards with an internal allocation of their uses of brokerage commissions, indicating the amounts and percentage used by the adviser to obtain executions services and soft dollar benefits, specifically detailing the types and amounts of the various kinds of benefits? Should there be separate allocations among the types of research, such as research produced by underwriters, or other broker-dealer affiliates?

We do not have any specific view on this question.