Mutual Fund Distribution Fees
File No. S7-15-10

Thank you for the opportunity to comment on the SEC's proposal to modify some of the mutual fund accounting rules and fee caps. I am a retired individual investor with no employment or other incentive links to the financial industry, apart from trustee fees I receive for managing my parents' family trust. I rely heavily on mutual funds in my own and my parents' portfolios. Since I do my own analysis in managing these portfolios, an effective mutual fund accounting framework that all funds adhere to is quite important to me.

Please Shine More Light on Mutual Fund Expenses in All Areas

I strongly agree with the comments that Morningstar's Karen Dolan submitted on October 20 to the Commission regarding the subject proposal. Morningstar is the preeminent source of mutual fund data and is accessed by most serious non-professional mutual fund investors. It's apparent that many mutual fund companies place such confidence in Morningstar's data that they simply provide links to Morningstar's pages from the mutual fund's website rather than maintain some aspects of fund performance on their company site. In addition, I'm told that many financial industry professionals purchase special versions of Morningstar data that they pass on to their clients. My point is that Morningstar has a very wide audience. If the additional expense clarification that Karen Dolan discussed in her comments would aid the analysis of mutual funds that Morningstar provides to its customers, a huge number of American mutual fund investors would benefit.

After reading Karen Dolan's comments, I read the Commission's subject proposal in its entirety. I was impressed with your efforts to listen and attempt to reconcile the substantial input you received on earlier versions of this proposal. Clearly the overall thrust of this project is to increase transparency of distribution and account service fees which are currently placed in the 12b-1 "bucket," and to add new controls and options for account servicing and marketing expenses so that total expenses will continue to decline.

I agree with the statement in your proposal that it's much better to use a functionally descriptive label (e.g., "marketing & service fee" or "sales/service fee") rather than a label that refers to a Commission rule that few people are familiar with. It also appears appropriate to limit the timeframe/total fee imposed for (currently labeled) 12b-1 expenses in excess of 0.25%. Many funds have a class of shares (usually called C-class) that include 12b-1 fees of 1%. However, Karen Dolan has pointed out that this only amounts to about 5% of total investor mutual fund holdings. By broadening the scope of your proposed rules amendments your intervention will benefit far more investors.

One part of your proposed changes is troubling:

> "[F]unds (including no-load funds) may use the marketing and service fee to pay for shareholder call centers, compensation of underwriters, advertising, printing and mailing of prospectuses to other than current (*i.e.*, prospective) shareholders, and other traditional distribution activities."

Immediately before this, you clarify that the marketing and service fee may be used to pay for participation in a fund supermarket as well as for paying retirement plan administrators for the services they provide participants.

On the one hand, you propose to limit the newly defined marketing and service to 0.25%. However, the current, market-determined price for participation in just a fund supermarket is 0.4% (an ongoing annual cost). That's what Fidelity, Schwab and TD Ameritrade currently charge a large number of fund companies to participate in their group of "NTF fee" mutual funds. By creating (by rule) a bucket that is too small to realistically contain the intended cost components, you are encouraging a continuation of creativity by each fund company to find ways to account for their expenses within your defined categories. That is one strong reason in favor of Karen Dolan's proposed expense buckets. Another is that the expense buckets proposed by Karen appear to distinctively partition costs into categories that will aid both investors and Morningstar in evaluating some important differences between mutual funds.

It is not realistic to believe that by creating a marketing and service ongoing expense bucket that is limited to 0.25% and another expense bucket (currently used by only about 5% of the mutual fund universe) that has a sunset in terms of maximum charges, this will have a substantial impact on lowering overall mutual fund expenses. There are simply too many ways for the costs to be allocated to a widening assortment of share classes. Look at American Funds, as an example. They have 16 different share classes, each with different fund expenses, for many of their popular funds. The best way to encourage lower fund expenses is to make all expenses more visible to everyone.

Please Shine More Light on Mutual Fund Trading Costs

At present, mutual fund trading costs (including but not limited to the brokerage costs incurred when the fund manager buys and sells shares held by the fund) are not included in the fund's expense ratio. This fact is not known by a significant number of mutual fund CSRs, let alone many mutual fund investors. In 2009, Arijit Dutta at Morningstar estimated that mutual funds incur an average trading cost of 1.6% of fund assets per year. This estimate is consistent with that made by Jack Bogle in 1994 and in more recent academic studies. In addition to brokerage costs, the larger components of trading costs include market impact (price movement) from trading large blocks of shares and bid/ask spreads. Only the brokerage costs are currently disclosed, rather obscurely, in the fund's statement of additional information.

With the abundance of index funds with exceptionally low trading costs, the range of trading costs among various mutual funds is now quite large. Trading costs are admittedly complex to calculate, apart from the brokerage cost component. But in my opinion their size demands that something be done to alert investors to their existence and substantial impact on overall fund performance.

> "The average investor can't really even begin" to get a strong grasp on these additional costs, said Richard Kopcke, an economist at the Center for Retirement Research at Boston College who co-wrote a recent study about fees and trading costs of mutual funds in 401(k) plans. "There's just not enough information. Not even close." (WSJ 3/1/2010)

Please take a hard look at requiring an estimate of these costs in a form easily available to all investors. If that is not practical, please find a way to design a proxy for trading costs that would be made available to investors. This might, for example, take the form of a trading cost category rating from 1 (low) to 5 (high), similar to the way that passenger car tires are rated for various performance characteristics. Brokerage costs, asset turnover and other factors could be used to establish the assigned trading cost category for a fund.

As pointed out in the Commission's proposal, nearly half of all American households hold mutual funds; the value of these assets is well in excess of $10 trillion. Since the average fund expense ratio exceeds 1%, *the total of currently disclosed expenses paid by U.S. mutual fund investors exceeds $100 billion.* These expenses include investment advisory fees, fund administrative costs (e.g., record keeping and mailings), and 12b-1 fees. The magnitude of this expense demands that the accounting framework used by fund companies when reporting to their shareholders be as clear, accurate and disclosing of key cost categories as possible. Trading costs represent an additional, and hidden, roughly $100 billion in costs. The transparency improvements suggested above will maximize quality decisions by shareholders in choosing various funds, improve the available assortment of various fund classes, and place maximum pressure on reducing the average costs across all mutual funds.

David Kosters
Individual Investor