provided to investors so that they may be better able to assess and compare investment company expenses and performance. The Commission is adopting the proposed amendments with several modifications that reflect the comments received.[6]

II. Discussion

A. Accounting for Expenses

1. Brokerage/Service Arrangements

The Commission is adopting, substantially as proposed, amendments to rule 6–07 of Regulation S–X[7] to require that the amounts of various expenses (such as custody fees, transfer agency fees, printing and legal fees, and other miscellaneous fees) listed in a fund's statement of operations be adjusted, or ''grossed-up,'' to include amounts paid with commission dollars.[8] The rule amendments require funds to make adjustments to their statements of operations at the time financial statements are prepared, but do not require daily expense accruals for services paid with commission dollars. The rule amendments do not require funds to adjust amounts in the financial statements other than expenses and the expense ratio.[9]

A majority of the commenters that addressed the substance of the proposal supported the proposed accounting changes. These commenters agreed that the gross-up adjustment to expenses would accurately reflect the economic effect of these arrangements, would assist investors in comparing expenses among funds, and would be consistent with current industry reporting standards for statements of operations. Fund industry commenters stated that the method proposed for reflecting broker-paid liabilities as fund expenses was appropriate and not burdensome.[10] Some commenters, however, opposed the proposal, asserting that grossing-up fund expenses would not provide meaningful disclosure to investors and could mislead investors about the benefits to the fund of brokerage/service arrangements. Other commenters objected to the proposal arguing that it would cause funds to overstate expenses.

Commenters opposing the proposed amendments asserted, in effect, that comparable commission rates might be paid by funds that choose not to enter into brokerage/service arrangements, and, therefore fund services provided under brokerage/service arrangements should be treated as ''free'' services and payments by brokers should be ignored. If brokers made these payments to funds in the form of cash, however, fund expenses would not be affected. Thus, it is merely the form these payments take, rather than their substance, that has permitted such payments to reduce fund expenses. To the extent that investors benefit from these arrangements (which the Proposing Release acknowledged they may), the benefit is reflected in overall fund return rather than as a reduction of fund expenses—a result that more accurately reflects these arrangements as a rebate on brokerage.

2. Expense Offset Arrangements

a. *Fee Reductions.* Some funds enter into arrangements that, like brokerage/service arrangements, have the effect of reducing reported fund expenses. In these arrangements (''expense offset arrangements''), however, expenses are reduced by foregoing income rather than by recharacterizing them as capital items. For example, a fund may have a ''compensating balance'' arrangement with its custodian under which the custodian reduces its fees if the fund maintains cash on deposit with the custodian in non-interest or below market interest bearing accounts. Similarly, a fund may enter into a securities lending agreement under which the fund permits the custodian to loan fund securities to third parties (typically unrelated broker-dealers) in exchange for a reduction in custody fees.[11] Expense offset arrangements may involve explicit oral or written agreements regarding the amount of fee reductions. A fund's custody fee may, however, reflect an estimate of the income the custodian expects to derive from an expense offset arrangement, and the resulting fee reduction is not expressly stated in the custodial agreement.

The Commission requested comment whether an adjustment to fund expenses similar to that proposed for brokerage/service arrangements should be required for expense offset arrangements, or whether these arrangements should be addressed in footnotes to the financial statements.[12] In addition, the Commission requested comment whether the amount of any increase in fund expenses to reflect these arrangements should include only amounts that are explicit in the agreement, or should also include amounts implicit in the basic custodian fee.

Most of the commenters addressing this issue supported an adjustment to fund expenses for expense offset arrangements. Commenters generally stated that requiring disclosure for expense offset arrangements would be consistent with requirements relating to brokerage/service arrangements. Commenters were divided, however, on whether the amount of any increase in fund expenses should include only

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[6] As discussed in section II.A.2 below, one of these changes requires funds to reflect as expenses liabilities reduced in connection with certain expense offset arrangements.

[7] Article 6 of Regulation S–X specifies the contents of financial statements included in registration statements, proxy statements and shareholder reports of registered investment companies. Rule 6–07 of Regulation S–X sets forth the requirements for investment company statements of operations.

[8] The staff previously has required funds to disclose in footnotes to the fee table, financial highlights table, and financial statements their participation in brokerage/service arrangements and the effect these arrangements may have on the level of brokerage commissions paid to the fund. *See* Proposing Release, *supra* note 3, at n.2. The amendments to rule 6–07 eliminate the need for this disclosure and therefore the staff will no longer require such footnotes.

[9] The Proposing Release explained that a fund's investment adviser can benefit from brokerage/service arrangements, particularly if a reduction in fund expenses affects the amount of any expense waiver or reimbursement by the adviser. Proposing Release, *supra* note 3, at n.1. Section 17(e)(1) of the 1940 Act [15 U.S.C. 80a–17(e)(1)] makes it unlawful for an affiliated person of a fund (such as its adviser) to accept from any source compensation (other than regular wages) for the purchase or sale of fund shares. The receipt by a fund's adviser of any direct or indirect economic benefit as a result of brokerage/service arrangements would almost certainly violate section 17(e)(1), unless the benefit received fell within the safe harbor provided by section 28(e) of the 1934 Act. *See supra* note 1. However, the Commission believes that if a fund adviser voluntarily imposes a limitation on the fund's expenses or waives its fees, the fund's brokerage/service arrangements would not violate section 17(e)(1). Similarly, if compliance with expense limitations imposed by statute or by contract is measured by reference to the fund's total expenses (*i.e.*, expenses adjusted to include the cost of services provided under brokerage/service arrangements), a fund's brokerage/service arrangements would not result in a violation of section 17(e)(1).

[10] In the Proposing Release, the Commission requested comment on an alternative accounting method that would require funds to allocate each commission paid between execution cost and payment for fund services, and to present their financial statements based upon those allocations. This method would have required funds to separate commissions into brokerage and expense components, and reflect the expense component as an expense in the financial statements. Commenters that addressed the alternative accounting method were uniformly opposed to it on grounds that it would be impractical, costly, and burdensome for funds to calculate, as well as difficult to audit.

[11] Securities lending arrangements may raise other issues under the federal securities laws. The Commission is not addressing in this release the merits of any particular securities lending arrangements.

[12] Footnote disclosure of compensating balance arrangements under which the withdrawal or use of cash or cash items is restricted, either legally or as a practical matter, is currently required by rule 6–04.5 of Regulation S–X [17 CFR 210.6–04.5]. In addition, Rule 6–04.11 of Regulation S–X [17 CFR 210.6–04.11] requires fund balance sheets to state the value of securities loaned and to indicate the nature of collateral received as security for the loan.