amounts that are explicit in agreements between the fund and the service provider.

The amendments to rule 6–07 of Regulation S–X, as adopted, require funds to include as expenses the amount of any reduction in fees or expenses arising from expense offset arrangements.[13] A fund's statement of operations must reflect as the cost of services provided the amount that the fund would have paid in the absence of the expense offset arrangement.[14] The requirement only applies to agreements that provide for specified or reasonably ascertainable fee reductions in exchange for use by another person of the fund's assets. It does not apply to fee reductions that are implicit in the service provider's basic fee.

b. *Foregone Income.* The Commission also requested comment whether funds should be required to estimate income foregone under expense offset arrangements and reflect such amounts in fund financial information.[15] The Commission asked commenters to suggest methods for estimating income foregone under these arrangements. Some commenters supported such a requirement, suggesting that funds should make a ''reasonable estimate'' of foregone income. Other commenters noted the difficulty of estimating lost income and expressed concern that such a requirement could result in misleading financial information. Moreover, one commenter argued that, in order to estimate lost income, a fund would have to assume income, which is inconsistent with generally accepted accounting principles (''GAAP'') and could prevent auditors from issuing an unqualified report that fund financial statements are prepared in accordance with GAAP.

The Commission shares certain of these concerns and has therefore decided not to require funds to reflect in fund financial information income foregone as a result of expense offset arrangements. As amended, rule 6–07 requires a fund that enters into an expense offset arrangement to include in a footnote to financial statements a statement that the fund could have invested the assets used by the other person in an income-producing asset if it had not agreed to a reduction in fees or expenses under an expense offset arrangement.

3. Accounting Method

Under rule 6–07, as amended, a fund's total expenses reported in the statement of operations must include expenses paid under brokerage/service and expense offset arrangements.[16] Total expenses are then reduced by the total amount paid under brokerage/service and expense offset arrangements. The remainder appears on the statement of operations as ''net expenses.''[17] The following example illustrates adjustments to the statement of operations required by the amended rule:

Expenses:	
Management Fee	$50
[Other direct fund expenses]	48
Custodian Fee [would include 8 paid by brokers]	10
Total Expenses	108
Fees Paid Indirectly[18]	(8)
Net Expenses	100

The increase in ''Total Expenses,'' and the offsetting ''Fees Paid Indirectly,'' reflect the amount that the fund would have paid for services in the absence of brokerage/service and expense offset arrangements. If a fund directly negotiates the service provider's fees, the cost of the services for purposes of making the required adjustments is the amount negotiated, presumably the same amount the fund would have paid for the service in the absence of the arrangement. If the fund cannot readily determine the actual cost of such services, *e.g.,* when a broker arranges for the services or provides them itself or through an affiliate, the fund must make a good-faith estimate of the amount it would have paid if it had contracted for the services directly in an arms-length transaction.[19]

4. Financial Statement Note Disclosure

As proposed, the amendments to rule 6–07 would have required a fund to identify separately in a note to the financial statements any expense that the amendments would require to be increased by five percent or more over the amount of the unadjusted expense.[20] Several commenters urged the Commission to require less detailed note disclosure, arguing that shareholders were not interested in individual expense amounts. In response to these concerns, the amended rule requires a fund to state separately in a note to the financial statements the total of expense increases resulting from brokerage/service and expense offset arrangements (which together should be equal to the amount of the ''Fees Paid Indirectly'' line item in the statement of operations). The amended rule also requires a fund to state in the footnote each category of expense that is increased by an amount equal to at least five percent of total expenses.[21]

B. Exception for Research Services

As proposed, the requirement to adjust reported expenses to include amounts paid with commission dollars excepted the cost of research services (as that term is used in section 28(e) of the 1934 Act) provided by broker-dealers.[22] Most commenters believed that the exception was appropriate. Many pointed out the difficulties of allocating research received by the adviser among accounts when the brokerage of those accounts is used to acquire the research.[23] Some also asserted that it would be difficult to value research services, particularly when combined with brokerage services, while others objected to

[13] Rule 6–07.2(g)(2) of Regulation S–X [17 CFR 210.6–07.2(g)(2)]. Under the amendments, expense offset arrangements include arrangements under which a service provider reduces its fees in return for the use of fund assets as well as arrangements under which another person, in return for the use of fund assets, makes payment to a fund service provider which in turn reduces its fees charged to the fund.

[14] Amendments to fund registration forms adopted today incorporate similar requirements for fund prospectuses by reference to rule 6–07.

[15] Proposing Release, *supra* note 3, at section II.D.

[16] A fund must also use the total expense figure to calculate its expense ratio, its ''Other Expenses'' listed in the fee table, and its yield. *See infra* sections II.C and II.D.

[17] Because only expenses, and not realized gains/losses or unrealized appreciation/depreciation, are adjusted in the statement of operations, the presentation of ''net expenses'' is necessary to ensure that net investment income is not affected by the adjustment to expenses.

[18] As amended, rule 6–07 requires funds to include a footnote to the financial statements that states separately the total amount of expenses paid through brokerage/service arrangements and the total amount of expenses paid through expense offset arrangements. *See infra* section II.A.4.

[19] The good-faith estimate may be based upon price quotes for the services obtained by the fund or the amount funds of similar size and having similar investment objectives pay for the same services.

[20] Proposing Release, *supra* note 3, at n.12. The amendments, as proposed, would have permitted funds to aggregate amounts that individually were less than five percent of the unadjusted expense and required funds to state the total of these amounts.

[21] The five percent threshold is consistent with an existing provision of rule 6–07 that requires funds to state separately expense items that exceed five percent of the total expenses shown in the statement of operations. Rule 6–07.2(b) [17 CFR 210.6–07.2(b)].

[22] *See supra* note 1. Because research services are typically provided to the adviser, not the fund, the specific exception may be unnecessary. In light of the widespread use of research soft dollar arrangements, however, the Commission is adopting a specific exception.

[23] Twenty commenters expressly opposed allocation of research on an account-specific basis, stating that such a requirement would be burdensome (with no corresponding benefit to investors), costly, arbitrary or impossible.