

SEC to Lift Veil on Omnibus Accounting

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One of the industry's proposed steps to curb market timing will likely end up helping to cure another major headache for fund directors—omnibus accounting.

A new SEC rule, if finalized, would impose a 2% redemption fee on short-term trades of less than five days. A necessary byproduct of that mandate would be more information for funds on shareholders who buy fund shares through what are called omnibus accounts.

Omnibus accounting is where individual trade orders processed by third party providers are lumped together into a single block order. What troubles directors about this method of trading is that fund firms often do not know the identity of the shareholders who buy fund shares through omnibus accounts.

The lack of information makes it difficult for fund firms to monitor market timing in these accounts. Market timers often use omnibus accounting to time funds precisely because their activities are more likely to go undetected. Because their trades are bundled together with hundreds, if not thousands, of other investors, timers know their frequent trades will probably not be singled out.

Now, the SEC's proposed rule would require funds and intermediaries to work together to impose and collect the redemption fee. Currently, many of the approximately 10% of funds that do impose redemption fees are unable to collect those fees because they lack shareholder information from intermediaries, according to the SEC.

Under the new rule, intermediaries would be required to make weekly reports to fund firms of transaction information, including tax-payer identification numbers, redemptions, as well as exchange and purchase orders. The fund firms would use these reports to check that redemption fees were levied.

Directors and industry insiders agree that the weekly reports are an important step toward greater transparency of omnibus accounting and toward discouraging market timing within those accounts.

Because funds will receive more info on trades processed through omnibus accounts, they'll be in a better position to police market timing within those accounts.

In addition to the weekly reports, fund firms would choose one of three ways to implement the redemption fee. This will ensure the redemption fees are being applied to trades processed through omnibus accounts.

The three possible ways of levying the redemption fee were proposed for maximum flexibility, says C. Hunter Jones, assistant director of the SEC's Office of Regulatory Policy. Jones was one of the staffers involved in the drafting of the proposal.

With the first way, broker-dealers would transmit information on every transaction to the fund firm. The fund firms would then use that information to levy the redemption fee.

Under the second way, broker-dealers would transmit information to the fund firm only on trades that necessitated the redemption fee. As with the first method, fund firms would levy the fee. The third way would place responsibility for assessing the fee on the intermediary, which would then remit the proceeds to the fund.

The fund firm is ultimately responsible for choosing the method of imposing the redemption fee; that said, fund firms will probably coordinate with intermediaries in determining that method, says Jones.

The rule does not require fund directors to approve the method chosen. How the decision is made -- with or without the board's involvement -- will depend on the individual fund firm and the way it functions. In many cases, however, fund firms will probably

involve the board as part of general oversight, says Jones.

The first approach – receiving information on every trade and having fund firms be responsible for levying the 2% redemption fee – would be preferable to fund directors, says Peter Gavian, independent director of the **Calvert Funds**. But in the end, says Gavian, the important thing is that the redemption fee is levied, regardless of who does it.

The first approach puts independent directors in the strongest position, agrees Niels Holch, founder of The Coalition of Mutual Fund Investors and partner with **McGuinness & Holch**. “Directors of mutual funds need to know who their shareholders are and need to know what they’re doing,” he says.

The third approach, in which intermediaries assess the redemption fee and remit it back to the fund, is preferred by an NASD Task Force that examined how best to implement the 2% redemption fee on trades processed through omnibus accounts. As the proposed rule states, this approach would “alleviate the burden” on intermediaries to transmit information to the funds about every transaction.

The SEC has requested comment on the new rule. Comments should be sent by May 10.

SEC Proposed Methods for Imposing 2% Redemption Fee:
<ul style="list-style-type: none">• The intermediary transmits information on every transaction to the fund firm. The fund firm uses that information to levy the redemption fee.• The intermediary transmits information to the fund firm only on trades that necessitate the redemption fee. The fund firm levies the redemption fee.• The intermediary assesses the redemption fee and remits the proceeds to the fund.

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