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CORPORATE GOVERNANCE

Mutual fund reform targets short term trading through intermediaries

By Washington

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Senator Fitzgerald

A study conducted by the Coalition of Mutual Fund Investors (CMFI) concludes the largest mutual fund groups are unable to significantly monitor or regulate market timing. The problem is the use of shareholder accounts held by third-party financial institutions.

The study evaluated the 50 largest mutual fund groups for the use of redemption fees and other mutual fund policies aimed at deterring excessive short-term trading. Since a significant percentage of mutual fund shares are sold by third-party financial institutions, called fund intermediaries, the CMFI study evaluated the ability of a mutual fund to enforce its market timing policies uniformly under the accounting structure used by these institutions, called "omnibus accounts."

The study concludes that funds cannot effectively enforce their policies because many of their customers are hidden in third-party omnibus accounts.

Many third-party financial institutions buy and sell mutual fund shares through omnibus accounts, in which the intermediary consolidates all of its mutual fund transactions into one order during each trading day, keeping the identities and transactions of fund shareholders invisible.

By examining these fund groups' recent public filings with the U.S. Securities and Exchange Commission (SEC), the CMFI study concludes that the use of these omnibus accounts makes it impossible for mutual funds to enforce their anti-timing policies within these third-party accounts. Some of the study highlights include:

- * Of the fund groups with a redemption fee policy, 88 percent disclosed in public filings that they exclude, limit, or waive the enforcement of redemption fees in third party accounts where the outside financial institution maintains the underlying shareholder account.
- * Of the fund groups with no policy to impose a redemption fee, 50 percent disclosed concerns about their ability to enforce their market timing policies within these third party accounts where the shareholders are unknown to the mutual fund.
- * None of the fund groups with redemption fee policies use a "last in, first out" accounting method (LIFO) to apply the fee, permitting market timers to circumvent these trading restrictions, especially in third-party accounts.

Pending Legislation in Washington

Mutual fund reform legislation (S. 2059) has been introduced into the U.S. Senate, sponsored by Senator Peter Fitzgerald (R-Ill). A House companion bill (H.R. 4505) has been proposed by Rep. Paul Gillmor (R-OH).

Section 216 of Fitzgerald's Mutual Fund Reform Act of 2004 would require financial intermediaries to disclose to mutual funds the identities and trading activities of shareholders in omnibus accounts who

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buy and sell that fund's shares.

"To enforce fund policies fairly and uniformly, there are two possibilities," stated Senator Fitzgerald. "Either the funds themselves do it, in which case they obviously need the information about their omnibus account customers and their trading, or the intermediaries do it, which they have not and which is unlikely since they have a financial disincentive to enforce these policies themselves."

For more information on mutual fund reform, download the [June issue of Corporate Governance News](#)

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