# Hidden Market-Timers

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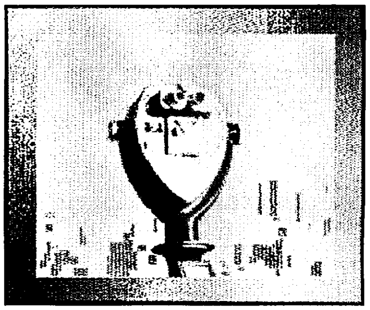
A new study of mutual fund firms' enforcement capabilities affirms what many in the industry have known for some time—that omnibus accounting practices by fund intermediaries make catching timers virtually impossible.



"Anybody with any familiarity with omnibus accounting has known this," says Matt Bienfang, an analyst at TowerGroup, a Boston-based research firm.

The study, conducted by the Coalition of Mutual Fund Investors (CMFI), a shareholder advocacy group made up of three lawyers, attempts to shed light on the problem for the uninitiated. CMFI examined public filings to the SEC of the 50 largest mutual fund companies and concluded that they can't effectively enforce their timing policies when intermediaries use third-party omnibus accounts.

Niels Holch, executive director of CMFI, says he hopes the report will result in increased disclosure and improve awareness within the industry and among investors that funds are still vulnerable to timers.

The industry at least appears to have understood this all along. Indeed, the SEC has been looking at the potential for this type of abuse for more than a year now. In fact, last year the Commission requested the NASD convene a working group to analyze the extent of the problem and propose solutions. The result was the NASD Omnibus Task Force, consisting of 16 professionals from broker/dealers, mutual fund sponsors, banks and others. It issued a report in January 2004 that suggested a combination of a mandatory redemption fee on each account engaging in this type of trading and increased disclosure to shareholders of such activities.

This would allow fund companies to, at a minimum, audit whether intermediaries are applying the rules, says the report. The problem, says Holch's study, is that in order to mete out penalties, individual shareholder trading activity and records have to be available, and they're not.

With omnibus accounts, an intermediary consolidates all of its mutual fund transactions into one order during the trading day, consequently keeping the identities and transactions of the individual fund shareholders invisible. Many third-party financial institutions, including the largest b/ds, buy and sell mutual fund shares through these types of accounts.

"Intermediaries, like broker/dealers, use omnibus accounting to save themselves money," says Bienfang. "It's a reasonable expectation then, especially since all the information about the shareholder resides with them, that they do the policing of timers."

Among the findings of CMFI's study, 88 percent of the fund groups with a redemption policy said in public filings to the SEC 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.

Additionally, none of the funds with redemption fee policies use a "last in, first out" LIFO accounting method to apply the fee. Preferred by the SEC, the LIFO method would most likely catch the most abusive short-term traders, according to the NASD task force, the Securities Industry Associate and certain fund companies. However, they note, such an approach would also punish investors in retirement account programs and periodic purchase programs.

Early praise for the study has come from Washington's loudest critic of the mutual fund industry, Sen. Peter Fitzgerald (R-Ill.). Included in Sen. Fitzgerald's controversial Mutual Fund Reform Act of 2004 (S.2059)—which seeks, among other things, to ban 12b-1 fees, soft dollars, directed brokerage and revenue sharing—is a section specifically requiring financial intermediaries to disclose to mutual funds the identities and trading activities of shareholders in omnibus accounts who buy and sell that fund's shares. Not surprisingly, the bill is unpopular within the industry. (People familiar with bill say the approaching election and the SEC's request for hands-off from Congress will keep it shelved indefinitely.)

But Fitzgerald feels strongly about the topic of hidden market-timing. "To enforce fund policies...there are two possibilities," says Fitzgerald in a prepared statement about the study. "Either the funds themselves do it, in which case they 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."

Burt Greenwald, a Philadelphia mutual fund consultant, says the funds and the b/ds have been trying to break the veil on omnibus accounts since market-timing abuses surfaced.

"This is something they've been working on for some time," says Greenwald. What's causing the delay is up for debate. Both Greenwald and Holch say the mutual fund companies and the b/ds have the technological capability to communicate trading and individual shareholder account information more accurately, but operationally they may not be ready.

The task force says in its report that "broker/dealers using National Securities Clearing Corporation (NSCC) networking level 4 [one of the most widely used networking levels]...already transmit TINs [tax identification numbers] to fund transfer agents without incurring significant costs." Additionally, some large fund transfer agents already have software—that currently identifies account linkage opportunities for breakpoints—that might be modified in order to match purchases of shares and redemptions, says the report.

A Fidelity spokeswoman, while unable to provide a firm expert to speak on the subject, did say the firm has been trying to correct the transparency problems associated with omnibus accounts since market-timing abuses surfaced. A spokesman for MFS also said the firm was working on improving this situation but was unable to provide a spokesman at this time.