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GAO: SEC Should Overhaul Rule Proposals

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The opposition to the SEC's mandatory 2% redemption fees and hard 4 p.m. close rule proposals got a powerful ally in the form of a recently issued General Accounting Office study.

The study predicts that both rule proposals would increase costs to investors and goes on to recommend that the SEC adopt modifications or alternatives to the proposals. Some of those modifications are similar to what some in the industry have been suggesting all along.

McGuiness & Holch partner Niels Holch says that the GAO has a reputation for turning out excellent work, particularly in the financial services sector. So this report will carry some weight. Holch is also the founder of the **Coalition of Mutual Fund Investors**, a lobbying group for fund shareholders.

"Their analysts have done a lot of work and have a deep understanding of mutual fund issues," he says.

The GAO's study and its recommendations are in line with gripes that groups like the **Society of Professional Administrators and Recordkeepers** and industry leaders such as **Fidelity's** Ned Johnson have voiced about the hard 4 p.m. close proposal. And in the comment letters on the mandatory 2% redemption rule proposal, representatives from **Ariel Capital Management**, **Fair Value Research** and others raised concerns about the logistics of implementing such a rule.

Barbara D. Bovbjerg, director of Education, Workforce, and Income Security Issues at the GAO, says that the report was prepared at the request of Congress. A House of Representatives subcommittee on oversight specifically asked the GAO to look into the effects of the proposals on fund investors in pension plans, since they, as long-term shareholders, would be among those most affected.

In a nutshell, the study says that if the hard 4 p.m. close and mandatory 2% redemption fee rules are adopted as proposed, they would cost fund firms a pretty penny in technology upgrades. And those costs would most likely be passed along to shareholders.

While the report doesn't specifically recommend how the proposals should be changed, it notes two alternatives to the hard 4 p.m. close rule, including the so-called Smart 4 p.m. close and the Clearinghouse proposals.

As it stands now, the hard 4 p.m. close proposal would require fund firms, their transfer agents or the FundServ network (an automated trading platform offered through the **Depository Trust Clearing Corp.**) to receive trades by 4 p.m. each day.

That would require intermediaries such as broker-dealers and 401(k) administrators, which bundle trades from thousands of different clients, to implement significantly earlier cutoff times. That could delay some trades and result in significantly earlier cutoff times for West Coast shareholders. It could also adversely affect investors in pension plans, since they tend to be long-term investors.

The Smart 4 p.m. proposal, however, would require all companies that want to process trades after 4 p.m. to adopt a three-part series of controls. First, they would have to adopt electronic time stamping of all transactions so all trades could be tracked from the initial customer to the mutual fund company. Second, they would have to conduct annual certifications by senior executives that their companies have procedures to prevent or detect unlawful late trading and that those procedures are working as designed. Last, they would have to submit to annual independent audits.

According to the GAO, the Smart 4 p.m. proposal has been advocated by most ofthe fund intermediaries that it spoke with when it researched the topic.

The Clearinghouse proposal would require all mutual fund orders to be time-stamped electronically by an SEC-registered centralized clearing group before the market close to receive that day's fund price. The clearing entity's time stamp would be used as the official time of receipt of an order for a transaction.

But the GAO notes that because the **National Securities Clearing Corporation** (NSCC) is currently the only SEC-registered clearing agency operating an automated processing system for mutual fund orders, intermediaries who don't now use the system may face significant costs in upgrading their computer systems and establishing a connection to the NSCC.

The mandatory redemption fee rule would require fund firms to levy a 2% fee on virtually all redemptions that occur within five days of purchase.

Both proposals have sparked debate within the fund industry. Some have objected on the basis of inconvenience to shareholders, while others cite costs of implementation and risks that omnibus products that batch orders may become less competitive than direct-sold products.

Kirkpatrick & Lockhart partner Mark Perlow says that the SEC is coming to grips with the reality that both changes would involve completely retooling the infrastructure of mutual fund intermediaries.

"They're trying to see if there's a compromise that will accomplish the same aims as the original proposals," he says. "The SEC is very sensitive to the fact that many of these costs will be necessarily passed along to investors."

Perlow says he believes there may be more flexibility on the hard 4 p.m. close rule.

"I think the SEC is willing to consider more significant changes because of the draconian, hard-line nature of that solution," he says. "Whereas I don't think what the SEC is considering on the 2% redemption fee rule is as different from the original, although compromise proposals aren't as far advanced on this rule as they are on the hard 4 p.m. close proposal."

Ultimately, Perlow says, the SEC is trying to encourage the industry to come up with something acceptable that will close the door on abusive trading.

Another Capitol Hill insider says that while the new GAO report adds another highly credible voice on the issue, it won't single-handedly transform the debate in Congress.

"We have tremendous checks and balances," he says. "Nothing passes Congress without a lot of support. There must be a real consensus behind something for it to move forward, not just one or two influential people. This report will be looked upon as an influencing factor but not one that will sway the whole debate."