



August 16, 2004

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SEC to consider final rule on banning directed brokerage

Right on schedule, the SEC said it will consider the final rule on banning directed brokerage at an open meeting this Wednesday [computer icon]. In May, Paul Roye, director of the Division of Investment Management, told *BD Week* that the final rule would be ready by the end of summer (*BD Week*, May 17, 2004).

The proposing release also requested comment about 12b-1 fees in general. Roye said in May that any further action on 12b-1 fees is a longer-term project that probably would result in rule proposals only next year.

The tenor of the rule proposal [computer icon] left little doubt about the staff's view on directed brokerage. "We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders," the staff wrote.

Specifically, the staff believes that the payments compromise the role of broker-dealers: "Receipt of brokerage commissions by a broker-dealer in exchange for shelf space creates an incentive for the broker to

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Omnibus accounts could derail redemption fee plan, study says

The SEC's plan to hinder market timing with a mandatory redemption fee [computer icon] may run into a snag because of omnibus accounts, a new study suggests.

The study [computer icon] by the Coalition of Mutual Fund Investors, a Washington, D.C.-based lobbying group, analyzes prospectus disclosures by the 50 biggest mutual funds groups regarding redemption fees.

Of the 50 groups evaluated, 32, or 64%, have a redemption fee on at least one equity fund. However, 28 out of that 32, or 88%, exclude, waive or limit the enforcement of redemption fees in omnibus accounts, including broker-dealer accounts, retirement plan accounts, or other institutional accounts where the financial intermediary maintains the underlying shareholder account.

Among the 18 groups that do not have any redemption fees, nine of them, or 50%, disclosed concerns about their ability to enforce their market timing policies within omnibus accounts.

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Making variable annuity sales work: What to look for

Despite all the controversy swirling around variable annuities, many firms continue to conduct a prospering, and compliant, business by selling them. These firms have developed their own best practices for making sure the sales meet regulatory standards.

As NASD considers possible new rules for variable annuities, some broker-dealers have advocated adopting best practices benchmarks as an alternative (*BD Week*, Aug. 2, 2004). Henry Sanchez, vice president and general counsel at High Mark Insurance & Financial Services, a Lakeland, Fla. firm specializing in insurance products, likes that idea, especially since he thinks High Mark's practices *are* best practices.

In general, Sanchez says, the firm's 100 or so reps try to find out what the client really wants: Do you want guaranteed payments? Do you want to leave money to a beneficiary? Do you want to reduce estate taxes? Annuity contracts can be tailored to meet these objectives.

Their very flexibility makes annuities difficult to write rules for. For instance, "regulators don't even look at the insurance features," Sanchez says, echoing a point made by the Financial Services Institute in its


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The computer icon ([computer icon]) appears beside references to full-text documents which are available to subscribers in the electronic edition of *BD Week* at <http://www.bdweek.com>

Omnibus accounts may derail plan *(Continued from page 1)*

Niels Holch, executive director of the coalition and author of the study, acknowledges that the SEC proposal would require intermediaries to transmit details of the underlying accounts in an omnibus account on a weekly basis. "Weekly is not fast enough," he says. It would force the fund groups to run the shareholder file again.

The lobbying group recommends detailed reports on a daily or transactional basis. "Then it's real time and they can catch things right away," Holch says. He suggests adapting trading platforms at the National Securities Clearing Corp., which many broker-dealers already use, to generate the reports. This would also respond to broker-dealer concern about the cost of reporting requirements, he says, because it would not entail new systems on their side.

Most of the broker-dealer comment on the SEC proposal  opposed the fee. Many felt that it would be unworkable in omnibus accounts and considered alternatives such as fair value pricing a better solution to the problem. Holch says that a major concern of the broker-dealer community is preserving the primacy of the account. While the SEC said in a footnote in its proposal that the privacy of account information is protected by existing rules, Holch suggests that any rule should expressly provide that the account details are only for compliance purposes and cannot be used for marketing purposes by the fund groups.

Real-time reporting would have the additional benefit for fund groups of validating the accuracy of sales loads (including breakpoint

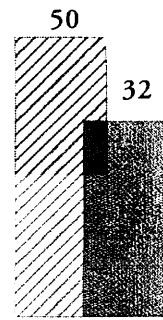
discount policies), other commissions and fees, contingent deferred sales charges, and dividend reinvestments, the study said.

FIFO fumbles

The study also found that those firms applying a redemption fee generally use first-in, first-out (FIFO) accounting to levy the fee. About 60% of the surveyed groups who have a redemption fee said they use FIFO, and the other 13 did not disclose their accounting method. None of the groups said it used last-in, first-out (LIFO) accounting.

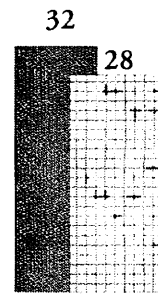
"You're never going to catch anybody if you use FIFO," says Holch. Market timers need only invest a certain amount in the fund as a "sticky asset," he says, and then they can proceed with roundtrip orders that avoid detection. The SEC proposal, however, specifies the use of FIFO for determining the imposition of redemption fees.

Funds With Redemption Fees




Of the 50 biggest mutual fund groups, 32 have a redemption fee.

Funds Waiving Redemption Fees for Omnibus Accounts



Of the 32 groups with redemption fees, 28 waive them for omnibus accounts.

GAO sees snags in mutual fund proposals

A new report  from the Government Accountability Office (the recently renamed GAO) urges the SEC to consider modifying its proposed rules regarding a "hard 4" close and a mandatory redemption fee because some aspects might adversely affect pension plan participants.

The GAO in general was concerned that the proposed rules would result in costs that would be passed on to mutual fund shareholders. More particularly, it was concerned that the hard 4 close would complicate proper calculation of loans that participants take out against their pension plan.

The redemption fee proposal could result in plan participants paying fees that are intended to deter market timing, even on such things as transfers to meet investors' objectives that clearly are not abusive trading.

In its response to the GAO report, the SEC said it is considering modifications and alternatives to the proposal that should mitigate these concerns. ■