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## Have Funds Solved Market Timing, Late-Day Trading Problems?

Nearly one year has passed since New York Attorney General Eliot Spitzer announced a sweeping investigation into trading abuses in the mutual fund industry.

Since the scandal broke, the industry and the SEC have taken numerous steps to correct the problems. Looking back at the past year, what are the most significant changes undertaken to combat the trading abuses? How have fund boards been involved in addressing the problems? And, most importantly, are these measures working?

### SEC shifts into high gear

When Spitzer upstaged the SEC last September with his complaint against hedge fund Canary Capital for engaging in improper trading with mutual funds, the agency reacted by quickly shifting into high gear. Initially, the industry believed only a few bad apples had engaged in abusive trading. As the months wore on, however, dozens of bad apples emerged.

The SEC adopted a two-pronged attack, stepping up both rulemaking and enforcement.

Of the two types of improper trading discovered, market timing and late trading, the former turned out to be more widespread. In a survey of 88 mutual fund groups conducted immediately after the scandal began, the SEC discovered that about half of the groups appeared to have agreements with frequent traders that were inconsistent with stated policies.

Market timing, as most in the industry know by rote, is not illegal. Late trading, on the other hand, is illegal.

In the weeks following Spitzer's settlement with Canary, the agency announced a package of thirteen rulemaking initiatives aimed at ending abusive trading and changing the environment that made those abuses possible.

So far, ten of the SEC's thirteen rule proposals have been passed. Many of them force fund boards to play a stronger role in fund oversight. Most notable is the new rule that requires independent chairmen to preside over boards.

Yet, only one of the newly passed rules directly tackles improper trading. It requires fund firms to disclose the policies and procedures adopted to deal with market timers. The other finalized rules deal with the trading abuse problems indirectly through requiring greater disclosure to shareholders and improved governance mechanisms.

One rule that was suggested before the scandal began has taken on new meaning post-Canary. The rule requires funds firms to adopt and implement compliance programs and to hire a chief compliance officer (CCO) to oversee those programs. The final rule states that the compliance programs must provide for policing market timing. Boards must approve the hiring and firing of the new CCO and sign off on the new compliance programs.

Two of the SEC's three remaining rules under consideration confront market timing and late trading head on. They would require a 2% redemption fee on trades made within five days and a hard 4 p.m. cutoff for trading. Both have sparked controversy and their fate remains uncertain. In a mid-August open meeting, SEC Chairman William Donaldson said the agency is on track to finalize these rules by the end of this year.

Along with its rulemaking, the SEC has considerably beefed up its inspections. In this arena as well, the board is no longer on the sidelines. The SEC recently said it is considering conducting annual visits with the boards of the largest 100 fund groups. In the past, directors have not usually been involved in the inspection process, except when issues were discovered that directly related to the board.

### **Funds take action**

While the SEC does its part to snuff out the trading abuses uncovered last September, many fund shops have taken matters into their own hands.

Fund firms, often at the instigation of boards, are increasingly adopting fair valuation policies which make market timing less profitable. Fair-value pricing has long been considered one of the most effective means of curbing timers.

Two firms that offer fair valuation services, **FT Interactive**, and **Investment Technology Group** (ITG), have had a surge in business since last September. In August 2003, FT Interactive had 13 fund complexes as fair valuation clients. Now it has 82. Similarly, ITG had 6 or 7 fair valuation clients a year ago, and now has more than 60.

Increased fair valuing is resulting in less stale prices, says Eric Zitzewitz, an economics professor at Stanford Business School. According to his research, about 10% of the staleness was being removed via fair valuation pre-scandal. At the end of this year's second quarter, about 55% of the staleness was being removed. "It is a very big change," he says.

More fund firms are also back testing to check the accuracy of their fair valuations, says Andrew Hunter, partner at **Barrington Partners**, which released a study on market timing and fair valuation in August. Sixteen investment advisors were included in the study; all of them have adopted formal fair valuation policies, and all conduct back testing.

Another tactic employed to thwart market timers is imposing redemption fees on short-term trades. While the SEC's proposed rule requiring 2% redemption on short-term trades is still under debate, many fund firms are implementing redemption fees of their own volition.

For example, **MFS** announced last year that beginning in December it would charge a 2% redemption fee on all its international and global funds for exchanges that occur within 30 days of each other. In March, **AIM** imposed 2% redemption fees on 12 of its funds. More recently, **Gabelli** stated in an August SEC filing that it will institute a 2% redemption fee on six of its funds.

The increase in redemption fees is regarded as a positive step toward thwarting market timers. But a new study raises questions as to whether those fees are actually being successfully implemented.

About 88% of 32 fund groups with a redemption fee policy could not guarantee implementing the fee when it comes to omnibus accounts, according to a study carried out by the Coalition of Mutual Fund Investors, a shareholder advocacy group. Omnibus accounts consolidate thousands of individual trades into one block trade, making it difficult to identify timers. Eliot Spitzer's investigation revealed that at least one firm disguised late trades and market timing by mixing those trades in with legitimate trades in omnibus accounts.

"If you read in a prospectus that there's a 2% redemption fee, and then you fail to read later on in the prospectus that there's an exemption for any kind of omnibus account, you are getting a false sense of security that you're being protected from market timers because of the fund's policies and procedures," says Niels Holch, founder of the Coalition.

Directors and industry experts agree that omnibus accounts remain susceptible to market timers. Part of the problem is that often the SEC does not have power over the third-party intermediaries that place the trades. Therefore the agency can't force the intermediaries to share information on rapid traders with funds firms. As a result, some fund firms are only doing business with intermediaries who promise to cooperate in this area.

"One fund company reported that it had stopped doing business with one broker-dealer that it suspected was hiding a repeated market timer [in an omnibus account]," says Barrington Partner's Hunter.

### **Will history repeat itself?**

Although most people acknowledge that the industry has made enormous efforts to eradicate market timing and late trading, some fear that history will repeat itself,

particularly when it comes to market timing.

“The arbitrage issue is still a potential issue,” says Geoff Bobroff, industry consultant.

The fact that a year has passed since the scandal began and the root of the trading abuses still exists – as seen with omnibus accounts – is “troubling,” says Holch.

For now, though, many seem to think the past year of intense scrutiny and criticism will be enough to push fund firms to police trading more vigilantly. In short, many people believe the industry is doing its utmost to get rid of timers and late traders.

“I don’t think people are going to start to be asleep at the switch when it comes to short-term trading,” says Craig Tyle, partner at law firm **Shearman & Sterling**. “I’ll be very, very surprised if this issue recurs in the foreseeable future,” he adds.

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