

# Omnibus fare

Why is it so hard to come up with a plan to end the rapid trading that has ensnared so many mutual funds in scandal? • By Jinny St. Goar

Just about everyone agrees that rapid trading of mutual funds by investors is a bad thing. It forces portfolio managers to set aside money so that they have funds available to meet frequent withdrawals. This money goes into low-yielding cash equivalents and therefore can hurt the fund's overall returns for long-term investors. But there's much less consensus on how to solve these problems. In fact, the issue has set off a contentious industry debate that now pits powerhouse Fidelity Investments against titans Vanguard Group and Merrill Lynch & Co., among others.

Traditionally, fund companies have tried to limit rapid trading, also known as market timing, by imposing redemption fees on investors who sell their shares before brief holding periods expire. Although in principle the fees apply to all fund shareholders, in practice they are levied only on the investors whose trading activities are easily tracked — that is, individuals who buy their funds directly from the fund families and not through such intermediaries as fund supermarkets, brokers or 401(k) plans.

Since New York State Attorney General Eliot Spitzer opened his industry-wide crackdown on mutual fund trading practices 16 months ago, redemption fees — and their application to hard-to-track investors — have taken on new controversy and urgency.

That's because in the past decade many mutual fund firms have become reliant on omnibus accounts: consolidated accounts from third-party 401(k) administrators, banks and broker-dealers. According to the Investment Company Institute, the mutual fund trade association, the share of assets administered by third parties for both retail and institutional investors, as opposed to direct holdings of individuals, rose from 49 percent in 1996 to 60 per-

cent at year-end 2003. These accounts have been largely exempt from redemption fees.

Unlike many mutual fund companies, Fidelity Management and Research, the fund company arm of Fidelity, pulls in a relatively small share of its assets from omnibus accounts — 19 percent at the end of 2003. Some 47 percent of Fidelity's assets come from intermediaries, but they are not combined as omnibus accounts. Like its rivals, Fidelity has exempted omnibus accounts from redemption fees.

But in December 2003, as the mutual fund scandals were unfolding, Fidelity announced a change in policy. When the new plan is implemented — the start date is up in the air — Fidelity's redemption fees will apply to all its fund holders, including those in omnibus accounts. The fees range from 75 to 200 basis points, and the minimum holding period varies from 30 to 90 days. "It's not appropriate for shareholders to be treated differently depending on their investment vehicle," says Janice Morris-Hatch, the Fidelity vice president charged with managing the firm's response to the new regulatory climate.

Some recordkeepers who manage omnibus accounts that include Fidelity funds quickly rebelled; they saw the



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change as an administrative nightmare. The most outspoken opponents are two asset managers that run 401(k)s for plan sponsors whose platforms include a range of mutual fund families: Vanguard Group, with \$300 million invested in Fidelity funds, and Merrill Lynch, with \$400 million.

Applying redemption fees to all investors would require intermediaries to file weekly reports about the trades of individual investors. Currently, intermediaries simply aggregate the trades, netting them daily. Reporting individual trades would require a substantial investment in

new software. Mutual fund families appear on numerous recordkeepers' platforms and maintain relationships with hundreds of broker-dealers.

"For some intermediaries, this is harder than for others," concedes Fidelity's Morris-Hatch.

It's not that redemption fees are unusual — in fact, they're commonplace. In a study released in August, the Coalition

Fidelity senior vice president who heads FMR Co., the investment management unit.

The Securities and Exchange Commission has joined the debate. In March, SEC chairman William Donaldson proposed a 2 percent redemption fee on any round-trip trade of a mutual fund within five days. "In proposing that redemption fees be levied on all investors, the SEC was go-

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of Mutual Fund Investors, a Washington, D.C.-based lobbying firm, found that 32 of the 50 largest mutual fund firms collected redemption fees on at least one equity fund, while the remaining 18 relied on "other mechanisms and policies" to deter market timing. But most omnibus accounts have been exempt from the fees.

The potential for abuse in these omnibus accounts is now well known. One group of market timers nabbed in Spitzer's investigation were members of Boilermakers Local 5 of Floral Park, New York, who — trading through their 401(k) accounts — capitalized on both the absence of redemption fees and the tax-free nature of their frequent transactions in Putnam Investments international equity funds. They bought shares in the international fund on days when U.S. equity prices were rising, betting that the international markets would follow Wall Street's lead, enabling them to net a quick profit.

Fidelity initially said that intermediaries and recordkeepers would be required to comply with its new redemption fee rules by March 31, 2004. That deadline came and went. In July, in the face of widespread industry opposition, Fidelity set a new deadline of January 1, 2005. Then in late October the firm sent out a conciliatory letter to the omnibus account keepers with whom it does business, suggesting further flexibility. "We are willing to work with people, as long as they make a commitment to full compliance and install [the systems to realize that commitment] by March 31, 2005," says David Jones, the

ing after omnibus accounts," notes mutual fund consultant Geoff Bobroff.

Although the ICI supported the SEC proposal, many in the industry opposed it on the grounds that the commission has no business setting fund fees. By early October the SEC was retreating, notes ICI general counsel Elizabeth Krentzman. "The commission will not support a mandatory redemption fee," she says.

Speaking at the Securities Industry Association conference in November, Donaldson said that he could not promise a final rule on redemption fees by year-end.

The SEC proposal had smacked of "getting into the pricing of funds," says Fidelity's Morris-Hatch. "Fees should be set fund by fund."

Most fund executives would agree with Morris-Hatch but some strongly reject Fidelity's own redemption fee policy. Among the more outspoken critics are Vanguard and Merrill Lynch.

"If Fidelity's proposal made sense, we would have raised our hands [in agreement]," says William McNabb, Vanguard's managing director for the client relationship group. Vanguard executives argue that participants in 401(k)s make many automatic purchases and sales of their mutual fund holdings, both when they invest their payroll contributions and when they lighten up to rebalance or to meet loan payments. Such transactions, Vanguard and others argue, should not be subject to redemption fees.

T. Rowe Price Group, for example, will impose redemption fees on retirement plans starting January 1, but only on

participant-directed exchanges, exempting transactions individual investors don't control, such as automatic rebalancing. Vanguard says it can enforce that policy.

In its late October letter, Fidelity said that it will "defer indefinitely" the collection of redemption fees on transactions in retirement accounts.

"This is the third time that Fidelity has drawn a line in the sand only to move it at the 11th hour," responds James Norris, head of Vanguard's 401(k) business. "What's more, Fidelity is purposefully exempting some transactions and not others. And finally, they've indicated that this is not a long-term solution, leaving our clients with uncertainty."

Vanguard has advised its plan sponsor clients to either freeze their participants' investments in Fidelity funds or divest from those funds. "We expect the SEC will provide the guidance needed to clear up this issue," Norris adds.

Merrill Lynch makes a similar argument. The Fidelity policy is "infinitely broader and more onerous to participants than anything we have seen to date," says Cynthia Hayes, Merrill's first vice president for retirement plans. The firm has 123 plan sponsor clients with Fidelity funds in their lineups. "We've told those sponsors that we will not administer Fidelity funds and that we will help them with their communications to employees to explain," says Hayes.

Fidelity's response? "What a surprise that some of our major competitors are recommending that their clients get out of our funds," says senior vice president Jones. "We are disappointed that people will deprive their clients of investment choices because of recordkeeping issues."

What's next? The SEC may well offer a new position on redemption fees that is more acceptable to the industry. "Without guidelines from the SEC," says John Doyle, who heads marketing and communications for T. Rowe Price's retirement plan services, "the types of transactions and the holding periods for redemption fees will be all over the place."

"No single set of rules is going to make everyone happy," says Vanguard's McNabb. "But we're hoping to find the ground on which the positives outweigh the negatives." Fidelity, for its part, believes that its redemption fee system will prevail. ■