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Study: Omnibus Accounts Wide Open to Timers

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The majority of the industry's largest shops have surrendered in the battle against market timers trading in omnibus accounts. That's according to a just-released study by **The Coalition of Mutual Fund Investors**, a Washington, D.C.-based investor advocacy group.

The study found that while many shops have taken steps to deter market timers, the majority of them have acknowledged, in regulatory filings, their inability to fully enforce these policies.

CMFI analyzed the regulatory filings of 50 of the top fund firms and found that 35, or 70%, say they employ a redemption fee on at least one equity mutual fund. This represents a 6% jump from last year's survey.

That may seem as though funds are stepping up their vigilance against timers, but another set of numbers is more revealing. Of the shops that have redemption fees, 97%, or all but one, say they exclude, waive or limit the enforcement of the fees in omnibus accounts. That represents a 9% jump from a study CMFI did last year.

A substantial portion of daily fund trading occurs through omnibus accounts. The accounts batch trades from brokers, 401(k) accounts and other intermediaries and submit them in one lump trade. While the accounts make it easier to process the trades, they also make it extremely difficult to track an individual's trading activity.

That is one of the ways timers have been able to get around the anti-timing police at fund firms. Now, funds are simply disclosing their inability to stop the activity in those accounts.

One such disclaimer can be found in a regulatory filing for the Columbia Acorn Fund dated Nov. 18, 2004."The Fund typically is not able to identify trading by a particular beneficial owner through an omnibus account, which may make it difficult or impossible to determine if a particular account is engaged in frequent trading," the filing states.

That, to some, is unbelievable.

"It's amazing that two years later, after a number of the market-timing abuses were uncovered in omnibus accounts, the industry is still not able to fix the problems," says Niels Holch, co-founder of CMFI.

Some aren't even employing redemption fees, because they deem them pointless. Of the 15 shops that do not have a redemption fee policy for market timers, 53% cited concerns about their ability to enforce such fees on omnibus accounts, including those from broker-dealers, retirement plan accounts, and others.

Industry observer Roy Weitz, publisher of *FundAlarm.com*, says the regulatory filings illustrate that fund companies took away the wrong lesson from the market-timing scandal.

Instead of cracking down harder on timers, especially in omnibus accounts, they decided to update the prospectuses, he says. Market timing is not illegal, but many firms got in trouble because they claimed, in their prospectus, that they deterred or prohibited market timing. But many of those same firms were discovered by regulators to have deals with select investors allowing them to market-time. Weitz does not believe firms are helpless in stopping market timers from trading within omnibus accounts.

"If there is a will, there would be a way," he says. "There is nothing in this they couldn't fix if they wanted to."

Weitz says many firms may be reluctant to push for individual shareholder account information due to competitive pressures in the marketplace. "I think what they're afraid of is if they really push for omnibus account holder information, it would limit the omnibus account investing," he says.

Holch says there is in fact a way to stop timers and that the report suggests several measures to help firms attack the timing problem. First, he says, firms should all institute redemption fees. Second, financial intermediaries should disclose omnibus account information to the funds on a daily or transactional basis. Firms currently have the ability to negotiate such requirements into contracts if they want to, he says.

Lastly, firms should all employ an accounting method called LIFO, or "Last In, First Out." That is a way to track the most recent transactions of individual account holders. Currently most shops use a method known as FIFO, or "First In, First Out," which is not really effective at all at tracking timers, Holch says. Timers are able to circumvent the FIFO system, he says.

Holch says the SEC has a role to play in stopping timers too. It has requested comment on its final redemption fee rule, which only requires funds to consider instituting a mandatory redemption fee. As Holch sees it, "the only answer is for the SEC to step up and create a uniform set of rules."

However, some observers say there has been progress combating timers and that focusing on preventing timers from trading in and out of funds may not be the most effective approach.

Eric Zitzewitz, assistant professor of economics at Stanford University, says it's not necessarily easy for fund shops to just demand the account information. "Some of the supermarkets have concerns about losing control of the client relationship," he says. And the supermarkets have some negotiating leverage as well.

Zitzewitz is the author of a paper called *Who Cares About Shareholders? Arbitrage-Proof Mutual Funds*, which claims market timers siphoned $4.9 billion a year from long-term investors.

Fixing stale pricing is a better way to curb timing, as opposed to focusing on trading activity, Zitzewitz says. On the international fund front, he says, firms have already made progress. Prior to the scandal, fair valuation, which updates stale prices, helped eliminate 20% of stale prices. As of the fourth quarter of 2004, that number is up to 70%, he says.

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