AN EVALUATION OF THE REDEMPTION FEE AND MARKET TIMING POLICIES OF THE LARGEST MUTUAL FUND GROUPS

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Executive Summary

As the U.S. Securities and Exchange Commission ("SEC") finalizes its regulations to address market timing in mutual funds, the Coalition of Mutual Fund Investors ("CMFI")[1] has reviewed the SEC filings for the 50 largest mutual fund groups, to ascertain their current redemption fee and short-term trading policies.

The CMFI study found that 70% of the largest mutual fund groups use redemption fees as a tool to deter abusive short-term trading. Unfortunately, virtually all of the fund groups—97% —have disclosed in regulatory filings that they are *excluding, waiving, or limiting* the enforcement of redemption fees in accounts held by third-party financial institutions.

Regulatory filings for the largest fund groups also disclose that the industry is using the *least effective accounting method* ("First In, First Out" or "FIFO") to calculate redemption fees, instead of an accounting methodology ("Last In, First Out" or "LIFO") that directly addresses short-term trading abuses.

This is the second study conducted by CMFI on this subject. In an August 2004 review of prospectus material filed by the largest fund groups, CMFI determined that a substantial majority of mutual fund groups—88%—were having difficulty applying redemption fees uniformly across all shareholder classes because a significant percentage of mutual fund shares are held in "omnibus accounts" managed by third-party financial institutions.

Many investors transacting in mutual funds through a third-party financial institution or intermediary, such as a broker or a retirement plan, do not deal directly with a fund. Instead, shareholder statements and recordkeeping are handled by each intermediary, as well as all aspects of the business relationship with the investor.

At the end of each market trading day, financial intermediaries that utilize omnibus recordkeeping bundle up all trading requests from their customers and send a consolidated purchase and redemption order to each mutual fund. A mutual fund handles this consolidated order as a single transaction, recording the third-party intermediary on its books as one shareholder or omnibus account. Each omnibus account order may represent the transactions of hundreds of thousands of customers of a particular third-party financial institution; however, no information is disclosed to the compliance personnel at a mutual fund about the individual activities of these omnibus account investors, nor are the actual identities of the investors known to anyone but the financial intermediary.

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[1] The Coalition of Mutual Fund Investors is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is based in Washington, D.C., and has a Website that can be accessed at www.investorscoalition.com.

A number of the short-term trading abuses uncovered by state and federal regulators over the past two years occurred in omnibus accounts, as investors are able to conceal their identity and trading activities.

The fact that an overwhelming majority of the largest mutual fund groups cannot enforce their rules within omnibus accounts demonstrates the need for full transparency in these accounts, in order to ensure that individual investors are protected from harmful market timing. *The best solution to this problem is a requirement that financial intermediaries disclose shareholder identity and transaction information to mutual funds when each order is placed*. With this information, funds can monitor shareholder activity at the individual investor level and be in a position to ensure the uniform application of their policies and procedures.

As a further protection to long-term mutual fund investors, every fund using a redemption fee should rely on the *LIFO ("Last In, Last Out") accounting method* as it is the only method which matches the most recent purchases with the most recent redemptions. For some reason, the industry standard is the FIFO ("First In, First Out") method, which permits market timers to avoid redemption fees and otherwise circumvent fund trading restrictions.

Methodology for the CMFI Study

CMFI reviewed prospectuses filed with the SEC for the 50 largest mutual fund groups. The latest filing reviewed was April 11, 2005.

The 50 largest mutual fund groups were identified and ranked by the Financial Research Corporation, as reported in Money Management Executive on May 10, 2004. The 50 fund groups were ranked by the dollar amount of long-term assets, excluding money market funds and exchange-traded funds ("ETFs").

To ensure a consistent comparison with data from the earlier CMFI study in August 2004, the list of 50 fund groups was not updated from last year. At least two of the fund groups have merged since the last CMFI study: (1) the Strong Funds were purchased by Wells Fargo Funds; and (2) the One Group Funds were purchased by JPMorgan Funds. For the purpose of this study, the Strong Funds and the One Group Funds have been evaluated as separate fund groups from their current merger partners.

Through a review of the public filings of these fund groups, each group was evaluated on the following questions:

(1) Does the fund group have a redemption fee for any of its domestic or international equity funds?

(2) Does the fund group have any other policies to deter market timing activities?

(3) Does the fund group have any exclusions, waivers, or limitations regarding its redemption fees or other market timing policies for shareholders in omnibus accounts held by third-party financial institutions or intermediaries, including broker-dealers, retirement account plans, financial advisors, or other institutional accounts?

(4) Does a fund group with a redemption fee policy use the LIFO ("Last In, First Out") or FIFO ("First In, First Out") accounting method?

Attached is a listing of the 50 fund groups with a short description of the study's findings for each group.

Summary of the Findings

(1) **Key Finding: Most Mutual Fund Groups Are Using Redemption Fees As a Tool to Deter Short-Term Trading Abuses**

Of the 50 fund groups evaluated, 35 groups (70%) have implemented redemption fees on at least one domestic or international equity fund. The 15 remaining fund groups (30%) do not use redemption fees for any funds, although virtually all of these groups use other mechanisms and policies to deter market timing.

This data represents a *6% increase* from the earlier CMFI study in August of 2004, where 32 of the 50 fund groups (64%) used a redemption fee on at least one equity fund.

(2) **Key Finding: More Fund Groups Are Disclosing in Prospectus Materials the Impossibility of Enforcing Redemption Fees Within Omnibus Accounts**

Of the 35 fund groups with a redemption fee, 34 of these groups (97%) disclosed in prospectus material that they 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. Only one fund group, GMO Funds, imposes a redemption fee policy without any exclusions, waivers, or limitations regarding third-party omnibus accounts.

This data represents a *9% increase* from the earlier CMFI study in August of 2004, where 28 of 32 of the fund groups (88%) disclosed exclusions, waivers, or limitations on the enforcement of redemption fees in omnibus accounts.

Excerpts from the most current prospectus material filed with the SEC include the following statements:

- "Fund Management's ability to monitor trades that are placed by

individual shareholders of omnibus accounts, which are accounts maintained by financial intermediaries on behalf of multiple beneficial shareholders, is *severely limited* because Fund Management does not have access to the underlying shareholder account information." Wells Fargo Advantage International Stock Funds Prospectus, April 11, 2005 (emphasis added).

- "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." Columbia Acorn Fund Supplement to Prospectus, November 18, 2004 (emphasis added).

- "…the ability of a Fund to assess a redemption fee on the underlying shareholders of an omnibus account maintained by a financial intermediary is *limited* due to the fact that individual shareholder information is maintained by the intermediary and not by the Fund." Evergreen Global and International Funds Prospectus, March 1, 2005 (emphasis added).

- "By their nature, omnibus accounts … *conceal the identity* of the individual investors from the Fund. This makes it more difficult to identify short-term transactions in the Funds, and makes assessment of the Redemption Fee on transactions effectuated through such accounts *impractical* without the assistance of the financial intermediary. Due to these limitations on the assessment of the Redemption Fee, the Funds' use of Redemption Fees *may not successfully eliminate successive short-term trading* in shares of the Funds." Allianz/PIMCO Domestic Stock Funds Prospectus, as revised April 1, 2005 (emphasis added).

- "There is *no assurance* that these policies and procedures will be effective in limiting short-term and excessive trading in all cases. For example, the adviser *may not be able to effectively monitor, detect or limit short-term or excessive trading* by underlying shareholders that occurs through omnibus accounts maintained by broker-dealers or other financial intermediaries." Scudder Core Global/International Funds II Prospectus, February 25, 2005 (emphasis added).

More than one-third of fund groups with redemption fee policies (34%) disclosed that operational deficiencies in intermediary record-keeping systems are a significant factor in the funds' inability to ensure enforcement of a fee. More than one-quarter of these fund groups (29%) also disclosed that a lack of information about the underlying shareholders in these third party accounts is a major factor.

(3) **<u>Key Finding: Many Mutual Fund Groups Are Not Able to Enforce Market Timing Policies in Omnibus Accounts</u>**

Of the 15 fund groups with no policy to impose a redemption fee, more than one -half of the groups (53%) disclosed concerns about the ability or practicality of enforcing their market timing policies within omnibus accounts, including broker-dealer accounts, retirement plan accounts, and other institutional accounts held by financial intermediaries. Excerpts from the prospectus material filed with the SEC include the following statements:

- "…the Funds *may not be able to detect* excessive or short-term trading in Fund shares attributable to a particular investor who effects purchase and/or exchange activity in Fund shares through omnibus accounts. Also, multiple tiers of these entities may exist, each utilizing an omnibus account arrangement, which may further *compound the difficulty of detecting excessive or short duration trading activity* in Fund shares." <u>AllianceBernstein Growth Funds Prospectus</u>, November 1, 2004 (emphasis added).

- "…the ability of the Funds to monitor and detect excessive share trading activity through omnibus accounts is *very limited*, and there is *no guarantee* that the Funds will be able to identify shareholders who may be engaging in excessive trading activity through omnibus accounts or to curtail such trading." <u>Dodge & Cox International Stock Fund Prospectus</u>, May 1, 2004, as supplemented August 30, 2004 and March 10, 2005 (emphasis added).

- "Because the funds receive these [omnibus account] orders on an aggregated basis and because these omnibus accounts may trade with numerous fund families with differing market timing policies, the funds are *substantially limite*d in their ability to identify or deter Excessive Traders or other abusive traders." <u>The Hartford Mutual Funds Prospectus</u>, March 1, 2005 (emphasis added).

(4) **<u>Key Finding: No Large Fund Groups Use the LIFO Accounting Method, Despite Its Effectiveness in Identifying Market Timers</u>**

In imposing a redemption fee, a fund typically chooses between two accounting methods: "FIFO" or "LIFO." Under FIFO ("First In, First Out"), fund shares held the longest time are treated as being redeemed first, and shares held the shortest time are treated as being redeemed last. Under LIFO ("Last In, First Out"), shares held the shortest time are treated as being redeemed first, and shares held the longest time are treated as being redeemed last.

Among the 35 fund groups with redemption fee policies, 22 groups (63%) disclosed in prospectus material that they use FIFO to calculate redemption fees. The other 13 fund groups (37%) did not disclose anything about their choice of accounting method in prospectus filings.[2] *No fund group disclosed in prospectus filings the use of the LIFO accounting method, despite the fact that LIFO more accurately addresses short-term trading abuses by matching the most recent purchases with the most recent redemptions*.

CMFI Recommendations

(1) **Redemption Fees Are a Helpful Tool to Deter Market Timing**

Excessive trading is harmful to the interests of long-term shareholders in a mutual fund. Trading profits taken by market timers dilute the value of the shares owned by other shareholders with longer time horizons. Short-term trading also increases fund transaction costs.

To address these problems, mutual fund boards have implemented redemption fees to eliminate or reduce the economic incentives of short-term trading. These fees also are designed to compensate long-term shareholders of a fund for the cost of abusive trading activities.

At least 70% of the largest fund groups use redemption fees as a tool to combat excessive short-term trading. Even though the SEC has decided that redemption fees should not be mandatory for all funds, the use of these fees is an important mechanism to protect the interests of long-term fund shareholders.

(2) **Financial Intermediaries Should Disclose Omnibus Account Information to Funds**

As determined by this CMFI review of the prospectus filings of the 50 largest fund groups, it is impossible for funds and their boards to ensure the equal and fair treatment of all shareholders when many shareholders own shares in omnibus accounts.

The current sales and distribution system in the mutual fund industry has created a bifurcated system in which there are really two types of shareholders: (a) the "direct purchase" shareholder who deals directly with the fund; and (b) the "omnibus account" shareholder who transacts in fund shares through a third-party financial institution, such as a broker-dealer, retirement plan or financial advisor.

A "direct purchase" investor is recorded as a shareholder by the mutual fund, with the fund's compliance personnel assigned the task of monitoring the investor's trading activities. An "omnibus account" shareholder, on the other hand, does not transact

[2] CMFI did not review the Statement of Additional Information for any fund or fund group with respect to this issue.

directly with a mutual fund. Instead, shareholder statements and recordkeeping are handled by each intermediary, which then consolidates all trades with a mutual fund into a single order. Each omnibus account order may represent the transactions of hundreds of thousands of customers and individual accounts.

It is clear from this review of prospectus filings that mutual funds cannot adequately monitor the activities of omnibus account shareholders, or properly enforce fund policies and procedures, with respect to these shareholders. While ultimately it is the intermediary's responsibility to enforce the fund's prospectus provisions, the funds have a parallel obligation to monitor the adherence of their intermediaries. *With only one exception[3], every fund group examined in this study has adopted language in its prospectus that informs investors that it cannot or will not apply a redemption fee to omnibus accounts held by third-party intermediaries*.

This issue is critically important because omnibus accounts were at the heart of many of the trading abuses uncovered by federal, state, and industry regulators over the past two years.

Many mutual funds use contractual commitments with fund intermediaries to enforce the rules of a particular fund. However, this approach is unworkable, as demonstrated by the results of this study, and by the fact that it is also not in the economic interest of these financial intermediaries to enforce mutual fund rules on their customers,

To address this regulatory problem, CMFI believes that the best solution is *to require that financial intermediaries disclose omnibus shareholder identity and shareholder information to mutual funds on a daily or transactional basis*. With this information, each fund can monitor shareholder activity at the individual investor level and be in a position to ensure the uniform application of its redemption fees. This disclosure requirement will also permit funds to ensure compliance with breakpoint discount policies and other corporate actions such as contingent charges and dividend reinvestments.

Same-day disclosure of omnibus account information was proposed in the last Congress in two pro-investor mutual fund reform bills, S. 2059 and H.R. 4505, introduced by former U.S. Senator Peter Fitzgerald (R-IL) and U.S. Representative Paul Gillmor (R-OH).

Additionally, CMFI believes that this information-sharing requirement can be accomplished with existing technology that is readily available within the industry. For example, the Fund/SERV, Networking, and Defined Contribution Clearance & Settlement processing platforms operated by the National Securities Clearing Corporation ("NSCC") permit transaction data to be provided in a standardized, same-day basis between mutual funds and their intermediaries. This technology provides a cost-effective

[3] The GMO Funds impose a redemption fee without exclusions, waivers, or limitations for third-party omnibus accounts.

mechanism for funds to monitor intermediary compliance with redemption fees, as well as other fund policies and procedures.

(3) **LIFO Should Be the Required Accounting Method for Redemption Fees**

Market timing in its most basic form involves a "round trip" trade (i.e., a purchase and a redemption) within a short period of time. The only way to effectively discourage this rapid trading activity is to use an accounting method which directly addresses the underlying market timing transaction.

Of the two choices, the accounting method which best accomplishes this objective is LIFO ("Last In, First Out") because it matches the most recent transactions with each other. Clearly, this is the accounting method which a fund should use to impose its redemption fee instead of FIFO ("First In, First Out"), the current industry standard.

The FIFO method does trigger redemption fees when short-term trading activity involves a large portion of an individual account; however, a market timer will be able to circumvent this accounting method by creating a timing "ladder" or "tranche." Under this structure, a market timer can rapidly trade smaller and defined portions of a larger account balance, leaving an equal amount of shares untouched in the fund to avoid triggering a redemption fee.

Ironically, this approach operates in a similar fashion to some of the market timing transactions uncovered by regulators: a significant sum is invested in a fund as a "sticky asset," while other monies are permitted to be used for market timing activities. The use of the FIFO accounting method will still permit market timers to rapidly trade fund shares as long as a "sticky asset" balance of an equal amount is maintained to avoid a redemption fee. For these reasons, LIFO is a better accounting method for funds to use and should be the method required by the SEC.

Conclusion

While it is universally accepted that redemption fees are a helpful tool to combat market timing abuses, an examination of the policies of the 50 largest mutual fund groups by CMFI demonstrates conclusively that the fund industry is not able to enforce redemption fees and other market timing policies on shareholders who are concealed in omnibus accounts operated by financial intermediaries.

Among those fund groups using redemption fees to deter short-term trading activities, *97% of these groups* have disclosed in SEC filings that they exclude, limit, or waive the enforcement of all 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. Of the fund groups with no policy of imposing redemption fees, *53% of these groups* have raised significant concerns in SEC filings about their ability to enforce market timing policies within omnibus accounts.

Many of the funds cite operational and systems limitations at the intermediary level as a cause of this problem. A number of funds also cite the lack of information about omnibus shareholders and their transactions as a reason for non-compliance.

To address this bifurcated structure of "omnibus account" and "direct purchase" shareholders, CMFI proposes that financial intermediaries be required to disclose shareholder identity and transaction information to mutual funds on a *daily or transactional basis*, so that each fund can monitor shareholder activity and be in a position to ensure the uniform application of its policies and procedures.

CMFI believes that intermediary information disclosure will not be expensive to implement because of existing technology that is readily available to make these disclosures on a daily or transactional basis.

CMFI also advocates that mutual funds apply redemption fees using the LIFO ("Last In, First Out") accounting method because that is the method which matches the most recent transactions with each other. The industry standard, FIFO, permits market timers to circumvent redemption fee policies.

For copies of the 2004 and 2005 CMFI studies or more information about CMFI and its activities, please visit the Coalition's Web site at www.investorscoalition.com.

Attachment

CMFI STUDY: AN EVALUATION OF THE REDEMPTION FEE AND MARKET TIMING POLICIES OF THE LARGEST MUTUAL FUND GROUPS

Description of Results By Fund Group

May 5, 2005

Key: OA=Omnibus Accounts; 3P=Third-Party

Fund Complex	Accounting Method	Redemption Fee(s)	Omnibus Account (OA) Policies
AIM		Yes	*Exempts* OA w/out systems to impose fee
Alliance		No	*No guarantee* that Fund can detect or curtail market timing in OA
American Century		Yes	Ability to monitor trades in OA is *severely limited*
American Funds		No	
Artisan Funds		Yes	Fee *waived* for accounts held through 3P intermediaries
American Express		No	OA are *exempt* from exchange restrictions
Columbia		Yes	*No guarantee* that Fund can detect or prevent frequent trading in OA
Davis Funds		No	Ability to monitor or enforce market timing policy in OA is *limited*
DFA Funds		No	Ability to monitor trades in OA is *severely limited*

Fund Complex	Accounting Method	Redemption Fee(s)	Omnibus Account (OA) Policies
Dodge & Cox		No	*No guarantee* that Fund can detect or curtail market timing in OA; ability to detect excessive trading *very limited*
Dreyfus Funds		Yes	Fund *may not be able* to identify abusive trading in OA
Eaton Vance		Yes	Fund *cannot ensure* application of fee in OA
Evergreen	FIFO	Yes	Funds ability to detect and prevent short-term trading is *limited* in OA; *no assurance* that fee will be charged in OA
Federated	FIFO	Yes	Fund *may not be able* to collect fee in OA because of intermediary systems limitations
Fidelity	FIFO	Yes	*No assurance* that Fund can successfully detect or deter market timing in OA
First American		No	Fund will request investor level information if OA surveillance detects excessive trading
Franklin Templeton	FIFO	Yes	Ability to assess or collect fee in OA is *very limited*
GMO		Yes	No waiver of fee in 3P intermediary accounts
Goldman Sachs	FIFO	Yes	*Exempts* fee in certain OA
Harbor Capital	FIFO	Yes	*Exempts* fee in OA without systems capability

Fund Complex	Accounting Method	Redemption Fee(s)	Omnibus Account (OA) Policies
Hartford		No	Ability to identify or deter excessive trading in OA is *substantially limited*
ING	FIFO	Yes	Funds *not able* to identify trading activities in OA
Janus		Yes	*Exempts* fee in OA without systems capability
JP Morgan		Yes	*No assurance* that Fund can successfully locate or eliminate market timing in OA
Legg Mason	FIFO	Yes	*Exempts* 3P retirement accounts
Lord Abbett		No	Fund has procedures in place to monitor 3P intermediaries
Merrill Lynch	FIFO	Yes	*Exempts* fee in certain OA
MFS	FIFO	Yes	*Exempts* fee in OA unless systems capability exists
Morgan Stanley (Retail)		No	
Morgan Stanley (Institutional)		No	
Nations		Yes	*No assurance* that Fund can identify or deter market timing in OA
Oakmark	FIFO	Yes	*Exempts* fee in certain OA
One Group (merged with JP Morgan)		Yes	*No assurance* that Fund can successfully identify and eliminate market timing in OA

Fund Complex	Accounting Method	Redemption Fee(s)	Omnibus Account (OA) Policies
Oppenheimer	FIFO	Yes	*Exempts* fee in OA
PIMCO	FIFO	Yes	Fund *not able to collect fee* in OA
Pioneer	FIFO	Yes	*Exempts* 3P retirement accounts; fee *may not* apply in OA
Prudential		No	
Putnam	FIFO	Yes	*Exempts* fee in certain OA
Frank Russell		No	Fund *may not be able* to detect frequent trading activity in OA
Charles Schwab		Yes	Fund *reserves right to waive* fee in OA
Scudder	FIFO	Yes	*No assurance* that Fund market timing restrictions can be effective with OA; Fund will *waive* fee in OA without systems capability to assess the fee
SEI Investments		No	Fund will monitor ST trading in intermediary accounts; some intermediaries may be *unable or unwilling* to enforce Fund restrictions
Smith Barney		No	
Strong Funds	FIFO	Yes	Fund lacks investor level information; ability to monitor and discourage excessive trading is *severely limited*

Fund Complex	Accounting Method	Redemption Fee(s)	Omnibus Account (OA) Policies
T. Rowe Price	FIFO	Yes	Fund *cannot always* monitor activity by individual share-holders in OA
USAA		Yes	Fee currently *waived* for all Funds; ability of funds to monitor trading in OA *limited* without investor data
Vanguard	FIFO	Yes	Fund *cannot monitor* investor level trade data in OA; *may waive fee* for certain investor categories
Van Kampen	FIFO	Yes	*Exempts* fee for certain OA
Waddell & Reed	FIFO	Yes	*Exempts* fee for most OA
Wells Fargo	FIFO	Yes	Fund lacks investor level information; ability to monitor and discourage excessive trading is *severely limited*