CMFI
Coalition of Mutual Fund Investors

Analysis of Redemption Fee Policies by the Fifty Largest Mutual Fund Groups

August 3, 2004

A. Background

As the U.S. Securities and Exchange Commission ("SEC") considers a 2% mandatory redemption fee to combat market timing abuses in mutual funds, the Coalition of Mutual Fund Investors[1] ("CMFI") has reviewed the SEC filings for the 50 largest mutual fund groups to ascertain their current redemption fee policies.

A number of fund groups already had redemption fee policies in place before the SEC issued its regulatory proposal on March 11, 2004. However, with the likelihood that a mandatory fee will be imposed by the SEC on the mutual fund industry, many other fund groups have recently started using redemption fees as a part of their anti-market timing policies.

Excessive short-term trading is harmful to the interests of long-term shareholders in a mutual fund. Trading profits taken by market timers dilute the value of shares owned by long-term shareholders and increase fund transaction costs. Abnormal redemption levels also force asset managers to have larger cash balances in a fund, a situation which limits the ability of a fund to be fully invested.

When properly implemented, redemption fees have proven to be a successful tool to discourage short-term trading. If the fee is large enough, it can reduce or eliminate the economic incentives of market timing. Redemption fees also provide a mechanism for long-term shareholders to be compensated for the dilutive effects of this type of trading activity.

Unfortunately, a substantial majority of mutual fund groups are having difficulty applying redemption fees uniformly across all shareholder classes because a significant percentage of mutual fund shares are held in "omnibus accounts." Under this accounting structure, a mutual fund records only one accountholder in its master shareholder file, usually the financial intermediary itself, instead of establishing separate accounts for each shareholder. At the end of each trading day, the financial intermediary either sends aggregated purchase and redemption orders to a mutual fund, or the same intermediary "nets" the purchases and redemptions into one order, which is then placed with a fund.

[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., with a Web site that can be accessed at www.investorscoalition.com.

This omnibus accounting structure is used primarily by broker-dealers, retirement plans, and other institutional investors.

An omnibus account may have hundreds of thousands of individual shareholders, all recorded as one shareholder—the financial intermediary—in the accounts of a mutual fund. The identities of individual shareholders purchasing and redeeming mutual fund shares are completely invisible to a fund, along with the actual transactions engaged in by these shareholders.

CMFI has reviewed prospectuses filed with the SEC by the 50 largest fund groups for the purpose of evaluating their current redemption fee policies. A summary of the findings of this examination follow, along with CMFI's recommendations for reforms in this area.

B. Summary of the Findings

1. **General Methodology for the Study**. CMFI reviewed prospectuses filed with the SEC for the 50 largest mutual fund groups. The latest filing reviewed was dated July 6, 2004. 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. A list of these fund groups is attached. The 50 fund groups were ranked by the dollar amount of long-term assets, excluding money market funds and exchange traded funds ("ETFs"). Through a review of the public filings of these fund groups, each group was evaluated on the following issues:

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

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

   (c) 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 financial intermediaries, including broker-dealer accounts, retirement accounts, or other institutional accounts?

   (d) Does any fund group with a redemption fee policy use a holding period in excess of the five (5) days required by the SEC's mandatory fee proposal?

   (e) Does a fund group using redemption fees employ the LIFO or the FIFO accounting method?

2. ***Key Finding:* The Use of Redemption Fees is Widespread Among Fund Groups**. Of the 50 fund groups evaluated, 32 groups (64%) have implemented a redemption fee on at least one domestic or international equity fund. The 18 remaining fund groups (36%) do not use redemption fees for any funds, although many of these groups use other mechanisms and policies to deter market timing.

3. ***Key Finding:* The Imposition of Redemption Fees in Omnibus Accounts is Severely Limited or Nonexistent**. Of the 32 fund groups with a redemption fee policy, 28 of these groups (88%) 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. Excerpts from the prospectus material filed with the SEC include the following statements:

    - "…American Century's ability to monitor trades that are placed by the individual shareholders of omnibus accounts maintained by financial intermediaries is *severely limited* because American Century does not have access to the underlying shareholder account information." American Century Veedot Fund Prospectus, February 27, 2004 (emphasis added).

    - "In the case of omnibus accounts, the Funds do not have access to information regarding trading activity by individual investors, and therefore are *unable to monitor* for excessive short-term trading or violations of the Funds' trading restrictions." Evergreen Domestic Equity Funds II Prospectus Supplement, June 30, 2004 (emphasis added).

    - "If you invest through omnibus account arrangements with financial intermediaries, note that the Funds generally are *not able to identify* an individual investor's trading activities." ING International Fund Prospectus Supplement, June 1, 2004 (emphasis added).

    - "…*the redemption fee does not apply to certain types of accounts held through intermediaries*, including… (3) certain omnibus accounts where the omnibus account holder does not have the operational capability to impose a redemption fee on its underlying customers' accounts; and (4) certain intermediaries that do not have or report to the Funds sufficient information to impose a redemption fee on their customers' accounts." Janus Equity Funds Prospectus, February 27, 2004 (emphasis added).

- "While the Funds monitor for market timing activity, the netting effect [in omnibus accounts] often makes it *more difficult* to apply redemption fees and locate and eliminate market timers from the Funds." One Group International Equity Index Fund Prospectus, February 28, 2004 (emphasis added).

- "Intermediaries often establish omnibus accounts in the T.Rowe Price funds for their customers. In such situations, T.Rowe Price *cannot monitor* activity by individual shareholders." T. Rowe Price Equity Income Fund Prospectus, May 1, 2004 (emphasis added).

One-quarter of those fund groups with redemption fee policies (25%) disclosed that operational deficiencies in intermediary record-keeping systems are a significant factor in the funds' inability to ensure enforcement of a fee. Some funds also disclosed that a lack of information about the underlying shareholders in these third party accounts is a major factor. Only 4 fund groups (12%) impose redemption fees without disclosing specific exclusions, waivers, or limitations regarding omnibus accounts or other intermediary accounts in prospectus filings.

4. ***Key Finding:* The Enforcement of Other Market Timing Policies in Omnibus Accounts is Difficult or Impossible.** Of the 18 fund groups with no policy to impose a redemption fee, 9 groups (50%) disclosed concerns about their ability to enforce 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:

   - "Entities utilizing such omnibus account arrangements *may not identify* customers' trading activity in shares of a fund on an individual basis." AllianceBernstein Growth Funds Prospectus Supplement, February 9, 2004 (emphasis added).

   - "The Fund typically is *not able to identify* trading by a particular beneficial owner in an omnibus account, which may make it *difficult or impossible* to determine if a particular account is engaged in frequent trading." Columbia Acorn Fund Prospectus, May 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." Dodge & Cox

International Stock Fund Prospectus, May 1, 2004 (emphasis added).

- "Because the funds receive aggregate purchase and sales orders from the financial intermediaries and omnibus accounts, the funds *cannot always know or reasonably detect* excessive trading by investors that enter orders through these intermediaries or omnibus accounts." The Hartford Advisors Fund Prospectus Supplement, June 3, 2004 (emphasis added).

5. ***Key Finding:* The Typical Length of the Required Investor Holding Period is Between 30 and 90 Days**. For 31 of the 32 fund groups (97%) with a redemption fee policy, the minimum investor holding period to avoid a fee ranges from 5 days to 5 years. A substantial majority of these fund groups (72%) impose holding periods ranging from 30 days to 90 days. Only 2 fund groups use a 5-day holding period, the minimum amount required under the current SEC proposal. One fund group uses a 5-year holding period for one of its funds and at least one other fund group imposes a very small redemption fee on all redemptions irrespective of the holding period.

6. ***Key Finding:* Most Fund Groups Use the FIFO Accounting Method for Redemption Fees**. 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 32 fund groups with redemption fee policies, 19 groups (59%) disclosed in prospectus material that they use FIFO to calculate redemption fees. The other 13 fund groups did not disclose anything about their choice of accounting method in prospectus filings. No fund group disclosed in prospectus filings the use of the LIFO accounting method. (CMFI did not review the Statement of Additional Information for any fund or fund group with respect to this issue.)

C. CMFI Recommendations

1. **Redemption Fees Are a Helpful Tool to Deter Market Timing**. Redemption fees, whether or not mandated, are an important weapon in the mutual fund industry's arsenal to combat excessive short-term trading. In order to provide uniformity within the industry, CMFI supports the SEC proposal to require a mandatory fee for redemptions within five days.

2. **Financial Intermediaries Should Disclose Omnibus Account Information to Funds**. As determined by this CMFI examination 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 some 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 sets of shareholders: (a) the "direct purchase" shareholders; and (b) the "omnibus account" shareholders. It is clear from this examination of prospectus filings that mutual funds cannot adequately monitor the activities of omnibus shareholders, or properly enforce fund policies and procedures with respect to these shareholders.

This issue is important because federal, state, and industry regulators have uncovered a number of abusive transactions involving omnibus accounts over the past eighteen months. These abuses include: (a) transactions occurring after the 4:00 PM market close (i.e., late trading); (b) activities involving excessive short-term trading and market timing; and (c) a failure to provide appropriate sales load discounts to customers (i.e., breakpoint discounts).

Many mutual funds use contractual commitments with fund intermediaries to enforce the rules of a particular fund. However, this approach is unworkable, a fact demonstrated by the substantial majority of the fund groups which have excluded or limited the application of their redemption fees and other market timing policies within omnibus accounts, as disclosed in the prospectus material filed by these fund groups with the SEC and noted above.

Since it is also not in the economic interest of these financial intermediaries to enforce mutual fund rules on their customers, CMFI believes that the best solution to this problem is a *requirement that financial intermediaries be required to 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 policies and procedures.

An additional benefit of this proposal is that a fund will also be able to use this information to validate the accuracy of: (1) sales loads, including breakpoint discount policies, (2) other commissions and fees, (3) contingent deferred sales charges (CDSC), and (4) dividend reinvestments.

CMFI's proposal is not an attempt to provide mutual funds with access to the customers of fund intermediaries. Non-public personal information shared with a fund by its intermediaries is protected by each intermediary's privacy policies and by current SEC regulations, ensuring that this information will be used for compliance purposes only and not for any marketing or customer relationship purpose.

A version of this proposal has been advanced by the SEC in its proposed mandatory redemption fee rule[2]. The SEC's proposal requires *weekly* disclosure of this information; the CMFI proposal advocates *same-day* disclosure of this information.

Same-day disclosure of omnibus account information also has been proposed in two pro-investor mutual fund reform bills, S. 2059 and H.R. 4505, introduced in the U.S. Congress by Senator Peter Fitzgerald (R-IL) and 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 mechanism for funds to monitor intermediary compliance with the mandatory redemption fee, 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

[2] Mandatory Redemption Fees for Redeemable Fund Securities, 69 Fed. Reg. 11762 (proposed March 11, 2004) (to be codified at 17 C.F.R. pt. 270).

these reasons, LIFO is a better accounting method for funds to use and should be the method required by the SEC.

D. 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 has demonstrated 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, *88% 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, *50% 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. Some 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. 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.

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 more information about CMFI and its activities, please visit the Coalition's Web site at www.investorscoalition.com.

Attachment

ATTACHMENT

TOP FIFTY (50) MUTUAL FUND GROUPS
(Ranked by Long-Term Assets and as of March 30, 2004)

Source: Financial Research Corporation, as reported in
Money Management Executive, May 10, 2004

Rank	Name of Fund Group	Web Address
1.	The Vanguard Group	www.vanguard.com
2.	Fidelity Investments	www.fidelity.com
3.	American Funds	www.americanfunds.com
4.	Franklin Templeton Investments	www.franklintempleton.com
5.	PIMCO Funds	www.pimcofunds.com
6.	Putnam Investments	www.putnam.com
7.	T. Rowe Price	www.troweprice.com
8.	Oppenheimer Funds	www.oppenheimerfunds.com
9.	Janus Capital Group	www.janus.com
10.	MFS Investment Management	www.mfs.com
11.	AIM Investments	www.aimfunds.com
12.	American Century Investments	www.americancentury.com
13.	Scudder Investments	www.scudder.com
14.	American Express Funds (AXP)	www.finance.americanexpress.com
15.	Van Kampen Investments	www.vankampen.com
16.	Dodge & Cox Funds	www.dodgeandcox.com
17.	Merrill Lynch Funds	www.ml.com

TOP FIFTY (50) MUTUAL FUND GROUPS (continued)

Rank	Name of Fund Group	Web Address
18.	Dreyfus Funds	www.dreyfus.com
19.	Smith Barney	www.smithbarney.com
20.	Alliance Fund Distributors	www.alliancecapital.com
21.	Columbia Funds	www.columbiafunds.com
22.	Evergreen Investments	www.evergreeninvestments.com
23.	One Group Investments	www.onegroup.com
24.	Federated Investors	www.federatedinvestors.com
25.	Lord Abbett Funds	www.lordabbett.com
26.	Morgan Stanley Funds (retail)	www.morganstanleyindividual.com
27	SEI Investments	www.seic.com
28.	Nations Funds	www.bankofamerica.com
29.	Davis Funds	www.davisfunds.com
30.	Prudential	www.prudential.com
31.	Dimensional Fund Advisors (DFA)	www.dfaus.com
32.	Eaton Vance	www.eatonvance.com
33.	Charles Schwab	www.schwab.com
34.	Pioneer Investments	www.pioneerfunds.com
35.	GMO	www.gmo.com
36.	Goldman Sachs Funds	www.gs.com
37.	Oakmark	www.oakmark.com
38.	Legg Mason	www.leggmason.com

TOP FIFTY (50) MUTUAL FUND GROUPS (continued)

Rank	Name of Fund Group	Web Address
39.	JP Morgan Funds	www.jpmorganfunds.com
40.	USAA	www.usaa.com
41.	Morgan Stanley (Institutional)	www.morganstanley.com
42.	First American Funds	www.firstamericanfunds.com
43.	Wells Fargo Funds	www.wellsfargo.com
44.	Waddell & Reed	www.waddell.com
45.	Strong Funds	www.strong-funds.com
46.	Frank Russell Company	www.russell.com
47.	The Hartford Mutual Funds	www.thehartford.com
48.	Artisan Funds	www.artisanfunds.com
49.	ING Funds	www.ingfunds.com
50.	Harbor Capital Advisors	www.harborfund.com