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## Ready, Set, Request Data: Funds' New Tool to Fight Timers

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By Beagan Wilcox

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As of today, funds can officially obtain underlying shareholder data from broker-dealers or retirement plan administrators that hold shares on behalf of other investors.

In the past, funds typically were not able to get this data from intermediaries. But today's deadline to comply with Securities and Exchange Commission Rule 22c-2, otherwise known as the redemption fee rule, means funds will have another way to fight excessive frequent trading that can rack up transaction costs, cause liquidity problems for portfolio managers and dilute value for other shareholders.

The challenge for funds is finding the right frequency for requesting data from the appropriate intermediaries. Directors and advisors seek to balance the substantial costs of analyzing and storing this trading data with the benefits to shareholders of detecting market timers.

Directors "have to look at the expense to shareholders and dilution of value with market timing," says Mike McVoy, chief compliance officer for US Bancorp Fund Services, which does Rule 22c-2 work for about 140 fund families.

Many funds are using a risk-based approach to decide which intermediaries to collect data from and how often to do so, according to a survey of mutual fund directors and executives commissioned by PFPC, which also provides Rule 22c-2 services to funds.

Four out of 10 directors surveyed say their funds "risk rank" the intermediaries that distribute their funds. (The survey, which was conducted in July, included 57 independent directors and 44 interested ones, along with 53 fund executives.)

"Those intermediaries that are assessed with higher risk rankings may see more trading restrictions imposed by fund companies," says Peter Rigopoulos, senior vice president at PFPC. "Likewise, higher risk rankings may increase fund company requests for shareholder data under the 22c-2 rule," he says.

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### Where Directors Stand on Implementing Rule 22c-2

- 43% of directors surveyed report that their funds risk rank intermediaries
- 65% of larger fund companies will risk rank
- 18% of smaller fund companies will risk rank intermediaries
- 78% of larger fund companies impose a short-term redemption fee on market timers
- 62% of smaller fund companies impose a short-term redemption fee on market timers
- 69% of directors say market timers will still time the market regardless of short-term redemption fees

Source: PFPC Mutual Fund Board Study

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Risk ranking may be spreading. More than 80% of the fund groups that participated in a recent Investment Company Institute survey regarding implementation of Rule 22c-2 said they are using

risk ranking to determine which intermediaries they'll collect data from. The ICI's survey included 35 fund companies with about \$3.7 trillion in assets under management.

At the top of the list of criteria for ranking an intermediary's risk is trading patterns, followed by the presence of regulatory issues or violations, the intermediary's holdings in the fund, and whether it's an omnibus account, according to the ICI survey.

Indeed, omnibus shareholder accounts have been a notoriously opaque area for funds. They are particularly prone to abusive frequent trading because they combine shareholders' or brokers' trades into one large order, thus obscuring individual trades.

In 2003, regulators discovered that hedge fund managers were being allowed to market-time mutual funds in exchange for parking "sticky" assets that increased the funds' assets under management and boosted advisory fees.

The redemption fee rule is a result of the improper-trading scandal that followed and aims to thwart timers. Under the multi-part rule, boards must evaluate annually whether funds should have redemption fees. With today's deadline, funds had to have "shareholder information agreements" in place with intermediaries stipulating that they would provide shareholder identity and transaction data upon request to the funds.

About 80% of the fund groups surveyed by the ICI say they will also evaluate the ratio of sales to redemptions in omnibus accounts to detect short-term trading; 52% say they will look at the correlation of market movement to omnibus account movement.

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**Top Criteria for Risk Ranking Intermediaries:**

- Trading patterns
- Regulatory violations or issues
- Intermediaries' holdings in fund
- Whether it's an omnibus account

Source: ICI Transfer Agent Advisory Committee Rule 22c-2 Survey

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Many of the fund groups (23) surveyed by the ICI say they will evaluate and review the risk status of intermediaries when short-term trading is detected through these other types of analysis. Eleven fund groups say they will review risk status annually and the rest will do it either on a semi-annual, quarterly or monthly basis.

Funds that request data from intermediaries will now be able to see for themselves whether the intermediaries are enforcing their own frequent trading policies, says US Bancorp's McVoy. It's in everyone's best interests to cooperate with each other in this work and it's unlikely funds would get to the point of ending a relationship with an intermediary because it's not following policies, he says.

At least one critic of the redemption fee rule questions its effectiveness in really stopping timers precisely because of the nature of the information-sharing agreements between funds and intermediaries. Niels Holch, founder of the Coalition of Mutual Fund Investors, says looking at transaction data after the fact is not enough and that funds should be analyzing this information on a daily basis.

"These market timers are really smart," Holch says. "They're in and out before anyone's going to catch them. We need to be doing this on an ongoing basis so that regulators or compliance folks can act in a timely way."

Some funds that are susceptible to market timing, such as international and emerging-markets funds, are in fact looking at omnibus transaction data every day, says Diana McCarthy, partner at Drinker Biddle & Reath.

About 23% of the groups surveyed by the ICI (eight out of 35) say they are requesting data from broker-dealers with omnibus accounts every day. The majority, about 63% of those surveyed, say they are asking for the data "on request." However, it's unclear from the survey who at the fund group would initiate this request.

But others say the cost of daily analysis could outweigh the benefits. Funds have to "walk a fine line between protecting shareholders and not eating into their profits at the same time," says Rick Niedt, product line manager for compliance solutions at Access Data, which obtains and analyzes this data from intermediaries for 20 fund groups.

Funds that charge short-term redemption fees typically do not disclose the frequency with which they request and analyze this data, says Holch, who studied disclosure of the top 50 fund groups regarding redemption fees and omnibus accounts earlier this year. Nearly all of those groups stated they can't enforce market-timing restrictions in omnibus accounts.

In the study, Holch cites a JPMorgan fund filing that states: "The Funds have attempted to put safeguards in place to assure that Financial Intermediaries have implemented procedures designed to deter market timing and abusive trading. Despite these safeguards, there is no assurance that the Funds will be able to effectively identify and eliminate market timing and abusive trading in the Funds particularly with respect to omnibus accounts."

It's unclear whether compliance with Rule 22c-2 will change the current situation when it comes to enforcing redemption fee policies.

In any case, most directors and fund executives note that data sharing with intermediaries is not the only way to fight timers. They say it's only one arrow in their quiver along with tighter fair valuation processes, which funds are also using to diminish timers' returns

In fact, about 70% of the directors surveyed in PFPC's survey say market timers will still persist despite the redemption fees imposed on these trades.

"People will still be trying this," says Timothy O'Sullivan, director in Deloitte & Touche's regulatory and capital markets consulting practice, referring to market timing. "What I've seen and heard from clients is they've seen the issue diminish, not go away."

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