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October 16, 2007

# Small Investors Face A New Fund Hazard

## SEC Rule Meant to Discourage Market-Timing Yields Fees and Lockouts For 401(k) Savers; the Risks of Rebalancing

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*October 16, 2007; Page D1*



Many buy-and-hold mutual-fund investors are being hit with extra fees and trading restrictions because of a new rule meant to deter rapid trading of fund shares.

The Securities and Exchange Commission rule, which takes effect today, requires brokerage firms, retirement-plan administrators and other intermediaries who hold fund shares on behalf of individual investors to share those individuals' trading data with mutual-fund companies upon request.

**MARKET-TIMING FALLOUT**

*Regulatory changes are bringing more trading restrictions to many mutual-fund investors. Here's what's happening:*

- A new rule helps funds enforce trading restrictions in 401(k) plans and brokerage accounts.
- Investors who violate a fund's trading restrictions may pay extra fees or be blocked from investing in the fund.
- Certain transactions, such as a 401(k) hardship withdrawal, may be exempt from trading restrictions.

The rule is meant to help funds monitor short-term trading and deter "market timers," who trade quickly in and out of funds for quick profits. These investors' activity can be costly to longer-term investors because it can raise a fund's transaction costs and trigger heftier tax bills for fund holders.

But some of the intermediary firms that have already started giving the trade data to fund firms in advance of today's deadline say the rule is having adverse effects on regular investors who aren't market-timers. Many fund firms have been quick to request trading data, and a growing number of individuals making routine trades, such as quarterly rebalancing of their 401 (k) accounts, are being slapped with redemption fees as high as 2% or even blocked from trading certain funds, these firms say.

The issue could affect millions of small investors who hold mutual funds in their brokerage and retirement accounts and have no intention of market-timing. In order to protect themselves, they should take a closer look at their funds' trading restrictions.

While redemption fees and trading restrictions aren't new, some investors have been able to avoid these penalties if they hold funds through an "omnibus" account such as a 401(k) plan, which can make it tough for fund companies to detect who's trading and how often. The new rule, which was issued by the SEC in early 2005 after the effects of widespread market-timing became wellknown, helps fund companies to peek inside these omnibus accounts and enforce their short-term trading restrictions.

Much of the impact so far has been seen in retirement plans, where investors don't always control when and where their money is moved. Steven Kaye, an investment adviser in Watchung, N.J., works with one 401(k) plan that recently moved to a new recordkeeper, the Online 401(k), which this year began sharing individual participants' trade data with fund companies and imposing the funds' redemption fees on participants. Participants' assets were automatically moved into new funds whose investment objectives are similar to those of the funds they'd held with the previous recordkeeper.

One 47-year-old participant in the plan had a portion of his account automatically switched into the Artisan International Fund. But one week later, he decided to adjust his allocation and moved more than $24,000 from the Artisan fund into a real-estate fund. The participant, who has made only three other trades this year, is hardly a market-timer, Mr. Kaye says. But his move cost him nearly $500 because the Artisan fund charges a 2% redemption fee on shares held less than 90 days.

The participant "felt the system was gamed against him and initially was very resentful," Mr. Kaye says.

**Rebalancing Act**

In some cases, retirement-plan participants making regular rebalancing trades -- a practice advocated by many financial advisers -- have been flagged by fund companies as potential abusive traders. In plans provided by ePlan Services Inc., a 401(k) administrator and recordkeeper based in Denver, two participants making regular rebalancing trades were singled out by fund companies for potential trading abuses in the past 90 days, says Mark Gutrich, ePlan's president and chief executive. The firm spent hours researching their trades and calling the participants and ultimately convinced the fund companies that the trades weren't abusive, Mr. Gutrich says.

Fund companies seeking to curtail frequent trading may simply block active traders from their funds. DailyAccess Corp., a 401(k) administrator and recordkeeper based in Mobile, Ala., started sharing individual trade data with fund companies about a year ago. Its participants have paid hundreds of redemption fees in recent months, though most are relatively small. Early this year, several participants who didn't have a history of frequent trading were blocked from investing in **Bank of America** Corp.'s Columbia funds after they violated the firm's trading restrictions.

Retirement-plan participants generally don't make a lot of trades. But such trading activity is picking up for many investors as plans add "managed accounts," in which participants turn over management of their 401(k) to financial professionals, and programs that automatically rebalance participants' accounts on a regular basis, often every quarter. More than 40% of plans now offer automatic rebalancing,

### What to Watch Out For

Investors who hold a handful of mutual funds may be subject to a hodge-podge of trading restrictions. Here are some key trading policies to look for in fund prospectuses and retirement-plan literature.

| Trading policy | How it works | Example |
|---|---|---|
| **Redemption fee** | Amounts to as much as 2% of the amount redeemed and may penalize investors who hold fund shares for only a few days—or a few years. | Vanguard Developed Markets Index Fund charges a 2% redemption fee on shares held less than two months. |
| **Trading blocks** | Some funds may block future investments from investors who make a certain number of trades | An investor who redeems shares worth $5,000 or more from American Funds' stock or bond funds generally will |

up from 26% two years ago,
according to consulting firm Hewitt Associates.

Such programs "may trigger some penalties, and that's not what was intended because we do want participants to rebalance, and we're creating systems" to do that for them, says Fred Barstein, chief executive of 401kExchange Inc. a Greenacres, Fla., 401(k) service provider. "We're penalizing people for doing the right thing."

Investors don't have to make any trades at all to feel the impact of funds' new scrutiny of omnibus account trades. Hotchkis & Wiley Mid-Cap Value Fund recently threatened to pull out of a physicians' group's 401(k) plan because two of the 800 participants were making rapid trades in and out of the fund, says Mr. Kaye, the investment adviser. After Mr. Kaye sent the two rapid traders a letter saying that they may face trading restrictions or be allowed to trade only by written request rather than online or over the phone, the participants agreed to stop the active trading, he says.

Investors can find information on a fund's short-term trading policies, including redemption fees and potential trading blocks imposed on frequent traders, in the prospectus. Such policies can vary widely from fund to fund, even within a single fund firm. The Vanguard Developed Markets Index Fund, for example, charges a 2% redemption fee on shares held less than two months, while Vanguard Tax-Managed Balanced, Vanguard Tax-Managed Capital Appreciation and other Vanguard tax-managed funds charge a 1% redemption fee on shares held less than five years. More than 60% of the 50 largest fund groups charge redemption fees, according to a recent survey by the Coalition of Mutual Fund Investors, a shareholder advocacy group.

Policies on blocking trades also vary widely from fund to fund. Capital Research and Management Co.'s American Funds -- including Growth Fund of America and EuroPacific Growth -- typically have a "purchase blocking policy" whereby investors who redeem shares worth $5,000 or more can't invest in the fund within the next 30 days. Other fund companies, such as Guinness Atkinson Asset Management, say they implement such trading blocks on a case-by-case basis.

Some retirement-plan providers and fund companies have exempted certain plan transactions, including loans and hardship withdrawals, from trading restrictions -- but such exceptions aren't universal. In 401(k) plans provided by Merrill Lynch & Co., for example, regular automatic rebalancing doesn't trigger a redemption fee. In plans provided by Vanguard Group, however, automatic rebalancing can trigger a redemption fee, though hardship withdrawals aren't subject to those fees.

**Watching for Warnings**

Investors should take a close look at their retirement-plan literature to learn where trading restrictions apply and watch for any trading-penalty warnings as they make transactions. A number of large plan providers, such as Merrill, warn investors when they're about to make a trade that could trigger a redemption fee, but smaller providers don't always offer such warnings.

Some shareholder advocates and industry executives question the rule's ability to deter market-timers. If a rapid trader can make 5% on a quick trade, "is the 2% [redemption fee] going to deter me from wanting to profit from it?" asks Chad Parks, president and CEO of the Online 401(k), based in San Francisco. And since funds have to request the individual trade data from intermediaries, rather than receiving, say, a daily report on all shareholders' trades, they may miss much of the abusive trading activity occurring in omnibus accounts, says Niels Holch, executive director of the Coalition of Mutual Fund Investors.

Another downside: As retirement plan participants see more trading restrictions, they may also pay higher plan fees, some experts say. In complying with the rule, "a lot of money has been spent, which is going to be charged to plan participants," says David Wray, president of the Profit Sharing/401(k) Council of America. The Online 401(k) has already charged employers a one-time fee to help cover the costs of complying with the rule. And if fund companies continue to request trade data at the rate they have in recent months, "we definitely have to increase our pricing," says ePlan Services' Mr. Gutrich.

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