

# **SAAFTI Position Paper on the Mutual Fund Scandals of 2003**

The mutual fund scandals that have erupted on Wall Street in 2003 involve three types of activities:

- 1) After closing trading,
- 2) international arbitrage taking advantage of stale pricing caused by time zone differences, and
- 3) funds that claimed to be concerned with excessive trading in their prospectuses but allowed big investors or fund associates, and, in some cases, fund employees, to engage in trading levels denied to other investors.

The first is illegal and can only be accomplished by nefarious means. The second is legal for the practitioners but calls into question the funds' adherence to the Investment Company Act's requirement that they provide "fair pricing." The third arises out of sloppy or fraudulent fund governance.

While such review makes it clear that these are mutual fund management problems, they have, instead, been termed "market timing" problems.

All traders and most investors time the market – they buy and they sell over time. The term itself is so broad as to lack any meaning. It has been used, however, throughout this scandal to refer to the practice known as international arbitrage. In contrast, within the financial service industry, market timing has instead typically been used to describe any investor or manager who actively directs his or her investments, rather than following a buy and hold approach.

This paper addresses the following points:

## **Who is SAAFTI?**

Traditional Use of Market Timing.  
Active Management is in the Investors' Interest.  
The Need to Manage Investment Risk.  
SAAFTI's Fair Practices Policy.

## **Failure of Proposed Solutions to Resolve the Mutual fund Scandals**

### **Inappropriateness of Mandatory and Unlimited Redemption Fees**

Legislative Background.  
Trading Costs Are Overestimated.

### **Imposition Of A Mandatory 2% Redemption Fee Is Punitive, Not Compensatory.**

Excessive Holding Periods Unrelated to Issues.  
Need to Deal with Stale Prices.

## Redemption Fees Are Most Harmful To Small Investors.

### **Finding Equitable Solutions**

More Study Is Needed.

Mandatory Disclosure of "Adverse Market Timing" Rules.

A Hard 4:00 Close Is Not the Answer.

Need for Better Mutual Fund Governance.

## **Who is SAAFTI?**

SAAFTI is a national industry trade group formed in 1989 that represents registered investment advisor practitioners who use active investment management techniques to manage the assets of more than 100,000 individual investors invested primarily in mutual funds. The membership includes more than 170 registered investment advisory firms managing in excess of \$15 billion. While the investment strategies used by each firm differ, they tend to fall under the broad classifications of tactical and strategic asset allocation, sector rotation and market timing in its traditional meaning.

The clients of SAAFTI members tend to be small investors. Nearly 50% are retirees and depend upon their advisors to control risk and assure a reasonable return on their investments. The average minimum balance required by a SAAFTI member is \$25,000.

SAAFTI has been a strong and consistent supporter of the cause of greater transparency, accountability and governance of the fund industry (including the original version of HR 2420). Yet, a handful of other proposals being advanced would "throw the baby out with the bath water" in trying to quell the justifiable outrage over the acts committed, not by SAAFTI members or their thousands of clients, but by members of the fund industry itself.

## **Traditional Use of Market Timing**

Traditionally, market timing has involved following trends in the financial markets and increasing or decreasing allocations to market segments in response to long-term trends. One of the first formal market timing systems was developed by *Wall Street Journal* editor Edward D. Jones. Based on investment theories espoused by Charles Dow, the first editor of the *Wall Street Journal* in the 1890s, Dow Theory offers trading guidelines for moving in and out of the equity markets. These guidelines are designed to take advantage of up trends and to avoid declining markets.

Dow Theory specifies that closing prices should only be used because closing prices reflect the price level at which informed investors are willing to carry positions overnight. Mutual funds have traditionally adhered to this guideline, pricing shares as of the close of the market.

Contemporary market timing owes much of its use to the experience of investors during the 1973-1974 market collapse. The founding members of SAAFTI, the premier association for active money managers, were veterans of this period in the market. Several worked in the brokerage industry; others were managing personal accounts. But they all came away from the experience with the belief that there had to be a better way to manage money that did not leave investors vulnerable to bear markets.

This generation of market timers, however, had a tremendous advantage over prior active managers – computers and electronic databases. Now multiple decision parameters could be overlapped and data analyzed daily. Risk management concepts developed in engineering and manufacturing fields could be applied and non-emotional systems based on mathematical relationships developed.

At its most basic level, active investment management is risk management. An active manager strives to reduce the risk of loss from down markets by developing probability based computer models to determine market direction.

### **Active Management is in the Investors' Interest**

Unlike hedge funds and professionally managed institutional portfolios, active investment management strategies are available to the general public. Through organizations such as SAAFTI, small investors have access to managers who help them preserve their portfolios in market downturns. Numerous publications are also available that offer investors guidance in dynamically positioning their investment portfolio to take advantage of cycles in the market and minimize bear market losses.

Opponents of market timing argue that studies have proven market timing doesn't work. But new academic studies are showing very different results.<sup>1</sup> These studies state that there is clear evidence of ability in the managers' results.

### **The Need to Manage Investment Risk**

To assume that investing in mutual funds places an individual investor on a level playing field with professional investors is simply wrong. Mutual funds can be good tools for investors, but they should not be entered into blindly as a buy-and-hold-forever investment.

The performance of a mutual fund is directly tied to the performance of the overall market. The larger a fund is, the more its performance will mirror that of the greater market. Mutual funds are not designed to protect investors' assets in down markets. Indeed, the charters of many funds require that a specified percentage of assets under management be invested in a specific asset class regardless of whether or not that asset class is suffering losses.

While mutual funds may minimize individual security risk, investors are still exposed to market risk and fund manager risk.

Mutual fund managers are typically compensated based on both performance (vs. a benchmark) and assets under management. A fund manager is successful if he or she loses less money than the index against which he is being measured. They have no incentive to tell investors to sell, even when they see little but red ink ahead. Because compensation

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<sup>1</sup> **The Performance Of Professional Market Timers: Daily Evidence From Executed Strategies**, Don M. Chance *Department of Finance, Virginia Tech, Blacksburg, VA* and Michael L. Hemler *Department of Finance and Business Economics, University of Notre Dame, Notre Dame*, Original version, February 1996, Published in *Journal of Financial Economics*, November 2001.

**Behavior and Performance of Investment Newsletter Analysts**, Alok Kumar, *Cornell University Department of Economics* and Vicente Pons, *Yale University, School of Management*, November 2002.

arrangements are confidential, investors have no way of knowing how a manager is compensated and whether this compensation structure creates a conflict of interest.

### **SAAF TI's Fair Practices Policy**

Most investment advisors who use active management strategies operate their businesses in a responsible manner. Member firms in SAAFTI must adhere to and operate by a code of ethics with respect to mutual fund companies. The SAAFTI Fair Practices Policy, unanimously adopted at the association's 1997 annual meeting is as follows:

*In the interest of developing and maintaining cooperative relationships with the mutual funds with which our members do business, the Society of Asset Allocators and Fund Timers, Inc. (SAAF TI) has developed the following standards to guide its members in working with mutual fund families.*

1. *SAAF TI members shall deal openly and fairly with the mutual fund family:*
  - a. *Members will comply with fund family policies, as understood by the member after reasonable inquiry of fund personnel with apparent authority to speak for the fund, regarding amounts to be invested per mutual fund and the reporting of lists of clients.*
  - b. *Before establishing or when assuming power of attorney over accounts within a fund family, members shall make every effort to contact fund personnel with apparent authority to speak for the fund to ensure that the advisor is complying with the asset guidelines of the fund and to offer to provide background information and explanations of the member's management style, including past trading practices.*
  - c. *Members shall make every attempt to keep open channels of communication with the fund.*
2. *A member shall not control the movement of more than five percent of a fund without prior negotiation or approval from fund personnel with apparent authority to speak for the fund.*
  - a. *If, due to withdrawals beyond the SAAFTI member's control, assets suddenly exceed fund limits, the advisor shall, as soon as possible, contact the fund regarding proper steps to be taken.*
3. *When working directly with a fund family, SAAFTI members will make every attempt to use other funds within the family when re-allocating or moving assets.*
4. *If requested, whenever possible, SAAFTI members will provide the mutual fund with advance notice of portfolio changes.*
  - a. *If a member anticipates an upcoming move in the near future because of past experience with his/her asset management model, the member will notify the fund of the possibility of the move.*
  - b. *If circumstances permit, the member will provide the fund administrator with as much advance notice as is possible/practical.*
5. *When modifications in an advisory firm's investment management practices alter the frequency or magnitude of portfolio changes, the member will inform the mutual fund companies of the change in investment approach in advance of its implementation.*
6. *Any apparent violation of this Fair Practices Policy shall be reported to SAAFTI according to the procedures specified in Article III, Section 7 of the SAAFTI Bylaws.*

## Failure of Proposed Solutions to Resolve the Mutual fund Scandals

Small investors, including the multitude of individuals who rely on 401k's for their retirement, are being put at risk by misguided proposals to reform the mutual fund industry.

- The so-called reforms being pushed hardest by the fund industry would:
  - unfairly saddle small investors with extra costs;
  - give professional investors a big advantage over small investors;
  - and unfairly reward the very funds that supposedly are being reformed.
- As the Wall Street Journal has editorialized, some reforms being considered "would punish the innocent along with the guilty." The newspaper wisely counseled "let's hope the political class takes more time and care in thinking about all of this than it did after the accounting scandals of 2002."
- The two most egregious reform proposals are being pushed by the funds themselves, and they are the entities that will benefit most from changes that are supposedly meant to protect investors.
- Rather than racing to see who can fix the broken parts of the fund industry the fastest, regulators and legislators need to step back and make sure reforms are focused on what best serves the people who have been hurt the most – individual investors who were taken for a ride.

## Inappropriateness of Mandatory and Unlimited Redemption Fees

Legislative Background. The legislative background on redemption fees was precisely summarized in the SEC's 2001, Fidelity Korea Fund No-Action Opinion Letter:

During the legislative hearings on the Act (Investment Company Act), the Commission characterized the right of mutual fund shareholders to receive the net asset value of their shares upon redemption as "the most important single attribute which induces purchases of the securities of open-end companies."<sup>29</sup> The Commission further stated that "the importance of the redemption feature of open-end securities appears to the Commission beyond question."<sup>30</sup>

Congress incorporated the Commission's views into the Act by requiring that the securities of an open-end investment company be "redeemable,"<sup>31</sup> which in turn requires that fund shareholders receive approximately their proportionate share of the issuer's current net assets, or its equivalent in cash, upon redemption.<sup>32</sup> The effect of these requirements, as the Commission has recognized, is that:

The imposition of any charge or fee upon the redemption of fund shares raises serious questions. ...***A fee payable upon redemption may take the securities issued by the fund outside the definition of a "redeemable security".***<sup>33</sup>

Because the imposition of a redemption fee by an open-end fund raises serious questions about the redeemability of the fund's shares, the Commission has adopted rules that permit funds to impose only limited redemption fees, and the staff has taken no-action positions consistent with those rules.<sup>1</sup>

The mutual fund industry, in support of its attempt to avoid SEC oversight of its redemption fee setting process, suggested on October 30, 2003, after a hastily convened, closed-door conference call "task force," a departure from the policy developed from over sixty years of practical experience.<sup>2</sup>

While the present scandal involves international arbitrage using day trading to take advantage of stale pricing, the fund industry seeks to make mandatory redemptions applicable throughout the industry, in an amount and after a holding period solely to be determined by the very industry mired in these same scandals. Yet, no study has yet concluded what the true costs of such trading activity are, or even attempted to define what is "adverse market timing."

Trading Costs Are Overestimated. Determining the real costs of trading activity in fund shares requires a review of a number of factors, including, without limitation:

- 1) The net redemptions occurring on the date of the trading activity. On many days with trading activity, there are more incoming dollars than redemptions, yielding no redemption costs, even though fund share trading has occurred.
- 2) The cash position of the fund on the date of the trading activity. Even if there is net redemption activity on a trading day, essentially no trading costs are incurred if the net redemptions are less than the cash or money market portion of the fund's portfolio.
- 3) If a fund has insufficient cash or needs to restore its level of liquidity necessitating the raising of cash to meet redemptions, at least three additional factors must be considered in assessing the cost to the fund:
  - a. The availability of short-term lines of credit to the fund and the cost of borrowing (hence, the cost is variable and dependant on the level of interest rates at the time of the redemption). In many cases, the costs of short-term borrowing will be significantly less than commissions and/or slippage. For example, at 6% interest rates, the daily cost of borrowing is less than one sixth of a basis point (.0016%) per day;
  - b. Trading commissions – while these may be known at the time that a redemption fee is instituted, commissions have come under enormous downward price pressure. A redemption fee established when trading commissions ran three cents a share is seriously overpriced when commissions have fallen to less than a penny a share. In addition, if the average share trades at \$50, a penny per share trading cost amounts to 0.02%. Even a \$10 per share security would only generate a 0.1% charge. These are a far cry from the 2% or higher fees sought by the fund industry.
  - c. Market slippage – similarly, the trading considerations affecting the amount of slippage experienced by trading activity is not a constant. Rather, as markets develop, liquidity increases, spreads narrow, and derivative and hedging opportunities increase. The estimated slippage underlying a redemption fee justification at inception may be out of date and not reflective of real costs in a rather short period of time.
- 4) Administrative costs – The costs of processing trades on the fund companies' books obviously occur regardless of who makes the trades. Equally obvious, increased frequency of trades adds costs of processing. However, it is noteworthy that the source of the trades also affects the cost of the processing. Individual trades are smaller and more numerous, requiring more processing time, costs and manual intervention. In contrast, trades arriving from financial intermediaries (brokerage and trust platforms, third-party administrators and advisors) often arrive electronically in a format designed to match the funds' internal systems or are instituted with batch instructions on internally generated lists where duplicate

instructions are applied to all accounts submitted. In other words, the costs are lower to process the large intermediary orders than the small individual orders.

- 5) Dilution Costs – Academicians have speculated that redemption activity may dilute a fund's returns for its remaining shareholders due either to the need for increased liquid assets or the incurring of costs of redemption in the settlement period after the trade date. Professors Greene and Hodges found in their exhaustive study published in 2002 in the Journal of Financial Economics that such dilution was measurable and substantial in international funds, while for domestic stock, growth and bond funds "the average and median dilution impact from fund flows is essentially zero..." (In fact, they found that in more than half of the fund cases studied the impact in these domestic funds of fund inflows and outflows on passive shareholders was positive!)<sup>3</sup>

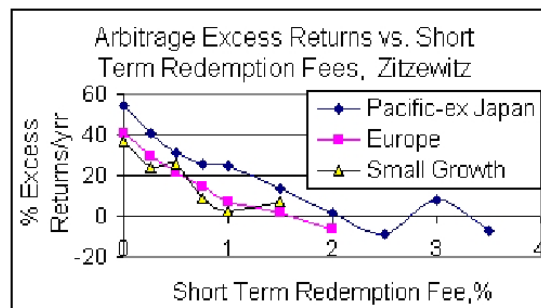
### Imposition Of A Mandatory 2% Redemption Fee Is Punitive, Not Compensatory.

Although no one has determined any dilution cost to passive shareholders in domestic stock and bond funds, we can demonstrate the extent of the punitive nature of the imposition of a 2% redemption fee on fund traders by looking at the most egregious case of dilution: international funds. Greene, et al estimate that the dilution cost to passive investors in international funds was \$420 million during their 26-month period study. But if the trading activity used to generate that number were assessed a 2% redemption fee, the fees would have totaled \$6.9 billion! Since the Greene, et al study was of a 20% sample of the mutual fund industry; one could extrapolate the redemption fees to a \$34.7 billion cost versus a dilution effect of just \$2.1 billion. The punishment does not fit the crime (see spreadsheet attached).

If one uses the data from the Greene, et al study to measure the impact of redemption fees outside of the international fund arena (at just the 2% maximum, not the 4% or 5% levels being suggested by some), the true nature of the mandatory redemption fee as a punitive tax becomes apparent. Although the study demonstrated 1) that there was no dilution effect on domestic stock and bond fund shareholders, and 2) to the extent that there was any fund flow impact on passive shareholders of such funds it was mostly positive, the costs that would be imposed by a redemption fee on this portion of the industry would be substantial. For every 1% of fund flow from non-traders who inadvertently incur the redemption fee, the cost to the redeeming shareholders would total over \$845 million per year. That's the case even if international arbitrage disappears from the international fund arena. If just 10% of the investor trades are affected, then the cost climbs to \$8.4 billion per year.

To make matters worse, while these figures are calculated using a 2% redemption fee, the fund industry wants the right to impose redemption fees **in excess of 2%**. And they make no mention of the fees charged being tied to actual fund costs occasioned by the redemption. This is in stark contrast with the present rules that link the imposition of the fees to the costs arising from the trading activity.

Dr. Gary J. Harloff, a member of SAAFTI, created the following graph using the data from Table 6 of Dr. Zitzewitz October 2002 paper. This graph makes it clear that there is no need to raise the 2% cap on redemption fees since the deterrent effect occurs well before the present 2% cap.



Under guidelines set forth in recent SEC no action opinion letters, an open-end fund generally may not impose a redemption fee unless it is (a) paid directly to the fund, and (b) no greater than the **lesser of**: (i) an amount approximating, or reasonably related to, the anticipated, specific Administrative Costs; or (ii) 2% of the net asset value of the redeemed shares. Administrative costs are defined as (a) brokerage expenses incurred in connection with the liquidation of portfolio securities necessitated by the redemption; (b) processing or other transaction costs incident to the redemption and not covered by any administrative fee; (c) odd-lot premiums; (d) transfer taxes; (e) administration fees; (f) custodian fees; and (g) registrar and transfer-agent fees.<sup>4</sup>

Today, in order to charge a redemption fee, the Board of Directors of the fund company must make a finding that, among other things, the fee a) was necessary to discourage short-term trading, b) compensates the fund for the high costs and other adverse effects of that trading, c) protects the interests of non-redeeming shareholders and the viability of the fund, d) was reasonably related to the Portfolio/Administrative Costs expected to be incurred by the fund from the anticipated redemptions and exchanges, and e) arises from a required holding period that is limited and reflects the directors' estimate of the time during which short-term trading redemptions or exchanges were most likely to occur.<sup>5</sup>

Why would regulators and shareholders and their representatives wish to abandon the current considered approach? Why would they wish to impose an arbitrary rule over one that requires separate findings of fact as to the true adverse costs that are being experienced before taking away a portion of an investor's savings? Why would regulators who are supposed to be looking out for individual investors, long term and short term alike, be willing to cede third party oversight, and hand the mutual fund industry a blank check for future redemption fees to be charged against those very investors?

And it is a blank check with lots of zero's. While the industry pretends that the fees will only go to the fund shareholders, in fact, the fund industry stands to benefit handsomely. First, fund performance will be enhanced by including the amount of the redemption fees they collect, which is unrelated to the job their managers do in managing the investment. Second, while the fees go into the funds, they also increase assets under management for fee purposes. If we assume an average 1% management fee, based on the Greene data, every 1% of fund flow that generates a redemption fee will produce over \$8 million in unearned profits for the fund industry every year. These are supplemental management fees from investors, and don't include the additional fees that will be generated from the returns on the redemption fees collected (the compounding effect). Again, this is calculated at a 2% redemption fee. At 4% the fund industry profits would be doubled. And if fund flows are 10% instead of 1%, the industry stands to profit by \$160 million!

### **Excessive Holding Periods Unrelated to Issues**

The mutual fund industry suggests that it be allowed to impose an unlimited redemption fee of 2% or higher and that the imposition be occasioned by a failure to hold the fund shares for a period of time equal to a "minimum of five days."<sup>6</sup> In other words, they seek the ability to set any holding period that they want beyond five days. This makes a mockery of any claim of redeemability, and contradicts the original, central tenant underlying the creation of the open-end fund industry.

What generated this suggestion? The industry claims that it is the current market timing scandal. Yet for purposes of this scandal, market timing has been defined as frequent trading

to take advantage of stale prices caused by time zone differences (international arbitrage). Those differences are erased by the passage of time within a 24-hour period. Why does the industry need more than five days to correct this day trading problem?

The cost shifting of frequent trading from active to passive investors is also a short-term issue. The problem occurs when an investor buys and sells within the settlement period for the fund. The costs of the purchase and sale can sometimes be avoided if the investor is out before the trade settles and before that investor's trade costs are fully reflected in the fund's NAV. Since the settlement period for mutual funds varies from only one to three days, it is difficult to see why a three-day maximum rather than a five-day minimum holding period would not be sufficient to address the issues that surfaced with the scandal.

The mutual fund industry supports its call for mandatory redemption fees by stating that "A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (e.g., a broker-dealer or a retirement plan record keeper.)"<sup>7</sup> This argument fails for a number of reasons: 1) settlement occurs within three days regardless of whether or not an intermediary is involved; 2) most SAAFTI firms trade primarily through intermediaries and the funds seem to have no problem identifying their trades, as they are routinely contacted by fund managers to discern the advisors' intentions on the same day that they place their trade; and 3) the Canary Capital trades, it is alleged, occurred because a deliberate attempt was made to hide the transactions among the unrelated trades of 401(k) participants submitted at the same time. Given the intent to hide the trades, it's difficult to see how having a mandatory redemption fee period of whatever duration would have helped uncover them.

### **Need to Deal with Stale Prices**

Witness after witness at the recent Congressional hearings pointed out that the "market timing" issue at the heart of the scandals was based on stale pricing of international securities in U.S. mutual funds. For years, the academicians, SEC and ICI have all counseled the fund industry to do something about the problem. The SEC has been vigilant in providing guidelines on fair value pricing. In addition, last year the SEC blessed another approach in a no action letter – delayed exchanges of fund shares.<sup>8</sup> Despite the availability of these weapons, the fund industry has largely failed to implement them. Instead, they return to mandatory, unrestricted redemption fees, unrelated to the costs of trading, as their primary solution to the problem.

Professor Eric W. Zitzewitz, whose study of the stale pricing issue is said to have led Attorney General Spitzer into the present fray, testified that short-term trading fees or restrictions were not the best solution:

"I should emphasize that short-term trading fees or restrictions are not a substitute for fair value pricing. The greatest danger I see in the current debate is that this will not be recognized. Fees have not been fully effective historically... Even a complete ban on selling within 90 days would only reduce arbitrage excess returns to 5 percent per year: These excess returns are still attractive to hedge funds. And my guess is that average investors would not appreciate such a ban. Fees may be a good idea, but they are no substitute for eliminating stale prices.

"A related danger I see in the current debate is that the SEC might allow funds to use solutions that allow them to deny arbitrage opportunities to

some investors, but allow them to others. Fair value pricing removes arbitrage opportunities for all investors. Other solutions, such as short-term trading fees, monitoring by the fund company, and allowing funds the option to either delay exchanges or retain gains from short-term trades, can be applied or not applied as funds see fit. This limitation of many of the currently popular "solutions" has clearly contributed to the scandal."<sup>9</sup>

Similarly, Professor Mercer E. Bullard, president of the non-profit, investor watchdog group, Fund Democracy, states:

"Canary Capital and the Putnam managers sued by the Massachusetts Attorney General did not allegedly profit by driving up the costs of funds for other investors. Their profits were made by exploiting funds' stale prices. A redemption fee does not solve this problem ..."<sup>9</sup>

The focus of remedial action in the wake of the mutual fund scandals, then, should be on insuring that funds have the best, fair pricing possible. If this cannot be done on a particular fund, then delayed pricing should be considered. For single country or regional funds, delaying pricing on new orders until the markets in those countries reopen solves the problem.

### **Redemption Fees Are Most Harmful To Small Investors**

By saddling new fees on investors who want the flexibility to reclaim their own money, funds are penalizing people for practicing risk management with their life savings. As soon as investors are told they will be paying a minimum 2% tax for moving their money, their inclination will be to avoid the tax, even if it means experiencing an entirely avoidable loss in the fund's value.

Redemption fees not only modify and reduce the effectiveness of risk management strategies employed by professional money managers, but they also impact the numerous small investor clients that rely upon them. While the manager can employ strategies that avoid the holding period redemption fees for most of its clients, individual clients starting or leaving the advisor's management are penalized through no fault of their own.

Worst of all, the minimum 2% fee makes it harder for people to get their money back for unforeseen emergencies. Small investors are precisely the group most likely to have to draw on their investments for such emergencies regardless of whether or not they just invested. As the Wall Street Journal editorialized, "some of the early 'reforms' now being talked about in Congress and the SEC would punish the innocent along with the guilty. Charging fees for quick fund trades, for example, could hurt honest folk who have a sudden need for their cash."

### **Finding Equitable Solutions**

More Study Is Needed. SAAFTI believes that before the SEC adopts a mandatory redemption fee, it should conduct a study of the success of present redemption fees in dealing with any perceived cost shifting from active to passive investors. Have they reduced turnover? What percent of shareholders do they impact? How much fees have been raised? Do the fees collected reflect, fall short, or exceed the cost of the redemption?

In addition, the SEC should: 1) Require reporting of daily trading costs and daily redemption activity so that unbiased third parties can assess the costs of fund flow activity. 2) Audit funds that have adopted redemption fees to determine if the representations made in their request for no action letters were backed up by the requisite findings required by the opinion letter. 3) Look also to whether the facts relied upon at the time of the opinion letter remain current – reflecting present day commission and market liquidity levels.

Without performing this investigation first, one can imagine that the next mutual fund scandal will be discovered in a class action lawsuit against, or Attorney General inquiry into, mutual funds imposing redemption fees that were not based on the requisite or represented findings. Think of the possible damages.

Mandatory Disclosure of “Adverse Market Timing” Rules. For decades the mutual fund industry has hidden behind ambiguous language in its prospectuses as to what it considers excessive trading or adverse market timing. The typical prospectus states:

“We discourage market timing or other abusive trading practices, and we take steps to minimize the effect of these activities in our funds. Excessive, short-term (market timing) or other abusive trading practices may disrupt portfolio management strategies and harm fund performance. To minimize harm to the funds and their shareholders, we reserve the right to reject any purchase order (including exchanges) from any investor we believe has a history of abusive trading or whose trading, in our judgment, has been or may be disruptive to the funds.” (American Century Prospectus)

This gives no guidance whatsoever to investors as to what level of trading activity is permitted. What is “market timing,” “abusive trading practices,” or “trading...that may be disruptive”? And what exactly is trading that “may disrupt portfolio management strategies and harm fund performance”? No one knows. Nor can one know until the fund decides – after the fact!

It’s not surprising that such undisclosed internal policies result in uneven application. How can there be any other result? They require professionals to seek out private assurances from the funds that their trading activity will be permitted on behalf of their clients. Despite these assurances, time after time the funds have reneged on their promises. Even where the manager was trading less than the internal guidelines (and always less than allowed for individual investors), trading privileges have been withdrawn. Recently, this occurred with a fund that had published guidelines in their prospectus (four trades per year per fund) and the trading activity did not even approach that level!

This makes it very difficult for advisors to conduct their business. It also entraps and ensnares investors into fund and variable annuity families. Repeatedly, funds and variable annuities will give assurances that a level of trading activity is not deemed excessive. The advisor then markets its services, and investors seeking its management invest in those funds or variable annuities. Then a new policy is instituted. Suddenly, the trading level that was viewed as permissible is now unilaterally deemed excessive. Investors are left without a manager and are trapped in the funds by back-end surrender fees. To continue under management elsewhere they are forced to pay the surrender fees to exit.

Rather than letting the fund industry dodge the question, mislead investors and professional managers alike and entrap and ensnare investors into their web of surrender fees, the SEC should require full disclosure of what each fund believes is excessive trading or adverse market timing. This disclosure should be specific and not open ended. Number of trades, percent of assets, and holding periods should be published, so that future variance is subject to a claim for misrepresentation.

Funds should not be allowed to use prohibitory language regarding “market timing” or “excessive trading” without defining precisely what it is that they have in mind when they use that term. There is no industry-acceptable definition that fits all types of funds.

A Hard 4:00 Close Is Not the Answer. Another of the fund industry’s “remedies” seeks to impose a hard 4:00 pm market close on all trading activity, including reconciliation of trades from financial intermediaries. The Investment Company Institute admits that “85 to 90 percent” of mutual fund buy and sell orders are made through intermediaries!<sup>11</sup> Their proposal for a “hard close” threatens the liquidity of the market system in the United States, punishes a whole range of substantial institutions that happen not to be mutual fund companies and has a disproportionate impact on small investors and investment advisory firm clients over professional investors.

Many large professional investors either trade in securities directly or place their orders directly with fund companies. As such, they would have until 4:00 pm to make decisions based on market activity and the day’s news. In contrast, small investors tend to rely on intermediaries to place orders. They would be forced to make their order decisions hours before the big professionals. By closing the deadline only on those who rely on intermediaries to execute orders, reformers would hand large investors a huge advantage over small investors.

As Mathew Fink, President of the Investment Company Institute, conceded “...in many cases, investors may no longer have the ability to obtain same-day prices.”<sup>12</sup> The reality is most small investor orders will not be fully executed on the day that they are placed. This means that their final price on fund shares may not be determined until the next day or even after settlement as much as three days later. With multiple 1% - 5% down days in the market in just the last three years, these delays in executing the orders can be costly to investors.

The fund industry trade association in supporting the proposal is once again feathering its nest. Investors would have to open accounts at fund families instead of at trust companies and brokerage houses to have their orders executed on the same day they are placed. Who benefits from that?

At least one fund family has broken from the industry ranks and analyzed the proposal closely enough to realize it isn’t fair to small investors. Fidelity Investments has described the shortened deadline as an overly simplistic approach that “ends up hurting the shareholders, not helping.”<sup>13</sup>

Again, Professor Mercer E. Bullard, president of the non-profit, investor watchdog group, Fund Democracy, states:

“This reflects a failure of fundamental compliance, not a problem of existing legal requirements. Late trading should not be painted as a failure of the rules, rather than a failure of compliance and oversight; nor should we allow the fund industry to address late trading simply by

placing additional burdens on shareholders when the primary responsibility for this scandal rests with the fund industry itself.”<sup>14</sup>

Mutual Fund Governance. As should be clear from the current mutual fund scandal, all of the problems arise as a result of failures in mutual fund governance. Better compliance and methods to secure compliance is what the industry needs now, not further restrictions on investors who are the victims of the scandal, not the perpetrators. The alleged perpetrators are a part of an industry that mouths platitudes about being the fiduciaries for 95 million investors, yet can only find remedies that further victimize the victims. SAAFTI members did not cut preferential deals with mutual funds; instead, they were prevented from using the very same funds named in the scandal because they respected the funds' publicly disclosed policies.

SAAFTI strongly supports the current efforts by Congressman Baker and Senator Akaka, and the co-sponsors of their legislation, to bring greater compliance resources, director independence and higher standards of governance to an industry that sorely needs a cure to an almost terminal bout of self-interest. In addition, Congress should, as suggested by Fund Democracy, consider requiring that all persons responsible for receiving fund orders keep records of the time that each order was received in a non-erasable, non-editable format that shall be available to fund companies and regulators upon request.<sup>15</sup> Rather than changing the system and then revisit it later if new technology develops, as the ICI suggests; we should preserve a system that but for compliance breakdowns at the fund level has worked in the best interest of the investing public and only change it after technology delivers a better way.

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## Footnotes

<sup>1</sup> SEC response to No-Action Letter, March 7, 2001, Fidelity Advisor Korea Fund, Inc., SEC File No. 811-8608 citing: <sup>29</sup> See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency*, 76th Cong., 3d Sess. at 985 (1940) (memorandum introduced by David Schenker, Chief Counsel, SEC Investment Trust Study) ("Schenker Testimony"). See also *Offers of Exchange Involving Registered Open-End Investment Companies and Unit Investment Trusts*, Investment Company Act Release No. 16504, at n.43 (July 29, 1988) (revised proposal of Rule 11a-3) ("the shareholder's right of redemption is fundamental to the concept of an open-end investment company"). <sup>30</sup> See Schenker Testimony, *supra* note 29. <sup>31</sup> See Section 5(a)(1), *supra* note 17. <sup>32</sup> See Section 2(a)(32), *supra* note 18. <sup>33</sup> See Investment Company Act Release No. 16504, *supra* note 29, at text accompanying n.43 and text preceding n.45 (revised proposal of Rule 11a-3).

<sup>2</sup> Investment Company Institute, Executive Committee Statement Calling for Reforms to Address Trading Abuses, October 30, 2003.

<sup>3</sup> Greene, J. T., Assistant Professor of Finance, Georgia State University; Hodges, C.W, Associate Professor of Accounting and Finance, State University of West Georgia (2002) *The Dilution Impact of Daily Fund Flows on Open-End Mutual Funds*, *Journal of Financial Economics*, p. 147.

<sup>4</sup> Fidelity Advisor Korea Fund, Inc., *supra*.

<sup>5</sup> Fidelity Advisor Korea Fund, Inc., *supra*.

<sup>6</sup> Investment Company Institute Statement, October 30, 2003, *supra*.

<sup>7</sup> "Mutual Funds: Who's Looking Out for Investors?", Testimony of Paul G. Haaga, Jr., Chairman, Investment Company Institute, before the Subcommittee of Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representative (Nov. 4, 2003) at p. 3.

<sup>8</sup> SEC Response to Investment Company Institute Letter on Delayed Exchanges of Fund Shares, November 13, 2002, SEC File No.132-3.

<sup>9</sup> Mutual Funds: Who's Looking Out for Investors? , Testimony of Eric W. Zitzewitz, Assistant Professor of Economics, Stanford Graduate School of Business, before the Subcommittee of Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representative (Nov. 6, 2003) at pp. 5-6.

<sup>10</sup> Mutual Funds: Who's Looking Out for Investors? , Testimony of Mercer E. Bullard, Assistant Professor of Law, University of Mississippi School of Law, before the Subcommittee of Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representative (Nov. 4, 2003) at p. 39.

<sup>11</sup> Mutual funds: Trading Practices and Abuses That Harm Investors, Testimony of Mathew Fink, President, Investment Company Institute, before the Subcommittee of Financial Management,

the Budget and International Security, Committee on Government Affairs, U.S. Senate (Nov. 3, 2003) at p. 8, n. 6.

<sup>12</sup> Testimony of Mathew Fink (Nov. 3, 2003), *supra*.

<sup>13</sup> Wall Street Journal (October 31, 2003) quoting Fidelity's Chief Operating Officer, Robert Reynolds.

<sup>14</sup> Mutual Funds: Who's Looking Out for Investors? , Testimony of Mercer E. Bullard, Assistant Professor of Law, University of Mississippi School of Law, before the Subcommittee of Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representative (Nov. 4, 2003) at p. 37-38.

<sup>15</sup> *ibid.* p.38.