

Directors: Give us More Information on Omnibus Accounts Published on Mar. 02, 2004

As boards try to figure out how to curb trading abuses, they're turning their attention to the complex system in which funds are traded. One method drawing their ire is so-called omnibus accounting, in which individual trade orders processed by third-party providers are lumped together into a single block order. As a result, fund firms often have no way to identify individual trades and thus stop market timers.

Fund directors say that in the current situation fund firms rely too much on intermediaries for crucial information that would better enable them to police trading abuses.

"As a fund, you're at the mercy of how good a job the intermediary is doing, how seriously they take the responsibility," says Ken Scott, independent director of the **American Century Funds**.

Directors won't feel comfortable overseeing omnibus accounts until fund firms receive daily information from intermediaries as to the identity of individual shareholders within those accounts. That could mean big changes to omnibus accounting as the industry knows it.

"Give us the names and account numbers of the customers in the omnibus accounts so we can ourselves ensure that we are preventing market timers," says Peter Gavian, independent director of the **Calvert Funds**.

Omnibus accounting is widespread throughout the industry. According to a 2003 research report by the **TowerGroup**, about 65 million shareholder accounts are processed through omnibus accounting, with an estimated total 380 million shareholder accounts in the entire industry.

Along with fund directors, the SEC and other regulators have also been scrutinizing omnibus accounting. The ample possibility for committing trading abuses under the cover of omnibus accounting was brought to light last September when Eliot Spitzer's investigation revealed that **Security Trust Company** had disguised late trades and market timing activity by mixing those trades in among legitimate trades within omnibus accounts.

A recently proposed SEC rule designed to curb market timers would impose a 2% redemption fee on short-term trades of five days or fewer. During an open meeting to announce the rule, Chairman William Donaldson noted that financial intermediaries are often reluctant to provide the information fund firms need to collect redemption fees. The rule would solve this "impasse," he said, by "requiring funds to impose redemption fees in a consistent, standardized way, and financial intermediaries to assist funds in their efforts to collect them."

The mechanics of exactly how the intermediaries will provide the information remains unclear and will probably be unveiled when the rule proposal is released.

The approximately 10% of funds that currently impose redemption fees typically cannot collect those fees from intermediaries because of their reluctance to provide individual shareholder information, said Paul Roye, director of the SEC's division of investment management.

"I think the rule will solve that," Roye said during the open meeting. The SEC has asked for comment on various provisions of the rule, including whether the redemption fee should be mandatory or voluntary.

This is not the first time that omnibus accounting has come under fire. The practice was scrutinized as recently as last year. The reasons were different then, but also pressing. After a round of inspections at broker-dealers, the NASD and

SEC found that some fund investors were paying too much in sales loads. Omnibus accounting made it difficult to ensure that the correct sales charges were being levied on individual accounts.

Boards were focusing on the issue of omnibus accounting prior to September 2003, and the beginning of the ongoing scandal, says Carl Frishling, an independent director of the **AIM Funds** and independent counsel to several fund boards. But the recent spate of market-timing abuses has heightened directors' concerns regarding omnibus accounting.

"Greater transparency can only help alleviate some of those concerns," says Marco Adelfio, partner at the law firm **Morrison & Foerster**. If the proposed 2% redemption fee on short-term trades were to take effect, changes in the operations of omnibus accounting would be necessary.

During the recent open meeting, the SEC said that the software architecture is already in place to support providing individual information, but that it's not used because intermediaries frequently do not want to share such information.

"I don't see how omnibus accounting can survive if a mutual fund is to exercise its fiduciary duties properly and apply its policies and procedures, fees and charges uniformly," says Niels Holch, a partner with **McGuinness & Holch** and founder of The Coalition of Mutual Fund Investors. The prospect of implementing the proposed mandatory redemption fee is just another example of the difficulties funds face in dealing with omnibus accounting, Holch adds.

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