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Funds Drop Redemption Fees as Market-Timing Fears Wane

By Maura McDermott July 5, 2011

The redemption fees imposed after the 2003 market-timing scandals are becoming less widely used as funds rely more on techniques such as fair valuation to deter short-term trading. Industry attorneys say the fees have outlived their usefulness in many cases.

However, some experts argue certain funds – especially international funds that are vulnerable to time-zone arbitrage or small-cap funds where liquidity is scarce – still benefit from the fees.

Another group of industry insiders dismisses the question of whether funds should charge the fees, saying efforts to prevent market timing are all but pointless, since omnibus accounts hide the activities of individual investors and provide a hiding place for market timers.

“It’s a growing problem for boards because so many of the transactions are not transparent to the funds and their compliance personnel,” says Niels Holch, executive director of the Coalition of Mutual Fund Investors. “There’s no transparency into whether the intermediaries are enforcing market-timing policies.” Please read this issue's related opinion by Holch [here](#).

Redemption fees first gained popularity after a high-profile investigation in 2003 revealed the secret deals allowing favored investors to trade rapidly in and out of many mutual funds. The short-term traders harmed long-term investors by diluting profits, forcing funds to pay high transaction costs, triggering capital gains taxes and requiring funds to keep extra cash on hand to meet redemptions.

The SEC revised Rule 22c-2 after the scandal, requiring funds to either impose a short-term redemption fee that would reimburse funds for the costs associated with frequent trading or formally decide that the fees were unnecessary and disclose their policy.

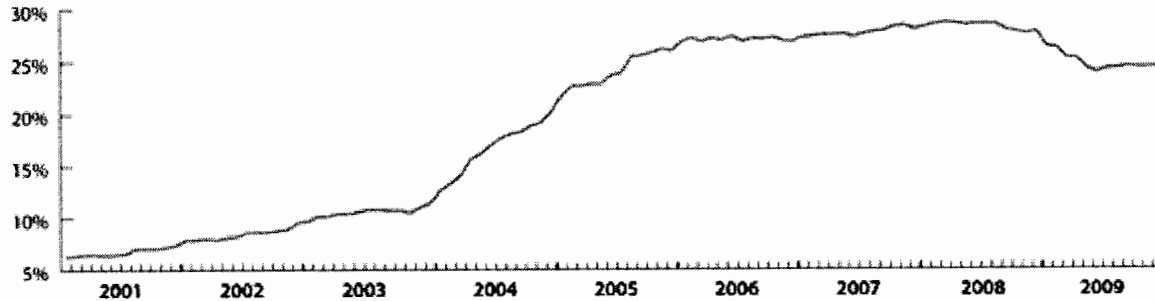
“The idea was to give boards a tool to immediately address market timing,” says Michael Mabry, a partner at **Stradley Ronon Stevens & Young**. Before then, he says, the redemption fees were permitted only by no-action relief. Redemption fees, along with exchange fees, are the only charges paid directly to funds to benefit shareholders, not advisers, intermediaries or third parties.

The percentage of U.S. non-specialty equity funds that charge a redemption fee rose sharply after the market-timing scandals, from about 10% at the beginning of 2003 to a high of nearly 29% in 2008, according to the Center for Research in Security Prices. However, the number fell gradually to 24.5% by the end of 2009.

A more recent analysis of 7,822 funds across a range of asset classes showed a drop from 10.6% to 9.2% from 2007 through the first quarter of this year, according to **Broadridge Financial Solutions**. The analysis was of funds offered continuously throughout that period.

Redemption Fees Fall out of Favor

Many mutual funds imposed redemption fees in response to the market-timing and late-trading scandals of 2003, but more recently U.S. equity funds have been dropping the fees.*



*U.S. equity funds, not including specialty funds such as sector funds, and not including funds with less than two years of return data.
Source: The Center for Research in Security Prices, University of Chicago Booth School of Business

This year's SEC filings also reflect the trend toward dropping redemption fees. **J.P. Morgan** dropped its 2% redemption fee from 26 funds in May and now has no more funds that impose the fees. In May, **Pimco** cut the holding period for certain classes of its Senior Floating Rate Bond Fund from 60 to 30 days. **BlackRock** announced in a fund filing that it was dropping its 2% redemption fee on more than 30 funds in April. In March, **Cohen & Steers** dropped the fee it had imposed on certain classes of Preferred Securities and Income Fund shares held less than 60 days.

The growth of the ETF market has created a better venue for short-term trading than mutual funds ever were, says Jeff Tjornehoj, senior analyst at **Lipper**.

"The whole point of the redemption fee was to stop people from getting in and out of the fund too quickly, causing disruption in the cycle of flows and the expected cash flows into the portfolio," he says. "Now that those investors have a better opportunity using ETFs, there's less pressure on mutual funds to ensure that those people aren't using mutual funds for that intended purpose."

As a result, "there's less need for a punitive redemption fee on most funds," he says.

Even more significantly, most funds have adopted techniques designed to block short-term traders. Funds now commonly use fair valuation to determine the value of securities whose price might not reflect market developments, whether because of time-zone differences or lack of liquidity. The SEC laid out funds' fair-valuation responsibilities in Rule 38a-1 the year of the scandal, and the following year, the SEC stated that funds must fair-value "any time that market quotations for their portfolio securities are not...reliable."

Fair valuation has dramatically cut short-term traders' ability to exploit stale prices, says Alyssa Albertelli, a partner with **Ropes & Gray** who has investigated market-timing allegations for special review committees of mutual fund boards.

One of the major fair-value pricing services follows 70,000 securities, providing coefficients that funds can use as they set prices each day, Albertelli says. The services are not very expensive, she adds.

“All the fund groups that I work with now use them,” she says. “It really has closed a lot of that gap that was there.”

Funds also have implemented policies that limit investors’ “round trips” in and out of funds, banning short-term traders from making another purchase after they have met their limit.

Such strategies “are a lot more narrowly targeted and sophisticated,” Mabry says. “Redemption fees were kind of a blunt instrument, and sure they were an impediment to market timers, but they were also an impediment to anybody else who for whatever reason wanted to do a short-term redemption... They’re no longer the first line of defense in combating market timing, and they really don’t need to be.”

Redemption fee programs can also be expensive, with their numerous exemptions for hardships, for those investing through wrap accounts or asset allocation programs with automatic rebalancing, or those re-investing dividends or exchanging share classes, Albertelli says. “Someone has to monitor all that, and it’s costly,” she says.

However, some experts maintain redemption fees are still beneficial for certain funds, especially international and small-cap funds.

Redemption fees are strongly linked to better performance, says David Nanigian, a professor at The American College. Comparing funds that invest in illiquid securities, those with the SEC’s redemption fee maximum of 2% for holding periods of longer than two months outperform those without redemption fees by 3.26% a year, according to 2009 research by Nanigian, Michael Finke and William Waller.

“The funds that do not have redemption fees tend to hold more cash” in order to meet redemptions, Nanigian says. “Cash over the long run is expected to generate a lower rate of return than stocks are, so the more money a fund has sitting in cash, the lower its rate of return.”

Some complexes are standing by their funds’ redemption fees. **Vanguard** imposes the fees on 30 funds, including the Total International Stock Index Fund, which imposes a 2% fee on holding periods of less than two months, the Information Technology Index Fund, which imposes a 2% fee on holding periods of up to one year, and the Tax-Managed International Fund, which imposes a 1% fee on holding periods of up to five years. The complex has not changed its redemption fee policy significantly since 2003, according to Vanguard spokesman Joshua Grandy.

“Historically, international equity funds have experienced higher levels of short-term trading activity related to investors attempting to profit from differences between the closing prices for stocks in foreign markets and 4 p.m. [Eastern time], the pricing time for our international funds,” Grandy said in a statement. “The continued need, amount assessed and holding period duration are regularly reviewed by each fund’s adviser and the board.”

Some insiders say the fees can be problematic from a marketing standpoint, since many investors object to any fee, even if it gets paid into fund assets. “Even people who are long-term investors sometimes seem opposed to redemption fees,” says Joel Goldberg, partner at **Stroock & Stroock & Lavan** and former director of the SEC’s Division of Investment Management.

But that should not concern the board, since the fees can provide a real advantage to long-term shareholders, especially in emerging markets and small-cap funds, he says.

“When the question is whether a fund should have or keep a redemption fee, the management might have a conflict of interest that the independent trustees should mediate,” Goldberg says.

“Management might be tempted to try to get rid of a redemption fee, and the board has to really make sure that the fee is not needed to protect the existing investors before agreeing to get rid of it.”

Still others maintain that with so much investor money in omnibus accounts, the fees are irrelevant since funds typically do not know what is happening within the omnibus accounts.

The J.P. Morgan Funds do not authorize market timing, and they use “reasonable efforts” to identify market timers, according to a May 3 SEC filing. However, the filing states that in accounts that include multiple investors, “the identity of individual purchasers and redeemers whose orders are aggregated are not known by the [f]unds.”

Mutual funds and intermediaries must sign agreements in which intermediaries promise to cooperate with funds’ requests for information on individual investors. However, the funds don’t receive that information on a daily basis, which would allow them to intervene, says Holch.

“An individual investor can be market timing away, and the mutual fund will never know it because there’s no transparency in these accounts,” Holch says. “That’s a very efficient model for the broker-dealers, but it’s not a very good model for the mutual funds.”

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