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## Funds Powerless to Stop Omnibus Timing: Study

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Fund firms are increasingly claiming they can't enforce market-timing restrictions when omnibus shareholder accounting is used, according to a recent study by the Coalition of Mutual Fund Shareholders.

Nearly 100% of prospectuses for funds that don't have short-term redemption fees now make such claims, according to the study, called "An Evaluation of Mutual Fund Redemption Fees and Other Market Timing Procedures."

In comparison, a similar study by the group in 2005 found that only 53% of prospectuses for funds that charged no redemption fees made such claims. The coalition completed a similar study in 2004.

The change results from increased concerns over market-timing activities. "I think there is a big focus on these issues," says Niels Holch, the study's author and founder of the organization. "When you do focus on it, it becomes clear that fund firms can't enforce their policies."

Holch conducted the study by analyzing prospectuses from 50 of the largest fund shops.

Market timing within mutual funds, which often involves frequent trading of fund shares, is strongly discouraged in the fund industry, especially after the timing scandal in 2003. Some market timers may dilute investors' earnings by purchasing fund shares with net asset values, or NAVs, that don't accurately reflect recent changes in the performance of various markets, such as those in other countries.

The practice is called time zone arbitrage and often involves frequent trading in and out of certain funds. In addition to diluting investment returns, it can also jack up funds' trading expenses.

Holch maintains that fund firms are often hard-pressed to stop the practice in omnibus platforms, however, because they don't get to observe individual trades. Broker-dealers that use omnibus accounting combine shareholders' or individual brokers' trades into single large accounts. The broker-dealers then submit the large trade orders, rather than trade orders for individual brokers, to fund shops.

While the process eliminates the need for broker-dealers to submit large numbers of small trades, it also blocks fund shops from receiving information on individual brokers' or investors' trading activities.

As a result, nearly all fund firms note in their fund prospectuses that they are unable to police market timers that trade through omnibus accounts, Holch says.

In a similar matter, fund firms continue to state that they can't enforce their redemption fees when funds are distributed through omnibus accounts. In 2005, 97% of prospectuses for such funds said frequent trading fees can't be enforced by fund firms when the trades are conducted in omnibus accounts, Holch says. That increased to 100% this year.

The SEC, meanwhile, has taken action to help improve transparency of trading conducted in omnibus accounts. Under the SEC's Rule 22c-2, broker-dealers will have to honor fund firms' request for the trading-level data. The requirement will kick in this fall. The rule also stipulates that fund firms must modify their selling arrangements with broker-dealers to ensure that they will receive the trading information.

The rule and fund firms' efforts to comply with it have increased awareness of omnibus issues, adds Fred Reish, a partner in the law firm of **Reish Luftman Reicher & Cohen**.

"My opinion is that people are more focused on [stopping market timing] than in the past and are [now] saying, 'Oh, my God we simply can't do it with any precision.'"

While increased awareness of market-timing issues is playing a role, some fund firms may have simply followed the lead of other fund shops by adding wording to their prospectuses addressing problems with policing the practice.

"If I were a fund company and I saw everyone else do it, I would probably do it also," adds Harold Evensky with financial planning firm **Evensky & Katz**. "That way, a firm has one less thing to worry about."

The idea is that fund shops may decrease the risk of being hit by litigation from shareholders claiming that they weren't informed that their fund shop wasn't able to police market-timing activities within omnibus accounts, he says.

Holch maintains that 22c-2, also known as the redemption fee rule, will help reduce market timing, but more needs to be done.

With 22c-2, fund firms will receive individual trading information, but only after trades are completed. Thus an individual investor or broker may move in and out of a fund before the fund firm gets a chance to scrutinize the activities. By the time the fund shop gets the trading data, the market timer may have moved on to timing through another fund firm's funds, he says.

Reish, in comparison, maintains that the study underscores the need for fund firms to work closely with fund distributors, such as broker-dealers and 401(k) service providers, to prevent market timing. For example, fund firms can work closely with distributors to ensure that the firms are policing market timers and enforcing market-timing procedures, he says.

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