

***Mutual Funds:
The Impact of the Scandals
Disclosure Issues***

W. John McGuire
Washington, DC
May 4, 2004

Morgan Lewis
C O U N S E L O R S A T L A W

Introduction

- The mutual fund industry is currently embroiled in a number of scandals
- Federal and state regulators, including the U.S. Securities and Exchange Commission (SEC), are currently investigating the mutual fund industry, including abusive and illegal trading and sales practices
- The allegations currently being investigated relate primarily to “late trading,” which is generally not a disclosure issue, and “market timing,” “revenue-sharing,” and failure to apply “breakpoint” discounts
- Amongst other regulatory proposals, Congress, the SEC, and NASD have called for or required new or improved disclosure requirements in response to these scandals

What Is “Late Trading”?

- Mutual fund transactions are priced at net asset value (NAV), usually calculated at the close of the New York Stock Exchange at 4:00 p.m. (ET)
- Late trading permits the purchase of mutual fund shares at a stale price
 - Late trading permits the party entering into the trade to take advantage of information announced after market close
- The purchase of shares after the calculation of NAV at that day’s NAV violates Investment Company Act Rule 22c-1, which dictates that orders, placed after that day’s calculation of NAV, be made at the next day’s NAV
- Late trading is illegal

SEC Response to Late Trading

- To address late trading, the SEC proposed a requirement that all orders be received by the mutual fund by the 4:00 p.m. (ET) deadline (“Hard 4:00 p.m. Close”)
 - Currently, financial intermediaries (brokers, 401(k) plans and their recordkeepers) consolidate orders received by the intermediary before 4:00 p.m. and convey a net buy or sell to the fund after 4:00 p.m. (omnibus trading accounts)
 - The proposed rule could require many intermediaries to impose earlier cut-off times on purchases and redemptions
 - The proposed rule has drawn stiff opposition, especially from West Coast investors and the 401(k) industry
 - The heads of the House and Senate finance committees have also weighed in against the rule
- This is not a disclosure issue

What Is “Market Timing”?

- Rapid trading in and out of mutual funds in response to market factors
- “International arbitrage” - taking advantage of anticipated changes in a fund’s NAV, particularly in international markets, when the value of stocks underlying the mutual fund are not reflected in the fund’s NAV until the next day
- While market timing is not per se illegal, permitting it may be an actionable violation of the securities laws if the fund has policies against market timing, particularly if those policies have not been equally applied to all shareholders
- Can result in increased costs to the mutual fund, and can cause long term shareholders to receive a lower rate of return

SEC Response to Market Timing

- The SEC adopted requirements that funds disclose market timing policies and procedures
 - Disclose risks market timing may pose for other shareholders
 - Describe any policies for deterring market timing
 - Disclose any special arrangements to permit frequent purchases and redemptions of fund shares
 - Disclose fair valuation procedures
 - Does apply to exchange-traded funds (ETFs) and funds that specifically permit market timing, but not money market funds
- The SEC proposed a 2% redemption fee on shares held for five business days or less
 - De minimis exception for fees of \$50 or less
 - Exception for personal and financial emergencies
 - Does not apply to money market funds, ETFs or funds that specifically permit market timing

What Is Revenue-Sharing?

- Revenue-sharing payments are incentive fees that fund advisers pay to brokers over and above sales loads or 12b-1 fees
- Revenue-sharing arrangements are not approved by a fund's board or shareholders
- Revenue-sharing payments are not capped by NASD rules governing payments to broker-dealers from sales loads and 12b-1 fees
- The details of revenue sharing arrangements have not typically been disclosed in fund prospectuses

SEC Response to Revenue-Sharing

- The SEC proposed that funds include brief disclosure in the prospectus regarding revenue sharing payments
 - Direct investors to the disclosure regarding revenue sharing that the SEC is proposing to require in the confirmation and point of sale disclosure
 - Disclose if any person in the fund complex makes revenue sharing payments
 - If any such revenue sharing payments are made, disclose that specific information about revenue sharing payments to an investor's financial intermediary is included in the confirmation or periodic statement required under proposed rule 15c2-2 and in the disclosure provided at the point of sale required under proposed rule 15c2-3
- The SEC proposed that brokers selling fund shares disclose any revenue sharing at the “point of sale”

What Are Breakpoint Discounts?

- Breakpoints are volume discounts on front-end loads that investors pay on mutual funds
- In order to insure that a discount is granted, a broker-dealer needs to cross-reference all of the various accounts an investor may hold and then communicate the information back to the fund
- Breakpoints are currently required to be disclosed in the fund's statement of additional information
- 15 brokerage firms have agreed to pay more than \$21.5 million in fines and over \$86 million in disgorgement to settle charges of denying investors their breakpoint discounts

SEC Response to Breakpoint Discounts

- The SEC proposed new rules that would require mutual funds to provide prospectus disclosure regarding breakpoint discounts on front-end sales loads
 - Describe arrangements that result in sales load breakpoints, including a summary of eligibility requirements, with more detailed information permitted in the SAI
 - Disclose the methods used to determine whether a shareholder has met sales load breakpoints
 - State, if applicable, that to obtain a breakpoint, it may be necessary for a shareholder to provide information and records, such as account statements, to a mutual fund or financial intermediary
 - State whether the fund makes information regarding its breakpoints available on its website

Mutual Funds: The Impact of the Scandals Disclosure Issues

Gail Weiss & Associates
Washington, DC
May 4, 2004

Morgan Lewis
COUNSELORS AT LAW