

Mutual Fund Scandals: The Industry Responds to Recent Challenges and SEC Regulation

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Introduction

- The mutual fund industry is currently embroiled in a number of scandals involving trading irregularities
- 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 practices
- The allegations currently being investigated relate primarily to “late trading” and “market timing”
- The SEC has proposed or adopted numerous new regulations 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 is in violation of 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

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 that 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 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 require 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.

SEC Response to Market Timing

- The SEC adopted requirements that funds disclose market time 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
- 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, exchange-traded funds (ETFs) or funds that specifically permit market timing

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