-The Unequal and Unfair Pricing of Mutual Fund Shares-
-SEC Proposes New Rules Acknowledging Problem-

What if I told you that the total amount of money that was lost by the investors in the Bernard Madoff scandal doesn't even approach the amount that is now being lost by investors in mutual funds, due to the unfair daily pricing of mutual fund shares? Find it hard to believe? The total Madoff loss to investors was estimated to be at $17 billion. It is estimated that approximately a total of $20 billion a year is unfairly skimmed from all mutual fund accounts.

Currently, when mutual funds price their shares at the close of each trading day, they inadvertently allow new investors who are purchasing shares and current shareholders who are liquidating shares avoid paying their portion of the trading commissions that were previously paid to assemble the mutual funds' current portfolio. These portfolio trading commissions were previously deducted from the assets of the mutual funds and therefore are not included in computing that day's closing price. This means new investors and liquidating shareholders avoid paying their share of the existing portfolio trading commissions that should have been allocated to them. They are getting a free ride by avoiding paying their portion of these commissions by transferring their allocated commission costs to the existing shareholders, most of them who are long term investors. The longer these mutual fund shareholders are invested in the fund the more they are transferring a portion of their wealth to the daily buying and selling shareholders.

This all documented by a research paper ***Mutual Fund Liquidity and Conflicts of Interest*** written by Dr. Miles Livingston of the University of Florida and Dr. David Rakowski of the University of Texas that was recently published in ***The Journal of Applied Finance.*** The $20 billion dollar estimate is based on calculations using independent data from the Investment Company Institute's ***Investment Company Fact Book*** and various SEC public documents.

In the interest of full disclosure, I was issued a U.S patent that is basically an algorithm that adjusts this unfair pricing of mutual fund shares by charging a specified fee to the daily purchasers and sellers of the funds' shares and then directing these fees back into the assets of the mutual funds so as to compensate the remaining shareholders, thus creating a fair price for all shareholders and establishing a level playing field. This patent also has the effect of reducing excessive short-term trading in many mutual funds thereby increasing portfolio performance and liquidity. I refer to the SEC Investment Company Act release 26782, dated March 22, 2005 that states "that excess trading can harm long term investors because the fund manager must hold extra cash or sell investments at inopportune times to meet redemptions". This is also referred to as "market impact costs". Not only will this patent create a fair price for all and help increase market performance, it is also cost effective to the mutual funds and to their management companies. (**The SEC on September 22, 2015 proposed major new rules on mutual funds which are discussed a few paragraphs down.)**

Drs. Livingston and Rakowski write in their research paper that the portfolio trading commissions for equity funds approximate an average of.15% to .20% of assets. It should be noted that only equity funds report their portfolio commissions to the SEC. Other types of funds, such as bond, balanced, hybrid, etc. are not required to report this. Portfolio trading commissions in all funds vary according to their size and objectives. Drs. Livingston and Rakowski do not include in their computations the inherent differential spread costs between the bid and ask prices of the portfolios' securities which naturally increase the trading costs. They also write that "market impact costs" add an additional cost of .20% to .40% of assets. They also add that many published research papers put this at a much higher amount.

Mr. John C. Bogle, founder and former Chief Executive of the Vanguard Group, in his recently released research paper ***The Arithmetic of "All-In Investment Expenses"***, believes that the average portfolio commissions for all mutual funds equal .5% of assets. This amount includes the differential spread costs between the bid and ask prices of the portfolio securities. Mr. Bogle, in a letter to me, referring to the patent, wrote "you have an interesting and important idea…. "

Over the past few years we have notified the SEC and its related divisions to inform them of this price discrepancy. We also filed, under their rules, a Petition For Rulemaking , requesting that under the “full disclosure” and “disclaimer” provisions of the Securities Act of 1933, that mutual funds should be required to include this unfair pricing information in their current prospectuses.

On September 22, 2015, the SEC voted to propose a comprehensive package of rule reform designed to enhance effective liquidity risk management by – open-ended mutual funds.

This included a section on “Swing Pricing” which states “The commission will consider proposed amendments to Investment Company Act rule 22c-1 that would permit, but not require open-end funds to use “Swing Pricing”. “Swing Pricing” is the process of reflecting in a fund’s NAV the costs associated with shareholders’ trading activity in order to pass those costs on to purchasing and redeeming shareholders. It is designed to protect existing shareholders from dilution associated with shareholder purchases and redemptions and would be another tool to help funds manage liquidity risks.” The complete SEC text of “Swing Pricing” contains all the aspects of our patent and acknowledges the problem of uneven pricing. According to our calculations, our patent would be the <u>most effective method</u> to use in “Swing Pricing” and would achieve the best outcome for shareholders.

Over 90 million Americans own $16 trillion in mutual funds, which includes $5 trillion in retirement related accounts. This unequal and unfair pricing of mutual fund shares that is picking shareholders’ pockets of an estimated $20 billion a year is too large an amount for the SEC, the mutual fund industry and the investing public to let continue.

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Seymour Sacks is the President of Sacks Equalization Model Inc, the owner of the patent.