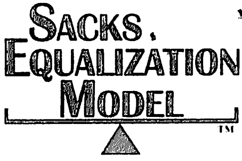
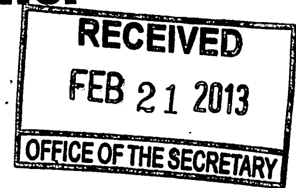


Sacks Equalization Model Inc.



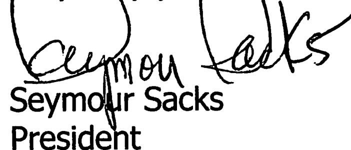
February 15, 2012

Ms. Elizabeth M. Murphy, Secretary
U. S. Securities & Exchange Commission
100 F Street, NE
Washington, DC 33434

Dear Ms. Murphy:

We wish to submit the enclosed letter that was published in the Financial Times on February 14, 2013 as a letter of comment for our petition for Rulemaking that was submitted to your office on November 28, 2012, file number 4-656.

Very truly yours,



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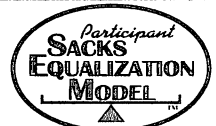

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Economists' Forum

Time for mutual funds to favour shareholders

February 14, 2013 6:08 pm by Financial Times

By Dr Miles Livingston

The legendary John Bogle, founder and former chief executive of The Vanguard Group, recently met with the US Securities and Exchange Commission to urge it to propose a rule that would require anyone providing retail investment advice to act as a fiduciary.

Mr Bogle and two other representatives of The Institute for the Fiduciary Standard argued that investment advisers at large mutual fund companies and other financial institutions often operate with conflicts of interest and do what is best for themselves rather than their shareholders. The Investment Company Act of 1940 requires that mutual funds be organised and managed in the interest of shareholders, rather than their managers or directors, but Mr Bogle pointed out that in practice, the spirit of the law is violated.

Fiduciary responsibility encompasses everything from how a fund is structured and managed to individual judgment calls by the fund's sales representatives. Yet in equity funds, there is an inherent conflict of interest that costs investors at least $10bn annually. This number is much higher if you consider the total universe of funds.

These costs are generated whenever someone buys or sells shares and the problem is exacerbated when short-term traders move in and out of funds. Portfolio brokerage commissions and market impact costs associated with buying and selling shares are borne by all shareholders, which means short-term shareholders are getting a free ride – or at least a cheap ride – at the expense of long-term shareholders.

Mutual fund companies know these hidden costs are being passed along to all shareholders, but they do not disclose them in prospectuses and they are not included in a fund's expense ratio. Funds should either address this problem by charging trading costs to the buyers and sellers or include a disclaimer in their prospectus.

Several procedures have been used to reduce this wealth transfer from long-term investors to traders, including minimum holding periods, restrictions on the total number of transactions during a specific timeframe and redemption fees for a specific time period after purchase. Restrictions on minimum holding periods or the number of transactions may reduce in-and-out trading, but only minimally. Redemption fees do nothing to reduce liquidity costs

created by inflows, which are substantial.

If none of these procedures are effective in reducing short-term trading costs, why do some mutual funds continue to use them? The reason appears to be the compensation pattern for management fees. Management fees are typically a percentage of assets under management, which gives fund managers an incentive to increase assets as much as possible. This is where a key conflict of interest lies and fiduciary responsibility gets trampled.

But it is time for mutual funds to put investors first by changing the way they charge shareholders for trading. Quite simply, a "pay as you go" system is needed so those who are buying or selling pay for their trades.

In a research paper, *Mutual Fund Liquidity and Fiduciary Conflicts of Interest,* David Rakowski, associate professor of finance at the University of Southern Illinois, Carbondale, and I discuss the enormous costs of the current system and a new approach to correct the inequitable wealth transfer in mutual funds. Known as the Sacks Equalization Model, it is a patented algorithm developed by Seymour Sacks, a 50-year veteran of the securities industry.

Mr Sacks recently filed a petition for a rulemaking request with the SEC requiring mutual funds to fully disclose that all shareholders are paying the costs of portfolio trading commissions generated by new investors buying shares and by current investors liquidating them.

With SEM, the portfolio brokerage commissions for purchasing shares are added to the purchase price and the revenue generated by this mark up is returned to the general revenues of the fund. The price paid to redeeming investors is the net asset value minus brokerage costs incurred to sell some of the fund's securities.

SEM can logically be extended to include the market impact costs of transactions caused by new inflows to the fund or redemptions. For example, if brokerage commissions and market impact costs result in a cost of $0.04 to buy or sell a share with a net asset value of $10.00, a purchaser would pay $10.04 and a seller would receive $9.96.

This approach not only meets the fiduciary responsibility standard, but it can easily be adopted by any open-end mutual fund and improve fund performance by up to 1 per cent per annum. What's more, the algorithm can improve performance for nontrading shareholders without unduly punishing short-term traders or dampening assets under management.

We now have a straightforward and efficient solution to a problem that has been with us as long as the mutual fund industry. The question now is will the industry – or the SEC – take action?

Miles Livingston, PhD, is Bank of America professor of finance at the University of Florida, Gainesville, and has studied mutual funds and the capital markets extensively

Tags: mutual funds