

File No. S7-11-04

Comments on Proposed 2% Fee and Alternatives

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Here are some comments on the 2% fee Proposal (File No. S7-11-04). As background I am a Professor of Economics and Finance at the University of New Orleans. I have taught investment course to undergraduate, graduate, and PhD students as well as published extensively on stock market theory. In particular I have published on how to profitably trade mutual fund accounts (and won a cash best paper prize for the work). One of my PhD students, Mazumder, is doing a PhD thesis on the predictability of international and global mutual funds. Hopefully, before the close of your comment period he will be able to provide the results of some simulations he is doing as to the effects of the proposed 2% fee. They show it would be relatively ineffectual in reducing the profitability of short term trading of international firms. I am also a personal investor who has extensively traded mutual funds (very profitably) and sub-accounts in variable annuities, brokerage accounts, and my retirement funds. Thus, I believe I can bring some helpful insights to the process.

In the over all scheme of things, issues relating to frequent trading are minor with investors losing much more to high and excessive fees, or to high fee unsuitable products sold to them for the commissions to be earned. The question of frequent trading is basically one of contract design. How should the risks and returns of investors in investment companies be partitioned, especially when new investors are added and old ones leave. Of course, once contracts are entered into they should be enforced. The SEC should not be rewriting contracts already entered into, especially where the effect is to hurt investors who have already bought securities.

In brief I see virtue in the adoption of next day pricing and widespread use of fair value pricing (via statistical models), but little virtue in the proposed 2% fee. Paradoxically, the proposed 2% fee will probably hurt both traders and long term mutual fund investors through inducing traders to stay in a particular fund just long enough to avoid the fee, and just long enough for the funds to fully invest the new money. The increased transaction costs for the funds will probably exceed any gains derived by investors. Hopefully, a graduate student of mine will be filing a study providing more detail on the profits possible if this proposal is implemented.

I will proceed by setting out the apparently better ideas of next day pricing and routine use of fair value pricing. I will then discuss the proposed, less useful, redemption fee proposal and some technical comments (notably exempting same day purchases and offsetting sales, and proposing use of 5 calendar days instead of 5 business days).

Because my comments are lengthy, I am supply a table of contents to help in finding topics that may be of particular interest to different SEC staff members and other interested parties.

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Next day pricing

There is much to be said for a proposal to use next day pricing. It was reported (see Statement of the Shadow Financial Regulatory Committee (Washington), Statement 202, at http://www.aei.org/research/shadow/publications/pubID.19556,projectID.15/pub_detail.asp) that “The Shadow Financial Regulatory Committee Dec. 8 called on the Securities and Exchange Commission to give mutual funds the option of T+1 pricing as a means to stem inappropriate market timing, late trading--which is illegal--and day trading.” This seems like a sensible proposal.

It appears to implement a reasonably well specified Congressional goal of providing fair pricing for redeemable securities using the power granted to the SEC to provide for regulations regarding the timing of valuation. In contrast, the proposed fee regulation starts out that no fund shall redeem a redeemable security unless a certain fee is charged. Given the clear Congressional goal of assuring that redeemable securities are really redeemable, a regulation that forbids redemption (even if only in certain

circumstances) appears an odd way to go about it. In the unlikely, but possible event that a fund for some reason does not provide for a redemption fee, a previously redeemable security become unredeemable, going directly against the intent of Congress.

As next day price is more representative of the prices the fund will receive when it trades in response to an inflow or outflow of money. It would hence come closer to the goal of permitting remaining shareholders to retain their proportionate interest in the assets of the funds.

Whenever a fund receives less for the new shares it issues than it will cost to expand its assets proportionately, or redeems old shares for less than the assets it will sell to finance the redemption, the existing shareholders suffer dilution and are hurt. To see this, imagine a fund that maintains no cash reserves and that invests in only a single bond which was priced at \$100 at 4PM when redemption prices were set. The fund owns 2000 bonds and has a total asset value of \$200,000 as of 4PM and has 20,000 shares outstanding. Thus, the net asset value of the funds shares is calculated as \$10 as of 4PM. An investor redeems 10,000 shares for which he will receive \$100,000. Paying this \$100,000 is now an obligation of the fund and will be taken into account next time the net asset value is calculated. The next day the fund learns of the \$100,000 cash outflow and realizes it must raise \$100,000 by selling the bond it invests in. Alas, this bond is now priced at \$50. To raise the required \$100,000 it must give to the redeeming share holder, it must sell 2000 bonds. This just happens to be its total holdings. After the sale, it has no bonds, total assets of \$0, and a net asset value of \$0. The remaining shareholders have been completely wiped out by the redemption.

The redeeming shareholder has been either lucky or very smart. Perhaps the reduction in the bond value was due to the unexpected announcement after the close that the company had been the victim of a major fraud and would be filing in bankruptcy. Whatever the cause, the remaining shareholders have suffered. Notice the loss to the remaining shareholders does not depend on how long the redeeming shareholders have held the shares. The redeeming shareholders could have been the first investors in the fund. The problem is not uniquely caused by short term traders.

With pricing one day later, the bond price would be priced at \$50 and the net asset value would be \$5. The next day when the fund management learned of the redemption of 10,000 shares or half of its shares outstanding, it would realize it had to sell half of its portfolio to raise the money. It could do so at the new \$50 price. This sale would raise the \$50,000 it needed to pay for the redeemed shares. It would still have half of its portfolio left. The remaining shareholders would share in the 1000 bonds, now worth \$50,000. The calculated asset value would be \$5.00.

Under the existing regulations the fund would have the option of making an in kind distribution for such a large redemption and could redeem the shares for 1000 bonds. Notice how under existing rules, the fund could take advantage of later arriving information about security prices to benefit the remaining shareholders (and the fund management company).

In less extreme cases the remaining shareholders would suffer dilution if the fund was not able to make an in kind redemption (perhaps because it agreed to cash before it learned the bad news, or because the redemption was too small for it to legally tender securities).

Similar examples can be constructed where the remaining shareholders benefit from a sudden jump in bond prices. Suppose there is unexpected good news (a bankruptcy court has just held the bonds will be paid off in full). The bonds were at \$50 and 4PM and the net asset value is calculated to \$5. The fund considers the possibility of offering a thousand bonds to meet its redemption obligation. Realizing such bonds would be worth \$100,000, it chooses to redeem in cash for \$50,000. The next day it raises the \$50,000 by selling 500 bonds, leaving it with 1500. At the close the next day the portfolio is worth \$150,000. With 10,000 shares outstanding, the net asset value is now \$15. The remaining shareholders have benefited from the post 4PM news.

Notice in this example who bears the risk of post 4PM news are the remaining shareholders. However, because their managers can make decisions after 4PM on whether to offer redemption in kind for large redemptions, the remaining share holders benefit. The fund management (presumably thinking of the welfare of the remaining Shareholders) can base decisions on information received after 4PM. Two redeeming shareholders could be affected quite differently if the smaller one received the net asset value in cash, and the larger redemption received an in kind distribution. This seems unfair (especially if several smaller redemptions that added to the same value as the large redemption were beneficially owned by the same person).

If the net asset value is calculated using asset prices the fund could actually trade at, this problem is much less serious. With net asset values based on the next day's prices, whether the remaining shareholders are adversely affected does not depend on whether redemption is made in kind or in cash. This seems fairer.

Assuming all redemption will be made in cash, it does seem fairer to base redemption prices (and purchase prices) on prices representative of those the fund can actually trade at. If investors cannot predict the prices in the future, all that is at stake as to which date is used for pricing is how the risk of price movements after 4PM is distributed.

If such movements are truly random, the remaining share holders will benefit on some days and be hurt on other days.

However, if some investors can predict future prices, they can sell before declines and buy before increases, and benefit at the expense of other shareholders.

When the last recorded trade before 4PM is a stale price, basing net asset values on 4PM prices on orders received before 4PM that day makes it possible for informed traders to time their purchases and sales of fund shares so as to benefit. This benefit may come at the expense of the remaining shareholders if the prices used to set net asset values are not those the fund can really trade at. If the prices used in valuation are prices the fund can trade at (and the fund does trade at these prices), the remaining shareholders are not particularly hurt by the trader's ability to predict future prices.(I am leaving out the effects of any transaction costs that the redeeming shareholders do not pay).

As is well known, the last available prices for most foreign stocks and some domestic stocks and bonds may be well before 4PM, and well before the order is received by the fund company (or its agent). Basing net asset values on prices set after the order is placed (i.e. the next day) can better protect the interests of remaining shareholders and better meet the Congressional goal of protecting the proportionate ownership of the remaining shareholders.

Of course, when ever the fund pays less for new assets than the net asset value the new share holders received, or sell assets for more, the existing shareholders benefit. For random transactions, including trades made for liquidity reasons, the two effects probably roughly balance. However, smart traders in stocks and mutual funds prefer to sell before a decline in the market and buy before a rise. To the extent they succeed (and they may not) the existing shareholders may suffer from dilution.

While complicated rules and redemption fees (such as the SEC is proposing) can reduce this dilution, they are imperfect and have high administrative costs. A much simpler solution is to base net asset values on transactions occurring after the orders are placed (and after the last time they can be canceled, of course). Calculating net asset values with the next day's prices is an efficient way to do this. While one can use fair value pricing to estimate the next day's price and the prices the fund could actually trade at, using actual next day's prices seems a direct procedure.

Same day pricing is Destabilizing

As I pointed out in a paper of mine (Miller, Edward M. and Prather, Larry M. Exploitable Patterns in Retirement Annuity Returns: Evidence from TIAA/CREF. Financial Services Review, Vol 9, Fall 2000, No. 3, 219-230) ordinary stock market speculation is stabilizing. If a speculator thinks prices today are a bit lower than they should be (passed on his guess as to tomorrow's prices), he naturally sells today. His selling serves to force the stock prices down, moving them towards what he regards as the right price. If he thinks they are too low, he buys and his buying tends to raise the price. It can be, and is argued, that such trading serves a socially useful purpose in aggregating the information possessed by various investors and keeping prices close to a fair value.

However, with the current procedure of valuing mutual fund redemptions and new sales at the next calculated net asset value (normally 4PM), such trading can be destabilizing. Suppose an informed speculator decides the stock market (or a particular sector) will decline the next day. He may very well decide to sell mutual fund shares today, just as he might decide to sell shares of any other stock. (He might prefer mutual funds shares because the transactions cost are zero, or because he is holding some in a tax deferred accounts such as a retirement plan or a variable annuity). If he sells, he gets the net asset value calculated at 4PM for that day. His decision to sell normally does not affect stock prices that day (orders usually become final at the close of the market and can be cancelled until then). However, over night his sell order is aggregated with that of other individuals. The next day the mutual fund manager probably learns it has net redemptions. This may cause the mutual fund to sell that day. The speculator caused mutual fund selling is likely to depress prices the next day, producing a self perpetuating prophecy.

The same happens in reverse when an informed trader decides the market will rise the next day. He may choose to buy mutual funds. He will receive the shares based on the net asset value at 4PM. The next day the fund learns it has an inflow of funds and buys stocks. This buying serves to move prices up, making the mutual fund selling a self fulfilling prophecy.

One can imagine fluctuations caused just by this. A comedian announces that when ever the Saints football team loses the market declines. A few sell their mutual funds next time the team loses. The funds sell stocks the next day, and these few make money. The next time the team loses, more sell. The word gets around. From then on any loss by the team is followed by people selling their mutual fund shares, and then profiting from the decline the next day. Eventually, the size of the declines would be limited by smart money (which may sometimes be the same people who sold the mutual fund shares) buying stocks on the days when their prices are expected to be forced below the long term equilibrium by the temporary mutual fund selling. A similar story could be imagined in which a signal comes to be associated with a rising stock market.

It would appear socially desirable to avoid having the above self fulfilling prophecies in the market. If instead of mutual fund net asset values being set before the funds had done any buying or selling associated with the orders, the prices were set after the mutual funds had done their buying or selling, the above problem would disappear. Instead, mutual fund trading would serve to stabilize prices. If smart investors saw prices were temporarily different from equilibrium they might choose to trade through their mutual funds (due to lower transaction costs), and the resulting trading would help keep prices closer to the equilibrium values.

As an illustration consider trading the day of the week effect. At certain times Mondays have actually had negative returns. In a forthcoming paper (Miller, Edward M, Prather, Larry M., and M Imtiaz A. Mazumder, "Day-of-the-Week Effects among Mutual Funds", forthcoming Quarterly Journal of Business and Economics), I and my coauthors show that trading certain categories of mutual funds based on the simple rule of selling on Friday and buying on Monday (to be out over the weekend and Monday) would have had higher returns than buy and hold (if desired we can send a copy of the page proofs to the SEC).

My PhD student Mazumder has documented that during his test period returns in most foreign funds could have been improved by staying out of the market on Mondays. Published literature (Compton, W., and R. Kunkle, "A Tax-free Exploitation of the Weekend Effect:A "Switching" Strategy in the College Retirement Equities Fund (CREF)," *American Business Review*, 17,June 1999, pp. 17-23) shows that such a rule for a CREF fund would have been worked to raise returns. In all of these studies, risk is lowered because the investor is out of the market part of the time.

With the current system, funds will typically learn of the Friday redemptions on Mondays. If they try to adjust their portfolios, they will force Monday prices down further. Then when the fund buying occurs on Mondays, the funds buy stocks on Tuesdays, tending to raise Tuesday's prices. This of course makes the Monday effect stronger not weaker. With next day settlement, mutual fund trading would tend to eliminate the Monday effect.

With next day settlement, such trading would tend to lower Friday's stock prices and raise those on Mondays. With the proposed next day pricing, someone anticipating a low Monday would have to place his order on Thursday. The funds would know of the fund outflow in time to sell on Fridays. The selling on Fridays would tend to lower the Monday effect (which is calculated as the decline from the Friday close).

Admittedly, rules against frequent trading might prevent some traders from playing the Monday effect every week (52 times per year). However, they could still

profit from a few trades per year. One who was planning to trade for another reason anyhow might time his trades to be out before Monday, and in on Mondays. With today's rules the sell orders are placed for 4PM close Friday, and the buy orders for Monday's 4PM pricing. With next day pricing the orders would be placed a day earlier. Their impact could be felt in the markets on the days the mutual funds learned of the cash flows.

While there is a question whether the classic Monday effect still exists, understanding how mutual fund investors could use it to improve their returns shows the problem with the current day of order pricing.

It is a question whether mutual funds would place their trades the same day as they learned of the redemption or sales of their own shares. However, if dilution is a problem it means that mutual funds investors are somehow timing their trades so that they get out before declines and in before rises. If it is fairly easy for a fund to determine if this is true. If it is true, they would be smart to trade on the day as soon as they learn of net inflow and outflows. If their share holders (at least in the aggregate) are better at timing than they are, they should use the expertise of their share holders. If need be, they can use the futures markets to adjust their exposures.

It is possible for a mutual fund to adjust their data on inflows and outflows for certain flows that are not likely to be informed by short term information (such as those made by payroll deduction, by automatic bank withdrawals, or calendar based rebalancing). They would be smart to see if the remaining flows reflected skill at timing purchases and sales and then to try to respond promptly if they did. With next day pricing this would be possible.

Thus, informed mutual fund traders would help to stabilize prices. Such trading would tend to reduce, and might even eliminate the Monday effect, as well as any other predictabilities in the stock market.

A one day delay in setting net asset prices would change mutual fund trading from being destabilizing to being stabilizing. (It is being assumed the mutual fund would respond to net inflows or outflows by adjusting their investing on the day the changes occurred and before the net asset values were determined).

Stale Pricing

Basing mutual fund pricing on the next days close would greatly reduce the problem of stale pricing. With 4PM NY time pricing, the prices for European and Asian funds are hours out of date. If mutual fund net asset values were set on a next day basis, there would normally have been a full day of trading in between the order being placed and the pricing. Most profits from being able to forecast how events that occurred between the close of a foreign market and 4PM New York time would be eliminated.

The major exception would be for a few occasions a year when there was a foreign holiday that was not observed in the US. An example is Easter Monday, which closes European markets, but not US ones. Prices based on 4PM New York time on Easter Monday would not normally incorporate the reaction of European markets to events that occurred since the last European close, which would have been Thursday, a little before noon New York time. If such events had occurred, smart traders might be

able to benefit from them. Similar comments would relate the different closings around Christmas (many markets are closed on Boxing Day, the day after Christmas), the Chinese New Year, the Golden Week in Japan and other occasions (patriotic holidays) when foreign markets closed on days the New York markets are open.

Fair value pricing could deal with these dates. In addition, there would seem to be a case for permitting funds with most or a substantial fraction of their investments in a country where up to date prices were not available to delay pricing until market based prices were available. For instance European funds (and possibly international and global funds also) might be permitted to delay pricing (which would mean delaying redemptions) till the Tuesday after Easter.

It should be noticed that even without special holiday rules, delaying pricing for one day would greatly reduce the stale pricing over foreign holidays problem. Consider the Easter weekend (this section is being written on Easter Monday). Under current rules any trades placed Easter Monday in an European fund would be executed at prices that were set in most of Europe on the previous Thursday (the markets are actually closed by noon NY time). If events (terrorist attacks, natural disasters etc.) had occurred over the long weekend, that might be expected to affect European markets (and Hong Kong, Australian markets). Traders could take advantage of these events. With the proposed one day delay, orders placed on Easter Monday would be executed at net asset values based on Tuesday trades. The only period whose news would not be reflected in pricing would be the period Thursday between the European market closes and 4PM Thursday. Order placed in the US Friday based on knowledge of what happened during that period might be able to benefit from stale pricing. However, this is a period of only about 5 hours. The current system can lead to prices being used that are over three days old.

Similar comments would apply to Boxing Day (the day after Christmas) and to foreign holidays in general. Since many countries adjust their holidays to have them fall adjacent to weekends, US traders now trade on events over a long week end. This would become less possible with next day pricing.

Similar comments would apply to any stale pricing that occurs in US markets for US stocks. Sometimes for a small infrequently traded US stock, the last price available is several hours or days old. It may not affect recent events. With next day pricing, the bulk of this problem would disappear, since there usually would have been a trade that had occurred after the placing of the order.

It is possible that there are some US small stock pricing errors that reflect lags that are not technically stale pricing. There are US studies that show that US small stocks lag large stocks. One mechanism arises from limit orders. Suppose somebody place a 5000 share order to sell with a \$5.00 limit. There has been news that might make the equilibrium price \$5.10, but the limit order seller is unaware of this and does not change his order. At 3:59 a 100 share market buy order is executed. This trade is done at \$5.00. The next day, if nothing has changed the prices moves to the equilibrium value of \$5.10. Thus limit orders can induce lags in small stock pricing.

The proposal to delay pricing till the second day would eliminate most of this effect for two reasons. (1) Many limit orders are day orders that expire at the end of the day. Even if placed again the next day (for the remainder of the quantity desired), the buyer or seller may adjust the price allowing for any new information, including how

similar stocks closed the previous day. (2) Many limit orders may have been filed before the next day, permitting the price to move towards equilibrium.

Insider Trading

The next day pricing proposal might reduce insider trading. While most insider trading is probably done in individual companies, there probably are a few who use mutual funds. This is especially likely for those who know of things that are likely to affect the whole economy, or the major sectors that are represented by funds (whole countries, major industries). For instance, suppose the President is to make a major address (or an overseas official is to) that evening that is expected to announce things that will move the whole market (new tax proposals, wars, his resignation). Often during the day various Congressmen and other are told what will be announced. Someone knowing of the impact on markets may choose to use investment companies because of the low transactions costs and the high diversification. The diversification is important because any company may be affected by many company specific events in addition to the presidential announcement. With a one day lag, such trading would no longer be profitable (although the smaller number who have the information more than a day in advance might trade on it).

Disadvantages

I see few disadvantages to the ordinary investor from a one day lag in fund pricing. The major cost is that the investor selling or buying might have to wait a extra day for the proceeds of a sale, or to have his funds invested. Now funds settle the next day. With the proposal they would probably settle in two days. One day would be due to waiting for the net asset value to be determined, and another day might be consumed in actually issuing checks, wire transfers, etc.

Two days for settlement would seem tolerable since few use mutual funds as stores for emergency money (except for money market funds which would be excluded). It should be noticed stocks settle in three days now, and a two day settlement for mutual funds would still be quicker. In a world of credit cards there are few emergencies that call for cash in less than two days.

Should access to emergency cash be considered a problem an obvious solution is to permit a partial payment while waiting for the net asset value to be determined. Customers could probably be allowed as much as 90% of the last net asset value with little risk to the mutual fund. The last 10% would be paid after the exact amount was known. Because of the added cost of making two payments, a small fee should be charged for this service.

Also, mutual fund accounts are marginable. In most cases this is after 30 days (although Schwab permits them to be marginable immediately). This means that when held in a margin account, usually 50% of the value can be withdrawn immediately and could be used for emergencies. If a brokerage house is holding the mutual funds, a margin account can quickly be established. If emergency cash is a concern, the margin rules might be changed to make mutual funds for which a sell order has been issued (and checks requested) immediately marginable (possibly at a higher percentage than normal). This would provide any way to provide emergency cash for those that needed it.

Day after pricing would present some problems if adopted by only some mutual funds. In the case where there were transfers from one fund to another and one had such pricing and the other did not, both would have to be scheduled for the day the one with the later pricing occurred. This seems feasible, although it might require some explaining to customers. It would obviously involve some expense for reprogramming computers. Customers could be offered (or may already have) the option of exchanging out of one fund into a money market fund and then on the second day having the money go into the fund with two day settlement. This might be useful top investors when the fund (perhaps a domestic one) was perceived as risky or ready to decline, and the fund transferred into required second day pricing.

With next day pricing potential investors might be slightly deterred from investing by fear they would be caught in a declining market and unable to get out. However, this fear is not well grounded since few (if any) investors can see a decline coming in time to get out. Planning to sell before a decline is an unrealistic strategy for at least two reasons. Few investors can foresee declines well enough to sell before hand. Also, any event that makes the mutual fund investors anticipate a decline will also cause any potential stock buyers to expect a decline. There will be no one to buy the stocks being sold by the fearful investors.

If there is mass selling by fearful mutual fund investors, the remaining share holders will suffer under the current system. The early sellers get their money based on today's prices, while their selling causes the next days prices to be lower. This hurts the mutual fund investors who do not immediately sell on bad news. One can easily imagine investors racing to be the first to sell.

The proposed next day pricing rule would reduce this risk because worried investors would realize that by the time their mutual fund shares were priced the decline would already have occurred. Knowing this, fewer might sell. The proposed next day pricing system might actually make the system more stable.

Late Trading

One day delayed pricing would also eliminate most of the potential profit from any placing of orders after the closing time. In the recent scandals, even the latest trades were placed only a few hours after the 4PM official closing time (say as late as 10 PM). Because there is sometimes market moving information released after 4PM, such late trades can be profitable. However, with mutual fund prices based on a next days price, the information released between 4PM and say 10 PM can be expected to be reflected in the prices as of the next day. Even if the information would affect Japanese markets, the prices trades were made at would reflect the impact of the information.

With relatively little profit from placing late trades, and penalties for doing so, one would expect very little late trading.

As was pointed out in the comments by the American Bankers Association (in the record here) on the proposal to require that all fund orders be received by the fund company on or before the pricing time (now 4PM for most funds) can put banks and other intermediaries at a disadvantage, especially when they are handling retirement plans. With a later pricing time than the order cut off time the different channels are treated similarly. With several hours between the order cut off time and the pricing time, all channels (that are reasonably efficient) would be treated similarly. The problem

pointed out by them is solved in the next day pricing proposal by moving the pricing time forward so that all orders received by different channels before an order cut off time could reach the mutual fund company by the pricing deadline. The Bankers Association points out that under the SEC's hard close proposal retirement plan investors would probably receive next day pricing while investors dealing directly with mutual funds would receive same day pricing (with broker customers in between, with the results depending on how fast the brokerage firm works and exactly when the order was received). The proposal for next day pricing solves the problem by moving the pricing day forward for the mutual funds so they receive the next day pricing that retirement accounts would receive.

Legalities

Given the absence of strong public policy obstacles to pricing at the next day net asset value, it would seem obvious that any legal obstacles to this should be removed and mutual funds allowed to try next day pricing. As argued below, it appears more effective in dealing with the stale pricing problem than using redemption fees (such as the 2% fee proposed for sales within 5 business days). It is very likely that investors would prefer funds priced at net asset values on the next day to ones with redemption fees or restrictions on transfers. There seems no reason why funds should not be allowed to try this alternative.

The requirement that redemptions be priced at the net asset value "next calculated" appears to preclude next day pricing. Hence this requirement should be relaxed. The SEC power to determine the time of calculation would seem to permit this.

Earlier Pricing Times

Many of the benefits of next day close pricing could be obtained with even a shorter delay. Using the opening price (while requiring orders to be placed by 4PM the previous day) would provide a definite price at which funds could trade in response to purchases or sales of shares (at most, it might require a few more people work an evening or night shift in order to inform the fund managers of the net flow of fund). This would increase the probability that investors buying shares or selling shares did not change the proportionate ownership of the original (or remaining shareholders). Because there is usually a large volume on the opening, the prices might be representative of those funds could trade at, and might easily include the price impact of any trades made by funds.

According to a Market Watch story quote by William Hernandez in commenting on the SEC 2% proposal (on the SEC website) the British funds now use a version of forward pricing in which pricing is done at the next day's opening prices. If it works there it should work here. The SEC should have its economics office look at their experience.

A legal problem for using opening prices is that on the exchanges with specialists, the specialist opens the stocks at slightly different times. Being human they cannot make the decisions required for all stocks at one time. An individual specialist usually opens the largest stocks he is responsible for first and then moves to the smaller. Thus, NAV based on 9:30 security prices would actually be based on 4PM prices for many securities.

One solution would be to change the rules so that opening prices were used even if they were set at slightly different times. Some fair valuing adjustments might be required for the occasional stocks whose opening was delayed beyond some specified time or whose trading was suspended.

Another solution would be to pick a time be close to the opening prices. A 10PM pricing would have most stocks open. The last available transactions would be close to the opening prices.

Most of the foreign stale pricing problem would be solved since Europe would still be open at 10 or 11 AM and their prices would reflect the most recent information. While Asia and Australia would have closed, they would have traded since orders were placed and information available before the orders were placed would have been incorporated into their prices.

With modern computers it might be possible for funds (or at least most of them) to still provide next day settlement. If the pricing process took say two hours, a 11 AM pricing would be consistent with prices being announced by 1PM. There might still be time for wire transfers of funds, or for letters with check to catch the evening mail pickup. There would appear to be several disadvantages to this proposal.

1. With next day settlement, many clerical tasks (such as mailing out checks) would have to be accomplished in a few afternoon hours. While this probably could be done, it might require large staff and more equipment raising costs. I think most investors would prefer a little slower settlement in exchange for the lower costs of providing a full day for such tasks.

- 2 With realistic deadlines there would be less time for fair pricing for the few stocks that were suspended from trading, making this process a little less accurate. However, the need to provide prices to newspapers currently provides very little time for fair value pricing.

3. The net asset values that papers could publish would always be a day out of date. Funds would be under pressure to publish two set of prices, one the ones at which redemptions were being made, and another which would reflect the net asset values at the close (for those who wondered what their net worth was or wanted to use the numbers for financial planning).

The use of closing price seems to be a historical artifact tracing back to a pre-computer time when those were the only prices readily available. In the modern US computers would have little trouble keeping a list of the latest trades in a list of securities, and calculating net asset values as of a certain time.

It is possible that for certain foreign markets the data suppliers would not have prices available as of 10 or 11AM, or some other time when they were still trading. However, they would have closing prices. If the pricing time was noon Eastern Time, closing prices for Europe, Africa, Asia and Australia would be available. Probably the best solution for this problem would be to permit any funds for which getting prices was a problem (which would appear likely only for those investing in Latin American markets still open at the chosen time) to use a different time for calculating net asset values. I am not certain there are any markets for which either a closing price or a noon price could not be obtained. At most, data provider might have to modify their programs and possibly purchase intra-day feeds from a few exchanges. With exchanges anxious for US mutual

fund participation, I suspect any (if they exist) that could not now supply intra-day prices would quickly modify their systems to be able to do so.

Given the high costs of trying to do the settlement process in less than a day, I think investors would accept second day settlement. Then it becomes easiest to use prices as of 4PM on the next day, when closing prices for all of the major exchanges are available and few changes are need in procedures.

Must All Securities be Valued at the Same Time?

Current law and regulations presume that all the securities a fund owns should be valued as of the same time. Logically, this creates a need for fair valuing at least some securities in funds that invest internationally. The reason is that there is no time of the day in which all of the world's markets are open. The closest is from about 9:30 to 11:30 AM New York time when the Americas and Europe are both open. However, Asian and Australian markets are closed then.

As discussed, it desirable to use prices that are determined after order are placed and reflect publicly available information. Otherwise, profitable trading opportunities are created.

However, the optimal time for value determination probably depends on the ease of determining the value. It is easiest to determine at value if a time is chosen when the relevant market is open. One can then presume that if a willing buyer and a willing seller trade, that the price reflects value.

If 4PM New York time the next day is chosen for valuing US stocks, one could still choose earlier times for stocks traded on other markets. Doing so avoids the need for statistical adjustments or for the even more expensive procedure of human "fair value" pricing. For instance, a requirement that prices be based on values as of 4PM the next day logically requires that Asian and European closing prices be adjusted for events after the close of their markets. This cost something, and if practical should be avoided. Basing values on the last available prices in the markets they are traded in (as long as these are after the orders are placed) seems a very economical solution.

The Investment company Act in the definitions sections 2 41(a) says "in each case as of such time or times as determined pursuant to this title, and the rules and regulations issued by the Commission hereunder." Thus, it would appear the SEC could authorize the use of different times for different securities depending on which markets the securities were traded in, or when they last traded. In particular, stating that "the value is the price established by the last trade after the cut off time for orders" would appear to be within the SEC's powers.

There are two questions as to whether an earlier close might be used for some markets which close earlier.

One issue who bears what risks? To illustrate the point consider the hypothetical Great Japanese Earthquake of 2005. It occurs after the close of the Japanese market but before 4PM New York time. If values are to be based on the values of securities as of 4PM New York time, someone who has placed a sell order the previous day bears some of the loss of this. (I am assuming fair value pricing is done and someone had to make estimates of what the value of the Japanese stocks was as of 4PM New York time, when Japanese markets are closed). Someone who has placed a purchase order does not bear

any of the cost, (because the net asset value has been reduced for the effects of the earthquake).

If the rule was that the values were based on the last prices after the deadline for placing orders, the loss is borne by the other shareholders in the fund, not the selling shareholder. The unlucky purchaser of the shares bears a little bit of the loss.

Short of very rare events (like the above mentioned hypothetical earthquake) the difference in valuation time is probably an issue of at most 1 or 2 pennies, and for most funds not even enough to change the price after rounding to the nearest cent. Thus to save fair valuing cost I would suggest that the rules accept the latest prices established after the deadline for placing orders.

Of course, the value setting trade should occur after the order deadline. Otherwise opportunities are created for smart traders. Under the traditional procedure of basing values on the last available price, someone might see the earthquake damages on TV and deduce that Japanese securities had gone down in value, and that the prices would be lower when the Japanese market reopened. Such a person could profit by selling a Japanese fund he owned and receiving a net asset value calculated from the last available prices. This problem is easily avoided by requiring that value setting trades be after the cut-off for orders.

If a company hits a problem and is suspended from trading the last price may be well above the true value of the stocks. If the net asset value is calculated using this value, a smart trader knowing this may decide to sell the fund before trading is reopened and the net asset values reflect the true value of the security. Thus, occasional fair valuing would be still needed.

Fair value pricing should also be used for securities that close limit down or up. Certain foreign exchanges limit the price changes that can occur during the day (as do US commodity exchanges). When this happens there may be trades on record and these will be between a willing buyer and a willing seller. However, the prices are probably not equilibrium ones. Suppose a company finds it is missing a few billion Euro's from its Cayman Island bank account. This produces such a wave of selling that the stock price moves down the limit, perhaps several days in a row. The prices reported are not equilibrium ones until everyone who wishes to sell can find a buyer within the price limits.

If a fund has a large position in such a security, use of the last trade (even if after the deadline for orders) will produce a net asset value that is too high. It is too high in the sense that it does not reflect the value of the remaining share owner's investment. Smart traders may decide to sell now since the odds are that next day the net asset value will be lower. Thus, fair valuing may be desirable in such cases. Of course, the test is not whether the last price for the stock is far from equilibrium, but whether this will lead to a material error in the net asset value. If the funds position is very small, the error in net asset value may not be material. A 5% error in the price of a stock (such as might happen if the bad news should have produced a 12% price decline, but exchange rules prevented trades at more than 7% below the previous days closing price) that is only 1% of a funds portfolio is a .1% error, and this may be less than the rounding error when the net asset value is about \$5.00. The expense of fair valuing may not be worthwhile in such a case.

A later deadline for Orders

It might be noted that if the closing prices on the next day are to be used for pricing, there is no reason for requiring that orders be placed before 4PM the previous day. Orders might be accepted as late as say midnight Eastern time (or some other hour based on the convenience of investors and employees). However, an earlier hour would be desirable to permit funds to trade in Japan and Australia at the prices that were close to those they based redemptions on. Investors who worked might appreciate being able to call from home and still get the same prices as those who could call from work. White collar workers (who usually can make calls from their offices) would not have an advantage over blue collar workers (who often lack phone access from their workplaces).

To avoid stale pricing problems in Asian and Australian funds the cut off time for orders should be before these markets have closed. Midnight EST appears to achieve this goal while providing a nice simple round number. This would be consistent with 8PM on the West Coast which would let people there place order from home phone after consulting with their spouses.

The earliest market to close may be the New Zealand alternative market (for small New Zealand securities) which closes at 4PM New Zealand time, which is currently midnight New York time. While I suspect few securities on this exchange are in the portfolios of US mutual funds, a midnight close for orders would mean reasonably recent prices would be available for fair valuing or a slightly earlier deadline for order would permit using actual last traded prices. The main New Zealand market closes at 5PM New Zealand time or 1AM New York time, permitting the closing prices to be used for asset valuation. There is also the South Pacific Exchange in Fiji which has a morning call market and may close even earlier. It lists only 15 companies and I suspect few, if any, are held by US mutual funds. Given the small US interest in Fiji and New Zealand, order closing times as late as 2AM might be used. This would provide current quotes for Japan and Australia.

One cost to a time this late is that competitive pressures might force a few firms to keep their phone centers open to an hour when they otherwise would not wish to. Of course, if few wanted to call that late, firms should be free to close the call centers earlier. Centers can be located in the West if workers prefer not to work as late as midnight.

Of course, if the order close was delayed into the evening, certain back office workers who now get off in the early evening might leave work at a later hour. Tasks that are now done 4-6 PM might be schedule for 9-11 PM or later.

One benefit of this proposal is that the call center volume might be spread over many more hours than now (say from 7Am to 12PM) permitting firms to use two shifts. This might generate more night jobs for those who wanted evening hours (either for a second job, or so that they could be home to care for children when their spouse was working). A more even call volume would reduce capital costs. Since there would be little financial profit in placing orders just before the deadline, the peak loads would be less than for the present system. This would probably reduce total staffing needs a little. Since most people in the country go to bed before midnight EST there would be a natural tapering off of phone volume.

If someone called at a busy time (other than just before the closing time for getting the next day's price) and had a 5 minute hold the usual result would be that he

was irritated a little, but he would not be forced to endure a 1 day delay in having his order executed. This would reduce the temptation for firms to violate the official closing time by such techniques as giving people a 4PM time if they were in the phone queue by 4PM, even if they got through to a representative at 4:02. Mutual fund call center employees should be happy not to have to tell many customers that even though you placed your call 15 minute ago, it is now after 4PM and you will not get today's price. (Admittedly there will be a few such cases with any fixed cut off time, but fewer people will not be making late night calls where this is a problem). Since little market moving information (and virtually none that they could profitably trade on) comes out in the evening hours, individuals will not be tempted to wait till the last moment before deciding what they wish to do and how to trade.

My impression is that many call centers close about 8PM EST now. If they chose a 8PM Central close (as VALIC does) for their call center, they might easily and legally adopt a rule that all calls in the queue before then are taken. The cost of keeping customers happy via this policy would be only a small amount of overtime. This would result in happier customers, since no one would be in a long hold, and then find he had missed the deadline for getting that day's price.

This logic currently applies to all European and Asian securities since the markets close before 4PM New York time. However, this need for fair valuing is eliminated if a time for valuing the assets is set after their markets are open. Then the markets incorporate any new information.

Order Deadline and Dilution Issues

Another consideration in setting a deadline for orders is how to best serve the Congressional goal of keeping the proportionate ownership of the remaining shareholders constant after redemptions. If the shareholders redeeming their shares receive a valuation based on prices the fund cannot sell its own securities at, the Congressional goal is defeated. This happens routinely under the current system since the prices used in valuation are as of 4PM New York time. If the funds wait to know their total redemptions, the earliest the funds can trade is the next day. If prices have gone down the exiting shareholders have their interest valued at a higher price than the remaining shareholders.

Under the proposal a fund would have plenty of time to sell its securities the next day when it got redemptions. The only way the Congressional intent would be defeated is that the selling fund would pay commissions and sell as the ask price while the redeeming shareholders had values based on a last observed (closing price) which is closer to an average of and the bid and ask.

With a proposal to use next observed prices, the same could happen for Europe. I understand the current system gets the portfolio managers the quantity being sold within a perhaps eight hours of the deadline for canceling orders. Thus, funds having net redemptions could sell before the close. The redeeming shareholders would get prices based on close to prices the fund could sell at, although the fund might have a shorter time to trade. As discussed above, any net imbalance in mutual fund sales or redemptions would be expected to result in net selling or buying by the funds, making the process stabilizing.

For Asian and Australian markets this goal might not be achieved. If the aggregation process did not start until mid-night, mutual funds might not know their cash positions until after the markets had closed. If it was desired to be sure the funds had an opportunity to trade on net inflow and outflows, which promotes stabilization and achieves the Congressional anti-dilution goal, it might be necessary to have either an earlier close for funds heavy and Asian or Australian stocks.

It is also possible that most funds and intermediaries would adopt an earlier close and start their order processing process afterwards. If they closed their call centers at 9PM New York time and started processing orders afterwards, funds might learn of their cash positions in time to trade even in Asia and Australia.

Thus, even with next day pricing there remains an issue of what time to use for the order closing time. To maximize the chance of achieving the Congressional goal of avoiding dilution of existing share holders position, a feasible compromise might be a deadline for accepting orders that was in the evening when many call centers now close. A 9PM deadline might permit funds to trade in Asia and Australia while still giving many blue collar workers a chance to make phone calls from home in time to achieve the next day's price. (Admittedly this would prove a problem for the West Coast, although they would be much better than in the current situation where they have a 1PM deadline for placing orders).

Recognizing that one of the real issues here are ones of who bears risks, avoiding disputes, and minimizing the costs of fair pricing, a case can be made for allowing the parties to make different contracts depending on the circumstances, and to provide for different times for securities priced in different markets. I would argue it is more important that the rules be clear and give an easily determined price, than exactly what they are. I suspect that if this was done, the last available price (after an early evening order deadline time) would be chosen. The effect would be the use of values in Asia, Europe, and North America that were set at different times. Investors would bear the risk of (indirect) security ownership for a short time after placing their sell orders, with the exact number of hours depending on the market the underlying securities were traded. With a midnight New York time close for placing orders, the selling investors would bear the risk of being invested in Japanese securities for about 2 hours, many European securities for about 11-12 hours, and North American securities for 16 hours.

Likewise, for thinly traded US securities (and similar securities overseas), the time of the last trade might be appreciably before the close of the market. A seller of a micro cap fund might bear the risks of indirect ownership for an average of only 15 hours (to 3PM New York time if that was the average time of the last trade). The same would apply to the indirect ownership in micro cap securities in a fund that held only a few of them.

Optional Next Day Pricing

Even if the SEC decides to require the 2% fee, firms that choose to use next day pricing should be exempted from this. As discussed above next day pricing solves most of the problems (and better) than the proposed fee. The market place might be allowed to determine which solution was best. Admittedly, retirement plans, insurance companies etc. might want consistency. They might choose to offer only funds that used one system for their plans. This would appear workable. I could imagine that many fund families

might offer clones in which one fund had fees and same day pricing (at 4PM) and the other used next day pricing. Insurance companies, retirement plans, etc. would choose which they wanted to offer.

It might even be desirable to offer the choice of same day pricing and a short term fee, or next day pricing and no fee within the same fund. This would be done via different classes with one class providing for the fee and another for next day pricing. There are funds now that short term redemption fees on some classes but not others (which seems inequitable). Different redemption fees on different classes would be less inequitable.

My impression is that the traders would choose the redemption fee class and the long term investors the next day pricing since if they wanted cash in a hurry they could get it quicker with next day settlement. I believe few really will need cash so urgently they will pay a 2% fee rather than waiting. Those that choose a next day pricing to wait in a redemption fee system can actually get cash quicker when they want it.

It would even be feasible to offer individuals a choice when they place a sell order as to whether they want to pay a redemption fee and get cash quickly, or place an order (not revocable of course) with next day pricing.

Market timers trying to take advantage of stale price would be handicapped because selling for next day pricing would usually eliminate any benefit from selling before a decline. Of course, market timers might be more willing to go in if they knew they could immediately place an exit order for pricing one day out (those limiting their market risk to two days).

Recommendation

I would suggest that if changing the time of net asset value calculation is used as a solution for the problem of stale pricing, it merely require that the net asset values be for the day following the placing of an order, and at a time when the major market where the funds securities are priced on is either open or has just closed. I would expect most funds to continue with 4PM pricing, since this provides time to get quotes in the next days papers and the organizations are used to using this time. Legally, with this rule they could set the closing time up to midnight. One might permit them to use midnight other than Eastern even, such as when their headquarters were in a different time zone. However, if they have any appreciable positions in stocks traded in the Pacific Region, (including Japan, Korea, and Australia) they should be required to pick a time that doesn't normally result in stale prices for these regions (i.e. if the time is later than the close of such markets, the latest prices may be almost 24 hour old). In practice the latest time for accepting orders would probably be when their call centers now close.

A minor issue is whether to permit Internet orders to be placed up to a later hour (such as midnight). In favor of the later hour is that some customers might prefer it, and a later hour would do little real damage (as long as stale prices were prevented). On rare occasions there might be market moving news after the call centers had closed, and customers without internet access might feel they were at a disadvantage. Imagine the hypothetical Great California earthquake of 2005 which occurs at 11:38 PM EST when call center are closed (but CNN and other news services are still open to report on it). Customers with Internet orders could still get the next days NAV while those using phones would have to wait a full day. A system where exchanges could be placed via the phone key pad (which some firms now offer) might reduce this problem.

Of course, even in this case the next day's price would be after a full days trading and the prices would reflect the earthquake damage. The few customers without Internet access who were still awake when this occurred and who wanted to trade would not actually be at any major disadvantage with regard to the profits they made. (Depending on luck they might actually get better prices than those who could place orders just before midnight).

Improved Fair Value Pricing

Fair value pricing as frequently done does not appear to completely eliminate potential profits from short term trading trying to take advantage of stale prices. It appears that one reason is that the rules as written contemplate a different problem than is today's problem.

The legal goal as set out in the Investment Company Act in Sec. 22 refers to net asset values which are set

“in each case for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities.” The legislative goal is on setting a net asset value which is fair, not on using prices. The legislative goal seems quite consistent with use of statistical methods to calculate the security values used to calculate net asset values. The major problem with this goal is that it seems to not recognize the goal of protecting those purchasing or redeeming securities from unfair pricing. Fortunately, a fair system would probably protect both the existing holders and the buyers and sellers.

According to news reports a SEC sponsored study found that surprisingly little use was being made of fair value pricing. A partial explanation is probably fear of lawsuits. The regulations as currently written expose mutual funds unnecessarily to legal action if they use statistical methods to set fair values.

The type of fair pricing that appears most desirable is clearly not contemplated by the regulations, and may even be illegal. The problem contemplated originally appears to have been an infrequent event affecting a single company which made the latest prices incorrect. An example might be a Japanese earthquake occurring in a single city at 2PM New York time, which would be during trading hours in New York. If prices were based on the last available price for a company in that city, the prices might overstate what the shares were worth, and what they would trade for when the Japanese market next traded. The reason is that a US investor selling a mutual fund would have the stock valued at the last available price at 4PM New York time. However, at 4PM New York time the Japanese market have been closed for many hours (they close about 2AM New York time) and the price would be pre earthquake. In such circumstances the error in prices would be material. It would seem appropriate to have people exam the circumstances, decide whether the error was large enough to be material, and then decide on a new “fair value.”

While the above type of problem is real and occasionally occurs, it is not the bulk of the problem. Frequently, a large pricing error in a stock that a fund has only a small position in does not have an appreciable effect on the net asset value of the fund. For instance, if .2% of a fund is in a stock, an error of 20% in the value of the stock produces

only a .04% error in the net asset value of the fund. If the fund net asset value is \$10, this is less than a 1 penny error in the net asset value.

The more common problem is a very large number of relatively small errors in the value of the stocks the fund holds that together create an opportunity for profitable trading. The most frequent cause for this is the practice of basing prices on the last available prices, which for some securities (notably foreign ones) are many hours old. Suppose on average every stock in a foreign portfolio is priced at an average (weighted) .1% less than the value it is likely to open at when the foreign exchange next opens. It is also plausible that on average the closing prices for these exchanges equal the opening price. Consider a foreign stock fund that has a reported net asset value of \$10. The best guess that when it next computes its net asset value (basing it on the next set of closing prices), the net asset value will be 10.01. Many lawyers (and judges) might not regard a penny error as a “material” error. In this case, they might advise their clients that the law forbids any adjustment in prices. Many might say errors of a penny are not important and should not be worried about.

Frankly, they are probably correct if the errors are random and can not be predicted. Investors should merely recognize that errors occur, and that the prices they buy or sell at are often off by a penny.

However, suppose a smart trader can guess which way the error is more likely to be. Many investors would say that an expected profit of a penny per share is not worth trading for. In stocks they would be right, because commissions and spreads usually exceed this amount. However, most mutual fund investor experience no transactions cost from buying or selling. A profit of a penny may be worth pursuing. If one has a \$100,000 and trades a \$10 mutual fund, a penny per share is \$100. If one has \$1,000,000 a penny per share is \$1,000. For many of us, such profits justify the time required to make a phone call or to log on to a web site.

If there are 100 opportunities per year to make a trade that earns \$1,000, the net profits are an extra \$100,000. This is about an extra 10% on the funds invested. Since the normal returns of 10% may also be earned (perhaps the investor switches into another fund when he leaves one fund), the result is a rate of return of 20%. The exact numbers are not important. What is important to understand is that small systematic errors can lead to large profits. The key question about errors in pricing a security is not how large the errors are but whether they are systematic errors that are correlated with errors in other securities, and whether they are predictable. Many might argue that .1% pricing errors are not “material,” but such errors can lead to large volumes of (profitable trading). If the errors are not “material,” the law and regulations seem to be require that the last available prices must be used.

In practice, such systematic errors can be found where prices are stale, such as often happen for foreign funds. Empirically, there is a tendency for Asian and European prices to follow those in the US (this is documented in unpublished research done by my graduate student Mazumder and in various places in the academic literature). Thus, on average one can “guess” which way prices in these markets will move by noting how prices have moved in the US.

Those who have referred to this as “arbitrage” are being very misleading, because arbitrage normally implies low risk trading. Such trading is risky. On any one day the foreign market may open down even though the US had moved up on the previous day.

Or the foreign market may open up even when the US market had closed down the previous day. By referring to such trading as “arbitrage” the SEC may encourage investors to make high risk trades that are not in the investors interest.

Risk is further increased by the fact that US mutual funds prices are based on the closing prices in the foreign markets, and there are usually large price changes (which are essentially unpredictable) between the open and the close in all markets. However, if one has a trading strategy that increases the odds, using it repeatedly is likely to result in large enough profits to justify incurring the risk for many investors..

Thus, the standard for when to use “fair value pricing” should be not whether there is believed to be a “material” error in the value of any one stock, but whether there likely to be either material errors in the net asset value of the mutual fund, or ideally any errors (beyond the most minor) at all in the net asset value. A “material” error standard may work if “material” is interpreted as being a penny or more, or if material is interpreted as large enough to justify trading on.

However, if “material” is interpreted as several cents, profitable trading opportunities will remain. If it is required there be strong enough evidence to convince a jury or judge that the last available prices for any particular differ from “fair value”, fair value will be used much less than it should be.

As a practical matter, there are very few days when there is really convincing evidence that any particular stock’s last closing price is far from fair value, or far from the price a willing buyer would pay a willing seller at 4PM New York time (ie. Evening in Paris or early morning in Tokyo). However, regression of changes in net asset value for international and global funds on changes in US indices, such as my graduate student Mazumder has done (and I have done separately) provide strong evidence that on average the reported net assets value differ from the present value of the expected net asset value for the next trading day. This implies that profitable trading strategies exist.

Thus, if it is thought that there is too much trading, a partial solution is to base net asset values on the best estimate of what a “willing buyer would pay a willing seller”. In turn, this is the discounted (by one days normal return) of the expected opening price for the security the next day. If two investors were negotiating to buy or sell a security at 4PM New York time (5AM Tokyo time), they would base their prices on the expected prices when trading starts in 4 hours (at 9AM in Tokyo), not on the previous day’s close. Both of the investors would be aware of what happened in the US markets and how it would likely affect opening prices on the Tokyo market for that stock. If the US market had moved up since Tokyo had closed, the seller would ask for a little more (and he would have a good idea how much more to ask for), and the buyer would be prepared to pay a little more (and he would have a good idea as to how much more he should be willing to pay). Adopting the rule that mutual funds should be redeemable at a net asset value which is based on what a willing buyer would pay a willing seller appears consistent with the goals of the law. When the fund owns securities traded in a different time zone, such a valuation will seldom be the sum of the values calculated at closing prices.

When Congress wrote the initial law and the SEC the implementing rules, cheap computations were not available and adjusting large numbers of security prices for small biases was not worth the cost. Thus, the rules are written in terms of relatively large

pricing errors where each security is individually priced by judgment. However, today statistical methods are practical and should be routinely used.

Fortunately computing is so cheap now. It is very feasible to write programs that start with the net asset values calculated from the last available prices (which may be many hours old for foreign stocks) and use information from US indices to adjust them to what a willing buyer should pay a willing seller.

As illustrated above, two Japanese investors negotiating at the time New York closes would probably trade at their best guess of the price the security would open at in a few hours.

If the investors are trading a European stock, it would be evening in Europe when the New York market closes. The opening will be the next day. A potential buyer will be aware that if he makes his trade the next day on a European exchange, he can keep his money in the bank for one more day and earn a days interest. The seller will realize he is losing a days interest by trading then. Thus, the price they trade at will be slightly lower than the anticipated opening price the next day. However, one day's interest is a small amount and this is not much of an adjustment.

A major obstacle to fair value appears to be that the above procedure is arguably inconsistent with the current law and regulations. Indeed, the comments of the law firm of Arnold and Porter submitted here make that argument. The 1940 securities Act in the definitions sections in defining value says "as used elsewhere in this title, (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors;." "It could be argued that closing prices for securities are "readily available" even if they are a few hours stale.

Congress should be asked to amend the law to make clear that stale prices can be adjusted by statistical methods. The law also refers to actions by the Board of Directors, which is not the same thing as by a computer. Of course, if large numbers of prices are to be routinely adjusted, the role of the Board of Directors should be to oversee the process, not to do the work themselves. Again, the SEC should propose legal amendments to permit use of fair value pricing via statistical methods. Congress might wish to require the use of fair value pricing or authorize the SEC to do so.

These laws and implementing rules should be altered to make it clear that such statistical adjustments should be made every day, not merely on days when there are large movements in the US markets. It should be realized that such statistical procedures will normally produce large errors for any one stock on any one day. However, such errors should average out over all the stocks in a portfolio and over many days. Such a procedure should eliminate any profits arising from stale prices now made by frequent traders in funds investing in foreign stocks, or by longer term investors who correctly time their purchases and sales.

Quite acceptable results can be obtained by using an adjustment factors derived from a regression of a funds net asset values on a single US index. My PhD student, Mazumder had done such regressions for all the international and global funds he had data for. However, given the cheapness of computing power, it is probably worthwhile to use a separate equation for each security in the portfolio and to use different US indices (and perhaps other indices, or even other data series) as inputs.

In theory, the foreign closing prices take into account any information available before the closing. When London closes at 4:30PM London time, it is 11:30 AM in New York. London investors are presumably aware of all information before then, including how the US market has acted. An adjustment for a London company to a 4PM close would use the movement in US indices between 11:30 AM and the close. For Tokyo it would be the full movement in the US index from the previous days close.

One would expect a US auto index would be more relevant for adjusting the price of Toyota or Honda than a US consumer electronics index, while the consumer electronics index might be more valuable for adjusting the price of Sony. The prices of a US ADR may be a good guide to the fair values for the foreign stock.

What would be expensive (and not worthwhile for the mutual fund investors to pay for) would be any procedure that required routinely that humans make decisions for every stock. (Certainly there will be special situations where humans have to look at the data for stocks that the mutual fund has a large position in). Since realistically Board of Directors of mutual funds do not make valuation decisions, the rule should be rewritten to specify merely that they supervise the process and possibly approve the methods chosen.

It appears that the reason such fair valuation procedures are not more widely used is that they appear to conflict with the law and regulations. However these laws and regulations should be changed to provide a “safe harbor” for funds using such statistical procedure. I believe the SEC has “exemptive” powers that would accomplish this pending Congressional action.

Using fair value pricing appears a better solution for the problem of stale prices than trying to forbid people from trading on them or charging high redemption fees. With a redemption fee, investors can still exploit stale prices by timing their purchases for the days they get a bargain and timing their sales (after the time period required to avoid the redemption fee has passed) so that they get a good price.

Similar stale pricing problems arise for certain thinly traded stocks. If the US market for similar stocks has moved up, a trade made a few hours before the close may not be representative of the price the security would trade at if a willing buyer and a willing seller were to trade at 4PM New York time. Again, statistical procedures can be used to adjust these last prices using the change in US indices since the time of the last trade. This should solve the stale pricing problem.

However, I have a feeling that even with non-stale prices, the prices of small stocks may lag those of larger stocks (academic studies have shown this , see the book by Andrew W. Lo and A. Craig MacKinlay, A Non-Random Walk Down Wall Street). Even after fair value pricing for all securities lacking a trade within a few minutes of closing, a trader may find a rule that permits profitable trading. One possible reason for the existence of such rules is the use of limit orders discussed above. Suppose there is a limit order for 5,000 shares at \$10. The prices of similar stocks moves upward but all buy orders continue to be executed at \$10. A market order just before the close is filled at \$10 and that becomes the closing price. This is what a willing buyer is paying a willing seller.

However, some time during the next the limit order no longer plays a role.

- 1) the limit order may have been a day order that is not placed again the next day.
- 2) The limit order may be placed the next day again as a day order but with an updated price that reflects that other related stocks have moved up in price.

These two may result in the opening price following with a lag the movement in an index for the previous day.

- 3) The limit order may be filled and then the price moves up.

Repeated over many stocks, the above can induce serial correlation in small stocks such that one day's data can be used to predict the next day's net asset values. Data for the last two hours or less may be especially useful in making such predictions.

Again it is possible to write computer programs that estimate the magnitude of such effects. These can be used to adjust the net asset values to the present value of the next days open or close. If this is done the long term share holders would be expected to benefit. Such adjustments with the goal of approximating either the opening or the closing prices would appear to be now forbidden by law and regulations. However, changing the law and regulations would appear to be in the interest of long term investors in funds. On any one day the difference is probably only one or two cents, but such apparently small amounts are sufficient to create trading opportunities, and such trading imposes costs on long term investors. Thus the relevant laws and regulations should be changed.

An obvious alternative to using statistical procedures to adjust the last available price to approximate the closing prices of the next day is to wait until the next day's prices are available, and then use them in calculating the net asset value. This is, of course, the proposal to use next day pricing discussed above. Naturally, using the actual next day closing prices is cheaper than using statistical methods to estimate them. Using actual closing prices also reduces the risk of manipulation or inside trading (i.e. that someone might change the formula to benefit himself or take advantage of knowledge of the formula). The use of actual closing prices the next day is also a lot simpler to explain to investors, and more likely to inspire confidence, than the use of a statistical adjustment process that few will understand. Investors could easily understand the rationale of basing the prices received when they redeem their shares on the prices the mutual fund could actually realize when it sold the stocks it owned.

It would be desirable to clarify somewhere in investor documents just what the goal of fair value pricing is, especially for certain rare cases. I would suggest that an explicit statement be that it may be based on what a US investor would pay another US investor. The goal would be to consider in advance what to do if foreign securities become non-tradable overseas, possibly due to foreign governmental action.

If for instance, new foreign exchange rules or taxes make it hard for a foreign fund to sell stocks and send the money back to the US, there is an issue of how to value the holdings of the fund. The foreign prices are likely to be non-representative of what the fund might actually receive and be able to bring back to the US. It would seem that the net asset values should be based on the prices it could receive, which might differ from those other investors would receive. Using next day prices might reduce risk, since after such a change the new prices the fund could transact might be clearer. A new tax on foreigner's selling to bring shares or on foreigner's investing home might be announced after the close of the foreign market. This might also be after the close of the US market. To use historic prices might be unrealistic even though they were available. Trying to estimate what prices would prevail as of 4PM New York time would be difficult. If trades involving US citizens or companies were treated differently, I would argue the prices a

local investor might easily differ from those the fund could receive. To use the prices the fund could receive would seem fairer to existing share holders.

Even after this decision the issue of how to estimate this price would be hard. If pricing was on a next day basis, there might be some actual transactions to use as a guide. Indeed many might be by the fund itself. Informed investors hearing of such actions are likely to rush to redeem their shares and might be able to place order before the 4PM close, figuring the next days prices would be lower. Knowing, they would receive the next days prices they would have less of an incentive. In fact with a large amount of expected panic selling, many investors would choose to delay, guessing the panic sales prices would reflect over reaction.

The Financial Services Roundtable (in a comment filed here) has suggested that an exemption from a mandatory redemption fee might be provided for funds that use fair value pricing. This would be sensible if the fair valuing pricing was of the sort discussed above, since such fair value pricing would eliminate the profit motive for most frequent trading. However, much fair value pricing seems to be applied only occasionally and is inadequate to the task.

Giving funds the alternative of the proposed fees, next day pricing, or statistical fair pricing should provide additional flexibility in that for particular investment companies one may be easier to implement than the other or one may be more effective. In particular, domestic funds might be able to use fair value pricing easily since very few prices would need adjustments, and this would avoid redemption fees (fair valuing would resemble the current system). If the funds feel that redemption fees present a marketing problem this might provide them with a powerful incentive to go to a fair value pricing system, which would probably reduce the losses to their long term shareholders more than a redemption fee would.

The 2% 5 Day Redemption Proposal

Either next day pricing or statistical fair value pricing appears a better solution than the 2% 5 day proposal. The redemption fee proposal seems to impose high costs on investors. Some will pay a fee by accident. As a practical matter, few investors will pay the fee, and the major impact will be to force those who bought to wait 5 business days before selling. Those waiting will loose liquidity.

With this proposal the SEC is imposing an arbitrary “tax” on some transaction with the proceeds to be sent to the funds. Such a redistribution by government fiat does not seem to have been contemplated by the laws the SEC is using as legal justification. Traditionally, contracts have been enforced not arbitrarily set aside by government. The theory has been that when two parties agree on pricing or other terms they know their interests better than the government does and their will should prevail. Either statistical fair value pricing or next day pricing involve relatively minor changes to the existing systems and few investors would even notice the difference. The change in the sum they receive on a redemption would be typically extremely small, and on average virtually zero. In contract, the 2% fee would be appreciable for those paying it. On a \$100,000 redemption it is \$2,000, which is an appreciable sum.

In practice, the 2% fee would reduce the liquidity of mutual fund shares since most investors would choose to delay redemption rather than pay it. In a few cases it might even remove their redemption privileges for five days since the rule as written

forbids redemptions if provision has not been made for the fees (and for various reasons there may be a few cases where no provision is made either through oversight, or because of contractual provisions or legal provisions whose details we are not aware of). In contrast fair value pricing does not reduce liquidity and next day pricing would, at worse, delay settlement by a day. (As discussed above some versions would permit the current next day settlement).

The Redemption Fee Reduces, but does not eliminate the Profits from trading

The proposed redemption fee will certainly reduce the profits from certain trading strategies, especially those that involve trading at stale prices. However, the SEC has probably overestimated the effectiveness of trading fees.

There is little dispute that funds that have implemented redemption fees have experienced a reduction in turnover. I saw a dramatic illustration of this at a professional conference where the comparison was post and after such fees for one fund.

However, what is true for one fund is probably not true for the whole industry. The reason is that when one fund puts on a redemption fee, the traders simply moved to another fund. It would have still been profitable to trade the fund with the fee, but since there were other funds available that promised higher returns, the fund with the fee saw a dramatic reduction in short term turnover.

The effect is probably exaggerated because some traders may have even shifted to the fund planning the fee in the period before the fee went into effect. What was their rationale? Many funds limit the frequency of transfers. Even without a stated limit, they may decide some one is a frequent trader and decline to accept future trades. Hence when fund A announces it will soon be imposing a transaction fee, some traders may decide to make their next trade or trades in that fund. The reasoning may be that they would not reach their cut off limit (if the fund allows only so many exchanges per year) before the fee starts. If you go on their "black list," it does not hurt much since you probably would not be trading them after the fee anyhow. If you choose another fund for your next trade, you are using up a trade against their limit. Such a strategy is quite rational, and a fund introducing redemption fees probably experiences an increase in trading in the period just before the introduction of the fees. I have actually chosen to do some of my trading in funds that were planning to introduce fees on this rationale.

Thus, when the fund makes a comparison of the turnover in its shareholders before and after the fees, it finds that the fees had a gigantic effect.

However, if the whole industry goes to fees and it is still profitable to trade after the fees are imposed (as appears to be true for the proposed 5 day, 2% fee), the funds will find that the reduction in turnover is much less than the earlier experience had suggested.

There is a well known joke about the two hunters on seeing a bear.

Sam: Are you afraid?

Tom: No.

Sam: Why not? A bear like that is dangerous.

Tom: I can run fast.

Sam: But you cannot run faster than a bear.

Tom: You are right, but all I have to do is to run faster than you. The bear will get you before it reaches me.

Funds are like hunters. Any move that makes them less suitable as a trading vehicle will shift the trading to another fund.

As long as there are funds suitable for trading without fees, all a fund has to do to radically reduce the volume of trading in its fund is to make it less desirable as a trading vehicle than the other funds. However, when the whole industry introduces fees, the effect experienced by any one fund will be much less.

To some extent the above situation creates an unstable situation. When no fund has fees, the trading (small in relation to the aggregative dollars invested) is so widely scattered that no one fund notices a problem. However, as more and more funds introduce redemption fees the trading shifts to the remaining funds. These funds notice there is a larger turnover than previously and choose to introduce fees (or other restrictions). Eventually, all funds suitable for trading (and with reasonably competent board of directors looking out for the interests of their shareholders) are likely to have fees. Just from observation, we seem to be well into this process for the international mutual funds (the ones for which the stale pricing problem is most serious). There are very few international funds on the long list Schwab offers that do not have redemption fees. It looks like the SEC goal of using fees to reduce exploitation of stale pricing in international and global funds has been already made moot. It is not clear that the problem in other types of funds is large enough to require the proposed fees.

Should the problem in other types of fund prove serious, I would anticipate the above process to result in fees or another solution being adopted by the industry.

While I can imagine circumstances where someone would anticipate such a decline in tomorrow's net asset value that they would rationally choose to sell now and pay a 2% fee (i.e. the expected loss is over 2%), such circumstances will be very rare. As a practical matter, the proposed fee will lead to the adoption of the rule of thumb that one does not sell within 5 days of a purchase.

This does reduce the profits from trading somewhat since some profitable opportunities to sell within 5 days of purchases will be sacrificed. However, the largest profits come from trading opportunities that are separated by on average more than 5 days. Most the profitable trades will still be possible with the proposed rule. Thus the traders will still find it profitable to trade (admittedly on fewer days). However, the profits on the days they do trade will not be reduced by the proposed rule. On these days, the rule will do nothing to reduce any effects on the long term investors in the fund.

To the extent the 5 day fees reduces the number of investors adopting a high turnover strategy, it will be by increasing risk, and hence discouraging the more risk averse traders. During the 5 day holding period various things can happen, some favorable and some unfavorable. This increase in risk will make trading strategies appear riskier. Even though the expected (in the technical statistical sense) return for the remaining trades undertaken is expected to be higher, the percentage of trades that are profitable will be much smaller. Traders who require a high probability of success on each trade (and there are some) may decide not to continue to trade. In particular, those who buy on a clear signal and plan to liquidate the next day, or who plan to liquidate on even a weak indication the relevant market will decline, may decide not to trade at all if they must wait 5 days before selling.

Fair value pricing and next day pricing are much better ways to protect the long term investors (and short term investors also, since the effects on remaining shareholders are the same regardless of holding period) from any dilution caused by short term trading in funds. It protects against dilution caused by all who are knowledgeable enough to time their purchases and sales properly. The remaining shareholders suffer exactly the same loss in proportionate ownership when a long term holder exits on the day before a decline in net asset value as they do when a one day holder does. Changing the pricing system so that the net assets values used for valuation more accurately reflect the prices the remaining shareholders could exit at appears a better solution (see discussion above).

It is likely that the proposed rule will actually increase the costs to the long term investors (even while reducing the trader's profits). The reason is that many short term traders now get into a foreign fund whenever they expect its net asset value to rise by say .5% (A .5% rise may seem small, but on a million dollars it is a \$5,000 profit, and this justifies making a phone call or logging on to a web site). The more risk averse traders get out of the fund the first time they think its net asset value will decline even by a small amount. The result is that these traders are in and out of the fund very quickly. The funds probably do not have time to invest the money they receive before they have to return it. (This is especially likely if the fund manager knows, as he should, that a large inflow of money coincides with a day when his funds net asset value is based on stale prices). While the long term investors suffer some loss in potential profits (because on days when their calculated net asset value jump their mutual fund has an unusually large percentage in cash), the short term trading has probably not caused the fund to do any extra buying or selling of stocks.

However, if the money stays with the fund for five or more days, it is very likely it will be invested in stocks or bonds. Then, when the trader redeems his mutual fund shares, the mutual fund will need to sell stocks to have the money to return to him. The result of the five day rule is that the funds will probably do more trading than they would have done without the rule. Almost certainly, the loss to the funds in extra commissions and spreads will be greater with the 5 day rule than without it. I suspect these extra commissions and spreads are large enough so that they outweigh any reduction in dilution resulting from the actions of short term traders. Thus, the adoption of the 5 day rule (by a fund lacking any earlier redemption fee) will actually hurt the long term investors rather than help them. Since the proposed rule will also hurt the short term traders, it appears clear that it should not be adopted.

Far better would be the next day pricing proposal made above or routine fair value pricing. Ideally both should be adopted, with the fair value pricing used when current (after the order time) market prices are not available.

Details of the 5 Day Proposal

The SEC requests comments on the size and cost of the fee. There is some logic for a fee that is at most is the cost of a round trip trade by a fund. In practice since many trades cancel out, the true cost of a redemption is much less than that of a round trip by a fund in liquid securities.

There is a rather large literature on the cost of trading that the SEC economist should be requested to access. For most funds the costs is clearly lower than 2%. The 2% is used by certain funds because it is the maximum allowed. It certainly is not

representative of average costs over all funds. Fund families differ in the size of fee and these presumably reflect real differences in trading costs. The Fidelity family is a good example, where fees go from 2% to .75% in a generally rational way.

For large liquid US stocks, which is how most money in mutual funds are invested, the cost of a round trip is far below 2%. It follows the weighted (by amounts invested in different types of funds) average cost is below 2%. The above discussion is obvious to anyone familiar with the US security markets.

What is perhaps less obvious is that a fund subject to frequent trading has options that reduce its cost. The simplest of course is not to trade, but to rely on a liquidity reserve to meet redemptions. Admittedly, this can have a cost for the fund, but the fact that is what they usually do suggests this is the cheapest solution from the fund viewpoint for funds that permit frequent reversals of positions (i.e. sales quickly following purchases). A fund can fairly easily write computer programs that tell them which fund flows are likely to reverse quickly (the idea is unusually large inflows on days when traders are likely to be making purchases are likely to be primarily trader money). Knowing the flows are likely to reverse, the funds can be expected to hold these inflows in cash. While there may be a loss to the funds long term stockholders, it is the dilution from holding cash and perhaps a reduction in the long term percentage invested. For a few days this is likely to be less than the cost of buying securities and then selling them.

In saying this, I am allowing for the practical difficulty of learning of flows before the close. A few funds may be able to get indications from their own data systems, or experience, or special feeds from large customers, that tell them what inflows or outflows to expect that day. Although most funds permit trades to be canceled up to 4PM, I suspect only a few are. Hence a fund may be able to find out as of say 3:45PM whether it will have an inflow or an outflow and how big. They can then invest or sell (possibly using futures), getting a price similar to the net asset value that will prevail near the close (minus costs).

One of the merits of the proposal for next day pricing made above is that most funds (especially domestic ones) could trade in response to the in or out flows, and the prices mutual fund owner receive would more closely resemble those the funds themselves pay when rebalancing their portfolios.

Another technique for reducing trading costs is to maintain buy and sell lists. When what ever models the fund uses say the investment in a stock should be reduced, the stock is added to a sell list. When the model says the investment should be increased, the stock is added to the buy list. When cash inflows are received and a decision is made that it is worth investing the money, the stocks bought come from the buy list. When the fund experiences outflows, the stocks sold come from the sell list. This sensible strategy is an alternative to the widely followed practice of when a decision is made to substitute one stock for another, immediately selling one and buying the other. At the expense of accepting a few days delay, the desired trades can be accommodated in the normal in and outflow of cash (some of which may be coming from market timers in fact). While there probably are cases when the costs of delay in trading are large, these cases are not typical.

Academic theory suggests that markets are what is called efficient, and that they cannot be beat. If this theory was very wrong funds would beat the market consistently. They do not. While I personally believe there are statistical techniques that can beat the market and probably some professionals who can, only seldom do either of these produce

recommendations for stocks that are expected (in a statistical sense) to outperform the benchmark by much. When the out performance is small, the cost of delaying a trade by a few days is also very small. In these case the true incremental cost of accommodating inflows and outflows by the strategy described (buying from a buy list, selling from a sell list) is small. In other words if you looked at the performance of a fund that had no reversals in flows (i.e. always taking in more than leaves) and traded by buying and selling immediately, and compared it with the results of one that experienced inflows and outflows while trading with buy and sell lists, I suspect the difference would be small. It is this small difference that represents the true costs of having the inflows and outflows that reverse.

Especially if the stale pricing problem was dealt with by improved fair value pricing, or if next day pricing was used, I suspect the costs for most funds of accommodating in and out flows would be small.

The system of using buy and sell lists is most useful for active managers since they have opinions on stocks. It is less useful for passive managers. It then follows the appropriate redemption fees might be higher for passive managers (index funds). Active managers whose successful predictions work out very quickly (which I suspect are few, but which may exist) will find the proposed trading strategy inferior to purchasing when the idea hits, even if they are expecting inflows and outflows.

Even under current conditions the costs for most domestic large cap funds (which is where most of the money is) should be quite small, certainly below 2%. The SEC economist's office could probably do a quick study using a quantitative model and comparing results with and without random cash inflows (or in and out flows that follow some other rule) if the flows were accommodated by an optimum trading rule of the type described. I am confident the costs of accommodating the inflows would be small. I suspect that fees set to approximate average costs would be no more than .25%.

Free liquidity

The current practice of having mutual funds buy and sell their shares at net asset value provides free liquidity. Even when purchases and sales cancel, there are some administrative costs of the trading. If the fund is experiencing a net inflow of funds, it will be selling new shares at net asset value, but it will buy investing the money, typically paying the ask price (which is above the average of the last trade) and paying commissions. If the fund experiences net outflows, it sells at the bid, and pays commissions. Since institutions trade in large quantities, they often experience price impacts making the spread relatively large for them.

For transactions made on a particular day, the costs borne by the funds are the same regardless of how long the funds have been invested with them. If a fund is raising ten million dollars, of which nine million dollars comes form liquidations of long term money, and one million of money that came in yesterday, the above costs are the same. It would hence seen sensible to abandon the idea of mutual funds redeeming shares at net asset value, and have them redeem them at the a price that represents what will be left after the costs of selling securities. This would accomplish the Congressional of "the purpose (section 22 of the Investment Company Act) "of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such

company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities;”

I suspect the appropriate charge for funds holding large cap US securities might be about .25%. This would be appropriate regardless of how long the shares had been held.

One piece of evidence that the costs of accomodotating frequent inflows and outflows is low is provided by the Section 529 Plans for college savings. These permit changing the asset mix only once per year. Most plans appear to use regular institutional funds rather than putting these monies in a separate account which would benefit from the very low turnover.

Likewise, on a purchase the typical purchaser should get a number of shares that his money could purchase without diluting the position of the existing owner. This would be calculated using ask prices and the commissions the fund would pay. Again the charge would be small, perhaps.25%.

Such charges might be even smaller. Given the tradition of rounding of buying and selling prices to the nearest cent, it might merely mean the bid and ask prices for funds would differ by \$.01.

For those planning to hold over periods of years, these charges would be very small. Those planning to hold for short periods of time would then bear the costs they imposed on the funds.

A side effect of this proposal would be that any short term traders would pay the costs imposed on the funds they traded.

Ideally there would be a small per trade cost in addition for the paperwork cost of a trade, perhaps \$10.

Under the current system liquidity is provided free to traders. If they paid a fairly estimated cost to the funds (which would be typically far below 2%) they might do less trading.

It is recognized that changes to the law might be required to implement this. However, there seems no public policy reason for forbidding mutual funds from having slightly different bid and ask prices. It would seem wise to give funds this freedom and see whether some adopted it. Such funds might be attractive to very long term investors, knowing they were less likely to be hurt by market timing. Even funds with redemption fees for sales within as long as 365 days still suffer if investors time their entrances and exits to the short term outlook. Investors who were thinking in periods of many years might prefer funds with such fees, because even this level of fees would discourage those with shorter time horizons from investing in such funds.

A benefit of such small fees is that it would probably discourage some forms of market timing. If combined with fair valuing, the problem of stale pricing would probably be solved. Even if the fair value adjustment formula was slightly off, such small costs would probably make trading to exploit it unprofitable.

Small transaction fees would also seem appropriate for those who are frequent traders just for the amusement value, and because the costs of gambling this way is lower than at the casino.

Use Calendar Days Instead of Business Days

One way to reduce the cost of errors is to replace the proposed “five business days” rules with a “five calendar days rule”. The benefit would be virtually the same in that the seller would have to wait a full week after buying before selling, but there would be fewer errors.

The calendar rule would be expressed in saying that sales within a week of a week of a purchase (but not on the same day as the purchase for reasons discussed below) would be subject to a fee. Investors need merely remember the day of the week they bought on to determine whether a week has passed by. If he bought on Monday he will pay a fee if he sells before next Monday. To avoid the fee he must wait until it is again Monday. He does not have to worry about possible intervening holidays.

From a programming viewpoint five calendar days are a little easier to program than 5 business days or 5 trading days. One does not need a calendar of holidays, and one does not have to worry about such complexities as when does Easter fall this year. This makes compliance easier.

It would be desirable to warn investors when a fee is to be charged, or may be charged. This is a lot easier to program when the rule is a week. If the date is represented by a number, the current date minus the purchase date can tell whether a fee may be charged. If 7 or more no fee may be charged. If less than 7 but greater than 0, a fee may be owed and it is necessary to consult records of holdings and previous purchases to see if one is owed under first in, first out rules. If the system must be specially programmed to give warnings, a system of temporary records can be set up that is emptied after a week has passed.

The current proposal is a little ambiguous since a “business day” seems not to be defined. It would normally include days when the majority of firms were open for business, but I have a feeling that what is really intended are days when the major stock exchanges are open for business. The two concepts are very similar but may differ.

Consider the Friday before Easter (Good Friday). I believe this is a business day in that most firms and the US government are open for business, but the major stock exchanges are closed.

Other problems occur in certain regions for the more minor holidays. For instance, some places may not celebrate President’s Day. In New Orleans, where I am, it is not generally treated as a holiday. Instead, Mardi Gras, which usually occurs a few weeks later is taken as a holiday instead. People in New Orleans could easily miss that a President’s Day has occurred and think five business days had passed. They would be unhappy if they were charged a fee they could have avoided. Naturally, customer service representative will blame the SEC when this happens.

There may be similar problems in other parts of the country where the local holidays are somewhat different than those celebrated in New York.

Hopefully, the major mutual funds would try to warn customers when their sell orders would cause them to pay a fee (this could be by a warning appearing on a web site or a phone representative issuing a warning). In most cases, upon receiving such a warning the investor would chose to wait a few days (or what ever time was required) before selling. However, there would be the cases where due to poor planning, or mistakes, a person would still have to pay the fee. As mentioned, a likely common case will be someone planning to use the proceeds of selling a mutual fund to make a down

payment on a house (or similar large purchase). If he had not allowed for an intervening holiday, he may find himself in a position where he had bought on last Tuesday and thought he could sell this Tuesday without a fee to raise the funds needed for Wednesday's house closing.

It should be noticed that either version of a 5 day rule would subject the trading strategies that involved selling on certain days of the week and buying on other days to the 2% fee. As discussed above, in a paper in page proofs, I and my coauthors (Miller, Edward M, Prather, Larry M., and M Intiaz A. Mazumder, "Day-of-the-Week Effects among Mutual Funds", forthcoming Quarterly Journal of Business and Economics) have shown such strategies would have outperformed buy and hold strategies during the period studied (and almost certainly most other periods).

The above problems could be minimized by using a calendar day rule rather than a business day rule.

The Data Collection and Consolidation Burden

The procedure of collecting data on all transfers and sending them to the fund company is very complex. It is proposed to then try to collect fees from someone who bought in one account and sold in another. It far from obvious that this is a problem, or fees should be charged when it occurs.

In many case investors with multiple assets may hold the same security (or security related interests) in multiple account. I know this has been true for myself at times. I have several variable annuities, a deferred compensation plan, several 403 b plans, a pension plan with a previous employer, at least one 529 plan, and a brokerage account. Sometimes the same mutual fund or an interest in one (as for a variable annuity account) is in more than one account.

Any frequent trading I do is likely to be the same in each of these accounts (subject to the assorted constraints on frequency of trading). I doubt if a rule making a sale in one account within 5 days of purchase in another account would subject me to greater fees than applying the rules plan by plan. However, I suspect some additional fees might be collected from long term buy and hold investors if all the accounts are aggregated. In addition, the complexity of administration is greatly increased if all of the data is aggregated, and someone later must determine if a fee is owed and attempt to assess a fee.

As an example of the complexity consider this problem. If two days after the event it appears there has been a purchase in one account and a sale in another, and the administrator is told to charge a fee, an obvious question is which mutual fund (or sub-account of an annuity) should the money be taken from (most investors will have several funds in their accounts). What if when the money is taken from one fund, this is a redemption that is within 5 days of a purchase and another fee is owed?

The above is quite possible. Suppose, fund A is sold to buy B in a deferred compensation plan. Two days later mutual fund A determines that a purchase of A was made within 5 days in another retirement plan (perhaps through payroll deduction and automatic crediting). The mutual fund contacts the deferred compensation plan and insists the fee be collected. All of the money is now in fund B, which was purchased just a few days ago with the proceeds of selling fund A. The administrator of the deferred compensation plan has no source of funds other than redeeming some share in fund B.

Since this occurred within a few days of purchase, an additional redemption fee is incurred.

One could imagine computer systems that are programmed to take the money from one of several funds where such a secondary fee would not be charged. One can imagine cases where the owners of the account would have to be phoned and asked which account to take the funds from (most plans and brokerage accounts do not now authorize administrators to sell mutual funds without instructions). If the agreements were rewritten to provide for an automatic answer, there would be investors who then go back into their accounts and move money to where they want it to be.

It would seem wise to exclude redemptions that are made by administrators to collect the fee from being classified as redemptions on which a fee must be collected.

What if the account is closed? Are administrators then to go in search of previous owners who owe a small sum in fees?

The Need for Data Consolidation and Reporting

It might be thought that without all this data consolidation investors would gain trading opportunities they would not otherwise have. This is less likely than it looks. It is true I could put \$100,000 (purely theoretically) in one retirement plan into American Century International and \$100,000 into a money market fund. When after a few weeks I get a trading signal I could move the \$100,000 from the money market fund into American Century International. The day later, if I decided to sell I could move the \$100,000 in the other retirement plan out of American Century International. It appears I have made a short term trade of \$100,000, which in economic significance I have.

However, if I had held the first \$100,000 for more than 5 days, I would be free of the fee. Now suppose I again had \$200,000 and put it in one account, directing \$100,000 to the money market fund and \$100,000 to American Century. After a few weeks I decide to buy another \$100,000 in American Century International. The next day I sell it. Again I pay no fee because of the first in, first out rule. (A last in, last out rule would produce different results).

There is actually no reason to complicate things under a First In, First Out rule by doing trades in multiple accounts which could be done in a single account. However, there are reasons for non-traders to do what look like trades when they have multiple accounts.

As a practical matter, someone who is knowledgeable enough to know when to buy and to sell will probably be making the same trades at the same time in each account, if he happens to hold the same mutual fund through different vehicles. I believe that when I had multiple positions in American Century International, and decided it was likely to go down, I got out of the positions in all of the plans in which I had a position. Doing so would certainly be sensible rather than holding a position expected to go down in value. If there had been fees, I probably would have either owed a fee in all of the accounts, or none of them (depending on how long it had been held). I don't think consolidating the records at the mutual fund would have changed anything except to increase administrative costs.

However, when the motive for trades is not that the fund may go down (such as raising money to buy a house, investing a payroll deduction, tax management, obtaining funds to investing in a mutual fund that was expected to go up (which may not have been

available in the other retirement plans), consolidating the accounts might change the total fees owed. For examples see the above discussion of circumstances in which an investor might make offsetting trade in the same fund but in different accounts. An investor who was not careful could find himself owing a fee in these circumstances. Unfortunately, more observers would feel that collecting a fee in these cases would not contribute to the SEC's goals.

What about buying a mutual fund in one account and then transferring the whole account to another and then avoiding the fee? Would not that evade the 5 day fee? As a practical matter I don't think it would work. My experience with transfers of accounts (and I have done several) is that they take quite a few days to go from one brokerage house to another, or from one annuity company to another, or from one IRA carrier to another. Usually more than 5 days would have been consumed, making this impractical. Also I could describe all sorts of hassles, confusions, administrative foul ups etc. that make this impractical as a routine way to avoid a 2% fee. Admittedly if the fee was to apply over a month or 90 days, such maneuvers might work. In any of these transfers the account is frozen on one day and then, if you are lucky, a new account is opened and funded several days later at the other firm. During this time, your funds are either not invested at all or cannot be treated.

Incidentally, in many cases the actual positions are not transferred. If an account is transferred from one variable annuity to another, what is transferred is only money. All positions are converted to cash and then the money transferred. For instance, if I have a position in sub-account in a variable annuity in one insurance company that invests in American Century International and I decide to do a 1035 exchange (a tax free exchange) to another firm that also offers a sub-account investing in American Century International, the American Century International holding can not be transferred. A check goes from one company to the other. If I view myself as a long term holder of American Century International, I would have to allocate the incoming money to American Century International in the new fund, or purchase it there. The transfer from one company to another could happen if I got unhappy with one insurance company's fees, and noticed I could get the same fund in the other company but pay less in total fees.

As noted, this transfer process can not be counted on to occur within 5 business days from when one starts it (and from talking to investment professionals seldom does). However, if it did occur that quickly, I might under the proposed rule find that I had to pay a 2% fee. A smart sophisticated investor might avoid this problem by directing the incoming money go into a different fund (perhaps the money market fund), and then only directing a transfer to American Century International after the 5 day period was up. However, less well informed buy and hold investors might find themselves subject to a fee.

Many transfers between retirement vehicles can only be made in cash. If one wants to hold the same mutual fund in the new vehicle as he held in the old vehicle, he must "sell" in one and "purchase" in the other when the new vehicle has received the cash. Charging a fee in these case does little to protect the mutual funds (unless the threat of the fees prevents someone from changing vehicles at all, which is not the intent of the proposal.

It may be thought that if a transfer sometimes could occur within 5 days and the fund position its self was transferred (not cash), it would be worth attempting. However,

because the time of the sale is usually unknown, one does not know in advance whether the trouble of the transfer will pay off. Because of the uncertainty in timing and the likelihood that it will take more than a week, chances to make profitable trades free of fee will be lost by transferring. If a transfer is started and not completed by day six, an opportunity to sell on day six is lost because the mutual funds will be tied up in the transfer. Also real life insurance companies, fund trustees etc. incur real expenses in setting up accounts. They probably would not tolerate someone who repeatedly opened new accounts and then quickly transferred them out. Staying put and waiting for an opportunity to sell after 5 days is a more profitable strategy.

I suspect that most fees that would be collected from combining data across different retirement plans, brokerage accounts, annuity contracts etc. will come not from frequent traders (who are likely to know how to avoid such fees), but from buy and hold investors who by accident make trades in opposite directions within five days.

Thus, it appears that little would be gained from requiring such entities as insurance company separate accounts, retirement plans, and trustees for IRAs, 403b's, 401ks etc. to send extensive data to the mutual funds. Few extra fees of any type will be collected, and those collected will not be from frequent traders but typically from buy and hold investors who accidentally became vulnerable to the fee. Much better to just exempt individuals who make opposite direction trades in different directions in such accounts.

From the discussion above it can be seen there is a positive case for exempting sales and purchases of the same fund that are made pursuant to a transfer of cash between different accounts (1035 variable annuity exchanges, different retirement plans). It is likely to be long term buy and hold investors who purchase the same mutual funds in the new place as they held in the old. A frequent trader is likely to know enough to have his money invested in a different fund in the new place in order to be sure he is not caught by the fee.

Transfers between entities may work within brokerage firms or banks (holding trust accounts) if a fund position is transferred to a wife or a trust. These may be relatively quick. Admittedly, if transfers are reported to the fund companies, a few fees may be collected this way. However, if the only events reported are purchases and sales and tax id numbers, these cases will be missed since the purchase will be done under a different tax number than the sale. The regulation as written appears to require reporting only of tax id on purchases and sales. It apparently does not require reporting of information on transfers of ownership. Thus, if the ownership was transferred to a trust for the benefit of the purchaser, or to the son or wife of the purchaser, the mutual fund would be unaware that a sale was within five days of a purchase. If it is decided to go ahead with this proposal, it would appear desirable to require the reporting of transfers of ownership within the same brokerage firm or trust company in order to close this obvious loophole.

If the brokerage firm reports enough data to identify such attempts to avoid fees by transferring ownership within the firm, it follows that the brokerage firm or bank has enough data to identify the trades as made within 5 days. It would be a lot simpler to have a rule that said that the brokerage firms (and trust banks) should keep the records to identify fee obligations on mutual funds transferred between accounts.

A backup rule might prohibit firms from assisting individuals from trying to avoid the fees by facilitating routine transfers of accounts that are quickly reversed. This would

be aimed at say two brokerage houses somehow figuring out how to do quick transfers between pairs of accounts that are frequently reversed in order to accommodate a frequent trader.

Of course, even simpler than rules for elaborate records of purchases, sales, and transfers is to abolish the major incentive for disruptive frequent trading by fair valuing or by next day pricing.

First in, First Out

Details like whether to use First In, First Out accounting might be left to the funds. In practice, both will accomplish what the SEC and the ICI seem to be trying to accomplish, forcing frequent traders to pay fees. First In, First Out seems best in general. The problem of small recent purchases followed by a redemption such as can arise from payroll withholding, automatic rebalancing, emergencies arising right after a purchase etc. is reduced by first in, first out accounting. With last in, last out my payroll deposit of say \$800 to a fund with a balance (say \$20,000 built up over years) might be subject to a fee if I do a rebalancing and decide to transfer \$5,000 to another fund. Advisors would be handicapped if they had to devote time to being sure a rebalancing did not expose a client to a fee, or if actions had to be delayed to avoid a fee. I think arguments of this nature would persuade most fund managements to prefer a first in, first out approach.

However, there may be some funds for which implementing such a system is difficult. For last in, first out, you need only a few days records to determine that there has been a trade within 5 days. If the data in the current computer data base shows the sale was within a week of a purchase, a fee is owed.

For first in, first out you have to then check to see if there was an earlier purchase. Possibly the records of these earlier purchases was held on a different system and are not accessible. With first in, first out accounting whether a sale of \$5,000 made four days after a purchase of \$5,000 depends on whether the customer had made an earlier purchase of over \$5,000 that was still being held.

If customers are to be told in advance when a fee is to be charged, and how large it will be, last in first out is probably easier to program. One does not need records of transactions that are older than 5 days. Otherwise, one need access to records of the balance in the account plus the last 5 days purchases. If balance records are not available it may be possible to write programs that merely flash a warning after a transfer order whenever a "purchase" has occurred within 5 days. An explanation can then be offered that first in, first out accounting is used and if there were earlier purchases the fee may not actually be charged.

Especially, in cases where accounts are transferred from company to company administering a first in first out system would be hard since the records on purchase dates would have to transferred. It might be desirable to permit or even require companies to treat any shares that they gained possession of within 5 days as having been purchased on the date they gained possession of them. Not to do this may lead to people avoiding fees by quick transfers of funds out of the account they were purchased in. However, doing may force a delay of 5 days after a transfer before anything can be done. This may be a hardship if the transfers itself had taken several days or weeks, as they may with a less efficient firm.

Also, some transfers result from events which make a prompt sale desirable. A donation of an appreciated mutual fund share to a charity would probably be accompanied by the charity wishing to sell it immediately for instance. A transfer on death might be accompanied by the new owner wishing to change how the funds were invested, such as going from a risky fund to a fund suitable for “widows and orphans.” Transfers as gifts, divorce settlements, changes in pension fund managers etc. may all fall into this situation.

Companies might give some freedom to make rules. One is we presume the share was just purchased when we received it. (an alternative is we presume it was a long term holding), since that date is probably recorded by our system. However, if it comes with records showing when it was purchased, we will put that date into our records. If you know you will promptly wish to sell it, and can provide proof of when it was bought, we will use that date. Otherwise, we will presume it bought the day before we got it into our account.

Another obvious possibility is all “transferred in” shares will be presumed to have been bought five days earlier. This will be the normal case. It is especially plausible for transfers between brokerage firms which often take several days to weeks. The risk of course is that a loophole might be opened that could be exploited. One might transfer the shares to another account in the same firm (say a wife’s account or a trust) and then immediately sell them.

Possible Exemptions

Same Days Sales that Offset Buys Should be Excluded

The apparent goal of the proposed rule is to charge fees to people that force funds to sell securities to meet their redemption requests. However, as written it would apparently impose fees on my sale of a fund share that was exactly offset by a purchase (probably in a different account). However, if there were offsetting purchases and sales the mutual funds does not have to do any trading of securities to accommodate me (and there may not even be any added administrative costs if in both cases by orders are merely added to those of others and then transmitted to the mutual fund company).

These offsetting trades do not force funds to trade and the owners should not be penalized.

It would seem wise to change the wording of the proposed regulation to say that the fee should be charged only when the sale was made on a different day, but within 5 days or a week (preferable wording) of the purchase. Alternatively, an explicit exemption could be made for offsetting sales and purchases on the same day.

There must be occasional individuals who just through accident buy and sell on the same day. This is especially likely where automatic systems such as investing through payroll deductions are combined with discretionary decision making.

I can imagine other reasons for both buying and selling one the same day. In a taxable account one may wish to realize a capital gain in a year when ones tax rate is unusually low. Thus one may buy and sell the same fund on the same day in the same account. .

Incidentally, there may be brokerage firms (or mutual funds) whose book keeping system would not permit a buy and sale on the same day. This may arise from clearing

problems, for instance. If not careful, such individuals may find themselves paying the 2% fee.

There are several reasons why buys and sells of the same fund (including annuity sub-accounts which have this underlying fund) may be made on the same day, but in different accounts. For a less careful investors these reasons could lead to trades separated by only a day or two.

Many retirement plans do not permit withdrawals prior to service (this is a problem for at least three of my accounts) or prior to a certain age (problem for another account which permits withdrawals only after age 60 for one who has separated from service). Several other plans involve tax penalties for early withdrawals (IRA's and annuities). Others involved surrender fees. None of these are suitable as sources of liquidity. I have a bank account and brokerage accounts for this. Except for a small working balance in a bank, my major liquid assets are in mutual funds in a brokerage account.

If I like a particular fund it is likely I will have funds in it through several routes. I may be having payroll deductions directed to it from a job (I have payroll deductions sending money to both a 403b plan and a deferred compensation plan). I may also hold it in a brokerage account. When I need funds, such as when I recently bought a house, I may have to liquidate mutual funds in the brokerage accounts. About the same time money may be being sent to the same fund through payroll deductions. This could result in a fee being charged even though no timing was intended.

If one has a preferred allocation of asset being held in a variety of forms and one sells heavily one of them, one should rebalance the total portfolio to return to the preferred proportions. This is standard wisdom in portfolio management and investments (which I teach). Suppose I have decided that 20% of my funds should be in international stocks and I choose to hold this in my favorite international fund held in a brokerage account (possibly for tax reasons, such as utilizing the foreign tax credit). I then buy a house and finance it by selling in the brokerage account (the funds in the various retirement plans are not available for this). This implies that my goal of 20% foreign is no longer being met. I look around and notice that one of my other plans offers the same fund. I choose to buy enough of that fund in a retirement plan to return me to my goal of being 20% in a foreign stock mutual fund. As written I could find myself forced to pay a redemption fee even though these same day trades are offsetting from the viewpoint of the fund.

As mentioned above, I and many other investors have multiple types of accounts which may hold mutual funds in common. Each of these accounts has a different set of funds available and different rules. There may be circumstances where at about the same time in one fund I am finding B is superior to C and moving money to B. In another account I find A is superior to B and am moving money from B. If there was one account, I would be being illogical. But if one account has A and B, and another B and C, this is logical.

I actually on a recent day sold one bond fund in one account and bought the same bond fund in another account. I was concerned the bond fund might go down over the weekend and transferred the funds to a money market fund type fund (I understand that this part of the firm does not regard frequent trades in and out of a money market funds as forbidden). In another account (paradoxically with the same large insurance company),

there was a frequent trading policy in which more than a single round trip in any fund (including the money market account) within 30 days is considered excessive trading. I found myself with a small stock fund position which I feared might decline. Since using the money market fund as a safe place to park cash might create a violation of their frequent trading policy, I chose to park the funds in the bond fund. I expected the bond fund to decline less than a stock fund, I moved it to a bond fund, which happened to be the same bond fund as I was selling that day in another account. (Interestingly, both accounts are with the same leading insurance firm, that at this point seems to have different policies in different parts of the organization).

It is usually argued that individuals should manage their holdings as a unit, first deciding what to hold, and then deciding which type of account to hold it in. It is often suggested that funds that produce large amounts of income subject to taxation (short term gains, interest) at ordinary rates be held in accounts which provide for tax deferral (IRAs for instance) and assets which mainly produce long term gains (growth stock mutual funds) be held in a taxable account (a brokerage account). To implement this strategy (upon learning of it, or being advised how to do it) one might decide fund A should be sold in a taxable account, and at the same time the same fund purchased in a non-taxable account. This can produce two trades in the opposite direction on the same day.

Changes made in one portfolio combined with a limit of the amounts in tax sheltered vehicles can result in the optimal allocation shifting. The optimal place to hold mutual funds providing large amounts of dividends (tax favored now) may shift between the taxable and tax deferred accounts.

Around the time of annual distributions an investor may choose to sell the position in a taxable account and on the same day purchase the fund in a tax deferred account. The two transactions will be offsetting from the funds viewpoint.

Smart people may be able to minimize the above problems by techniques such as avoiding using the same fund in different vehicles. American Century International may be a good fund (I have the opportunity to invest in it, I think, through three different retirement vehicles as well as directly), but to avoid accidentally paying a fee it might be wise to choose it for only one account and to seek out another international fund in the other accounts. This need to use different funds probably would somewhat lower the quality of my overall portfolio, and would force me to spend more time on becoming familiar with funds. Without the risk of unexpected fees, I might note that a fund I knew and trusted was offered in a retirement account or annuity, and invest in it without having to even investigate the other similar funds open to me in the same account.

It is probably the less well informed investors who will find themselves accidentally exposed to the fee through events such as described above. When the fund company decides they owe the fee and order the retirement vehicle, insurance company, or brokerage firm to deduct the fee, the investors will be unhappy (to word it mildly). When they complain, the customer service representatives will explain they had no choice, but the SEC made them charge the fee even though it makes no sense. The SEC will take the blame.

Emergency Cash Needs

There will obviously be a few who have emergency needs for cash for whom waiting 5 days will be a problem. In a world of credit cards there seem to be few real cases where emergency access to mutual fund money is required. The request for comments mentions emergency surgery.

American hospitals have to provide treatment for accident victims until they are stabilized (which means giving them credit). Anyone with a mutual fund could use that as evidence of financial ability to persuade a hospital to give a short period of credit. Usually, hospitals take at least 5 days to bill in any case. Those wealthy enough to buy mutual funds usually have credit cards.

I strongly dislike systems where the honest are penalized.

The proposed exemption for requests of under \$10,000 would result in a system where mutual funds collect documents that claim there is an emergency and exempt the holder from the fee. Those willing to sign such documents benefit at the expense of the more honest. Mutual funds will lack both the tools to monitor the statements and an incentive.

As noted above (in discussing next day pricing), provision can be made for early payments of redemption money (at a small fee) when an irrevocable order is placed for execution five days after the fund was purchased. This could be for as high as 90% or even 95% of the estimated value with little risk to the fund. Funds for which such orders have been made could also be made marginable.

Market breaks are often when it is profitable to sell foreign funds and small cap funds due to stale pricing effects. To provide exemptions then would defeat the purpose of the rule.

To try to permit only those who are panicked to get out fee free while restricting market timers appears impractical.

Probably the most common problem will be those who are purchasing new houses, planning to use the proceeds of mutual fund sales for the down payments. A certain number will fail to place sell orders in time to get their money without paying a redemption fee and will be forced to pay the fee. While one can imagine complicated exceptions and waiver rules (such as fees for redemptions, but an exception where the proceeds are claimed to be for a house down payment), administering such a system of would be expensive. The most likely result will be that the dishonest can fill in a form and avoid the fee while the honest pay the fee.

However, there may be a case for permitting one free short term trade per calendar year to provide for emergency cash needs or wants. Such a trade might be for next day pricing (with an irrevocable order of course). With next day pricing, a trader acting on stale prices would not get even one sale per year (for net asset values based on stale prices) within five days of purchase. With next day pricing, a trader acting on stale prices would not get even one trade per year within five days of purchase. However, for those needing cash for unexpected “needs” or (more realistically) “wants” or to deal with cases of poor planning could get to their funds fee free in two days.

Mistakes

In practice there will always be a few who pay the fees because of mistakes or poor planning. Someone may not be aware of the fees and place sell orders. Someone may make a mistake and buy the wrong fund.

For instance, Fidelity used to use the abbreviation Int. Bond on their web site, and on the confirm page merely asked if you really wanted to buy the fund in question, giving its abbreviation rather than the full name. I once bought an intermediate bond fund (intermediate starts with int) when I was planning to buy the international bond fund (international start with int). Many automated phone systems use fund numbers and many printed forms do. Judging from conversations with phone representatives, their data entry terminal often use numbers. Mistakes inevitably occur. Under the current system some one finding a mistake has been made may reverse it the next day or whenever he realized there has been a mistake. Even if he is convinced the error was not his, he may not be able to prove a mistake, and will merely reverse it when he discovers it.

With the proposed fees, there will be a 2% charge to reversing a mistake. Many will stay in the incorrect fund for a week just to avoid the fee (generally this is the best choice). This will impose a real cost on investors, primarily in being exposed to a undesired risk.

I am opposed to rules that permit avoiding the fee just because one has made a mistake in order entry. They lead to the dishonest (those willing to claim a mistake) avoiding fees the honest pay.

However, there may be a case for permitting one free short term trade per calendar year or otherwise to solve this problem and others. Such a trade might be for next day pricing (with an irrevocable order of course). With next day pricing, a trader acting on stale prices would not get even one trade per year within five days of purchase. However, there would be provision for correcting mistakes and for those needing cash for unexpected "needs" or (more realistically) "wants".

Exempting Small Transfers from the Fee

Exempting small transfer from the fee (or permitting such an exemption) is probably useful. As discussed it is easy to imagine payroll deduction purchases, automatic rebalancing purchases, etc. that are quickly reversed and other wise could result in a fee being owed.

In some cases, investors will find it hard to know in advance what purchases have recently been made in their account and hence hard to know whether a redemption will trigger a fee. For the firm that has my university retirement assets, ING, information on the dates of previous purchases and contributions is not on their web site. Since it is hard to predict when a payroll deduction will actually be credited (there is a very substantial lag), lack of this information would make it hard to know if a transfer would trigger a fee. An exemption that exceeded the size of most contributions through payroll deduction would reduce this problem.

If complicated data transfers rules are adopted, exempting a minimum amount greatly reduces the amount of data transferred.

It would seem wise to make the rule provide for (or permit) exempting the first x dollars, rather than only trades under the magic amount. This is done for many tax payments. Such a rule would avoid the odd result that a \$2540 redemption (subject to the

fee) results in receiving less money than a \$2500 redemption (fee exempt). This seems fairer. It is the less well informed investors (or organized ones) who are likely to send in redemption orders that just slightly exceed the critical amount. It would seem wise to protect them from their mistakes.

As written, I believe the rule could lead to multiple requests for small amounts instead of a large one. Somebody wishes out of a fund he just bought. Each day he sends in the \$2500 minimum (or what ever figure is chosen) for 5 days. This runs up administrative costs, even though little timing is likely. The same applies if he needs money for some reason.

Offsetting Sales by Purchases in the Same Omnibus Type Account

In practice, most sales of funds and purchases are offset by transfers in the opposite direction. Mutual Funds do not have to purchase or sell securities to meet redemptions or purchases when this happens.

One problem with frequent trading by knowledgeable investors is that their trades are less likely to be offsetting. If there is reason to believe that the net asset value of a fund will be lower tomorrow, knowledgeable investors will often wish to get out. Each of these trades may be individually relatively small, but in the aggregate they may present a problem for the fund. A hundred thousand dollar exchange is probably minor for most funds, but a hundred people making the same exchange (at a time when there are only 10 going the other way) aggregates to a \$10,000,000 in redemptions (offset by \$1 million in purchases). It seems grossly unfair that when an individual's trade actually reduces the burden on the fund (as for the 10 in the above example who are trading in the opposite direction) that he should be required to pay a fee.

A case could be made for exempting individuals from fees when the omnibus account had net purchases. Administratively, this would be difficult but not impossible. It would require a trial aggregation of sales and purchases, and then the calculation of fees only if redemptions exceeded purchases.

If there are typically not enough traders selling to cause net redemptions for the intermediary, the trader's selling is unlikely to be a problem for the fund. Notice that if there is a system that permits traders to anticipate market declines or market rises, the traders might be placing trades in such quantities that they would expect to pay the fees. If selling by traders typically caused net redemptions they would quickly learn that fees would be required and would allow for this. Knowing they would pay fees, they would be unlikely to sell within 5 days of purchase. The goal of deterring short term trading would still be accomplished.

Omnibus accounts might also be permitted to not collect the fees on days when sell orders are more than offset by purchases. Many mistakes occur on such days and the net flows to the mutual funds are reduced if such offsetting trades are permitted. Individuals trading to correct mistakes or for liquidity might figure they had at least a 50% chance of not paying the fee (more for retirement accounts having net inflows) and choose to take the risk.

Such individuals might be allowed to place order to be executed only on days when they were going against the flow. Most intermediaries can not now handle such orders, but I suspect some would be happy to program their systems to handle them.

Offering this possibility would be a nice accommodation for the customer who calls to redeem, and is dismayed to learn an immediate redemption will involve a fee. They might be happier if told they can place an order that will be executed today if there are net purchases, and otherwise will be executed tomorrow, or on the first day with net purchases.

Since such a system would involve some decision making (but not by the investor) after the close for pricing, it might take an exemption from the close of pricing to permit it. Since such orders would help both the mutual funds and the investors, permitting them would seem a win win situation that should be permitted.

Although it would be more complex, such orders might be permitted at the fund level where the fund would be allowed to offer to accept fee free those redemption orders that were offset that day by net purchases. Otherwise they would be rejected, or held for the next day (two options).

Exemptions for Payroll Deductions and Automatic Transfer Programs

There is probably a basis for exemptions for funds that resulted from automatic transfer programs or recent purchases through payroll deduction, unless they are covered by the \$2500 exemption. When I decide I want all of my money invested in a certain way, the most recent contributions are likely to be moved.

For the firm that has my university retirement assets, ING, information on the dates of previous purchases and contributions is not on their web site. Since it is hard to predict when a payroll deduction will actually be credited (there is a very substantial lag), lack of this information would make it hard to know if a transfer would trigger a fee.

The ING web site is such that you can only specify an end result transfer. For instance, you may say you want 50% of your money in one fund and 50% in another. If getting you to this position requires selling the fund that was just bought through payroll deduction, it is hard to avoid. The system only takes requests in whole percentages, so the idea of trying to calculate an end result mix that just avoids the fee requires at best calculations. Thus, if \$888 had just been deducted from a payroll and deposited in a bond fund, your decision to get the accumulated retirement money out of the stock market into the money market fund would automatically result in a sale of the bond fund money and the payment of a fee (I am told the phone representatives have access to a system that can avoid this outcome, but have not confirmed this). There is a certain degree of randomness in when payroll deduction money will reach this account, and the place you have these funds sent may represent a conservative alternative that is not often changed. Thus, the money may not be where you would like it to be when it arrives. I suspect other companies have such poorly designed systems, or systems with other odd peculiarities.

Payments at Death

One plausible exemption may be for payments caused by death. The major reason for such an exemption is that the Congress has denied the SEC the power to regulate the "business of insurance" and requiring that death benefits be reduced by up to 2% when the money had been recently invested in a fund would appear to violate this. This legal point primarily affects the separate accounts behind variable annuities and variable life insurance policies. However, many would argue for consistency between investment vehicles and wish to extend it to other investment companies. The point is probably moot

in most cases since the time needed to get a death certificate to the investment company (especially considering the probability that usually the owner was in no shape just prior to death to do transfers) would allow for 5 days to have passed.

Most people will not time their deaths just to do a fee free fund trade. However, death benefits are not paid out based on the date of death, but based on when the paperwork is filed in proper order. A smart executor might be able to time when the paperwork was filed in order to make a trade within the 5 day limit (trying to be sure the money was invested until just before a anticipated decline in net asset value). However given the usual randomness in processing, and the expertise of the typical executor, the scope for timing payments on death appear very minor.

Most beneficiaries would wish to delay processing until no fee was required, Many, but not all funds, would probably try to at least warn the executor or beneficiary of the advantages of delaying a few days. However, this can not be counted on, and many contracts probably give the insurance company or investment company no discretion. In particular, mutual funds and other investment companies are required to redeem upon request, even if this would require charging the fee. If the SEC chooses not to exempt payment due to death, it might grant a general exemption from the redemption requirement to permit a long enough delay to permit avoiding the fee (at least in the cases where the executor or beneficiary did not insist on immediate payment, but merely faxed in paperwork, possibly unaware of the fee issue).

Even if executors do delay requesting payment for up to 5 days to avoid the fee, this is probably exposing the heirs to a risk they may not want. At death, funds may be invested in a way traditionally considered unsuitable for “widows and orphans”. If the funds are to go to “widows and orphans” as they frequently will, an immediate transfer to a more conservative fund would be considered prudent. Consideration might be given to permitting a fee free trade made after death to position the funds to where the beneficiaries (or new owners) would like them. Thus, in the (admittedly rare case) where an investor had just put all his money into something like a technology fund, and was then killed in an accident, the widow (or the executor or financial planner with a power of authority) might be allowed one fee free transfer to move the funds to something more conservative. Notice this would not necessarily be a withdrawal upon death since it might be a while before such a withdrawal could be made (due to the documents needed for a withdrawal), or the whole account might be transferred. Use of such an exemption would be rare since right after death there are other urgent matters to attend to rather than thinking of such financial moves. While usually by the time anyone is in a position (emotionally and legally) to modify the portfolio, a week would have passed, it would be good to have a special rule for when there was someone who could and would act (possibly a trust administrator or someone else with a power of attorney).

Other Insurance Contract Issues

The proposal would extend to variable annuities. The language of the proposal contains a very important factual error saying “many investors' holdings in mutual funds are through accounts held by broker-dealers, banks, insurance companies, and retirement plan administrators.” Actually, virtually no investors hold mutual funds through accounts held by insurance companies. Of course, there are many variable annuity and variable life insurance contracts outstanding whose contract values are tied to the value of various

mutual funds. However, the investors do not hold mutual funds through the insurance companies. The insurance companies own the mutual funds, which are typically held in “separate accounts”. Admittedly, the investors can move his interest from one sub account to another and the insurance company sells and buys mutual fund shares in the separate account, so that its liabilities to the policy holders for payments based on the value of the sub-accounts is exactly offset by ownership of shares in the funds. However, the investors do not own the shares.

This apparently technical legal point is critical to the tax treatment of these investments. If the investors actual had holdings in mutual funds through insurance companies, every time they transferred from one sub-account to another, there would be a taxable event since they would have bought and sold securities. However, since the shares are owned by the insurance company, these products provide tax deferral and are marketed as such. The designers of these products have gone to great trouble to be sure that the policy holders do not own any mutual fund shares, but merely have a contract with the insurance company in which certain key items (notably death benefit, initial value of the annuity when the policy is annuitized, and the amount received upon surrender of the policy) are based on an account value which is calculated from the value of the mutual fund shares (and certain other investments). If the SEC somehow makes investors the owners of these securities and every exchange from one sub account to another sub-account a purchase or sale of a mutual fund, the tax deferral basis of these accounts would be destroyed.

This apparently technical point as to who owns the mutual fund shares owned by the separate account of a variable annuity also has major implications for the legal authority of the insurance company to deduct redemption fees from the accounts of the policy holders. Annuity and variable life separate accounts are not omnibus accounts, but accounts of the insurance company (one account), subject to certain special regulatory and taxation treatment.

I own several annuity contracts and the language in none of these contracts would provide for the collection of such fees from the annuity owners. The contracts have very explicit provisions as to the fees that may be charged. This is appropriate since investors would be very reluctant to send large sums of money away for an investment product if they did not know in advance what fees and expenses they would be subject to.

Very recently, insurance company prospectuses (and I assume the contracts they were offering) have contained provisions that would let them charge such fees to the policy holder’s accounts. However, these are often very specific and may not permit passing on the fees in question.

For instance, the May 1, 2004 Nationwide Futures II Prospectus does appear to provide for short term trading fees, but in the fees section it is stated that the “maximum short term trading fee” is 1%. I assume any contract issued under this prospectus would have such a provision. There could be problems if a purchaser of this contract having seen this language and agreed to 1% fees then found that he was being asked to pay a 2% fee.

While the funds might be able to charge the fees to the insurance companies, the insurance companies can expect problems in passing them on to the annuity holders under the existing contracts. There are usually clauses that state that underlying funds will be valued at net asset value. Specific accounting clauses set out procedures by which

the value of the sub-account is the first day's value times a product of the ratio of the net asset values with a deduction for certain named taxes and fees (short term trading fees typically not being among them).

The formulas give one number for the growth of a sub-account, and each policy holder in that sub-account shares proportionately. They simply do not distinguish between different policy holders with an interest in the same sub-account. Thus, on a particular day every policy holder who had all of his funds in a particular sub-account would find the value of his interest had increased by say 1%. There is no provision for treating policy holders differently, and saying that the one who transferred his money out of this account experienced a 1% loss (1% minus a 2% fee). I see no way these fees can be passed on to the individual contract holders without in some way violating the term of the typical older contract.

The legal owner of the mutual funds is the insurance company's separate accounts. Each investor has a right to receive money from the insurance company related to the value of the sub-account related to each mutual fund. This investment is measured in accumulation units. As pointed out, application of the formulas in contracts results in the same burden for all investors with the insurance company's burden rising proportionately to the asset value of the underlying mutual fund. This does not provide for the fees being collected.

If the sub-account still pays the fees, a possible interpretation of some older contract would be that the burden is spread evenly among all who have a stake in that sub-account. The reason is that the interest of each policy holder in the account is the same and undivided. I suspect many state laws even require that the holders in the sub-account be treated the same. Of course, the terms of contracts probably differ. With substantial sums at stake one can imagine disputes. It is very risky (and unwise) for the SEC (or any outside body) to take actions whose effects on individual contracts is unknown.

Many contracts seem to be worded so that the "contract value" grows at the rate of the net asset value of the mutual fund the account is invested in (minus the specified fees and taxes). The "contract value" is a legal obligation of the insurance company. The amount of this obligation is part of the "business of insurance" and it is reserved to the states.

In the standard variable annuity and variable life policy, the obligations of the investment company are hedged by investing equal dollar amounts in the underlying mutual funds whose values determine the "contract value." This hedging is in the interests of both the policy holder (since it makes it very likely the funds will be available to the insurance company to meet its obligations) and the insurance company who otherwise would be exposed to large risks.

However, if the hedging proves difficult the parts of the contract that determine the obligations of the insurance company remain in effect.

If the contract value grows at this rate and any fees are paid, eventually the insurance company will have to pay money into the separate account to make it whole, or the insurance company will have pay money from its general account to meet its obligation. This means the insurance company will be paying the fees.

I suspect the insurance companies would be very reluctant to absorb the fees, and would dispute the above clear application of the language in the contracts they have

executed (of course contracts could be drafted with different provisions, and one would expect future contracts to have suitable provisions).

Some insurance companies may have language in their contracts that permits them to restrict transfers, or could be interpreted as permitting this. If they have a clause related to excessive trading, but no provision for passing on fees, they might define excessive trading as exchanges with 5 days. This would keep them from bearing the costs of the fees, and eliminate the expense of litigation over the point. However, such an interpretation might be stretching the trading language, especially when the redemption was due not to exchanges between sub-accounts but due to surrender of the policy, death, a loan, or a similar non-trading event. To avoid paying the fees on policies surrendered they might go slow on processing surrenders, death payments, loans, etc. to make sure the fee issue did not come up. Such actions would have an adverse effect on many investors. Inducing insurance companies to take such actions does not appear to have been the intent of the SEC.

Another possible legal solution for an insurance company is to affirmatively declare that it permits short term trading, and that such trading may involve additional costs to the fund (which under the proposal gives it an exemption from charging the fee). The fund could probably specify the amount and type of short term trading it permitted, such as short term trades that did not exceed 20 per year. This would leave many firms where they are now. However, the final outcome might actually be more short term trading than now occurs since the insurance company would be in a weak position to restrict ad hoc trading that did not violate the limit (since they had declared they permitted short term trading). This approach might have the virtue of leaving the insurance company free to process surrenders, death payments etc. without charging the proposed fee. It would be free of the very burdensome record keeping rules given above.

This might be a very sensible solution for the older contracts where the language of the contracts seems clearly inconsistent with collecting fees. If new contracts of this type were not to be issued the insurance company would probably find the amount of short term trading did not increase beyond the current amount, which is typically minor.

An obvious problem is that the underlying mutual funds might still impose a fee and the insurance company might find itself paying the fee (although a lot of transfers would cancel). However, a large insurance company could find or create suitable funds that said short term trading was permissible if limited in quantity (by selling only to insurance companies who would use these fund in existing products, they could expect to experience levels of turnover similar to what is now experienced). These might be clones of the funds now being offered. If this route was taken there might be a net reduction in the number of funds available to policy holders, not an intended effect. Also, small insurance companies might lack the size to set up such funds or to negotiate for them to be set up and suffer disproportionately.

If the fees end up being imposed on investors many of the holders of existing contracts will feel (correctly) they have been subjected to an unexpected fee, and that promises to them were broken. The insurance company customer service agents will quickly divert the blame onto the SEC saying the charges were SEC required. Taking the blame this way is not good for the reputation of the SEC. I notice many of the public comments on this proposal describe it (probably incorrectly) as a SEC imposed tax. Taking the blame for fees is very bad public relations for the SEC.

Given the underlying regulatory policy enforced by the SEC of full disclosure and having firms live up to what is in the Prospectus, it would be embarrassing for the SEC to require that insurance companies violate the commitments made in their Prospectuses.

Investors that have been subjected to unexpected fees may be less likely to invest in the future, and to make provision for their own retirements. It is a major act of trust to send an investment company or an insurance company a large check and trust that you will get your money back as promised. If the companies are able to charge additional fees, this trust is violated. Even if it is blamed on SEC (government) regulations, investors would be reluctant to trust again. This would defeat the important policy goal of encouraging saving, investments, and individuals making provision for their own retirements.

Some companies may argue that for a government mandated charge like this they can unilaterally rewrite their contracts. Even if contracts can be legally rewritten in these cases, there may be more than one way to rewrite them and policy holders may be unhappy with how they were rewritten.

When one party has lived up to its side of a contract and the other has not the contract has been breached. Various remedies exist. The general remedy is damages for failure to perform. I see nothing in this proposal that prevents this remedy.

Another standard remedy is to declare the contract void and seek an equitable dissolution of the relationship. In the case of a variable annuity this would require returning the contract value to the contract owner and releasing the insurance company of the obligation to meet its other obligations (a death benefit, delivery of an annuity at a certain age etc.) For many policy holders this would create a massive tax liability. A 1035 exchange to another insurance company would be a possible solution for this. If the policy was already tax sheltered, (such as a 403b plan etc.), the policy holder might like to transfer it to another vehicle with lower fees.

Most annuity contracts provide for a surrender fee. Most of these insurance companies can be expected not to offer to cancel the policies just because the SEC made it impossible for them to live up to their contracts. One reason is that they have already paid commissions to those selling the policies and upon surrender they would lose the revenue stream from the policy that was needed to recover these commissions.

Some policy holders would be still hurt even if they could get out of their contracts with no surrender charge. Many provide for a death benefit that is tied to a historical value of the policy, which is now higher than the policy value.

Attempts by insurance companies to collect fees not provided for in the contracts will create problems. If this happens many of their policy holders will be unhappy (to say the least). Most of these contracts have substantial surrender charges so a policy holder who did not get what he was promised in his contract cannot easily just take his money and invest elsewhere (Surrender fee free policies are only a small minority of those issued). The surrender fees on many of these contracts are quite substantial (typically 5-7%). The major reason I could see for someone putting money that was already tax sheltered into such a high fee product was the explicit promise of the annuity company that they would be able to transfer it among sub-accounts.

In the case of at least some purchasers frequent trading was a primary reason they bought the contract. In exchange for this they agreed to pay high fees and surrender charges. I am in this situation with several contracts. One is in a 403b retirement plan

which already provided tax deferral. I would not have agreed to pay a second, high level of fees (beyond what say a mutual fund family would have charged or a brokerage firm) without the explicit promise of frequent trading (which was made in the prospectus).

The proposed regulation appears to have been designed for new sales of mutual fund shares. It is extended almost as an afterthought to insurance company separate accounts, where the products have already been sold and the contracts signed. The effect would be to seriously hurt many investors in existing products. The existing investors should be grandfathered in and given what they were promised.

For new purchasers, it may be acceptable to impose these fees. If they do not think the variable annuities are worth purchasing they can invest in other ways, or they can find a variable annuity that has reasonable fees and no surrender charges. Perhaps they can shift their business to a non-US insurance company. Changed the registration statements and prospectuses for these separate accounts could be accompanied by newly drawn up contracts offered to new purchasers that were consistent with these new documents.

However, changing these documents does not automatically rewrite the existing contracts between the investors and the insurance companies. It is not clear the SEC has authority to rewrite these contracts. Congress has made it clear that the “business of insurance” is to be regulated by the states. Rewriting existing contracts between policy holders and the insurance companies seems to go well beyond the mandate of the SEC.

These contracts contain explicit rules regarding the calculation of account values, transfers, death benefits, surrender charge etc that constitute a package. Changing one feature can affect others. Even if the SEC has the authority to rewrite the contracts, or one aspect of them, it should tread carefully in a complex area where one provisions affect another.

One complexity appears not to have been considered. This proposals makes a transfer from one sub-account to another the equivalent of a purchase or a sales that subjects a policy holder to a redemption fee. Does this also make this event a sale or purchase that is a taxable event under the Internal Revenue Code? The whole variable annuity industry is built on such events not being taxable. The SEC doesn't appear to have considered all of these complexities.

The death benefit is usually calculated by an explicit formula that is tied to the net asset values of the underlying funds. The SEC proposed fees do not change net asset values, and would not appear to change the death benefit promised. The SEC does not appear to have authority to change these formulas. The same applies for the contract provisions relating to the sums to be given to the policy holders if they surrender their contracts. These amounts are based on net asset values and agreed on fees owed to the insurance companies (which typically do not include the fees proposed above). For instance, suppose that right after I happen to transfer \$1,000,000 from one sub-account of an annuity to another I have a heart attack and die. At the time of my death the contract value is \$1,000,000. That is the death benefit owed me. The SEC does not have the power to regulate the “business of insurance” so that obligation remains. The contract provides that the “accumulation units” in the account will be liquidated and the shares in the underlying mutual fund liquidated to pay this benefit. If the SEC has required that a 2% fee be collected, the 2% fee will be collected, which is \$20,000. It will be owed by the insurance company since I am owed \$1,000,000. I fear however, that the insurance

company will default on the agreement and try to take the \$20,000 from the \$1,000,000 my heirs, leaving them with \$980,000.

It does appear that such an act would be a “conversion” and this is stated to be a criminal act in the Investment Company Act. I fear that the SEC will not enforce this part of the act. It is paradoxical that the SEC, charged with enforcing a law, is preparing to create a large financial incentive to violate it.

Similar problems arise with the surrender provisions of contracts and the transfer provisions. There is no evidence that the SEC has inspected even representative contracts and considered these problems.

If the SEC does have the power to require that the insurance company separate accounts pay fees, new and large financial obligations have been placed on the insurance companies (which are the owners of the separate accounts). The dollar values of the insurance company’s obligations to their policy holders are provided for in the formulas in the contracts, and should not be changed by any statement in the SEC regulation proposed here.

It follows logically from simple accounting that with obligations unchanged and expenses raised that the proposed regulation will reduce the net worth of the insurance companies and their ability to pay claims, including claims arising under automobile, fire, life, and other policies. The SEC, not being assigned the task of regulation “the business of insurance” is not equipped to consider all these complexities in the way the state insurance regulatory commission are.

Existing Insurance Contracts Should be Grandfathered In

I would urge the SEC to “grandfather” existing contracts and to provide for an exemption from the fees for the separate accounts underlying such existing contracts.

While there are certainly a few individuals who own are frequent traders in their annuity contracts, I suspect the number is not large in relation to the total number of contracts outstanding. Many existing annuity contracts (not all however), do contain language that permits the insurance companies to restrict what they consider excessive trading.

There are some traders who purchase an annuity (typically a no surrender charge one) with the intention of using it as a trading vehicle. If they are restricted in their trading, they may do a 1035 tax free exchange into a new contract. For instance, if an annuity limits the number of annual trades to 20, after 20 have been used up, the annuity is exchanged for a new one, via a 1035 exchange. Currently this is a viable strategy (although time consuming and involving periods when the money is not invested). If this is considered a problem, the best solution is fair valuing pricing (or next day pricing) which limits the profitability of the trading.

Thus, the relatively small problem of frequent trading in annuity contracts can be reduced by merely requiring that new contracts contain provisions for fees. It is not necessary to mandate the charging of fees to the separate accounts of funds where the contractual language does not provide for passing such fees on to the policy holders.

Hence, the SEC could accomplish its goal by merely regulating what new contracts and the associated documents filed with the SEC had to contain without having to step into regulating “the business of insurance” and trying to rewrite existing contracts.

It would probably wish to provide that mutual funds could continue to redeem shares related to such existing contracts without fees being charged.

Of course, mutual fund companies would be expected to disclose such arrangements. They would be expected to press the insurance companies to use the powers, if any, under existing contracts to prevent excessive trading. Recent final rules making clear the duties of fund board of directors is likely to result in them exerting pressures on insurance companies to use the powers in the existing contracts.

Even if the SEC succeeds in forcing a rewriting these contracts to permit the fees to be passed on, it can be expected that there will often be more than one way to rewrite these contracts and major disputes. There is no evidence that the SEC has inspected even representative contracts and considered these problems.

It is clear that Congress did not intend to give the SEC the power to rewrite insurance contracts. Annuity contracts are insurance contracts and these are traditionally regulated by the states. Law provides that “the business of insurance” is state regulated. While in the VALIC decision the Supreme Court did conclude insurance company separate accounts were “investment companies” within the meaning of the Investment Company Act, this proposed fee unavoidably goes beyond the investment aspects of the separate account.

Full Disclosure of Fees is Needed

Of course any fees imposed should be fully disclosed well in advance. Those who have not been informed of fees, or who have bought contracts with the promise of only certain fees that were specified in the a prospectus, should not be expected to pay fees.

It is clear from the legislative history of the securities laws that the intent of Congress was that investors should be provided with a full disclosure of what they were purchasing before they purchase it, and that after the purchase they should get what they were promised. This will done only if investment companies are required not only to state in their prospectuses what fee they will charge but are required to actually provide the prospectuses with these disclosures to investors.

Although the law seems to require that Prospectus be supplied to purchasers, there seem to be quite a few cases where the Prospectuses are not supplied prior to the offering of the securities. What seems to be happening is that the Prospectuses are filed with the SEC and given an effective data (often May 1). The investment companies often seem not to even begin printing and distributing the prospectuses until the effective date. With printing and mailing delays, the Prospectus may not reach potential buyers for perhaps a month and a half. Meanwhile the securities are being offered for sale on web sites of intermediaries (such a variable annuity companies), perhaps in such a ways that the investors do not even know they are buying a different security than was described in the last prospectus they received. (This seems to occur when there is a new class of shares with a fee which has essentially the same name as the old class, and the investors are given no notice). This has led to investors discovering they were being subjected to fees they had not expected to be subjected to.

For instance, on the day I am writing this (May 8) I received a Prospectus for American Century International dated March 1 with a form letter from an annuity company saying this was legal document relevant to a fund I had recently purchased.

This Prospectus mentions certain short term trading policies and fees on certain classes. By the time I was informed of these fees, the position had already been liquidated. I assume I was not charged any fees, but am not certain. This sort of thing should not happen.

I have looked at a couple of prospectuses dated May 1, 2004 and there is no mention of the possible 2% fee, or apparent provisions for collecting it. If adopted it will probably come as a surprise to most investors.

I understand one insurance company collected about a million dollars in trading fees (i.e. by just taking the money from their accounts) this year from investors who had made trades in 2003 without having been notified of the fees at the time of purchase. The possibility of fees was mentioned in a Prospectus (although the insurance company did not have provisions in its contracts for collecting such fees in many of their contracts) which was dated May 1, but printed and mailed out (via slow bulk mail intended for catalogues) reaching policy holders much later. This insurance company had done the same thing in previous years, starting the prospectus dissemination process too late for word to reach potential investors and offering the securities for sale on the effective date of the Prospectus. The same thing was done this year, 2004. Web site searches (the SEC site) suggests a Prospectus exists (but it is not on the site of the insurance company). The customer service representatives tell me the Prospectuses are not yet printed.

From Conversations with the customer service representative and visits to the SEC website documents suggests new sub-accounts in a variable annuity (probably with a newly issued class of shares in several mutual funds) is being offered for sale and that there are redemption fees associated with redemptions of such shares. However, it is hard to learn exactly what is going on without access to a Prospectus. Frequently there is more than one Prospectus like document on the SEC web site for a particular company so investors can not use that to find out what fees they may be subject to. Investors without Internet access have only a written Prospectus to rely on, and if that is not provided, they will not know what fees they are subject to.

There is no real excuse for not delivering a valid Prospectus to potential purchasers before offering the investment to them. The process should be started early enough so the prospectuses are in the hands of investors on the date when they need the information.

If the process of printing and distributing a prospectus is to be started only on the effective date of the Prospectus, the starting date for the proposed fees should be set late enough so that potential investors would be aware of them. Judging from the speed with which some companies disseminate prospectuses, this probably should be at least six weeks from the effective date of the Prospectus just to allow for distribution delays.

In many years, a failure to supply the legally required prospectus prior to offering a security for sale (such as an interest in a sub-account in a variable annuity) is of little practical importance. The new prospectus is very similar to the old prospectus, differing only by the inclusion of updated financial information, and possibly the name of the individual managing a portfolio. Investor's decisions on whether to invest in the investment company or how long to hold this investment would not have been affected by having the legally required prospectus prior to purchase, as long as they had an earlier prospectus.

However, the proposed fees are the sort of change in terms investors should be aware of before buying, or even more importantly selling (or doing a transfer between sub-accounts that amounts to selling and incurring a liability for fees). If the SEC does not start insisting that a valid prospectus be provided before offering a security for sale (which appears unlikely as of now), the proposed regulation should be amended to require that newly filed prospectuses provide for the charging of the fee six weeks or two months after the effective date of the prospectus. Thus, if the procedure is followed of only starting distribution of a prospectus on the effective date, and the effective date is set the day after it is illegal to use the old prospectus, investors would still receive notice of the fees before investing in investment companies that would charge them.

The SEC rule 485 provides that prospectuses are in normal conditions not to become effective for a period of 65 days or more in order to give the SEC time to review the documents. There is a clause (b) which provides for immediate effectiveness if the only purpose of the amendment to the registration statement is to update financial statements or certain other purposes.

It appears that Prospectuses describing this fee would not fall under Section 485(b). If so, the SEC should so state in advance, hence minimizing the current practice of some investment companies falsely certifying that their filing falls under Sec 485(b) and hence evading prior SEC review.

If Rule 485 is observed (as it should be) it should be realized that the papers will have to be at the SEC well before the effective date. This will make it more likely that the effective date will be very close to the date when the old prospectus becomes ineffective. There appears a real risk that many investment companies will have effective dates of say May 1, 2004. They may immediately start selling shares providing for the collecting of such fees even though investors have not been provided with Prospectuses describing the fees. We could again find numerous investors purportedly liable for fees they have not been informed of, and had not agreed to.

It would also be desirable that if the fee is charged to any investors that they informed of it and the amount of the fee. The procedures of many companies would provide for this, but it should be required. If a statement merely shows so many shares transferred out of one sub-account and so many bought in another, it may not be obvious a fee has been charged.

If a fund deducts the transaction fee from the price paid, they may show merely so many shares redeemed at a certain price. If the net asset value is \$10.00 and they redeem the shares for \$9.80, it should be made explicit that net asset value was not received and a fee was charged. If the company charges the fee by redeeming more shares, again it should be made clear what was done. Most companies would probably do this as a matter of course, but it should be required. Investors unaware of the existence of the fees might learn this way, and avoid being charged a second time.

If some days after a transfer or sale a fee is deducted from an account, the investment company should be required to notify the investor of the deduction and why it was made. This is just good practice and probably most companies do so.

However, in the case of one large insurance company where I have two large annuities I noticed one day a very large number of transactions processed on one day (February 26) with effective dates dating back to July of 2003. The first of these reduced my account by over \$9,000. This may, or may not, relate to the retroactive charging of a

transaction fee. I know the insurance company was trying to charge accounts retroactively after the fund requested that the fee be collected. I have gotten different answers from different customer service representatives. A March letter inquiring remains unanswered. I understand the same issue has arisen with numerous other investors, mainly relating to an attempt to collect in 2004 fees purportedly owed as a result of transactions made in June and July of 2003. The proposed new fees along with the apparent intent that transactions in different accounts be combined to compute fees could lead to many situations of this type.

Thus, the SEC should require that investors be given written (or electronic if agreed to) notice of all redemption fees charged to their investment accounts, and of all adjustments made to their accounts related to retroactive charging of fees. Incidentally, this incident shows the complexity that can result from the SEC proposal to charge fees on redemptions made within 5 days in another account, and points at the problems when out of the blue deductions from accounts are made with no explanations.

Thus, as a final suggestion if any fee is imposed by the SEC, the investors paying it should be informed of it, and investments companies should not be allowed to collect it (much less required to collect it) until investors have been informed of it. The regulation as written does not appear to insure that investors are warned of the fee, but merely that it be charged. Other laws and regulations do appear to require that investors be informed of such fees, but my experience and that of others shows that these provisions are frequently ignored, especially when new fees are introduced.

It would be highly desirable if before an exchange was made that might trigger the fee, the customers were warned. Technically this is not hard to do. The data base is searched for purchases with the 5 day limit (even easier if it is 5 calendar days), and a warning screen appears stating it appears a fee may be charged. Slightly more complicated programs could calculate the fee and state what it would be, or how much could be sold or transferred without a fee. Schwab appears to have such a program in place now.

The only annuity company I do business with that claims the right (incorrectly) to charge a fee made it clear in its recent prospectuses that it did not intend to warn investors in advance of fees (even though a program could be written to warn of fees). Since fee collection is easy (once a firm has a customer's money it merely removes any sum it wishes to from the account), firms can get away with this. When contracts have substantial surrender fees, customers cannot take their money and go elsewhere merely because such information is not provided.

For the firm that has my university retirement assets, ING, information on the dates of previous purchases and contributions is not on their web site. Since it is hard to predict when a payroll deduction will actually be credited (there is a very substantial lag), lack of this information would make it hard to know if a transfer would trigger a fee. Unfortunately, I suspect a firm that cannot make historical information available to its customers on the web might also find it hard to draw on this data to warn customers of possible fees.

If the SEC does go with this proposal I would hope it would launch a public relations campaign to warn investors of the fees they might be subject to. Certainly, when the investors complain about unexpected fee the customer service representatives will blame the SEC.

