Statement 202
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Statement of the Shadow Financial Regulatory Committee

on a

Simple Proposal to Deal with Market Timing and After Hours Trading

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Recent scandals have exposed a number of abuses related to Rule 22c-1 under the Investment Company Act of 1940. The rule requires mutual funds to price all transactions at the net asset value (NAV) as next determined by the fund (usually at 4 p.m. ET) after the purchase or redemption of shares (the “next-determined-price”). At least three separate abuses have been uncovered. First, and most blatant, is “late trading,” where some investors have managed to trade at 4 p.m. prices after significant movements in probable market prices have taken place due to information released after the markets have closed. In some instances, this has involved direct fraud in which the investor has paid the fund management company (or suborned an employee of the management company) to collaborate in obtaining gains at the expense of the shareholders in the mutual fund. In other cases, after hours trading has been disguised in the normal flow of orders from intermediaries and aggregators who routinely report trades made by their clients (purportedly prior to 4 p.m.) when processing is completed several hours later. This can amount to an intentional fraud perpetrated by the trader and intermediary on the management company and shareholders in the mutual fund. But this later case is much more difficult to monitor, given that the current state of information technology underlying many omnibus accounts does not permit funds to obtain the timing of individual trades.
The second kind of abuse does not involve violating the next-determined-price rule. Rather it takes advantage of instances where 4 p.m. prices may not represent the most recent information—"stale price arbitrage." This is clearly an issue with international funds in which the NAV reflects prices in foreign markets that have closed hours before 4 p.m. ET. Since the US is the last major market to close in any 24-hour day, it is relatively easy for market timers to take advantage of the stale prices in US mutual funds by trading on information that has become available after the foreign market closed. Stale prices are also a problem with regard to some small cap stocks, junk bonds and municipal bonds that are not traded every day. As with the case of foreign stocks and bonds, market timers can take advantage of existing mutual fund shareholders by buying at prices that do not reflect the true current value of some securities in the portfolio and then selling once the increase in values is reflected in market prices. This not only dilutes profits that should have gone to existing shareholders but also inflicts additional transactions costs on the fund.

Third, some "day traders" have found that mutual funds are a cheap way for them to play their lunches about movements in market prices. While direct purchases of securities incur brokerage commissions, mutual fund shares can often be exchanged without incurring any transactions costs for the trader. While this does not represent an appropriation of profits that should have accrued to the existing mutual fund shareholders as in the case of after hours trading and stale price arbitrage, it does inflict transactions or opportunity (for foregone investments) costs on the mutual fund that are borne by the other investors.

The SEC has offered several proposals to deal with these abuses. First, it has proposed that mutual fund companies and their agents accept no orders after 4 p.m. This so-called "hard close", buttressed by requirements for a reliable, time-stamped audit trail of transactions, would certainly deter late trading, but would not deal with stale price arbitrage or day traders. This would also impose heavy costs on intermediaries that are likely to be passed on to some categories of investors, costs that would be obviated by our proposal. Even intermediaries with the best technology would be obliged to stop receiving orders at least an hour and a half before the 4 p.m. close in order to complete the required processing. Other intermediaries would be forced to incur substantial information technology expenses to comply and would need to stop taking orders much earlier in the trading day.
In addition, the SEC has advocated the adoption of fair-value pricing, in which mutual funds attempt to adjust stale prices for information that has arrived since the last transaction. This process is costly and necessarily subjective. Nonetheless, it should reduce stale price arbitrage. It does nothing, however, to deter late trading or day trading.

The Shadow Financial Regulatory Committee believes that there is a much simpler, more effective and less costly way to deal with all of these three abuses. We urge the SEC to change rule 22c-1 to permit mutual funds that wish to be categorized as “long-term investment funds” to price their NAVs at 4 p.m. on the day following the day in which the trade was initiated (“T+1” pricing). This would eliminate or reduce each of the three abuses.

First, late traders could no longer gain advantage by trying to sneak in after 4 pm, because their trade would be valued at 4 pm prices on the following day, and would thus reflect whatever informational edge they might have had. Second, most stale prices should have been updated over a two-day span and so “long-term investment funds” would not provide an attractive vehicle for arbitrage. Finally, day traders, who have notoriously short investment horizons, would find long-term investment funds less attractive than other investment vehicles such as Exchange Traded Funds or funds specifically designed for active trading.

Although we believe that T+1 pricing would be an important advance over current practices, it may still be useful to establish a fair value for securities that are not traded and thereby repriced within the two-day window, and it may be useful from a transactions cost standpoint to impose limits on the number of round-trips an individual investor can make or to raise redemption fees. In this regard, we see no justification for the SEC’s current 2% ceiling on redemption fees. These fees are returned to the fund to compensate the remaining shareholders for the costs imposed by shareholders who leave during the redemption fee period, but they have proven to be much too low relative to the gains available to stale-price market timers.
What are the possible costs of T+1 pricing? First, investors in long-term investment funds will bear an additional day of price uncertainty. This is not a heavy cost for investors with long horizons, although it could take a psychological toll in sharp market swings. (Nonetheless, market data show that in many cases investors in such instances would be better off trading at next day prices.) Second, investors will lose one day of liquidity should they need to redeem their shares to meet an emergency. This concern could be easily addressed by permitting a strictly limited number of same-day withdrawals per year to meet emergency circumstances. Third, any trading by fund investors could produce inside information about order flows, which can have value if the investor knows precisely how the fund will trade. In this regard, T and T+1 (same and next day) pricing are the same. Insider trading laws should continue to be enforced and should be as effective against T+1 order flows as T order flows.

In sum, we believe that the SEC should amend rule 22c-1 to provide mutual fund companies with the option of T+1 pricing. Clearly T+1 pricing is not for and should not be imposed on funds, such as money market funds and S&P 500 index funds, where there is no problem with stale pricing. But other categories of funds that have experienced difficulties with after hours trading, stale price arbitrage and day trades may find the option attractive, and it would certainly impose markedly lesser costs on intermediaries. Moreover, if a fund in these other categories chooses not to adopt T+1 pricing, it would face a heavier burden of showing how the ways they are dealing with these potential abuses will defeat after hours trading, diminish stale price arbitrage and discourage day trading as effectively as T+1 pricing.