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**ICI** INVESTMENT
COMPANY
INSTITUTE[Home](#) | [Search](#) | [Site Map](#) | [Site Index](#) | [What's New](#)**ICI MEMBERS****MUTUAL FUNDS: INVESTING IN AMERICA'S FUTURE**[Key Issues](#) | [Statements & Publications](#) | [Statistics & Research](#) | [About Shareholders](#) | [About Investing](#) | [Newsroom](#)**KEY ISSUES****Questions and Answers About the Mutual Fund Investigations**

On September 3, 2003, the New York Attorney General's office announced it had settled a complaint against Canary Capital Partners, a hedge fund, its principal, and two of its affiliates. The complaint alleged fraudulent conduct involving [late trading and market timing](#) of mutual funds. Four mutual fund families were also identified in the complaint.

In the following weeks, many other mutual fund families and other financial services providers were linked to allegations of late trading, market timing, and other improprieties. Other state securities regulators also announced investigations.

The Securities and Exchange Commission regulates mutual funds and it, too, began ongoing investigations. Both the U.S. Senate and the House of Representatives held hearings on mutual fund practices and considered legislative proposals.

How has the Institute responded to these developments?

In [testimony](#) before the United States Senate Committee on Banking, Housing, and Urban Affairs on November 18 Institute President Matthew Fink said he was "...outraged by the shocking betrayal of trust exhibited by some in the mutual fund industry" and that those who have violated criminal laws "...should be sent to prison."

"Our goal is simple and profound: we want to work with you and other policymakers to rebuild trust, renew confidence and reinforce our previous history of putting the interests of investors ahead of everything else," he said.

The Institute denounced the abuses and urged action in three areas. First, government officials must identify and sanction all wrongdoers. Second, shareholders who were harmed must be made right. Third, strong and effective regulatory reforms must be put in place that ensures these abuses never happen again. Regarding regulatory reforms, Institute Chairman Paul Haaga has stated that, "Everything is on the table."

The Institute urges three specific measures to help eradicate abusive trading practices.

Late Trading

The Institute called for a firm 4 pm deadline for reporting orders to mutual fund firms as the most efficient way to end late trading. Only buy and sell orders received by mutual funds or certain

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designated agents by 4 pm could receive that day's price.

Market Timing

To combat market timing the Institute recommended a mandatory minimum 2 percent redemption fee to be charged whenever an investor sells fund shares other than money market funds or funds specifically designed for short-term trading within five days of purchasing them. These fees would be returned to the fund to benefit long-term shareholders.

Personal Trading

After allegations that some portfolio managers and senior industry executives had traded shares in their own companies' funds, the Institute called for mutual funds to clarify or amend their codes of ethics. The changes would cover procedures for senior staff trading in shares of their companies' mutual funds.

In addition, the Institute supports SEC Chairman Donaldson's plan to propose tough new regulatory standards addressing late trading and abusive short-term trading of mutual fund shares.

What is market timing?

Market timers dip in and out of mutual funds hoping to profit from anticipated short-term market moves up or down. Because of time zone differences among international stock markets, market timers frequently target funds that invest in foreign stocks. This strategy is called "time zone arbitrage." It seeks to exploit fund share prices that are based on closing prices of foreign securities established some time before the fund calculated its own share price.

Market timing in and of itself is not illegal. In fact, there are some mutual funds that promote themselves as suitable for short-term trading. A key issue in the current investigations is whether some funds had market-timing policies that were selectively enforced. That would allow some fund investors to market time while others could not or were subjected to penalties if they did.

But if it's legal, why do some mutual funds discourage it?

Rapidly buying and selling mutual fund shares can disrupt efficient fund management because it can force fund managers to hold excess cash or sell holdings at inopportune times to meet redemptions. It also can boost the fund's trading and administration costs. Long-term investors forfeit return as a result.

What do mutual funds do to stop market timing?

Some funds charge redemption fees of up to 2 percent on trades made within a given period following purchase. They can also restrict exchange privileges or limit the number of trades within a specified period. Some funds bar market timers from further trading or even expel them from a fund.

Funds are obligated to use "fair-value pricing" under certain circumstances and this can reduce the impact of harmful short-term trading. But fair-value pricing cannot by itself eliminate such trading.

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Why don't funds use fair-value pricing every day?

Mutual funds generally are required to value their holdings using closing market prices. When market prices for portfolio securities are not readily available, funds must establish a "fair value" for the securities. Fair valuation is not an exact science. It involves using judgment. Funds adopt rigorous policies and procedures concerning fair valuation that seek to appropriately balance concerns about introducing too much subjectivity into the pricing process.

What is late trading and why is it illegal?

Under federal securities laws mutual funds are required to price their shares daily. Nearly all funds do that at 4 pm, the close of trading on the New York Stock Exchange. By law, all orders to purchase or redeem shares placed by investors must receive the next calculated price. This is called "forward pricing." Thus, any orders placed by investors after 4 pm must get the next day's price.

Late trading occurs when an investor places an order after 4 pm, but receives the per share price calculated as of 4 pm that day. Late traders can take advantage of knowledge about developments in financial markets that occurred after 4 pm.

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