January 2004

Report of the

Omnibus Account Task Force

January 30, 2004

As part of its efforts to combat abusive market timing in mutual funds, the SEC intends to propose a mandatory redemption fee on short-term trades. On November 17, 2003, the SEC requested that NASD convene a working group of industry experts to consider how this initiative may be affected by the use of mutual fund omnibus accounts. This memorandum summarizes the views expressed by members of the Omnibus Account Task Force (Task Force) established by NASD.

Introduction and Summary

Mutual fund complexes typically do not have information that identifies the customers who acquire and dispose of mutual fund shares through omnibus accounts held at intermediaries. The SEC is concerned that this lack of transparency may impede successful implementation of a mandatory redemption fee designed to deter abusive short-term trading. The Task Force's specific mandate was to provide the SEC with suggestions on how to achieve the SEC's objectives in an omnibus environment.

The Task Force consists of 16 industry professionals who represent a broad range of participants in the omnibus trading process – broker-dealers, mutual fund sponsors, third-party administrators (TPAs), banks, transfer agents, and clearing corporations.[1] During December, NASD staff conducted individual telephone conference calls with each Task Force member to solicit their views on the best ways to facilitate the imposition of mandatory redemption fees on trades processed through omnibus accounts. The Task Force met in Washington, D.C. on January 9, 2004, to consider, as a group, the comments and ideas that were raised in the conference calls.[2] Since that time, NASD staff has had further discussions with certain Task Force members to clarify views expressed at the meeting.[3]

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[1] Attachment A is a list of the Task Force members.

[2] Also present at the January 9th meeting were representatives of the Securities Industry Association and the Investment Company Institute.

[3] NASD staff also had discussions with interested parties who, although not members of the Task Force, either contacted NASD staff or were otherwise identified as having expertise in the area. These interested parties include the Investment Company Institute, the Securities Industry Association, the Profit Sharing/401k Council of America, the SPARK Institute, and the American Society of Pension Actuaries. We also spoke with several members of NASD's Independent Dealer/Insurance Affiliate and Variable Insurance Products Committees to identify challenges unique to the insurance products industry. These Committee members noted that insurance products might offer an attractive alternative to market timers because of the ability to make tax-free exchanges; significant systems modifications would be required to detect frequent trading by variable contract holders; and some insurance contracts grant an unlimited right to transfer among funds and there may be legal issues associated with imposing fees in those instances.

A. Redemption Fees

There appears to be general consensus among Task Force members that a redemption fee, if mandated by the SEC, should be imposed under the following conditions: (i) the fee should be assessed at the recordkeeper (usually the intermediary) level (for example, broker-dealers, bank trust departments and TPAs) based only on positions held through that intermediary; (ii) the fee should not be assessed on *de minimis* trades; (iii) mutual funds or their designated transfer agents should have access to information on investor trading activities to, at a minimum, audit whether intermediaries are applying the rules properly; and (iv) to avoid confusion and inefficiencies, the SEC should establish the size of the redemption fee and the holding period that would trigger application of the fee. There is, however, no general consensus among Task Force members on a number of issues related to the fee, such as (i) the length of the holding period; (ii) whether all of a shareholder's accounts with an intermediary should be aggregated for purposes of assessing a redemption fee; (iii) the appropriateness of excepting certain transactions from the fee; (iv) the assessment of redemption fees on a Last-In, First-Out (LIFO) or First-In, First-Out (FIFO) basis; and (v) periodic reporting of customer transactions to mutual fund transfer agents by intermediaries processing transactions on an omnibus basis.

B. Supplemental Steps

Task Force members generally concluded that, absent a significant holding period requirement, such as 30 to 90 days, redemption fees alone will not deter market timing abuses, and several members recommended that supplemental steps be taken. Many Task Force members concluded that mutual funds or their designated transfer agents should have access to shareholder-specific information that enables them to assess a shareholder's trading across all accounts and intermediaries. This would enable a fund or its transfer agent to effectively enforce exchange limitations and oversee the "big picture" of a shareholder's trading in the fund's securities for problematic behavior. Some Task Force members also favored the creation of a database listing those investors that have been denied access to funds based on apparent trading abuses. [4]

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[4] Some Task Force members expressed the view that, in addition to (or instead of) redemption fees, the SEC should consider fair value pricing and other trading restrictions, such as a limit on the number of exchanges, as a means to address abusive short-term trading.

Task Force Deliberations

At its January 9th meeting, members of the Task Force considered a number of models (and combinations of models) for the transmission of information to mutual fund transfer agents, and the advantages and disadvantages of each. These models are described below.

A. Options Considered by the Task Force

1. Daily Reports of TIN and Related Information

First, the Task Force members discussed an option that would enable a fund transfer agent to assess, on a daily basis, a shareholder's trading with a fund through multiple accounts or intermediaries. Under this model, all intermediaries processing mutual fund orders would transmit to a fund's transfer agent, either at the time of each transaction or in a daily report, the Tax Identification Number (TIN) and, possibly, account title information (e.g., customer name and address), for each transaction by a fund shareholder.[5] Armed with this information, a fund transfer agent would have a fairly complete picture of an individual's trading activity.

Transmission of this level of information to a fund or its designated transfer agent would address abusive short-term trading by helping to ensure that funds are able to identify individuals who engage in trading by purchasing in one account and selling in another. If the SEC requires that redemption fees be assessed on a basis that takes into account all short-term trading by an individual, regardless of the account or intermediary through which such trading takes place, the transmission of this level of information would give funds the information they need to comply with that mandate. For example, if a participant purchased Fund X in his 401(k) account and the next day sold a pre-existing holding in Fund X in his brokerage account, this type of transparency would help ensure that a redemption fee could be assessed. A fund or its transfer agent could match purchases and redemptions made through multiple intermediaries and compute and collect redemption fees. Alternatively, if intermediaries collect redemption fees, receipt of this information by a fund or its transfer agent would help ensure that funds are able to exercise adequate oversight over the process.

Further, the enhanced transparency at the fund level that this approach yields would equip funds with the information necessary to employ tools in addition to redemption fees to police against short-term trading abuses, such as exchange limitations. In the current environment, for example, exchange limitations cannot be imposed effectively at the beneficial owner level because funds do not have the data needed to identify trading by particular

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[5] Some broker-dealers are concerned about sharing proprietary information with funds. This concern could be mitigated through confidentiality agreements that limit the use of information concerning beneficial owners. Limiting the information transmitted to TINs, which appears not to raise the same level of competitive concern, may solve this problem. One Task Force member believes that regulators should adopt specific rules mandating the proper uses and protection of such data.

investors, and intermediaries do not have information on purchases/redemptions made through other intermediaries.[6]

On the other hand, some Task Force members questioned the need to track customer trades across multiple accounts and intermediaries. They believe that there is limited economic incentive to market time through multiple intermediaries or accounts, because, without an ability to sell short, such a strategy would require the investment of assets in an account that is subject to a holding period requirement. Other Task Force members disagreed, expressing the view that a sufficient incentive might exist to conduct market timing through multiple accounts unless the holding period required to avoid the imposition of the fee is sufficiently long to eliminate the economic value.

Several Task Force members expressed the view that implementation of this full transparency model would be cost prohibitive. It would require intermediaries that use omnibus accounts to transmit millions of records, including TINs, to fund transfer agents on a daily basis, and would require fund transfer agents to store the data.[7] Information supplied by Task Force members indicates that in excess of 100 million investor accounts are held in the omnibus environment, and many of these investors place numerous small orders through periodic purchase plans. These Task Force members believe that the costs associated with such an endeavor would be extremely high, and ultimately could be borne by investors or force some processors, such as small TPAs, to go out of business.

Some Task Force members also stated that this solution would undermine the efficiencies of omnibus processing that result from the elimination of duplicate recordkeeping by intermediaries and transfer agents.[8] While other industry participants disagree, omnibus processors believe that these efficiencies allow them to operate at lower cost, reduce the number of errors, and return confirmations to customers more rapidly. Additionally, at least one Task Force member representing a large omnibus processor believes that, at a minimum, the NSCC

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[6] Some large fund transfer agents have software (currently used to enhance breakpoint discounts by identifying account linkage opportunities) that might be modified to facilitate matching of purchases and redemptions. Broker-dealers using National Securities Clearing Corporation (NSCC) Networking Level 4 (one of the most widely used Networking Levels), as a general matter, already transmit TINs to fund transfer agents. It also appears that broker-dealers using other Networking Levels could transmit TINs to fund transfer agents without incurring significant costs. One Task Force member already includes TINs for all orders transmitted through Networking, on a transaction-by-transaction basis, including Networking Level 3.

[7] The storage costs possibly could be mitigated if the transaction-specific data only needed to be readily accessible for a limited period of time, such as the period of the redemption. Such a limitation, however, would diminish the value this data could serve in other contexts. Transmission costs also could be minimized if the data were made available to fund transfer agents through a mechanism such as secure Web access.

[8] One Task Force member observed that a better approach might be to mandate that certain specified information be transmitted by intermediaries to a central repository. Funds or their designated transfer agents could access this information for monitoring purposes without having to receive and retain voluminous account records. At least one other Task Force member, however, believed that creation of a “shadow” set of records at a central repository was not a feasible alternative.

Networking system would be significantly strained if omnibus processors used it to communicate data to funds on a transaction-by-transaction basis.

We also note that this approach, although more comprehensive than others, would not be fully comprehensive because an individual could trade through accounts with different TIN numbers. For example, trusts often have TINs that differ from those of their beneficial owners. A shareholder also could trade using both a personal account and that of a closely-held corporation, which would have a different TIN number. This problem would exist even if the account name were disclosed, because in many instances the account name of a trust or business would not reveal the names of beneficial owners. Further, this solution would not prevent other trading strategies, such as a husband and wife purchasing in one spouse's account and selling in the other's.

2. *Partial Transparency*

The Task Force also considered three alternatives that would provide "partial transparency" to fund transfer agents. Under one option, all intermediaries could be directed to provide fund transfer agents with data on transactions (TINs and, possibly, customer names and addresses) on a periodic basis, such as semi-weekly, weekly, or monthly. This alternative would require the transmission of the same data to funds as the full transparency model, but on a less frequent basis.[9] A disadvantage with using periodic reporting to assess redemption fees across accounts is the lag time between a redemption and a report. The fee might be impossible to assess against an account that has been closed if the proceeds have been remitted to the shareholder before a report is received. Also, the longer the delay between submissions, the greater the frequency with which intermediaries would have to make retroactive adjustments to customer accounts, possibly causing loss of customer confidence.[10]

A second partial transparency option considered by the Task Force would differ from the full transparency model in that it would allow certain orders to be carved out of the reporting requirement. Reporting may be unnecessary for smaller trades; one Task Force member's experience suggests that market timers often trade anywhere from $10,000 to $1 million in a single trade.[11] The "carve-out" could cover certain types of smaller orders, such as purchases made pursuant to a periodic purchase or regular 401(k) contribution plan, those under a certain dollar amount, or loans or withdrawals from a 401(k) plan. For each category of transactions carved out from the obligation to make data available, costs would be reduced.

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[9] At least one Task Force member that processes on an omnibus basis has developed a proprietary system for submitting TINs to fund transfer agents weekly (for purposes of assisting in the identification of breakpoint discounts).

[10] In addition, a uniform time period would be preferable for fund transfer agents, and some omnibus processors expressed a preference for a daily regime for transmitting information, which they are following today.

[11] This Task Force member is a TPA and supplied data on average daily trading activity in 401(k) plans it manages. The data shows that transfer/reallocation events make up a small number of the transactions that occur on a daily basis but account for a large percentage of the assets. In contrast, contributions make up a large percentage of the transactions but a small percentage of the dollars.

Carving out small dollar transactions could reduce compliance costs significantly, without impairing the ability to identify trading abuses by large investors. On the other hand, carve-outs complicate the systems necessary for the reporting process, and it may prove difficult to establish appropriate, clear standards for which transactions should be exempted. Finally, for each transaction exempted from reporting, the extent to which the redemption fee addresses market timing abuses decreases to some extent.

A third partial transparency model would require intermediaries to provide account-specific, rather than customer-specific, information to fund transfer agents. As envisioned, a fund transfer agent would receive some type of intermediary-specific identifier for each account's transaction with a fund, such as a Broker Identification Number (BIN) (which is usually the investor's account number at the particular broker-dealer). This does not appear to be a viable approach. The only clear advantage of this approach is that it would avoid the sharing of customer-specific data that some intermediaries view as proprietary information. One major drawback of this alternative is that it would not permit the identification of market timing carried out through multiple accounts within a single intermediary unless the intermediary uses an identification system that links all accounts of a single beneficial owner. This alternative, moreover, would not allow funds to assess a shareholder's activity across intermediaries. While Task Force members generally believe that account level reporting is sufficient for the purpose of imposing a redemption fee, there was general agreement that it would not give funds a complete picture of a shareholder's trading activity and therefore would be insufficient for fund monitoring efforts.

3. Delegating Responsibility

Finally, the Task Force considered a model under which mutual funds would be required to either (1) obtain all the data necessary to police against market timing abuses or (2) enter into agreements with intermediaries under which this obligation could be delegated.[12] To the extent that the matching of purchases and redemptions is delegated to intermediaries, the cost of making information available to fund transfer agents and the concern over sharing proprietary information would be eliminated. On the other hand, splitting the compliance effort among various intermediaries and fund complexes likely will complicate both industry efforts and regulatory oversight.[13] Moreover, if the matching of purchases and redemptions is delegated to intermediaries, investors could circumvent mandatory redemption fees by placing orders through multiple intermediaries. Although intermediaries could be required to transmit data to other intermediaries at which customers hold positions in the same funds, this would be a complex effort and would work only if customers actually inform intermediaries about positions held through others.

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[12] Of course, if the SEC were to adopt this approach, delegation likely would not relieve mutual funds of their obligation to ensure that adequate procedures are in place to detect market timing abuses and to exercise adequate oversight over their delegate.

[13] If compliance is centralized, with responsibility placed on the fund transfer agent, the various intermediaries could still carry out administration of the fee. Many Task Force members expressed a strong preference for intermediary administration.

B. Views of the Task Force Members

At the January 9th meeting, members of the Task Force worked to identify an approach that would accomplish the SEC's goals in a comprehensive, cost-effective manner. The discussions revealed that many Task Force members were of the view that abusive short-term trading may be addressed in an omnibus environment through a combination of:

- A mandatory redemption fee assessed on each account that engages in short-term trading as defined by the SEC, with no attempt to match a shareholder's purchases/redemptions through multiple intermediaries. This would inhibit market timing through a single account, which the Task Force members generally believe is the most common means of abusive short-term trading;

- Periodic reports containing shareholder-specific information (including TIN information) from intermediaries. A fund or its designated transfer agent could use these reports (or equivalent access to the information) to analyze all trading by an individual, whether through a single account or through a number of accounts held with one or more intermediaries. This would provide a fund with a nearly complete picture of an individual's trading activity, which would enable a fund complex to identify abusive short-term trading through the use of multiple accounts.

Several Task Force members also support the creation of a centralized means by which fund transfer agents or intermediaries would report and share the TINs of shareholders who have been denied trading privileges with a fund based on abusive short-term trading practices. Each of these strategies is described below.[14]

1. Mandatory Redemption Fee

Most Task Force members are of the view that there is no need to impose redemption fees on a cross-intermediary basis if funds are given information that enables them to assess a shareholder's trading across accounts and intermediaries, and thus, in turn, to eject shareholders that engage in abusive short-term trading. Some Task Force members believe that a redemption fee will be effective in addressing abusive market timing only if the holding period is of sufficient length to vitiate the associated economic benefit with such trading practices (periods of between 10 business days and 60-90 days were mentioned), but others believe a lengthy holding period is not necessary. The latter group is of the view that most abusive trading occurs through a single account, because economic incentives, in any event, generally would not favor timing through the use of multiple accounts. Members were strongly of the view that the SEC should establish clear

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[14] In addition, as noted earlier, a number of Task Force members were of the view that the SEC should consider other means to address abusive short-term trading, such as fair value pricing of fund portfolio securities and exchange limits.

guidelines as to whether the fee should be assessed on a LIFO or FIFO basis, and the length of the holding period that would trigger the fee.

FEE ASSESSED ON EACH ACCOUNT IN ISOLATION	FEE ASSESSED BY AGGREGATING ALL ACCOUNTS HELD WITH AN INTERMEDIARY
Most market timing may occur through use of a single account. Assessing a fee on an account-by-account basis may be easier to administer.	Aggregating all accounts held by a fund shareholder with a particular intermediary would ensure that any potential timing through multiple accounts with a single intermediary is discouraged.

LIFO	FIFO
Would capture short-term trading. For example, if an investor invested $100,000 in Fund A on January 1, purchased $10,000 on January 22, and then sold $10,000 on January 25, the LIFO method of assessing a redemption fee for purchases and sales within a five-day period would result in a fee being charged. Under the LIFO method, an investor purchasing fund shares on a periodic basis likely will always have shares (albeit a small amount) that fall within the redemption period. Use of LIFO might require exceptions to the application of a mandatory redemption fee, such as investments made through a periodic purchase plan.	May not capture short-term trading. In the example to the left, use of FIFO would not cause a redemption fee to be charged, even though the shareholder purchased and sold within the five-day period. Concerns over calculating redemption fees on periodic purchase plans would be reduced if a FIFO method were permitted to calculate holding periods. For purposes of calculating redemption fees and Contingent Deferred Sales Charges (CDSCs), FIFO is the current industry standard, although some firms do utilize LIFO to calculate redemption fees. Adoption of a FIFO approach for purposes of assessing a mandatory redemption fee would be easier for the industry to implement, and allow for quicker implementation of the proposal.

SHORTER PERIOD	LONGER PERIOD
Some Task Force members believe that the vast majority of abusive trading occurs in one- or two-day turnarounds, and therefore favor a very short holding period (*e.g.*, 1-5 business days) during which a mandatory redemption fee would be assessed.	Some Task Force members expressed concern that a shorter time period would capture "amateur" market timers, but would not deter more sophisticated timers, who would employ hedging strategies to evade redemption fees assessed only for a short holding period. Some Task Force members noted that redemption fees are a more objective way in which to inhibit market timing than other approaches (such as reviewing all trading for trading that is suspicious to the fund). Thus, under this analysis, the longer the redemption period, the more effective the deterrent presented by the redemption fee and the less the need to rely on subjective alternatives. Some Task Force members commented favorably on a period of 10 business days, and 30-90 days.

DE MINIMIS STANDARD	NO DE MINIMIS STANDARD
Task Force members generally agreed that it would be appropriate for the SEC to establish a threshold amount for the imposition of a mandatory redemption fee. One suggestion was that a fee be imposed if the redemption fee would be more than $50.	Application of a mandatory redemption fee, with no exclusions for smaller trades, may be easier to administer, but would penalize small investors whose trading does not affect the fund.

FEE ASSESSED BY FUND TRANSFER AGENT	FEE ASSESSED BY INTERMEDIARY
For the reasons discussed above, transmitting the data to funds to assess redemption fees in a timely manner is problematic.	If the intermediary assessed the fee, it could be done at the time the trade is processed, which would eliminate the need to go back to the investor to assess and collect the fee at a later time. Intermediaries could compute and assess fees, even if the transfer agent assumes responsibility for monitoring market-timing activities. Bifurcating the compliance function among various intermediaries and fund complexes could complicate both the compliance function and regulatory oversight. Concerns over bifurcating the compliance function could be diminished through contractually delineating responsibilities.

2. Periodic Reports to Fund Transfer Agents

Members of the Task Force observed that, at least absent a significant holding period, such as 30 to 90 days, redemption fees are not, standing alone, sufficient to deter short-term trading. With a lengthy holding period, provision of further information to the fund does not appear necessary to deter market timing activity. However, it still would be desirable so that the fund could audit intermediary performance in assessing redemption fees and otherwise be able to review and analyze fund trading on a comprehensive basis. For that reason, many members of the Task Force favored a requirement that intermediaries provide funds or their designated transfer agents with periodic reports concerning, or access to, customer purchases and redemptions of mutual fund shares through the intermediary's omnibus account. All trades would be reported, along with a TIN number that enables funds to match trades through different intermediaries. Under such an approach, fund complexes would be required to review the reports, identify trading that violates a fund's policies on timing, and take action to prevent the shareholder from any further transactions with the fund. Members of the Task Force generally concluded that reporting that did not provide a customer-specific identifier, such as a TIN, would not effectively help funds identify abusive short-term trading.

More Frequently – Daily or Transaction by Transaction	Less Frequently - Weekly or Monthly
The SEC may choose to require that intermediaries report to fund transfer agents on a daily or even on a transaction-by-transaction basis. Costs may be greater with greater frequency. Because daily reporting might be very difficult for many 401(k) providers to implement, the SEC may wish to consider weekly reporting for these entities.	Less frequent reporting may be more cost-efficient. On the other hand, infrequent reporting may allow timing activity to proceed undetected between report dates. The SEC could mandate different reporting periods for different types of intermediaries. However, consolidating information from sources operating under different reporting schedules could cause confusion.

TIN or TIN Plus	BIN or Other Intermediary-Specific Identifier
Providing TIN information would enable funds to match purchases and redemptions across accounts and intermediaries. Providing customer names and addresses in addition to TINs would not appear necessary for funds to track shareholder trades across intermediaries. Intermediaries likely will oppose a proposal that requires them to disclose customer names and addresses, which many regard as proprietary information.	BIN-only information would not enable fund complexes to compare a shareholder's holdings across intermediaries. Also, unless intermediaries use an identifier that links all accounts held by a customer with the intermediary, a fund would not even be able to assess a customer's total trading with a fund through a single intermediary.

All Trades Reported	Certain Exclusions Apply
The most comprehensive approach would be to require that all trades be reported, regardless of size or the nature of the transaction.	Many Task Force members were of the view that it makes sense to exempt transactions that present little danger of abuse – *e.g.*, those below a certain size, payments made pursuant to a periodic plan or payroll deduction plan, etc. This approach would allow firms to focus compliance resources on higher-risk events. Other Task Force members are concerned that exempting certain types of transactions will add to the complexity of the undertaking. Additionally, it may be difficult to draw the line as to which exemptions should be exempted.

Transmitting Data to Funds	Posting Data on Web sites
Consistency in reporting is important and it would be appropriate for an industry group to develop a standard template.	Intermediaries could post the relevant data on purchases/redemptions on a secure Web site that could be accessed by the appropriate fund or their designated transfer agent. Allowing this option might be more cost-effective and need not interfere with a standard template.

3. Reporting Abusive Short-Term Trading

As noted above, the Task Force also discussed the possibility of the industry (or a third party provider) maintaining a centralized means by which funds, transfer agents, and/or intermediaries would report and share the TINs of shareholders who have been denied trading privileges with a fund based on abusive short-term trading practices.[15]

Maintaining an Industry Database	Concerns about Database
Such a list could be a helpful tool in funds identifying investors who engage in problematic trading. Such a list is similar to tools already used by the industry in other contexts.	Such a list could be viewed as an unfair impediment to free trading. Care would need to be taken so as to avoid any regulations concerning investors' rights to freely invest, particularly in retirement plans.

[15] Financial institutions currently use vendor services such as McDonald Information Service, which functions as a centralized repository for material adverse information pertaining to institutional and retail accounts that can be accessed by subscribers.

Attachment A

Omnibus Account Task Force Members

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