

MEMO# 17059

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NASD SUBMITS REPORT OF THE OMNIBUS ACCOUNT TASK FORCE MEMBERS TO THE SEC

[17059] February 4, 2004 TO: SEC RULES MEMBERS No. 15-04 SMALL FUNDS MEMBERS No. 9-04 UNIT INVESTMENT TRUST MEMBERS No. 4-04 PENSION MEMBERS No. 8-04 OPERATIONS MEMBERS No. 8-04 BROKER/DEALER ADVISORY COMMITTEE No. 4-04 TECHNOLOGY ADVISORY COMMITTEE No. 3-04 RE: NASD SUBMITS REPORT OF THE OMNIBUS ACCOUNT TASK FORCE MEMBERS TO THE SEC On January 30th, the NASD submitted to the SEC the Report of the Omnibus Account Task Force Members (the "Report").¹ This Report resulted from a request of the Securities and Exchange Commission that the NASD convene a working group of industry experts to consider how imposition of a mandatory redemption fee on short-term trades may impact mutual fund omnibus accounts. In response to the Commission's request, the NASD produced its Report that, in lieu of providing the Commission specific recommendations, instead discusses the various points of view of members of the Task Force on the issues it considered. The Report is briefly summarized below.

I. VIEWS OF THE TASK FORCE MEMBERS With respect to omnibus accounts, the Task Force members were of the view that abusive short-term trading could be addressed through a combination of (1) 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 and (2) periodic reports containing shareholder-specific information (including taxpayer identification numbers ("TINS")) that would be provided to a fund or its transfer agent by an intermediary.²

1 A copy of the Report is expected to be posted on the NASD's website, www.nasdr.com, within the next few days.

2 According to the Report, some Task Force members were of the view that, in addition to or instead of redemption fees, the Commission "should consider fair value pricing and other trading restrictions, such as a limit on the number of exchanges, as a (sic) means to address abusive short-term trading."

2 • Mandatory Redemption Fees – Members of the Task Force observed that, absent a sufficiently long holding period – suggestions included 1-5 business days and 60-90 days, with other Task Force members expressing the view that a lengthy holding period is unnecessary – redemption fees, alone, would not be sufficient to deter short-term trading. Most Task Force Members also believed 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 eject shareholders that engage in abusive short-term trading. Task Force members "generally agreed" that the SEC should establish a threshold amount for the imposition of a redemption fee (e.g., if the fee would be more than \$50). The Task Force also noted that, if the intermediary assessed the fee at the time of the trade, this would eliminate the need to collect the fee from the

investor at a later time. The Task Force members “strongly” agreed that the SEC should establish clear guidelines as to whether the fee should be assessed on a LIFO or FIFO basis, and the length of the holding fee that should trigger the fee.

- Periodic Reports to Fund Transfer Agents – While members of the Task Force were of the view that, “with a lengthy holding period, provision of further information to the fund does not appear necessary to deter market timing activity,” “many” members of the Task Force favored requiring intermediaries to provide funds or their designated transfer agent with periodic reports concerning, or access to, customer transactions effective through the intermediary’s omnibus account, together with the customer’s TIN, so the fund could match trades through different intermediaries.³ This information is “desirable” to enable a fund to audit intermediary performance in assessing redemption fees and review and analyze fund trading on a comprehensive basis. If provided this information, funds 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 effecting any further transactions with the fund. Several Task Force members also supported the creation of a centralized means by which fund transfer agents or intermediaries could report and share the TINs of shareholders who have been denied trading privileges with a fund based on abusive short-term trading practices.

II. METHODS TO ENHANCE THE TRANSPARENCY OF FUND TRANSACTION INFORMATION

The Task Force discussed the following various options for transmitting information to a fund’s transfer agent so the transfer agent could monitor the shareholder’s trading with the fund through one or more accounts or intermediaries.

1. Option Providing Full Transparency

The one option considered by the Task Force that would provide the fund full transparency regarding customer transactions would involve a fund intermediary transmitting

³ The Task Force noted that some large fund transfer agents have software, “that is currently used to enhance breakpoint discounts by identifying account linkage opportunities” and that might be modified to facilitate matching of purchases and redemptions. Also, broker-dealers using NSCC’s Networking Level 4, as a general matter, already transmit TINs to fund transfer agents without incurring significant costs.

⁴ daily to the transfer agent the customer’s TIN and, perhaps, other account title information (e.g., customer name and address). This option would:

- (i) better enable funds to identify individuals who engage in abusive short-term trading through multiple accounts;
- (ii) if redemption fees are imposed, better enable the fund or its transfer agent to oversee the appropriate imposition of such fees; and,
- (iii) enable funds to employ tools in addition to redemption fees (e.g., exchange limitations) to police against short-term trading abuses.

While some broker-dealers apparently expressed concern that this option would result in intermediaries having to share proprietary information with funds, the Report notes that this concern could be mitigated through confidentiality agreements that limit the use of information concerning beneficial owners. While this approach would be more comprehensive than other alternatives considered by the Task Force, it would not be fully comprehensive because an individual could trade through accounts with different TINs. Also, some Task Force members were concerned that this option would be cost prohibitive because of the number of trades and accounts for which data would have to be transmitted.

2. Options Providing Partial Transparency

The Task Force discussed four options that would provide partial transparency to omnibus trades. These four, and the issues they raise, are:

- Periodic Reporting of Transaction Information – Under this alternative, intermediaries could be directed to provide fund transfer agents with data on transactions (e.g., TINs, names, etc.) on a periodic basis (e.g., semi-weekly, weekly, monthly). This alternative would require the transmission of the same information as under the full transparency model, but on a less frequent basis. A disadvantage of this approach would be the delay between the time of the trade and the time the information is provided to the transfer agent.
- Requiring Full Transparency but Excepting Certain Accounts – This option, which is a variant of the full transparency model

discussed above, would require full transparency but with certain accounts carved out (e.g., smaller trades,⁵ periodic purchase plan trades, regular retirement plan contributions, etc.). By eliminating transactions that present little danger of abuse, this approach would allow firms to focus compliance on higher- risk events. Some Task Force members were concerned, however, that (1) exempting certain accounts might add to the complexity of the undertaking, and (2) it would be difficult to determine which accounts should be exempted.

- **Requiring Intermediaries to Provide Account-Specific Information to Fund Transfer Agents** – This approach would require the intermediary to provide account-specific (rather than customer-specific) information to the fund’s transfer agent. So, for example, the fund’s transfer agent might receive “some type of intermediary-specific identifier for each account’s transaction with a fund, such as a Broker Identification Number (BIN).”⁴ Information supplied by Task Force members indicates that in excess of 100 million investor accounts are held “in the omnibus environment.”⁵ According to one member of the Task Force, market timers often trade anywhere from \$10,000 to \$1 million in a single trade. The carve out could be for trades below a similar threshold.⁴ According to the Task Force, however, this “does not appear to be a viable approach” because it would not give funds a complete picture of a shareholder’s trading activities in that (1) 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, and (2) it would not allow funds to assess a shareholder’s activities across intermediaries.
- **Delegating Responsibility** – The third partial transparency approach considered by the Task Force would involve mutual funds being required either to: (1) obtain all data necessary to police against market timing abuses; or (2) enter into agreements under which this obligation could be delegated to intermediaries. The Task Force Report notes that, while delegation of responsibilities would eliminate costs and concerns with sharing proprietary information, splitting compliance efforts among various intermediaries and fund complexes “likely will complicate both industry efforts and regulatory oversight.” Also, this approach may not capture all trading by those investors that place orders through multiple intermediaries.

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