

Market timing itself is not illegal. However, market timing may dilute the value of long-term shareholders' interests in a mutual fund if the fund calculates NAV using closing prices that are no longer accurate. Dilution may occur, for example, if fund shares are overpriced because redeeming shareholders will receive a windfall at the expense of the shareholders that remain in the fund. Similarly, dilution may occur when a fund sells its shares at a price lower than its NAV.¹³

Market timing also may harm shareholders because it may cause mutual funds to manage their portfolios in a disadvantageous manner. For example, a mutual fund's investment adviser may maintain a larger percentage of its assets in cash or may be forced to liquidate certain portfolio securities prematurely to meet higher levels of redemptions due to market timing. This is particularly true for mutual funds that invest primarily in foreign or emerging market securities, which are often thinly traded. Mutual funds also may incur increased brokerage and administrative costs related to the frequent purchases and redemptions associated with market timing.

In order to discourage market timers, many mutual funds have developed policies and procedures with respect to frequent purchases and redemptions of fund shares. Some mutual funds disclose in their prospectuses that they do not permit market timing, and many mutual funds have taken steps to discourage market timing. These steps may include, for example:

- Imposing redemption or exchange fees on shares that are redeemed or exchanged within a certain time period following their purchase;
- Restricting exchange privileges, for example, by restricting exchange

requests submitted through a particular medium, such as telephone or facsimile transmission, or received after a certain time of day, or by delaying both the redemption and purchase sides of an exchange;

- Restricting frequent trading, for example by limiting the total number of exchanges that an investor may make within a certain time period, or by limiting the number of "round trip" transactions where an investor purchases shares of a fund, exchanges those shares for shares of a different fund, and then exchanges back into the originally purchased fund;

- Delaying the payment of the proceeds from the redemption of fund shares for up to seven days;¹⁴ and
- Identifying market timers and restricting their trading privileges or expelling them from the fund.

While many mutual funds disclose in their prospectuses that they discourage market timing, many do not identify with specificity the frequency or type of trading that they consider to be problematic, or the specific steps that they will take to ensure that market timing trades are detected and prevented. Other mutual funds disclose specifically the number of trades that they consider to be problematic and the steps that they take to prevent and detect market timing. Item 7(c) of Form N-1A requires mutual funds to disclose in their prospectuses procedures for redeeming the fund's shares, including any restrictions on redemptions; any redemption charges, including how these charges will be collected and under what circumstances the charges will be waived; and the circumstances, if any, under which the fund may delay honoring a request for redemption for a certain time after a shareholder's investment.¹⁵ Item 8(a)(2) of Form N-1A requires a description of exchange privileges, which may be provided in the prospectus or the Statement of Additional Information ("SAI").¹⁶ Item

3 of Form N-1A requires a mutual fund to include any exchange fee or redemption fee in the fee table of its prospectus.¹⁷

Other aspects of mutual fund policies and procedures to deter market timing are not explicitly required to be disclosed, however. For example, our registration forms do not explicitly require funds to describe with specificity the circumstances under which restrictions on frequent purchases and redemptions will not be imposed, or the terms of arrangements with particular investors pursuant to which frequent purchases and redemptions are permitted.¹⁸

We believe that it may be useful to require mutual funds to describe with specificity the restrictions they place on frequent purchases and redemptions and the circumstances and arrangements under which the restrictions are not imposed. These additional disclosure requirements would enable investors to better assess a mutual fund's risks, policies, and procedures in this area, and to determine if a fund's policies and procedures are in line with their expectations.

B. Selective Disclosure of Fund Portfolio Holdings

Currently, mutual funds are required to include their complete portfolio holdings in the reports that are delivered to all shareholders twice a year.¹⁹ In December 2002, we proposed amendments that would require mutual funds to disclose their complete

The SAI is part of a fund's registration statement and contains information about a fund in addition to that contained in the prospectus. The SAI is required to be delivered to investors upon request and is available on the Commission's Electronic Data Gathering, Analysis, and Retrieval System.

¹⁷ Item 3 and Instructions 2(b) and 2(c) to Item 3 of Form N-1A. Similarly, Item 3(a) and Instruction 10 to Item 3(a) of Form N-3; Item 3(a) and Instruction 11 to Item 3(a) of Form N-4; and Item 3 and Instruction 2(b) to Item 3 of Form N-6 require fee table disclosure of fees charged for transfers of contract value among sub-accounts.

¹⁸ Commission staff sent information requests to 88 of the largest mutual fund complexes, with approximately 90% of the fund industry's total assets and 4,100 individual funds or portfolios under management. Fifty percent of the fund groups that responded to these staff information requests appear to have one or more arrangements with certain shareholders to allow these shareholders to engage in market timing.

¹⁹ Section 30(e) of the Investment Company Act [15 U.S.C. 80a-29(e)] (requiring a registered investment company to transmit to its stockholders, at least semi-annually, reports containing financial statements and other financial information as the Commission may prescribe by rules and regulations); rule 6-10(c)(1) of Regulation S-X [17 CFR 210.6-10(c)(1)] (requiring that a portfolio schedule be filed in support of the balance sheet entry for investments in securities of unaffiliated issuers).

and estimating arbitrage returns available in convertible and high-yield and convertible bond funds at 10-25 percent). See also William Goetzmann, Zoran Ivkovich, and K. Geert Rouwenhorst, Day Trading International Mutual Funds: Evidence and Policy Solutions, Working Paper No. ICF-00-03, Yale School of Management, Yale University (Oct. 2000), available at: http://papers.ssrn.com/paper.taf?abstract_id=217168, at 7-8 (describing opportunities for arbitrage in stale pricing of Russell 2000 index).

¹³ By one estimate, dilution resulting from market timing can cost investors in international stock funds that are focused on a particular geographic region as much as 2.3% of their assets each year, and may cost fund shareholders as a whole up to \$4.9 billion per year. See Zitzewitz, *supra* note 12, at 2 and 16; Jason Greene and Charles Hodges, *The Dilution Impact of Daily Fund Flows on Open-End Mutual Funds: Evidence and Policy Solutions*, 36 Journal of Financial Economics, 131-158 (2002) (estimating annualized dilution from market timing of 0.48% in international funds and nearly 1% for a subsample of funds whose daily flows are particularly large).

¹⁴ Under section 22(e) of the Investment Company Act [15 U.S.C. 80a-22(e)], in general no registered investment company may suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security, for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption.

¹⁵ Items 7(c)(1), (c)(2), and (c)(6) of Form N-1A. Form N-1A is the registration form used by mutual funds to register under the Investment Company Act and to offer their shares under the Securities Act of 1933 [15 U.S.C. 77a].

¹⁶ Item 8(a)(2) of Form N-1A. Similarly, Items in the registration forms for insurance company separate accounts that issue variable annuities and variable life insurance policies require disclosure of provisions and limitations for transfers of contract value among sub-accounts of the separate account. Item 8(b)(ii) of Form N-3; Item 7(b)(ii) of Form N-4; Item 6(b)(2) of Form N-6.