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Hard Close Rule Off SEC's Agenda

By Christopher Faille, Senior Financial Correspondent

WASHINGTON (HedgeWorld.com)—The Securities and Exchange Commission has withdrawn from its recently published semiannual regulatory agenda a rule it proposed in December 2003 that would have required a "hard close" for mutual funds.

This withdrawal may end an era, the post-*Canary* scandal era. It began when then-New York Attorney General Eliot Spitzer (now the state's governor) made his high-profile announcement in September 2003 that "a hedge fund manager arranged with several prominent mutual-fund companies to improperly trade their fund shares—some after the market's close—reaping tens of millions of dollars in profits at the expense of individual investors."

The hedge fund was, of course, Canary Capital Partners LLC in Secaucus, N.J. Previous HedgeWorld Story.

The SEC proposed two new rules as a result of the hubbub surrounding Canary and mutual fund market timing and late trading of mutual fund shares. One of them involved a rigid 4 p.m. cutoff for fund trades; the other involved enhanced disclosure requirements. The disclosure proposal, in time, was finalized as a regulation Previous HedgeWorld Story.

The "hard close" draft never became a regulation, though. In a recent conversation, one authority in this field sought to put the *Canary*-era hubbub and its consequences in perspective. Paul Miller, a partner at Seward & Kissel LLP, said that Mr. Spitzer's activities "brought to light late trading and market timing and pressed the industry to reform itself."

Then as now, mutual funds are sold in one of two ways, he said. "They can be sold directly—an investor can purchase shares from a Vanguard fund after opening an account with the fund—or indirectly—an investor can purchase shares through an intermediary, such as broker-dealer, 401(k) plan, bank, etc.," Mr. Miller said. "Under the rule the SEC proposed, these intermediaries would have had to make arrangements to receive and process investor orders well before 4 [p.m.], so they could be sure to get those orders to the fund or its transfer agent by 4 [p.m.] or the hard close."

The rule would have imposed considerable costs on the industry and its intermediaries, who made their displeasure known during the comment period.

"The fact that it is not on the latest regulatory agenda means little one way or the other, but if the hard close proposal is resurrected, it will likely be in a modified form," Mr. Miller said.

Late trading is illegal. Market timing, the frequent trading some hedge funds were doing with mutual fund shares in the pre-Spitzer era, was not. Nonetheless, it could hurt ordinary shareholders, most of whom aren't allowed to make more than a few round-trip trades within a given period.

Mr. Miller has been with Seward & Kissel since 1998, and his practice focuses primarily on registered investment companies, registered investment advisers and broker-dealers. "Market trading itself is not illegal, but it may violate fund policies and related prospectus disclosure," he said Wednesday [Jan. 23]. "If a fund discourages market timing, the fund's prospectus will disclose to fund investors that the fund doesn't allow frequent trading."

In August 2006, Prudential Equity Group LLC reached a $600 million settlement over market-timing allegations Previous HedgeWorld Story.

Another authority in the field, John Baker, said in a posting on an internet news group recently that the SEC staff has lately been focusing on technological and other alternatives to the hard-close rule, "including a tamper-proof time-stamping system and an unalterable fund order-sequencing system, but those alternatives too seem to have been set aside for now."

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