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Market-timers costing long-timers?

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Many buy-and-hold mutual-fund investors are being hit with extra fees and trading restrictions because of a new rule meant to deter rapid trading of fund shares.

The Securities and Exchange Commission rule, which took effect last week, requires brokerage firms, retirement-plan administrators and other intermediaries who hold fund shares on behalf of individual investors to share those individuals' trading data with mutual-fund companies upon request.

The rule is meant to help funds monitor short-term trading and deter "market timers," who trade quickly in and out of funds for quick profits. These investors' activity can be costly to longer-term investors because it can raise a fund's transaction costs and trigger heftier tax bills for fund holders.

But some of the intermediary firms that have already started giving the trade data to fund firms say the rule is having adverse effects on regular investors who aren't market-timers. Many fund firms have been quick to request trading data, and a growing number of individuals making routine trades, such as quarterly rebalancing of their 401(k) accounts, are being slapped with redemption fees as high as 2 percent or even blocked from trading certain funds, these firms say.

The issue could affect millions of small investors who hold mutual funds in their brokerage and retirement accounts and have no intention of market-timing. In order to protect themselves, they should take a closer look at their funds' trading restrictions.

While redemption fees and trading restrictions aren't new, some investors have been able to avoid these penalties if they hold funds through an "omnibus" account such as a 401(k) plan, which can make it tough for fund companies to detect who's trading and how often. The new rule, which was issued by the SEC in early 2005 after the effects of widespread market-timing became well-known, helps fund companies to peek inside these omnibus accounts and enforce their short-term trading restrictions.

Much of the impact so far has been seen in retirement plans, where investors don't always control when and where their money is moved. Steven Kaye, an investment adviser in Watchung, N.J., works with one 401(k) plan that recently moved to a new recordkeeper, the Online 401(k), which this year began sharing individual participants' trade data with fund companies and imposing the funds' redemption fees on participants. Participants' assets were automatically moved into new funds whose investment objectives are similar to those of the funds they'd held with the previous recordkeeper.

One 47-year-old participant in the plan had a portion of his account automatically switched into the Artisan International Fund. But one week later, he decided to adjust his allocation and moved more than $24,000 from the Artisan fund into a real-estate fund. The participant, who has made only three other trades this year, is hardly a market-timer, Kaye says. But his move cost him nearly $500 because the Artisan fund charges a 2 percent redemption fee on shares held less than 90 days.

The participant "felt the system was gamed against him," Kaye says.

In some cases, retirement-plan participants making regular rebalancing trades -- a practice advocated by many financial advisers -- have been flagged by fund companies as potential abusive traders. Retirement-plan participants generally don't make a lot of trades. But such trading activity is picking up for many investors as plans add "managed accounts," in which participants turn over management of their 401(k) to financial professionals, and programs that automatically rebalance participants' accounts on a regular basis, often every quarter. More than 40 percent of plans now offer automatic rebalancing, up from 26 percent two years ago, according to consulting firm Hewitt Associates.

Investors can find information on a fund's short-term trading policies, including redemption fees and potential trading blocks imposed on frequent traders, in the prospectus. Such policies can vary widely from fund to fund, even within a single fund firm. The Vanguard Developed Markets Index Fund, for example, charges a 2 percent redemption fee on shares held less than two months, while Vanguard Tax-Managed Balanced, Vanguard Tax-Managed Capital Appreciation and other Vanguard tax-managed funds charge a 1 percent redemption fee on shares held less than five years. More than 60 percent of the 50 largest fund groups charge redemption fees, according to a recent survey by the Coalition of Mutual Fund Investors, a shareholder advocacy group.

Market-Timing Fallout

Regulatory changes are bringing more trading restrictions to many mutual-fund investors. Here's what's happening:

- A new rule helps funds enforce trading restrictions in 401(k) plans and brokerage accounts.

- Investors who violate a fund's trading restrictions may pay extra fees or be blocked from investing in the fund.

- Certain transactions, such as a 401(k) hardship withdrawal, may be exempt from trading restrictions.