
The Boston Globe

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May 17, 2004

USPS WANTS TO DELIVER FAIRNESS TO MUTUAL FUNDS USPS WANTS TO DELIVER FAIRNESS TO TRADES

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The government agency that brings you snail mail wants to stop lightning-fast traders from ripping off mutual funds.

The US Postal Service says its fancy new technology can clean up the greatest scandal to ever hit the mutual fund industry, in which unscrupulous investors sneak late trades into funds after prices are set each day at 4 p.m.

The agency has created an electronic postmark that will stamp the time and date on a document. Investors and mutual fund companies could then use the information to verify that a trade was made before the 4 p.m. cutoff for that day's prices. More important, the technology offers elaborate security provisions that the Postal Service says would detect any effort to manipulate or tamper with a mutual fund trade.

The system offers independent verification of the validity of a document from a government agency with a long track record of delivering mail and executing financial transactions. Plus, it has the power of federal law behind it, since it is a crime to tamper with documents in its system.

"We're a disinterested third party," said Chuck Chamberlain, who runs the electronic postmark project for the USPS. "There's nobody to bribe in this system. No single person has access to the system whereby they could manufacture a transaction or alter one without being detected."

The Postal Service and its corporate partner, AuthentiDate Inc. of New York, are among vendors and financial firms pitching technology solutions to federal securities regulators who are weighing new rules to prevent late trading and other mutual fund abuses.

At the other end of the spectrum from the Postal Service proposal is a solution being pushed by Fidelity Investments and other mutual fund players that would use simpler time-stamping technology and procedures, which they say would end the trading abuses at less cost.

Either way, industry officials say that technology is the key to battling human corruption. "I truly believe this industry can use technology to solve this problem," said Chip Voneiff, who runs the investment management practice at PricewaterhouseCoopers.

"If you take away the human element" from processing trades, "it becomes much more difficult to do something inappropriate," he said. "You're never going to get rid of bad apples, but you can make it a heck of a lot harder for them to get away with it."

Late trading is an illegal practice in which investors take advantage of that day's market movements to submit trades after the daily close of trading but still get the price mutual funds set at 4 o'clock. Attorney General Eliot Spitzer of New York has likened late trading to betting on a horse race after the finish.

Regulators said unscrupulous traders exploited weaknesses in the current system that allow brokers and other financial intermediaries to ship that day's batch of orders to mutual fund companies hours after the 4 p.m. cutoff and yet still receive the fund price set earlier. Fund companies say they trusted financial intermediaries to vouch that each order from a customer was placed before 4 p.m., but government investigations showed that some investors, often with the help of a company insider, hid their late trades in the huge batches of orders that are bundled at the end of the day.

To fix this, the Securities and Exchange Commission has proposed that all mutual fund trades must reach their end destination either the fund company or its trade-clearing agent by 4 p.m. to receive that day's price. The hard 4 o'clock close proposal, as it's called, is highly contentious, with administrators and record-keepers of retirement plans saying that it would force investors to make trades much earlier in the day if they are to be processed in time to get the 4 p.m. price.

Sensing an opportunity, the Postal Service and AuthentiDate have been hawking the electronic postmark system to regulators and financial firms. Like many electronic time-stamping programs, the Postal Service time clock is based on the atomic clock maintained by the US government, which eliminates the opportunity for corrupt insiders at financial firms to manipulate the time on internal computer systems to make it appear that a late trade was made before 4 p.m.

Once the program is installed, users activate the postmarking program by clicking the blue icon of the Postal Service eagle mascot. The Postal Service's software imprints digital signatures and electronic postmarks, which look much like current paper postmarks, on documents prepared in Microsoft Word. The postmark also seals the document by creating a unique coded record of the specific contents of each individual document using computer algorithms. Proponents have likened this "hash code," as it's called, to an electronic fingerprint or DNA code in which, just as in biology, no two are alike and each represents a unique set of facts in the documents.

The Postal Service stores the hash code in its secure data centers. Recipients of the document, in this case mutual fund companies receiving a trade, would then use the postmarking software to verify with AuthentiDate that the contents match the hash code.

"If anyone tried to change the document, it would compute a different hash code, and later,

when you did an audit or check, it would not match the original code, and that would indicate it was changed or tampered with," said Michael Wolf, chief technology officer of AuthentiDate.

Right now, the state of Indiana uses the system to send electronic copies of motor vehicle records to local courts. The Postal Service is also trying to sell the system to companies that, for example, file forms and other documents with government agencies and courts. In the private sector, job applicants or vendors could receive job offers in an electronic job format that has been signed and sealed with an electronic postmark.

Other vendors are pitching solutions that use computer algorithms to time-stamp and secure documents. Surety Inc., a Herndon, Va., firm, has what it calls a "widely witnessed" model, in which it publishes a snapshot of its hash codes every week in the commercial announcements section of The New York Times. The purpose is to eliminate the potential for collusion between Surety and a customer to manipulate stored data, since outsiders could use the published code to verify the contents of stored documents without having to trust Surety that the contents are safe.

"We prove that an electronic record existed at a specific point in time and hasn't been changed since, and we take trust out of the equation to independently verify this," said Surety chief executive Tom Klaff.

These technologies are not now widely used, and many firms in the financial industry are reluctant to embrace them. "It's overkill," said Janice Morris-Hatch, senior vice president of the Fidelity Investments Operations Group. While admitting that the Postal Service-AuthentiDate approach is interesting, Morris-Hatch said it would require a "significant technological change" by financial firms to use it.

But Chamberlain, the Postal Service product manager, said that since the mutual fund industry is "suffering from a lack of trust right now, a little bit of overkill isn't too bad."

Fidelity and other firms are backing a simpler technical solution that would require all mutual fund orders to be routed by 4 p.m. to a single trade-processing operation, the National Securities Clearing Corp., which already handles much of the trades made in the industry each day.

The NSCC would certify each trade with commonly available time-stamping technology linked to the government's atomic clock, notify mutual fund companies of that day's transactions, and keep a record of the trade.

Proponents of this approach say that once the trade is in the hands of NSCC, an independent company regulated by the SEC, it can't be tampered with by an unscrupulous trader. "We couldn't think of any way to break into NSCC and manipulate orders," Morris-Hatch said.

NSCC said it would cost \$5 million to beef up its computer systems to accommodate increased

trading activity. It currently charges 17.5 cents to process a transaction, while the Postal Service would charge 10 to 80 cents to postmark each mutual fund transaction. The SEC said there were 166 million mutual fund trades in 2002.

Such a seemingly simple approach, however, is controversial among retirement plans. Plan administrators complain that they would not be able to get most customer orders to NSCC in time to receive the 4 p.m. daily closing price. For example, plan administrators or their recordkeepers often wait until after 4 p.m. to record that day's price for mutual funds on customers' trading instructions and then ship the batch of orders to mutual funds.

Ann Bergin, head of distribution services for NSCC parent Depository Trust & Clearing Corp., said her company is working with retirement plans to shift their daily work load to earlier in the day, in order to get trades to the clearinghouse by 4 p.m. She said plan administrators can send basic information about a customer's trade share amount or value and targeted fund to NSCC before 4 p.m. and then receive updated information later in the afternoon or evening, such as the fund's price that day, to complete the paperwork on that order.

But Jim McGhee, a technology manager for benefits consultant Hewitt Associates, said that it would require considerable time and expense for recordkeepers to get clients' trades processed in time and that most retirement plan administrators would probably stop accepting trades from customers much earlier in the day to make the 4 p.m. cutoff.

Smaller firms complain they could not afford the technology upgrades necessary to process trades earlier, and some retirement plans said they would also be forced to set up a second system to reconcile customer orders after the fact.

Other financial firms are lobbying for an alternative system in which individual companies would adopt time-stamping technologies and subject those systems to certification by outsiders, such as regulators.

The divergence of approaches has forced the SEC to proceed slowly. Given the complexities of issues involved, the SEC might not decide what tools the mutual fund industry must use to combat late trading until the end of the year, an SEC spokesman said.