By Roger M. Kubarych

Mutual Fund Cleanup

Washington's surprisingly slow-motion efforts at reform.

America's financial markets—and the nation's reputation for market integrity—have been rocked by repeated scandals in recent years. But perhaps the most egregious scandal of all swirls around segments of the mutual funds industry. Mutual funds in the United States have exploded in size and significance in the past two decades. At mid-year 2003, total equity and bond funds held just over $4 trillion in assets. Twenty years ago they amounted to an insignificant $47 billion. In addition, money market funds totaled $2.1 trillion at mid-2003. Twenty years ago they did not exist at all.

Almost one hundred million Americans have a stake in mutual funds. Mutual funds are perhaps the single most important ingredient in the quiet revolution of the U.S. pension fund system, away from company-organized and company-managed defined benefit pension plans and toward a system of employee-directed defined contribution pension plans. Roughly half of all 401(k) accounts are invested in mutual funds and roughly half of all investments in equity mutual funds are 401(k) investments. So what happens in the mutual fund industry has enormous consequences for the long-term retirement savings of millions of Americans. That makes it a political, not just a financial market, issue.

Despite the scandals that plagued other parts of the U.S. financial system, mutual funds had been almost entirely spared the bad headlines and lawsuits—that is, until September 2003, when New York State Attorney General Eliot Spitzer revealed that a number of mutual funds were ignoring, or worse, facilitating, illegal or questionable trading by certain individuals and investment institutions, including hedge funds. Those activities directly diluted the financial positions of the small retail investors whom mutual funds are meant to serve. Since the initial revelations, the scandal has broadened to involve more funds and other varieties of questionable behavior.

In addition to the mutual funds themselves, the other major casualty of the scandal has been the reputation of the industry's primary regulator, the Securities and Exchange Commission. On September 3, 2003, SEC Chairman William H. Donaldson made a statement after the Spitzer action that, "The conduct alleged in the complaint

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is reprehensible and there is no place for it in our markets." But he went on to concede, "There is too much at stake for us to know as little as we do about these funds, in particular, and how they operate." It is rare for the head of a major regulatory body to make such an admission.

Once the scandal was out in the open, the SEC moved with dispatch—and in coordination with Spitzer and the Attorneys General of other states—to initiate civil and criminal proceedings. Indeed, the best descriptions of what wrongdoing was done and how are to be found in the court documents which are readily available on the SEC's website.

How can these abuses be prevented in the future? A modest beginning has been made. The SEC has taken some small steps to curb abuses but is meeting resistance on some of them. The U.S. House of Representatives overwhelmingly passed a bill submitted by Financial Services Committee Chairman Michael Oxley (R-OH), of Sarbanes-Oxley fame, with only two negative votes. However, as of mid-December the Senate had not come up with its own bill. Several mutual funds themselves have already responded, either by firing executives or traders or by establishing new rules. Others are lying low. But adding it up, the corrective efforts so far have been insufficient to repair the damage and construct a secure basis for protecting the small investor for whom mutual funds are designed. Much more can be done over and above what has been put forward by the House and by the SEC.

WHAT WAS THE WRONGDOING?

Most questionable activities stemmed from the particular convention that is followed in the pricing of U.S. mutual funds and transactions in them. That is, all the buy orders and sell orders for a mutual fund for an entire trading day are executed at the net asset value calculated at the normal close of business of the New York Stock Exchange, 4:00 p.m. Eastern time. It is illegal to buy or sell after 4:00 p.m. for settlement at the 4:00 p.m. price. That would allow the crooked trader the ability to make a sure profit at the expense of all other fund holders.

Other types of activities are legal but deplorable, such as rapid in and out trading to take advantage of pricing anomalies between the true value of the individual securities held in a mutual fund's portfolio and the formula used to compute net asset value. This practice has been confusingly referred to as "market timing" (the same term used to describe a totally unobjectionable, but difficult, portfolio strategy). A better term would be "stale price arbitrage." That is because the clever or corrupt trader is taking advantage of the fact that transactions will not be conducted at fair market value, but at prices that are outdated. Especially for funds that invest all or a good part of their assets in international securities, the prices used to compute the net asset value would have been set many hours before, for example at the close of the previous session's trading in Tokyo or Frankfurt

These market timing or stale price trades inflict harm on existing investors in a fund, who are normally small investors who simply buy and hold a fund for the long term. If the corrupt traders reap profits, those can only be at the expense of the passive investors in the fund. For many years, mutual funds themselves have recognized their capacity for ripping off the little guy, and they have tried, with more or less diligence, to discourage the practice. Many mutual fund prospectuses contain specific references to market timing, state that the fund's policy is to discourage the practice, and explain how it intends to implement that policy. Diligent enforcement was rare, unfortunately.

What takes the matter from sheer sloppiness to possible discouraging fraud is when the fund ignores its policies and actively facilitates market timing, often for a *quid pro quo.* Consider a February 2003 internal memo written by Timothy J. Miller, chief investment officer of Invesco Funds Group Inc., a company charged by the authorities for civil securities fraud: "These guys…are day-trading our funds, and…they are costing our legitimate shareholders significant performance. I had to buy into a strong early rally yesterday, and now I'm negative cash this morning because of these bastards and I have to sell into a weak market." The memo was cited in the SEC complaint, along with Invesco's own data showing that trading was costing ordinary mutual fund investors nearly one percent a year. Invesco's parent, Amvescap PLC, has denied any wrongdoing and will contest the charges.

It is too soon in the investigations to know how widespread the abuses have been, but every day it seems a new allegation is made public. Industry leaders have given diametrically opposed judgments—guesses, really—of how far the corruption goes. One respected CEO was quoted as saying it was just a "few rogue traders," but how would he have known? If he did know, did he tell the SEC or the cops about it? Others claim that "everybody did it," a frequent defense for everything from tax evasion to philandering.

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Based on the genuine sense of outrage with which most people in the industry reacted to the news of the scandals, it is fair to conclude that the revelations came as a big surprise. The

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SEC testified to a U.S. Senate subcommittee in November on the results of a one-time survey they had done to gauge the extent of possible infractions. The results were damning. Twenty-five percent of funds knew of instances of late trading, while up to 50 percent knew of funds that facilitated market timing by favored customers. That is not just a "few rogue traders" and is too close to "systemic" for comfort.

THE INSUFFICIENT REGULATORY RESPONSE

The SEC certainly found out something was wrong by last spring, when a regional office was contacted by a whistleblower about questionable practices at a major fund. The office seems not to have investigated. The SEC held a Roundtable on issues related to corporate governance of mutual funds back in 1999 and the topics of late trading and market timing abuses didn't make it to the agenda. But in 1997, the chief of the division that enforces the rules and regulations covering investment companies (the formal name for mutual funds), called attention to potential abuses, including market timing. In any case, it does not seem that the SEC had a systematic program to uncover wrongdoing in the management of mutual funds. Now it is trying to get up to speed.

Spitzer got involved because of the success of the New York attorney general's office in investigating and punishing investment banks that were corrupting the equity research process. Whistleblowers naturally turned to that office when they were unsure that the SEC would be responsive. But it is important to recognize that state laws are fundamental to the organization and governance of investment companies. As Paul Roye, director of the SEC's Division of Investment Management, has said: "Since investment companies, like other corporations, are organized pursuant to state law rather than federal law, the Investment Company Act is not the only source of authority for the management power of investment company directors." In other words, Spitzer and other state Attorneys General are not interlopers or merely "pushy politicians," as they have been described by their adversaries, but are at the center of the regulatory system for the mutual funds industry.

POOR CORPORATE GOVERNANCE CAUSES CORRUPTION

So far, in addition to Invesco, several mutual funds, hedge funds, and other institutions have been implicated in the scandal in one respect or another: Eddie Stern and Canary Funds, Strong, Janus, Pilgrim/Baxter, Putnam, Bank of America, Bank One, and Security Trust. For each story there appears to be a different set of facts, circumstances, and angles. But there are two common denominators. The first is that there was a rather pervasive indifference to the rules and to the basic sense of fiduciary duty. (It did not help that nobody seemed to be watching, either.)

But the second and more fundamental common denominator is an absence of internal oversight. Corporate governance of mutual funds has always been something of a charade. It defies common sense that the same individuals can simultaneously be independent directors of the boards of dozens of mutual funds within a fund complex. And this is a part-time activity for all of them. However worthy as individuals and accomplished in their own professions, independent directors can hardly perform even the most perfunctory of due diligence over what is going on in any of those funds, let alone dozens. However, the regulators have had a rather rarified notion of what independent mutual funds directors can do. They seem genuinely to believe that independent directors play a crucial role in ensuring shareholders' interests are protected.

The reality is that they do not and cannot play anything like that highly informed, necessarily intrusive, oversight role. Formally, they basically have two functions: hiring the investment manager and hiring the outside auditor. But these are formalities. No one can remember a case in which the board of a major mutual fund fired the fund manager for consistently poor performance or for a shareholder-unfriendly fee structure and shifted to another fund complex that might do better. As for exercising

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a duty of care, the independent directors have no way of accomplishing that. They have no staff, no independent legal or accounting advice, no ability to conduct independent due diligence, and no access to what actually goes on within the fund.

It is clear in each of the cases under investigation that board members had not been informed of the shady activities of either market timers or the fund managers' efforts to facilitate their questionable activities. It would be interesting whether any of the independent directors ever bothered to ask about the danger of returns to retail shareholders being diluted by such activities. And since there are no examinations or other tests of the ability of independent directors to fulfill their obligations, it is impossible to know how many are truly qualified.

PREVENTING FUTURE ABUSES

It has by now become a cliché for industry apologists to say that you cannot legislate morality. But you can put in place mechanisms to detect law-breaking or behavior proscribed by a fund's own prospectus and take steps to end it. These regulatory measures should include:

- Compel all mutual funds to introduce stiff redemption fees, rather than merely allowing larger fees to be applied (as would be authorized under the Oxley bill).
- Bar round-tripping altogether by banning in-and-out trades within a day or a week.
- Bar large investments in mutual funds. If a fund complex wished to set up a separate "clone" fund for institutional investors, that should be possible (that's the way it's done in the United Kingdom, for instance). But investments above, say, $1 million have no place in a fund meant for the little guy.
- Get rid of the 4:00 p.m. fixing and mandate fair market value pricing on a continuous basis wherever implementation is practical.
- Support the SEC's hard 4:00 p.m. time limit for transactions, even for the bundling of 401(k)-type actions which at present are allowed to be effected after 4:00 p.m. if the retirement plan participant had initiated the request for the transaction before 4:00 p.m.
- Beef up the SEC's examiners for investment companies. There are well over ten thousand bank examiners in the country to oversee the banking system. The mutual fund industry has just about the same amount of assets, but there are something like 350 examiners to do the same kind of work. That is not enough.
- Outside the 401(k) market, an estimated 80 percent of mutual funds are sold through brokers. Make the brokers liable for damages for selling any mutual funds that they know are involved in corrupt practices.

Regulatory improvement would be worthwhile, but for there to be fundamental change, the corporate governance of mutual funds has to be radically redesigned. One way would be to eliminate mutual fund boards. The fund management companies would then become the sole entity with which the individual shareholder must contend. To make sure the shareholder is not abused by the inherent conflicts of interest, there would be two alternatives. Either the fund company would put the funds under the supervision of a Master Trustee, who would be charged with overseeing the operations, fees, and practices solely on behalf of the shareholders and could demand changes. Or the fund could pay a fee and ask the SEC to perform that function.

A less radical alternative would be to retain mutual fund boards, but give them real responsibility and teeth. That would require limiting the number of boards a director could serve on, much in the same spirit as the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) does for depository institutions (banks and thrifts), and making the independent directors personally liable to the shareholders for gross negligence by the fund manager. One could also combine the two, installing a Master Trustee for the fund complex and independent directors for individual fund boards, but have the Master Trustee rather than the fund manager responsible for appointing directors.

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At a minimum, we should force independent directors of mutual funds to write an explanatory letter to all shareholders for funds that underperform their benchmarks by more than a specific percentage for three successive years. Among other things, the letter should disclose the questions they posed to fund management about the bad performance and the steps taken to improve it. A discussion of excessive management fees, including the kind of questionable soft dollar commission bundling that Robert A. Schwartz and Benn Steil have been writing about, would also be appropriate.

This does not in any way exhaust the list of possible remedies. Retail shareholders have a right to having their interests protected. The SEC should take the lead, with broad bipartisan support from the Congress, in making sure they are. But if the SEC does not do it, I suspect that the only alternative will be to let in the trial lawyers. That surely will be the outcome if the housecleaning, reforming corporate governance of mutual funds, and improving oversight is not done quickly and well. ◆