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SPECIAL POLICY BRIEF 13

Overview of Mutual Fund Scandal: "A Gauntlet of Fraud"

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December 14, 2003
UPDATED: January 27, 2004, February 3, 2004

I. Impact of Mutual Fund Scandal

There are many aspects to the fraud committed upon investors in mutual funds. This section estimates the cost of that fraud to a typical American family over the five years from 1996 to 2001 (that period was chosen to conform with the data and to simply the analysis by not having to worry much about the effects of the bust and bear market on the returns on the typical fund).

Consider the typical American family as represented by someone in the middle quintile – the one ranging from 40% to 60% of the income distribution (using data from the Federal Reserve's Survey of Consumer Finance for 2001). The average income for a family in that bracket in 2001 was $40,300. About 66% of them own their own home. Their average holding of mutual funds, assuming that half of their retirement accounts are held in the form of mutual funds, was $83,000.

How much more would that typical family have had if it were not for the losses from fraudulent market timing and late trading of mutual funds? A good estimate of the damages to a typical family's savings held in mutual funds for a five year period is $3,740.

Here is the method for calculating the figure. Assume that family pays a broker commission at least once year. A study by the SEC and NASD shows that the average over-charge on broker commissions for mutual fund trades was $364. Next, use estimates of the cost to the average mutual fund from "market timing" trading. Zitzewitz (2002, see Table 4) estimated that the cost due to "dilution" from "market timing" trades was 0.14% per year on the average fund (it is 0.69% on international funds and much lower on others).

Greene and Hodges (2002) estimated that dilution was less than half of the total costs to funds from market timing trading. (Other costs or reductions to fund returns from market timing trading include transactions costs, opportunity costs from holding cash, disruption of investment strategies, and increased tax liability from early realization of gains.) A conservative measure of this is to assume that other costs such as transactions costs and opportunity costs from holding cash assets costs fund investors another 0.14% in return. Together these lower the return to the mutual fund investor by 0.28% per year.

Taking these pieces together, the annual loss from the $364 in commission over-charges, the annual loss of 0.28% in return from market timing and the joint effect compounded by the rate of return to the S&P500, the typical middle-income American family lost about $3,740 over five years.

SOURCES

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II. A Gauntlet of Fraud

People investing through U.S. mutual funds have had to run a gauntlet of abuse. The following section identifies at least eight categories of fraud and investor abuse. Perhaps it is no coincidence that the eighth circle of Dante's account of hell contained those guilty of fraud.

By Brokers

1. SEC regulated securities brokers overcharge customers for getting them into mutual funds. A report by the SEC, NYSE and NASD found that 41 of 43 broker-dealers over-charged their customers. Another report claimed that 450 brokers had over-charged their customers.

2. Securities brokerage firms gave undisclosed commissions and incentive bonuses to brokers for pushing their customers into certain funds (an example of this Morgan-Stanley).

By Fund Managers

3. Managers traded on their own accounts with <u>inside</u> <u>information</u> on the holdings of the fund.
4. Managers traded ahead of the fund (with inside information) by buying or selling before the funds bought or sold.

By Fund Companies and others "special" investors such as hedge funds

5. Fund companies used "soft dollars" or "bundled commissions" to transfer value out of mutual funds and into other spheres of their business.
6. Fund companies practiced price discrimination in which retail customers are charged different management than larger institutional customers, such as trusts and endowments, for managing the same portfolio.
7. Market Timing. Funds allowed certain special customers to engage in "market timing" trades. It is strictly illegal if the mutual fund prospectus stated that market timing was prohibited or that all customers must substantial penalties for short-term trades. This generated the following benefit to special customers at the expense of all other people investing in the fund.
   a. avoid commissions – hedge funds and wealthy clients trade in and out of mutual funds because it is cheaper than purchasing comparable securities in the cash market. This becomes higher transactions costs and opportunity costs for other fund investors.
   b. exploit stale prices – this is especially the case for international funds with investments in East Asia where markets close as much as 13 hours before the 4 pm EST close time for mutual funds. Mercer Bullard estimates that mutual funds can lose as much as 2% of NAV in a single day from this activity.
   c. Deliberate mispricing. Funds that include less liquid securities such as corporate and foreign bonds have been found to have deliberately used false or out of date prices to report their daily NAV prices. This has allowed certain investors with knowledge of this practice to capture excess profits from buying undervalued and selling overvalued funds.
   d. arbitrage – the case of Wilshire, amongst others, in which investors buy index based mutual funds and then sell the relevant stock index futures short in order to profit when the stock index future is over-valued. This becomes higher transactions costs and opportunity costs for other fund investors.
   e. exploit stale prices
8. Late Trading. Late trading is the case when select customers are allowed to buy or sell after the 4pm closing time. This activity, although strictly illegal, is all the more lucrative when combined with a short derivative position in the same securities that allow the investor to profit by buying or selling fund shares after the price is set at 4pm. See the case of Bank of America and Canary hedge fund in complaint by Elliot Spitzer.

III. Fact Sheet

The mutual fund scandal involves a large number of financial firms, and these include banks, securities brokers, mutual fund companies, and hedge funds.

It directly impacted millions of investors. As yet it is not known how many of the 95 million Americans who invest in one or more of 7,000 mutual funds, or how much of the $4 trillion invested in mutual funds (75% of which is held directly by households), has been harmed in these fraudulent activities. [*Note the newspapers are repeating a figure of $7 trillion in mutual funds. This is not supported by the Federal Reserve data as reported on the Z1 report. If you add in money market mutual funds and closed-end funds, which have not been subject to these allegations of fraud, then the size grows to $6.36 trillion.*]

There is a new study by ZAG – Zero Alpha Group – that cosponsored a recent conference in Mississippi with Mercer Bullard and release a study, "Mutual Fund Brokerage Commissions," to study the magnitude of brokerage commissions paid by mutual funds. The report can be found at:
www.zeroalphagroup.com/headlines/ZAG_mutual_fund_true_cost_study.pdf

Financial Institutions

Many financial institutions have been involved, or named in subpoenas as being potentially involved, in the mutual fund scandal. The breadth of the scandal is reflected in the wide array of financial institutions; these include banks, securities brokers and broker-dealers, mutual fund companies and hedge funds. The following list of financial firms was compiled from statements by federal and state regulatory authorities as well as articles in the press. Sometimes the information was limited and it was not possible to obtain follow-up information; therefore the following list and information should be considered incomplete. It is provided to help others begin their research and investigations into this important policy area.

BANKS

Bank of America, owner of Nations Funds, (suit filed)
Wachovia (part owner of Prudential, although purchased after date of)
Citigroup (owns Smith-Barney), (late trading, fired executive)
Bank One (owner of Bank One Funds, improper trading, traded with Canary hedge fund, executive resigned)
Canadian Imperial Bank of Commerce – CIBC (sold operation to Oppenheimer and Company, lending to hedge funds and its customers for trading abuses, two executives dismissed)

SECURITIES BROKER-DEALERS

Morgan Stanley (incentive scheme for mutual fund sales) subpoena from
Galvin Prudential Securities (SEC charges against brokers, market

timing of international funds, worked for 8 hedge funds, late trading)

Prudential Equity Group

Merrill Lynch (helped Millennium)

Goldman Sachs

Oppenheimer & Company (formerly CIBC, facilitated trading abuses with hedge funds)

Smith-Barney (canceling trades after hours, market timing trades, fired brokers on two separate occasions)

Legg Mason (overcharging customers for brokering mutual fund accounts, subpoenaed by Spitzer)

Bear Sterns (fired two brokers over trading problems)

Charles Schwab (owns US Trust, accused of market timing and late trading)

D.C. Capital

Franklin Resources

MUTUAL FUND COMPANIES

Many mutual fund companies received subpoenas, the following list includes those where there is an indication of subsequent further investigations or charges.

- Bank One Funds (owned by Bank One and after merger by J.P. Morgan Chase, investigation by Spitzer for trading abuses with Canary hedge fund)
- Putnam, #5 mutual fund, (securities fraud and improper trading)
- Nations Funds (Bank of America)
- Franklin Templeton, Franklin Resources (letter of inquiry and subpoena from Galvin)
- PBHG Funds (executives Baxter and Pilgrim have resigned)
- Alliance Capital (suspended two executives)
- American Express (market timing and late trading, investigation by SEC and NASD)
- Strong Capital Management (investigation by Spitzer, executive resigned, suit filed)
- Fred Alger Management (illegal trading, market timing, late trading, cover-up)
- Janus Capital (investigation by Spitzer, admits to market timing; Morningstar withdraws any recommendation of Janus; Janus loses pension fund investments, suit filed)
- Federated Investors Inc. (the country's fifth largest fund management company, engaged in late trading and market timing, fund managers charged with trading in accounts they managed, facilitated trades by Veras hedge fund)
- MFS Investment Management (subsidiary of Sun Life, received subpoena, under investigation by New Hampshire, Massachusetts, New York and federal regulators)
- Investco (subpoena with Millennium)
- Old Mutual PLC, bought United Asset Management which owns Pilgrim Baxter (market timing with hedge fund owned by mutual fund executives)

HEDGE FUNDS

Many hedge funds received subpoenas, others were named in complaints filed by the SEC of states' attorneys general and others were mentioned in the press as being linked to the scandal. They are not necessarily the subject of further investigation or formal charges. For example, market timing trades are sometimes not illegal even if they viewed as scandalous behavior.

- Canary Capital Partners (traded with Bank of America, Janus, Strong, Bank One)
- Da Vinci Fund (also managed by Edward Stern)
- Veras Investment Partners (Texas based, trading abuses with Fred Alger Management and Federated)
- Millennium (pleaded guilty to fraud following Spitzer investigation)
- Chronos Asset Management (mentioned in Galvin complaint against Prudential executives as having a market timing account; traded through Prudential from referral by CIBC)
- Head Start Advisors (trading abuses with CIBC)
- Pentagon Capital Management (trading abuses with CIBC)
- Samaritan Asset Management (investigation by Illinois state regulators, also trading with CIBC)
- Atlantique Capital Advisors (trading abuses with CIBC)
- Alliance Capital Management hedge fund
- Tidewater Capital (related to a SEC subpoena of brokerage A. Brean Murray)
- Peconic Capital Fund (related to a SEC subpoena of brokerage A. Brean Murray)
- Diamant Asset Management (related to a SEC subpoena of brokerage A. Brean Murray)
- Diamant Master Fund (related to a SEC subpoena of brokerage A. Brean Murray)
- Lighthouse Multi-Strategy Fund (related to a SEC subpoena of brokerage A. Brean Murray)
- Ritchie Capital Management (mentioned in Galvin complaint against Prudential executives as having a market timing account; related to a SEC subpoena of brokerage A. Brean Murray)
- Headstart Advisers (mentioned in Galvin complaint against Prudential executives as having a market timing account; related to a SEC subpoena of brokerage A. Brean Murray)
- Trout Trading Fund (renamed Tewksbury Capital Management, related to a SEC subpoena of brokerage A. Brean Murray)

Other Financial Service Firms

- Security Trust Corporation (Phoenix Arizona, provided electronic platform to conduct late trading, worked with Canary)
- Wilshire Associates Inc. *[Wilshire operates a major stock index and consults for the large pension funds]* (executive engaged in market timing trades, used stock index futures to profit from discrepancies between index and value of index funds)

Statutes and Regulations

Governing statutes

- Securities Act of 1933
    - covers fraud
    - covers prospectus and whether it states by "market timing" is permitted
- Securities Exchange Act of 1934
    - covers fraud
- Investment Company Act of 1940
    - covers "stale pricing"
    - covers "late trading" by requiring 4pm pricing (amendment in 1968)
- Investment Advisors Act of 1940

IV. REFORM PROPOSALS

Amongst the many reform proposals, there are two legislative efforts that warrant watch. The first is from Congressman Richard Baker (R-LA) which has passed the House, and the second is a bill proposed by Senators Corzine and Dodd. A third legislative initiative was recently announced by Senators Carl Levin and Peter Fitzgerald, it promises to substantially expand the reporting requirements of mutual fund fees, but the legislative language will not be available until February 2004.

In the interest of brevity and getting this out quickly, the following summaries of the Baker and Corzine-Dodd legislation is taken largely from the words of the relevant bill sponsors.

Congressman Baker's bill, H.R. 2420:

Strengthen Funds' Compliance with Rules;

- Existing regulations governing trading by insiders in the underlying securities owned by mutual funds will be extended to apply to trading in fund shares.
- Funds' codes of ethics will have to be published, as well as any waivers or violations of such codes.
- All funds will be required to have chief compliance officers who report directly to the independent directors, as well as whistleblower protections and internal compliance procedures.
- Independent directors will be required to certify that they have reviewed and approved portfolio manager compensation, and to certify that procedures are in place for valuation, oversight of fund flows, provision of breakpoint discounts, establishment of appropriate classes of shares, enforcement of codes of ethics, and oversight of internal compliance.

Eliminate Conflicts of Interest in Portfolio Management;

- Joint management by the same person(s) of mutual funds and hedge funds will be prohibited. The ability of firms to provide advisory services to both kinds of funds, however, will not be limited.

Ban Short-Term Trading by Insiders;

- Insiders will be prohibited from short-term trading of their own fund shares. This bolsters a provision in the underlying bill requiring fund managers to disclose holdings in the funds they manage.

Allow Higher Fees to Discourage Short-Term Trading;

- Funds will be allowed, but not mandated, to charge higher than the current limit of two percent for redemption fees in order to discourage short-term trading that harms long-term investors.

Encourage Fair Value Pricing; and

- The Securities and Exchange Commission (SEC) will be required to issue clearer rules to encourage fair value pricing, thereby eliminating the stale pricing that makes market-timing profitable.

Establish Strict Monitoring of the 4 p.m. Close to Eliminate Illegal Trading.

- To ensure a full trading day, investors could place orders up to but not after 4 p.m.
- In some cases, this means intermediaries could place trades with funds after the close; however, strict monitoring and an audit trail will be required to ensure that the 4 p.m. closing system is not being gamed. In this manner, those in the western parts of the United States and pension funds or other investors using intermediaries will not be disadvantaged. Investors will also be assured of receiving same-day execution of orders.

Senators Corzine and Dodd's bill:

This legislation will help provide coordinated, comprehensive allocation of regulatory resources to oversee this industry and to ensure that the problems we are witnessing are redressed. This will help guarantee a fair and level playing field to ensure greater investor confidence.

The bill would strengthen fund governance by establishing truly independent mutual fund boards, chairmen, nominating committees and independent audit committees that conform to Sarbanes-Oxley Act requirements for those at publicly traded companies.

The bill would also improve fund governance by requiring Sarbanes-Oxley-like "certification" from Board Chairman and Chief Compliance Officers that shareholder safeguards are in place within the fund, and that information, including cost and fee information, provided to shareholders in the prospectus and their quarterly statements are accurate. Other 'certifiable' requirements include disclosures that internal controls, a code of ethics and designated personnel responsible for ensuring adherence to stated polices and compliance with relevant Securities laws, including measures preventing market-timing and late trading abuses, are in place at the fund and with the investment adviser. Additionally, the legislation calls for the disclosure of insider transactions by mutual fund managers and Board notification of Securities and Exchange Commission (SEC) deficiency letters.

The legislation includes numerous provisions aimed at improving the cost, fee and other disclosures shareholders receive from mutual funds, including requirements that funds disclose the actual cost borne by each shareholder for the operating expenses of the fund and the estimated expenses paid for costs associated with management of the fund that reduces the fund's overall value, including brokerage commissions, revenue sharing and directed brokerage arrangements, transactions costs and other fees. The legislation requires the breakout of these respective costs to be displayed as a graph provided to shareholders that will enable them to compare the costs associated with owning shares of different mutual funds.

In addition to these requirements, the legislation requires fund companies and investment advisers to fully disclose certain sales practices, including revenue-sharing and directed brokerage arrangements and disclose the value of research and other services paid for as part of brokerage commissions, directing the SEC to study so-called "soft-dollar" arrangements.

The bill also requires a review of the allocation of SEC resources dedicated to industry oversight and a study into the feasibility of establishing a new, independent regulator - the Mutual Fund Oversight Board. The bill also would direct the SEC to establish incentives and protections for whistleblowers and requires the General Accounting Office to independently review and report to Congress on the coordination of enforcement efforts between the SEC, its regional offices, and state regulators. The bill also calls for improved efforts to promote financial literacy among mutual fund shareholders.