

# **Mutual Funds: The Impact of the Scandals**

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# Agenda

- ◇ **Mutual Fund Scandals Overview**
- ◇ **Proposed Changes**
- ◇ **Consequences**

# Big Business

- ◆ **As of January 2005:**
  - ◆ **\$8 trillion**
  - ◆ **8,046 funds**
  - ◆ **92 million shareholders**

**Source: Investment Company Institute**

# Operational Issues

- ◇ **Mutual Funds may be traded:**
  - ◇ **Phone**
  - ◇ **Fax**
  - ◇ **Mail**
  - ◇ **Internet**
  - ◇ **Intermediaries (broker/dealers and banks)**

# Operational Issues

## ◇ Trading through Intermediaries:

◇ Phone

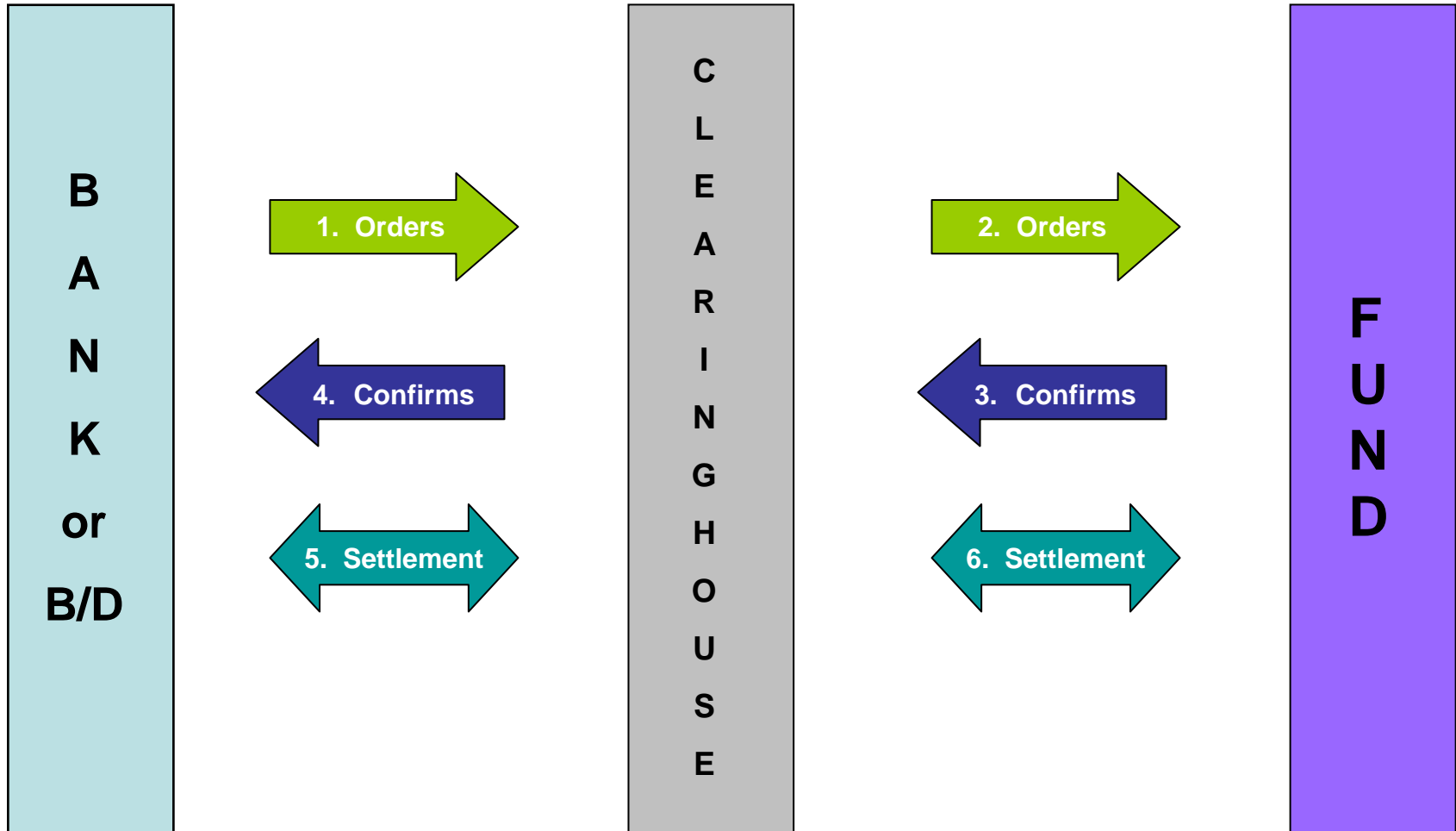
◇ Fax

◇ Mail

◇ Internet

◇ Electronic

# Operational Issues



# Operational Issues

- ◆ **Intermediaries are permitted to roll up transactions into an omnibus account or may trade fully-disclosed**
- ◆ **Currently intermediaries are permitted to deliver their trade instructions after the close of the market. This additional time is used to validate the trade instructions, verify breakpoints, calculate exchange orders, etc.**

# Scandals

- ◇ **Breakpoints**
- ◇ **Broker Incentives**
- ◇ **Shelf Space**
- ◇ **Late Trading**
- ◇ **Marketing Timing**

# Breakpoint Scandal

- ◇ Typically for larger purchases, the sales charge generally declines as specified quantity discounts are reached
- ◇ These breakpoints are listed in the prospectus

# Breakpoint Scandal

- ◆ **The NASD estimates that one in three investors were overcharged because breakpoints were not properly applied**
- ◆ **Over 600 brokerage firms have been ordered by NASD to refund these overcharges**

# Broker Incentive Scandal

- ◇ **Fund companies routinely held contests and offered incentives to brokers to encourage the sale of their funds**
- ◇ **Awards included professional sports or concert tickets, travel and golf outings, etc.**



# Broker Incentive Scandal

- ◇ **Inherent conflict of interest**
- ◇ **Brokers are obligated to seek out the best investment option**

# Shelf Space Scandal

- ◇ **Mutual fund companies are giving brokers a portion of their profits in return for preferential positioning**
- ◇ **Often in addition to other forms of compensation**
- ◇ **Some brokers limit their offering to include only a select group of funds that pay increased incentives**

# Shelf Space Scandal

- ◇ **Potentially harmful to investors if investments are limited**
- ◇ **These arrangements are not typically disclosed to the investor**

# Late Trading Scandal

- ◇ **The practice of permitting a purchase or redemption order received after the calculation of that day's net asset value (NAV), typically 4:00pm ET, to receive that day's NAV share price**
- ◇ **Investors that have knowledge of after market activity or pricing may have an unfair advantage**
- ◇ **Late trading is always illegal**

# Late Trading Scandal

- ◆ **SEC Recommendation**
  - ◆ **4:00pm ET Hard Close**
- ◆ **Technology Solutions**

# Late Trading Scandal

- ◆ **Impact of SEC Recommendations**
  - ◆ **Cut off times to submit orders through intermediaries**
  - ◆ **Same day exchange across multiple fund families**
  - ◆ **Timing of investments and settlement**
  - ◆ **Float on uninvested funds**

# Market Timing Scandal

- ◆ **Refers to the practice of buying and selling mutual fund shares over the short term to exploit potential pricing inefficiencies**
- ◆ **Usually, market timing is contrary to the stated policies of a mutual fund and is set forth in the prospectus**
- ◆ **Not illegal**

# Market Timing Scandal

- ◇ **Incurs additional trading costs**
- ◇ **Loss of investment opportunity**
- ◇ **Shareholder dilution**

# Market Timing Scandal

- ◇ **Market Timing can be done with or without the consent of the mutual fund**
- ◇ **Deals to permit market timing usually required sticky or static money, and limit the number of roundtrips**

# Market Timing Scandal

## ◆ SEC Initial Recommendations

- ◆ **2% Short-Term Redemption Fee for 5 days**
- ◆ **More conservative approach is permissible**

# Market Timing Scandal

- ◆ **SEC adopts rule on March 3, 2005**
  - ◆ **Voluntary Redemption Fee**
  - ◆ **No more than 2% for 7 days**
  - ◆ **Fund retains the fee**
  - ◆ **Information sharing requirement**
  - ◆ **Money market and ETFs are excluded**

# Market Timing Scandal

- ◆ **Impact of SEC recommendations**
  - ◆ **Technology costs**
  - ◆ **Delivery of redemption fee information be added into NAV**
  - ◆ **Processing of cash remittances**
  - ◆ **Tracking of omnibus activity**
  - ◆ **Investment discretion authority**

# Consequences

- ◇ **Regulatory actions and settlements**
- ◇ **Reforms and changes to fees and other industry practices**
- ◇ **Displacement of business and executives**
- ◇ **Class action law suits**

# Regulatory Settlements

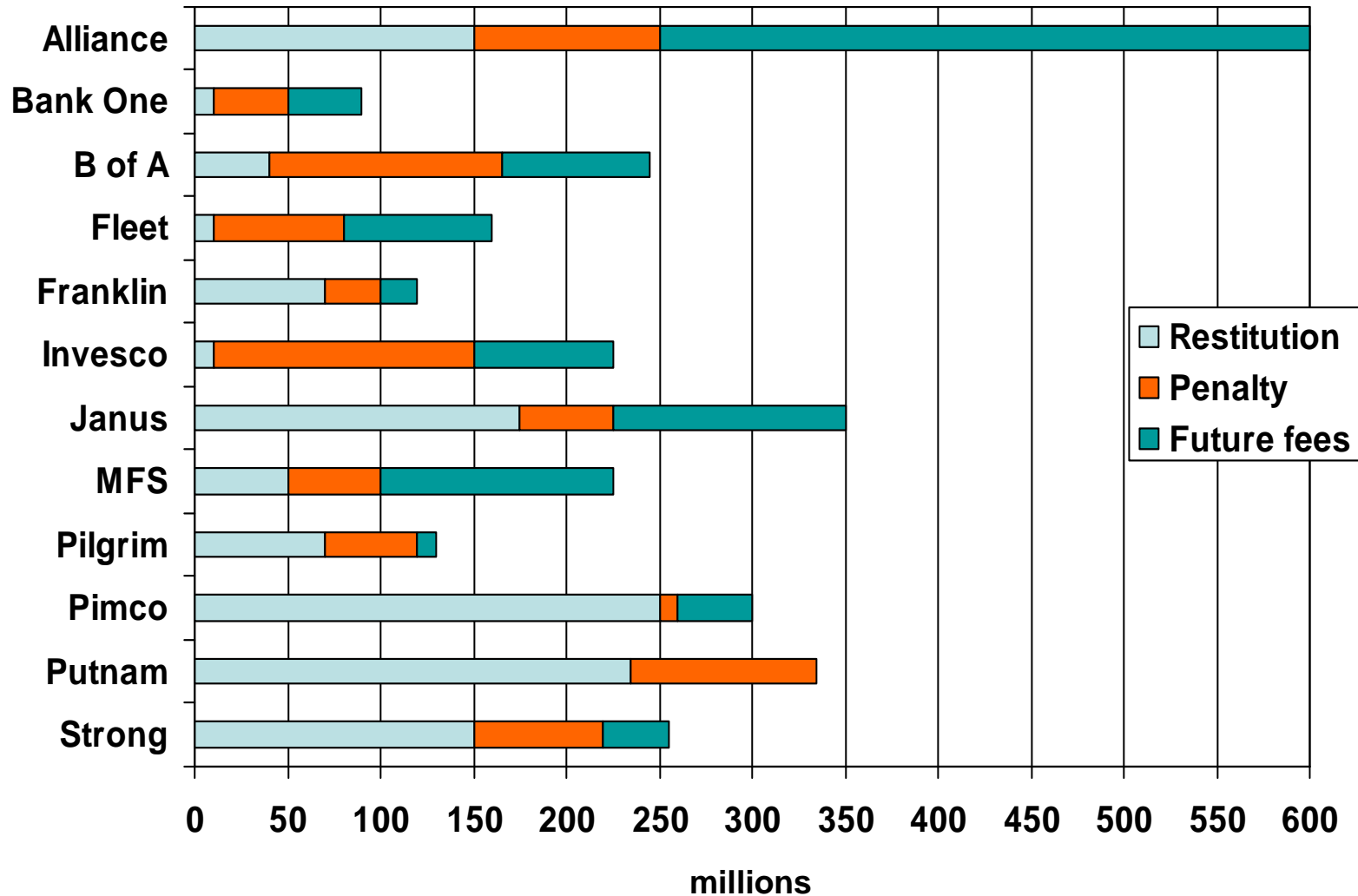
- ◆ **Regulatory settlements have grown to a total of approximately \$3 billion**
  - ◆ **Approximately \$950 million in future fee concessions**
  - ◆ **Approximately \$2 billion in restitution and penalty assessments earmarked for payment to mutual fund-holders who incurred loss through late trading or market timing**

# Regulatory Settlements

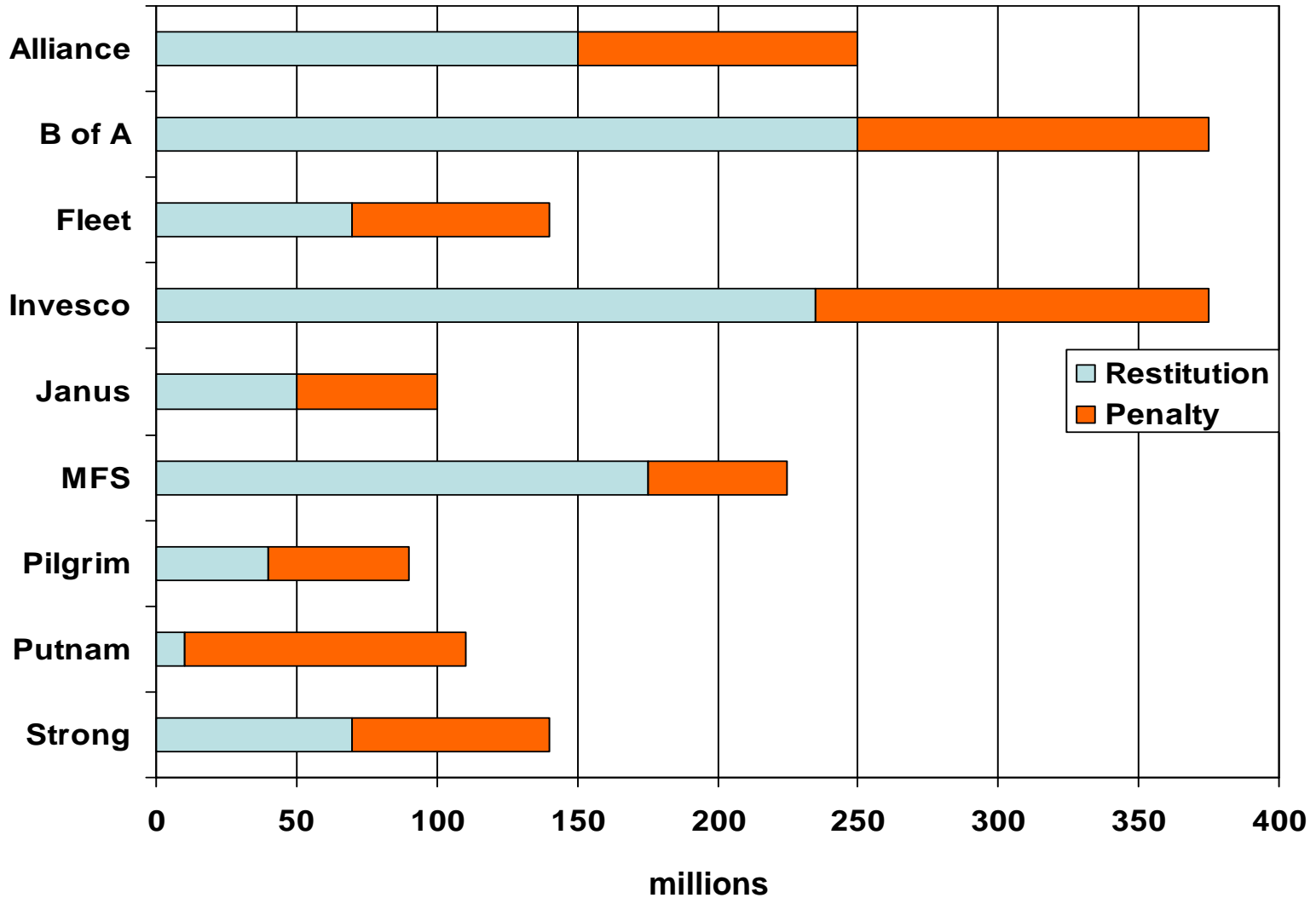
|                              | Penalty and Restitution<br>in Million | Future-Fee Reductions<br>in Millions |
|------------------------------|---------------------------------------|--------------------------------------|
| Alliance Capital Management  | \$250                                 | \$350                                |
| Bank of America              | 375                                   | 160                                  |
| FleetBoston Financial        | 140                                   |                                      |
| Invesco/AIM                  | 375                                   | 75                                   |
| MFS                          | 225                                   | 125                                  |
| Putnam Investments           | 110                                   |                                      |
| Janus Capital Group          | 101                                   | 125                                  |
| Strong Financial             | 140                                   | 35                                   |
| Banc One Investment Advisors | 50                                    | 40                                   |
| Pilgrim Baxter               | 90                                    | 10                                   |
| Gary Pilgrim & Harold Baxter | 160                                   |                                      |
| Pimco Advisors               | 18                                    |                                      |

Source: Wall Street Journal

# Regulatory Settlements



# Regulatory Settlements



# Allocation of Settlements

## ◇ Penalties

- ◇ SEC

- ◇ State

## ◇ Restitution

- ◇ Direct shareholders

- ◇ Investors in fund complex

# Allocation of Settlements

- ◆ **Operational Issues**
  - ◆ **Calculation methodology**
  - ◆ **Determining recipients**
  - ◆ **Timing of allocations**
  - ◆ **Cost**

# Industry Developments

## ◆ Fees

- ◆ 1,800 funds have lowered fees over the last year

## ◆ Reforms and changes to industry practices

- ◆ Compliance Officer who reports to the board
- ◆ Directed brokerage is prohibited
- ◆ Additional disclosure requirements

# Industry Developments

- ◆ **Displacement of well-known executives**
  - ◆ **Putnam, Pilgrim Baxter, Strong Financial**
- ◆ **Winning v. Losing Fund Families**
  - ◆ **Janus and MFS net withdrawals**
  - ◆ **Fidelity and Vanguard net increases**

## ◆ Defendants

- ◆ Fund families including trustees, boards and parent companies
- ◆ Market timers and late traders
- ◆ Brokers and other facilitators
- ◆ Clearing platforms
- ◆ Third party financiers of timing and late trading activity

# Claims Asserted

- ◆ **Funds increased assets under management by:**
  - ◆ **Entering into undisclosed agreements with select customers to permit market timing and/or late trading**
  - ◆ **Otherwise permitting market timing and/or late trading activity**

# Claims Asserted

- ◆ **Funds benefited by:**
  - ◆ **Increased asset base which increases management/advisory revenues**
  - ◆ **“Sticky Assets” increase asset base which increases management/advisory revenues**
  - ◆ **“Static Assets” are a concession for allowing timing and/or late trading**

# Claims Asserted

- ◆ **Funds misrepresented or omitted details in the prospectus by:**
  - ◆ **Disclosing policy to prohibit/discourage excessive/abusive trading**
  - ◆ **Portraying as long-term investments**

# Alleged Harm

- ◇ **Dilution of profits to long-term holders because timers entered funds when they predicted a profitable event**
- ◇ **Losses disproportionately fall on long-term holders because timers got out of the market before a predicted loss would hit the funds**

# Alleged Harm

- ◆ **Forced sale of fund assets at inopportune times due to timer activity**
- ◆ **Disparate treatment**
- ◆ **Increased costs created by timer trading**
  - ◆ **Possible taxable capital gains**
  - ◆ **Increased transaction costs**

# Conclusion

- ◇ **Reforms are necessary**
- ◇ **Changes are starting to take form**
- ◇ **Uncertainty of next steps**