MARKET TIMING, LATE TRADING and OTHER MUTUAL FUND ABUSE in the UNITED STATES ©

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DESCRIPTION of U.S. REGULATORY STRUCTURE

Regulatory structure relating to securities in the United States is diffuse. At the Federal level it derives from the following Acts of Congress enacted during the Great Depression which followed the stock market crash of 1929.

U.S. STATUTES and REGULATIONS

Governing Statutes

- Securities Act of 1933

  This Act governs the issuance of stock by underwriters, underwriting syndicates and others. This market is known as the primary market and is regulated by the Securities Exchange Commission (SEC) which requires the filing of prospectuses or other documents and polices the market for fraud.

- Securities Exchange Act of 1934

  This Act regulates the secondary market in which shares of stock, having been issued, are permitted to trade. As such, it directly controls the Securities Exchanges in the United States, as well as the brokers and brokerage firms which act as broker/dealers. Again, the SEC is the regulator.

- Investment Company Act of 1940

  This is the Act which directly regulates the mutual fund industry. It is the primary focus in dealing with market timing, late trading and other mutual fund abuse although each of the other Acts here plays a role.

- Investment Advisors Act of 1940

  This Act regulates investment advisors who advise mutual funds and others.

In addition, each state regulates securities sales through its Blue Sky laws. Most states have adopted variants of the Uniform Securities Act which is a model act drafted for the purpose of encouraging uniformity in regulation at the state level. While this appears duplicative, state regulation often differs from federal regulation to a considerable degree, as it does from state to state.

DESCRIPTION of U.S. REGULATORY STRUCTURE (Continued)

Also, various other federal and state laws are important such as the Maloney Act of 1938 which allowed the securities industry a measure of self-regulation. Today, the New York Stock Exchange, the National Association of Securities Dealers and various other exchanges also function as self-regulatory organizations, or SRO's, and promulgate rules for their members.

An important state law is the Martin Act, a once-dormant 1921 New York Blue Sky law, which Eliot Spitzer has used to combat stock fraud schemes. Under this Act he has both the power to subpoena and indict, which the SEC can only do by referral to the U.S. Department of Justice.

MUTUAL FUND OFFENSES

Market Timing –

This is a difficult issue and is illegal only if prohibited by the fund's prospectus, or if favoritism is shown toward employees or favorite customers. It is difficult because frequent trading has always been a part of the mutual fund industry, and because share liquidity and the shareholder's right of redemption have been basic tenets of the mutual fund industry at least since passage of the '40 Act regulating Investment Companies. The regulatory environment has always been strongly in favor of the rights of shareholders to redeem and freely exchange shares.

In addition to the disruption of the orderly management process of a fund, frequent trading requires fund managers to hold more cash to meet redemptions and results in increased transactions costs for other investors. Market timing is especially harmful for international funds investing in Asia where markets may close 12 or more hours before the 4 p.m. EST close for mutual funds in the U.S. It has been estimated that such funds could lose as much as 2% of net asset value (NAV) in a single day by knowledgeable investors buying the fund at the U.S. close after substantial trading in the post-close Asian market has pushed prices up there relative to the "stale" Asian close prices used for U.S. NAV purposes.

Examples also exist where out-of-date or false pricing has been deliberately used in U.S. mutual funds to allow knowledgeable investors to profit from incorrectly reported daily NAV prices.

In addition to these examples where stale or incorrect prices allow profit to be made, investors will sometimes use mutual funds or indexes ("index funds") to arbitrage improper index or futures prices elsewhere. Further, wealthy clients and hedge funds will sometimes trade in and out of funds because it is cheaper that purchasing the same securities in the cash market

Management firms implicated in directly cheating their own mutual funds include Putnam and Strong Capital Management.

Late Trading –

Late trading involves allowing selected customers to buy or sell after the 4 p.m. closing time. As such, it is strictly illegal as a 1968 amendment to the Investment Company Act of 1940 made clear. It required all orders received after the daily NAV calculation to receive next day pricing.

This illegal late trading is often confused with permitted order processing after 4 p.m. Fund intermediaries such as broker-dealers and retirement plan administrators routinely submit orders to purchase or redeem after 4 p.m. so that their investors are on the same footing as those who deal directly with the fund. These intermediaries are, of course, permitted to submit only orders they have themselves received by 4 p.m. Of course, mistakes as well as deliberate attempts to evade the system occur and if events causing major price moves happen shortly after the 4 p.m. close(as they frequently do owing to corporate announcements after that hour), then the late trader can profit. This occurred at Fred Alger Management, Nations Funds (Bank of America), and Federated Investors Inc.

MUTUAL FUND OFFENSES (Continued)

Selective Disclosure –

Selective disclosure of portfolio holdings is an offense that often occurs with market timing and late trading. After all, unless the holdings of the fund are known to those involved in market timing and late trading how can a profit be made with a certainty? Knowledge of what stocks are in the portfolio and may be subject to stale pricing is vital to market timing as it is to late trading schemes based on profiting from rapid movement in the price of certain stocks after the 4 p.m. U.S. market close. As with market timing, disclosure of portfolio holdings is not unlawful and indeed benefits the careful investor who must know holdings in his funds to maintain proper diversity. The offense lies in *selective* disclosure which is often made to those same organizations allowed to benefit from market timing and late trading.

MUTUAL FUND OFFENSES (Continued)

Other Mutual Fund Abuses –

Abuses in the area of market timing and late trading only scratch the surface. At least six other areas of abuse or alleged abuse in the U.S. mutual fund industry have come to light.

- ◊ Managers trading in their own accounts with inside information on the holding of their funds.
- ◊ Managers "front running" their own funds, i.e., buying or selling before their own funds bought or sold.
- ◊ Fund companies using "soft dollars" to transfer value out of their own mutual funds in other areas of their business
- ◊ Fund companies charging retail customers higher management fees than institutional customers for managing the same portfolio
- ◊ Brokers overcharging customers for getting them into mutual funds
- ◊ Brokerage firms giving incentives such as large commissions or bonuses to their brokers to push customers into certain funds including their own offerings.

In contemplating these eight categories of fraud and investor abuse is it any wonder that the eighth circle of Dante's inferno is for those who are guilty of fraud?

(See the Financial Institutions Appendix for a list of those accused in the U.S. mutual fund scandal.)

COST to U.S. INVESTORS

The U.S. mutual fund scandal is the "biggest black mark in that industry's history" according to Arthur Levitt, former S.E.C. chairman. It involves a large number of financial firms including banks, securities brokers, mutual fund companies and hedge funds.

It has impacted millions of investors. 95 million investors have invested $4 trillion in more than 7,000 mutual funds. What harm have they suffered?

Zitzewitz (2002) and separately Greene and Hodges (2002) have estimated that the total cost of market dilution from market timing at an annual loss of 0.28%. Taken together with the results of a study by the S.E.C. and N.A.S.D. which showed that the average overcharge on broker commissions for mutual fund trades at $364, Randall Dodd of the Financial Policy Forum has concluded that the typical middle-income America family lost about $3,740 from 1996 to 2001.

So much for the idea that these losses represent just pennies skimmed from millions of investors. The financial impact on millions of Americans saving for retirement or their children's education, or just for a rainy day, is huge.

Put another way Zitzewirz estimates that the cost of market timing alone on domestic equity funds could be as great as 2% annually compared to an average stock mutual fund return of about 10% a year. Incidentally, he concludes that illegal late trading harms investors far less, amounting only to about 5 basis points (0.05%) for international equity funds and less than 1 basis point for domestic equity funds.

Small wonder that U.S. equity funds have a hard time beating market averages such as the S&P 500 index. When these costs are added to the average annual expense ratio for a no-load fund of about 1.5% per year the impact is staggering.

Separately, Eliot Spitzer has estimated that an individual investing $100,000 in a mutual fund would lose up to $6,000 over 10 years because of excessive and undisclosed fees.

Zitzewitz, Eric 2002 "Who Cares About Shareholders?",
Manuscript, Stanford Graduate School of Business, October, 2002.

Greene, Jason T. and Charles W. Hodges 2002, "The Dilution Impact of Daily Fund Flows on Open-end Mutual Funds', Journal of Financial Economics pp 131-158.

Dodd, Randall, Special Policy Brief 13, Overview of Mutual Fund Scandal: A Gauntlet of Fraud, May 21, 2004 Update, Financial Policy Forum, Derivatives Study Center, 1660 L Street, NW, Suite 1200, Washington, DC 20036

REFORM PROPOSALS for the U.S. MUTUAL FUND INDUSTRY: OPPORTUNITIES and PROBLEMS

Interestingly, the mutual fund industry was the subject of reform by the U.S. Congress as recently as 1996. It is worthwhile to revisit the key points of reform then to provide a contrast to later efforts in 2004 after the scandal recorded above unfolded. Key points to reform in 1996 were

1. Federal regulators obtained exclusive jurisdiction over the structure and operations of mutual funds as well as the review of fund prospectuses and advertising. State regulators were left to investigate and prosecute sales practice abuse and fraud, collect fees for mutual funds sold in their state and to require notice filings.
2. The SEC was granted exclusive jurisdiction over mutual fund advisors and other large advisors with $25 million or more under management while the representatives of large advisors continued to be regulated at the state level.
3. Fees paid by the securities industry to the SEC were reduced by $850 million over 10 years.

Contrast these reforms, which the industry warmly embraced, with those of the past year. Among the 10 new regulations approved are

1. A requirement that mutual funds create a new position, chief compliance officer, who reports directly to the fund's board, not its management.
2. A new SEC rule, effective January 1, 2006, that mutual fund boards must have at least 75 percent independent directors, including the chairman.
3. A ban on a widespread practice known as directed brokerage where a fund places brokerage orders with firms that agree to push its funds. A related practice known as revenue sharing where a fund company uses its own money to compensate brokerage firms that provide favorable treatment has not been banned.

The SEC has not yet acted on proposals to curb market timing and late trading. Chief among the proposals to deal with these abuses are requiring a 2 percent redemption fee on fund sales made within five days of a purchase and a hard 4 pm close that would prohibit any trading whatever after that time. Also proposed but not implemented are a rule that would mandate brokers to provide investors with more information about distribution costs including commission flow and conflicts of interest including revenue sharing at the point of sale.

Will such steps be effective in limiting future abuse? Many argue including Eliot Spitzer that sufficient regulation is already on the books and that what has been lacking is sufficient enforcement activity. Among the most effective deterrents, it is argued, is the fear of detection and subsequent "disgrace" that follow detection. To others what is missing are steps to promote a more ethical approach in the securities business including a requirement for ethics training by those who would sell securities including mutual fund shares. As those who sell securities have a fiduciary responsibility to purchasers why not make those standards really clear to brokers and mutual fund executives?

The rewards for more ethical behavior also include an enhanced reputation for any organization that attempts to set high standards in this area, and that translates into sales. Studies show that a top reason why potential investors decline to open accounts is a wide-spread belief that brokers, mutual fund sales persons and others in the investment business are not honest, and do not have their best interest in mind in sales situations. High standards and disgrace for those who break these standards are a potent weapon to not only prevent abuse, but also to build a potent sales force within an organization prized for its integrity.

THE EUROPEAN CHALLENGE

With new regulatory practices coming into existence in Luxembourg and elsewhere in the European Community the question is what can be learned from the U.S. experience, and what can we in the U.S. learn from the differing regulatory approaches coming into existence here?

Already in Canada, for instance, the Ontario Securities Commission has launched a probe into possible market timing and late trading abuses there.

In Luxembourg new regulations in effect for accounting periods ending on or after December 31, 2003 require that fund accountants play a central role in achieving effective regulation over Undertakings for Collective Investment (USI's)...the equivalent of U.S. mutual funds. As such accountants are charged with producing two types of audit reports including a so-called Short form annual report in accordance with Article 86 (2) of the Law of 30 March 1988 on UCI's. This report must contain a Balance sheet, or Statement of assets, a detailed Statement of income and expenditure for the period, a report on the activities for the period under review, and the other disclosures required by Schedule B to said law, together with any additional significant information necessary for investors to make an informed judgment on the developments in the fund's activities and performance.*

In addition a Long-form audit report is now required in which the fund's accounts are required to opine upon a large number of topics including those in which so much abuse has been discovered in the U.S. This document is not intended for the general public. It is issued for the exclusive use of the board of directors of the fund or of the fund's management company and of the Commission de Surveillence du Secteur Financier (CSSF). Among the topics which the auditors must survey and report upon are any "window dressing" activities where the fund has added to or disposed of securities during the two weeks either side of the year end, the efficacy of the fund's anti-money laundering procedures, the fund's methods for valuing securities, its risk management system, tests for possible churning of

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**Commission de Surveillence du Secteur Financier (CSSF), language here and elsewhere adapted from a free translation of the French original by the Deloitte & Touche Luxembourg Knowledge Office for information purposes only.*

fund assets, brokerage commission rebates and soft commission arrangements, retrocessions (payments to sell product), derivative transactions, material errors in computing NAV and other subjects of possible regulatory interest. Where problems are detected, the auditor must inform both the board of directors of the fund and the CSSF.

This system has the advantage over the U.S. regulation in that each UCI is reviewed for possible regulatory non-compliance each year where U.S. surveillance is a government or SRO function carried out on a selective basis. From the perspective of a U.S. person who is familiar with the performance of U.S. accountants including that of Arthur Andersen in the Enron scandal and who has previously detected scandal in the International Commodities Investment Fund (ICIF) some years ago where accountants from the Jersey Isles were improperly employed, I am inclined to a natural skepticism about so heavy a reliance on auditors employed by the UCI's as a primary regulatory system.

The knowledge that my firm, Market Consulting Corporation (MCC), has gathered in these areas and in the court room has taken more than 20 years to acquire and so we were naturally pleased to see that the regulations do permit and anticipate that professionals in other areas will be employed where necessary to perform a complete audit. If accounting firms are dedicated to a quality audit and are given the resources to bring together a team to accomplish the multitude of tasks imposed upon them in this regulatory structure it may prove a cost effective way to provide a high level of regulatory supervision over UCI's.

The above discussion has been adapted from Internet sources including

BusinessWeek Online: www.businessweek.com
Financial Policy Forum: www.financialpolicy.org
Forbes.com: www.forbes.com
Franklin Templeton Investments: www.franklintempleton.com
MSN.com: www.moneycentral.msn.com
MSNBC / Newsweek: www.msnbc.com
National Review Online: www.nationalreview.com
Northwest Indiana News / NWITimes.com: www.nwitimes.com
The New York Times: www.nytimes.com
Office of New York State Attorney General: www.oag.state.ny.us
Ontario Securities Commission: www.osc.gov.on.ca
Registered Rep: www.registeredrep.com
U.S. Securities and Exchange Commission: www.sec.gov
WashingtonPost.com: www.washingtonpost.com

APPENDIX: List of Financial Institutions Involved in Mutual Fund Scandal

BANKS

- Bank of America, owner of Nations Funds
- Wachovia
- Citigroup
- Bank One
- Canadian Imperial Bank of Commerce (CIBC)

SECURITIES BROKER-DEALERS

- Morgan Stanley
- Prudential Securities
- Prudential Equity Group
- Merrill Lynch
- Goldman Sachs
- Oppenheimer & Company
- Smith-Barney
- Legg Mason
- Bear Stearns
- Charles Schwab
- 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 investigation of charges.

- Bank One Funds
- Putnam
- Nations Funds
- Franklin Templeton, Franklin Resources
- PBHG Funds
- Alliance Capital
- American Express
- Strong Capital Management
- Fred Alger Management
- Janus Capital
- Federated Investors Inc.
- MFS Investment Management
- Investco
- Old Mutual PLC

HEDGE FUNDS

Many hedge funds received subpoenas, others were named in complaints filed by the SEC or 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 are viewed as scandalous behavior.

Canary Capital Partners
Da Vinci Fund
Veras Investment Partners
Millennium
Chronos Asset Management
Head Start Advisors
Samaritan Asset Management
Atlantique Capital Advisors
Alliance Capital Management Hedge Fund
Tidewater Capital
Peconic Capital Fund
Diamant Asset Management
Diamant Master Fund
Lighthouse Multi-Strategy Fund
Ritchie Capital Management
Headstart Advisers
Trout Trading Fund

OTHER FINANCIAL SERVICE FIRMS

Security Trust Corporation
Wilshire Associates Inc.