

The Mutual Fund Industry Scandal and What Is Being Done to Correct It
James Atkinson

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University of Notre Dame
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“One thing is clear: The mutual fund industry operates on a double standard. Certain companies and individuals have been given the opportunity to manipulate the system. They make illegal after-hours trades and improperly exploit market swings in ways that harm ordinary long-term investors.” – New York State Attorney General Eliot Spitzer, September 3, 2003.

It was with this announcement in his press release, STATE INVESTIGATION REVEALS MUTUAL FUND FRAUD that Spitzer rocked the \$7.6 trillion mutual fund. The same day, his office also had released an official legal complaint against Canary Capital Partners, LLC, a multi-million dollar hedge fund, and Edward J. Stern, the manager of Canary. The Attorney General’s office had reached a \$40 million settlement with Canary, who had obtained illegal trading opportunities that harmed long-term investors with Bank of America, Banc One, Janus, and Strong.

And this was only the beginning. Spitzer acknowledged that this was the start of a long investigation into the mutual fund industry: “Mutual funds are in deep trouble,” Spitzer added (Schurr). “Every time we turn over a rock in the mutual fund business, we find vermin crawling beneath it” (Elkind, 108).

The mutual fund industry has long been regarded as an ethically pure business, making the funds themselves the perfect instruments for which small investors could invest long-term savings. The investigation, however, sheds light on the fact that the industry is not as clean as most once thought. Some companies unfairly have been giving preferential treatment to Wall Street big shots at the expense of the little guys. John Collins, a spokesman for the Investment Company Institute (ICI) has said, “If these charges prove true, there has been a breach of law that cuts close to the heart of what protects all mutual-fund shareholders” (Vickers).

There are basically two fraudulent schemes in which fund companies engage to earn tens of millions of dollars at the expense of buy-and-hold investors, those who invest for the long run. The two schemes are known as “late trading” and “market timing.” This paper will examine how Canary profited through late trading and market timing by conspiring with mutual fund companies. It should be noted, however, that by no means is Canary or the mutual fund companies listed here the only firms under investigation. To the contrary, many more companies than are listed here have been caught up in charges by state attorney generals or the SEC.

LATE TRADING

Unlike a stock, whose price fluctuates constantly throughout the day, a mutual fund’s price is determined by its “net asset value,” or NAV. The NAV is calculated at the end of a trading day, 4:00 P.M. Eastern Time. Each mutual fund order placed throughout the day is forward priced and executed at the closing NAV. This levels the playing field for investors. All orders placed before the 4:00 close receive the same price, i.e. that day’s closing NAV. Any order placed after the 4:00 close, by law, is supposed to receive the following day’s closing NAV.

The Martin Act and SEC regulations prohibit late trading. Certain financial institutions, however, including Bank of America, Banc One, Janus, and Strong, allowed Canary to place orders after the deadline and still receive that day’s NAV. Sometimes Canary placed orders as late as 9 P.M., allowing the hedge fund company to benefit from valuable post-4:00 information to which smaller investors were not privy.

According to the “forward pricing” rule, which became law in 1968, no investor should benefit from post-4:00 information: “An investor who has the ability to avoid forward pricing and buy at the prior NAV enjoys a significant trading edge” (Brown, 5). Spitzer likens this practice to “betting on a horse race after the horses have crossed the finish line.”

One such incident of illegal late trading by Canary occurred October 16, 2002. On that day, the Dow Jones Industrial Average had fallen by 219 points, while the Nasdaq had fallen by 50 points. After the market closed at 4:00, “IBM announced a stunning earnings surprise, beating expectations by 3 cents a share and signaling a new direction for the market.” Canary’s traders were able to purchase funds shortly after the announcement at the closing price that reflected the 3% market drop for that day, in other words “stale NAVs,” knowing that the market would rise the next day because of IBM’s announcement. The following day, the market did indeed bounce back: The Dow went up 238 points, while the Nasdaq went up almost 40 points. “Canary made a killing” (Elkind, 124).

There is, however, no such thing as a free lunch. The killing made by Canary cost the long-term buy-and-hold fund shareholders a pretty penny. Canary would purchase a fund one day when they knew the market would rise and then sell a day or two later, reaping the profits that would have otherwise gone to the funds long-term investors: “The late trader’s gain is the long-term investor’s loss” (Brown, 6).

MARKET TIMING

Market timing is considered a legal gray area. While not nearly as illegal as late trading, it still has negative effects for the long-term buy-and-hold fund shareholders through the dilution effect, or the transfer of wealth by rapid trading of short-term timers. A study conducted by Eric Zitzewitz at Stanford University estimates that U.S. mutual funds lose \$4 billion to timers each year (Zitzewitz, 37). International mutual funds are usually the funds of choice for market timers, as they are able to take advantage of time zone arbitrage.

Consider an international mutual fund that invests in Japanese stock. The Japanese market closes at 2:00 A.M. Eastern Time, 14 hours before the U.S. market closes. Because the NAV for the Japanese mutual fund managed from the U.S. does not update until 4 P.M. Eastern Time, investors have 14 hours to gather information after the Japanese market close and are able to place orders with the stale, 14-hour hold NAV. For example, an investor who observes a rising U.S. market could purchase shares of the Japanese mutual fund at a stale NAV and almost be guaranteed that the Japanese stock market will rise the following day.

On October 28, 1997, the Asian markets had dropped significantly because the U.S. stock market had declined 10% just one day earlier. By 4 P.M. that afternoon, however, the U.S. markets had recovered. The NAVs of Asian mutual funds, however, showed no recovery, because fund managers used a stale 13-hour old NAV based on the close of the Asian stock market. Market timers stood ready, knowing that the NAVs of Asian mutual funds would rise the next day: “They poured money into Asia/Pacific funds and sold them the next day, pocketing a one-day profit of around 10%. This profit came directly out of the pockets of the remaining shareholders” (Brown, 8).

Market timing is hardly new. It was pioneered in 1980 by Gil Blake, an investor who made a fortune by developing a trading strategy based on the historic pricing patterns of mutual funds. Blake averaged a 40% annual return in his first 12 years as a fund timer (Elkind, 110). While not illegal, market timing is likened to card counting in a casino: it is the bane of the mutual fund industry. Blake made most of his fortune in the 1980s by timing the Fidelity funds. In 1989, however, the fund company imposed large redemption fees on short-term trades. Today, almost every fund company has some sort of short-term trading fee, or early redemption fee, that penalizes timers who attempt rapid trading.

Market timing itself is not illegal in the eyes of the SEC. Almost every fund company's prospectus, however, indicates that the company discourages timing and does its best to regulate such activity because it is a burden on the shareholders. Janus Capital Group's prospectus clearly states:

Frequent trades in your account or accounts controlled by you can disrupt portfolio investment strategies and increase Fund expenses for all Fund shareholders. The Funds are not intended for market timing or excessive trading. To deter these activities, the Funds or their agents may temporarily or permanently suspend or terminate exchange privileges of any investor who makes more than four exchanges out of a Fund in a calendar year and bar future purchase into the Fund by such investor (Brown, 13).

This statement, however, is extremely misleading. And this is where mutual funds are getting into serious trouble with state attorney generals and the SEC—making fraudulent

claims. Janus, despite their statement in the prospectus, did not attempt to shut down short-term timed trades made by Canary, who exchanged the fund well more than four times during the course of a calendar year. And Janus was not alone. In fact, Canary exchanged funds at some fund companies well over 100 times per year. At Pimco, for instance, “in the space of 18 months Canary made more than 200 trades ... averaging \$20 million a pop. Total trading volume involved: more than \$4 billion” (Elkind 120).

WHY WOULD MUTUAL FUND MANAGERS ALLOW THIS?

Fund managers, being fiduciaries for their investors, are supposed to do their best to protect their customers from the dilution that late trading and market timing cause. So why would fund managers allow late trading and rapid timing transactions to occur? It’s all about the money. A hedge fund, such as Canary, makes sure that the illegal transactions that harm fund shareholders is worthwhile, financially speaking, for fund managers. Fund management fees increase with increased assets, and Canary was providing just that, investing millions of dollars in a long-term security while rapidly trading in and out of separate funds.

Peter Elkind describes how it works in his recent article in *Fortune* magazine:

Market-timing hedge funds ... negotiated secret ‘capacity’ arrangements in which they gained the right to run a predetermined amount of money in and out of a fund and were exempted from short-term redemption fees. In return, the market timer handed over a second predetermined amount of money to the fund company—‘sticky assets,’ which sat quietly and generated extra management fees for the fund complex (114).

Therefore, managers at certain fund companies were profiting at the expense of their buy-and-hold shareholders.

HOW CANARY DID IT

Canary obtained the ability to place late orders at the stale NAV and engage in high volume market timing by striking deals with the mutual fund companies themselves, in contradiction to the fund company's prospectuses. Canary's biggest accomplice was Bank of America, who allowed Stern's hedge fund to both late trade and market time in large quantities, on the scale of hundreds of millions of dollars.

Theodore Sihpol, at the time a Bank of America broker who has since been fired and indicted, forged the relationship with Canary in April 2001. Sihpol allowed Canary to use technology proprietary to Bank of America to make late trades. Specifically, an electronic late trading platform was installed in Canary's offices. This computer system allowed Canary to make trades up until 6:30 without having to speak to a Bank of America representative. According to the Spitzer's complaint:

Starting in 2001, the Bank of America (1) set Canary up with a state-of-the-art electronic late trading platform, allowing it to trade late in the hundreds of mutual funds that the bank offers its customers, (2) gave Canary permission to time its own mutual fund family, the 'Nations Funds,' (3) provided Canary with approximately \$300 million of credit to finance this late trading and timing, and (4) sold Canary the derivative short positions it needed to time the funds as the market dropped [during the bearish market of 2001 and 2002] (Brown, 18).

Thus, Stern was able to trade in and out of funds “over and over again – systematically transferring wealth out of the fund” and into the hands of his customers and himself (Brown, 15). Trading with Bank of America and other mutual fund companies continued from 2000 to May 2003, when Stern decided to return all funds contributed by outside investors. In a letter to his investors, Stern wrote: “Strategies that had worked well for a number of years have not worked recently.... We hope that you considered the ride to be a good one” (Elkind, 127).

Just a few months later, Spitzer filed charges against Stern and Canary. Stern paid \$40 million in fines and restitution of improper profits but wouldn't spend any time in jail. Instead, he became a star witness for Spitzer, helping the Attorney General's office plunge deeper into the scandal (Elkind, 127).

REACTIONS FROM THE INDUSTRY

As of now, there has been surprisingly little public reaction from the mutual fund companies themselves, as Daisy Maxey claims in her *Wall Street Journal* article that ran March 1, 2004. While some mutual fund companies have restructured by replacing firing brokers and replacing chairmen or other high-ranking officials (Janus just replaced its CEO on Monday), asset management firms have been quiet with their words. Few who have been charged have stated a notice of apology or concern regarding their institutions. Those who have not been charged have remained quiet as opposed to touting their innocence as some might expect they would.

The reason for fund companies not responding more vocally is simple: integrity is something that one cannot assert, but must instead demonstrate (Maxey). Secondly, a

fund company's worst nightmare would be advertising their good ethics one day and then receiving a subpoena and getting dragged through the mud the next day. Companies are being cautious.

REACTION FROM SEC AND CONGRESS: FINES AND NEW REGULATIONS

The SEC and the attorney generals of numerous states have fought back against the crimes committed by fund firms by levying hefty penalties. Fines paid so far include \$40 million by Capital Canary Partners, \$350 million by Massachusetts Financial Services, \$600 million by Alliance Capital Management, and \$675 million by Bank of America / FleetBoston Financial.

Fines penalize those who have done wrong, but new regulations will aid the prevention of future abuses of the system. The quarterly review of mutual funds in the April 1, 2004 edition of the *Wall Street Journal* provides a thorough analysis of the new regulations being proposed by both Congress and the SEC to overhaul fund companies. Paul Roye, director of SEC's Division of Investment Management has laid out the goals of the overhaul proposals: "We're trying to strengthen the overall regulatory framework, improve compliance and oversight, cut off abusive conflicts of interest, and improve disclosure' to better inform investors and help curb improper industry practices" (Damato and Burns). Indeed, many of the proposals attempt to put more information into the hands of the fund shareholders.

Damato and Burns' article focuses on five of the most hotly contested proposals, three of which are (1) require independent board chairman, (2) impose a mandatory 2% redemption fee, (3) impose a 'hard 4 P.M.' close.

Requiring an independent board chairman is essential, claims the SEC, because as of now, there exists a conflict of interests between a fund manager and the fund shareholders. Allowing market timing may increase fund assets, thereby increasing a fund manager's income at the expense of the buy-and-hold shareholders.

A 2% mandatory redemption fee, proposed by the SEC, would limit the ability of investors to engage in market timing by requiring fund companies to impose a 2% fee on anyone who sells his shares within five days of purchase.

The hard 4 P.M. close is perhaps the most controversial. This proposal would mandate that all orders be placed with the fund companies by 4:00 Eastern Time. While this may seem like a good idea, it may hurt small investors whose orders take several hours to process. Concerns have also been voiced by California Senator Barbara Boxer, who indicates that a 4:00 hard close would put a lot of pressure on investors in the Pacific Time Zone, who would have to have orders completed by 1:00. With some orders taking two hours to process, the order would have to be placed by 11 A.M. Pacific Time.

Just in the last two weeks, the SEC passed two new regulations. The first requires that fund companies disclose fund timing policy more clearly in their prospectuses: The SEC aims "to shine some light on what has proved to be a dark and dingy corner in the mutual fund industry," SEC Chairman William Donaldson said in regards to market timing practices (Drawbaugh). The second regulation will require that all mutual funds have a hired fund compliance officer by October 5, 2004. The chief compliance officer will report directly to the fund director and not the executives of the fund management company (CNN Money).

While the SEC may be late to jump on the mutual fund industry, stepping in only after Spitzer's office filed the complaint against Canary, the agency is now taking a leading role in preventing further abuse. Congress, too, may step in with new legislation. The SEC, however, feels that such Congressional action is unnecessary and could be counterproductive (Reuters, April 9). In any case, the mutual fund industry has suffered quite the black eye over the course of the last 6 ½ months. Now the hard part is cleaning up and restoring the image to an industry once thought to be pristine.

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