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The Unfinished Business of Mutual Fund Reform

Thomas R. Hurst*

Background: Growth of the Mutual Fund Industry

During the long bull market of the 1980s and 1990s, the investment company industry experienced almost unprecedented growth. From 1970 through the end of 2003, the number of funds registered under the Investment Company Act of 1940 increased from 361 to 8,124.¹ Even more startling was the total dollar amount of assets which the public placed in such funds, which increased dramatically from \$48 billion to \$7.2 trillion.² Spurred by increased investor use of the Individual Retirement Account (IRA) and the increasing use of 403(b) and 401(k) tax-deferred retirement savings accounts by employers to replace traditional defined benefit retirement accounts, mutual funds became the investment vehicle of choice for an increasing number of investors, many of whom had no prior experience investing in the stock market. The investment company industry quickly recognized the opportunity presented and has heavily directed its marketing efforts toward investors with retirement funds to invest. Indeed, a majority of the assets held by mutual funds today are held in tax-deferred retirement accounts.

As the fund industry grew, the industry witnessed an increasing number of special purpose funds offered to satisfy investor demand for funds which would provide diversification within a particular industry, country, or other market segment. In the early 1970s, the first money market fund, Capital Preservation Fund, came into existence. This fund served a dual purpose. First, it gave investors a chance to participate in the market for commercial paper and large denomination bank certificates of deposit, and thus receive a yield on a short term debt instrument which substantially exceeded that available on a typical bank passbook savings account. Second, as money market funds came to be

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1. James K. Glassman, *A Better Mutual Fund Reform*, AM. ENTERPRISE ONLINE, April-May 2004, available at http://www.taemag.com/issues/articleid/17953/article_detail.asp.

2. *Id.*

offered by large fund companies such as Fidelity and Vanguard, they enabled the management companies to retain funds within their organization. Thus, these funds remained with the firm and could be easily reinvested at the exact time of the investor's choosing. In addition to money market funds, most of the large investment companies came to offer families of funds so that investors whose investment preference shifted from, for example, foreign securities to domestic growth stocks, could shift their investments easily from one fund to another within the same family without the need to engage in time consuming redemption procedures formerly required to transfer funds from one mutual fund to another. An additional factor which encouraged popularity of the funds was the offering, by brokerage houses, of literally hundreds of funds to their customers which could be bought and sold through an investor's brokerage account. This enabled customers easily to move investments not just within one fund family but from one fund family to another. Thus an investor wishing to redeem shares in Fidelity Magellan Fund and to invest the proceeds in Oakmark International Fund could do so with a single phone call or online instruction. Thus trading in fund shares became as easy as purchasing and selling securities in individual companies. Finally, the long bull market extending from August 1982 until March 2000 multiplied the funds on deposit substantially and further increased investor confidence in the industry as average annual returns of the average fund soared to unprecedented levels.

The Recent Scandals: Late Trading, Market Timing and Directed Payments

The recent bear market of 2000-2002 changed things considerably. Many investors who should have known better became caught up in the tech stock boom and invested in speculative technology-oriented funds, many of which suffered major losses as the NASDAQ index plunged by more than two-thirds. At first, scandals involving Enron and Worldcom seemed to leave the mutual fund industry itself unscathed. However, many funds held significant amounts of securities of these and other corporations that experienced fraud or financial difficulties. This led some investors to begin questioning the investment acumen of mutual fund advisors. In the summer of 2003, more serious allegations surfaced concerning the behavior of the fund industry itself. In September 2003, New York Attorney General Eliot Spitzer announced that an investigation of the mutual fund industry had uncovered numerous instances of market timing and "late trading" in several well-known

funds. The first major case alleged that Canary Capital Partners, LLC had engaged in illegal late trading and market timing activities that harmed other investors in various mutual funds in which such trading activities took place. The action was immediately settled with Canary and its managers agreeing to make restitution of \$30 million to the funds involved and also to pay a \$10 million penalty.³

Other enforcement actions quickly followed on the heels of the Canary Capital Partners proceedings. In October 2003, the SEC accused the chairman of Strong Capital of late trading in the shares of several Heartland mutual funds.⁴ Two months later, the SEC filed civil fraud charges against Heartland Advisors, Inc., its Chief Executive Officer and several officers and portfolio managers. Among the charges were deliberate mis-pricing of two high yield municipal bond funds which, when disclosed, caused their Net Asset Value (“NAV”) to fall by \$93 million within a space of two weeks.⁵ In addition, several individuals were accused of insider trading when they sold shares in these funds prior to public disclosure of the mis-pricing. Several months later in February 2004, the SEC announced enforcement proceedings against Massachusetts Financial Services and its CEO for allowing improper market timing in violation of the fund’s public disclosures.⁶ Other well-known funds were subsequently charged with wrongdoing, including Janus Capital, Invesco, Putnam, Franklin Resources and many others.⁷

Major brokerage houses were not immune from wrongdoing either. In September 2004, the SEC charged that one of the nation’s largest discount brokers, Charles Schwab & Co., had allowed some investment advisor customers to change mutual fund orders after the 4 p.m. closing, creating the risk that they could capitalize on late breaking developments at the expense of other customers.⁸ And in December 2004, the SEC

3. Richard L. Levine, Yvonne Cristovici & Richard A. Jacobson, *Mutual Fund Market Timing*, 52-JAN FED. LAW. 28, 29 (Jan. 2005).

4. *Id.*

5. Press Release, SEC, SEC Levels Fraud Charges Against Heartland Advisors, Inc., 12 Company Officials and Others for Misrepresentations, Mispricing and Insider Trading in Two High Yield Bond Funds (Dec. 11, 2003), available at <http://www.sec.gov/news/press/2003-171.htm>.

6. Press Release, SEC, Massachusetts Financial Services Co. Will Pay \$225 Million and Make Significant Governance and Compliance Reforms to Settle SEC Fraud Charges Concerning Mutual Fund Market Timing (Feb. 5, 2004), available at <http://www.sec.gov/news/press/2004-14.htm>.

7. Levine, *supra* note 3, at 30-32.

8. Press Release, SEC, SEC Charges Charles Schwab & Co. with Improperly Allowing Certain Customers to Purchase Mutual Fund Shares After Market Close (Sept.

announced that it was seeking \$570 million in penalties from Daniel Calugar, owner of a smaller brokerage firm, for profits resulting from late trading.⁹

Many of the cases brought against funds and their advisors involved "late trading." This term refers to purchases of shares in mutual funds occurring after the close of trading, which is normally 4 p.m. EST, for the share price set at the closing. This practice is a clear cut violation of the SEC's Forward Pricing Rule, Rule 22-c-1, promulgated under the Investment Company Act of 1940, which requires that purchases or sales of shares of open-end mutual funds be made at the NAV of the fund calculated after the order is received. Thus, for the vast majority of mutual funds which only price their shares once a day at the 4 p.m. closing, this means that orders received after 4 p.m. must be priced at the closing on the following day. Late trading has allowed favored investors to profit based on developments affecting a particular company or the market in general which are announced after the 4 p.m. closing. The benefits of late trading occur most often when shares are traded on overseas markets after the 4 p.m. closing of the NYSE and other U.S. markets since observed price action in overseas markets can indicate the likely pricing in U.S. markets the following day. Mr. Spitzer has analogized late trading as being similar to placing a bet on yesterday's horse race.

The beneficiaries of late trading are not only the customer engaged in it but also the mutual fund or brokerage house allowing it. In fact, the main reason why mutual funds have tolerated late trading has been to earn large fees generated by the large accounts of some customers engaging in it. For example, in the Canary case, Bank of America allowed Canary to engage in late trading in its own family of funds in exchange for Canary's agreement to hold large amounts of assets in the firms' bond funds.

While late trading is clearly prohibited by Rule 22c-1, some firms have given plausible reasons for allowing it in clearly limited circumstances. Large brokerage firms, such as Charles Schwab and Fidelity, which offer their customers literally hundreds of funds through their brokerage accounts, argue that it is impossible for them to forward all orders which they receive in the hour prior to the 4 p.m. closing to the

14, 2004), available at <http://www.sec.gov/news/press/2004-128.htm>.

9. See Matthew Goldstein, *In Fund Scandal, Calugar Stands Alone*, THE STREET.COM, Dec. 21, 2004, <http://www.thestreet.com/markets/matthewgoldstein/1020009.html>.

individual funds prior to the close of trading. Thus, they argue that investors placing orders through a broker would be disadvantaged vis-a-vis investors dealing directly with funds if they place their order with the broker prior to 4 p.m. but are not given the benefit of that day's closing price. While this argument has some validity, those opposed counter that if exceptions are allowed, abuses may creep in unless it is possible to determine for a certainty that an investor has in fact placed the order with the broker prior to 4 p.m. and is not allowed to cancel it after the 4 p.m. closing.

In contrast to late trading, market timing has been a well-known activity of mutual fund traders for a number of years. The term refers simply to frequent in and out trading of shares in mutual funds by investors who intend to profit from market inefficiencies which may cause the NAV of a fund's shares not to reflect the real underlying market value of the securities held by that fund. This most often occurs where a foreign market closes several hours prior to the 4 p.m. EST NYSE close and developments affecting the price of those securities are announced after the close of the overseas market but prior to the 4 p.m. New York close. If the NAV of the fund is based on the foreign exchange's closing price, market timers may seek to profit on the stale information reflected in the NAV by purchasing or selling shares whose NAV will likely be adjusted the following day based on the newly announced developments.

Another type of market timing involves an attempt by investors to profit from trading shares of mutual funds which hold illiquid securities, often preferred shares or bonds, whose true value may not be reflected in the NAV of the fund due to market or company developments which occurred after the latest trade in the security. This enables investors to engage in a "liquidity arbitrage" by buying or selling mutual fund shares to profit from a presumed discrepancy between the quoted NAV of the fund and the true value of its underlying securities.

In contrast to late trading, market timing is not explicitly prohibited by any SEC rule or court decision. However, the harm to other investors in the fund is similar to that resulting from late trading in that it enables the timer to profit at the expense of other investors by purchasing the security at an unfairly high or low price relative to the fund's NAV. However, if the fund, in its own prospectus, explicitly states that frequent trading is prohibited or will be limited if engaged in excessively yet the fund allows favored investors to engage in such activity, this may provide the basis for an action for a false and misleading statement in the

prospectus in violation of section 17 of the Securities Act of 1933, section 10(b)-5 of the Securities Exchange Act of 1934 or the Investment Advisors Act of 1940. In addition, such action may constitute a breach of fiduciary duty by the fund's management to investors.¹⁰

Still another type of abuse uncovered during SEC investigations involved payments by mutual funds to brokerage firms which recommended their funds to customers. In September 2004, the PIMCO Funds agreed to a \$11.6 million settlement of SEC charges that they had failed to disclose their use of directed brokerage to pay for shelf space at brokerage firms.¹¹ In December 2004, the SEC settled charges levied against Franklin Advisors, Inc. and its underwriting subsidiary alleging that Franklin had used fund assets to compensate brokers for recommending its funds to their clients, a practice referred to in the industry as purchasing "shelf space."¹² More recently, the NASD charged American Funds Distributors with violating its anti-reciprocal rule by making improper payments to brokerage firms for recommending American Funds shares to its customers.¹³ Directed payments have the potential to encourage brokers to recommend funds which are unsuitable for a customer's particular needs, have exhibited below-average performance, or charge higher than average expenses to investors. As such, the potential mischief resulting from directed payments may be a more serious detriment to investors than late trading or market timing.

Investors quickly reacted to the widely publicized allegations of misconduct by pulling massive amounts of money from the affected funds. In the eleven months following Spitzer's first public announcements, approximately \$155 billion was withdrawn from the affected companies at a time when the rest of the industry experienced net inflows of \$124.6 billion.¹⁴ However, investors' disillusionment with those funds directly implicated in improper activities has not cooled investors' ardor for the fund industry overall. By the end of November 2004, total money invested in U.S. based stock, bond, and money market

10. See, e.g., *Dudley v. Putnam Int'l Equity Fund*, No. 03L1539 (3d Jud. Cir. Ill. filed Nov. 5, 2005); *Cullen v. Templeton Growth Fund Inc.*, No. 03859 (S.D. Ill. filed Dec. 16, 2003).

11. *In re PA Fund Mgmt. LLC*, SEC, File No. 3-11661, 2004 SEC LEXIS 2085 (Sept. 15, 2004).

12. See John Hechinger, *SEC Report Shows Putnam Investments' Managers Were Given 'Lavish' Paychecks*, WALL. ST. J., Mar. 25, 2004, at C1.

13. 37 Sec. Reg. & L. Rep. (BNA) 316 (Feb. 21, 2005).

14. See Brooke A. Masters, *A Year of Charges, Reforms for Funds; Regulators Imposed Fines, Crafted New Rules*, WASH. POST, Sept. 1, 2004, at E1.

funds reached \$7.9 trillion, an increase from \$7.4 trillion the end of 2003. This \$500 million increase is equal to the size of the entire mutual fund industry in 1985.¹⁵ This is perhaps not surprising since more than 60% of equity fund assets exist in tax-deferred retirement accounts.¹⁶ Thus, other than buying individual stocks, investors have little alternative but to remain with the mutual fund industry. Although total inflows are up, investors did react rationally to the fund scandal. Major fund families, untouched by adverse publicity, such as Fidelity, Vanguard and T. Rowe Price, experienced record inflows while the Putnam, Janus and Heartland families suffered major net withdrawals.

Proposals for Reform and Criticisms Thereof

Despite the publicity which market timing and late trading have received, it is not clear that reform to deal with these issues should be the primary concern of mutual fund investors or the SEC. The SEC estimates that the annual cost to investors of late trading is \$400 million.¹⁷ While the need to take steps to prohibit late trading is undeniable, a study by The TowerGroup concludes that the costs associated with the current proposals exceed their benefits.¹⁸ The SEC proposals include a “hard” 4 p.m. close for fund orders, redundant accounting by funds or establishing a registering clearing agency for all fund orders, time stamping of transactions and independent certification by outside auditors of intermediary trades.¹⁹ The TowerGroup study opines that the costs of establishing a separate database associated with all client transactions would be staggering.

Similarly, while the TowerGroup study estimates that cost to investors of market timing in international funds is around \$200 million annually, the annual cost of the proposed 2% redemption fee intended to discourage such transactions is estimated at \$1 billion.²⁰ “In other words, the proposed solution would spend \$1 to save 20 cents.”²¹ The

15. See Chet Currier, *What's This? New Growth at Tired Old Mutual Funds*, SUN-SENTINEL (Fort Lauderdale, Fla.), Jan. 14, 2005, at 3D.

16. *Id.*

17. John Spence, *Fund Reform Proposals Carry Price Tag; Study: Is Cure Worse Than the Disease?*, MARKETWATCH, Aug. 17, 2004, <http://www.marketwatch.com/news/story.asp?guid=%7B7DAE3041-1099-4EF3-91B8-1E2C94B28601%7D>.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

TowerGroup report concluded that “fair value pricing” would be a better solution to the market timing problem.²² Under fair value pricing, a fund will change the NAV of a fund from the 4 p.m. closing price to reflect the impact on foreign share prices which news developments occurring after overseas markets would have had on such prices had the exchanges been open. However, not all commentators agree that fair value pricing is a panacea for the market timing problem. Although the SEC has instructed mutual funds to estimate the value of the securities in their portfolios to take account of aftermarket news developments, approximately one-third of the 960 funds surveyed by the SEC have chosen not to do so.²³ The SEC concluded that investors in about 15% of the funds surveyed suffered losses of roughly 2% through market timing. However, because fair value pricing is necessarily based on an estimate of the effect of news developments on the price of a security, it is an inexact science at best, and at worst, it may create temptations to manipulate share prices for reasons other than promoting fairness to investors in the funds. For example, a survey of the valuation of shares of Toyota Motor Company on October 31, 2003 showed that U.S. based funds valued such shares at prices ranging from a low of \$28.42 to a high of \$29.01 per share.²⁴ Furthermore, different funds have different standards which trigger when a fair value price should be substituted for the actual closing price of a security. Funds are reluctant to publicly disclose the details of such standards, both for competitive reasons and to avoid giving market timers information which might enable them to beat the system. Thus, while the establishment of bright line rules by the SEC would avoid embarrassing discrepancies between prices assigned to shares by different funds, it would also open the door to abuses by market timers bent on evading the rules. In short, there is no perfect solution to this problem.

An even more serious problem with fair value pricing is that it may be abused by a fund manager to conceal poor investment results by smoothing out substantial losses on securities held by the fund rather than making a substantial price adjustment in a single session. The most publicized example of this occurred in the fall of 2003 when the SEC charged Heartland Advisors and its outside consultant with conspiring

22. *Id.*

23. See Ian McDonald & Tom Lauricella, *Mutual Funds' Pricing Flaw: What's the French Judge Say? Use of 'Fair Value' is Elusive Despite the SEC's Concerns*, WALL ST. J., Mar. 24, 2004, at C1.

24. *Id.*

fraudulently to mis-price the shares of two high-yield municipal bond funds.²⁵ Together, Heartland and the advisor, Interactive Corp., were accused of writing down the value of certain fund holdings by fifty cents per day for each \$100 of face value for several weeks until the value of the securities reached approximately \$80 per \$100 of face value. This “smoothing” was intended to create the appearance of stability in the bond funds’ values and to conceal improper mis-pricing of securities held by the funds which had occurred over a period of several months. Apparently, Heartland’s supposedly independent advisor on pricing was relying on information supplied by Heartland itself which had a vested interest in concealing the mis-pricing. As it turned out, the effort to cover up mis-pricing ultimately was unsuccessful and Heartland was forced suddenly to write down the value of the two bond funds by 44% and 70% in a single day in October 2000.²⁶ The problem involving Heartland and Interactive involved thinly traded municipal bonds, not securities traded on foreign exchanges, but the potential for abuse by the advisor clearly exists in both situations. In short, fair value pricing may overall have a net benefit for fund investors but stringent regulations are needed to prevent abuses and to ensure that pricing advisors render truly independent and impartial advice to the funds they serve. Another alternative to fair value pricing is the “one-day hold” in which the purchase price for investors placing orders on a particular day is based on the fund’s closing price the day following submission of their order. Since this solution effectively forces all investors to accept a stale price on their trades, it seems the least satisfactory of the alternatives which have been proposed.²⁷

In December 2003, the SEC acted quickly to propose remedial measures to deal with late trading, market timing and related abuses.²⁸ The proposal provided that orders to purchase shares in mutual funds must be actually received by the fund or its transfer agent by the time the fund sets for calculating its NAV, typically 4 p.m. It also required all

25. See Karen Damato, *One Case Shows the Perils of “Smoothing,”* WALL ST. J., Mar. 24, 2004, at D1.

26. *Id.*

27. Eric Zitzewitz, Stanford Bus. Sch., Comments at the American Enterprise Institute for Public Policy Research Conference: Mutual Fund Litigation and Regulation: Is the Cure Worse Than the Disease? (Jan. 28, 2004) (transcript available at http://www.aei.org/include/event_print.asp?eventID=733).

28. Press Release, SEC, SEC Takes Steps to Address Late Trading, Market Timing and Related Abuses (Dec. 3, 2003), available at <http://www.sec.gov/news/press/2003-168.htm>.

funds to have in place written policies to deal with market timing, fair valuation of securities and disclosure of portfolio holdings. Finally, each fund must designate a chief compliance officer who must report directly to the board of directors. Two months later, the SEC proposed adopting a requirement that mutual funds impose a 2% fee on redemptions made within five days of purchase.²⁹ However, in the face of widespread opposition from the fund industry and brokerage houses, the SEC backed away from its original proposals and, on March 3, 2005, issued a modified rule permitting, but not requiring, funds to impose redemption fees on short term trades.³⁰ The new Rule 22c-2 requires funds that redeem shares within seven days to either adopt a redemption fee of no more than 2% or determine that a redemption fee is not appropriate for the fund. The rule also requires written contracts between a fund and its intermediaries who must agree to provide the fund with the identity of shareholders so that the fund may enforce the rule.³¹ Also, the SEC left open the issue of whether it should adopt uniform standards for redemption fees by funds. It also indicated that it was still considering whether to adopt standards to guide funds on the use of fair value pricing.³² Considering that the issues of market timing and late trading were the issues that initially focused attention on mutual fund abuses, the rules adopted thus far by the SEC to deal with these abuses are surprisingly mild.

Additional Areas of Reform: Independent Directors

Fortunately, the SEC has made more dramatic changes in other, less publicized, areas of mutual fund regulation which may, in the long run, benefit most investors more than additional regulations dealing with market timing and late trading. The most significant of these changes mandated by the SEC concern mutual fund governance and are intended to ensure that investors receive impartial advice from brokers and dealers selling fund shares. In January 2004, the SEC proposed that the chairman of a mutual fund must be independent from the funds investment advisor and that 75% of the funds directors be independent.³³

29. Mutual Fund Redemption Fees, Investment Co. Act Release No. IC-26782, 17 C.F.R. pt. 270 (Mar. 11, 2005); *see* 36 Sec. Reg. & L. Rep. (BNA) 383 (Mar. 11, 2005).

30. 17 C.F.R. pt. 270.

31. 36 Sec. Reg. & L. Rep. (BNA) 383 (Feb. 23, 2004).

32. *Id.* at 394.

33. Investment Company Governance, Investment Company Act of 1940 SEC Release No. IC-26323, 17 C.F.R. pt. 270 (proposed Jan. 15, 2004).

Since approximately 80% of mutual fund boards are currently chaired by interested directors, this proposal proved extremely controversial.³⁴ Nonetheless, by a 3 to 2 vote, a sharply divided SEC approved this proposal in June 2004.³⁵ In adopting the rule, the majority dismissed arguments by opponents who argued first, that since a majority of the board is already required by law to be independent, members should be free to choose whether an inside or independent director will best serve the interests of the shareholders; second, an inside chair is needed because of his or her familiarity with management company issues; third, an independent chairman will require a separate independent advisory staff which will increase administrative costs to shareholders; and fourth, there is no empirical evidence that an independent chairman would be more effective in protecting shareholders.

Proponents of the rule argued first, that it was necessary to avoid the inherent conflict of interest which exists when, on the one hand, the chairman of the fund's board has a duty to maximize the profits of the management company and, on the other hand, a duty to maximize the investment return to fund shareholders; second, that most directors are on the board because they were nominated by the chairman, thus compromising their independence; and third, that empirical evidence is not always necessary or available to justify a proposal such as this one because it should be intuitively obvious that, due to the inherent conflict of interest, an independent chair should better protect the interests of investors. Prior to the rule's adoption, all seven living former SEC chairmen publicly supported the proposal for an independent chairman, a factor which may have carried the day for adoption of the proposal.³⁶

In September 2004, the U.S. Chamber of Commerce sued the SEC in an attempt to set aside the new regulation.³⁷ In June 2005, the D.C. Circuit Court ruled for the plaintiffs and remanded the proposed regulation to the SEC on the ground that the Commission had failed to consider all alternatives prior to its adoption.³⁸ In a controversial move, SEC Chairman William Donaldson called an expedited hearing and, on June 30, one day before his term expired, the SEC readopted the

34. See Comments of Comm'r Paul Adkins, 36 Sec. Reg. & L. Rep. (BNA) 37 (Sept. 20, 2004).

35. 36 Sec. Reg. & L. Rep. (BNA) 1154 (June 28, 2004).

36. 36 Sec. Reg. & L. Rep. (BNA) 1113 (June 21, 2004).

37. Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

38. *Id.*

regulation requiring an independent director by a 3 to 2 vote.³⁹ Assuming the revised regulation is upheld, only subsequent events will tell how significant this reform will prove to be in providing added protection to investors. For this rule to have any significant effect, both the chairman and board members must be truly independent and responsive to the needs of fund shareholders. The Enron, Worldcom and other recent corporate governance scandals are reminders that an independent chairman who dominates the board and can do as he wishes is not necessarily always going to act in the best interests of the small shareholders. A recent study has found that board size and compensation exhibits a more positive correlation with keeping fund fees low and avoiding scandal than does the number of independent directors on the board.⁴⁰ For example, Putnam Investments, one of the first groups charged with improprieties in the recent scandal, has one of the most independent boards of any major fund group.⁴¹ On the other hand, many long-established fund management companies such as Fidelity, T Rowe Price and Vanguard, which have remained almost entirely free of charges of impropriety in recent fund scandals, do not have fund boards which are independent of their management companies.

In another significant reform, in December 2003, the SEC adopted a rule requiring each fund to designate a chief compliance officer who must report directly to the fund's board.⁴² The rule also requires each fund to develop compliance policies and procedures which must be reviewed at least annually. The Investment Company Institute backed this reform and its president, Paul Stevens, has stated that the new compliance rule "may have the greatest long term impact" of any of the recent reforms instituted by the SEC.⁴³ While the change is welcome, it remains to be seen how effective this rule will be in improving compliance by funds with SEC rules and regulations.

Regulation of Fees and Other Charges

Another significant area of reform which has the potential to generate substantial savings to investors is the reduction of fees and expenses charged by funds. It is widely recognized that mutual funds, on

39. 36 Sec. Reg. & L. Rep. (BNA) 26 (June 25, 2005).

40. Suzanne McGee, *Who's Harry?*, BARRON'S, Apr. 11, 2005, at L12.

41. *Id.*

42. 35 Sec. Reg. & L. Rep. (BNA) 2014 (Dec. 8, 2003).

43. 36 Sec. Reg. & L. Rep. (BNA) 1215 (July 5, 2004).

average, have significantly underperformed broad-based market averages such as the Dow Jones Industrial Average and the Standard and Poor 500 Industrial Average.⁴⁴ The causes of this are numerous, but one of the most significant is the relatively high fees which mutual funds levy on their customers. Morningstar's review of funds indicates that the average fund charges annual expenses of 1.56%.⁴⁵ The effective annual fee is even higher if investors buy what are called "B" class shares, which levy a stiff exit fee when an investor sells his shares.⁴⁶ Surprisingly, the average fee has increased significantly during the past quarter century at a time when the size of the fund industry has grown exponentially. In 1951, the average annual management fee was roughly 0.75% when total mutual fund assets were about \$2 billion; in 2003, they were approximately \$7 trillion, yet the average fee has more than doubled.⁴⁷ While one would expect that economies of scale and competition among the increasing number of funds would have caused fund fees to decline during this period and to regress toward the mean, precisely the opposite has occurred.⁴⁸ Financial theorists are puzzled by this disparity since standard financial asset pricing models indicate that there should be almost no dispersion in fees charged to investors. In fact, it has increased.⁴⁹ Also, during the late 1990s, the market share of the funds with the lowest fees was decreasing while the market share of new funds with higher fees was increasing.⁵⁰ One explanation for this puzzling phenomenon is that, in a period when most funds average

44. See Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-64*, 23 J. FIN. 389 (1968); Burton G. Malkiel, *Returns From Investing in Equity Mutual Funds 1971 to 1991*, 50 J. FIN. 549, 562-67 (1995).

45. See John Mauldin, *The Endgame for Mutual Funds*, in THOUGHTS FROM THE FRONTLINE, July 30, 2004, <http://www.frontlinethoughts.com/printarticle.asp?id=mwo073004>.

46. See Daisy Maxey, *Monthly Mutual Fund Review; How to Look at Mutual-Fund Fees; Most Investors Pay Less Than Mean of All Expenses; When You Should Weigh In*, WALL ST. J., Feb. 7, 2005, at R1 (The fund industry argues that this figure is misleading and that a dollar weighted average of what investors actually pay is only 0.936% according to Lipper Inc. This is because the vast majority of fund assets are held in very large funds, including index funds, with a lower fee structure while the straight arithmetic average is higher due to a large number of relatively small funds with a higher cost structure.)

47. Lawrence C. Strauss, *Fixing Mutual Funds*, BARRON'S, Jan. 12, 2004, at L12.

48. *Id.*

49. Chad Sayverson, Stanford Bus. Sch., Comments at the American Enterprise Institute for Public Policy Research Conference: Mutual Fund Litigation and Regulation: Is the Cure Worse Than the Disease? (Jan. 28, 2004) (transcript available at http://www.aei.org/include/event_print.asp?eventID=733).

50. *Id.*

annual growth in NAV substantially exceeded historical norms, investors paid less attention to fees than they might have otherwise. Indeed, the Investment Company Institute reported that in 2003, following the bear market of 2000-2002, about 70% of new money invested in stock funds was placed in funds with an expense ratio of 1% or less.⁵¹

Probably the least justifiable fees levied on investors are the “12b-1” fees charged by some funds to aid in the marketing of additional fund shares. Following the bear market of the mid-1970s, the fund industry contracted as investors pulled their dollars out of equity funds seeking safer alternatives. At this time, the fund industry persuaded the SEC to authorize these fees to assist in marketing funds to new investors with the rationale that, if the size of the fund was maintained or increased, it would result in lower average costs per share and thus would benefit existing investors. Whether or not this original rationale was sound, it certainly lost its original justification when the bull market of the 1980s and 1990s resulted in a cascade of money into funds. Furthermore, many funds with above average performance records closed to new investors during this period yet continued to levy a 12b-1 fee! This practice is completely without justification and should be prohibited. In fairness, the fund management company, which is the direct beneficiary of the sale of additional fund shares, should bear the expenses of marketing additional fund shares, not the investors in the fund.

While 12b-1 fees seem unfair to investors, at least they are fully disclosed in the prospectus so that potential investors receive notice of them and can choose funds without such fees if they wish. However, other charges are also levied on investors which are not fully disclosed and which significantly cut into the returns fund investors receive. A recent study by the Zero Alpha Group concludes that investors in equity mutual funds are paying roughly \$17.3 billion in hidden trading costs that are not reported in the published expense ratios of funds.⁵² This study of over 500 domestic equity mutual funds concluded that trading costs averaged 43.4% of reported mutual fund expense ratios, yet they are not required to be included as part of expense ratios published in the prospectus or semi-annual reports to investors.⁵³ For some funds, the

51. Jonathan Clements, *Focus of Mutual Funds Turns to Costs, but Low Expenses Aren't Everything*, WALL ST. J., Mar. 9, 2005, at D1.

52. Jason Karceski, Miles Livingston, & Edward S. O'Neal, *Portfolio Transaction Costs at U.S. Equity Mutual Funds*, ZERO ALPHA GROUP, http://www.zeroalphagroup.com/news/execution_costspaper_Nov_15_2004.pdf (last visited Oct. 19, 2005).

53. *Id.*

trading costs were large enough so as to exceed published expense ratios. The study indicated that 46% of all small cap funds have “all-in” trading costs in excess of published expense ratios, while 21% of mid-cap funds and 7% of large cap funds fell into the same category. Overall, 17.6% of all funds have trading costs that are twice the level of annual expenses.⁵⁴ One of the most striking conclusions of the study was in the difference between actively and passively managed funds. The total trading costs of actively managed funds averaged 0.48% per year while index funds averaged 0.064% annually.⁵⁵ In other words, investors in actively managed funds incurred trading costs seven times as large as those in index funds! John Bogle, former CEO of the Vanguard Group, has estimated that all costs, including management fees, 12b-1 fees, commissions, trading costs and redemption fees, average at least 2.5% annually.⁵⁶

Current SEC regulations do not require the disclosure of trading costs either as part of the mutual fund expense ratio or separately. Thus, these figures cannot be easily obtained from publicly available documents. When the modest level of disclosure required of mutual funds is compared with the detailed information required to be given to consumers obtaining a mortgage or auto loan, the difference is striking and seems to be without justification.⁵⁷

Another important area in which investors would benefit from enhanced disclosure involves “soft dollar commissions.” Although mutual funds can trade shares of most domestic stocks for about 0.5 cents per share the commissions they pay brokers average about 5 cents per share or ten times that amount.⁵⁸ Of this amount, roughly three cents per share is refunded to the fund manager as so-called “soft dollars” to cover research expenses, which may either be conducted by the broker or contracted out to a third party. The term “research” has been broadly construed to include not only traditional investment analysis but other fund operating expenses such as computer hardware and software, publications, conference registration and travel, accounting and proxy services.⁵⁹ By operating this way the funds are effectively covering a

54. *Id.*

55. *Id.*

56. Strauss, *supra* note 47, at L12.

57. *Id.*

58. Benn Steil, *Get Tough on Soft Commissions*, FIN. TIMES (London), Dec. 20, 2004, at 19.

59. *Id.*

portion of their operating expenses in a manner that does not appear as part of the fund's published annual expense ratio. In other industries such practices would constitute an unlawful kickback. However, this practice is specifically condoned by the SEC in Rule 28(e), issued pursuant to the Securities Exchange Act of 1934, which defines research broadly to include goods or services which assist the advisor in making investment decisions.⁶⁰ The rule effectively creates a "safe harbor which relieves investment advisors from any possible charges of breach of fiduciary duty for not paying the lowest commissions possible." Intense lobbying pressure from the securities industry will make repeal of this rule difficult.⁶¹ Many independent research analysts argue that they would be forced out of business if funds were forced to pay for these services directly and that fund investors would suffer if less research took place. However, given the performance pressures on funds, it is equally plausible to argue that such independent research services are not worth the expenditures which funds are now making on them indirectly. One proposed solution to the disclosure problem is to require that trading costs be included in the annual administration fee charged by the fund manager. This would give fund managers the incentive to limit research and related non-trading expenses to those essential to efficient stock selection and execution of trades. One study estimates that such a rule would cause funds to raise management fees by eighteen basis points, or 0.18%. Thus, if current soft commission practices are costing mutual fund investors about seventy basis points, the net savings to investors would be at least fifty basis points (0.5%) per year.⁶²

Thus far, there has been only limited response to the criticism of soft-dollar commissions. In March 2004, Massachusetts Financial Services announced it would abandon the use of soft dollars to pay for market data and research from broker-dealers.⁶³ This announcement was followed several months later by Fidelity Investments, the largest fund management company, which announced that, beginning July 1, 2004, it was phasing out soft dollar commissions and would pay for market data services out of its own pocket.⁶⁴ However, Fidelity will continue to use

60. Commission Guidance on the Scope of Section 28(e) of the Exchange Act, SEC Release No. 34-45194, 17 C.F.R. pt. 241 (Dec. 27, 2001).

61. *Id.*

62. *Id.*

63. 36 Sec. Reg. & L. Rep. (BNA) 515 (Mar. 22, 2004).

64. Fidelity Phasing Out Soft Dollars for Market Data Services Beginning 7/1, 37 Sec. Reg. & L. Rep. (BNA) 1154 (July 5, 2005).

soft dollars to pay for other research, arguing that the research it receives from sell-side brokerage houses benefits fund shareholders by providing valuable customized research. Chairman Donaldson recently stated that he opposes an outright ban on soft-dollar commissions because they support outside third party investment research, which he believes is a net benefit to investors.⁶⁵ Rather, he favors more limited reforms such as establishing a tighter definition of what types of services may be paid for with soft dollars.

If a major issue for mutual fund investors today is the unnecessarily high fees and other charges levied on their shares, the answer may lie at least partially in innovations spawned by the fund industry itself. Over two decades ago, the Vanguard Fund Group initiated the first widely marketed index fund designed to track the Standard and Poor's Index of 500 industrial stocks. While the Vanguard group has long been known for its low management fees, its fees for index funds were even lower, averaging around 0.20% annually. Furthermore, since an index fund does not attempt to trade the market, its transaction fees are lower than those of actively managed funds. With the widespread publication of data showing that the typical index fund will over the long term, outperform the vast majority of actively managed funds, sophisticated investors have flocked to these funds. In addition to index funds designed to track the broad market averages, index funds that track various more specialized indices covering overseas markets, bonds, REITs and others are now available.

More recently, the creation of exchange traded funds or ETFs, has exerted additional downward pressure on fund fees. These funds, which hold baskets of stocks designed to track market indices, differ from traditional index funds in that they trade continuously on a major stock exchange. Thus, an investor is not limited to purchasing at the closing price each day. This feature essentially eliminates the "stale pricing" problem which led to the late trading scandals discussed above. As with index funds, an ETF's annual fees are typically very low and transaction costs are also sharply reduced from the typical fund since it does not actively trade securities in an attempt to beat the market. The ETF does have one disadvantage for the small investor who wishes to make frequent, regular purchases in small dollar amounts: since ETFs are purchased through a brokerage firm, the investor will have to pay a

65. See Andrew Parker, "Soft Dollar" Fees Look Set to Stay: SEC Chairman Wants Reform of Commissions Rather than Outright Ban: Concerns Raised Over Future of Independent Equity Research, FIN. TIMES (London), Feb. 22, 2005, at 17.

brokerage commission on each purchase thereby raising effective transaction costs. Such an individual would be better off purchasing shares of a no-load index fund directly from a mutual fund company.

ETFs and index funds seem destined to take an increasing share of the mutual fund market as the average investor comes to recognize their benefits.⁶⁶ Nonetheless, at the present time the market share of index funds and ETFs is only around 10% of the total assets of the mutual fund industry. Given the widespread publicity, the low fees and the performance such funds have over most traditional managed funds, this low figure is discouraging. The explanation for it may be simply that the vast majority of mutual funds, like other financial products such as whole life insurance and tax-deferred annuities, are sold and not bought. The average investor, whose knowledge of financial products is relatively limited, may have been attracted to invest in mutual funds by the long bull market run of the 1980s and 1990s. Such investors are easily persuaded by a salesperson to purchase a fund with a high expense ratio when even high annual fees are dwarfed by impressive recent annual appreciation in NAVs. If a fund, for example, boasts an average annual appreciation of 25% over a three year period, the prospective investor is likely to have little or no concern whether the management fee is 1% or 2%.

If there is cause for optimism it is that the bear market of the current decade may sharpen investors focus on fees since they tend to eat up a relatively larger portion of the funds' investment returns. This has already had an effect on several money market funds when, due to the sharp drop in short term interest rates, investors faced the possibility that their net return after fees would be negative. In order to avoid this potential embarrassment, these funds were forced to cut, at least temporarily, their management fees.⁶⁷ The increasing publicity given to fund fees may also be having the desirable effect of putting pressure on fund managers to lower fees. Between January 2004 and March 2005, more than ninety fund companies lowered fees, which was more than double the number in the previous two years combined.⁶⁸

Given the fact that most funds are aggressively sold to investors, perhaps one avenue of reform which would provide the most benefit to

66. See generally Mauldin, *supra* note 45.

67. See Tom Lauricella, *Quarterly Mutual Funds Review: Fund Fees are Falling; Investors Benefit From More Price Competition, Regulatory Settlements and New SEC Rule*, WALL ST. J., Apr. 4, 2005, at R1.

68. *Id.*

investors would be to eliminate conflicts of interest by brokers so that they would be in a position to honestly recommend the most successfully performing funds which met the investment needs of each particular investor. Unfortunately, recent fund marketing practices in which bonuses are paid to brokerage firms for marketing shares of a particular fund family, give a strong incentive to brokers to market the funds which compensate their firm most generously, not those best-suited to the needs of the individual investor. In a recent working paper, Bergstresser, Chalmers and Tufano reported that a study conducted by them showed that if anything, investors fared worse when purchasing funds recommended by a broker than with funds purchased on their own. While funds sold directly trailed their benchmark averages by 1.070% annually on average after expenses, broker sold funds lagged the benchmark averages by an average of 2.282% annually.⁶⁹ One explanation for this phenomenon is that broker sold funds tend to have higher expense ratios than funds sold directly since the funds need to cover higher costs of distribution. However, even after expenses are accounted for, broker sold funds still performed somewhat worse than directly sold funds.⁷⁰ The study noted that there may be some offsetting advantages to purchasing funds through a broker including benefiting from a broker's advice on the suitability of funds for a particular investor's needs, finding hard to locate special purpose funds, and obtaining advice on asset allocation decisions.⁷¹ The benefits of these factors are difficult to quantify and may vary from one investor to another. However, with the difference in performance being indisputable, the burden would seem to be on the brokers to justify the need for their services in choosing funds for investors.

In a welcome reform, the SEC has adopted rule changes which prohibit mutual fund advisors from directing fund portfolio transactions to broker-dealers as payment for promoting the sale of fund shares.⁷² The rule, which amends Rule 12b-1, prohibits selling considerations from influencing an investment advisors decision of how best to carry out transactions in a fund's securities.⁷³ In a welcome turnabout, this reform was supported by the Investment Company Institute which had

69. Lawrence C. Strauss, *Who You Gonna Call?*, BARRON'S, Dec. 20, 2004, at F2.

70. *Id.*

71. *Id.*

72. 36 Sec. Reg. L. Rep. (BNA) 1113 (Aug. 23, 2004).

73. *See* 36 Sec. Reg. L. Rep. (BNA) 293 (Feb. 16, 2004).

previously opposed such reforms.⁷⁴

Conclusion: Recommendations for Further Action

It has been less than two years since the late trading/market timing mutual fund issue was first highlighted by Eliot Spitzer with his investigation of Canary Capital Partners in the summer of 2003. Although initially upstaged by Spitzer, the SEC has moved aggressively since the fall of 2003 with investigations and regulatory reforms of its own. Indeed, the SEC has already implemented more reforms than most observers would have predicted eighteen months ago. While only modest reforms dealing with late trading and market timing have been implemented, the SEC has moved aggressively in other needed areas. First, it has adopted rules to require that a funds chairman be independent of the fund management company, a move adopted over the aggressive opposition of most of the mutual fund industry. Second, it has required each fund to designate a chief compliance officer to review, at least annually, its compliance operations. Third, it has also moved to increase disclosure of fund performance figures and of annual fees. Finally, it has moved to bar directed payments by funds to brokerage houses in an attempt to improve the impartiality of the advice which fund investors will receive in determining which funds are more suitable for their personal needs. While these steps are welcome, and represent significant improvements, more steps need to be taken to ensure that adequate protection for fund investors exists.

Specifically, much remains to be done if investors are to receive the information and protection from conflicts of interest which they rightly deserve. One year ago, a report prepared for the Consumer Federation of America proposed several reforms to increase investor confidence in the fund industry.⁷⁵ Among the steps recommended in this report, which would be highly beneficial and have thus far *not* been implemented, are the following: (1) the creation of an independent regulatory organization to oversee mutual funds; (2) the redefinition of “independent director” to ensure that such individuals are not in fact closely tied to a fund’s management; (3) establishing a fiduciary duty on fund managers to ensure that all fees, including offering fees paid to broker/dealers are

74. See 35 Sec. Reg. L. Rep. (BNA) 2014 (Dec. 22, 2003).

75. Mercer Bullard & Barbara Roper, *A Pro-Investor Blueprint for Mutual Fund Reform*, CONSUMER FED’N OF AM., http://www.consumerfed.org/mutual_fund_reform_blueprint1.pdf (last visited Oct. 19, 2005).

reasonable (current law imposes a fiduciary duty only with respect to fees received by the manager); (4) reform sales practices to ensure that brokers must make full disclosure of all compensation which they receive from a fund manager prior to the sale to an investor and require the delivery of a fund profile prior to the sale; (5) require the disclosure of all compensation received by the broker for the sale of a fund prior to the sale; (6) increase disclosure of mutual fund fees to include all transaction costs and to include such transaction costs in the expense ratio; (7) eliminate 12(b)-1 fees as a separate item altogether and provide investors with a full breakdown of how the fees charged are spent, whether for marketing, trading, overhead or other purposes; (8) require disclosure of how fees charged by one fund compare with the average, high and low fees charged by other funds, including index funds and exchange traded funds in a manner similar to the way energy efficiency statistics are now required to be included on home appliances; (9) prohibit soft dollar commissions entirely and require separate payment for amounts currently paid with soft dollars.

Also, in early 2004, a bipartisan group of Senators introduced the Mutual Fund Reform Act of 2004, legislation which proposed several significant reforms.⁷⁶ While the bill's proposal requiring a majority of funds directors to be independent has been implemented by the SEC through the rulemaking process, its proposal creating specific guidelines regarding the fiduciary duties of directors has not. Currently, fiduciary duties are so broadly defined as to be "almost meaningless," according to Senator Peter Fitzgerald (R-Ill), one of the bill's sponsors.⁷⁷ Strengthening fiduciary duties is one of the key elements remaining for effective mutual fund reform. The bill would also specifically require the disclosure of transaction costs and operating expenses, thus going considerably farther than the current SEC rules. Finally, the bill would prohibit soft dollar commissions, going far beyond current SEC backed reforms altogether.

In conclusion, the need for further reform remains in two major areas. First, there is a need for greater and more effective disclosure of fund charges and greater transparency in the manner in which funds operate. While it is probably overly optimistic to expect that this will make a dramatic difference in investors' preferences for one fund over another, at least it will make it possible for the investor who does care

76. 36 Sec. Reg. L. Rep. 299 (Feb. 16, 2004).

77. *Id.* at 300.

about costs and conflicts of interest to determine how efficiently a particular fund is managed vis-a-vis its competitors. A generation ago, funds with a front end sales load averaging 6% was the norm. Due to increasing publicity and competitive pressures, the no-load fund has replaced the load fund as the norm in the fund industry. Also, the increasing popularity of index funds and ETFs, while still not a majority of fund sales, shows that there are, in fact, investors who are sensitive to the importance of mutual fund expenses and sales charges as an important component of a fund's long-term relative performance. Further education and disclosure, through both the financial press and fund prospectuses, should increase the pressure on funds to operate efficiently and in furtherance of the fiduciary duty which they owe to their investors.

Second, in order to protect less sophisticated investors from being sold unsuitable funds with high fees and mediocre performance, the need exists for the strengthening of fiduciary duties owed by fund managers and financial advisors to ensure that they put investors' interests ahead of their own. With the defined contribution retirement plan rapidly becoming the primary vehicle for retirement savings for millions of individuals, the need for strong and effective mutual fund regulation now is more compelling than it has ever been.