

MUTUAL FUND SCANDALS

I. History

The past 20 or so years saw tremendous growth in the mutual fund industry. This growth resulted from investor confidence, which in turn resulted from the high standards associated with the industry – standards that included putting the investor first. Unfortunately, putting the investor first has fallen by the wayside in many funds' operating procedures and trouble has begun to brew. Two practices at the heart of these troubles are abusive market-timing, also called rapid trading, and late trading, which is illegal.

Let's start with a basic explanation about how these practices occur. From the beginning, we should establish that mutual funds set their prices once a day, which makes them likely targets for attempts to manipulate the sudden changes in the marketplace. This valuation, called the Net Asset Value or NAV, is done at 4 p.m. when the New York market closes and is based on the value of the underlying securities in the fund.

Late trading occurs when mutual fund shares are purchased after 4 p.m. at a price that does not reflect post-market-closing events, for instance, the announcement of corporate earnings. For obvious reasons, this practice is illegal, specifically prohibited by the Martin Act and SEC regulations. A common illustration used for late trading is betting on a horse race after the horses have crossed the finish line, according to New York Attorney General Eliot Spitzer.

Market-timing, on the other hand, is not an illegal practice but most mutual fund companies claim to discourage or even prohibit it. Unfortunately, the truth is that this is a

common practice that is abused on a wide scale. Market timing, also referred to as rapid trading, is a form of arbitrage that seeks to exploit stale prices. Prices can be stale because all open-ended mutual funds value their portfolios each day, typically at 4p.m. eastern when the market closes. See SEC Rule 22c-1, 17 C.F.R. 240.22c-1. All purchases or redemptions made during the 24 hours prior to the 4p.m. market close are transacted at the next asset value (NAV) per share determined at that time. If the 4 p.m. price undervalues the fund an investor could buy at the cheap price and redeem at the next day's price when the fund had eventually adjusted its NAV to reflect market developments.

International stock funds are the most susceptible to market timing. Due to time differences foreign markets may have been closed up to 15 hours by the 4 p.m. valuation point. The closing prices in those foreign markets will often be stale. Therefore, if there have been significant developments in the U.S. in the interim, it is usually predictable which way those foreign stocks will move when they open in a few hours for trading over seas.

This causes a detrimental effect on long-term shareholders for whom mutual fund investors are designed, such as retirees and "buy and hold" investors. The NAV price of the mutual fund, set at the 4 p.m. market close, does not reflect the current market value of the stocks held by the mutual fund. When a "market timer" buys mutual funds at the stale NAV, it realizes a profit when it sells those shares at a later time, thereby diluting the value of shares held by long term investors. The short-term trading drives up transaction costs for all investors in the fund and provides an unfair advantage to timers.

Shareholders suffer injury from market timing in two distinct ways. First a shareholder's gains are diluted because they must be shared with the in-and-out market timers. Second their mutual fund must maintain an artificially high case level in their portfolio to handle the predictable redemptions when the market timer cashes out in a day or two. So, although this practice is not illegal, it may still qualify as fraudulent when a fund violates its own stated policies to allow it, or when the trader is someone with a duty to protect the fund's shareholders, which will be mentioned later in our discussion of causes of action.

In response to these mounting troubles, corrective measures are being taken on several fronts. Let's briefly look at the steps that are being taken:

A. Legislative Action:

In response to these issues, Congress is developing legislation that will curb these practices and restore investor confidence in the mutual fund industry. In November, the U.S. House of Representatives voted overwhelmingly (four-hundred-and-eighteen to two votes) to approve new legislation mandating harsher penalties for rule violations and greater disclosure for investors. The legislation, proposed by Representative Richard Baker, R-La., makes directors on fund company boards more independent from fund managers. The legislation also speaks directly to the practice of market-timing. According to Baker, the aim of the new measure was to "help bring the bright light of truth into fund fees, clean up the way funds are managed, and eliminate the conflicts of interest and utter disregard of [fund directors'] duty to mutual fund investors that plague this industry." The Senate has not yet approved the legislation, where several different versions have been proposed. Senator Joseph Lieberman, D-Conn, a co-sponsor of one

of the Senate proposals, has also weighed in on the issue, stating, “More must be done to assure mutual fund investors that their trust has not been misplaced.”

B. SEC Regulatory Action:

The SEC is taking its own steps to stop these abuses. They launched a comprehensive survey in September, discovering that late trading was surprisingly common, despite its illegality. It found that a quarter of the nation’s largest brokerage houses helped clients trade mutual funds after hours. Other information also suggests that employees at 10% of the fund companies knew some customers were violating the rules against late trading.

Additionally, half of the 88 largest mutual fund companies had arrangements that allowed select customers to use market-timing. Despite their claim that they discourage these quick in-and-out trades by imposing high fees, the survey found that some companies cut special deals with wealthy investors that may have violated disclosure rates.

The SEC survey further uncovered that about 70% of the brokers said they were aware that some of their customers were timing the market and 30% said their employees had helped clients carry out that task.

As a result, the SEC plans to make changes in how fund companies govern themselves and other areas through new rules it will be considering in the coming months. These changes include a requirement that board chairmen of fund companies be wholly independent from the companies managing the funds. This is a reversal of the SEC’s previous position.

Also, 75% of the directors sitting on a fund company board would have to be independent, up from the currently required 50% of directors.

In early December, the SEC voted to demand mutual funds have a “hard close” to end late trading and abusive market-timing. According to the proposal, a mutual fund should receive purchase or transfer orders before 4 p.m. or by the time the fund has established for calculating the NAV.

A key to the enforcement of these rules will be the designation by the funds of a chief compliance officer who must “answer to, and be accountable to the fund’s board of directors.” The funds were given nine months to accomplish this rule after its publication in the Federal Register.

Finally, the new rule would require funds to disclose market timing policies and procedures, how they determine “fair valuation” and their policies about disclosing their own portfolios.

C. State Action:

Investigations are being conducted by several states to determine the extent of these illegal trading schemes. The most reported is the investigation already underway by New York Attorney General, Eliot Spitzer. His office began the investigation in early 2003 and quickly zeroed-in on late trading and market-timing. Specifically, evidence was discovered pointing to several fund companies that gave special trading opportunities to the hedge fund Canary Capital Partners. Those mutual fund firms included Bank One Corporation, Janus Capital Group, Inc., Strong Capital Management, Inc., and Bank of America Corporation. In September 2003, a complaint was filed against Canary Capital

Partners and its managing principal, Edward Stern. In exchange for settling the charges, Canary agreed to pay \$30 million in restitution and a \$10 million penalty.

Attorney General Spitzer has also joined with SEC Director of Enforcement in charges against other 'bad actors' that include Theodore Sihpol, III, a Bank of America broker and Steven B. Markovitz, a former executive and senior trader with Millennium Partners, L.P. As many as 11 other hedge funds have also received subpoenas for information regarding these practices.

Other states are also taking a close look at the mutual fund industry. Massachusetts' Secretary of the Commonwealth has filed numerous complaints against fund firms, fund executives, and brokerage employees in the effort to increase investor protections. Colorado Attorney General Ken Salazar announced in December that his Office filed suit against INVESCO Fund Group, Inc. for engaging in market-timing and they are seeking an injunction, penalties and restitution.

More charges continue to be levied against other fund families and those involved in the industry as the burgeoning investigation is broadened to include additional hedge funds.

II. CAUSES OF ACTION

1. FEDERAL SECURITIES LAWS

The federal securities laws include anti-fraud provisions which contain private rights of action for defrauded investors.ⁱ These laws provide a cause of action in the event that a mutual fund manager engages in any scheme to defraud, makes untrue statements or material omissions, or engages in any practice that deceives the investor. This includes misrepresentation or failure to disclose information necessary in the context of the

statements, and numerous other instances in which a manager abuses a customer's account. Specific causes of action include:

a. Violation of Section 17(a) of the Securities Act:

- Ex.: Mutual Fund directly and indirectly, acting intentionally, knowingly or recklessly, in the offer or sale of securities by the use of the means or instrumentalities of transportation or communication in interstate commerce or by use of the mails: (a) employed devices, schemes, or artifices to defraud; (b) obtained money or property by means of untrue statements of material fact or omissions to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; and (c) engaged in transactions, acts, practices or courses of business which operated as a fraud or deceit upon purchasers of securities.ⁱⁱ

b. Violations of Section 15(c)(1) of the Exchange Act:

- Ex.: Mutual Fund (a) employed devices, schemes or artifices to defraud; (b) made untrue statements of material fact or omitted to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in acts, practices or courses of business which operated as a fraud or deceit upon certain persons.ⁱⁱⁱ

c. Violations of Rule 22c-1 Promulgated Under Section 22(c) of the Investment Company Act of 1940:

- Ex.: Mutual Fund sold, redeemed or repurchased the shares of registered investment companies at prices not based upon the current net asset value of such securities computed after receipt the orders to sell, redeem, or repurchase the shares of such registered investment companies.

2. STATE BLUE-SKY LAWS

Several state securities laws, referred to as "blue sky" laws, contain anti-fraud provisions which include private rights of action.^{iv} These tend to follow the federal provisions as to prohibited stockbroker activity, in particular in those states which have adopted the Uniform State Anti-Fraud Securities Act. However, it should be noted that certain states do not include a private right of action for individual investors under their state blue-sky laws. Investors in such states must rely upon the federal causes of action and common law rights.

3. CONSUMER PROTECTION STATUTES

Some state consumer protection laws cover securities investing among the protected activities.^v Certain states specifically include securities trading under their Unfair and Deceptive Trade Practices Act, and provide a private remedy for defrauded

investors. In these states, the typical claims of securities fraud will generally also constitute prohibited unfair and deceptive trade practices under that state law.

4. FRAUD AND MISREPRESENTATION

A claim of securities fraud will generally include a common law claim of fraud and misrepresentation.^{vi} General elements of the common law action for fraud and deceit are that there was a false representation of a material fact with knowledge of the falsity for the purpose of inducing the investor to act, and that the investor relied upon the representation as true and acted upon it to his detriment. Although there generally must be a statement or representation for fraud to occur, a "mere omission" may constitute fraud if there was a duty to disclose the fact omitted. In most jurisdictions the requirement that the action was "knowing or intentional" is satisfied by reckless conduct.

5. NEGLIGENCE AND MALPRACTICE.

The cause of action for negligence or malpractice is based upon the duty owed by a broker to the customer and the breach of that duty, including the duty to exercise due care in connection with the mutual fund account.^{vii} Even if a manager did not have actual knowledge as to the falsity of statements which he made, his activity may constitute negligent misrepresentations. There may also be negligent management of an account, or negligent supervision in failing to implement or enforce supervisory and compliance procedures. Federal securities laws and NASD and Exchange rules require brokerage firms to reasonably supervise their brokers for the purpose of preventing violations of the

rules and regulations of the securities industry. In order to satisfy its obligations, a brokerage firm must show not only that they had in place supervisory and compliance rules and procedures, but also that they effectively implemented and enforced their compliance rules and procedures so as to diligently supervise the activities of the brokers. Related to the cause of action for failure of supervision is the secondary liability of a brokerage firm for the acts of their agents under the statutory "control person" provisions and the common law doctrine of respondeat superior holding the employer liable for the wrongful acts of the employee acting within the scope of employment.

6. BREACH OF CONTRACT

A cause of action for breach of contract may arise from the Prospectus.^{viii} These standard documents generally require the mutual fund family to be handled in accordance with the rules and regulations of the securities industry and self-regulatory organizations. A breach of contract claim may also be based upon a failure to follow the customer's instructions. Mismanagement of the account may also be included in a breach of contract claim based upon implied warranties to handle the account with due care and diligence. A breach of an implied covenant of good faith and fair dealing may also provide the basis of a cause of action for breach of contract. This cause of action has been set out in the following way^{ix}:

- A contract, impress or implied, existed between Plaintiff and the Mutual Fund Family, in the form of the Prospectus;

- Mutual Fund covenanted to protect the Plaintiff from the adverse impact of late trading;
- Mutual Fund breached these covenants when it permitted favored investors to engage in late trading at the expense of the Plaintiff;
- Mutual Fund's breach caused Plaintiff to suffer damages.

7. BREACH OF FIDUCIARY DUTY

The relationship of trust and reliance between the customer and the mutual fund managers and employees gives rise to a fiduciary relationship in many jurisdictions.^x A fiduciary, like a trustee, is subject to a degree of duty that obligates the fiduciary to act in a diligent and faithful manner to further the customer's best interests. A fiduciary is held to rigorous duties of good faith, loyalty, care, and candor, and must conduct himself with the utmost integrity. Since investors are encouraged to place their trust and confidence in their mutual fund investment, relying upon mutual fund managers for expertise in making the investment decisions, the mutual fund management is held to this high standard. This cause of action has been set out in the following way.^{xi}

- Defendants breached their fiduciary duties by permitting mutual fund managers to engage in market timing.
- Defendants breached their fiduciary duties by failing to take appropriate action to discourage or prevent market timing.
- Defendants favored their own interests over the interests of investors.

8. UNJUST ENRICHMENT

Unjust enrichment is an equitable doctrine that a person shall not be allowed to profit or enrich himself inequitably at another's expense. It applies when a person has something of value at another person's expense under circumstances that impose a legal duty of restitution. BLACK'S LAW DICTIONARY (4th Ed. 1951), p. 1705. This cause of action has been set out in the following way:

- Defendants have received a benefit through permitting market timing and failing to discourage, prevent or stop such market timing.
- Defendants received such benefit at the expense of plaintiffs.
- Defendants received such benefit under circumstances that would make it unjust for defendants to retain such benefit without payment.

ⁱ See generally, Garry S. Miller: *Securities Fraud & Investor Protection* (last visited January 29, 2004) <<http://www.securitieslaw.com/causesofaction.html>.

ⁱⁱ U.S. Securities and Exchange Commission (last visited January 29, 2004) <<http://www.sec.gov/litigation/complaints/comp18489.htm>>

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- iii Id.
iv See id. <<http://www.securitieslaw.com/causesofaction.html>.>
v Id.
vi Id.
vii Id.
viii Id.
ix See Lepera v. INVESCO FUNDS GROUP, INC., complaint.
x See id. <<http://www.securitieslaw.com/causesofaction.html>.>
xi See Lepera v. INVESCO FUNDS GROUP, INC., complaint.