MUTUAL FUND SCANDALS

I. Introduction

The past 20 or so years saw tremendous growth in the mutual fund industry.[1] According to some reports, as many as 95 million Americans own shares of mutual funds.[2] A key factor in this growth was 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. Two practices that evidence this deviation are late trading, which is illegal, and market timing, which is not illegal but easily abused and therefore strongly discouraged. Another practice gaining attention is the push by fund families to encourage and reward representatives for promoting and selling proprietary mutual funds without disclosing to client investors the financial incentives. A fourth issue that investors have only recently turned their attention on is the excessive fees being charged by several of the major fund companies. All of these practices, and possibly others, have destroyed the "squeaky clean image" mutual funds have long enjoyed and tarnished their reputation. Based on these findings, it has become obviously clear that big financial institutions are cutting corners and maybe worse to win business. These practices potentially cost mutual fund shareholders billions of dollars annually.

The following paragraphs give a basic explanation of how the practices of late trading and market timing 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 SEC regulations.[3] 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.[4]

Market timing, on the other hand, is not an illegal practice though most mutual fund companies claim to discourage or even prohibit it.[5] Unfortunately, on-going investigations are showing that it is in fact a common practice and is abused on a wide scale.[6] Here is how market timing works: quick-turnaround traders trade in and out of certain mutual fund in order to capitalize on temporary price anomalies. This causes a detrimental effect on long-term shareholders for whom mutual funds are designed, such as retirees and long-term 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. For example, a fund made up of international stocks might be based on "stale" pricing due to international time differences. The short-term trading drives up transaction costs for all investors in the fund and provides an unfair advantage to timers. So, although this practice is not illegal, it may still qualify as fraudulent when a fund violates its own stated policies to disallow 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.

The issues surrounding proprietary mutual funds involve high-pressured sales tactics used to sell a fund's proprietary products over other non-proprietary external funds.[7] These sales tactics, geared toward the fund's registered representatives or "financial advisors," include sales contests, hidden compensation, such as travel and expense reimbursements, business development dollars, and most offensive, a higher compensation pay-out for selling a fund's proprietary products. The problem with all of this is the fund's failure to disclose any of these financial incentives to its client investors. To add injury to insult, those involved took aggressive measures to conceal these conflicts of interest.[8]

Federal regulators are also looking into the legality of fees that are charged by fund companies. At this time, the focus is on index funds which use a computer program to purchase the exact mix of stocks or bonds to replicate Standard & Poor's 500 or another major indicator. The investigations have found that in many cases, these charges are done in such a way as to make it difficult and even impossible for investors to detect.

The SEC has recently requested information from several index funds that seem to be paying high commissions to the brokerage firms that buy and sell stocks for them. These payments reduce the investors' returns but are not disclosed in the funds' reported fees. "In actively managed funds, [the manager] can say, 'The fees are high because I am worth it.' Its hard to make that argument with an index fund," said SEC Enforcement Division Director Stephen M. Cutler.[9]

II. Causes of Action

Most of the recent mutual fund class actions are premised in late trading and market timing activities, which as previously discussed, are unlawful or deceitful actions designed to financially benefit short-term investors in detriment of long-term investors. Injured plaintiffs are afforded causes of action under federal and state laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Act of 1940, the Investment Advisers Act of 1940, state Blue Sky Laws and common law theories.

A. Federal Securities Laws

The federal securities laws include anti-fraud provisions that contain private rights of action for defrauded investors.[10] These laws provide for a cause of action in the event that a mutual fund officer engages in any practice that deceives an investor. Specific causes of action include:

1. Violation of Section 11 of the Securities Act of 1933

Section 11 of the Act of 1933 imposes liability on select individuals for material misstatements that appear in a registration statement.[11] The section limits liability to the following class of persons:[12]

a. persons who sign the registration statement, present and certain future directors, underwriters;

b. accountants, engineers, or appraisers, or any other professional who certifies any part of the registration statement; and

c. any person who has prepared or certified any part of the registration statement, or has prepared or certified any report or valuation used in connection with the registration statement, whose profession gives him authority to do so. Ex.: an attorney's conduct as an "expert" with respect to the registration statement may make him liable under section 11.[13] A cause of action under Section 11 has been pleaded as:[14]

- Statements contained in the Prospectuses were materially false and misleading for a number of reasons, including that they stated that it was the practice of the Fund to monitor and take steps to prevent timed trading because of its adverse effect on fund investors, when in fact, select investors were allowed to engage in timed trading and traded at the previous day’s price. The Prospectuses failed to disclose and misrepresented material and adverse facts.

2. Violation of Section 15 of the Securities Act of 1933

Section 15 states that every person who controls any person liable under Section 11 or 12 shall also be liable jointly and severally with and to the same extent as such controlled person. However, no liability attaches if the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist. A cause of action under Section 11 has been pleaded as: [15]

- Each individual of the fund management was a “control person” within the meaning of Section 15 of the Securities Act, by virtue of its position of operational control and/or authority over the Fund. They had the power, directly or indirectly, and exercised that power, to engage in this wrongful conduct, and participated in the issuance of materially false and misleading statements in the prospectuses.

3. Violation of Section 10(b) of the Exchange Act and Rule 10b-5

Perhaps the most well known securities regulation is Rule 10b-5, promulgated pursuant to Section 10b of the 1934.[16] The Rule is commonly used in the area of securities law, and most every securities fraud case involves Rule 10b-5. A cause of action under Rule 10b-5 has been pleaded as follows: [17]

- Defendants employed schemes to defraud; made untrue statements of material fact or omitted material facts; and engaged in acts, practices, and a course of business which operated as a fraud and deceit upon the purchasers of the funds' securities. This was done in an effort to enrich defendants through undisclosed, manipulative trading tactics by which they wrongfully appropriated assets and otherwise distorted the pricing of their securities in violation of Section 10(b) of the Exchange Act and Rule 10b-5.

4. Violation of Section 20(a) of the Exchange Act

Section 20(a) provides a private right of action based on "contemporaneous trading." That is, "any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction. . . ." A cause of action under Section 20 has been pleaded as: [18]

- Each defendant acted as a controlling person within the meaning of Section 20(a) of the Exchange Act. Because of their operational and management control and their systematic involvement in the fraudulent scheme alleged herein, each defendant had the power to influence and control, and did in fact influence and control, directly or indirectly, the decision-making and actions of the Funds, including the content and dissemination of the various statements which plaintiffs contend are false and misleading. Defendants had the ability to prevent the issuance of the statements alleged to be false and misleading or to correct these statements.

5. Violation of Section 36(a) of the Investment Company Act

The language of Section 36 only expressly allows the Securities and Exchange Commission to bring suit.[19] "Despite that clear language, four Courts of Appeals have found an implied private right of action. Lest there be any doubt concerning the private right of action, Congress, in 1980, amended the ICA in the Small Business Investment Incentive Act, and evidenced a clear intent for courts to imply a private cause of action in § 36."[20] A cause of action under Section 36(a) has been pleaded as such: [21]

- Defendants have breached their fiduciary duties by, among other things, devising this plan and scheme solely for their own benefit and by failing to reveal to them material facts that would allow them to make informed choices about the true value and performance of the Mutual Fund.

6. Violation of Section 36(b) of the Investment Company Act

Section 36(b) addresses compensation or payments as a basis of fiduciary duty. A cause of action under Section 36(b) has been pleaded in the following way: [22]

- Defendants have breached their fiduciary duties by, among other things, devising and implementing a scheme to obtain substantial fees and other income for themselves and their affiliates by allowing the mutual fund to engage in timing in return for substantial fees and other income.

7. Violation of Section 206 of the Investment Advisers Act of 1940

In general terms, Section 206 prohibits the employment of any device, scheme or artifice to defraud a client or a prospective client. A cause of action under this section has been pleaded as follows:

- Mutual Fund Management breached its fiduciary duties owed to plaintiffs by engaging in a deceptive contrivance, scheme, practice and course of conduct pursuant to which it knowingly and/or recklessly engaged in acts, transactions, practices and courses of business, which operated, as a fraud upon plaintiffs. Defendants secretly engaged in timed trading of shares, with the purpose and effect of enriching defendants at the expense of plaintiffs.

B. State Blue Sky Laws

Several state securities laws, referred to as "Blue Sky" laws, contain anti-fraud provisions, which include private rights of action.[23] Although these state Blue Sky laws can vary widely in their terms and scope, most states have adopted some form of the Uniform Securities Act.[24] "The 1933 Act, the 1934 Act, and the state Blue Sky laws are not mutually exclusive--an issuer could conceivably be subject to all three in a single transaction."[25]

In general terms, state Blue Sky Laws regulate the securities trade in three ways:[26] First, most state statutes contain antifraud provisions. Second, many statutes require that persons engaged in the securities business be licensed or registered. Finally, some states also require that the securities themselves be registered or licensed. Specific provisions of individual Blue Sky laws are beyond the scope of this article.

C. Consumer Protection Statutes

Some state consumer protection laws cover securities investing among the protected activities.[27] 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.

D. Common Law

In certain cases, a common law cause of action may be applicable. In the majority of states, this includes fraud and misrepresentation, negligence, breach of contract, breach of fiduciary duty, and unjust enrichment.[28]

1. Fraud And Misrepresentation

A claim of securities fraud will generally include a common law claim of fraud and misrepresentation.[29] 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.

2. Negligence And Professional 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.[30] 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, 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. 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.

3. Breach Of Contract

A cause of action for breach of contract may arise from the Prospectus.[31] 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[32]:

- A contract, express 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; and
- Mutual Fund's breach caused Plaintiff to suffer damages.

4. 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.[33] 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.[34]

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

5. Unjust Enrichment

Unjust enrichment is the retention of a benefit conferred by another, without offering compensation, in circumstances where compensation is reasonably expected.[35] This cause of action has been set out as follows[36]:

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

III. Remedies

A. Blue Sky Remedies

The sale of securities in the United States is regulated by two major schemes, federal and state.[37] The state Blue Sky laws are usually more liberal to the aggrieved purchaser of securities than federal laws.[38] One of the principal remedies available to plaintiffs under state Blue Sky laws is that of rescission, "namely to rescind the purchase of securities and restore the tendered consideration to the plaintiff purchaser or investor."[39] The basic elements that give rise to the remedy of rescission in Blue Sky laws are:[40]

> (1) there is a violation of the state securities laws of the rules and regulations promulgated thereunder by the state regulatory authorities;
>
> (2) the plaintiff or plaintiffs did not knowingly participate in the violation; and
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> (3) the plaintiff or plaintiffs did not at the time of the transaction have knowledge of the violation.[41]

In addition, state Blue Sky laws expressly provide for attorneys' fees to the successful plaintiff.[42]

B. Federal Law Remedies

Federal securities laws provide plaintiff with various remedies.[43] Some provisions of the Securities Act and the Exchange Act provide express remedies, while in other situations, courts develop remedies through implied rights of action, such as in SEC Rule 10b-5 actions.[44] Because the remedies provided under the securities laws are not exclusive, additional remedies such as equitable relief and arbitration are also available.[45]

b.1. Equitable Relief

An equitable remedy available to a claimant is rescission. Rescission seeks to place claimant and respondent in the position they were in before the fraud occurred, "that is, to undo the bargain".[46] If the investor-claimant elects rescission and is still in possession of the mutual fund share, the defrauded purchaser tenders the securities back to the seller.[47] "The seller returns the purchase price, subject to appropriate offsets for monies received through ownership of the security, i.e., dividends or interest."[48] Where rescission is technically impossible, e.g., in the event the claimant has sold his shares, rescissory damages may be available.

b.2. Damages

"Recovery of damages is a remedy which is expressly prescribed by several sections of the federal securities acts, which may also specify the elements and measure of recovery."[49] It should be noted that section 28(a) of the Exchange Act states that "no person permitted to maintain a suit for damages shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages."[50] However, "several measures of damages are consistent with this limitation and may be recovered, for instance, in an SEC Rule 10b-5 action, but it is sufficient to say that speculative, remote, or conjectural damages cannot be recovered."[51]

IV. Securities Arbitration

It is typical of brokerage firms to compel their clients to execute arbitration agreements as a condition of doing business. The United States Supreme Court in Shearson/American Express, Inc. v. McMahon[52] upheld the validity of pre-dispute arbitration agreements under the Securities Exchange Act of 1934 between brokerage firms and their customers.[53] In certain cases, arbitration may be beneficial to the defrauded investors. Increasing evidence shows that many investors emerge victorious from arbitration, even recovering punitive damages in appropriate cases.[54] The lack of intensive pre-trial discovery, the more expeditious time frame in which arbitration proceeds and the informality of pleading rules are attributes of the arbitration process.[55] This “may favor the public investor who cannot match the brokerage firm's litigation resources.”[56]

V. History: How the Scandal Broke

A. State Action

Although many were not aware of the problems in the mutual fund industry until last fall, investigations around the country began as early as last spring and possibly before. One such investigation in Massachusetts began last March when regulators received an anonymous complaint from a broker in Boston regarding the pressure tactics discussed above being used at Morgan Stanley’s Back Bay Branch to sell proprietary funds.[57] Morgan Stanley responded to these inquiries in a written statement filed on May 8 denying that brokers and branch managers received special compensation for selling certain funds without disclosing the financial incentive to investors. Further investigation revealed evidence to the contrary and as a result, regulators filed a complaint on July 14 against Morgan Stanley alleging the firm’s May 8 filing was false and misled regulators when it denied the use of financial incentives.[58]

On the same day, Secretary of the Commonwealth of Massachusetts William Francis Galvin and New York Attorney General Eliot Spitzer announced a joint inquiry into Morgan Stanley’s pressuring of brokers to sell proprietary mutual funds to investors.

Specifically, they intended to determine the extent of these practices within the Morgan Stanley firm and whether the practices also exist at other Wall Street firms.[59]

The resulting action from the joint inquiry was an administrative complaint filed against Morgan Stanley on August 11, 2003 by the Massachusetts Securities Division. The complaint alleged that, "Registered representatives of the broker-dealer Morgan Stanley engaged in illegal activities involving high pressured sales tactics to sell Morgan Stanley proprietary products, including but not limited to Morgan Stanley and Van Kampen mutual funds over other non-proprietary external funds."[60]

New York Attorney General Eliot Spitzer's office has also actively pursued investigations regarding other abuses within the mutual fund industry. As a result, he announced on September 3, 2003 that these investigations had discovered evidence of widespread abuses primarily dealing with the practices of 'late trading' and 'market timing.' These practices cost mutual fund shareholders billions of dollars annually. At that time, Spitzer acknowledged that the "full extent of this complicated fraud is not yet known."[61]

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 the SEC Director of Enforcement, Stephen M. Cutler, in charging other 'bad actors' involved in the scandals. On September 16, 2003, Spitzer released a statement announcing state criminal and federal civil charges against Bank of America broker, Theodore C. Sihpol, III, who oversaw Bank of America's Nations Fund Family. The allegations stemmed from his role in permitting Canary to engage in late trades. Sihpol was key in landing Canary as a Bank of America client and in one memorandum, he speculated how valuable Canary's business could be to his employer. He even went so far as to have Bank of America install a computer system at Canary's office to assist them in their late trading.[62]

Another individual implicated in the scandal is Steven B. Markovitz, a former executive and senior trader with Millennium Partners, L.P. Markovitz pleaded guilty to violating New York's Martin Act as a result of his participation in late trading.[63] A violation of the Martin Act is a felony and punishable by a maximum of four years in prison.[64] The SEC filed separate civil charges alleging that Mr. Markovitz committed securities fraud. Without admitting or denying the SEC's charges, he has agreed to a lifetime bar from association with an investment adviser or mutual fund. He also agreed to abstain from working with or for a registered investment company.[65]

Other action taken by New York Attorney General Spitzer include the following:[66]

- Arrest, conviction and lifetime industry bar of James Connelly, Jr., former Vice Chairman and Chief Mutual Fund Officer at Fred Alger & Company, Inc. for offenses relating to his involvement in market timing.
- Coordinated action with the SEC against the founders of the Pilgrim-Baxter funds for market timing
- Coordinated action with the SEC and the Office of the Comptroller of Currency against three senior executives of Security Trust Co., N.A. for late trading.
- Coordinated action with SEC against Invesco Funds Group and its chief executive officer for market timing.
- Arrest of Paul Flynn, former Managing Director of Equity Investments at Canadian Imperial Holdings, Inc., a subsidiary of Canadian Imperial Bank of Commerce (CIBC) for late trading and market timing.
- Action against Massachusetts Financial Services (MFS) for market timing resulting in a $350 million settlement, a portion of which will go to compensate current and past investors.
- Coordinated action with SEC against Alliance Capital Management for market timing resulting in a $600 million settlement, of which $150 million will compensate affected shareholders and $100 million will be a penalty.

Other states are also taking a close look at the mutual fund industry. Colorado Attorney General Ken Salazar announced on December 2 that his Office filed suit against Invesco Fund Group, Inc. for engaging in market timing and they are seeking an injunction, penalties and restitution.[67] He also confirmed on December 18 that his office had been investigating and begun settlement negotiations with Janus Capital Group for market timing activities.[68]

California is actively investigating whether fund companies have defrauded investors by not disclosing deals in which brokers received compensation for recommending certain funds.[69] Tom Greene, the chief assistant attorney general, was recently chosen by California Attorney General Bill Lockyer to head the investigation. At this time, their investigation is centering on three California-based firms: Pacific Investment Management Co. (Pimco), Capital Group Cos., which runs the American Funds, and Franklin Resources. Attorney General Lockyer believes that others may join these three as the investigation continues.[70] These three are among the five biggest firms in the business and have, until recently, had a stellar reputation. It is likely that they will claim they were following industry guidelines or that the obligation to disclose this information lies at the feet of the brokers who meet with clients face to face.[71]

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

B. Legislative Action

In response to the issues surrounding the industry, Congress is developing legislation that will curb these practices and restore investor confidence. 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."[72] 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."[73]

C. SEC Regulatory Action

The SEC is taking its own steps to prevent further abuses. They launched a comprehensive survey in September 2003, discovering that late trading was surprisingly common, despite its illegality.[74] 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.[75]

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.[76]

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.[77]

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.[78]

Also, 75% of the directors sitting on a fund company board would have to be independent, up from the currently required 50% of directors.[79]

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.[80]

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."[81] The funds were given nine months to accomplish this rule after its publication in the Federal Register.[82]

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.[83]

VI. Conclusion

In conclusion, it's important to reiterate that these practices impose extraordinary costs on ordinary shareholders and more steps should be taken to prevent them from being practiced. The practices of a few have eroded the former "squeaky clean image" mutual funds have enjoyed for a long time. And it will take a long time for investor confidence to return to the height it was at prior to the breaking of these scandals. It is also necessary to point out that not every fund within a family has been invaded by these practices. In fact, in most instances only a few funds within a family have been affected. Finally, these are complex cases that must be investigated and tried with extreme care and diligence. It is best to associate someone with experience in these matters.

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[1] Paul G. Haaga, *Mutual Integrity, Mutual Trust*, (visited Jan. 27, 2004). <http://www.ici.org/statements/remarks/03_haaga_soft_oped.html#TopOfPage>

[2] Brooke Masters, *State of the Mutual Fund Industry*, WASHINGTON POST, Jan.12, 2004, available at <http://www.washingtonpost.com/wp-dyn/articles/A9761-2004Jan12.html>

[3] See <www.oag.state.ny.us/press/2003/sep/sep03a_03.html>

[4] See <www.oag.state.ny.us/press/2003/sep/sep03a_03.html>

[5] Mark Hulbert, Market Timing's Effect on Funds, New York Times, Sept. 7, 2003, available at <http://home.flash.net/~factoids/fact2/f0309b.htm>

[6] Meg Richards, *Spitzer's Charges Mutual Funds With Illegal Trading Schemes*, Sept. 4, 2003, available at <http://home.flash.net/~factoids/fact2/f0309b.htm>

[7] See In the Matter of Morgan Stanley DW, Inc., (filed by the Massachusetts SEC on August 11, 2003), complaint.

[8] Id.

[9] Brooke A. Masters, *SEC Studies Legality of Fees at Some Index Funds*, WASHINGTON POST, Feb. 7, 2004, available at <http://www.washingtonpost.com/wp-dyn/articles/A20314-2004Feb6.html>

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

[11] Fred N. Knopf, *Using Federal Magistrates to Resolve Securities Disputes: A Viable Alternative*, 12 Bridgeport L. Rev. 537, 543 (1992).
[12] David J. Beck, *Legal Malpractice in Texas, Other Causes of Action*, 43 Baylor L. Rev. 157, 176-77.
[13] Beck, *supra* note 10.
[14] Complaint, Vann v. Janus Capital Group, District Court, City and County of Denver, Colorado (No. 03CV6965) (October 29, 2003) [hereinafter Janus Fund Complaint].
[15] Janus Fund Complaint.
[16] Mark J. Astarita, *Introduction to the Securities Laws* (last visited February 10, 2004) <http://www.seclaw.com/seclaw.htm>
[17] Janus Fund Complaint.
[18] Id.
[19] See McLachlan v. Simon, 31 F.Supp.2d 731, 736 (N.D. Cal. 1998).
[20] Id.
[21] Id.
[22] Id.
[23] Harry S. Miller, *Legal Causes of Action Against Brokers and Brokerage Firms*, (last visited February 10, 2004) <http://www.securitieslaw.com/causesofaction.html#state>.
[24] Lucian Murley, *Closing a Bankruptcy Loop-Hole or Impairing a Debtor's Fresh Start? Sarbanes-Oxley Creates a New Exception to Discharge*, 92 Ky. L. J. 317, 321 (2003-2004).
[25] Murley, *supra* note 20.
[26] Knopf, *supra* note 9 at 543.
[27] Id.
[28] Joseph C. Long, *Blue Sky Law*, (Vols. 12 and 12A, Securities Law Series) § 4:50 (2003).
[29] Id.
[30] Id.
[31] Id.
[32] Complaint, Lepera v. Invesco Funds Group, Inc., District Court, City and County of Denver, Colorado (September 30, 2003) [hereinafter Invesco Complaint].
[33] Miller, *supra* note 8.
[34] Invesco Complaint.
[35] BLACK'S LAW DICTIONARY 1536 (7th Ed. 1999).
[36] Invesco Complaint.
[37] Stephen G. Christianson, *What Gives Rise to Right of Rescission under State Blue Sky Laws*, 52 A.L.R.5th 491 (1998).
[38] Id.
[39] Id.
[40] Id.
[41] Thomas v. Hemmelgarn, 579 NE2d 1333, 1337 (Ind. App. 1999).
[42] Douglas M. Branson, *Choosing the Appropriate Default Rule-Insider Trading Under State Law,* 45 Ala. L. Rev. 753, 774-75.
[43] Thomas Lee Hazen, *Overview of Remedies Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 1 Law. Sec. Reg. § 1.8 (4th ed.).
[44] American Jurisprudence, Second Edition Database updated May 2003 Securities Litigation – Federal § 1068.
[45] Id.
[46] Hazen *supra* note 39 at 925.
[47] Id.
[48] Id.
[49] American Jurisprudence *supra* note 40 at § 1076.
[50] Id.
[51] Id.
[52] See Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987)
[53] Marc I. Steinberg, *Winter 1996 Symposium Securities Arbitration: A Decade After the McMahon Securities Arbitration: Better for Investors than the Court?,* 62 Brook. L. Rev. 1503, 1531-32.
[54] Id.

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