US mutual fund industry hit by fraud scandal

Joseph Kay
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The latest scandal to hit Wall Street and corporate America centers on the mutual fund industry. Several mutual fund firms, investment banks and hedge funds have been implicated in "market timing" and illegal late trading of mutual fund shares. These practices have benefited an elite group of investors and fund managers at the expense of millions of small investors.

The US Securities and Exchange Commission (SEC) and state regulators in New York and Massachusetts have brought charges against such firms as the mutual fund giant Putnam Investments, the brokerage firm Prudential Securities and a series of smaller mutual fund companies. Individual brokers and executives at some of these firms are facing criminal charges, while the mutual funds themselves face civil fraud charges.

Congressional hearings are currently being held, and new charges continue to surface. What started two months ago as a settlement with a single hedge fund has expanded to encompass large sections of the mutual fund industry.

The charges concern manipulations made possible by the peculiar way in which mutual funds are priced. A mutual fund firm invests in a broad range of stocks or other securities on behalf of a large number of individual clients, often small investors who purchase mutual fund shares through retirement plans or other savings. The mutual fund was devised as a means of bringing small investors into the market. It allows the small investor to diversify holdings (and thereby decrease risk) by creating a vehicle for a small amount of capital to be invested in a large number of different securities.

Mutual funds are not priced continuously on the market. Rather, at the end of each trading day (4 p.m. Eastern Standard Time), the total value of the fund's investments is calculated and this figure is divided by the number of outstanding fund shares, yielding the price per share. An order to buy or sell a share in a mutual fund is held until the end of the day, when it is processed at the closing price. This pricing policy tends to discourage short-term trading of fund shares, since investors are generally unable to take advantage of temporary fluctuations in the price of the underlying assets.

This has not, however, prevented insiders and wealthy investors from finding ways to exploit the pricing mechanism of mutual funds to their own advantage. One of the ways highlighted by the current charges is known as market-timing.

In market-timing, an investor takes advantage of the fact that the price of a mutual fund is determined by the closing value of the shares owned by the fund, regardless of when this closing value was set. International stocks owned by the fund are priced at the value of the stock at the time of the closing of the market in which they are traded, which can be hours before the closing of the American markets. It is this "stale" value that determines the transaction price of the mutual fund share, even though in the intervening time (between the closing of the foreign market and 4 p.m. EST) events may have occurred that lead investors to conclude that the actual value of the foreign shares is different from its closing value.

The real value of the mutual fund is therefore different from the calculated value at the close of the US trading day, providing an avenue for savvy investors—especially those with inside information—to make an easy profit.

Market-timing is not necessarily illegal. An investor engaged in market-timing buys or sells shares legally and during the normal trading hours, but takes advantage of information that is not readily available to ordinary investors. A mutual fund can, however, be accused of fraud if it has a public policy against such trades, but violates that policy by allowing some clients to execute such transactions. Most mutual funds, including those involved in the scandal, have such a public policy. Many of these funds have as their stated aim the provision of a relatively safe place for long-term investors to invest retirement benefits or other savings.

Late trading, on the other hand, is clearly illegal. Orders to buy and sell mutual funds must be placed before the close of markets, when the value of the fund shares is calculated. An investor who places an order after 4 p.m. EST can take advantage of information revealed in the intervening period, again allowing the investor to capitalize on the "stale" price of the fund shares. If, for example, a company in which the fund was invested declared bankruptcy after 4 p.m., a late trader could sell his shares at the pre-bankruptcy price.

Detecting late trading is complicated by the fact that the deadline applies to the placement of the buy or sell order, and this holds whether the order is placed directly to the mutual fund or through an intermediary, such as a brokerage firm or a 401(k) plan. Since the latter may take several hours to process, the trades are still allowed to go through to the mutual fund after the deadline, as long as the original order was placed before the deadline. Unscrupulous brokerage firms or mutual funds can benefit select investors by processing late orders as if they were placed before the close of the trading day.

Not only do such practices provide a windfall for an elite group of investors; they also negatively affect the savings of millions of ordinary mutual fund investors. Any time an investor sells at a price above the true market value of the fund's shares or buys at a price below the market value, the difference must be absorbed by the mutual fund itself. For example, the fund may have to pay an investor selling his shares more than the actual value of the share. This means that the total value of the assets owned by the fund—and therefore the holdings of each individual shareholder—must go down.

In his testimony before the Senate Governmental Affairs subcommitteeon November 3, New York attorney general Eliot Spitzer quoted the *Financial Analysts Journal*: "Because the gains [of market timers] are offset by losses to other investors in the fund, the funds clearly have a fiduciary duty to take some preventative action. All the gains are being offset, dollar-for-dollar, by losses incurred by buy-and-hold investors." The same applies for late traders.

Moreover, the extra transactions require the funds to buy and sell shares in their own holdings more frequently, thereby increasing transaction costs to the firms, which must again be deducted from the value of their shares.

This type of illegal or fraudulent activity has generally been carried out on behalf of hedge funds, which are investment vehicles restricted to wealthy individuals. In a few instances, managers or brokers have

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benefited personally by engaging in these trades.

In his testimony before the same Senate subcommittee on November 3, Stephen M. Cutler, the director of enforcement for the Securities and Exchange Commission, stated that more than a quarter of major brokerage firms examined by the agency had allowed some big investors to trade late. Cutler also said the SEC had examined the records of 34 brokerage firms and found that almost 30 percent had helped some investors perform market-timing trades. He added that more than 30 percent of brokerage firms had disclosed information about their portfolios in a manner that would give select customers an advantage.

An SEC survey of mutual funds showed that 10 percent may have allowed late trading. These figures are most likely understated.

The mutual fund scandal began in early September, when Spitzer announced a settlement with Canary Capital Partners, a hedge fund. Spitzer had accused the company of various abuses, including late trading and market-timing. This initial investigation has spread over the past two months to encompass many of the mutual funds with which Canary did business.

The four funds implicated by Spitzer are Bank One, which manages a $100 billion fund, Janus, which manages $152 billion, Bank of America Corp., and Strong Financial Corp., which was founded by Richard Strong. In addition to aiding Canary in engaging in market-timing, Richard Strong, according to investigators at the New York attorney general's office, has engaged in market-timing on his own fund's shares. He reportedly made $600,000 in the process. No charges have yet been formally filed, though Strong recently resigned from his position as chairman of the board of the fund.

The scandal is beginning to spread beyond Canary and the mutual fund firms associated with it. Other funds under investigation include Federated Investments, Inc. and Fred Alger Management. One of the more recent casualties has been Putnam Investments, the country's fifth-largest mutual fund. Putnam manages some $270 billion and serves 12 million individual shareholders. It has been charged with both abetting market timing by hedge funds and allowing its own managers to engage in such trades. The CEO, Lawrence Lasser, was recently ousted under pressure as a result of the revelations.

Massachusetts regulators are also investigating potential violations by Morgan Stanley, Franklin Resources Inc. and Fidelity Investments. Fidelity is the country's largest mutual fund company, with $900 billion in managed assets.

Brokerage firms have only recently been directly implicated. On November 4, Massachusetts regulators brought civil charges of securities fraud against two former managers and three former brokers at Prudential Securities. The SEC filed its own charges against five brokers and one manager. The charges allege that the brokers concealed their own identities to help certain hedge funds evade market-timing restrictions.

The ease with which the scandal has spread throughout the mutual fund industry and beyond is an indication of the extent to which such practices are commonplace on Wall Street. It is merely one example of the sort of insider dealing and market manipulation that pervades corporate America.

These practices have long been condoned by those participating and by the agencies that supposedly exist to regulate the market. Market-timing has been an established practice in the industry for years, with many brokerage firms actively advertising their expertise in the area. The SEC has raised concerns in the past, but has done nothing to halt the practice. Howard Schiffman, a former SEC enforcement attorney, noted, "The funds which were allowing market-timing were allowing it openly."

Spitzer has denounced the SEC for its inactivity. "This has been an outrageous betrayal of the public trust... The regulators who were supposed to have been watching this industry were asleep at the switch." The phrase "asleep at the switch" minimizes the complicity of SEC regulators. It would be more accurate to say they have deliberately ignored such fraudulent practices.

There are many parallels between the scandal in the mutual fund industry and previous investigations into conflicts of interest on Wall Street. Those investigations—also pursued principally by New York attorney general Spitzer—led to a settlement earlier this year.

These probes revealed that banks were handing out hot initial public offerings (IPOs) of stock to executives of major companies in return for investment banking business. At the same time, market analysts employed by the banks talked up the stock of the new companies as well as the stock of the companies giving business to the bank.

The common thread between the probes into the banks and the mutual funds is the manipulation of the market by insiders and big investors to their own advantage. Contrary to the rhetoric that depicts the market as a dispassionate mechanism for setting values, it is, in fact, constantly manipulated by those with the leverage to do so.

And in the previous investigation, few of those implicated in the mutual fund scandal will be punished. Even those who are ousted often walk away with huge windfalls. For example, the CEO of Putnam, Lawrence Lasser, is due to receive $89 million in parting pay. Lasser has been one of the highest paid executives in the industry, pulling in over $100 million in pay and bonuses over the past five years.

As with the settlement that was eventually reached in the Wall Street investigation, the outcome of the mutual fund scandal will likely be no more than a slap on the wrist. Spitzer, the SEC and some congressmen are calling for a few cosmetic changes, including tighter deadlines on trades and a possible mandatory surcharge on transactions to prevent frequent trades.

Lawmakers and big financial interests want to reach an agreement that heads off a crisis of confidence in mutual funds. Today, mutual funds manage some $7 trillion in assets. During the 1990s, mutual funds were critical in bringing ordinary Americans into the stock market, providing a massive source of profit for fund owners, managers, banks and brokerage houses. Today, nearly 100 million Americans are invested in the stock market through these funds, including half of American families.

If Wall Street is to avert further declines, let alone sustain another bull market, it is critical that these millions of small investors—many of whom lost their life savings and retirement nest eggs as a result of the 2000-2001 stock market collapse—be brought back into the market in even greater numbers than in the past. What is certain is that none of these investors will be compensated for the enormous sums they have already lost.

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