News flash

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Mutual Funds – The Next Scandal?

After securing a $1.4 billion settlement from investment banks, the New York Attorney General, Elliot Spitzer has found a new target in his crusade to protect US investors – mutual funds. Nicola Blakemore and Simon Gildener report.

In September 2003, Mr Spitzer announced that he had started an investigation into improper trading practices carried out by various fund management groups, such as Janus and Bank of America's National Fund. As a result of the initial investigation, Canary Capital Partners LLC, a hedge fund, agreed to pay the State of New York a $40 million settlement. Its trading partners, such as Bank of America, are now embroiled in a major damage limitation exercise.

Since the Canary announcement, Mr Spitzer's investigation has mushroomed to involve some of US's largest investment groups (such as the US's largest mutual funds firm, Fidelity Investments) and to include intermediaries. It has already led to sackings, suspensions and charges of securities fraud.

These investigations are now running parallel to US regulators' reviews of both the mutual fund and the hedge fund industries.

What are Mutual Funds?

Mutual funds are similar to the UK's unit trusts. Investors buy shares in a fund, which is managed by a fund manager, who uses the fund's assets to invest in eg. shares in blue chip companies or foreign securities. The share price of the mutual fund reflects the performance of its investment portfolio.

The funds are popular with small, mostly unsophisticated, investors who view the funds as a safe, long term investment and offer diverse exposure to the stock markets with a low risk and are simple to use.

What are Hedge Funds?

By contrast, hedge funds are private limited partnerships or limited liability companies which pool the resources of a number of investors. They are largely unregulated. However, these funds tend to be more aggressive in their investment strategies. They may produce higher returns than mutual funds, but at a higher risk. Investors have traditionally been high net worth individuals, but now may include pension funds seeking higher returns.

How has the investigation arisen?

The share price of a mutual fund is set once a day, at 4pm. It is alleged that some hedge fund managers have been engaged in improper, and in some cases illegal, trades in mutual fund shares to take advantage of this fixed price. Further, it is alleged that large financial institutions have assisted hedge funds in these practices.

Late Trading and Market Timing

The allegations in the various enquiries into mutual and hedge funds surround the practices of "*late trading*" and "*market timing*".

"Late trading" is illegal. After the share price in a fund is set at 4pm, no further trading is permitted until the next trading day. This is because after that time, the price may not be an accurate reflection of the market value. Late trading takes place where investors buy shares in funds after the 4pm deadline, when they can see that the actual value of the fund is greater than the indicated price.

"Market timing" is not illegal, although it is discouraged. This is short term trading of shares which takes advantage of the small discrepancies between the 4pm closing price and early stock movement of the next day. This practice also takes advantage of differences in time zones and so it is sometimes known as "*time zone arbitrage*". Fund managers often state in their prospectuses that they disapprove of market timing and prohibit such practices.

Securities and Exchange Commission ("SEC")

The SEC has been concerned for some years (since 1996) about the mutual and hedge funds industries and has been conducting its own investigations for over a year. The Chairman of the SEC, William Donaldson, has advised the Senate that the SEC is drafting rules to prevent market timing.

The SEC has already reported on the hedge fund industry following its investigation and has made a number of recommendations to improve the industry's practices. It is now co-operating with Mr Spitzer to bring criminal and civil charges

against individuals. Steven B Markovitz, a senior trader with the prominent hedge fund firm Millennium Partners, has pleaded guilty to charges of securities fraud brought by both Mr Spitzer and the SEC.

It is not only in New York that concerns have been raised in respect of mutual and hedge funds, there are parallel investigations from a number of sources around the US, including the National Association of Securities Dealers (NASD), the securities regulator in Massachusetts (William Galvin), and Congress.

What is the impact on the financial risks market in the US?
According to 2002 figures from the Investment Company Institute (ISI), about 95 million individual investors across the US own mutual fund shares. The damage caused by late trading and market timing on the fund values may therefore be widespread and affect many millions of investors. Nearly a dozen plaintiff law firms have already issued lawsuits against fund managers. On the basis that Wall Street firms were prepared to settle IPO claims for over $1 billion, these lawyers have their eyes on some very significant potential settlements with mutual funds.

In these early stages of the investigation, some researchers have suggested that the industry as a whole has lost around $5 billion, and others have suggested that as much as $4 billion is lost *annually* from market timing, and $400 million from late trading. That is a large liability to pass on under a fidelity/ commercial crime, bankers blanket bond or professional liability policy such as brokers' E&O.

The scale of the investigation is increasing daily as more and more mutual fund companies receive subpoenas from Mr Spitzer. The publicity it is bringing is spurring financial institutions on to initiate reviews and purges of their personnel. Bank of America is breathing a temporary sigh of relief, having earned praise from Mr Spitzer in starting its own internal investigation. However, it has also had to promise restitution not only to shareholders in its own mutual funds, but also other funds which may have been affected by its alleged late-trading arrangements.

It is likely that other companies will follow Bank of America's example to avoid sanctions by Mr Spitzer and the SEC. Large settlements are likely to follow, although it is anyone's guess whether it will be on the scale of Mr Spitzer's previous successes.

There is some hope for insurers. For the plaintiff's bar, establishing liability may be difficult and costly, and neither will it be easy to assess the damage caused to individual investors. Also, Standard and Poor consider that it is still too early to assume that the whole industry is tainted. Some commentators suggest that whilst the investigations are growing, the scandal is unlikely to trigger widespread outrage, mainly because the schemes complained of are complex and much harder for the average investor to understand than, for example, the Worldcom fraud. Finally, there are no visible effects, such as the sight of thousands of employees being left unemployed at the end of Enron. All of these factors may prevent the investigations from developing into a full blown scandal.

What is the Impact on European Financial Institutions?
Across Europe, several large financial institutions have reported an upsurge in time zone arbitrage activity in European funds since the Spitzer investigations became public. It seems that some arbitrageurs are seeing whether they can get away with the practices in Europe now that the US markets are closing to them. In response to this (and concerns about potential liabilities), many European institutions have begun to closely monitor and expel these so-called "hot-money investors".

And the UK?
We understand that the FSA is privately talking to fund managers and their industry body to establish whether there is a problem in the UK.

The industry seems fairly confident that these "suspect" trading practices are not prevalent in the UK, given the regulatory system in the UK which requires an independent trustee to act on behalf of trust holders and to report to the FSA. However, some fund managers admit that they had not perceived market timing to be a problem.

Questions will undoubtedly be asked whether the industry is doing enough to prevent these practices. Fund managers appear unwilling to use current measures designed to prevent losses due to market timing, such as a "dilution levy" or "fair value pricing". There is concern about the image of fund management, lack of investor confidence and a potential threat of further regulation, so it is possible the fund management companies will investigate internally and weed out these practices before an investigation (formal or otherwise) can be launched.

It is not yet clear whether the FSA will launch an official investigation into mutual and hedge funds. The regulator is anxious to reform the regulation of the collective investment industry, but unlike the splits and pensions debacle, investors have not experienced known losses and are not pressurising the regulator to take action.

However, if Mr Spitzer's inquiry does discover a wide-scale problem in respect of improper or illegal trading practices among mutual funds, the FSA may be forced to place the UK fund management industry under further scrutiny.

If this does happen, then IFAs, stockbrokers, fund managers and other professionals in the financial arena may find their premiums heading for a serious hike. The US experience is a salutary lesson for what might happen here in the UK and the outcome of the investigations needs to be closely monitored.

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