BLB&G

Bernstein Litowitz Berger & Grossmann LLP

Volume 5
Fourth Quarter 2003

INSTITUTIONAL INVESTOR

Advocate

A Securities Fraud and Corporate Governance Quarterly

THE MUTUAL FUND SCANDAL

Is There No Longer Any Shelter From The Storm?

By Gerald H. Silk and Joseph A. Fonti

Since the genesis of the mutual fund industry in the 1920s, mutual funds were thought of as a relatively safe investment vehicle for America's small investors. Mutual funds were sold as a limited risk investment which were, in the words of the great poet Bob Dylan, "always safe" and, thus, represented to the vast number of hard-working, middle-class Americans "shelter from the storm" that surrounded much of Wall Street's shady practices. However, on September 3, 2003, this perception was shattered by the revelation that certain of the country's most venerable mutual fund companies were engaged in unlawful conduct. On the heels of such major scandals as Enron and WorldCom, the public sadly learned that the $7 trillion mutual fund industry was rife with illegality and impropriety.

Recently discovered evidence shows that, not only were funds preferentially allowing select investors to unlawfully trade in exchange for higher fees and other forms of profit, but fund insiders, including the most senior executives and founders of certain funds, engaged in the very same unlawful trading conduct for their own personal gains. In addition to the unlawful trading through market timing and late trading of fund assets, numerous other forms of illegality at mutual funds have been uncovered, including rampant conflicts of interest and breaches of fiduciary duties. These far reaching allegations are evidence that the unlawfulness was not the result of just a few "bad apples," but represents "systematic corruption in this industry" requiring sustained probing and attention to resolve the root causes. (Jim Jubak, "Three More Mutual Fund Scandals in the Making," *The Street.com*, Dec. 3, 2003.)

> *Not a word was spoke between us, there was little risk involved. Everything up to that point had been left unresolved. Try imagining a place where it's always safe and warm. Come in . . . I'll give you shelter from the storm.*
>
> — Bob Dylan

This illegality is rooted in the historical failure of the mutual fund industry to be held accountable to investors. The sudden and traumatic disclosure of this unlawful conduct – and the prospect of even more devastating news to come – has cast the spotlight on the need for reforms and accountability. While the mutual fund industry is the subject of numerous state and federal law enforcement investigations as well as congressional inquiries, little confidence can be placed in the regulatory and congressional actions to effectuate the full level of sanctions and reforms necessary to rehabilitate this industry and ensure that investors are protected in the future. For example, the first bill to clear the House of Representatives in November was described as "essentially the status quo, and we know that the status quo is not working." (Diana Henriques, "A Band-Aid for the Fund Industry's Broken Leg?," *New York Times,* November 21, 2003.) Further, the SEC's recent decision to enter into a fast settlement with Putnam provided little, if any, improvement to an organization in need of serious reforms. The settle-

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ment, which was reached within three weeks of the first disclosure of illegal trading at Putnam and simply called for an "independent board of directors, something the company previously claimed to have; compliance controls, which the Company was already supposed to have; and employee trading restrictions, which Putnam should have had all along," and, thus, demonstrates the political difficulties in imposing any kind of serious reforms. (Gretchen Morgenson, "Slapping Wrists as the Fund Scandal Spreads," *New York Times*, November 16, 2003.)

While there have been numerous private lawsuits filed in state and federal courts in connection with the mutual fund violations, most have been brought by law firms on behalf of numerous small, individual investors, who will essentially be no more than "figurehead plaintiffs" controlled by the attorneys representing them. As explained in more detail below, institutional involvement could prove critical to the success of these litigations and bringing about industry-wide reform.

Background

Unlawful activities at mutual funds first came to light on September 3, 2003 with the filing of a civil complaint centered on illegal trading by Canary Capital Partners, LLC, a multi-million dollar New York hedge fund, accused by New York Attorney General Eliot Spitzer of conducting market timing trades and late trading in shares of several mutual funds. Mr. Spitzer's complaint alleged that numerous mutual fund companies, including Bank of America, Strong Capital Management, Inc., Janus Capital Corporation and Bank One, had engaged in a fraudulent scheme to pilfer profits from ordinary investors by participating in rapid in and out trading and by allowing late-trading, or selling mutual fund shares at yesterday's price to purchasers in possession of today's news.

Since Mr. Spitzer's filing of this initial action, civil lawsuits have been filed by investors against each of the mutual fund companies. Moreover, allegations relating to fraudulent conduct at numerous other mutual funds have been lodged by prosecutors, regulators and investors against funds offered by Putnam Investment Management Trust, Federated Investors, T. Rowe Price, Prudential Securities, Pilgrim Baxter Funds (known as PBHG Funds), Fred Alger Management, Fidelity, John Hancock, Alliance Capital Management, INVESCO, MFS Investment Management and Charles Schwab. As the investigation continues to widen, numerous other mutual funds and financial institutions are likely to become the subject of law enforcement scrutiny and civil lawsuits. To date, these investigations have revealed what Attorney General Spitzer describes as "egregious" conduct by "very senior people" in the industry and have resulted in criminal investigations, civil lawsuits, high-level firings, criminal and civil charges and a government imposed shut down of mutual fund intermediary Security Trust Company. For example, on November 20, 2003, the SEC and Mr. Spitzer filed complaints against Gary Pilgrim and Harold Baxter, the founders of PBHG Funds, alleging that these two men deliberately allowed certain investors to trade billions of dollars in and out of the PBHG Funds reaping millions of dollars in profits for preferred investors as well as themselves.

These revelations have damaged investor confidence in the capital markets themselves. Since September 3, 2003, tens of billions of dollars have been removed from mutual funds by investors. In many cases, institutional investors and public pension funds have led the charge. At Putnam, for example, from late October through early December, institutional investors such as CalPERS, Massachusetts Pension Fund, Vermont Teachers' Plan, Arkansas Teachers Retirement System and Pennsylvania Public Schools Employees' Retirement System withdrew $1.2 billion, $1.7 billion, $91 million, $500 million and $1 billion, respectively. These amounts are just a small portion of the over $32 billion pulled from Putnam's asset management in that period, $21 billion of which were assets held by institutions.

The Illegal Conduct

In their simplest form, the mutual fund cases involve a basic scheme in which mutual fund companies (as well as their senior executives) allowed certain preferred clients to make illegal trades, including rapid in and out trades as well as trades based upon information not yet reflected in the price of the mutual funds' assets. This illegal conduct was perpetrated for mutual funds insiders' own financial gain and to the detriment of long-term mutual fund investors. The preferential treatment resulted in windfall profits for select investors and fund managers, while ordinary investors suffered damages amounting to hundreds of millions, if not billions, of dollars. The unlawful profits made by select investors came dollar-for-dollar from the holdings of long-term investors. In addition to harming investors by improperly reaping profits from the funds, the unlawful conduct resulted in much higher costs to be absorbed by long-term investors and lost profits that should have inured to these investors' benefit. Not only did certain mutual funds allow select investors to engage in unlawful trading, but several fund insiders engaged in the very same conduct for their own personal gain.

The unlawful trading schemes engaged in by mutual funds involved two practices known as "market timing" and "late trading." These manipulative practices were possible because of the way in which mutual funds are valued. Specifically, mutual funds are valued once a day, at 4:00 p.m. Eastern Time ("ET"), following the close of the financial markets in New York. The price, known as the Net Asset Value ("NAV"), reflects

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MUTUAL FUND INVESTIGATION SCORECARD*

IN REVERSE CHRONOLOGICAL ORDER

	INVESTIGATIONS			ALLEGED VIOLATIONS			HIGH-LEVEL CASUALTIES
COMPANY	**Federal**	**State**	**Civil**	**Market Timing**	**After-Hours Trading**	**Insider Trading**	
Massachusetts Financial Services Co. (MFS)	X	X	X	X			None
Strong Financial	X	X	X	X			Richard S. Strong, Chairman and founder, resigned
Invesco Funds Group	X	X	X	X			None
Federated Investors			X		X		One employee was fired and two resigned
Securities Trust Co.	X	X	X		X		None
Pilgrim, Baxter & Associates	X	X	X	X		X	Gary Pilgrim and Harold Baxter, co-founders, resigned
Putnam Investments	X	X	X	X			Lawrence Lasser, CEO; Justin M. Scott and Omid Kamshad, managing directors; 14 unnamed Putnam insiders resigned
Fred Alger Management	X	X	X	X	X		James P. Connelly Jr., former vice chairman, was sentenced to one-to-three years in prison
Bank One	X	X	X	X			Mark Beeson, President of One Group; John AbuNassar, head of Institutional Management group resigned
Prudential Securities	X	X	X	X	X		Frederick J. O'Meally and 11 other brokers and managers resigned
Alliance Capital Management	X	X	X	X			Gerald T. Malone, a portfolio manager, and Charles B. Schaffran, a marketing executive, were suspended
Bank of America	X	X	X	X	X		Theodore C. Sihpol III, broker, dismissed and facing criminal charges. Robert H. Gordon, Sihpol's boss, dismissed. Charles Bryceland, head of brokerage and private banking, dismissed
Janus Capital Group	X	X	X	X			None
Canary Capital Partners				X	X		Edward J. Stern, managing principal, agrees to pay a $10 million fine and $30 million in restitution

* As of January 9, 2004

Sources: The New York Times, The Wall Street Journal the closing prices of the securities that comprise a particular funds' portfolio plus the value of any uninvested cash that the fund manager maintains for the fund. Thus, although the shares of a mutual fund are bought and sold all day long, the price at which the shares trade does not change during the course of the day. Orders placed any time up to 4:00 p.m. are priced at that day's NAV, and orders placed after 4:01 p.m. are priced at the next day's NAV. This practice, known as "forward pricing," has been required by law since 1968.

1. Market Timing

The practice of timing is an investment technique that involves short-term "in and out" trading of mutual fund shares. According to a Stanford University study, market timing may have caused losses to long-term mutual fund investors of approximately $5 billion each year.

Such rapid trading is antithetical to the premise that mutual funds are long-term investments meant for buy and hold investors. In and out trading capitalizes on the fact that a mutual fund's price, or NAV, does not reflect the fair value of the assets held by the fund, or has become "stale". A typical example of market timing involves a U.S. mutual fund that holds Japanese shares. Because of the time zone difference, the Japanese market may close at 2:00 a.m. ET. If the U.S. mutual fund manager uses the closing prices of the Japanese shares in his or her fund to arrive at an NAV at 4:00 p.m. in New York, the manager is relying on market information that is fourteen hours old. If there have been positive market moves during the New York trading day, which is a reliable indicator that the Japanese market will rise when it later opens, the fund's stale NAV will not reflect the expected price change and, thus, will be artificially low. Put another way, the NAV does not reflect the time-current market value of the stocks held by the mutual fund. On such a day, a trader who buys the Japanese fund at the "stale" price is virtually assured of a profit that can be realized the next day by selling at a higher NAV.

Because the artificial difference between the NAV and fair value has long been recognized, mutual funds represented to their investors that they imposed policies to prevent investors from profiting from the stale pricing by rapidly trading in and out of the funds. Most mutual fund prospectuses represent to investors that the funds monitor, prohibit and prevent rapid trading because it is detrimental to long-term investors. Some of the measures purportedly taken by mutual funds to prevent market timing include early redemption fees for the sale of assets purchased within a short time frame, limits on the number of such trades, or the total prohibition of selling shares purchased within a set time period.

Despite their representations to the contrary, mutual funds as well as their investment advisers permitted such trading for their own profit. The resulting harm caused by the transfer of wealth from long-term investors to market timers is known as "dilution," and came dollar-for-dollar from long-term investors' profits. Buying and selling shares on a short-term basis to cash in on an increase in the NAV of the fund, the market timer effectively "skims" part of the buy-and-hold investors' profit by lowering the next day's NAV for those who were still invested in the fund.

2. Late Trading

The manipulative practice known as late trading is the practice whereby certain mutual fund companies allowed selected investors to purchase mutual funds after 4:00 p.m. using that day's NAV, rather than the next day's NAV, as required under the law. As Attorney General Spitzer explained: "Late trading can be analogized to betting today on yesterday's horse races."

Because a fund's NAV is calculated after the markets close at 4:00 p.m. ET, orders to buy, sell or exchange mutual fund shares placed before 4:00 p.m. ET on a given day receive that day's NAV. Orders placed after 4:00 p.m. ET are supposed to be priced at the following day's NAV. This pricing mechanism was legislated in order to place all investors on a level playing field whereby no investor can benefit from after-hours information in making investment decisions. Certain mutual funds, however, allowed select customers to capitalize on positive earnings news by agreeing to sell them mutual fund shares at the prior trading-day's NAV. In essence, these select investors were allowed to immediately reap the benefit of the stock's upward movement the following day due to information learned after 4:00 p.m. ET. In contrast, all other investors who purchased after 4:00 p.m. ET were required to pay the next day's NAV. For example, if a mutual fund invests in the stock of a particular company that announces positive results at 5:00 p.m. after the close of trading, a late trader gets to buy shares of that mutual fund at the 4:00 p.m. price, which does not reflect the favorable information. When trading opens the next day, the price of the affected company's stock will rise, causing the fund's NAV to rise. The late trader can either hold onto his mutual fund shares, acquired at yesterday's cheaper price, or sell those shares and realize an immediate profit.

Again, dollar-for-dollar, the profits enjoyed by these late traders come directly from the profits that would have otherwise gone to the fund's long-term investors. Additionally, in order for the late trader to redeem these profits, the fund manager had either to sell stock or use cash on hand — both of which are assets belonging to the long-term investors.

How Could This Have Happened?

1. The Motivation

Mutual fund managers have a very strong incentive to engage in the wrongful conduct described above. The management company's fees are typically a percentage of the assets in the fund, so the more assets in the family of funds, the more money the manager makes. It is for this reason that a mutual fund manager will typically require that a market timer invest additional assets in the fund in exchange for the ability to time trades. These assets, known in the industry as "sticky assets," are typically in the form of long-term investments, which managers can count on for a steady flow of fees. The fund managers profit handsomely from this arrangement while the fund's investors are hurt by lost profits and higher costs. Despite the simplicity of these arrangements, the unlawful trading is difficult to detect because the market timer's profits are hidden in the fund's performance data. Although each timing trade affects individual investors by cheating them a few cents on their holdings, such trading is estimated to cost mutual fund investors as a whole approximately $5 billion per year. Mutual fund insiders and managers were well aware of the damaging effect timing had on long-term fund investors. For example, Mr. Pilgrim, who is now charged with market timing in PBHG Funds for his own personal gain, wrote in a 2000 e-mail that "timers are losers for our shareholders and probably not even in our business model."

In addition to the unlawful trading, mutual funds and their investment advisers favored a select few in various other ways. Preferential treatment included setting up computer systems at certain hedge fund customers to facilitate these illegal trades, multi-hundred million-dollar loans and private banking services. All of this was provided so that the fund's management and advisers could profit themselves. For example, Bank of America's private banking group provided up to $200 million in loans to Canary for its trading strategy. Bank of America knew full well that the loans were used for unlawful mutual fund trading. Further, because the collateral for these loans was Canary's mutual fund positions, the bank's credit department tracked Canary's trading to make sure the bank was fully secured.

This illegality is rooted in the historical failure of the mutual fund industry to be held accountable to investors.

2. Pervasive Conflicts of Interest

Pervasive fraud was able to flourish at mutual funds because, among other reasons, those charged with guarding investors' interests — the so-called gatekeepers, such as funds' boards of directors — suffered from disabling conflicts of interest. Mutual fund boards have typically operated as nothing more than a rubber stamp for the investment adviser that managed the funds assets. Because mutual funds, corporations in their own right, do not have a staff or employees, the funds hire an investment adviser, which is almost always a corporate sibling (or captive) of the fund itself. Indeed, it is not uncommon to find as much as 60% of a mutual fund's board composed of either insiders or board members of the investment adviser. Moreover, insiders have a strangle hold on not just individual funds but the entire fund family and its dealings with the investment adviser. For instance, each of the mutual funds in the Putnam family of funds has hired Putnam Investment Management LLC as its investment adviser. Even more disturbing is the fact that Fidelity Investment's Chief Executive and Chairman, Edward Johnson, is the Chairman of the independent boards of 266 Fidelity Funds.

This incestuous relationship results in ineffective governance and exorbitant costs. In 2002 alone, separate and apart from the trading and transaction costs discussed above, mutual funds paid advisory fees of more than $50 billion and other management fees of nearly $20 billion. Attorney General Spitzer testified that "in no other industry would a board of directors be permitted to issue billions of dollars in no-bid contracts annually. Yet that is par for the course in the mutual fund industry, where fund directors essentially contract out for all of the fund's operations." The reality is that the majority of board members had every incentive not to negotiate the best fees because they personally profited from those excessive fee arrangements.

Illicit arrangements between mutual funds and brokers have decreased investors' returns by billions of dollars. Over the course of last year alone, mutual funds paid brokers about $6 billion in commissions. As much as $4 billion of this amount went for something other than trade executions. It has been reported that mutual funds paid billions of dollars to brokers in order to gain favor from the brokerage sales staff and to acquire prominence among the broker's offerings, or "shelf space". This arrangement amounts to revenue sharing through which the fund pays the broker a portion of its own profits in exchange for pushing its funds to investors.

The Legal Claims

At the core of this scandal are the mutual funds' false and misleading statements relating to market timing and late-trading. Provisions of the Securities Act of 1933 (the "33 Act") address the absence of truthful disclosure in the mutual funds' registration statements and prospectuses, and these claims can be brought as class actions. In order to sell mutual

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fund shares, each fund must issues a registration statement and prospectus. Under Section 12(a)(2) of the 33 Act, the mutual fund prospectus must not contain any materially false or misleading information relating to the fund and its trading practices. As explained above, many fund prospectuses describe the fund's policies and procedures to prevent timing and late-trading, when, in fact, the funds were knowingly permitting it to flourish and profiting from these trades.

Additionally, for many funds, the prospectus was incorporated by reference into the funds' registration statement, thus rendering the registration statement also false and misleading. Under Section 11 of the 33 Act, an investor has a right to sue for monetary damages if it can be established that the registration statement contained a materially false or misleading statement or omission. Section 11 provides for strict liability against the issuer of the registration statement and negligence against all directors of the fund. In contrast to the antifraud provisions of the Securities Exchange Act of 1934 (the "34 Act"), Sections 12(a)(2) and 11 do not require a plaintiff to establish a defendant's mental state. In other words, no showing of fraudulent intent is required.

Illegal trading at mutual funds also gives rise to claims for intentional fraud. Under Section 10(b) of the 34 Act, and Rule 10b-5 promulgated thereunder, a mutual fund, its officers and directors may be held liable for their false and misleading statements. Further, these defendants would be liable under Section 10(b) based upon their fraudulent scheme to engage in illicit arrangements with select investors that were detrimental to ordinary investors.

In addition to the claims arising from any false or misleading statements or omissions made by a fund, certain breaches of fiduciary duties owed to investors are subject to claims under federal and state law, and can be brought as class actions. Mutual fund directors and their investment advisers owe a fund's shareholders the fiduciary duties of loyalty, candor and fair dealing, and, under the Investment Company Act, the duty to refrain from charging or collecting excess compensation or other payments for services in order to preserve the funds' property and assets.

The Need for Institutional Activism

The mutual fund cases represent an excellent opportunity for public institutions to seek appointment as lead plaintiff in class actions filed under the Private Securities Litigation Reform Act. Class losses as a result of the mutual fund frauds could measure in the billions of dollars, which belong to the investors who counted on this money for their retirement and life savings. The conduct at issue in many of the mutual fund cases is egregious and pervaded the highest levels of the mutual fund industry. The conduct involved a fundamental breach of trust and confidence between the fund administrators and investors and was systemic throughout the mutual fund industry. It is, therefore, important (if not critical) for an institutional plaintiff to send a strong message that this type of conduct will not be tolerated by the institutional investor community.

An institution as lead plaintiff would, undoubtedly, help to maximize the recovery for class members and help to implement change throughout the entire industry. Unlike small individual investors serving as lead plaintiff, an institutional lead plaintiff has the leverage and clout to insist upon certain corporate governance enhancements to improve the industry and attempt to implement safeguards to prevent this type of wrongful conduct in the future. Such remedial measures can include strengthening the independence of mutual fund boards of directors and requiring managers to report on a regular basis any trading of mutual fund shares by fund insiders or directors (or any entity they control). These types of far-reaching reforms are essential to restore investors' confidence in the mutual fund industry.

The reality is that the majority of board members had every incentive not to negotiate the best fees because they personally profited from those excessive fee arrangements.

Conclusion

The unraveling of the mutual fund industry represents a historic opportunity to right the wrongs of a corrupted industry, recover investors' losses, impose reforms beyond anything proposed by regulators or Congress, and carry out the legal process for the good of all investors harmed by the wrongdoing and all those whose renewed confidence is vital for the health of our economy. Pursuit of these claims as a lead plaintiff could put an institutional investor or state government investment plan at the forefront of the mutual fund litigations to protect its citizens' interests, ensure that the maximum recovery for the class and the state's plan participants is obtained, and implement change to remedy a severely damaged industry and, most importantly, provide investors with renewed faith that mutual funds can continue to serve as "shelter from the storm."

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