

# 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

*Continued on next page.*

*Understanding  
The Mutual  
Fund Scandal*

1

*Inside Look*

2

*Memo to Mutual  
Funds From  
Industry Expert  
Don Phillips*

3

*Eye On The Issues*

6

*Quarterly Quote*

7

*Pension Fund  
Involvement Leads  
to Larger Settlements*

8

*Institutional  
Investor Forum*

10

# Advocate

## MUTUAL FUND SCANDAL

Continued from page 1.

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 settlement, 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

Continued on page 4.

## Inside Look

This quarter, we bring you a special, longer edition of the *Advocate* focusing on what we view as one of the most disturbing corporate scandals of the past decade—the mutual funds fraud. On September 3, 2003, New York State Attorney General, Eliot Spitzer, shocked the nation by disclosing that the mutual fund industry—traditionally a relatively safe investment vehicle for America’s small investors—was rife with illegality and impropriety. In the lead article, *The Mutual Fund Scandal: Is There No Longer Any Shelter From the Storm?*, Jerry Silk and Joe Fonti masterfully examine the intricacies of the illegal conduct and the egregious motivations behind the fraud. This article also emphasizes the need for institutional investors to lead the efforts to recover billions of dollars in damages suffered by small investors as a result of these illegal activities and to encourage mutual fund industry reforms.

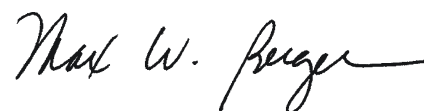
We are also delighted to share with you Morningstar Managing Director Don Phillips’ *Memo to Mutual Funds: It’s All About Trust*. This article, artfully phrased as advice to mutual fund managers in the wake of Eliot Spitzer’s investigation, strikes at the heart of the mutual fund scandal by reminding fund managers about their most basic fiduciary obligation to treat their shareholders’ money in the same way they would treat their own.

As usual, we also bring you our regular *Eye on the Issues* column. As has been the case for more than a year now, we could

fill the entire *Advocate* with news reports affecting securities and corporate law. In this issue, Tim DeLange, our *Eye on the Issues* correspondent, has again insightfully compiled the most significant developments in the field for your easy reference.

This issue of the *Advocate* also comes on the heels of our Institutional Investor Forum, which we hosted on November 13 and 14, 2003 in New York City. We would like to take this opportunity to again thank everyone who attended the Forum. We are told that the attendees yet again found the Forum valuable, informative and fun. For an overview of the Forum, you will all shortly receive our *Forum Highlights*. If you would like to attend our next Forum, please contact us.

We hope that you will enjoy reading this issue of the *Advocate*. As always, we endeavor to make it worth reading and we welcome your comments, questions and input. Most importantly, everyone at Bernstein Litowitz Berger & Grossmann LLP hopes you and your families enjoyed a happy holiday and that you all have a healthy and peaceful 2004.



# Advocate

## MEMO TO MUTUAL FUNDS: IT'S ALL ABOUT TRUST

By Don Phillips, Managing Director of Morningstar, Inc.

We came across this article in *The Wall Street Journal* and felt that the message bears repeating. Mr. Phillips was kind enough to oblige.

*Eliot Spitzer's office is on the line. Your firm is about to be named as the latest culprit in the mutual fund scandals. What do you do?*

First you need to identify and isolate the problem. Don't confuse the sum of money involved with the seriousness of the issue. It isn't the amount taken from investors, but the breach of fiduciary responsibility that's at the heart of these scandals. On this score, there can be no gray area. Your people were either acting in shareholders' best interests or they weren't. If not, it doesn't matter how valuable the employees have been in building your firm — they have to go. The money management business is built on trust; it's by far the most valuable asset your firm has. A money management shop can survive the departure of even the most talented employees, but it can never withstand a soiled reputation.

The stakes here are high. Putnam has lost \$21 billion in assets since being named in an SEC investigation last month. In addition, Mr. Spitzer is calling for complete disgorgement of all fees earned during the time in which improper behavior took place in a fund. But these costs may be minor next to the prospect of class-action suits. It's only a matter of time before lawyers claiming inadequate disclosure ask for investors who bought in at the market peak to be made whole. This is a tab few money managers could pay. Your business is at risk. Make sure you have a top-notch legal team in your corner.

Next you need to address what structural steps you can take to protect shareholders in the future. An internal compliance officer, a stronger fund board, a corporate ombudsman are all worth considering. If you're not sure which steps to take, bring in a corporate governance adviser to oversee this process. If you've really screwed up, bring in a big hitter like Arthur Levitt. If the sins aren't as grave, a lower-level former regulator may suffice. But in any case it must be someone who will inspire public confidence. You need a Kenesaw Mountain Landis, not a Bud Selig.

As you make these changes, you need to communicate openly and honestly with shareholders, regulators, and staff. Don't hide from the media; you need to show investors that you take these issues seriously and are taking bold actions to address them. Treat your fund shareholders like business partners. Tell them fully what happened, what steps have been taken to correct the situation, and what steps will be taken to ensure this will never happen again.

Now that you've done the easy work, it's time to address the real issue: What was it about your firm's culture that allowed this to happen? Do you hire the right kind of people? Do they have the right values? If you're constantly losing portfolio managers to hedge funds, it's a good sign that you've attracted people motivated too much by short-term gain. Don't confuse greed with talent. Top professionals are motivated by the ability to do great work and be part of something bigger than themselves. The best money management firms have a deep-rooted sense of purpose. Vanguard is committed to low costs, Capital Research to research excellence. Firms like Dodge and Cox, Longleaf, and First Pacific Advisors all have deep-rooted, investor-centric cultures. Have you created a firm with a purpose or have you merely gathered a lot of highly compensated stock jockeys?

Next, permanently align your employees' interests with fund shareholders' interests. If your employees aren't investing in the funds they manage or if their trading of the funds is not in keeping with the long-term focus you ask of your clients, fix it. Invest employee bonuses in fund shares and require long holding



horizons. Demonstrate to fund shareholders that management's interests will be strongly linked with theirs from this day on.

Finally, remember that this is a long-term proposition. A fund management company has to win the public's trust every day. Keep your people, even your top managers, in front of shareholders. Get them on the phone lines or at investor conferences. Never let them lose sight of whom they serve. Conceptually, the asset management business is a simple business. All you need to do is treat fund shareholders' money the way you'd want your money to be handled. If you get this principle right, your firm will never lose its way again, but if you don't, any changes you make today will be fleeting.

Reprinted from *The Wall Street Journal* © 2003 Dow Jones & Company, Inc. All rights reserved.

# Advocate

## MUTUAL FUND SCANDAL

*Continued from page 2.*

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 wind-fall 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 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

*Continued on page 8.*

# Advocate

## MUTUAL FUND INVESTIGATION SCORECARD\*

IN REVERSE CHRONOLOGICAL ORDER

COMPANY	INVESTIGATIONS			ALLEGED VIOLATIONS			HIGH-LEVEL CASUALTIES
	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

Sources: *The New York Times*, *The Wall Street Journal*

\* As of January 9, 2004

## Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES  
AND RECENT DECISIONS OF INTEREST

By Timothy DeLange

**Alliance Agrees to Pay Record-Setting \$250 Million.** Alliance Capital Management Holdings has agreed to pay \$250 million, the largest payment ever by a mutual fund advisor, to settle fraud charges by the SEC stemming from improper trading allegations. A part of the settlement, Alliance agreed to make significant governance and compliance reforms. In a separate settlement agreement with New York attorney general Eliot Spitzer, Alliance has agreed to a reduction in fees it charges investors. Alliance pledged a 20 percent reduction in fees on its U.S. long-term funds for a minimum of five years. *CNN/Money, December 18, 2003.*

**Milking Investors; Italian Dairy Giant Faces U.S. Lawsuits.** Parmalat, an Italian food giant, is now facing class action lawsuits in the United States arising from its multibillion-dollar accounting scandal. In addition to Parmalat, which is reportedly bankrupt, the lawsuits are targeting Citigroup, Inc, one of its units, Buconero LLC, and Parmalat's auditors Deloitte & Touche and Grant Thornton. The suits, filed in early January 2004, allege that Parmalat, its senior officers, auditors and financial advisors violated U.S. securities laws in a scheme to defraud investors. In particular, one complaint alleges that Citigroup used Buconero LLC (which literally translated means black hole) to assist Parmalat in covering up a hole on its balance sheet caused by its failing Brazilian subsidiary. *Reuters, January 6, 2004.*

**Big Board Oversight of Specialist Trading Firms Blasted.** In a confidential report, the SEC blasted the New York Stock Exchange for ignoring blatant violations in which investors were shortchanged by millions of dollars and for failing to police its elite floor-trading firms. The report says that almost 2.2 billion shares were improperly traded over the past three years, costing investors \$155 million. The report unveils a floor-trading system full of abuses, with firms routinely placing their own trades ahead of those by customers and an in-house regulator unable to monitor it. The SEC report concludes that even when the NYSE acts on investor abuse, it does little more than admonish the specialists in a letter or give them a slap on the wrist with a small fine. The NYSE's disciplinary program is viewed by specialists and specialist firms as a minor cost of doing business, and that it does not adequately discipline or deter violative conduct, the report says. *The Wall Street Journal, November 3, 2003.*

**SEC Reacts to Mutual Fund Scandal.** The Securities and Exchange Commission responded to the wave of scandal in the mutual fund industry, voting unanimously to propose that mutual fund companies may no longer accept buy and sell orders after markets close, for trades to be executed at that day's price. The proposal, which must undergo a public-comment period and a final vote, would close a loophole that allows illegal after-hours trading in mutual funds. The SEC also proposed new rules requiring mutual fund companies to clearly disclose their market-timing policies and procedures in sales material. *CNN/Money, December 3, 2003.*

**Quattrone Case Ends In Mistrial; Retrial Set for March 2004.** The trial involving the most important Wall Street figure to face criminal charges in over a decade ended with the jury deadlocked after almost five days of deliberations. Former Credit Suisse First Boston investment banker, Frank P. Quattrone, faced two counts of obstruction of justice and one count of witness tampering arising from an investigation into how shares in hot initial public offerings were handed out. The prosecution's case turned on a single two-line e-mail Quattrone sent to several hundred subordinates in December 2000, endorsing a plan to clean up those files. The prosecution contended he sent the e-mail because he had learned two days earlier of a grand jury subpoena. Quattrone alleged, however, that he was simply following the bank's document-retention policy. Quattrone will go on trial again, starting on March 22, 2004. *The Washington Post, October 25, 2003; Chicago Tribune, December 2, 2003.*

**Legislation Limiting Class Action Lawsuits and Damages Temporarily Derailed.** In a fiercely fought battle, Senate Democrats successfully blocked Republican-backed legislation designed to limit class action lawsuits and large damage awards against corporations. The proposed legislation says that if less than one-third of the plaintiffs are from the same state as the primary defendant, the case would go to federal court. In addition, at least \$5 million would have to be at stake for a class action lawsuit to be heard in federal court. The business community — which has poured millions into lobbying Congress to limit class action lawsuits — views federal courts as less likely to issue multimillion-dollar verdicts against big corporations. Defendant corporations don't want to be held liable for their misconduct, and if held responsible they want to pay less money, and that's what it comes down to, said Sen. Richard Durbin, D-Ill. *The Associated Press, October 22, 2003.*

**Putnam, SEC Settlement Criticized.** Putnam Investments, the fifth-biggest mutual fund company by assets, settled the SEC's charges that it allowed portfolio managers to profit personally at the expense of investors. Under the terms of the settlement, Putnam is required to tighten its rules against employee trading and strengthen its compliance department and board of trustees. An independent consultant would determine how

much investors should be reimbursed and the question of a financial penalty was left for a later date. Both New York Attorney General Eliot Spitzer and Massachusetts Secretary of the Commonwealth William F. Galvin criticized the settlement for not going far enough to punish Putnam and not addressing the broader problems in the mutual fund industry, such as high management fees. *The Washington Post*, November 14, 2003.

**House Passes Mutual Fund Reform Legislation.** The House of Representatives voted 418-2 to pass the first piece of legislation addressing the mutual fund scandal. The bill would require that at least two-thirds of a fund's board of directors be independent of fund management; would prohibit persons affiliated with a fund from engaging in short-term trading; would require brokers to disclose financial incentives; and instructs the SEC to implement new rules requiring fair-value pricing of fund assets. The Senate will take up the bill in 2004. *Chicago Tribune*, November 20, 2003.

**SEC Proposes Rules to Increase Proxy Access.** The SEC approved rule proposals that could dramatically shift the way independent directors are selected. Under the proposed rules, management would have to include as many as three directors proposed by shareholders owning at least 1 percent of a company on its own proxy materials when one of two trigger events occurred: 1) 35% or more of shareholders voting for a slate of directors withheld their votes for one or more management-backed directors; or 2) a proposal to force management to include outside candidates for its board of directors received more than 50% of the proxy votes cast in a particular year. The Business Roundtable, an association of CEOs of major corporations oppose the proposed rules, claiming they will lead to divisive boards that have difficulty functioning. Investor groups, including managers of pension funds and other large institutional shareholders, say the proposed rules don't go far enough. In most cases, it would take a group of investors at least two years to meet the standards for nominating a director. The public will have 60 days to comment on the proposed rules before the vote on final approval, in early 2004. *The Wall Street Journal*, October 9, 2003; *USA Today*, October 9, 2003.

**Retirement Plan Sponsors Must Weigh Options.** Speaking at the annual conference of the National Defined Contribution Council, Assistant Labor Secretary Ann Combs advised plan sponsors that the recent mutual fund trading allegations needs to be factored in to a plan sponsor's strategy. This advice reiterated Combs' remarks while speaking at the Stable Value Investment Association National Forum: Allegations of improper mutual fund practices where a plan is invested must be factored into the fiduciary's determination of the continuing appropriateness of that investment. Combs acknowledged that the plan sponsors may have to decide whether and how to participate in lawsuits or settlements arising from improper

## Quarterly Quote

*Some in clandestine companies combine,  
Erect new stocks to trade beyond the line;  
With air and empty names beguile the town,  
And raise new credits first, then cry 'em down:  
Divide the empty nothing into shares,  
To set the town together by the ears.  
The sham projectors and the brokers join,  
And both the cully merchant undermine;  
First he must be drawn in and then betrayed,  
And they demolish the machine they made:  
So conjuring chymists, with their charm and spell,  
Some wondrous liquid wondrously exhale;  
But when the gaping mob their money pay,  
The cheat's dissolved, the vapour flies away.*

Daniel Defoe  
*Reformation of Manners* (1702)

mutual fund activities and that a plan fiduciary must weigh the cost of participating in a lawsuit against the likelihood and amount of potential recovery. *PLANSPONSOR.com*, October 20, 2003.

**Has The Audit Industry Reformed?.** According to a study by Vanderbilt University researchers, the answer is a resounding No. Results from the study, co-authored by Vanderbilt's Owen Graduate School of Management associate professors Debra Jeter and Paul Chaney, and Pam Shaw of Tulane University, show that auditing firms are still likely to produce inaccurate audit opinions if they benefit a valued client and company officials think they won't get caught. The study suggests, however, that the recent increased scrutiny of the accounting industry could increase the likelihood of the firm getting caught, indirectly resulting in improved reporting. Our study indicates that audit firms may lie to keep a profitable audit client if the expected benefits of keeping the client happy outweigh the expected costs of an audit failure if the firm gets caught, Jeter said. The study will be published in the November/December 2003 issue of the *Journal of Accounting and Public Policy*. *NashvilleCityPaper.com*, October 27, 2003.

*Timothy A. DeLange is an associate in the California office of BLB&G. He prosecutes securities actions on behalf of the firm's institutional investor clients and can be reached at [timothyd@blbglaw.com](mailto:timothyd@blbglaw.com).*

**STUDY CONFIRMS THAT PUBLIC PENSION FUNDS INCREASE SETTLEMENT VALUES OF CLASS ACTIONS**

According to a PricewaterhouseCoopers study, the presence of public pension funds as lead plaintiffs significantly increases the average settlement amount of securities class actions. Since the Private Securities Litigation Reform Act became law in 1995, more than 50 class actions with public pension funds as lead plaintiff have been settled with an average settlement of greater than \$87 million. By comparison, during the same time period, the average amount recovered in class action suits without public pension funds as lead plaintiff was \$13 million. In 2003 alone, the average settlement with a public pension fund directing the litigation as lead plaintiff was 15 times greater than cases without a public pension fund. *PLANSPONSOR.com, January 7, 2004.*

**MUTUAL FUND SCANDAL**

*Continued from page 4.*

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 their 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.

# Advocate

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

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

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.

## 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

*Continued on page 10.*



Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions nationwide on behalf of institutions and individuals. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions. The firm also handles, on behalf of major institutional clients and lenders, more general complex commercial litigation. The firm's client base in securities fraud and corporate governance litigation includes large public pension funds and other institutional investors.

BLB&G: INSTITUTIONAL INVESTOR ADVOCATE is published quarterly by Bernstein Litowitz Berger & Grossmann LLP, 1285 Avenue of the Americas, New York, NY 10019, 212-554-1400 or 800-380-8496. The materials in this newsletter have been prepared for information purposes only and are not intended to be, and should not be taken as, legal advice.

© 2004. ALL RIGHTS RESERVED. Quotation with attribution permitted.

# Advocate

## MUTUAL FUND SCANDAL

Continued from page 9.

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 fund shares, each fund must issue 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

*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.*

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

### REGISTER NOW FOR THE NEXT INSTITUTIONAL INVESTOR FORUM!

MARK YOUR CALENDARS!! The 10th Institutional Investor Forum is October 7-8, 2004 in New York City. This past November, public pension fund and other institutional investor representatives from across the country gathered

for a fast-paced, informative and fun two days in New York. The response from the attendees was overwhelmingly positive. The

forum featured Columbia University Law School Professor John C. Coffee, one of America's foremost scholars on corporate law, securities regulation, class actions and white collar crime, as one of the Keynote Speakers as well as former CalPERS General Counsel Richard H. Koppes, Esq. and prominent national securities litigator Boris Feldman, Esq. REGISTER NOW for the 2004 Forum at [www.iiforum.org](http://www.iiforum.org) or call Doug McKeige at 800-380-8496.



[iiforum.org](http://iiforum.org)

# Advocate

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

*Institutional involvement could prove critical to the success of these litigations and bringing about industry-wide reform.*

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.

## 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,

## Contact Us

We welcome input from our readers. If you have comments or suggestions, please contact Editor Beata Gocyk-Farber, at 800-380-8496 or [beata@blbglaw.com](mailto:beata@blbglaw.com). If you would like more information about our firm, please visit our website at

[www.blbglaw.com](http://www.blbglaw.com)

**Editor:** Beata Gocyk-Farber

**Editorial Director:** Alexander Coxe

**Contributors:** Max Berger, Timothy DeLange, Joseph Fonti, David Kleinbard, Don Phillips and Gerald Silk

**BLB&G**  
BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP

**800-380-8496**

*E-mail:* [blbg@blbglaw.com](mailto:blbg@blbglaw.com)

### New York

1285 Avenue of the Americas  
New York, New York 10019  
*Tel:* 212-554-1400

### California

12544 High Bluff Drive  
San Diego, CA 92130  
*Tel:* 858-793-0070

### Louisiana

701 Poydras Street, Suite 3640  
New Orleans, LA 70139  
*Tel:* 504-525-3373

### New Jersey

220 St. Paul Street  
Westfield, NJ 07090  
*Tel:* 908-928-1700



provide investors with renewed faith that mutual funds can continue to serve as "shelter from the storm."

*Gerald H. Silk is a partner at BLB&G and practices out of the firm's New York office. He can be reached at [jerry@blbglaw.com](mailto:jerry@blbglaw.com). Joseph A. Fonti, also based at the New York office, is an associate of the firm. He can be reached at [joseph@blbglaw.com](mailto:joseph@blbglaw.com).*



*Bernstein Litowitz Berger*

*& Grossmann LLP*

*wishes you and your families*

*a happy, healthy*

*and peaceful 2004.*