The $7 Trillion Question: Mutual Funds & Investor Welfare - Overview and Update

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The $7 Trillion Question: Mutual Funds & Investor Welfare

OVERVIEW AND UPDATE

RICHARD BOOTH: Welcome to the University of Maryland’s third annual business law conference. This year we are focusing on the imbroglio in the mutual fund industry. We have a stellar crew of panelists, and it is going to be a very informative and interactive day. The fundamental idea behind this conference is to get practicing lawyers and people from the industry and academics together to share ideas in a format that I think is all too rare.

I would especially like to thank T. Rowe Price and Henry Hopkins, its general counsel. Henry Hopkins is an esteemed alumnus and great friend of the law school. T. Rowe Price has been very generous with its financial support.

My colleague, Professor Lisa Fairfax, will introduce and moderate the first panel.

LISA FAIRFAX: Thank you. This first panel will focus on how the current problems arose in the mutual fund industry and, to some extent, how to fix them. I am going to briefly introduce the panelists. Let me start with Jay Baris, a partner with Kramer Levin Naftalis & Frankel. He has practiced extensively in this area, which encompasses the regulation of investment companies, investment advisers, and broker dealers. Next to him is Professor Tamar Frankel, a professor at the Boston University School of Law. She has published extensively in the areas of financial systems, regulation, fiduciary law, and corporate governance. Next to Professor Frankel is Richard Phillips, a senior partner and head of securities at Kirkpatrick & Lockhart, where he concentrates in securities regulation, particularly investment management, broker dealers, and SEC enforcement. He has also held various positions at the SEC, including as staff director of the SEC corporate disclosure and investment company studies.

At the other table, we have Margaret Bancroft, a senior member of the financial services group at Dechert Price in New York. She is also an adjunct professor at the New York University School of Law. Next to Margaret is Tom Smith. He is a partner at the New York office of Sidley Austin, where his practice focuses on pooled investment entities, such as investment companies and real estate investment trusts. Mr. Smith is a co-chair of the task force of the ABA Subcommittee on Investment Companies and Advisors, where he is preparing the third edition of the Fund Director's
Next to him is Frank Razzano, a partner at Dickstein Shapiro Morin & Oshinsky. In addition, he is an adjunct professor here at Maryland. He specializes in white-collar criminal defense and SEC enforcement. He has also served as an assistant U.S. attorney in the District of New Jersey as well as a special assistant U.S. attorney in the District of Maryland.

We are going to have two presentations, the first by Professor Frankel and the second by Professor Razzano. They will lay the groundwork and provide context for the current mutual fund controversy. Then we will have a broader discussion among the panelists, both commenting on the presentations and trying to respond to the general question of how we got here.

**TAMAR FRANKEL:** Thank you very much. How we got into this mess is, of course, difficult to explain, and why we got into it is even harder to analyze. I would like to suggest six movements that have happened throughout the last twenty years that may have brought about what we see now. The first is that the adviser moved from being a profession to operating a business. What is the difference? The first goal of a profession is public service and the second goal is making a living. The main and only goal of businesspersons is profit; the public has to take care of itself. Section 36(b) of the 1940 Act\(^1\) demonstrates the professional aspect of investment advisers. When you look at the decision of *Gartenberg*,\(^3\) however, you will see the second aspect; it is a business.

Here is an example. Market timing is not new, but so long as the advisers cared about the performance of their funds, they controlled excessive sales or redemptions and purchases. But then advisers had an opportunity to receive payment to benefit some investors at the expense of others. What they did then is a cost-benefit analysis, which meant that even though they would lose on the lower performance of their funds, they would gain much more from the payment of allowing market timing. Now it is very good business to accept the payment. Why not? It is a terrible decision as a professional.

The second movement that got us into this mess is that advisers moved from emphasizing advisory services to focusing on sales. Advisers were viewed as trustees and got the fees of trustees that were connected to the assets. In the case of a trust, performance is what also rewards the trustee. In the case of a mutual fund, however, you can do much better by emphasizing sales, because even rising performance can never compare to good sales. The brokers have clout through revenue sharing or the other arrangements that we are seeing now, at the expense of the shareholders. What I think we have done is not only to allow, but also to encourage competition among advisers. What were advisers competing over? They competed

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over who was going to pay the brokers more. On this issue I agree with my friend Dick Phillips.

**Richard Phillips:** I haven't said anything yet. [laughter]

**Tamar Frankel:** No, but you have written on the subject. You have suggested that there should be a rule prohibiting this kind of competition.

The third movement that brought us to this mess is the relaxation of legal prohibitions, without accompanying controls. Again, market timing is a good example. There were good reasons for relaxing the 4:00 p.m. rule. There is no doubt about it. But without guarantees and responsibilities, we got the Canary [Capital Partners] hedge fund corruption. We also got the following of Canary hedge fund, and the result was that enforcement was not taken care of. The practice of market timing then undermined the culture of honesty in the industry.

The fourth movement that brought us this mess is that we have ignored the law on the books. It is clear that the greater the size of funds and the amounts under management, the higher the advisers' fees and other benefits. Size, however, is not always for the benefit of the shareholders. In rule 12b-1, under the Investment Company Act of 1940, there is a balance, there is some line, there is some guidance. The shareholders must benefit from the size as well. After all, they are the ones who pay the brokers. The balance, line, and guidance were ignored. This attitude breeds disdain for the law on the books. It breeds contempt not only for the particular rule, but also for every rule. That undermines the culture of following the law.

A fifth movement that brought us this mess is the movement from standards to specific rules. Advisers said to the regulators, "Tell us precisely what you want us to do or not do, and we will do it or not do it." The result is that everything else is permissible. The reason for that change was theoretical. Precision was arguably more efficient. Why shouldn't the fiduciary have an opportunity to engage in activities that do not hurt the clients and create more value? The answer is that this efficiency creates tremendous inefficiency in enforcement. We used to have some foggy gray area around the prohibition. And that meant more risk for the fiduciary. It also meant more effective enforcement. We have lost that effective enforcement, and now we are paying the price.

And, finally, we weakened fiduciary law by interpretation. I remember a time when we looked at the rule, and we said, "What is the purpose of this rule? What was the wrong that the rule was supposed to prevent?" We then looked at another situation and said, "OK, this is a new situation. Let's look at the particular problem and see whether the new situation raises the same problem." What do we do now? We go to the dictionary, and we say, "What is the meaning of this word?" We do so out of context. We have forgotten what the rule is about. We have forgotten what

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its purpose was. Now we ask, “How did we get into this mess?” My answer is that it is no wonder we got into this mess.

LISA FAIRFAX: Thank you. Now we are going to hear from Frank Razzano.

FRANK RAZZANO: How did we get into this? I think the answer to that question is Eliot Spitzer and the Martin Act. Eliot Spitzer ran for attorney general in New York in 1994, and he came in dead last in the Democratic primary. In 1998, he was back on the scene, and this time defeated the incumbent, Dennis Vocco, as attorney general in New York State. And when he assumed office, he assembled a team of lawyers from very prestigious firms in New York City. He seduced them out of private practice to work for the attorney general’s office. The first big case that Spitzer brought was with the research analysis investigation.

In June 2001, the Wall Street Journal ran an article about a pediatrician settling with a broker-dealer for $400,000, based on allegations of biased research. As a result of reading that article, he began an investigation—sort of what Stanley Sporkin used to do as Director of the SEC Division of Enforcement back in the 1970s: start investigations based on what he read in the paper. The investigation uncovered some interesting e-mails, and the broker-dealer wanted to settle. But it wanted to keep the e-mail traffic confidential, obviously to keep it away from class action plaintiffs. On April 5, 2002, Spitzer basically told the broker-dealer the game was up and it had to come to the table and make a deal. The broker-dealer then went to Rudy Giuliani and hired him to approach Spitzer. The same day that Giuliani called Spitzer, April 8, 2002, Spitzer went into court and got an injunction under the Martin Act. The injunction, as we will see, is not an injunction that any other attorney general could have gotten in any other state or even the federal government, because it was an injunction that enjoined the broker-dealer’s business practices without the need for proof of success on the merits while Spitzer continued his investigation. A month later he got a $100 million settlement.

Then, we had the hot issue of the IPO [initial public offering] spinning inquiry. Spitzer attacked the practice of spinning using the Martin Act’s disgorgement provisions. Until Spitzer attacked spinning, it was unclear whether IPO spinning was even fraudulent. Indeed, many people in the business said, “Hey, this is a good business-development tool, and that is the way you get business.” The NASD [National Association of Securities Dealers, Inc.] and the SEC knew about this, clearly. In fact, there was a Wall Street Journal article about spinning in the industry. In 1997, the NASD even issued a warning to its members about it. Spitzer was able to
attack the IPO spinning investigation, again, because the Martin Act made it easier for him to do that. And look at the results he got. Just look at the amounts of money he collected with the global settlement.

Then, in September 2003, the mutual fund scandal hit, a scandal that blindsided both the SEC and the NASD. And as soon as the investigation was announced, Spitzer got some terrific settlements. These were settlements he got within the first month of the investigation. Spitzer has been called Wall Street’s “top cop,” the “enforcer,” the “sheriff of Wall Street,” and it is rumored that he is going to run for governor in 2006.

Clearly he has been an activist attorney general. But he was able to do this only because of the Martin Act, which is different from any other piece of legislation. It was passed in 1921, and unlike “blue sky” laws or even the federal Securities Act of 1933,\footnote{10. 15 U.S.C. § 77a-77aa (2000).} it is not a regulatory statute. It is a law-enforcement statute that gives the New York attorney general very broad powers with respect to almost all areas of the securities business. It empowers the attorney general to bring actions without having to show intentional wrongdoing or negligent conduct. Indeed, you do not have to show that anyone intended to be defrauded or that anyone actually was defrauded. And like the RICO statute,\footnote{11. Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961–1968 (2000).} the Martin Act is supposed to be liberally and sympathetically construed.

The statute also has a criminal component. It is a misdemeanor violation in New York to violate the Martin Act. Again, no proof of intent is required, no proof that actual fraud took place is required, and no proof that anyone was defrauded is required.\footnote{12. N.Y. Gen. Bus. Law § 352-c(4) (McKinney 1996).} In 1986, the Martin Act was amended to incorporate a felony provision, which does require proof of intent.\footnote{13. Id. §§ 352-c(5)-(6).}

I just want to go briefly through why the Martin Act is so powerful. The first two provisions of the Martin Act look pretty much like the mail and wire fraud statute, 17(a),\footnote{14. 17 C.F.R. § 240.17a (2005).} and 10b-5;\footnote{15. Id. § 240.10b-5.} but look at this one, number three: making or attempting to make a “fictitious or pretended purchase or sale” of securities or commodities.\footnote{16. N.Y. Gen. Bus. Law § 352-c(1)(a) (McKinney 1996).} Many of you may remember the \textit{Mulhern} case where the Second Circuit expressed doubt about whether merely trading without investment intent could constitute securities fraud under the ’34 Act.\footnote{17. Savoie v. Merchants Bank, 166 F.3d 456 (2d Cir. 1999).} Here, however, there is no requirement of intent or, as in section 9 of the ’34 Act,\footnote{18. Securities Exchange Act of 1934, 15 U.S.C. § 78a-78nn (2000).} that you induce someone to enter the
market. Additionally, there is no requirement, as in 10b-5 under Affiliated Ute,\footnote{20} of a breach of fiduciary duty with respect to an omission of fact. If you have a “fictitious or a pretended purchase,” it is covered, and Mulhern-type trading without investment intent would be covered.

Look at this language: “employ[ing or seeming] . . . to employ any deception, misrepresentation, concealment, [or] suppression. . . .”\footnote{21} I suggest that what this means is that a material fact is actionable without proof of a breach of fiduciary duty. Forget about Chiarella\footnote{22} if you omit something that is a “concealment” and a “suppression” under this Act. And you do not have to show that there was a breach of fiduciary duty or that anyone acted intentionally.

Look at the criminal provisions. Again, we have this provision about “concealment” and “suppression.” But look at this one: “Any promise or representation as to the future which is beyond reasonable expectations or unwarranted by existing circumstances.”\footnote{23} You can be convicted of a misdemeanor violation without intent, without negligence, by saying something, which is beyond reasonable expectation; a fairly broad statute.

Look at this one: “Any representation or statement which is false.”\footnote{24} But look at later on: Where through a “reasonable effort”\footnote{25} you could determine what the truth was, but you did not make a reasonable effort to ascertain the truth. It sounds like a due-diligence standard for anyone who deals in securities, without any requirement of intent and without any requirement that fraud took place.

Then let me go into this provision, which is the one Spitzer was able to use most effectively. Under the Martin Act, the attorney general can conduct a private investigation or he can go to court and ask a judge on the New York Supreme Court, which is the original trial court in New York State, to issue an injunction while the attorney conducts a public investigation. That is what Spitzer did to the broker-dealer I mentioned at the outset of my remarks. He announced that he was conducting an investigation, and he asked the court, while he was conducting the investigation, to enjoin the broker-dealer and require it to disclose its relationships with issuers when it prepared research reports—very, very broad powers. The SEC does not have comparable powers. It cannot run into court and get an injunction while it is investigating, but Spitzer was able to do it.

So, I submit to you that how we got here is in large measure due to an activist attorney general with a statute—the Martin Act. This gave him broad powers to attack practices within the industry. These were powers that, to some extent, the SEC and the NASD just did not have. Thank you.

\footnote{24} Id. § 352-c(1)(c).
\footnote{25} Id.
LISA FAIRFAX: Thank you.

THOMAS SMITH: Can I just add one comment to Frank’s wonderful presentation? You know, when the tech bubble burst in 2000 and the securities firms laid off hundreds and hundreds of employees, many started knocking on Spitzer’s door with a story to tell, and that has continued to this day with the insurance industry. Many of these informants who come to him are very disgruntled ex-employees and—

MARGARET BANCROFT: But it was also a very active attorney general.

RICHARD PHILLIPS: I do want to take exception to one statement that Frank made in his excellent presentation: the suggestion that the SEC does not have the power to deal with the issues raised by the fund scandal. I do not believe it has the broad powers contained in the Martin Act, but it has plenty of power to deal with each and every issue that is now front and center before the agency. Until the appearance of Eliot Spitzer in the aftermath of Enron, the SEC either did not see it or did not think it was important enough to act aggressively. It is unclear, however, whether the SEC is moving in the right direction or just making a lot of enforcement noise but with very little meaningful regulatory reform to deal with the actual issues.

JAY BARIS: Let us not forget that notwithstanding Frank’s excellent presentation, these cases involved allegations of fraud. Blaming the SEC for these problems is like blaming the cops for the murder. While I appreciate everything you said, we should remember that there was some wrongdoing here. And related to what Professor Frankel said, I do not believe that there was a complete breakdown of all moral and ethical fiber in the investment advisory business.

MARGARET BANCROFT: I think, going back to the beginning, we had the snake in the Garden of Eden, a statement that was made some years ago and is encapsulated in the legislative history of the 1940 Act—that funds are sold and not bought. It is crucial to fund complexes and their advisers so that they gather more and more assets, or at least maintain those assets. This is the critical dynamic here. When you get to the market timing, what Stern at Canary offered (an offer that was seized upon) was this: In exchange for letting me time funds A and B, I will commit to your complex “sticky” assets of, say, $20 million, $30 million. Now, those commitments were made on the sales side of the advisers. They were understood on the sales side, and they were appreciated there as a means of increasing assets under management.

I saw something very interesting this morning about market timing that came over my Blackberry. After the market-timing scandal here, both the FSA [Financial Services Authority] in the U.K. as well as the European community said, “My God, I wonder what kind of market timing occurred in our markets.” Their report has
just come out. The interesting thing about the report, from reading the summary this morning, is that when fund complexes were approached in Europe with the same proffer, the Canary proffer, they turned it down. Now, that tells me that the European market was not as focused on the need to gather assets as we are in the U.S. and, therefore, did not have the same motivation. I really think that is going to be worth looking at to see how that plays out.

Richard Phillips: Let me just put this issue in a little perspective. We are talking about a mutual fund scandal; a picture of an industry permeated with fraud and corruption, one would think. But the facts are that, thus far (and there may be more cases coming down the pike, but not many more) twenty-three or twenty-four fund management firms have been charged with either market timing or late-trading wrongdoing by the SEC or Spitzer or both. That is twenty-four firms out of 400; about six percent of the industry in terms of numbers of firms, and probably fewer in terms of assets because the industry giants such as Vanguard, American Funds, and Fidelity have not been involved. So we are talking about six percent of an industry. Can we ignore it and all go home? No. It is not a pretty picture, but it is not a picture of an industry permeated by fraud or corruption.

Why did it happen? The industry forgot it was a profession? God help us if the industry thought it was only a profession and not a business. Would you really entrust $7 trillion dollars of assets to "professionals" who did not know how to run a business? Having organizations with hundreds and thousands of employees and with far-flung global activities, you had better operate as a business or there will not be much of an operation left, so I do not think that is the issue.

The issue is an industry that lost control of its shareholder-account relationships. Why? Because in the 1990s, control of the shareholders, to an ever-increasing extent, rested in the hands of the intermediaries, the brokers and pension fund administrators. They kept the individual account records of those who traded through omnibus accounts maintained by the administrators, and the broker-dealers who were paid for maintaining their customer records and traded for their customers through omnibus accounts. The industry, knowing there was a market-timing problem, organized police forces to control it, pressed for redemption fees and fair-value pricing against resistance by an SEC staff that did not have the foggiest idea that there was a problem with market timing. But concern by the fund industry was not enough to force the intermediaries, who have no motivation to interfere with their clients' transactions, to install expensive technology to identify market-timing transactions and to impose redemption fees. They are not going to do it unless they are forced by regulation to do so.

What is so discouraging about what we have been through is a picture of an SEC with two published rule proposals that really deal with the problems of market timing and late trading: the mandatory five-day, two-percent redemption fee and the hard 4:00 p.m. close. But the SEC is backing away from the rules and backing away from any requirement that would effectively enforce against intermediaries the obligation to assist fund managers in their efforts to curb market timing. If the SEC does back down, we will be back to where we started from twenty years from now.

MARGARET BANCROFT: Dick, as to your point about the role of the distributor, the other day the CEO of the Scudder fund group had this to say: “Distributors, not product manufacturers, are currently king.” This industry works in cycles. We have a distributor-dominated industry right now, whereas fifteen years ago it was a product-manufacturing industry. I think that is going to play into another one of your points.

RICHARD PHILLIPS: But that’s the world.

MARGARET BANCROFT: That’s the world today.

RICHARD PHILLIPS: So stop complaining and let’s regulate it.

MARGARET BANCROFT: That’s right, but the point is that fifteen years ago or more the manufacture of fund products, in fact, had people asking that they make more funds to sell. And one of the things that I think has changed, and has led to revenue sharing and the other things, is the turnabout. Now product manufacturers must persuade the third-party intermediaries to sell their products. That is part of your point and part of your point also about . . .

RICHARD PHILLIPS: You cannot persuade them; you have to require them. No individual fund complex can require them; only the government can do it.

MARGARET BANCROFT: That explains a lot of the revenue sharing and that sort of thing.

LISA FAIRFAX: Let me get Tom’s reactions.

THOMAS SMITH: Increasingly over the past two decades you had the mutual fund industry gravitating from the old-line fiduciary, respecting investment management funds, such as Henry Hopkins’s T. Rowe Price here in Baltimore, to the consolidated financial institutions and public companies that have been buying up fund groups, with the result that revenues have become king. The original Jack Bogels of the world were making more money than they ever dreamed of in the old days, but when you have public companies involved, and revenue-sharing alliances being formed, there was immediate pressure to get everything you could out of the fund relationships. And I would suggest that some of these companies (not all, but

I would suggest it is a bit more than six percent) started tampering with the golden goose. They were looking for more and more ways to get money from the funds, and this led to the things such as market timing and all sorts of other fees. And you had new entrants into the business, a number of whom did not understand or appreciate the fiduciary responsibilities and conflicts of interests involved, and you had the rise of the corrupting “everybody does it” mentality.

You also had all sorts of enablers, such as the hedge funds with all the money they brought to the game. You had some twenty or so hedge funds that were exclusively devoted, with billions of dollars, to market timing. You had the participation of financial intermediaries, you had the omnibus accounts, you had the participation of clearing brokers, and you had lenders. Some of these people were out coaching the fund managers as to how to set up market-timing arrangements.

Finally, you had your usual outliers: the Strongs of the world (Strong had been in the precinct house several times already), and Messrs. Pilgrim and Baxter, who were old-timers in this business. It was almost a perfect storm.

You know, Dick, when you talk about it being largely over, the SEC and the states are continuing to go after this. There was a settlement announced yesterday with Fremont Investment Advisers.28

RICHARD PHILLIPS: It was public that they were involved. That is not ... THOMAS SMITH: No, but it is interesting. It is $4 million in damages. I did not see any allegation in the settlement that the funds themselves suffered damages. There was a relatively small amount of market timing that had been committed and a small amount of late trading. My guess is that any number of investment advisory firms are in that same boat: They had limited instances of market timing, and it was not the big corrupting event that you had at Canary.

RICHARD PHILLIPS: No, I do not think there are many more firms out there that had been involved in making explicit deals with market timers. The SEC and Spitzer’s investigations have been fairly thorough. There are a few more. We have one that has not been charged and probably will be, but these are harder cases. They are not black-and-white cases. The fact of the matter is you are talking about twenty-odd firms that have been involved in making these deals. Of these firms, only one, or perhaps two, at the fund manager’s level had anything to do with late trading, other than being victims. Of those firms, there were only two of them, Strong and Pilgrim-Baxter, where top fund executives market-timed, and there are two others where portfolio managers were market-timing.

The essence of the problem was that twenty-odd firms made undisclosed deals to give market timers space in contravention of their prospectus representations. That is the magnitude of the so-called scandal, and it is inexcusable. It is fraud, and the SEC is well justified going after it. The real issue that the SEC cannot face is how to

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prevent it in the future. Disclosure is not going to do it. Fund governance is not going to do it. You need to get control of the intermediaries, and the SEC is backing down.

LISA FAIRFAX: I think that whether you see it as just six percent or you see it as the tip of the iceberg, we now have at least some regulatory reforms that appear to be trying to solve the problem. So, let me get a sense from everyone else: How can we solve some of these problems? If it is not through legal enforcement, certainly it could be through focusing on independent directors.

JAY BARIS: To answer that question, you must step back and look at what the environment was or how the environment got this way. And if you go back to when the Investment Company Act was passed in 1940, you had a particular market and a particular limitation on technology. In effect, the changes in the law were not able to catch up or keep up with the changes in the market and the changes in technology. In 1940, you had a total industry measured in the billions, and nobody back then could have foreseen that you would have a $7 trillion asset base. Back then nobody had heard of globalization. There were no computers. There was no ability to monitor the prices of securities in Japan at 4:00 a.m. instantaneously. There were not the same opportunities for arbitrage.

As these changes in technology and the changes in the market developed over time, giving rise to the intermediaries and so forth, the laws were not able to catch up. We now have an opportunity, as Dick said before, for the laws to catch up with technology. Add to this the element of fraud. Everybody was home, the doors were unlocked, and everybody felt secure. We did not expect anybody to just walk in the front door and steal the apple on the table.

That was a long-winded way of answering your question. What do we do now? Where do we go? How do we deal with this? What is going on in the boardroom? How are directors reacting? The directors who are our clients are all good people who want to do the right thing. To speak to Professor Frankel’s point, they are looking for guidance. How do we fulfill our fiduciary obligations? What do we have to do to satisfy our responsibilities to our shareholders? You cannot legislate morality. We can start by implementing a rule requiring a hard 4:00 p.m. close for accepting orders. That is something concrete. That is a rule, and everybody understands it. The increase of potential liability, the increase in lawsuits, the increase in enforcement actions has created a need for rules. You cannot just have fuzzy feelings saying you have to do the right thing.

MARGARET BANCROFT: Do you think the newest SEC-adopted rule, which is going to require seventy-five percent of the board to be independent together with an independent chairman, is a going to do anything? I certainly have views about it, but that strikes me as something that was picked up from a twenty-year debate in corporate America using these exact sorts of panaceas, and I question whether that is an answer.
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RICHARD PHILLIPS: The fund governance reforms the SEC adopted, such as the requirement for an independent chair, are largely irrelevant to the issue. Independent directors are not the cause of the market-timing problem. In only one case has it been suggested, but never proved, that the independent directors knew about the market timing. The independent directors are very important to the control of conflicts that are inherent in this industry, and they have gotten important new tools to do their job.

Those tools do not emanate from the fund governance reform rules as much as they do from the Sarbanes-Oxley\textsuperscript{29}—type reforms, including the new compliance rule, which was proposed long before Spitzer entered the scene with his Canary Partners’ complaint against the fund industry. It was proposed during the Harvey L. Pitt administration. The compliance rule, the Sarbanes-Oxley counsel reporting rule, the new relationship between the auditors and an independent audit committee (including the requirement that the auditors be hired by and report to the audit committee), and the whistleblower provision of Sarbanes-Oxley—all of this regulation establishes the underpinnings for a culture of transparency. This culture has to exist between the management and the independent directors if the independent directors are going to do their jobs and infuse some sensitivity into the impersonal relationship between the managers and the shareholders. I view these steps as positive, but they have very little to do with market timing.

TAMAR FRANKEL: I would like to add one more point. There is one principle that will cover a lot, including the expertise about business. There is my business, and there is the investor’s business. So long as I’m an expert in the investment business, I will be delighted, but when you become an expert in your business as a professional, then there is a problem. In addition, enforcement cannot be achieved by the SEC alone, because the industry is so large and because the SEC does not have the necessary resources. Advisers must operate internal controls; otherwise, the law will not be obeyed. Advisers must exercise morality, that is, self-limitation; otherwise, the law will not be obeyed. I think for many years this industry had the morality and the self-limitation. Advisers had a gut reaction about wrongful behavior, but moved away, because they began to view their activities as businesses. I suggest you go back—

RICHARD PHILLIPS: I don’t think you can go back; I think you have to accommodate—

TAMAR FRANKEL: Go forward.

RICHARD PHILLIPS: People are saying the same thing about the legal profession: It used to be a profession and now it is a business.

TAMAR FRANKEL: That is correct.

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RICHARD PHILLIPS: The fact of the matter is that in the world of globalization you need very large law firms, very large organizations, to serve the needs of society in the legal sphere. Those large organizations have to be run by people who understand that it is a business, because there are many families dependent upon, and many dollars flowing through, those organizations. It is not something a professional can run unless that person is also a businessman. Let's accommodate the change instead of wringing our hands and saying, “Oh, the world is changing and we're losing our sense of professionalism.” We have to accommodate it, and the regulatory system has to accommodate it, too.

LISA FAIRFAX: We started off with the discussion of the Martin Act. What is your idea about where to go with reform? Repeal the Martin Act?

FRANK RAZZANO: No, I would not repeal the Martin Act. What I do not like about this scandal and the government’s reaction to it, however, is best encapsulated by what former SEC Commissioner Roberta Karmel said many years ago: Regulation by investigation is wrong! If there is a problem, the government ought to fix the problem with appropriate regulations. But what we are doing today with respect to every single problem that we have is trotting out civil and, worse still, criminal enforcement mechanisms to go after the problem. We are trying to change the system through investigations and through civil and criminal prosecutions. I do not think it is healthy for us as a society to do it in that fashion.

If there is a problem, let's fix the problem with new regulatory schemes that are specific. If we want to have a hard 4:00 p.m. close, let's have a regulation that requires a hard 4:00 p.m. close. To go after people and destroy their lives because the SEC had a rule that was ambiguous about late trading, however, is wrong! As you know, even law firms like Piper Marbury did not think that the NAV [net asset value] was supposed to be exactly at 4:00 p.m. They are being sued for that now, but there is no suggestion they were corrupt in reaching their opinion or interpreting the old rule. I do not think that to go after people in this manner and destroy their lives is right.

JAY BARIS: I would just add that the environment is becoming poisoned. I am aware of a real-life case that is almost into the absurd. In this particular situation, a simple examination by the SEC found what everybody, even the SEC in the exit interview, considered to be a minor transgression; it was debatable whether it was even a transgression of any law. The SEC issued a deficiency letter that accused the trustees of a breach of fiduciary duty. This is an irresponsible use of a very powerful weapon. On a scale of one to a hundred, where market timing is a ninety, this was about a two, if it were that. So, you have regulators coming out with guns blazing. Who wants to be a director? Who is going to want to be in this business if you cannot exercise your business judgment and face an allegation of a breach of fiduciary duty, which in our world is a horrible and serious allegation?

RICHARD PHILLIPS: I have not found any less of a flow of applications from people who want to be investment-company directors. There are a lot of people...
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around who want to be investment-company directors. If you need a director, give me a call and I will give you about five names. The fact of the matter is, I do not think the scandal is impeding the ability of the industry to get directors. I think that it is requiring a much greater time commitment on the part of directors, and one has to take it more seriously. Some people are declining because they realize they cannot make the commitment. But there are plenty of people out there who like the idea of being directors, for good or bad reasons. And there are lots of good independent directors who are trying to figure out how they can most effectively exercise their oversight responsibilities.

Jay Baris: They have all transferred their assets to their spouses.

Margaret Bancroft: It doesn’t work. [laughter]

Richard Phillips: If you are saying they are being prudent, that’s OK.

Margaret Bancroft: I think just counting on mere numbers of directors and an independent chair is not going to do it. I think that the directors of funds have to have an understanding of the fund business that is at least as good as corporate directors have of corporate business. When you think about how corporate directors are picked, they have been picked to the extent that the management can still do it based on the expertise they can bring to the table. In many, many situations those corporate board members do understand business in general and may understand the particular business. Management looks on them as very serious peers. I think that has a very powerful effect in boardrooms where the members of the board are considered to be peers in the operation of the industry.

Fund directors, I would suggest to you, without an understanding of the distribution system, even if they asked questions, were probably not in a position to really know what fund advisers were doing in terms of distribution. Suppose management came in and told the board the following: “Look, we have an opportunity with Canary to permit the market timing of a couple of our funds. That’s going to give us more assets in another fund, and it’s generally going to be helpful to the fund complex. We vetted it with legal, and legal says our prospectuses are written in such a way that we could do this. We also went to the portfolio managers in question, whose funds were to be timed, and they told us they could handle market timing.”

I am not sure that an independent director would have understood what was wrong with this picture. He may not have appreciated the real mechanics of the market timing, although the performance of the fund as such might not have been affected. What was really going on with market timers was allocating to a short-term player long-term gains. If you had understood that, you might have had an effective director who would have said, “Stop, let me think about this and understand it.” I do think that one of the issues for independent directors, particularly going forward, is coming to understand the industry a great deal better. Certainly aspects of that are being undertaken, but it is important; it cannot just be a person
of high moral integrity and quality. I think it really requires an ability to take on
the things that you hear in the boardroom and be heard.

MALE SPEAKER: I would part company with you here. I do not think it requires
someone to have expertise in the investment business or in the mutual fund busi-
ness. I think it requires someone to have the interest in learning about it and the
capacity to learn about it and the willingness to spend the time. Most of all, they
must realize that they are not on the board to be cheerleaders for the development
of the manager's business. Rather, they are on the board to keep an eye on the
interests of shareholders, particularly where the interests of the managers and
shareholders may diverge.

MALE SPEAKER: There has also been a sea change in the way directors are selected
in the last few years.

MARGARET BANCROFT: That is true.

MALE SPEAKER: The boards themselves are much more involved in who is being
selected, and there has been a sea change in the amount of education for indepen-
dent directors. The Independent Directors Conference of the ICI [Investment
Company Institute] had a conference the other day. These things are sold out;
people come, and directors are mostly interested in their duties and responsibilities
much more so than they were, say, twenty years ago. Their consciousness has been
greatly raised by all this. I do not know of any instances where people went to
boards, as you described it, and got them to approve market timing. I think this
was largely done—

MALE SPEAKER: There was an instance in which that was alleged, and that was in
the Bank of America case.30

MARGARET BANCROFT: Yes, and that is why I asked whether the independent
director would have perceived the real problem. The other thing that should
change, and the SEC staff said this in 1992, is the agenda of the board books. The
agenda is a thicket of the annual review of this, the quarterly review of that, on and
on and on. It deflects the board with pages of data. Is everybody at fault here? Yes,
because fund advisers could, nevertheless, have sent routine board materials in ad-
vance of board meetings in order to leave time to open up the meetings to live
discussions of live topics. To see the agendas, they read like a liturgy. I think part of
what must be redesigned is what is discussed at meetings.

MALE SPEAKER: A large part of the mutual refund reform effort has nothing to
do with market timing, but like all kinds of scandals, they generate a broad-based
regulatory reform effort. A focus of that effort has been in the distribution area.
The panelists think that what the SEC is doing is going to be significant and impor-
tant in dealing with basically the distribution compensation, revenue sharing, bro-
kerage for sales, 12h-1,31 whatever.

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JAY BARIS: Whether you take the compensation out of the fund and separate it, bifurcate it, and put it to point of sale may have all kinds of tax implications.

RICHARD PHILLIPS: The tax implications are very small when you look at the dollars. I have done some back-of-the-envelope calculations, and it is a very small disadvantage. What we are talking about is a suggestion that 12b-1 is now a fee for distribution that is paid by the fund, or, more accurately, a class of shares of the fund. That has given rise to all kinds of charges that they are unjustified, and represent hidden subsidies by the fund that the shareholders do not understand, etc. In fact, it is, although 12b-1 wasn't designed to be so used—a substitute for the front-end sales load, where the investor pays on a deferred basis the distribution costs for use of an intermediary because they choose to. It is, in effect, a credit arrangement—a deferred way of paying for the sales charge.

It has been suggested that in order to get transparency, you have to move that charge (not abolish it, just move it) from the fund level to the shareholder account level. The effect is that each time there is a deduction from the account, the shareholder will understand that $28.56 was deducted this quarter from his or her account, just like they understand that when they are paying a front-end load, 5.75% of their investment goes for sales charge. I am strongly of the view that this should be done. This kind of transparency will, first, educate the investor as to what they are paying for and, second, eliminate what in my view is the greatest source of unjustified criticism and misunderstanding of the industry that I have ever seen. Very smart people cannot get it into their heads that 12b-1 fees are simply deferred sales charges—a sales charge, paid at the option of the investor on a deferred basis because the investor chooses to use an intermediary and chooses to pay for it that way. So let's take the charge out of the fund and charge it to the individual account. Call a spade a spade, disclose it in dollars and cents, and get rid of the issues.

MALE SPEAKER: Dick, a lot of investors are finding that out because the sales of Class B shares have gone way, way down and are certainly not what they were ten years ago.

RICHARD PHILLIPS: That is because of the publicity, but when that dies down—

TAMAR FRANKEL: What about the fund that is closed to investors, where the investors continue to pay that distribution?

RICHARD PHILLIPS: Tamar is as knowledgeable a person as you can find in the industry, and yet she is raising something that is a total nonissue. What the 12b-1 fee pays for is the salesman's services at the point of sale on a deferred basis. Whether the fund is closed today is irrelevant; it was open when the services were performed and when the costs were incurred. All that the fund is doing is paying out the deferred charge for those services.

TAMAR FRANKEL: Dick, for how long? For the next 10 years?

32. Id.
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Richard Phillips: If we had better disclosure you would be able to regulate that—

Male speaker: And, to be fair, part of that 12b-1 fee could be allocated to the ongoing servicing and is not for sales compensation at all.

Richard Phillips: That ought to be looked at. If it is servicing and that servicing takes place, it takes place irrespective of whether the fund is closed, because the investor's account is not closed. That is, if it does take place, and I have a question about whether it really takes place.

Jay Baris: Perhaps a more troublesome issue is what the SEC will do to regulate the so-called revenue sharing, which is not as transparent. There was a proposal in Congress that would ban all revenue sharing. How do you prevent somebody from taking their profits and spending them any way they deem possible?

Margaret Bancroft: If you think they want to.

Male speaker: If they want to.

Margaret Bancroft: I do not think they want to. I think that the distributors there have had the upper hand, and if you want your shares sold, you will participate in revenue sharing.

Male speaker: All you are saying to someone is, "You can use your profits any way you want, but you cannot use it for an illegal activity." It is illegal to pay a broker an under-the-table sum of money to encourage it to sell your shares; that is all. It is very easy to legislate.

Male speaker: So, you are saying disclosure would cure that?

Richard Phillips: I do not think disclosure does cure it, because I do not think the investor really gets it and can get it. Say there is a broker who is receiving a sales load for a transaction, in addition to receiving some brokerage from the fund he sold, and in addition he is receiving revenue-sharing payments from the distributor (all of which, when reduced to disclosure, is very complex) when the investor, who is dealing usually through a broker, looks at alternatives, he sees the same disclosure and the same payments.

Male speaker: But wait a minute. What about the new SEC proposal to require—

Richard Phillips: That proposal makes the best case for the ineffectiveness of disclosure. Look how complex it is, and that is only one piece of the compensation.

Male speaker: The proposal is only 500 pages.

Richard Phillips: Yes, that's right; that makes my case. Thanks for helping.

Question: One thing that nobody has said anything about is the effect of mispricing of funds on the potential to profit from market timing.

Richard Phillips: There are those who believe it is not feasible to take all of the mispricing out of funds, and I am not sure they are right. There are funds that use fair value pricing every day, and there are others who feel with equal justification that daily fair valuation would lead to unreliable pricing because the methodologies...
for fair value pricing are not that accurate. We have to realize that, just as with financial statements, fund pricing is not a “bureau of standards” exercise in precision.

**Male speaker:** It is kind of a battle of the computers, too.

**Male speaker:** Market timing had evolved when the hedge funds started coming in with these millions of dollars, where the funds were suffering, and you had the portfolio managers coming to management saying, “You’re killing my performance with the international funds and some of the thinly traded funds.” That was an evil right there. One thing I noticed yesterday in the Freemont settlement is that there was no allegation, at least in the SEC’s press release, that these funds themselves suffered any losses.

**Male speaker:** It is a real problem. We just got a call in real life: A client called up on Wednesday afternoon. An event that had taken place in the United States on Tuesday that affected the markets overseas. The Japanese futures in the United States were going through the roof, but the market in Japan had not yet opened. The issue was what to do. We know that anybody who buys into this fund is going to be getting the price of the last close of the Japanese securities market. We also know that is going to be lower than what those prices would be if the market were open now and what they would be when the market does open in a couple of hours. What do you do?

**Margaret Bancroft:** What I think is interesting, from reading the FSA report, is this: One would have thought the market-timing arbs [arbitrageurs] were an international crowd. They talk to each other. They know the theories. They have read the same papers on the viability of market timing, which are on the Internet. They understand exactly where the profits are to be made. It is interesting to me that, apparently, market timing simply is not being played out in the European fund marketplace. From what I can read in the FSA executive summary, to the extent that the arbs have said to European funds, “Let me market-time,” they have been told, “You can’t.”

**Male speaker:** So we should make arbitrage illegal?

**Female speaker:** Oh, we know it’s good. [laughter]

**Question:** I would like to hear reactions to the continuous pricing notion. In some sense, what we are going through now we have gone through several times before. Jay, you mentioned that the technology has changed, but this sort of arbitrage was common in the 1920s. We had this debate in the ’30s, and it led to a pricing rule, which we had for twenty-eight years and then we switched. You could think once-a-day pricing could be either forward looking or backward looking—just sort of an arbitrary decision you make to do it once a day. Why is it that we continue to hold to this antiquated notion of once-a-day pricing, and why is there so much resistance to pricing funds continuously, which would eliminate this sort of problem and maybe encourage arbitragers? Arbitragers are making money only to the extent they are moving prices to where they should be.
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Jay Baris: There is a movement, and they are called exchange-traded funds. Up until now the SEC has said that you can only have this moment-to-moment pricing with a fixed portfolio of securities so that everybody knows what is in them. You have a basket of S&P 500 securities. Everybody knows what is in them. The issue is whether we will move to an exchange trade of fund that will have a bucket of securities that can be traded where the public does not know what is inside. There is a bit of a disconnect there, but this is being considered. There is a movement in this direction, so you might see a bucket of securities traded on daily and then priced by the market.

Male speaker: I guess you have a cost factor there. It is worth mentioning that all of these new regulatory regimes that are being put in are going to be very costly. The cost for funds and fund managers has gone way, way up. Look at the insurance and these constant SEC examinations.

Male speaker: Not to mention legal fees.

Male speaker: I think there is a large cost to it. I think it is technologically possible, but expensive. Also, I am not sure it takes care of the problems. If you were buying a fund at 1:00 p.m. and securities that are priced at the close of the Tokyo market or securities that have been priced, because the last trade on the New York took place at 10:00 a.m., you still have the fair value. I am not sure continuous pricing is the answer to the problem. Continuous fair valuing might be, but you are getting into a world of estimation.

Interestingly, the SEC historically resisted fair-value pricing even for international funds because the Commission thought it was subjective. I think they now realize that the dilution that takes place when you do not do it is such that you have to accept the subjectivity. If you are fair value pricing continuously, that is difficult. After all, you are pricing, say, Japanese securities based on baskets of ADRs [American Depository Receipts] and the futures market—some intricate methodologies. People have different methodologies, different prices, and different judgments. I think that is where we are moving, but I wonder whether it is really worth it to do continuous pricing.

Jay Baris: Going forward, it is going to be very difficult for smaller fund groups to survive, and there are going to be downward pressures on advisory fees, which I assume will come up later today. I think one of the real sleeper provisions is the one that requires the funds to disclose the directed deliberations and their conclusions on advisory fees. I think this will provide downward pressures on advisory fees, and it is going to be something that both the SEC and the private bar can shoot at and second-guess.

Female speaker: I think that is right. It certainly makes the directors more self-conscious as to what they are doing. We have seen the effect already.

Male speaker: And Spitzer is already requiring fee reductions as part of his settlement.
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MALE SPEAKER: But that is part of Spitzer's genius. He knows how difficult it is to figure out what the damage is from market timing. Instead of doing the nasty haggling as to whether it is "X" cents of shares or "X" cents of shares, he goes after management fees and gets big dollars and big headlines. I have enormous respect for him as a high-flying regulator.

MALE SPEAKER: We're going to send him to California, Dick. [laughter]

RICHARD PHILLIPS: His genius, as Frank points out, is his ability to bring criminal—

MALE SPEAKER: No, I really think it is his activity. The Martin Act has been there, and it has been there, and it has been there, and he really has humongous energy.

MALE SPEAKER: He has enormous energy, enormous cleverness, and understanding that financial institutions cannot stand publicity. And he has no scruples about using the press to accomplish his aims. He is very effective.

MALE SPEAKER: Well, he is going to get his because his opponent for governor is going to be Chuck Schumer, who has all that in spades, plus a lot more money.

MALE SPEAKER: Yes, I think he may want to stay on as attorney general for a while. [laughter]

LISA FAIRFAX: Does anyone else have a question? OK, I thank the panel for their quite lively discussion and participation. I'm sure if you have a question you want to ask anyone independently, you can feel free to do so. Thank you.