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CONGRESSIONAL AND REGULATORY ATTEMPTS TO CURTAIL ABUSES WITHIN THE MUTUAL FUND INDUSTRY

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I. INTRODUCTION

Recent incidences of fraud within the mutual fund industry have created unease with the methods used to police securities by the Securities and Exchange Commission ("SEC"), the Department of Justice, and the states. In an almost axiomatic response, Congress rushed to offer legislation promising to clamp down on unscrupulous fund managers bilking smaller volume investors out of pensions and savings. The movement towards more intense securities regulation seems analogous to the prohibition-era emergence of bootlegger-busting feds, breaking up the speakeasies and stifling the hooch trade. Ironically, some of the tools previously used to prosecute organized crime figures may experience resurgence in the field of high finance.

Current thinking about mutual fund fraud rests on a simple premise: traders, using gaps in existing rules or openly subverting the law, conspire with brokers and dealers (and possibly fund managers) to reap illegal profits. As a result of the practices described below, illicit traders and broker-dealers achieve high levels of success in the market while ordinary investors are

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burdened with shares of a damaged fund. To be certain, these problems are not solely theoretical. Misconduct within the system exists, and there have been documented cases of fraud perpetrated by fund managers, traders and broker-dealers.[1] The examples that follow have motivated Congress to increase pressure on the SEC and the industry to eradicate wrongdoing.[2] The legislative proposals listed below expired with the close of the previous Congressional session;[3] nevertheless, the ideas espoused should not elapse. Almost certainly, there will be a need for mutual fund reform in the near future.[4] Whether promulgated as SEC rule or federal law, the next incarnation of mutual fund regulation must contain measures addressing late trading, broker-dealer relations, and should include a shift towards fair value pricing.

As the SEC promulgates new rules and Congress pontificates on the need for reform, investors, brokers, and dealers are thinking up new ways to circumvent the established policies. Thus, it is helpful to examine from where the controversy erupted, and to where the ultimate goal lies. Certainly, wherever vast amounts of wealth are concentrated there is motivation to cheat. The damage levied by fraud in this arena has the potential to affect many people and their personal finances.[5]

This article begins with an examination of the current problems in the regulatory structure of mutual fund oversight by looking at the methods advanced by unscrupulous investors, brokers, and funds. The three avenues explored below, late trading, unfair broker-adviser relations, and fair value pricing, are investors' dubious preferences for fast returns. I explore late trading first in order to emphasize the brazen attempts by brokers to circumvent existing law. The methods described give insight not only to the troublesome transactions, but also give guidance to correct the problem and prevent future abuses. Then, I will broach the legal, but no less insalubrious area of dealings between brokers and advisers. By examining the current scheme, as codified in federal law, I have arrived at the conclusion that these types of deals must be outlawed in order to protect investors from conflicts of interest. The final issue that warrants attention is fair value pricing and the argument for uniform market prices. This controversial proposal is often

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1 *See generally infra* notes 23 and 31 and accompanying text.

2 *See generally infra* Part V.

3 *Id.*

4 A 2004 survey by the Investment Company Institute concluded, following 15 Congressional hearings in an 8 month period, that "[R]egulatory reform was desirable to help address late trading and abusive short-term trading . . . ." Investment C. Inst., *Annual Report to Members* (2004) at 11-12, *available at* http://www.ici.org/pdf/04_ici_annual.pdf.

5 Mutual funds are a $7 trillion business. *See* Peter Elkind, *The Secrets of Eddie Stern*, FORTUNE, Apr. 19, 2004 at 106.

misunderstood. However, I demonstrate that global markets can be manipulated and bastardized, and thus, demand federal oversight.

Next, I will examine some failed attempts to reform the current system governing trading.[6] Although the legislation noted was not enacted, I believe that the ideas promoted should appear in future proposals. The strengths and weaknesses of three bills are explained; although these measures never received a vote, they are significant, primarily, because lawmakers have identified problem areas and have determined that action is necessary to resolve conflict.

I conclude with my own proposal to reform the mutual fund industry. Many of the ideas I have included appear in the three unsuccessful bills. However, the points that need additional attention are further discussed, and I arrive at a final suggestion.

II. LATE TRADING[7]

Mutual fund prices are set after the close of the exchange markets (4 p.m. Eastern) for the next business day's trading.[8] The net asset value (NAV) of the fund must be reported shortly thereafter.[9] During the period between the time that the market closes and the new NAV is reported, a shrewd investor could buy shares of an undervalued fund, or sell shares of a fund that will fall when the new numbers are released. The investor does not have to rely on speculation, as do ordinary traders, because companies often make important disclosures following the close of the market.[10]

The SEC has discovered several different methods by which late trades are conducted.[11] Previously, the SEC permitted trades of mutual fund shares

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6 *See generally infra* Part V.

7 In the interest of unqualified clarity, it is necessary to affirm that late trading is currently an illegal practice. *See* 17 C.F.R. § 270.22c-1 (2005).

8 *Id.* § 270.22c-1(b)(1) (2005).

9 The Wall Street Journal has reported that, according to Nasdaq, in the past year 7.6 percent of mutual funds transmitted daily prices to the Nasdaq mutual-fund quotation service before 5 p.m., 45.8 percent of funds transmitted their daily prices from 5 p.m. to 5:30 p.m. and 40.9 percent did so from 5:30 p.m. to 5:50 p.m. Thomas C. Frongillo, Christine S. Chung, and Najwa M. Nabti, *'Late Trading' of Mutual Funds: Chinks in the Armor of the Regulators' Claim That it is Illegal Per Se*, 10 NO. 10 ANDREWS SEC. LITIG. & REG. REP. 2, (Sept 22, 2004) (quoting Randall Smith & Tom Lauricella, *Law Firms Advised on Rules Governing Funds' Late Trading*, WALL ST. J., Dec. 2, 2003 at C1).

10 For one example of disclosure guidelines used by a public company, *see*, Magma Design Automation Corporate Disclosure Guidelines (January 24, 2006) *available at* http://investor.magma-da.com/downloads/CorporateDisclosureGuidelines.pdf.

11 *Testimony Concerning Recent Commission Activity to Combat Misconduct Relating to Mutual Funds*: Before the S. Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs, 108th Cong. (2003) (statement of Stephen M. Cutler, Director,

to pass through intermediaries, who would consolidate orders placed by all their clients and forward them in bulk to the fund managers.[12] These transfers would usually occur following the close of the market.[13] Intermediaries were required to time and date all trade orders received from their clients.[14] However, in several cases, traders would make orders to buy or sell based on speculation, and could have their theories confirmed or refuted before the trades were complete.[15] Note the following example:

Assume Trader X owns a significant number of shares of Generic Mutual Fund (GMF). GMF holds a high volume of stock in a company, ACME Inc. Trader X learns at 2 p.m., that ACME Inc. will make an announcement at 4:05 p.m., following the close of the market. Trader X believes that ACME plans to announce the award of a highly lucrative government contract. The company releases the information at 4:05 p.m.; if ACME announces the contract, Trader X (along with all ACME investors) can celebrate, and shares will appreciate when the new NAV of GMF is determined. However, suppose ACME drops a bombshell, and announces that they are under investigation for potential antitrust violations; shares of ACME are certain to fall when the market resumes trading. Overnight, GMF will price the value of its fund and shares to reflect this loss of value in ACME.

Now, consider Trader Z, who also owns shares of GMF, and also knows about the pending ACME announcement. Trader Z likewise believes that ACME will have good news, but wants to be certain. Trader Z calls his broker (they are old friends, and Trader Z does a lot of business with the broker's firm) and places an order to sell all shares of GMF. The broker takes the order at 2 p.m., but will pool the order with those of all other traders and report them as a group to GMF later in the day. Now, if ACME makes the disastrous announcement at 4:05 p.m., Trader Z can breathe a sigh of relief. His cautious nature has paid off, and his money is safe. On the other hand, if ACME does indeed announce the award of the government contract, which all traders believed they would, Trader Z can call his broker buddy and cancel the sell order of his GMF shares before it has been reported to the fund.[16] The order had been time stamped for 2 p.m., but will

Division of Enforcement, U.S. Securities and Exchange Commission), *available at* http://www.sec.gov/news/testimony/ts110303smc.htm.

12 17 C.F.R. § 270.22c-1 (2005).

13 *Id.*

14 15 U.S.C. § 78a, et seq., Rule 17a-3.

15 *See generally* Linda C. Thomsen, *Recent SEC Enforcement Cases*, SL047 ALI-ABA 199, Jan. 12-13, 2006.

16 The SEC notes that orders are routinely reported by brokers to fund managers in the middle of the night. Amendments to Rules Governing Pricing of Mutual Fund Shares, 68 Fed. Reg. 70,388 at 70,389 (proposed Dec. 17, 2003) (to be codified at 17 C.F.R. § 270.22c-1).

never be seen by the fund or the SEC, so no record of wrongdoing exists. In this scenario, the broker has assisted Trader Z in making a contingent trade. Trader Z will avoid a possibly devastating loss.[17] Trader X, on the other hand, who has made no after-hours decision, must face not only the loss on the value of ACME stock reflected in the share price of his GMF fund, but also must contend with the additional loss of value created by Trader Z and others of his ilk.[18]

The above example typifies one type of means by which a late trade can be completed. The use of contingent trades is relatively simple in concept and execution. Another simple type of late trade relies on falsified orders and documents.[19] Investors, with the assistance of brokers, merely backdate their orders to appear as if they had completed the transaction prior to the 4 p.m. cut-off. In such an instance, Trader Z would submit his order to his broker following ACME's disclosure. The market has closed, and GMF will have calculated a NAV for the next day's trading, but the broker will still be collecting all the orders placed during the day to forward to the fund. The broker will simply stamp Z's order to an earlier time, and forward it along with the rest. This ploy, the common late trade, requires a degree of collusion between an investor, and a fund's intermediary or the fund itself.

A similar type of late trade is much more savvy and unseemly. Investors, using computer software provided by brokers, submit and process their own trades after the 4 p.m. deadline.[20] At first glance, it would seem that the broker is merely a bystander to the fraud perpetrated, however, at least in one instance, the investor received the software, made trades with the knowledge of the broker, and made sales involving funds managed by the broker itself.[21] Additionally, lest we assume that the funds themselves are victims to these

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17 Note that a late trader often doesn't know the adjusted NAV of the fund they act on. The trade used as an example represents a case where the fund share will almost certainly drop in price; for other such transactions this may not be true. It is also impossible to determine how much or how little a fund's price will change as a result of an after-hours announcement.

18 Elkind, *supra* note 5, at 110:

> [R]apid trading by one very large customer can wreak havoc on the ability of the fund manager to make money for everyone else. Big sums rushing in and out rob the manager of flexibility in buying and selling stocks. He has to keep extra cash at the ready to pay the exiting timer, which dampens performance. Timing also boosts trading expenses and generates capital gains, which impose costs on the fund's shareholders. According to one academic study, timing costs long-term mutual fund shareholders as much as $4 billion a year.

Id.

19 *See* Elkind *supra* note 5.

20 *Id.*

21 *See infra* note 23.

schemes, it is important to note that the funds are aware that late traders are infiltrating their ranks.[22]

Canary Capital Partners, LLC,[23] now stands in court records and boardrooms as the archetype of late trading. Canary, a New Jersey hedge fund, recently settled a suit with the State of New York for $40 million and the promise to cooperate with investigators in the ongoing dragnet of illegal market timing.[24] The sheer magnitude of inside deals that the investigation exposed continues to rock the financial and political universes.[25]

When we think about the composition of mutual fund investors on the whole, the truly disgusting nature of this crime emerges. Mutual funds are used primarily as a vehicle for long-term investment and growth.[26] Funds are filled with investments from 401(k) plans, IRAs, higher education accounts, investments by insurance companies, and the like.[27] In general, the investors relying on the funds for some personal financial security to keep their accounts intact until such time that they retire, suffer injury, or send a child off to school.[28] In fact, these investors are injured most when insiders execute late trading schemes.[29] The damage affecting these non-savvy traders has motivated Congress and the SEC to propose new groups of regulations.[30]

A. *Current Regulations Enacted to Combat Late Trading*

Following a string of high profile cases resulting in civil actions,[31] the SEC proposed a revision of the regulations regarding forward pricing of

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22 "[T]he SEC surveyed the 88 largest fund companies and discovered, stunningly, that half admitted to allowing market timing—and 25% allowed late trading." Elkind, *supra* note 5, at 122.

23 State v. Canary Capital Partners, LLC, No. 402803/2003 (N.Y. Sup. Ct. Sept. 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf.

24 *See* Deborah Brewster, Gary Silverman and David Wells, *Spitzer Targets Mutual Funds Illegal Trading*, FIN. TIMES (London), Sept. 4, 2003, at 29.

25 *See* Peter Elkind, *Spitzer's Crusade*, FORTUNE, Nov. 15, 2004 at 129.

26 At the end of 2003, $2.7 trillion in retirement assets were invested in mutual funds. Investment Co. Inst., *Mutual Funds and the U.S. Retirement Market in 2003* (June 2004), *available at* http://www.ici.org/stats/mf/fm-v13n2.pdf.

27 *See, Mutual Funds Hold 21 Percent Share of U.S. Retirement Market Assets*, Investment Company Institute (June 28, 2002), *available at* http://ici.org/statements/nr/2002/news_02_retire_market.html.

28 *Id.*

29 *See* Elkind *supra* note 18.

30 *See infra* note 32 and accompanying text.

31 *See generally*, In the Matter of Strong Capital Mgmt., Inc., S.E.C. Docket 3178 (May 20, 2004) *available at* http://www.sec.gov/divisions/enforce/claims/strongcapital.htm; In the Matter of Alliance Capital Mgmt., L.P., S.E.C. Docket 3401 (Jan. 15, 2004) *available at* http://www.sec.gov/divisions/enforce/claims/alliance.htm; In the Matter of Putnam Inv. Co. Mgmt., LLC, S.E.C. Docket 1913 (Nov. 13, 2003) *available at* http://www.sec.gov/divisions/enforce/claims/putnam.htm.

mutual fund shares.[32] The new rules seek to halt the methods used by investors and brokers to make late trades. The most important proposition would limit the number of entities that can work directly with a fund to secure an order.[33] Under the new rules, only a fund, a designated transfer agent, or a registered clearing agency can complete a trade after the established pricing time, and still receive the same day price.[34] The SEC hopes that by limiting trades seeking to get same day prices to a select group of intermediaries, they will be better able to monitor instances of deceit.[35]

III. RELATIONS BETWEEN FUNDS, BROKERS AND ADVISERS

As a corollary to the scandal erupting as a result of late trading, relations between funds and advisers have been heavily scrutinized as of late. Not surprisingly, regulators have come to believe that standards are too lax regarding the comity existing between managers, brokers, and investors.[36] These problematic relations have infiltrated mutual funds. To combat these problems, new regulations will most likely seek to prevent the cozy deals that border on bribery.[37] Currently there are some 8,000 funds competing to secure investments.[38] Fund managers are always looking to fill their coffers with more capital. In this arena of high competition, federal law permits circumstances whereby managers can solicit brokers and assist them with making transactions and placing orders.[39] However, given the improprieties witnessed in some of the above cases, policymakers now question whether these rules are too lenient, and whether they allow for a pattern of wrongdoing.[40]

Canary Capital Partners would not have been able to reap enormous profits without the assistance (or collusion) of fund operators such as Banc One Investment Advisors Corporation.[41] Banc One permitted Canary to

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32 Amendments to Rules Governing Pricing of Mutual Fund Shares; Proposed Rule, 68 Fed. Reg. 70,388 (proposed Dec. 17, 2003) (to be codified at 17 C.F.R. § 270.22c-1).

33 *Id.*

34 *Id.*

35 *See supra* note 32. At the time of printing, these proposals had not been codified.

36 *See infra* Part V.C.

37 *Id.*

38 Investment Company Institute, *Mutual Fund Statistics* (last visited Jan. 21, 2005), *available at* http://www.ici.org/stats/mf.

39 15 U.S.C. § 78bb(e) (2002).

40 *See infra* Part V.

41 *See* Office of New York State Attorney General Eliot Spitzer, *Spitzer Announces Market-Timing Settlement with Banc One Investment Advisers* (June 29, 2004), *available at* http://www.oag.state.ny.us/press/2004/jun/jun29d_04.html.

engage in market-timing transactions, an activity that is expressly forbidden in Banc One's prospectus.[42] When mutual fund managers agree to permit market timing trades involving short-term transactions, they have opted for greed over maintenance of the fiduciary duty owed to investors. A host of regulators, including New York State Attorney General, Eliot Spitzer, believe that this sort of short-run thinking will damn the industry.[43]

A. *Soft Dollar Arrangements*

Few investors realize that their financial or investment adviser is not required to secure the best price on a mutual fund sale.[44] Federal law permits an adviser to bargain for a price that includes brokerage and research services.[45] The increase in price beyond the value of mutual fund shares has become known as soft dollars.[46] While an adviser generally has a duty to deal in good faith with a broker-dealer,[47] the range of fees that could be classified as brokerage or research services is galactic in scope.[48] An investor looking to secure a comfortable retirement would likely not understand the rule concerning the prices sought by their adviser, and also not know the current NAV of the fund they purchase. While an adviser is required to disclose policy and practices regarding commissions,[49] the curious investor would fare

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42 *Id.*

43 *See* Elkind *supra* note 25.

44 Securities Investor Protection Corporation, *SIPC/Investor Protection Trust Survey: 4 Out of 5 U.S. Investors Fail "Survival Skills" Survey Test*, Dec. 31, 2005 available at http://www.sipc.org/media/release13Dec05.cfm. "[T]he vast majority of American investors do not possess important 'investor survival skills' needed to build their savings into a retirement nest egg . . ."

45 15 U.S.C. § 78bb(e)(1) (2002).

46 *See* Eric W. Pinciss, *Sunlight is Still the Best Disinfectant: Why the Federal Securities Laws Should Prohibit Soft Dollar Arrangements in the Mutual Fund Industry*, 23 ANN. REV. BANKING & FIN. L. 863, 865-66 (2004):

> Soft dollars are generally defined as a discretionary arrangement where an investment adviser directs her client's brokerage transactions to a broker-dealer and the adviser receives (in addition to trade execution) research and other related services from the broker. To calculate soft dollars, the cost to execute a portfolio trade is subtracted from the brokerage commissions. Thus, the amount of soft dollar credits that an adviser accumulates with a particular broker is based on the volume of commissions that an adviser directs to the broker. (Citations omitted).

Id.

47 15 U.S.C. § 78bb(e)(1) (2002).

48 *Mutual Funds: Hidden Fees, Misgovernance, and Other Practices that Harm Investors: Before the S. Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs*, 108th Cong. (2004) (statement of U.S. Senator Daniel K. Akaka), *available at* http://akaka.senate.gov/public/index.cfm?FuseAction=PressReleases.Home&month=1&year=2004&release_id=278.

49 15 U.S.C. § 78bb(e)(2) (2002).

well to examine the fine print of any contract; there is no requirement that the disclosure be plainly stated.[50] Codification of soft dollar arrangements gives credence to the practice, and as such, an adviser would not be violating the fiduciary duty to an investor by striking a deal with a broker-dealer.[51] Investors, howling about the seedy nature of these relationships, are in good company; many lawmakers have also expressed severe displeasure with the rules governing soft dollar arrangements.[52]

IV. FAIR VALUE PRICING

Possibly the most controversial and misunderstood facet of mutual funds involves proposals espousing the use of fair value pricing. Quite simply, if we return to the hypothetical trade discussed above, we can imagine a more legitimate scenario by which the nefarious Trader Z can profit from information gained from a corporate disclosure following the close of trading. Instead of investing in ACME Inc., imagine GMF holds large amounts of stock in Sony. Now, when the Tokyo exchange closes and Sony announces record sales of the newest gadget, Trader Z will just be sitting down to his morning coffee (assuming the trader is an early riser). Currently, the net asset value of GMF will not reflect the change in the value of Sony stock, having been determined as of 4 p.m. the previous day. Trader Z can load up on shares of GMF, and then dump them the following day when GMF has had a chance to calculate its true value. While Trader Z has done nothing illegal, the same problems result from this trade as had from the ACME deal; long term investors suffer when Trader Z sells off his shares of the greatly appreciated GMF.

In the long run, mutual fund investors can only benefit from global trading. Dealing on the London, Frankfurt, and Tokyo markets allows managers to protect assets from problems in the American economy.[53] If we are to accept global trading as a fact and benefit, some argue that we need to institute a policy that prevents the type of dealing we consider illicit within the national field.[54] This concern prompted the push for fair value pricing.

The SEC's current fair value pricing rule allows mutual fund managers to adjust the value of a foreign security held in a fund's portfolio if the security is affected by a significant event.[55] However, as the industry

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50 *Id.*

51 15 U.S.C. § 80a-35(a)(1) (2002).

52 *See infra* Part V.

53 Jon Birger, *Don't Get Crushed by the Falling Buck*, MONEY, Feb. 1, 2005, at 53.

54 *See infra* Part V.

55 *See* Lewis Braham, *"Fair Value" Pricing Isn't All That Fair*, BUS. WK., April 28, 2003, at 110.

currently functions, there is no rule or uniform agreement when a significant event has occurred that warrants an adjustment, or what mathematical formula to use to revalue the security.[56] As a result, it is possible that some fund managers, reacting to an event, will raise the price of a security in their portfolio, others will lower the price of the same security, and still others will not act at all. This activity not only confuses and frustrates investors, but it also injects unnecessary volatility into an already skittish industry. Recently, the SEC ordered that funds disclose to investors when the fund will use a fair value price and what effect this adjustment will have on the value of the fund.[57] However, this ruling does nothing to dispel the wide variation in valuation models that funds apply. Fair value pricing, like many other issues plaguing the mutual fund trade, has drawn a response from the SEC, but like many of the rules instituted recently, the disclosure provisions advocated merely confuse the issue for investors.

V. CONGRESSIONALLY PROPOSED REMEDIES[58]

The close of the 108th Congress signaled the death of several proposals to reform mutual fund regulation.[59] However, it would not be unreasonable to surmise that the ideas found in those measures will return. Like Lazarus, mutual fund reform simply awaits the benediction of a motivated legislator. While future incarnations may vary, it is almost a certainty that the provisions outlined below will again receive a Congressional audience.

A. *S. 1958—Application of RICO to Late Trades*[60]

Introduced November 25, 2003, the Mutual Fund Investor Protection Act of 2003 exuded enough chutzpah to justify its haughty title. The bill, authored by Senators Kerry and Kennedy, is the only piece of legislation in this field that advocates criminal sanctions for trading abuses.[61] The bill

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56 *Id.*

57 17 CFR §§ 239.15A, 274.11A (2005).

58 The following bills from the 108th Congress contain many of the same terms; in the interest of brevity, the unique portions of each measure are explored.

59 The bills listed in this section were all referred to the Senate Committee on Banking, Housing, and Urban Affairs, and they did not receive a vote before the 108th Congress ended. The Library of Congress, Thomas, http://thomas.loc.gov (last visited June 8, 2006).

60 18 U.S.C. § 1961, et seq.

61 *See* S. 1958, 108th Cong. § 11A (2003) (hereinafter S. 1958), which would have added:

> [A]ny act that violates section 17(a) of the Securities Act of 1933, with respect to the sale of or an offer to sell securities of a registered open-end company . . . section 10(b) or 17(a) of the Securities Exchange Act of 1934, with respect to the purchase or sale of the securities of such

sought to expand the reach of RICO by widening the definition of "racketeering" contained in the statute.[62] The bill would also have increased penalties for late trading abuses to a potential $10,000,000 fine and 25 years in prison for a person convicted of a purchase or sale of mutual fund shares involving illegal market timing.[63] The penalty leaps to a $50,000,000 fine for companies involved in illicit purchases or sales.[64] These increases truly reflect the authors' frustration with late-trading practices, particularly considering that the practice was already illegal at the time of the legislation's drafting.[65] But, as has been repeatedly shown, the traditional civil remedies imposed by the SEC have done little to curb abuses;[66] at least these influential lawmakers believe that the Department of Justice needs to be involved.

In addition to increased civil and criminal penalties, the bill contained several regulatory provisions.[67] The legislation would have required a mutual fund's prospectus to announce the fund's policy with regard to market timing trades and to state what measures the fund managers would employ to prevent such abuses.[68] While this effort seems hollow given the incident involving Banc One,[69] the potential for a private action is greatly enhanced, and investors could more easily demonstrate violations of fiduciary duties, should their fund act contrary to its filed statements.

Along those lines, the Kerry - Kennedy bill would have required the SEC to promulgate rules regarding a fund's duty to show that fees paid by the fund are in the best interests of shareholders.[70] This, and other goals of S. 1958, represent an effort to force sunshine into the inner workings of the funds. It is not surprising that Congress seeks to allow for disclosure regarding transactions unrelated to direct purchases and sales.[71] However, it

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> a registered open-end company, or (I) section 22(c) of the Investment Company Act of 1940, with respect to the valuation of the securities of such a registered open-end company; to the definition of racketeering that appears in the RICO Act, 18 U.S.C. § 1961.

Id.

62 18 U.S.C. § 1961, et seq.

63 S. 1958, § 101(b)(2)(B) (2003).

64 *Id.*

65 *See* 17 CFR § 270.22c-1.

66 *See supra* parts II and III.

67 *See* S. 1958, § 101(d) (2003).

68 *Id.*

69 *See supra* note 41.

70 *See* S. 1958, § 101(g) (2003).

71 Mark J. Astarita, *Introduction to the Securities Laws*, SECLAWS.COM, 2005, http://www.seclaw.com/seclaw.htm:

> Leaving the specifics of the regulations to later chapters, it is sufficient to note that the vast majority of securities regulations are aimed at one goal—to promote fair and full disclosure of

is surprising that the industry has not been more receptive to these ideas without interference from federal lawmakers. Given the size and scope of the industry,[72] it is a wonder that larger funds are not making sufficient efforts to reform practices in an effort to woo investors who are tired of reading about scandals.

B. *S. 1971—Corporate Governance Reforms for Mutual Funds*

Senators Corzine and Dodd obviously kept Enron in mind when they submitted S. 1971, The Mutual Fund Investor Confidence Restoration Act of 2003.[73] The second of the failed mutual fund reform bills emphasized disclosure and oversight.[74] The legislation would have required revelation of the actual expenses (for maintenance of the fund) allocated to each shareholder.[75]

Also, the fund would have been required to disclose how the fund managers were to be compensated, as well as the ownership interest of the managers.[76] Along with a host of other information required, the bill mandated the release of details concerning soft-dollar arrangements.[77] Similarly, it required disclosure by investment advisers of soft-dollar fees received from funds or brokers.[78] Unfortunately, this bill contained disclosure exceptions for research and brokerage fees, as defined in the SEC regulations.[79] This omission facilitates the same type of abuses that currently occur, whereby investors are blind to relations existing between their advisers and the funds they purchase into (or the intermediary promoting the purchase). The legislation required publication of a wealth of other information that would have shed light into the complicated dealings of advisers, brokers and funds.[80]

> all material information relating to the markets, and to specific securities transactions, including all aspects of market trading, as well as the financing and financial reporting by public companies.

Id.

72 *See* Elkind *supra* note 5.

73 S. 1971, 108th Cong. (2003) (*hereinafter*, S. 1971).

74 *Id.*

75 *See*, S. 1971 § 101(a)(1)(A) (2003).

76 *See id.* § 101(a)(1)(B).

77 *See id.* § 101(a)(1)(E).

78 *See id.* § 102.

79 *See id.* *See also supra* note 45.

80 *See* S. 1971 §§ 101-104 (2003).

Interestingly, the bill called for the creation of a mutual fund code of ethics and its release to investors.[81] Advisers, brokers and funds would have been required to note waivers and violations of the code provisions, but the legislation did not provide for forfeiture of license as a remedial measure.[82]

The introduction of ethical considerations is an important step toward mutual fund reform. These rules would seem obvious to an entity entrusted with fiduciary duties, but given the current status of SEC regulations, too many decisions concerning revelation are left to the discretion of the individual advisers, brokers and fund managers.[83]

S. 1971 contains a provision that required the SEC to create rules regarding the use of fair value pricing.[84] The rules would have explained when and how fair value pricing was to be used.[85] Individual funds would be required to disclose internal policies to shareholders, and certify compliance with the policy.[86]

Finally, the legislation contained an important provision aimed to assist investors in understanding the information released by their advisers.[87] The language of the bill itself is rather benign, requiring only a study to determine what investors know, what they should know, and how they could become better informed.[88] However, the provision is significant for its admission that investors do not have all the facts. As has been repeatedly shown in other areas,[89] the optimal method of ensuring professionalism within the mutual fund industry is a vigilant and knowledgeable public that will move

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81 *See id.* § 301(a).

82 *Id.*

83 149 CONG. REC. S16015-17 (daily ed. Nov. 25, 2003) (statement of Sen. Dodd).

84 *See* S. 1971 § 304(a) (2003).

85 *Id.*

86 *Id.*

87 S. 1971 § 501(a) (2003) states:

> IN GENERAL—The Securities and Exchange Commission shall conduct a study to identify—
> (1) the existing level of financial literacy among investors that purchase shares of open-end companies . . . ;
> (2) the most useful and understandable relevant information that investors need to make sound financial decisions prior to purchasing such shares;
> (3) methods to increase the transparency of expenses and potential conflicts of interest in transactions involving the shares of open-end companies;
> (4) the existing private and public efforts to educate investors; and
> (5) a strategy to increase the financial literacy of investors that results in a positive change in investor behavior.

Id.

88 S. 1971 § 501(a)(1-5) (2003).

89 *See e.g.* Freedom of Information Act, 5 U.S.C. § 552 (2002).

their investment dollars away from funds and advisors who abuse their fiduciary duties. The bill recognizes that the informed investor is empowered; if investors demonstrated strong fiscal acuity, perhaps the current SEC regulations would be sufficient to guarantee compliance. However, this legislation made an important admission: sometimes the government must force sunshine where private industry is reluctant to permit.[90]

C. *S. 2059—A Comprehensive Overhaul of the Industry*

Of the three Senate bills profiled here, the Mutual Fund Reform Act of 2004[91] contained the most aggressive and sweeping regulatory changes. Introduced by Senator Peter G. Fitzgerald, the bill included many disclosure requirements found in the other legislation, as well as requirements that the information released to investors be standardized throughout the industry.[92] Like the Corzine—Dodd bill,[93] the information must contain details about fees charged to investors,[94] as well as information about the compensation of fund managers.[95] In addition, the bill would have required the SEC to approve any changes to a fee schedule before the amounts were passed on to shareholders.[96]

Importantly, this bill included a distinct provision that would have barred soft-dollar arrangements between parties to a transaction.[97] The Fitzgerald bill recognized the deficiency of the Corzine—Dodd bill, and admitted that no sort of kickback relationship could co-exist with a viable fiduciary duty to investors.[98] Rather than adjust the rules regarding soft-dollar relations and wait for another loophole to be exploited, the drafters of the bill took the more proactive step of an outright ban on the arrangement.[99] Surely, this measure would ultimately force advisers and brokers to adjust their practices and find new sources of research, possibly by raising fees. But, perhaps an increase in fees (which would be fully explained in accordance with the disclosure rules) is a necessary remedy for disreputable relations between brokers and funds. In any event, permitting the appearance of conflicts of

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90 S. 1971 § 501(a) (2003).

91 S. 2059, 108th Cong. (2004) [hereinafter S. 2059].

92 *See* S. 2059 §§ 210-217 (2004), *see also* S. 2059 § 210(a) (2004).

93 *See supra* note 73.

94 *See* S. 2059 § 210 (2004).

95 *Id.* § 211.

96 *Id.* § 210(e).

97 *Id.* § 311.

98 *Id.*

99 *Id.*

interest is the worst possible menace to the mutual fund industry if continued growth and confidence are to be the goal.

This legislation would also have directed the SEC to develop a policy concerning fair market value.[100] The SEC would have the authority to select the method whereby fair value price was calculated, and require its adoption by all funds. Given the controversy surrounding the practice, it would appear that the philosophy underlying this provision is that it is preferable to be wrong than it is to be different, thus, erroneous pricing is negated if all funds are mistaken together.

The bill contained a provision that parallels the Corzine - Dodd language concerning investor education.[101] However, the Fitzgerald provision is even more watered-down.[102] S. 2059 would require the SEC to study the feasibility of a requirement that funds post filings on the internet, and the SEC would, likewise, post the relevant laws and announcements.[103]

VI. PROPOSED CHANGES

While there are many problems afflicting funds, the three presented above, namely late trading, manger relations and fair value pricing, can be quickly and efficiently dealt with. Foremost, Congress needs to step forward and again clarify that late trading is patently illegal. As suggested in S. 1958,[104] RICO should be amended to allow for imprisonment of abusive managers and broker-dealers. The threat of civil penalties cannot possibly dissuade an avaricious investor when trillions of dollars are at stake. With the type of white-collar crimes involved, criminal sanctions can be an effective preemptive measure.[105] Late trading is motivated by greed, not any sort of

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100 S. 2059 § 313 (2004) reads:

> (a) IN GENERAL—Not later than 90 days after the date of enactment of this Act, the Commission shall prescribe . . . standards concerning the obligation of registered investment companies . . . to apply and use fair value methods of determination of net asset value . . . in order to prevent dilution of the interests of long-term shareholders or as necessary in the public interest or for the protection of shareholders.
>
> (b) CONTENT—The rule or regulation prescribed under subsection (a) shall identify, in addition to significant events, the conditions or circumstances from which such an obligation will arise, such as the need to value securities traded on foreign exchanges, and the methods by which fair value methods shall be applied in such events, conditions, and circumstances.

Id.

101 *See supra* note 84.

102 *See* S. 2059 § 415 (2004).

103 *Id.*

104 *See supra* note 61.

105 David Feige, *How to Deter White-Collar Crime*, THE NATION, June 23, 2005, http://www.thenation.com/doc/20050711/feige (discussing the recent white-collar convictions resulting

necessity; as such, a mutual fund investor, engaged in an illegal trade, can be distinguished from other types of criminals.[106] Careful planning must be undertaken and alliances must be forged to complete an illicit deal. At every step along this iniquitous path, the parties involved should be wary that their liberty is at stake, and the prospect of greater wealth may consume an even greater fee. No penalty, even revocation of trading licenses, matches the weight of criminal liability, and no broker or manager can dismiss such a possibility if the threat of action is real and ubiquitous.

Next, the mutual fund industry must recognize the obligation they owe to investors, and must comprehend who their investors are. Funds and broker-dealers that brush aside long-term investors in favor of big money clients erode the integrity of the institution and threaten the future of millions of Americans.

It seems palpable that part of the fiduciary duty owed to investors ought to include a plain-language assessment of the fund's policies, procedures, fees, and duties. In addition, the pragmatic fund or broker should cater to the sensibility of investors and opt to provide a clear outline of practices in an effort to garner more business; however, this is not the case. Without an effective regulatory mandate, funds and brokers will not provide a complete and accurate prospectus. At the very least, this information should contain complete detail of fee arrangements including, what fees exist and the amount of charges levied. Also, any disclosure should announce the interests that managers hold in funds. The public should be aware if a fund's managers own (or even more frightening, don't own) shares of a fund.

As is noted in the Congressional proposals above,[107] the information released to the public needs to be presented in a way that the average investor can read and absorb; releases, disclosure and accurate reporting can only assist the public if they can understand the materials they have been presented. If an investor makes a decision on a broker or fund based on this disclosed information, a cause of action may later arise if the facilitator has not complied with the information furnished.[108] This represents an effort to empower the investing public to take an active role in oversight of the mutual fund industry.

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from the Enron scandal):

> Men like Ebbers (or Ken Lay or Jeff Skilling, who have yet to face trial in the Enron debacle) weigh their options—objectively assessing risk and reward. This may make them canny crooks, but it also makes them supremely responsive to the deterrent factors that most legal economists wrongly imagine apply to everyone—chief among them is fear.

Id.

106 *See* Elkind *supra* note 5.

107 *See supra* part V.

108 15 U.S.C. § 80a-35(a)(1) (2002).

Like the Fitzgerald bill,[109] a rule barring soft-money arrangements should be adopted. No adviser or broker should receive any credit for steering customers to specific funds or houses. Even if the end result is higher fees charged to negate the cost of research services, the industry must not appear any less than absolutely forthright and independent about the responsibility to investors to secure the lowest possible price of fund shares.

An effective mutual fund industry needs to make a decision regarding fair value pricing and adhere to its rule. Indeed, this is literally a problem of global proportions, and any option will be criticized greatly; however, the current state of confusion allows some funds to apply the rules, others not to, and everyone to end up with a different price.[110] Because of the very nature of the problem (*i.e.* pricing of foreign securities), perhaps a successful solution will involve negotiations with figures from the Tokyo, London, and Frankfurt exchanges.[111] In any event, once chosen, the rule should be applied to all funds, and preferably in foreign exchanges as well.

Congress would be well served to adopt the changes outlined above. The public needs these reforms, precisely because the average investor does not generally understand the problems involved.

VII. UTOPIAN MUTUAL FUNDS

Clearly, the mutual fund industry exists in a state of chaos. Even if one were to disagree that the problems presented here actually harm investors, it is indisputable that the uncertainty surrounding proposals for regulations, indictments, and Congressional inquiries create havoc on the trading floor. Even if the SEC and Congress were to enact an entirely new set of rules, the industry would be able to cope, adjust, and thrive. However, as the situation now stands, today's standard could become tomorrow's crime. All the while, the casualties of these practices constitute the most sympathetic of all victims, namely pension funds, families, and retirees.

Taking the most cynical view, this arena provides an excellent opportunity for a legislator to win priceless political capital. A strong willed legislator seeking to become a populist champion would attain legendary status with the public by directing a war against the manipulative investment

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109 *See* S. 2059 (2004).

110 *See* Braham, *supra* note 55 and accompanying text.

111 *See generally Testimony Concerning Global Markets, National Regulation, and Cooperation: Hearing Before the House Financial Services Committee*, 108th Cong. (2004) (statement of Ethiopis Tafara, Director, Office of International Affairs, U.S. Securities and Exchange Commission) (discussing the need for harmonized securities regulation to prevent fraud).

houses and defending the common interest.[112] Given that the scope of mutual fund investment is expanding and will likely experience continued growth, millions of Americans seek to have their futures protected against the ominous specter of Wall Street greed. Congress should act on the situation and should move ahead, independent of the SEC's somnolent review process.

VIII. CONCLUSION: LOOKING TOWARDS THE FUTURE

The best interests of the economy are served by a viable mutual fund industry. Like so many other arenas, the industry has become corrupted by traders seeking quick returns that have diluted portfolios and injected uncertainty into the trade. Nevertheless, it is promising that so many Americans have entrusted their retirement, future security, and the financial future of their children to the funds. Acknowledging this trust, Congress needs to appreciate the duty they owe to protect the assets of ordinary citizens. Mutual fund reform has failed, but hopefully it is only a temporary failure. A reinvigorated Congress should realize the gravity of the situation, and opt to make the small adjustments necessary to shed light on the practices used. Once the process has been opened to scrutiny by regulators and investors, the industry will continue evolving. There is no longer a place for the Canary Capital and Banc Ones of the world to cannibalize other investors. If given the tools, the industry itself will push these rogues aside in order to welcome the assets of legitimate patrons.

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112 *See* Elkind *supra* note 25.