Mutual Fund Scandals in the U.S. Market: Causes and Reform Measures

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University of Hawai‘i

6th Tokyo Roundtable on Capital Market Reform in Asia
September 28-29, 2004
Tokyo, Japan
# Global Mutual Funds

Unit: US$ billion

<table>
<thead>
<tr>
<th>Economies</th>
<th>Net Assets</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>7,414</td>
<td>53.12%</td>
</tr>
<tr>
<td>France</td>
<td>1,148</td>
<td>8.22%</td>
</tr>
<tr>
<td>Luxemburg</td>
<td>1,104</td>
<td>7.91%</td>
</tr>
<tr>
<td>Australia</td>
<td>518</td>
<td>3.71%</td>
</tr>
<tr>
<td>Italy</td>
<td>479</td>
<td>3.43%</td>
</tr>
<tr>
<td>United Kingdoms</td>
<td>397</td>
<td>2.84%</td>
</tr>
<tr>
<td>Ireland</td>
<td>360</td>
<td>2.58%</td>
</tr>
<tr>
<td>Japan</td>
<td>349</td>
<td>2.50%</td>
</tr>
<tr>
<td>Canada</td>
<td>338</td>
<td>2.42%</td>
</tr>
<tr>
<td>Germany</td>
<td>276</td>
<td>1.98%</td>
</tr>
<tr>
<td>Top 10 Total</td>
<td>12,383</td>
<td>88.72%</td>
</tr>
<tr>
<td>World Total</td>
<td>13,958</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

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Geographical Distribution of Global Mutual Funds

North America
US$7,752
(55%)

Europe
US$4,593
(33%)

South America
US$217
(2%)

Asia
US$1,361
(10%)

Africa
US$35
(0.25%)

Unit: US$ billion

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Growth of US Mutual Funds

Total Net Assets (US$ bn)

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Net Assets by Fund Categories

Total Net Assets: US$7,414.08 billion

- **Hybrid Funds**: US$436.68 (6%)
- **Bond Funds**: US$1,240.92 (17%)
- **Equity Funds**: US$3,684.80 (49%)
- **Money Market Funds**: US$2,051.68 (28%)
## Net Assets by Fund Categories

<table>
<thead>
<tr>
<th>Category</th>
<th>Type</th>
<th>US$ bn</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity Funds</strong></td>
<td>World</td>
<td>1,858.84</td>
<td>25.07%</td>
</tr>
<tr>
<td></td>
<td>Capital Appreciation</td>
<td>517.7</td>
<td>6.98%</td>
</tr>
<tr>
<td></td>
<td>Total Return</td>
<td>1,308.26</td>
<td>17.65%</td>
</tr>
<tr>
<td><strong>Hybrid Funds</strong></td>
<td>Hybrid Funds</td>
<td>436.68</td>
<td>5.89%</td>
</tr>
<tr>
<td><strong>Bond Funds</strong></td>
<td>Corporate</td>
<td>200.06</td>
<td>2.70%</td>
</tr>
<tr>
<td></td>
<td>High Yield</td>
<td>153.7</td>
<td>2.07%</td>
</tr>
<tr>
<td></td>
<td>World</td>
<td>27.56</td>
<td>0.37%</td>
</tr>
<tr>
<td></td>
<td>Government</td>
<td>224.71</td>
<td>3.03%</td>
</tr>
<tr>
<td></td>
<td>Strategic Income</td>
<td>300.79</td>
<td>4.06%</td>
</tr>
<tr>
<td></td>
<td>State Municipal</td>
<td>150.94</td>
<td>2.04%</td>
</tr>
<tr>
<td></td>
<td>National Municipal</td>
<td>183.16</td>
<td>2.47%</td>
</tr>
<tr>
<td><strong>Money Market Funds</strong></td>
<td>Taxable</td>
<td>1,763.31</td>
<td>23.78%</td>
</tr>
<tr>
<td></td>
<td>Tax-Exempt</td>
<td>288.37</td>
<td>3.89%</td>
</tr>
</tbody>
</table>

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US Retirement Market Assets
(As of 2003)

1. Mutual Funds are holding 22% of total U.S. retirement assets of US$12.0 trillion
2. 36% of all mutual fund assets are held in retirement accounts

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Nature of Industry Scandals

- Abusive Trading Practices
  - Late Trading
  - Market Timing

- Questionable Industry Practices
  - Soft Dollar Arrangements
  - Directed Brokerage
  - Revenue Sharing
  - Excessive Charging of Fund Fees

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Abusive Trading Practices

1. Late trading
   - Allowed some investors to illegally place orders for funds after the 4 P.M., EST close of trading
   - Among 34 brokerage firms surveyed by SEC, more than 25 percent reported instances of late trading

2. Market timing
   - Allowed some investors to take advantage of temporary disparities between the stale net asset value of a fund and the value of its underlying assets

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Adverse Impact of Market Timing

1. Increasing Costs
   Greater transaction costs due to more frequently buy or sell shares of the underlying securities

2. Declining Investment Returns Over Time
   ♦ Greater percentage of cash holding in the fund’s assets to meet demand for redemptions
   ♦ Over the long term, cash holding lower investment returns

3. Dilution of Gains
   With price increase: Short-term traders gain more than long-term shareholders
   With price decline: Short-term traders lose less than long-term investors

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# Net Asset Value with and without Market Timing

**Day 1**

<table>
<thead>
<tr>
<th>Portfolio securities</th>
<th>With no market timing</th>
<th>With market timing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$90,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$100,000</td>
<td>$101,000</td>
</tr>
<tr>
<td>Shares</td>
<td>10,000</td>
<td>10,100</td>
</tr>
<tr>
<td>Net asset value</td>
<td>$10.00</td>
<td>$10.00</td>
</tr>
</tbody>
</table>

Market timer buys 100 shares

- Calculation of net asset value after 10% rise and $1,000 investment by market timer:
  - With no market timing: $99,000
  - With market timing: $99,000 + $11,000 = $110,000

**Day 2**

<table>
<thead>
<tr>
<th>Holdings of fund at end of day 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>With no market timing</td>
</tr>
<tr>
<td>With market timing</td>
</tr>
<tr>
<td>-----------------------------------</td>
</tr>
<tr>
<td>With no market timing</td>
</tr>
<tr>
<td>With market timing</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Total assets</td>
</tr>
<tr>
<td>Shares</td>
</tr>
<tr>
<td>Net asset value</td>
</tr>
</tbody>
</table>

Fund redeems market timer’s 100 shares at day 2 net asset value

- Market timer buys 100 shares

- Calculation of market timing:
  - Net asset value: $10.00 + $1,000 = $10.89

Source: U.S. GAO (July 2004)

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Arbitrage Profits and Dilution of Fund Value

A. Arbitrage Profits

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Annualized Arbitrage Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>International Equity Funds</td>
<td>35% - 70%</td>
</tr>
<tr>
<td>Small-Cap Equity Funds</td>
<td>20% - 25%</td>
</tr>
<tr>
<td>High Yield Bond Funds and Convertibles Funds</td>
<td>10% - 25%</td>
</tr>
</tbody>
</table>

B. Dilution of Fund Value (Basis Point)

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>International Equity Funds</td>
<td>66</td>
<td>46</td>
<td>63</td>
<td>114</td>
</tr>
<tr>
<td>Small- and Mid-Cap Equity Funds</td>
<td>59</td>
<td>51</td>
<td>81</td>
<td>147</td>
</tr>
<tr>
<td>Large-Cap Funds</td>
<td>4</td>
<td>2</td>
<td>2</td>
<td>-1</td>
</tr>
</tbody>
</table>


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Questionable Industry Practices

- Revenue Sharing
- Soft Dollar Arrangements
- Directed Brokerage
- Excessive Charging of Fund Fees
Revenue Sharing

- Mutual fund gives a brokerage firm a share of its revenues if the firm's brokers promote the fund's shares to their customers
- Revenue sharing in addition to the sales loads and 12b-1 fees
- Approximately 80% of mutual funds that partner with major broker-dealers make cash revenue sharing payments
- As large of $2 billion per year?
- SEC and NASD proposed rules that would require broker-dealers to disclose revenue sharing payments that fund advisers make to broker-dealers to compensate them for selling fund shares

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Soft Dollar Arrangements

- Mutual fund pays a brokerage firm for research or other services in the expectation that the firm's brokers will promote the fund's products.
- Current expense ratios of mutual funds are understated because the cost of research purchased with "soft dollars" is ignored.
- With the fixed commission rate abolished in 1975, broker-dealers differentiated themselves by offering research-related products and services to investment advisers.
Directed Brokerage

- Directed brokerage occurs when a mutual fund agrees to use a brokerage firm to buy stock for its holdings if that brokerage firm promotes the fund's shares to its other customers.

- In August 2004 SEC voted to prohibit mutual funds from directing securities-trading as a reward for selling fund shares to investors.
Mutual Fund Fees

I. Shareholder Fees:
   Directly Charged to a Fund Shareholder
   - Sales Charge (or Load)
   - Redemption Fee
   - Exchange Fee
   - Annual Account Maintenance Fee

II. Annual Fund Operating Expenses:
    Deducted from Fund Assets Prior to Distribution of Earnings
    - Management Fee
    - Distribution (12b-1) Fee
    - Other Expenses

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Shareholder Fees

- Sales Charge (or Load):
  Front-end load when purchasing shares
  Back-end load when selling shares

- Redemption Fee:
  Paid to a fund to cover the costs involved with a redemption, other than sales costs

- Exchange Fee:
  Charged when an investor transfers money from one fund to another within the same fund family

- Annual Account Maintenance Fee:
  Charged by some funds to cover the costs of providing services to low-balance accounts
Annual Fund Operating Expenses

- Management Fee
  Charged by a fund’s investment adviser for managing the fund’s portfolio of securities and providing related services

- Distribution (12b-1) Fee
  SEC Rule 12b-1 permits funds to debit shareholders' accounts to pay marketing and distribution expenses

- Other Expenses
  Fees paid to a fund’s transfer agent for providing various fund shareholder services, such as toll-free phone communications, computerized account services, website services, recordkeeping, printing, and mailing

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More on 12b-1 Expenses (I)

- SEC Rule 12b-1 has been in place since 1980
- Original intention:
  Facilitate growth of funds and sharing cost savings from economies of scale could be passed along to investors
- Some 12b-1 fees are as high as 1% per year aided by questionable practices; 12b-1 fees have largely degenerated into disguised loads
- Mutual Fund Reform Act under Review by US Senate would statutorily repeal Rule 12b-1
- Eliot Spitzer (2003):
  “A 25 basis point reduction in the fees would result in a $10 billion savings for shareholders annually”

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More on 12b-1 Expenses (II)

SEC Study (2004) by Lori Walsh

- Funds with 12b-1 plans grow faster than funds without them
- Shareholders do not gain benefits in the form of lower average expenses or lower flow volatility
- Shareholders are paying the costs to grow the fund, but fund adviser is the beneficiary from the growth

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Structure of a Mutual Fund

Mutual Fund Shareholders

Owners of Fund Providers

Board of Directors

Fund Providers (Investment Adviser)

Principal Underwriter
Administrator
Transfer Agent
Custodian
Independent Public Accountant

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Major Cause: Idiosyncratic Fund Governance System

- Fund Providers: Caught between Two Masters
- BOD’s Fiduciary Duty: Inadequate Performance
  - Are directors serving as the stewards of shareholders’ investments?
  - They rather act at the behest of the advisory and management companies
  - BOD is supposed to negotiate lower fees for their shareholders
  - BOD is supposed to oversee investment advisers
  - The Chairman of the BOD is usually a senior member of the owner of the fund provider
  - Directors sometimes serve on dozens or more fund boards and often join the fund board after retiring from a job at the management company

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Reform Measures by US SEC (I)

- **To Stop Late Trading: A Hard 4 Proposal**
  All fund transactions be received before 4:00 p.m., EST in order for investors to receive the same day’s price.

- **To Curb Short-Term Trading (including Market Timing)**
  - A mandatory 2-% fee on the proceeds of fund shares redeemed within 5 business days of purchase.
  - SEC has shelved this proposal and considers recommending that funds adopt fees voluntarily.
  - A greater disclosure of market timing, securities pricing, and portfolio disclosure policies.
  - New guidance issued: mutual funds may delay exchanges of shares from one fund to another in order to combat market timing.

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Reform Measures by US SEC (II)

- New regulations issued in April 2004 that require mutual funds to disclose the following information in their prospectuses:
  - risks to shareholders of frequent purchases and redemptions of shares
  - policies and procedures regarding frequent purchases and redemptions of shares
  - circumstances under which they will use fair value pricing and the effects of using fair value pricing
  - policies and procedures with respect to the disclosure of their portfolio securities and any ongoing arrangements to make available information about their portfolio securities

- Mutual funds must comply with these new regulations by December 5, 2004
Reform Measures by US SEC (III)

- For Improved Governance and Oversight
  Independent Chairman
  75% of BOD: Independent (currently 40%)

- Appointment of Compliance Officer
  reporting to BOD

- Independent Directors meet at least quarterly in a separate session

- Independent Directors authorized to hire employees and others to fulfill their fiduciary duties

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Thank You!
For Further References,
Please visit
http://www2.hawaii.edu/~rheesg