

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## The Spitzer Complaint: Ethical and Practical Considerations For Advisors and Their Clients

*Nathan Behan and Patrick Flynn, Prima Capital Holding, Inc.*

On September 3, 2003, Eliot Spitzer, New York state attorney general, filed a complaint stating that his office had uncovered illegal trading involving a hedge fund, Canary Capital Partners, LLC (“Canary”), and several mutual fund companies over the time period 1999 to 2003. The Attorney General stated in his complaint that Canary had entered into an agreement with Bank of America’s mutual fund operation to buy and sell shares of funds after the market closed and trade them the next day for a significant profit. This practice known as “late trading” provided the hedge fund the opportunity to buy a fund after news was announced about a top holding or the market in general and then sell the next day, after the announcement was reflected in the fund’s price. Under both New York State and federal law, it is illegal for investors to buy or sell mutual fund shares after the close of the NYSE, if those transactions were not received before the close. Late trading dilutes fund shareholders’ gains while enabling the hedge fund to extract a nearly risk-free profit.

Mr. Spitzer also alleges that Canary arranged relationships with Janus, Strong, Bank One and Nations funds, permitting the hedge fund to employ their market-timing strategy in exchange for investments in other funds, where they could collect additional fees.

Mutual funds calculate their share prices based on the value of the securities in their portfolios at 4 p.m. eastern time, when U.S. markets close. However, the most recent closing prices in the Far East could be as much as 15 hours old. Seeking to capitalize on sharp moves in the U.S. market, Canary purchased or redeemed shares of international funds in the U.S.,

believing that foreign markets would follow the next day. Market timing is not explicitly prohibited by securities laws; however, as fiduciaries for their investors, most mutual funds discourage market-timer trading because it dilutes performance and raises a fund’s transaction costs. According to the complaint, Spitzer believes that not only was there a failure to disclose timing arrangements to mutual fund investors, but that the mutual fund prospectuses contained materially misleading statements assuring investors that the fund discouraged and actively worked to prevent mutual fund timing.

Mr. Spitzer stated in his complaint that Canary entered into agreements with dozens of mutual fund families, allowing it to time many different mutual funds. Of the fund families mentioned, only Bank of America’s Nations Funds was mentioned as participating in the clearly illegal late trading. Bank One’s One Group Funds, Janus Capital and Strong Capital were all mentioned as participating in market timing. In each case the specific funds mentioned were either international funds or funds that saw a great deal of volatility, such as technology funds. These types of funds lend themselves to being manipulated in this type of arrangement. Coincidentally,

the three Janus funds referenced in Spitzer’s complaint – Janus Worldwide, Janus Mercury and Janus High-Yield – are the same funds that lost their long-time managers this year.

While just four fund families were mentioned in the Spitzer complaint in the intervening month since it was originally announced, two other firms – Prudential and Alliance Bernstein – have also been implicated in similar trading arrangements to the detriment of their

**THIS PRACTICE KNOWN  
AS “LATE TRADING”  
PROVIDED THE HEDGE  
FUND THE  
OPPORTUNITY TO BUY A  
FUND AFTER NEWS  
WAS ANNOUNCED  
ABOUT A TOP HOLDING  
OR THE MARKET IN  
GENERAL AND THEN  
SELL THE NEXT DAY,  
AFTER THE  
ANNOUNCEMENT WAS  
REFLECTED IN THE  
FUND’S PRICE**



clients. We would expect a significant number of additional fund families to be exposed before the end of the year.

### Damage: Real vs. Image

There is little doubt that investors in the Nations International fund were actually financially damaged and, just as certainly, the reputations of these fund companies have also been severely damaged. This corollary damage may be far greater and of a much broader scope, leading to greater monetary loss for the firms and investors. Investors – institutional and individual alike – have placed these fund managements in a position of fiduciary trust. Hopefully, each investment was made after a review of the prospectus of each fund, including the fund style and process, an assessment of the tenure and skill of the portfolio management team and, of course, performance. While Nations Funds' late trading is the only one of the offenses named in the complaint that is strictly illegal, that trust has been thrust aside for the named funds at least, and by the fund firms entirely at worst.

Currently, there are thousands of pension plan sponsors and 401(k) administrators who are considering the elimination of these fund families from their plans. For these administrators, the decision is fairly straightforward as fiduciaries for the employees and the firm. Many will worry about their future liability, should there be further revelations of misleading business practices or additional indications that individual investors are being mistreated relative to the institutions. In most cases, this will lead to complete withdrawal of all assets from the four mutual fund families (and any others implicated) which, in turn, will trigger a host of secondary costs.

But if these fund families are to be replaced, the administrators will have to select another fund company that they trust. It is nearly certain that additional fund families will be identified as having favored large institutional investors over individual investors. Further complicating this issue is the number of subpoenas that are being issued. While investigators are trying to ascertain how widespread this practice is, they are investigating many fund families, even if these companies

were only approached by Canary Capital (or another institutional trader) and turned the business down. This situation creates a feeling of distrust and uncertainty for all investors making a change.

### Sell or Not Sell

The "sell" or "terminate" decision for the funds named in the complaint, and indeed all funds in these families, will be up to each individual investor and plan sponsor. As mentioned, from a fiduciary point-of-view, it will be difficult for most plan sponsors to continue to use these fund families. For individual investors, many of whom have every reason to remain confident in the portfolio management of a particular fund, if not the management of the firm, this may be a difficult decision with few clear answers. Each investor will place a different emphasis on the matter of business ethics, and what it could mean for them in the future. The task now for each investor and their advisor is to ascertain the importance of business ethics in the fund selection process.

## SMART INVESTMENTS MAKE LOYAL CLIENTS

*Your expertise and iShares*

*The resources at iShares.com are designed specifically with advisors in mind. They are the same ideas and concepts institutional asset managers use.*

*Visit [iShares.com](http://iShares.com) to access our ETF products, advisor portfolio strategies and precise, yet easy-to-use tools. Make more informed investment decisions for your clients.*

**iShares** *Industrial strength investment tools from* BARCLAYS GLOBAL INVESTORS

iShares are distributed by SEI Investments Distribution Co. (SEI). Barclays Global Fund Advisors (BGFA) serves as an advisor to iShares. Barclays Global Investors Services (BGIS) assists in the marketing of iShares. BGFA and BGIS are subsidiaries of Barclays Global Investors, N.A., a wholly owned subsidiary of Barclays Bank PLC, none of which is affiliated with SEI. For complete information, including charges and expenses, call 1-800-iShares (1-800-474-2737) for a prospectus. Read it carefully before investing.

There are risks involved with investing, including the possible loss of principal.

© 2003 Barclays Global Investors. All rights reserved. iShares is a registered trademark of Barclays Global Investors, N.A. All other trademarks, servicemarks or registered trademarks are the property of their respective owners.



Individual investors will be affected by the retirement plan sponsors and should be aware of a series of issues that will affect all of the funds within a fund family. As these fund families inevitably face significant withdrawals, this will trigger several cause-and-effect problems. From short-term to long-term, these issues include:

- The withdrawals will have to be covered by asset sales triggering increased turnover for the fund and potentially creating taxable gains for all investors in the fund. These tax bills will be issued before the year-end. Additional trading costs could also significantly affect returns.
- As the assets in the fund decrease, fees for the foreseeable future will increase to cover the firm's cost structure.
- Since a portion of most portfolio managers' compensation is based on the assets that they manage, these withdrawals will likely trigger some management changes over the course of the next year. Overall firm culture and business ethics may trigger additional manager departures.
- The families certainly face increased legal costs and could face very significant compensatory and punitive damages from a host of class-action lawsuits.

Trading in and out of funds for reasons other than changes in the overall market or asset allocation decisions is usually a recipe for increasing losses, and the majority of the funds in the mentioned fund families were completely unaffected by this issue. But in this case, the corollary issues will likely affect all funds within the family, named in the complaint or not. Investors should also note their own specific tax situations when deciding to sell or not sell mutual fund shares. Recent tax law changes and the significant gains in the market this year could make some short-term sales more expensive than waiting until next year.

## Summary

Advisors and their clients should first decide if the revelations of the Spitzer complaint are enough to shake their confidence in the fund families in which they have invested. If so, a very careful search will need to be conducted for replacement funds, as additional fund families are likely to be implicated in similar trading schemes.

If the allegations of the complaint are not enough to trigger a sale, reviewing the potential damage from the secondary effects is in order. Increased taxes, trading costs, fees and manager changes are all likely for any fund in the families that have been named in the complaint. If these costs are estimated to be lower than the cost of changing funds, including a new search, and the fund still exhibits all of the characteristics that made it a sound choice

when it was first purchased, then clients should not move their assets.

In selecting new fund families, advisors and clients should look for some of the following signs that indicate a fund family is less likely to have abrogated their responsibility to their investors:

- **Minimal Hype:** Managers that do not routinely advertise "hot return" numbers are less likely to be looking for fast money or quick ways to increase their asset base.
- **Closing Doors:** A good indicator that fund managers are less interested in filling their own pockets is to check to see if they have closed any of their funds to new investors, when assets have reached a level that makes their investment process more difficult.
- **Insider Ownership:** While not required (and in fact, strenuously resisted by the industry overall), some funds disclose the amount of money invested in the funds by the portfolio managers and board members. The higher the level of insider investment, the more the manager's interest is aligned with the investors'. Among them are Davis, Longleaf, and Tweedy, Browne.
- **Redemption Fees:** Funds with high redemption fees (as much as 2%) for round-trip sales within 90 days are less attractive to market timers, assuming, of course, such fees are enforced.
- **Fair Value Pricing:** Some funds state in their prospectuses that they discourage market timing by adjusting the prices of overseas securities to reflect late news. Among them are Fidelity, Vanguard, and T. Rowe Price.

The Spitzer complaint has paved the way for the SEC to audit and scour the operations of every mutual fund family to uncover additional such abuses. Class-action lawsuits are inevitable as well. Some retirement plan sponsors will take this opportunity to improve the quality of the funds offered to their employees, which may be the only bright spot in this whole mess. Unfortunately, certainty about any of the issues will only come when the entire episode is well in the past. ■

## About the Authors

Nathan Behan, CFA, is a Senior Investment Analyst for Prima Capital. He has previously worked for both Merrill Lynch and EnvestnetPMC. He holds a M.Sc. in International Economics and Finance from Brandeis University.

As an investment analyst for Prima Capital, Patrick R. Flynn is responsible for separate account and mutual fund research. He received his B.S. in Business Administration from the University of Dayton.

For more information, please call 303-573-7315, ext. 200, or visit [Prima Capital Holding's web at http://www.primacapital.com](http://www.primacapital.com).

## SENIOR CONSULTANT

### THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT

JAMES P. OWEN  
Co-Founder

STEPHEN C. WINKS  
Co-Founder, Publisher & Editor-in-Chief

SYDNEY LEBLANC  
Consulting Editor

MAMIE WOO MCNEAL  
Production Editor

EDDIE BRYANT  
Marketing Consultant



### Advisory Board

JERRY BOTT  
Bott Anderson

JOHN BROCK  
Brock-Hazzard/Wachovia Securities

DICK CHARLTON  
New England Pension Consultants

BOB CLUCK  
Canterbury Capital

HAROLD EVENSKY  
Evensky Brown & Katz

JEFF FRUM  
Wells Fargo

RICH GLEASON  
Salomon Smith Barney

KATHLEEN E. HEGENBART  
Salomon Smith Barney

BRIAN HUNTER  
Prudential Securities

GREG HUNTER  
Merrill Lynch

BILL JOHNSON  
CapTrust

JOHN KELSEY  
Salomon Smith Barney

KEITH PHILLIPS  
Morgan Stanley Dean Witter

BOB ROWE  
Morgan Stanley Dean Witter

DICK SMITH  
Cap Group

JIM YANNI  
Yanni Partners

## SENIOR CONSULTANT

1457 Crystal Springs Lane  
Richmond, Virginia 23231

Ph 804-643-1075 ■ Fax 804-643-1544

[WWW.SRCONSULTANT.COM](http://www.SRCONSULTANT.COM)