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CHUCK JAFFE

Putting the fund scandals in the past

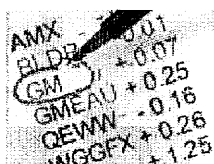
Three years later, at least there's been no repeat of abuses

By *Chuck Jaffe*, MarketWatch

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BOSTON (MarketWatch) -- The third anniversary of the mutual fund late-trading and market-timing scandals passed at the start of September virtually ignored. Truth be told, it's a story that the industry wants to move past and that most observers have grown tired of telling, mostly because the outcome remains a bit vague and unsatisfactory.

In the last few months, however, one key piece of the puzzle became a bit clearer, even if it fails to make most fund shareholders particularly happy.



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Over the summer, the Pilgrim Baxter, Columbia and Banc One Investment Advisors Corp. fund families proposed how they would pay out money to investors who were harmed by the rapid-trading activity that should have been prohibited in the funds. The three plans are similar and industry watchers believe that they will set the tone for the remaining 13 companies that got tagged by regulators.

In all, there is \$2.5 billion in restitution and fines waiting to go back to investors. But even with the distribution plans on the table, resolution will be slow and unsatisfying.

Before seeing why that is, let's consider the events that led to these big-dollar settlements. For most of the fund companies that got nailed either by the Securities and Exchange Commission or by state regulators -- most notably New York attorney general Eliot Spitzer -- the core of the problem was that they allowed some shareholders to make rapid-fire round-trip trades, profiting on in-out moves almost daily while putting the cost of such trading off on other investors.

By itself, market timing is not illegal; the problem was that the funds ignored rules against quick in-outs. In most cases, the firms put the problem onto "omnibus accounts," retirement or brokerage accounts where daily trades for many shareholders are aggregated. Think of the 401(k) plan, where most workers are buy-and-holders, but a few are rabid day-traders; the mutual fund processing the trades doesn't even see the names of the employees but instead sees fairly routine flow numbers for the plan as a whole.

Three years later, you still can't find a panel of experts to agree on just how much damage was done to fund performance. While individuals want to believe that their bear-market losses were caused by unscrupulous trading activities, it's not true; most insiders believe that the worst cases of rapid-trading cost shareholders in affected funds no more than 1% a year.

No one will get a big chunk of the billion-dollar prize pool. What's more, even with the distribution plans now out for public comment, payment won't be quick. The big issue is that the college professors and former regulators hired to oversee the distribution must first figure out who gets the money in those omnibus accounts.

Fund firms can easily determine how much money was invested through Brokerage X or Plan Y, but only the brokerage knows the individual account holders and the size of their accounts. The distribution consultants will ask brokerages and retirement plans for their records; the firms are not required to give up the details, but it's hard to believe they won't.

Token payments

Meanwhile, chances are that shareholders still won't get their pro-rated payback until 2008, around the fifth anniversary of the scandals; even when the money arrives, it will be in disappointing amounts.

If a fund is determined to have lost 1% of returns to rapid trading it would be expected to pay out that amount. That means an investor who had \$10,000 in the fund would be paid \$100 per year that the money was exposed to the bad behavior. Chances are the damages will be calculated at much less than 1%, making the payment smaller.

Better than nothing, but hardly the significant recovery some investors have hoped for. (The good news: Investors will be paid automatically, without the need to make any claims.)

Says industry consultant Geoff Bobroff of Bobroff Consulting: "No one is going to come away from this feeling any better. They won't feel like they got paid back, and they won't ever have the same trust in the industry."

Everyone in or around the fund business seems to agree that the bad trading actions have stopped, but it's not impossible that they could rise up again; regulations seem to make that impossible, but real-world realities around how omnibus accounts operate and report trading activity leave open loopholes that need to be watched.

"Millions of people will share in billions of dollars, recognizing that short-term traders were taking advantage of the system," says Niels Holch, executive director of the Coalition of Mutual Fund Investors. "Getting that check, even if it's a small one, shows that the regulators did their job. That may be more important than the size of any one person's check, because it may be what makes it so that this never happens again." ■

Chuck Jaffe is a senior MarketWatch columnist. His work appears in dozens of U.S. newspapers.



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