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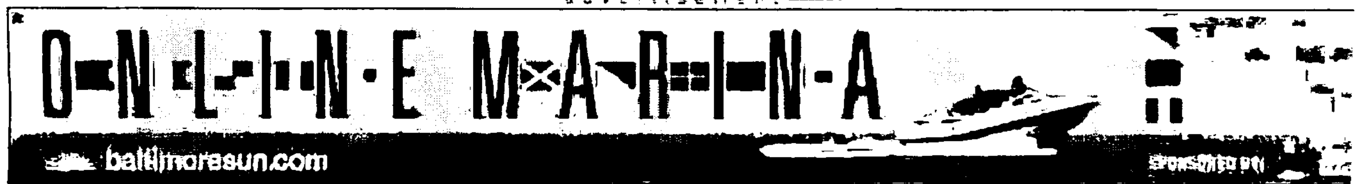

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From the Baltimore Sun

'Tough calls' on victims

Fund scandals lead to disagreement on deciding who gets repaid

By Laura Smitherman
Sun reporter

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State and federal regulators have won a string of settlements from Wall Street over trading scandals in the mutual fund industry, and more than $3 billion has been secured to be doled out to wronged investors.

But determining who has a right to the money and who, practically speaking, will actually get it is no easy task.

Should a mutual fund investor who lost pennies or dollars from trading improprieties see that money if the cost to process the claim and mail a check costs more? How far should companies go to track down people who used to invest in a mutual fund if the cost to do so is subtracted from the settlement money?

A horde of consultants, financial firms and regulators are trying to sort out these issues. And a handful of proposals for how to distribute the settlement money have been submitted to the Securities and Exchange Commission in recent months. But it could be many more months before distributions are made to investors, and in the end, many of those who were victimized might not be included.

The numbers haven't been crunched, but one estimate floated by industry observers contends that 90 percent of investors in the mutual funds that were harmed by improper market timing and late trading lost less than $10 each. Some plans generally would pay only those shareholders owed more than $10.

"There are just certain realities that dictate that some people who may be entitled to money won't get it because it's simply too expensive to get it to them," said Larry H. Goldbrum, general counsel at the SPARK Institute, which represents retirement plan service providers.

The problems posed in the mutual fund cases are common to large-scale legal settlements, in which justice is often measured in small dollar amounts and parties struggle to minimize expenses and fees to maximize the amount left over for claimants.

Those issues, though, are magnified by the complexities of the fund cases and the size of the industry.

More than 90 million individuals own mutual funds, and about 8,000 mutual funds hold $9.4 trillion in assets.

The SEC and New York Attorney General Eliot Spitzer have negotiated many of the settlements, and several more cases could be brought. About a dozen companies, including Deutsche Bank AG, have said they are still in negotiations with regulators.

Meanwhile, civil actions that could yield settlements with many of the same players are being litigated in federal court in Baltimore.

This week, Prudential Financial Inc.'s brokerage unit agreed to pay $600 million to settle charges that former employees defrauded mutual fund investors by helping clients rapidly trade funds. Under the agreement, $270 million will go to compensate the victims, with much of the rest going to pay a criminal penalty.

Hurt performance

The mutual fund scandals broke in 2003. The trading abuses enriched favored investment clients and mutual fund companies, but cost ordinary fund investors because overall fund performance was hurt.

Late trading involves buying and selling mutual funds after trading is closed to other investors. Market timing involves rapid trading that takes advantage of fund pricing changes.

The proposed settlement distribution plans that have been submitted concern Banc One Investment Advisors Corp., Pilgrim Baxter & Associates Ltd., Columbia Management Advisors Inc. and Franklin Advisers Inc. Dozens of different enforcement actions have resulted in settlements that will stream into so-called "Fair Funds."

The SEC is reviewing the plans and allowing the public to submit comments before they are approved. Under the plans, independent consultants ascertained the damage done to each mutual fund, devised formulas to calculate shareholder losses, and determined how - and whether - they should be paid.

"At the end of the day, it has to be fair and reasonable; it doesn't have to be perfect," SEC spokesman John Nester said. "The administrators will do the best they can, and we oversee the process to ensure they are, but tough calls have to be made."

A number of matters have to be resolved. A ruling from the Internal Revenue Service is pending over whether payouts would be taxable. And several groups, including the American Bankers Association, have raised concerns about how the process would work.

Perhaps the most vexing obstacle is how to identify mutual fund holders who bought their shares through an intermediary such as a 401(k). Neat records are kept of people who buy and sell funds directly. But trades by those in a retirement plan, for instance, are typically consolidated in one order for thousands of participants.

Further complicating the task is that the records span several years from the late 1990s, and some fund holders may have liquidated their accounts and not left a forwarding address.

Goldbrum of the SPARK Institute said formulas that calculate daily account activity should be simplified to instead use average account balances or month-end balances. He also said that rather than tracking down people who are due smaller amounts but who have left a retirement plan, the money could be disbursed to those currently in the plan.

Niels Holch of the Coalition of Mutual Fund Investors, an Internet-based advocacy group, said some of the plans could unfairly penalize investors.

"We shouldn't spend $100 to give someone a dollar, I agree with that," he said, "but where these distribution plans draw the line may not be where the line should be drawn."

Sarah A. Miller, chief regulatory counsel for the bankers association, said more guidance is needed and called for a more standardized approach.

"We share the same goals in that we want to see the money paid to the rightful owners, but there are so many of these settlement orders, and they all use different mechanisms," Miller said in an interview. "We think there is a real need for uniformity."

Industry impact

As for the civil lawsuits, confidential settlements have been reached with a few defendants, and other negotiations are under way.

Plaintiffs' attorney Alan Schulman suggested in court filings that the lawyers coordinate with the consultants working on distributing the regulatory settlements. However, defense attorney Mark A. Perry responded that it's premature for the court to address such issues.

What's more important than the settlement money is that the legal cases have had a profound impact on the industry, said Don Phillips, a managing director at mutual-fund tracking firm Morningstar Inc.

"The fund industry is going to be a cleaner, better-lit playing field, and you are seeing a trend toward lower costs and fund boards that are more engaged," he said. "That's the real benefit to investors - not the $17.50 that's possibly going to be returned to you."

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