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Attorneys Weigh In on Performance Fee Aftermath

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Despite submitting to regulatory settlements for overcharging investors on performance-based fees, several high-profile fund shops are unlikely to face the pain of class action lawsuits stemming from the cases.

The SEC last week [announced](#)¹ that five firms had agreed to pony up \$7 million in penalties after the regulator alleged the fund shops charged excessive fees. The firms were **Putnam, Dreyfus, Gartmore, Kensington Investment Group** and **Numeric Investors**.

It's not the first time the SEC has cracked down on the issue. The SEC found problems with performance-based fees at **Bridgeway Capital** and reached a \$5.2 million settlement with the firm in 2004. The regulator then decided to examine the use of performance-based fees at other firms.

For its part, Putnam modified performance-based fees for its funds in September 2004 upon learning of the SEC's concerns, a firm spokeswoman says. She adds that the firm previously wasn't aware that the procedures for calculating performance-based fees at Putnam were an issue with regulators.

A Dreyfus spokeswoman says her firm cooperated with the SEC staff, promptly discontinued the method it was using to calculate performance fees and subsequently reimbursed the funds with interest.

The other settling firms did not return calls seeking comment as of deadline.

"The issue here is that investment advisors had entered into contracts that were in violation of Rule 205," says Kit Addleman, an associate district administrator with the SEC in Fort Worth, Tex.



The rule, found within the Investment Advisers Act of 1940, provides restrictions on the use of performance-based asset management fees within mutual funds. With performance-based fees, an advisor's fee increases if a fund exceeds the performance of a specified benchmark, but declines if performance falters.

Fund firms involved in the recent settlements had followed procedures for calculating the fees as spelled out in fund prospectuses, but the procedures themselves violated the '40 Act, Addleman explains.

As an example, the settlement reached with Dreyfus points out that the firm calculated its fees based on daily average assets as opposed to average assets over a specific period of time.

If a fund uses a 36-month period of time to measure performance, the fees must be based on the average assets within the fund for that time period. By using daily average assets, Dreyfus overcharged investors in its Enterprise Fund \$938,344 and investors in its NexTech Fund some \$2 million. As part of the settlement, Dreyfus repaid the funds for the excessive charges while also paying some \$273,830 in interest. The SEC alleges the improper use of performance-

based fees occurred from 1997 to December of 2004.

Rather than reimburse individual shareholders, including shareholders who were in the funds at the time the problem occurred, the SEC decided to instead have the firms return the money to the funds. While that doesn't reimburse shareholders that have since sold their shares, it will make long-term investors whole, Addleman adds.

The SEC decided to use that approach because fund firms agreed to make the payments shortly after the problem was discovered. Thus, the bulk of shareholders that were harmed by the problem will be reimbursed. "We felt this was the best way to get the money back to the majority of investors," she says.

Some industry attorneys point out that fund firms involved in the problem neither denied nor acknowledged committing any wrongdoing. Attorneys add that settlements over market-timing problems often included similar wording, but firms were nevertheless hit with a large number of class action lawsuits.

However, attorneys say fund shops that settled performance-based fee cases may not share a similar fate. The market-timing scandal resulted in billions of dollars in settlements and fines, adds Tamar Frankel, a professor at Boston University School of Law.

In comparison, the most recent performance-based fee settlements totaled only \$7 million. Even if attorneys representing shareholders could convince the courts that damages to investors exceed that amount, the harm would probably be small, she says.

"The losses may be so small that prior shareholders may not care enough," she says. Of course, the combined damages may be enough to entice attorneys to litigate. Attorneys often receive a portion of settlements or lawsuit awards as compensation, she adds.

One challenge will be to seek the identities of former shareholders. That task could be highly burdensome for fund firms as shareholder records are held in a variety of databases maintained by brokers, retirement plan administrators and other intermediaries.

Attorneys representing shareholders would probably argue that fund advisors violated their fiduciary responsibility to ensure that fees charged are proportionate to the services they provide, she adds.

The majority of investors who held shares when the fees were improperly calculated will probably receive the benefits of the settlements, adds Niels Holch, executive director of the Coalition of Mutual Fund Investors.

"If you are a long-term shareholder, then you probably stayed in the fund [long enough to benefit from fund firms' returning money to funds]," he says.

Since the majority of investors harmed by the problem have already received compensation, there may simply not be enough damages left for lawyers to bother with, he adds.

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