Market Timing Payouts Benefiting Fund Advisers, Too

By Greg Saitz, *BoardIQ*, September 24, 2013 [subscription required]

One morning 10 years ago this month, fund directors and everyone else in the mutual fund industry awoke to headlines of a blossoming market timing and late trading scandal. In the ensuing years, fund company after fund company settled with regulators and paid princely penalties for their roles in the saga, and much of those fines have been returned to investors.

But a portion of the money – more than $257 million – has made its way back to at least nine fund complexes whose advisers paid in excess of $1 billion to resolve allegations they allowed improper trading in their funds, according to an analysis of orders from the Securities and Exchange Commission.

The commission authorized the latest payout to a fund group earlier this month: more than $1.4 million to certain **Federated** funds. When combined with a disbursement made last year to the fund complex, Federated funds have received back $16 million of the $77 million initially sent to investors. The fair fund – established by the SEC to benefit harmed investors – was financed with $72 million in disgorgement and a civil penalty from Federated Investors; the additional $5 million reflects earned interest.

Some question the appropriateness of such an arrangement, saying it can be seen as beneficial to the adviser that paid the fine in the first place by increasing assets under management, which increases advisory fees. But others contend sending money that can't be returned to investors back to the funds involved still benefits shareholders and only minimally enriches the manager.

A few distribution plans for the marketing-timing fair funds specified that money unable to be given back to investors would go to the U.S. Treasury rather than certain fund complexes.

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All told, fund advisers, banks, hedge funds and individuals paid more than $3.4 billion in fines and disgorgement for their market timing lapses, according to a tally calculated by the Coalition of Mutual Fund Investors. As of two weeks ago, nearly $3.6 billion, which includes earned interest, had been distributed.

In Federated's case, 21% of the $77 million went back to certain funds. "That's a lot of money that didn't make it back" to investors, says Niels Holch, executive director of the coalition and a partner at **Holch & Erickson**.

The percentage of undeliverable cash that went back to other settling fund companies varied. More than a quarter of the $170 million distributed to Putnam Funds investors wound up returned to the complex, while other fund groups received 13% or 14% back. The average was 19% for the nine complexes where SEC orders exist documenting such distributions.

Fair Fund Flows

Some advisers that paid market timing settlements ultimately saw some of that money return to their complex

Fund Group	Amount distributed to investors	Leftover amount distributed to funds	% of overall distribution sent to funds
Putnam Funds	$170,324,148	$46,077,446	27%
Janus	$102,014,002	$22,825,911	22%
Federated	$77,153,245	$16,005,966	21%
MFS Funds	$312,042,489	$61,654,108	20%
AIM	$78,037,264	$13,141,659	17%
Freemont Funds	$4,663,245	$688,000	15%
Invesco	$418,154,462	$57,821,352	14%
RS Funds	$26,970,432	$3,611,743	13%
PBHG Funds	$267,001,327	$35,380,631	13%
Totals	**$1,456,360,614**	**$257,206,816**	

Source: Securities and Exchange Commission, Coalition of Mutual Fund Investors, BoardIQ analysis

The money did benefit current fund shareholders, Holch says, noting Federated paid $72 million and will only "get 50 basis points of the money that goes back to the shareholder. It would be a modest benefit."

The bigger question for Holch: "Why didn't we distribute all this money to investors with supposedly accurate records that go back that far?"

The answer, according to Lehn, is the fair-fund administrator couldn't find the addresses of some shareholders, others had died and still others never cashed the checks, which were sent to more than 600,000 investors. (Include Holch in the list; he says he forgot to cash a $10 check from a fair fund before it expired.)

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It's unclear how much money remains to be distributed in market-timing fair funds. Many have been closed, but some still are active. It wasn't until last month that the SEC approved a distribution plan in the case against **Waddell & Reed**, which settled with regulators and paid $50 million in 2006.

Holch, from the mutual fund investors coalition, says he doesn't think "this kind of problem" will happen again in the fund industry.

"Clearly it was a wake-up call and I would expect fund directors are paying a lot more attention to this issue than they did before," he says.

But with the rise in popularity of omnibus accounts, which mask individual account-level activity, market timing could still be occurring. "There is the ability to trade frequently just because of the lack of transparency," Holch says.