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'Rough justice' for scandal-scarred US funds

By Joe Morris, Financial Times [subscription required]

US mutual funds cheated in the market-timing scandal of a decade ago are being short-changed again in their restitution payouts, shareholder advocates say.

Though the scandal dates back to 2003, the process of returning recoveries to investors is still continuing, with roughly $100m yet to be distributed.

The Securities and Exchange Commission, the US regulator, has collected $3.5bn in disgorgement and penalties from fund managers accused of the market timing, in which selected investors, typically hedge funds, were allowed to engage in rapid trading of fund shares at the expense of rank-and-file investors.

In many cases, all but tiny portions of the recoveries has been distributed to harmed investors or to the affected funds, but in a few cases millions of dollars was paid to the Treasury instead.

Nearly 40 per cent of the $16m in recoveries from a market timing prosecution of a Gamco Investors fund, for example, was paid to the Treasury, as will be any future recoveries in the case. The Treasury similarly received $5.4m of the market-timing recoveries from Invesco funds.

By contrast, the distribution plan established for Putnam Investments returned $170m to investors and to 53 Putnam funds, while just $1,380 was remitted to the Treasury.

The SEC declined to comment on the disparities in the payouts.

"It is not a very transparent process, so we really don't know what happened," says Niels Holch, executive director of the Coalition of Mutual Fund Investors, a shareholder advocacy group that tracks the payouts. "What we cannot figure out, is why do some of these fund families have larger residuals [money whose rightful owners either do not claim it or cannot be tracked down] and others have small residuals?"

Parcelling out recoveries to individual fund investors can prove agonisingly difficult, in part because many investors own their shares through "omnibus", or aggregated, accounts that are administered by broker-dealers rather than fund managers. Further complicating rightful compensation, many of the market-timing abuses date back more than a decade.

Almost all of the settlement distribution plans stipulate that any residual recoveries should be distributed to the funds on a pro-rata basis. But even in these plans, Invesco's among them, some portion of the money is nevertheless invariably channelled to the Treasury.

The Gamco fund distribution plan is unique in that it orders any residual recoveries be paid to the Treasury, not the fund, though the fund remains in operation today.

The consultant hired to oversee the Gamco fund distribution, Kenneth Lehn, a finance professor at the University of Pittsburgh, says he does not recall why the payout plan, which was drafted with the SEC's approval six years ago, excluded the fund from the settlement. This is contrary to other market-timing distribution plans he also administered.

Funds are more deserving of the residuals than the government, Mr Holch argues.

"Why should any of this money go to Treasury?" he says. Remitting to funds "is not perfect because you are looking at a different shareholder base, but at least you are getting it out to investors of those funds".

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A better solution yet, and one that appears to be catching on, is simply to try harder to find the people who lost money, Mr Holch says.

The administrators of two of the unretired payout plans – for AllianceBernstein and MFS funds – have been allowed to amend their terms to support renewed efforts to track down harmed investors, each citing sizeable residual balances. In the AllianceBernstein plan, the total comes to $61.9m, while MFS's plan was left with $35.7m.

"The earlier distribution plans were more limited in that they really did not have a second round of trying to find investors," Mr Holch says. "There is a growing recognition that there was not enough done."