Opinion

SEC Should Revamp Its Fair-Funds Process

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The SEC has distributed to mutual fund investors most of the $3.5 billion it collected in enforcement penalties for market-timing and late-trading violations first identified in 2003.

Now is a good time to review how the Securities and Exchange Commission's Fair Funds program worked and what can be done to improve its efficiency and effectiveness.

As many in the fund industry will remember, the SEC and several state regulators brought more than 30 enforcement proceedings against mutual fund firms and other financial services players for securities-law violations.

The SEC placed most, if not all, of the monetary penalties it collected into separate Fair Funds for each enforcement proceeding. These monies were then distributed as restitution payments to those investors who were harmed by market-timing and late-trading activities.

The SEC hired an independent distribution consultant for each Fair Fund. These consultants were generally responsible for:

· Developing a formula for estimating the losses that investors incurred in each fund cited for a violation on a daily basis, and

· Calculating the proportional restitution amounts that each firm had to pay to affected investors on a fund-by-fund basis.

Each consultant also developed a distribution plan describing the mechanics for how the SEC would identify and pay mutual fund investors for their losses.

Payments to investors did not start until sometime in 2007, as the SEC needed time to resolve tax and logistical issues. Since 2007, the SEC has authorized distributions of more than $3 billion to millions of investors in mutual funds affected by these enforcement proceedings.

As this Fair Funds process winds down, the SEC should undertake a review of what actually transpired and take steps to improve how Fair Funds work in the future. While most of these Fair Funds seemed to operate successfully, the process took more than a decade. The commission should consider several obvious improvements.

Improve Fair Funds' transparency. The SEC should make the Fair Funds process more transparent. It is very difficult for investors to monitor the day-to-day activities of these Fair Funds as the restitution process unfolds.

The SEC publicly discloses only the distribution plan and individual commission orders authorizing the restitution payments. There is very little information available to investors about the actual restitution process and the timing of payments to be made.

At the end of the Fair Funds process, the independent consultant files a two-page final accounting document with the SEC, which is only available by sending a Freedom of Information Act request to the commission.

The SEC should routinely make much more information available to the investing public about how these Fair Funds are operating, along with the timing of payments to be made.

Initiate additional efforts to find shareholders. A number of these Fair Funds ended up with millions of dollars of residual amounts. Some investors were hard to find because of omnibus subaccounting or because of the passage of time. In other cases, the SEC found investors who did not cash their restitution checks before the stated deadline.

Since the Fair Funds process is designed to identify and compensate those shareholders who were harmed by illegal conduct, additional steps should be taken to ensure that the SEC distributes more Fair Funds monies as intended.

Two of these Fair Funds, involving MFS and AllianceBernstein shareholders, recently received SEC permission to amend their distribution plans in order to conduct a further search for investors, as reported. Those firms are currently taking additional steps to address undeliverable and uncashed checks.

Additional investor search and follow-up procedures should be institutionalized for all Fair Funds, as well as the imposition of enhanced requirements for transparency within omnibus accounts, which are clearly part of the problem in the distribution process.

Reduce residual payments to the U.S. Treasury. Most of these Fair Funds authorized residual amounts to be returned to the mutual funds affected by the market-timing or late-trading activities. This approach benefits current shareholders, including any shareholders who have remained in these funds over the past decade.

However, after a Fair Fund makes these payments, it transfers any additional residual amounts to the U.S. Treasury. Millions of dollars that should be going to investors have ended up back in the federal government's hands.

For example, the Invesco Fair Fund transferred $5.4 million and the Pilgrim Baxter Fair Fund transferred $3.7 million in residual funds to the U.S. Treasury. The most egregious example was the Gabelli Fair Fund, which transferred $6.4 million out of a $16 million account to the federal government, instead of distributing this amount to shareholders, as reported.

As a part of its oversight responsibilities, the SEC should ensure that residual funds are returned to the affected mutual funds and that Fair Funds transfer only a minimal amount back to the U.S. Treasury.

These recommendations may just be the tip of the iceberg, as there is very little information available about how Fair Funds actually work in practice. The SEC should lift its veil of secrecy on the Fair Funds process and work with interested investors to improve the efficiency and effectiveness of what is otherwise an excellent mechanism to compensate investors for their losses.