



1 of 2 DOCUMENTS

Copyright 2006 Prism Business Media, Inc.
All Rights Reserved



Registered Rep.

December 1, 2006

SECTION: Pg. 63 ISSN: 0193-1865

LENGTH: 1382 words

HEADLINE: Payback Time ? Still

BYLINE: By Stan Luxenberg

BODY:

In September 2003, New York Attorney General Eliot Spitzer announced that hedge funds and other speculators had fleeced mutual fund shareholders. Employing the tactics known as market timing and late trading, the thieves had stolen huge amounts, Spitzer claimed. And with the confidence of a politician running for governor, he promised to return the cash taken by the evildoers. Now, more than three years later, not a single dollar has been paid to shareholders. That's bad, but worse: The whole process intended to distribute the cash has turned into a legal quagmire. "It will be years before all the money is paid out," says Larry Goldbrum, general counsel of the Society of Professional Administrators, an advocacy group that represents retirement-plan administrators and record-keepers.

Payback hasn't been delayed because mutual fund companies have been reluctant to write checks. Far from it. They couldn't wait to pay up - while neither admitting nor denying guilt - and move on. So far 20 fund companies have coughed up a total of \$2.8 billion in fines. The money now sits in escrow accounts collecting interest.

So, what's the hold up? The problem is that no one can figure out which shareholders should get the money. Fund companies have filed detailed plans for distributing the cash. But each plan has been greeted with howls of protest by shareholders and lawyers. A bewildered SEC has delayed the payments while it considers what to do. "The whole reimbursement process has taken a ridiculously long time," says Roy Weitz, publisher of FundAlarm.com, an online fund watchdog based in Tarzana, Calif. "Money was taken from shareholders and the cash should be returned."

Of course, fund companies keep embarrassing themselves. In a more recent scandal, the SEC has accused BISYS Fund Services of paying kickbacks to mutual fund companies for steering business its way. BISYS is an administrator that prepares prospectuses and provides other services. The administrator paid \$21.4 million in penalties. Once again, the SEC must figure out how to compensate shareholders.

That Was(n't) Easy

To appreciate the complexity of the problems, recall how speculators used late trading and market timing. Late trading occurred when speculators put in buy or sell orders after the 4 p.m. close - but nevertheless got that day's pricing. While late trading is clearly illegal, market timing is not necessarily illegal. The problem arose when fund companies said in prospectuses that they would not tolerate market timing. Turns out that some fund families said one thing and did another by allowing favored clients to time. Spitzer attacked those fund companies - and rightly so. Yet, remember market timing isn't a slam-dunk win for the trader. Here's a typical market-timing case: Take a day when the U.S. markets were rising. Just before trading stopped at 4 p.m. in New York, the speculator bought shares in an Asian fund. Although the fund was in New York, stocks in the portfolio traded on Asian markets, which were currently closed for the night. Asian stock prices were said to be stale because they didn't yet reflect the optimism in New York. Presumably, when the Asian markets opened in a few hours, share prices would rise and the speculator would profit.

Spitzer assumed that market timing and late trading always resulted in gains for speculators and losses for other shareholders. But figuring out the cost of the questionable tactics is difficult. Consider that after the speculator put his bet in, it could take several days for the fund portfolio manager to buy stocks with the cash. Meanwhile, the market could rise. If that happened, the fund would suffer because the cash position would be a drag on returns. Spitzer failed to note that if the market fell, the speculator would lose, and the cash would actually help most fund shareholders by cushioning the losses.

Undeterred by such uncertainties, Spitzer and the SEC fined fund companies and ordered them to come up with plans for distributing the cash to shareholders. The plans must be filed with the SEC and approved before they can be implemented. The first company to file was PBHG, which announced its plan in June 2006. As instructed by the SEC, the fund company hired a distinguished academic - Kenneth Lehn, a professor of finance at the University of Pittsburgh - to devise a plan for distributing \$250 million held in escrow accounts.

Lehn started by noting that PBHG had two kinds of shareholders. The first group bought their shares directly from the fund company. For these investors, PBHG has complete records of the names of shareholders and the dates when they owned funds. The second category of investors owned shares through omnibus accounts. These purchasers traded through 401(k) plans or brokerages such as Charles Schwab. For the omnibus accounts, PBHG did not know the names of individual shareholders or when they owned funds. Since he didn't have records of omnibus investors, Lehn ignored them in his initial calculations.

To figure out which shareholders deserved the most restitution, he combed through records of direct purchases, assuming that anyone who made four sales in a year was market timing. Based on this data, he estimated that 68.1 percent of the restitution funds should go to shareholders of the flagship PBHG Growth, while the rest of the cash should be used to compensate shareholders of other PBHG funds. Direct purchasers would receive checks from the escrow accounts. But what about the shareholders in omnibus accounts? The professor suggested that the omnibus managers would have 60 days after the plan went into effect to supply a list showing who owned how many shares. If the omnibus record-keepers failed to produce data by the deadline, their shareholders would be left in the cold. The money that should have gone to omnibus investors would instead wind up in the hands of direct purchasers.

This last point caused objections. "Direct shareholders will get more than they deserve, and people who invested through an intermediary won't get a dime," says Niels Holch, executive director of the Coalition of Mutual Fund Investors, which lobbies for the interests of individual investors.

Shortly after PBHG filed its plan with the SEC, two other fund companies - Columbia and Banc One - announced similar distribution plans. Besides the issue of fairness, some critics declared that the plans would be absurdly expensive to implement. "Most shareholders lost less than \$15, but it will cost much more than that to do all the research and cut checks," says David Wray, president of the Profit Sharing/401(k) Council of America, a trade group that represents plan sponsors.

Finding Shareholders

Some of the plans did not make clear who would shoulder the costs of finding injured shareholders. Brokers and administrators are worried that they will be left to pick up the tab. In addition, they wonder who will be fiduciaries for the reimbursements. Under some plans, money would pass from escrow accounts to brokers and administrators who would then cut checks for individual shareholders. If the brokers are considered fiduciaries, they could be sued in the likely event that some shareholders feel they have been shortchanged.

Though the problems seem thorny, some of the solutions may have appeared in a plan filed by MFS in September. Acknowledging that costs could be prohibitive, the MFS plan gives administrators some flexibility. If it is too expensive to track down every shareholder, the money would simply go to current shareholders of the funds. The system would not compensate someone who suffered from market timing in 1998 and then sold the fund. Still, the MFS plan is gaining supporters, says the Society of Professional Administrators' Goldbrum. "It is not perfect, but at least some shareholders would get paid," he says.

THE CHECK IS NOT IN THE MAIL

As punishment for the market-timing scandals, the SEC and other enforcers collected fines from 20 fund companies. Four fund companies have filed plans with the SEC to distribute the cash to shareholders. But so far the money sits waiting until the plans are approved.

Fund Company	Amount Sitting in Escrow Account
Banc One	\$50 million
Columbia	140 million
MFS	225 million
PBHG	250 million

Source: SEC and fund companies

LOAD-DATE: December 4, 2006