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Mutual funds in America

A rash of rules

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The SEC has handed down its most contentious reform of the troubled mutual-fund business

REFORMING America's scandal-plagued mutual-fund industry is a popular sport in Washington these days. One bill requiring more disclosure of fees and other regulatory changes has been passed by the House of Representatives; two more have been introduced in the Senate. But the Securities and Exchange Commission (SEC) has beaten Congress to it. At a testy meeting on June 23rd, the commissioners voted 3-2, in a rare split decision, to approve the most contested of its several proposed reforms.

From the end of next year, three-quarters of a mutual fund's directors will have to be independent of the company that manages the money, up from half hitherto. The chairman must be independent too. The idea is that on matters such as the fees paid by investors to management, the board will now be on the investors' side.

Much upheaval is in store: only one-fifth of the fund boards currently have independent chairmen, according to the Investment Company Institute, an industry association. But if mutual-fund managers are unhappy, they have only themselves to blame. They proclaimed their virtue during the Enron era, only to find themselves pursued last autumn by Eliot Spitzer, New York state's attorney-general. All sorts of fiddles came to light.

Some fund managers, such as Janus and Strong Capital Management, allowed favoured clients to make rapid, undisclosed trades in fund shares. This practice, dubbed "market timing", imposes trading costs on all investors in the fund, but allows a privileged few to skim off a quick profit. Other managers allowed "late trading"—in essence, clients placing orders after 4pm, the end of the trading day, when funds' prices are set. Regulators also peered into managers' murky fee structures and their often cosy dealings with brokers who peddle their funds.

In essence, mutual-fund managers were guilty of putting the tending of money already in their care (now totalling \$7.4 trillion) second to the seeking of new business and thus more money for themselves. The 16 reforms the SEC is considering this year are supposed to change that.

Already the commissioners have imposed a code of ethics and have ordered firms to disclose their policies on market timing. This week they also approved, unanimously, a rule designed to encourage fund boards to consider their contracts with investment advisers more carefully. And



they will soon vote on whether to impose a 2% levy on fund shares sold within five days of buying them, in an effort to discourage market timing. Other proposals focus mainly on disclosure—of brokers' possible conflict of interest, of the fees funds pay to brokers and of information about portfolio managers. The SEC is also considering whether to bar all processing of orders after 4pm.

Some fund managers are already reforming themselves as they try to woo back investors, many of whom have decamped to firms that have remained unscathed, such as Fidelity or Capital Research (see [article](#)). One reformer, Massachusetts Financial Services (MFS), has been especially energetic, having settled charges of market timing and of failure to disclose that it used brokerage commissions to pay for marketing. MFS named independent co-chairmen for its funds, and is about to start providing its investors with itemised estimates of fund managers' fees.

Such changes have not been cheap. Cutting out "soft dollars"—payments for services such as research that are hidden from view because they are bundled into brokerage commissions—is costing MFS more than \$20m a year, according to Robert Pozen, the new corporate chairman of MFS and a stickler for rules. In recent testimony to Congress he gave a strong lead to the rest of the industry.

But will the reforms work? Most managers are adamant that the requirement for an independent fund chairman will create only hassle. Fidelity argued in a letter to the SEC that there was no evidence that such a rule would do anything either to limit fees or improve investment performance. Indeed, some companies, such as Putnam, fell prey to market timing despite having independent fund chairmen. There is also a question about how many independents can even be found: being on a board these days means hard work and the risk of being sued.

Other proposed reforms are also touching nerves. The mooted 2% levy on shares redeemed within five days could hurt, say, today's buyer who unexpectedly finds himself strapped for cash tomorrow. The proposed ban on trading after 4pm will inconvenience pension funds, which tend to collect orders until 4pm and then submit them for processing later—a different matter from the late placing of orders, which the SEC is trying to root out. West-coast funds, which are three hours behind New York, especially need this extra time. Tony Evangelista of PricewaterhouseCoopers says that new technologies, such as sequential time-stamping of orders, could render this reform unnecessary by making it impossible to pretend that late orders were in fact placed before the close of the trading day.

Indeed, plenty in the industry are muttering about over-regulation. Mr Pozen predicts that the new rules will make it harder to persuade fund investors to accept increased fees, thus driving margins down and harming managers of small funds especially. He also notes that mutual funds will now be far more heavily regulated than rival financial instruments, such as hedge funds or even common trust funds and insurers. "We have a very elaborate code of ethics. Do insurance companies?" he asks.