

**THE MYSTERIOUS WAYS OF MUTUAL FUNDS:
MARKET TIMING**

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I. Introduction

The phrase “market timing” sounds innocuous, but after it was paraded in headlines amid the mutual fund scandals of the early 2000s, it assumed a deeply negative connotation. In its pernicious sense, market timing describes mutual fund insiders’ subtle use of the inherent structures of mutual funds and inside information to selectively provide benefits to favored participants at the expense of less-favored participants. Such technique involves *timing* purchase and redemption orders of mutual fund shares in light of *market* information known only to the privileged few.

This Article examines the intricacies of market timing practices to show that this arcane phenomenon presents a variety of theoretical and practical, financial and economic, cultural and ethical questions that entice analysis. Although mutual fund market timing mirrors our times as it presents opportunities for quick short-term profits by illegally exploiting informational asymmetries, it has a porous quality that makes law enforcement against it very difficult if not impossible.

Market timing reveals the purposes of and assumptions underlying the regulation of mutual funds and their managers and investors. The practice highlights a distinction between predator-investors and the victim-investors on whom they prey with the aid of fiduciary managers. This context provides an opportunity to examine the structure of most contemporary investment companies. These companies—called “open-end investment companies” in law and “mutual funds” in the marketplace—are managed pools of financial assets that offer redeemable securities to investors. They total \$8.1

trillion in managed assets, a figure that rivals the total assets commanded by U.S. banks.¹

A panoply of issues arises from the mutual fund market timing scandals. First, the Securities and Exchange Commission (“SEC”) and state prosecutors addressed market timing in different ways, raising fundamental regulatory and jurisdictional questions of national significance. Second, market timing demonstrates the difficulties of ensuring equal and fair treatment to mutual fund investors, as it begs the questions of whether such equal and fair treatment is even necessary to ensure continued investment in securities markets and whether investment by small savers in mutual funds is prudent. Third, market timing further exposes structural infirmities of the mutual fund vehicle as an institution, problems which have existed since before the industry was first subjected to specific federal regulatory oversight in the Investment Company Act of 1940.²

In this Article, we show how characteristics inherent in mutual fund structure make market timing an indelible feature of this investment vehicle. Further, we show how these features, though addressed in the Investment Company Act, reappeared in different forms in the late 1990s as a result of contemporary forces including a speculative market bubble, globalization, financial product innovation, business strategy, and investor demographics and appetites. We then turn to the full variety of mechanisms employed to address these challenges, including federal, state and private claims against participants in the mutual fund industry. We assess the harms of market timing and examine both regulatory and governance mechanisms currently being developed to mitigate these harms.

Ultimately, the daunting policy challenge is to identify, *ex ante*, all cracks in the regulatory and governance schemes that rogue fund managers, wealthy investors, traders and brokers may find or

¹ INVESTMENT COMPANY INSTITUTE, INVESTMENT COMPANY FACT BOOK 59 (45th ed. 2005), available at http://www.ici.org/pdf/2005_factbook.pdf (stating that mutual funds held \$8.1 trillion in total net assets at the end of 2004); see FDIC, *December 2004 Statistics: Latest Industry Trends*, STATISTICS AT A GLANCE (2005), <http://www.fdic.gov/bank/statistical/stats/2004dec/industry.pdf> (stating that as of December 31, 2004, FDIC-insured and FDIC-supervised banks had \$10.1 trillion in total assets, including \$8.4 trillion for commercial banks and \$1.7 trillion for savings institutions).

² 15 U.S.C. §§ 80a-2(a)(32), -22(e) (2000).

create to exploit. This analysis leads to the startling conclusion that, without a culture of honesty, enforcement and policy cannot possibly plug all the holes in mutual fund regulation. This general problem of regulatory strategy is especially acute with respect to market timing. No matter what laws and regulations are written, and no matter how elaborate a set of internal organizational controls are developed, the leakage risk that some favored investors will benefit at the expense of other investors remains. When a significant number of advisers allow favored investors to benefit at the expense of other investors, there comes a breaking point where neither the law nor market competition provides effective constraints. At that stage the leakage created by the favoritism may become an acceptable practice. Investors and advisers will benefit at the expense of weaker or less vigilant investors. An unequal practice of this sort can undermine investor trust. After all, even those who reward advisers for special benefits must recognize that they might be competing with other investors who might pay more to receive these and other benefits at other investors' expense. Such a system threatens the efficiency of mutual funds and our financial system.

When leakage reaches a significant number of mutual fund advisers and other fiduciaries, it raises the risk of swamping competing constraints; beyond a certain breaking point, neither law nor markets can control it. At that stage, leakage may become acceptable practice. However, if the practice is costly to the economy and financial markets, it either threatens the future of mutual funds and their managers or it threatens the efficiency of our financial system. Appreciating these realities can thus become a critical element in an overall strategy of coping with market timing.

II. Structure: Sources of the Problem

With mutual funds, as in many other fields of human endeavor, the more things change, the more they stay the same. Since the advent of mutual funds, the identification and measurement of net asset value have been persistent and challenging issues, which have only been brought further to the forefront as a result of the contemporary investment environment. The basic structure of mutual funds that causes this challenge makes market timing an inherent feature of this investment vehicle. While forces driving proliferation of market timing during the 1990s manifested contemporary conditions, in critical ways they are not *sui generis* but date to the era of the Investment Company Act of 1940.

A. Before 1940 (and After)

1. The Role of Net Asset Value

It is impossible to understand the issue of market timing without discussing mutual funds' investment structure.³ In the context of market timing, mutual funds combine two features. First, they invest in "securities"—stocks or bonds that are issued by other enterprises. Therefore, the value of mutual fund portfolios requires valuation of the securities that are contained in those portfolios. Second, the securities that mutual funds offer to investors are "redeemable." The funds, not the markets, provide liquidity for investors and set the price of the portfolio; if shareholders of these funds want to liquidate their investments, they do not *sell* shares to other investors but *redeem* shares by claiming from the mutual funds a *pro rata* share of the portfolio's net asset value. For example, if a mutual fund issued 100 shares and its net assets amount to \$100, each share is redeemable for \$1. In this respect mutual funds are like banks. People who deposit dollars in bank demand deposits can withdraw the same number of dollars on demand (minus charges or plus interest). Similarly, shareholders of mutual funds can invest their money in a mutual fund's shares and receive, upon demand, a *pro rata* share of the fund's net asset value within seven days.⁴ For shareholders, the advantage of the mutual fund structure is that shareholders can redeem their shares at the net asset value independently of the market price of the shares, which price is affected by demand for the shares.⁵

³ In addition to observing the *investment* structure, it is also worth observing the *organizational* structure of mutual funds, which typically consists of a holding company, a separate fund adviser and a family of individual funds each managed by portfolio managers. See generally 1 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS (2d ed. 2001).

⁴ 15 U.S.C. §§ 80a-2(a)(32), -22(e).

⁵ The key difference between mutual funds and banks is that the investment risk of bank assets rests with the bank and the investment risk of mutual fund assets rests with investors. In addition, the mutual fund structure, particularly the open-end structure, gives fund shareholders some clout over fund managers. If shareholders must sell shares in the open market, managers continue to hold and manage the portfolio of underlying assets. If shareholders redeem shares, managers hold a smaller portfolio. In fact, redemption constitutes a partial liquidation of fund assets. Since, in most cases, managers' fees are measured as a percentage of assets under

2. When to Determine Net Asset Value

Long before the Investment Company Act of 1940 (“Investment Company Act”),⁶ mutual fund redemption practices posed problems. If a mutual fund pays a redeeming investor more than the *pro rata* value of the investor’s shares, this payment dilutes share value for remaining shareholders. To avoid dilution, the redemption (and buying) prices of a mutual fund’s shares must be precisely the net asset value of the shares at the time a redemption (or purchase) occurs. Before the Investment Company Act, insiders diluted shares of outside investors by buying mutual fund shares at less than their net asset value and redeeming their shares at more than their net asset value.

Congress authorized the SEC to address this problem of share dilution and determine the process by which to ascertain the net asset value of shares for all shareholders alike.⁷ Ultimately, the SEC chose a process that eliminated the possibility of price manipulation by all buyers and redeemers, including insiders. Under Rule 22c-1,⁸ investors’ orders to buy or redeem mutual fund shares must be placed *before net asset value is determined*. This way, buyers and redeemers of shares do not know the price at which they buy or redeem shares because price is determined after they place their orders. This process assures that insiders will not be able to benefit from a price difference at the expense of remaining shareholders. The cut-off time, *i.e.*, the time when net asset value is determined, was set at 4:00 p.m. Eastern Standard Time (hereafter “4:00”), when the New York Stock Exchange closed. This time was chosen under the assumption that the value of the portfolio would not change much between the time of the orders and 4:00.⁹ Therefore, orders placed after 4:00 are executed at the price determined at 4:00 on the following business day.

management, the threat of such partial liquidations is a direct threat to managers’ fees. Performance fees, in contrast, are permissible only under special circumstances. Investment Advisers Act of 1940 § 205, 15 U.S.C. § 80b-5 (2000).

⁶ 15 U.S.C. §§ 80a-1 to -64 (2000).

⁷ Investment Company Act of 1940, ch. 686, § 22(c), 54 Stat. 789, 823 (codified as amended at 15 U.S.C. § 80a-22(c) (2000)); see Thomas S. Harman, *Emerging Alternatives to Mutual Funds: Unit Investment Trusts and Other Fixed Portfolio Investment Vehicles*, 1987 DUKE L.J. 1045, 1082 (noting Congressional concern about dilution) (citing S. REP. NO. 76-1775, at 8 (1940)).

⁸ 17 C.F.R. § 270.22c-1 (2004).

⁹ 15 U.S.C. § 80a-22(c); 17 C.F.R. § 270.22c-1.

3. How to Determine Net Asset Value

Before the Investment Company Act, investment companies offered investors redemptions under varying terms and used varying methods of net asset valuation. These differences confused investors, they made it impossible for them to compare the terms of alternative mutual fund offerings and they induced fraud. Congress addressed this problem in Sections 2(a)(32)¹⁰ and 22(e)¹¹ of the Investment Company Act by standardizing the terms of redemption, and in Section 2(a)(41)¹² by establishing a general method of portfolio valuation. If portfolio investments have available market prices, they *must* be valued at that market price. If no market price is available, the mutual fund's board of directors is authorized to establish a procedure by which investments will be valued.

B. Before 2000 (and Since)

The Investment Company Act attempted to create a “closed circle” approach to mutual fund regulation. Terms of redemption are defined, redemption price is based upon net asset value and prices of redeemed and purchased shares are determined according to a specified process, after orders are placed. Despite this effort to create a closed and non-discretionary system, a measure of discretion over the timing of orders and the valuation of net assets remained. Practically, this discretion became increasingly important as mutual funds grew in size (to command assets rivaling those of banks), in scope (to include a wide variety of securities issued by entities all around the globe) and in the variety and number of their shareholders (to include many thousands of savers under 401(k) and other tax deferred plans).¹³ Toward the end of the 20th century, the flexibility resulting from this discretion reopened the door to past problems manifested in new forms.

The problems plaguing mutual funds in the 1990s were the same as the problems of the 1940s: valuation and preferred treatment

¹⁰ 15 U.S.C. § 80a-2(a)(32).

¹¹ 15 U.S.C. § 80a-22(e) (requiring that redemption dollars be paid within seven days after demand).

¹² 15 U.S.C. § 80a-2(a)(41) (2000).

¹³ See Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451 (2004).

to some investors at the expense of other investors. However, the more recent problems came about in different and more complex ways. They reflected the changing contemporary environment: the emergence of global trading, sophisticated financial instruments in which mutual funds could invest, innovative mutual fund products, new intermediaries (often unregulated or regulated differently from mutual funds) and indirect ways for fund insiders to sell and gain preferences at the expense of other shareholders. These dramatic developments were accompanied by an overall weakening of the preventive regulations that were in place, designed to accommodate new pressures.

1. Globalization

The new environment of the securities markets raised anew the problems of valuation. Globalization of securities markets revived an old problem known as stale prices. If an investor placed an order before 4:00 and a major change occurred in the portfolio's net asset value after 4:00, either the remaining shareholders or the buying or redeeming shareholders will gain or lose, not by choice but by chance. For example, if the portfolio value fell at 5:00, buying shareholders would pay the higher 4:00 price and would lose. Redeeming shareholders and the rest of the shareholders would gain, having received, *pro rata*, a higher price. Conversely, if prices rose, redeeming shareholders lose, having received the lower price, and remaining shareholders gain.

Notwithstanding the 4:00 deadline, fluctuations in a portfolio's net asset value could occur, for example, when mutual fund assets contain a significant amount of securities traded in foreign markets. Net asset value calculations would use stale prices of the foreign securities, which continue to be traded long after the New York Stock Exchange closes, that is, after 4:00. Stale prices may also occur when there is news that affects the stock prices after the New York Stock Exchange closes. These changes are not reflected in today's net asset value calculation but likely in tomorrow's. However, it is notoriously difficult to determine when these changes actually occur. At best it can be inferred from the frequency of trades by particular investors, but these may simply be active traders or investors facing rapid changes in cash liquidity needs.¹⁴

¹⁴ See *infra* text accompanying notes 41-44 for further discussion.

This problem of stale prices prompted a relaxation in the rigid, “closed circle” regulatory system. The SEC allowed mutual fund advisers to change the value of portfolio shares when important events affecting the share price occurred *after* the magical hour of 4:00. Mutual fund advisers managing portfolios with such shares were permitted to “correct” the prices after the closing of the New York Stock Exchange and adjust them to reflect prices in global markets.¹⁵ This permission re-introduced the erstwhile discretion fund managers had to set prices after 4:00 for orders made before 4:00.

The use of such discretionary price adjustments grew geometrically as funds invested increasingly sizable portions of shareholder monies in international securities. Thus, mutual funds specializing in international securities gained market advantage by holding more costly-to-value securities issued by foreign entities and traded in foreign markets. Valuation of these securities was less transparent, especially when information about the securities issuers differed from information concerning United States issuers. As a result, not only could the timing of the purchase and redemption prices of these securities differ from the timing of the prices of domestic securities, but these prices were also harder to verify. The acceleration of the globalization phenomenon during the 1990s generated both a greater supply of and demand for these securities.

2. Derivatives

Beginning in the mid-1980s, financial engineers invented numerous forms of sophisticated financial instruments in which mutual funds invested. Now widely known as derivatives, these devices were virtually unknown in the 1940s and are notoriously difficult to value, especially when they are custom-made and one-of-a-kind.¹⁶ The signal characteristic of a derivative security is that its

¹⁵ See Putnam Growth Fund, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3088 (Feb. 23, 1981); see also Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. ECON. & ORG. 245, 249 (2003).

¹⁶ Basic forms of derivatives such as option contracts and forward contracts existed during the 1940s and for centuries before that, but the elaborate and intricate forms they assumed beginning in the late 1980s were unprecedented. For a sampling of the legal literature concerning financial derivative instruments, see Kimberly D. Krawiec, *More than Just “New Financial Bingo”: A Risk-Based Approach to Understanding Derivatives*, 23 IOWA J. CORP. L. 1 (1997); Frank Partnoy, *Financial*

value is a function of (it is “derived” from) the value of some other instrument or benchmark.

As with valuing international securities, valuing derivatives necessarily vests discretion in mutual fund managers. These managers, in turn, must rely on the expertise of others. Experts able to provide reliable valuation estimates are usually the financial firms that designed and sold the derivatives. These experts often exhibited a systematic bias in favor of overestimating rather than underestimating derivatives values. Moreover, the valuation exercises contained inherently subjective components, adding another layer of discretion onto the mutual fund net asset valuation process. This, of course, increased opportunities for abuse.

3. Product Innovation

In the 1940s, there were no 401(k) plans, variable annuities or variable life insurance policies. These investment channels only emerged later and directed the savings of hundreds of thousands of investors into mutual funds. However, this rapid increase in the number of investors posed a new administrative problem.

Like all other investors, the investors of these new vehicles had the right to place purchase and redemption orders just before 4:00. When insurance companies, brokers or other intermediaries offering these plans, annuities and policies received investors’ orders, they had to collate the orders into one group for “buy” and another group for “redeem” and send the two numbers to the related mutual fund. Given the volume of orders, these processes resulted in important changes.

First, there was a need for time extension to allow the sorting and collating of investors’ orders. Second, these processes often required the outsourcing of work to organizations that collected and collated investors’ orders – small unregulated organizations that were not vested with any discretionary powers, but were expected to merely perform manual functions (more on this factor below). Third, and also as a result of these other changes, there were quick and

Derivatives and the Costs of Regulatory Arbitrage, 22 IOWA J. CORP. L. 211 (1997); Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 U. PA. J. INT’L ECON. L. 421 (2001); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701 (1999); Symposium, *Derivative Securities*, 21 IOWA J. CORP. L. 1 (1995) (containing articles by Brandon Becker, Henry T.C. Hu, Jonathan R. Macey, Francois-Ihor Mazur, Lynn A. Stout and others).

repeated redemptions and purchases by investors in these plans, annuities and policies, the identities of whom the regulated mutual fund advisers did not know. Because funds only received one number that aggregated all purchase orders and another number for redemption orders, individual purchase and redemption orders did not affect the value of the mutual fund shares, at least so long as the aggregate figures were presented to the fund on time, and the fund did not bear associated expenses.

Insurance companies and other institutions that managed the new 401(k) plans, variable annuities and variable insurance policies sought a time extension, based on the assumption that small investors in 401(k) plans and insurance annuities should be entitled to wait until the cut-off time before placing their orders. The SEC responded by allowing insurance companies and managers of 401(k) plans to forward orders to mutual fund advisers up to three hours after 4:00.

This permission re-introduced the historical discretion of the investors' representative to determine the timing of share pricing. While the SEC focused on the right of investors to place orders near the cut-off time, it focused less on ensuring compliance and curbing abuse of discretion by managers to determine the timing of orders. Thus, both the SEC and mutual fund advisers lost control over the information and timing related to the execution of investors' orders. Flexibility and discretion are powers that create opportunities for abuse. Here, they were eventually abused.

4. Outsourcing

When thousands of shareholders began to place orders simultaneously, investment companies, insurance companies and broker-dealers managing these plans found order-administration to be costly. Many opted to "outsource" these administrative tasks to smaller firms, which were often unregulated. These smaller firms collated orders and presented fund managers with a net daily trading amount for clearance. That amount could represent the purchase and redemption orders of thousands of investors.

Although these firms were entrusted with purely administrative functions, they nevertheless facilitated abuse of the regulatory system. They could change the date of purchase or redemption orders, and they could accept orders before the cut-off hour while ignoring them later. These changes would be hard to

control without regulating the firms to which work was outsourced, but the funds, insurance companies and brokers who used them also failed to impose such controls over them. Thus, small enterprises entrusted with collating massive numbers of orders found themselves in positions of enormous potential power to help customers place late orders or withdraw earlier orders.

Once these outsourcing enterprises grasped the importance of their power, they expanded their client base beyond small investors to include medium-sized and large investors as well. They could then either accept such investors' orders after the 4:00 deadline or withdraw such investors' timely orders. However, these activities crossed the line to the illegal by violating the 4:00 cut-off rule. In the 1990s, when the stock market was bubbling, this privilege was extremely valuable because it allowed preferred investors to arbitrage different prices of the funds' shares without risk. If investors' bets on the price movement subsequently materialized, they could win by filing orders to sell, *ex post*, after knowing that the price had risen. Alternatively, if bets did not materialize, investors could withdraw their orders. This privilege revived the harm to remaining shareholders by diluting their share values. Moreover, this indirectly robbed the fund of investments that rose in value while leaving the fund holding investments that did not rise or fall in value.

5. Settlement Practices

Preferential treatment of select investors by manipulating the timing of orders was not limited to outsourcing firms. Abuses also arose when fund advisers allowed investors to submit orders after 4:00 for settlement at the 4:00 price. This practice violated Rule 22c-1 requiring that purchases and redemptions settle at the next calculated net asset value.¹⁷ This preferential treatment gave chosen investors a "risk-free arbitrage."

Under existing guidelines, orders were deemed received when placed with a broker: for example, orders placed at 3:00 but sent at 5:00 would be settled at the 4:00 price. The market-timing scheme involved placing the order at 4:15 (with knowledge of the 4:00 price), sending it at 5:00 and settling it at the locked-in 4:00 price. Often, advisers agreed to provide this favored treatment in exchange for the investor's agreement to make long-term

¹⁷ 17 C.F.R. § 270.22c-1 (2004).

commitments to the adviser in another fund, thereby increasing management fees.¹⁸

6. Rapid Turnover

During the 1990s, many investors in 401(k) plans engaged in market timing by quick turnover of purchases and redemptions. The costs of these activities were absorbed by the rest of the shareholders. The SEC was aware of investors' excessive purchases and redemptions.¹⁹ However, redemption rights of small investors seem to have trumped their costs, which were partly absorbed by the rising market.

7. The Market Bubble

Positive short-term trends and periodic rising markets were fundamental realities throughout the 1990s, amounting to a 10-year market bubble of inflated prices that could not be sustained. The sizable and steady increases in stock prices induced participants to believe that prices would continue to rise. This macro outlook likewise led a critical mass of mutual fund investors to adopt a similar micro belief that each day's 4:00 prices were likely to rise. In turn, this created a strong incentive to "trade" by purchase and redemption²⁰ and to make frequent exchanges of investments among different funds. Investors viewed fund share trading as akin to trading stock, but failed to understand the structural peculiarities of mutual funds, that is, the fact that the securities which mutual funds issue are not traded in the markets but are instead redeemed by the funds at net asset value. And trade they did! The period that produced "day traders" in stocks produced "day purchasers and redeemers" in mutual fund shares as well.

¹⁸ See Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288 (Dec. 11, 2003), 68 Fed. Reg. 70,388, 70,388-89 (Dec. 17, 2003) (to be codified at 17 C.F.R. pt. 270) (noting that "[f]und managers . . . have permitted late trades by favored investors").

¹⁹ Zitzewitz, *supra* note 15, at 249 (stating that a 1981 no-action letter "suggests that . . . the SEC understood the nature of the problem"). See discussion *infra* Part III.B.

²⁰ This belief can be attributed to what behavioral economics calls the "representativeness heuristic." See Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767, 783-84 (2002).

Shareholders not practicing continuous short-term purchases and redemptions suffered monetary harm far more acute than would otherwise have occurred in the pre-1940 era. Greater harm arose in part from the cost of executing continuous transactions. It also arose from attendant volatility in fund net asset value and related share price. These effects often prevented managers from pursuing a coherent investment policy.²¹ Though the exact costs of shareholder harm from trading-volatility are elusive²² and the net effect of the flood of transactions may have been neutral, it nonetheless appears that long-term fund owners suffered significant losses from transaction turnover, related volatility and associated tax consequences. These costs diluted the funds' share value to remaining and non-active shareholders.

8. Inside Information

Market timers sought to capitalize on inside information about the composition of fund portfolios. Investors who know what a fund portfolio holds—or, what it will hold—can engage in same-stock arbitrage. Such knowledge is of tremendous value, as it enables investors to buy and redeem fund shares, or buy and sell the underlying securities in the fund's portfolio, at favorable prices. In ordinary trading, an investor takes the risk that his predictions will not materialize and that the price of the shares will not rise or fall. His predictions would be more accurate if he knew the composition of the mutual funds' portfolio. Better still, an investor could gain much with no risk at all if he could place an order at the cut-off time, find out the price of the shares later, and amend his decision. That is, an investor who places a redeem-order could then either cancel the order when the price is lower or keep the order when the price is higher. If the investor places a buy-order he would do the opposite: he would keep the order when the price is lower and cancel the order when the price is higher.

Strong incentives to discover inside information thus fed into incentives for those who could provide it. This incentive "feeder system" is not new,²³ but its appearance in the mutual fund

²¹ See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,287 (Dec. 11, 2003), 68 Fed. Reg. 70,402, 70,404 (Dec. 17, 2003) (to be codified at 17 C.F.R. pts. 239, 274).

²² See Zitzewitz, *supra* note 15, at 248 (citing studies of trading volatility).

²³ SEC v. Boesky, 1986 SEC LEXIS 363 (S.D.N.Y. Nov. 14, 1986).

environment during a stock market bubble period was spectacular. Unlike mutual funds in the pre-1940 era, those in the 1990s involved both small and large non-insider investors. While few insiders appear to have engaged in market timing personally, many profited by passing information about the content of the portfolio, timing of future trades and other items that allowed preferred shareholders to gain.

Outside investors could not engage in market timing without the approval or supervision of mutual fund advisers, the enabling acts of the intermediaries, or the SEC or other regulators' loosening of the strict regulations by bestowing discretion on fund managers. Circumventing these restrictions, some insurance companies entered into contracts with future purchasers of variable annuities that enabled buyers to exchange their investments among different funds without limitation.²⁴ For a price, intermediaries and insiders allowed investors to manipulate the timing of their orders or to cancel orders. Therefore, amid the powerful dynamic forces of globalization, derivative products, innovation, outsourcing and a market bubble environment, regulatory laxity facilitated market timing on a magnificent scale.

III. Diagnosis: Harms from the Problem

The cumulative effects of the dynamic environment of the 1990s caused the practice of market timing to soar. It took a long time for people to recognize that market timing was a serious problem; however, both the ultimate diagnosis and cures for it remain murky.

A. What's Wrong with Market Timing?

Mutual fund investment vehicles provide a valuable intermediation function to promote capital formation and facilitate savings by small investors. Redemption, in turn, comes alongside investments in mutual funds, promising liquidity to investors. Both functions are thus desirable and far from being wrong. Indeed, the

²⁴ *See, e.g.*, Windsor Sec., Inc. v. Hartford Life Ins. Co., 986 F.2d 655 (3d Cir. 1993); Am. Nat'l Bank & Trust Co. v. Allmerica Fin. Life Ins. & Annuity Co., 304 F. Supp. 2d 1009 (N.D. Ill. 2003); First Lincoln Holdings, Inc. v. Equitable Life Assurance Soc'y of the United States, 164 F. Supp. 2d 383 (S.D.N.Y. 2001).

purchase of shares followed closely by redemption is not wrong either, even if motivated by the desire to profit from market timing. After all, the law does not condition purchase or redemption on motivation. There are many reasons for quick purchases, redemptions and repurchases: for example, shareholders may have found better investment opportunities or developed an urgent, unexpected need for cash. Why, then, should shareholders not engage in purchase and redemption for the purpose of arbitrage, which we now call “market timing”?

1. Investor Time Horizons

One argument against market timing is that it does not conform to the expected behavior of mutual fund investors. These investors are presumed to be long-term investors and not “traders” pursuing a purchase and redemption policy. Yet, there is nothing in law, mutual fund investment contracts or mutual fund charters to suggest that the expectation carries the weight of a requirement. To the contrary, the Investment Company Act requires mutual funds to pay shareholders who wish to redeem their shares within seven days.²⁵ Financial burdens on redemption are also limited under Section 2(a)(32) and related SEC interpretations.²⁶

The expectation that fund holders are long-term investors is instead based on certain conventional practices such as tax deferred plans, which cannot be liquidated fully for consumption. Mutual funds may entice investors to be long-term investors, and have used some devices to prevent turnover of purchases and redemptions, for example, by allowing investors to defer the payment of commissions to the time of redemption, and forgiving commissions altogether after a certain long-term holding. While limitations on redemptions are prohibited by law, some limitations on quick turnover of investments are permitted, and have been imposed in the past. Funds can close their doors to new investors or offer only existing investors the opportunity to buy more shares. Further, throughout the years, mutual funds have imposed conditions not only on redemptions alone, but also on purchases and redemptions closely followed by additional purchases and redemptions. If these conditions were disclosed in the funds’ prospectuses, reasonable shareholders would

²⁵ 15 U.S.C. § 80a-22(e) (2000).

²⁶ 15 U.S.C. § 80a-2(a)(32) (2000). *E.g.*, Liberty Fund, Inc., SEC No-Action Letter, 1971 SEC No-Act. LEXIS 1327 (July 23, 1971).

have no complaint. They would agree to the terms or shop for another fund. Presumably, the market will work to serve investors and their preferences.

2. Equal Treatment of Investors

Mutual funds and their advisers must comply with another limitation in all of their activities: they must treat all investors and, to a lesser extent, all potential investors, equally. One basis of this rule, applicable to investment advisers, is the Investment Advisers Act of 1940.²⁷ Another source, applicable mainly to mutual funds, is imposed on their organizational structure under the Investment Company Act of 1940.

Mutual funds can be organized under any state law but are subject to a superimposed federal law structure. Under federal law, mutual funds that are organized as corporations may not discriminate among existing shareholders with respect to payments, voting rights and similar obligations. With few exceptions, the Investment Company Act requires mutual funds to issue only one class of shares.²⁸ Moreover, mutual fund advisers may not discriminate among their shareholders by selling to some investors and not to others.²⁹

The treatment of potential shareholders is more complicated. As an offer of shares to the public and under freedom of contract principles, the corporation may limit the type of investors it chooses to sell to but also reserve the right to discriminate against them. If the arrangement is seen to involve fiduciary services, the same rules apply. Fiduciary relationships must be personal and voluntary.³⁰

²⁷ 15 U.S.C. §§ 80b-1 to -21 (2000 & Supp. I 2001).

²⁸ 15 U.S.C. § 80a-18(f) (2000) (prohibiting issuance of “senior security”); 15 U.S.C. § 80a-18(g) (2000) (defining “senior security” as a security with priority “as to distribution of assets or payment of dividends”); 15 U.S.C. § 80a-18(i) (2000) (requiring that each share of stock generally “have equal voting rights with every other outstanding voting stock”).

²⁹ See 2 FRANKEL & SCHWING, *supra* note 3, § 14.01[F], at 14-30 to -45, § 16.03[A][2], at 16-19 to -21 (duty of adviser not to favor some clients over others).

³⁰ See, e.g., Susan M. Gilles, *Promises Betrayed: Breach of Confidence as a Remedy for Invasions of Privacy*, 43 BUFFALO L. REV. 1, 46 n.202 (1995) (noting the theory that “the essence of a fiduciary relation is the fiduciary’s voluntary assumption of a position that requires him to further the interest of another”) (citing Austin W. Scott, *The Fiduciary Principle*, 3 CAL. L. REV. 539, 540 (1949)); *Berg v. King-Cola, Inc.*, 38 Cal. Rptr. 655, 657 (Ct. App. 1964) (finding fiduciary status “both because of the

Discrimination among shareholders can be represented by different classes of shares each having different rights, or it must be both publicly disclosed by prospectus and then evenly and fairly imposed as disclosed. For example, if a fund is closed to new shareholders, it may not sell its shares only to select new investors unless it disclosed in its prospectus covering the class of new shareholders that would be allowed to buy its shares when the fund is closed. After such disclosure, the fund must sell to all buyers of that class. A fund may limit access of investors to particular employees of the adviser, just as a fund can require qualifications of shareholders in general (e.g., minimum investment), but it is doubtful whether, after closing the fund to the public, the adviser may make an exception for employees without allowing all other existing shareholders to buy shares in that fund.

At this point, a complaining shareholder may have to assert a derivative claim for breach of fiduciary duties to the fund rather than to the investor. Yet, it is likely that a personal claim can be maintained as well because the fiduciary duties of the adviser and the fund's board to each investor are stronger than the fiduciary duties of a board to corporate shareholders. This surmise reflects a federal securities law policy emphasizing that the business of the fund is pooled, mass-produced investment advice and asset management to fund shareholders.³¹

Arguably, federal law follows these principles, even if the funds are organized as limited partnerships, trusts or limited liability companies. Thus, even on the purchase side, mutual funds may have to offer a higher level of fair treatment to future potential investors. On the redemption side, there are clear rules that prohibit funds from discriminating against their investors. To the extent that investors are not treated equally in their redemption rights, a fund's board and a fund's adviser may have violated fiduciary and statutory duties.

3. Purchase-and-Redemption as "Rights"

The right to purchase and the right to redeem are granted to all investors, but may fund advisers and fund boards of directors limit the frequency of trades? If so, may they treat shareholders and potential shareholders unequally? For reasons described below, and

personal relationship of trust and confidence . . . and because of the confidential relationship which exists between partners").

³¹ 1 FRANKEL & SCHWING, *supra* note 3, § 1.01[A][1], at 1-11.

building on the analysis above, we believe that a fund's directors and advisers may indeed limit the frequency of trades. However, we also believe that they may not discriminate among shareholders and potential shareholders in imposing any such limitations.

One justification for limitations on frequent trades is that trades reduce the value of a fund's portfolio in three ways. First, constant purchase and redemption create transaction costs that the fund must absorb.³² Second, such practices can increase a fund's tax liabilities.³³ Both these costs are susceptible to objective measures. Third, such practices impair the managers' ability to follow a coherent investment strategy.³⁴ While measuring this cost is more difficult, the three costs combined can significantly reduce portfolio value. However, in this case as well, equal treatment among shareholders makes a critical difference to the significance of these effects.

If all shareholders know that they may trade in a particular fund and choose to invest in it, some shareholders will gain and some will lose depending on how accurately they predict market movements. In such cases, the fund and its shareholders will resemble the market and its investors. The only differences are that the shareholders bear all or most of the cost of the trades and the fund's managers are impaired in their ability to follow a coherent investment strategy. In addition, such a fund may not attract successful managers, because they too may feel compelled to join in trades; but because they have inside information, they may deplete funds even more than the shareholders do by trading.

Similar limits are imposed in securities markets. Some legitimate transactions can create deceptive impressions and harm third-party investors, and are therefore prohibited. Section 9 of the Securities Exchange Act of 1934³⁵ prohibits transactions that produce deceptive impressions, such as transactions that negate each other and create a "wash." Such wash sales create the false impression of meaningful trading (*e.g.*, interest in the stock), but are in fact "empty" transactions. For similar reasons of promoting

³² *E.g.*, Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782 (Mar. 11, 2005), 70 Fed. Reg. 13,328, 13,329 (Mar. 18, 2005).

³³ *See id.* ("Frequent trading . . . may result in unwanted taxable capital gains for the remaining fund shareholders.")

³⁴ *Id.* at 13,328-29.

³⁵ 15 U.S.C. § 78i (2000).

justifiable investor confidence in the capital markets, federal securities laws also make it a crime for any person to trade securities on the basis of inside information.³⁶

Just as investors in U.S. securities markets are not expected to effect “empty” transactions, investors in U.S. mutual funds also are not expected to purchase and redeem constantly unless all investors are free to do so. Like fraud in securities markets, market timing in mutual funds imposes expenses on passive investors and may dilute the value of the shares in other ways as well. If the default rule in a particular mutual fund is that most investors are long-term investors, something must be done to correct the expectations of the other, shorter-term investors.

A general reason for limiting market timing is that the practice tempts violations of law and exploitation of unsuspecting investors. Instead of speculating, at the risk of mistake, market timers seek security through inside information or by correcting mistaken beliefs. For example, there is temptation to cancel orders to buy if the 4:00 price ends higher than anticipated, or to redeem if the 4:00 price ends lower than anticipated. Market timers indulged in this temptation, violating concepts prohibiting the unfair use of inside information and principles of anti-manipulation, by changing orders after the cut-off time in light of prices known to them but not to other fund holders. What this meant was that management that allowed market timing and benefited from the practice began to slide down the slippery slope of violating its fiduciary duties and other laws.

If only some mutual fund shareholders (and perhaps managers) trade, the costs and lower performance results will be borne by shareholders who did not trade. This unequal treatment threatens to diminish or destroy investor trust in mutual funds. Such mistrust can spread to encompass the entire mutual fund system, tainting funds and advisers who do not practice unequal treatment.

Other potential adverse effects on non-trading shareholders can arise from purchases and redemptions. The volatility of purchase-redemption activity results in mispricing of the portfolio, which in turn dilutes share value. Portfolio and share value may also suffer, particularly when the foregoing activities result in violations of law. Fund value is destroyed when violations of law are exposed, whether due to unequal treatment of shareholders, selective

³⁶ 17 C.F.R. § 240.10b-5 (2004); *see, e.g.*, *United States v. O’Hagan*, 521 U.S. 642 (1997); *Chiarella v. United States*, 445 U.S. 222 (1980).

permission to engage in market timing, provision and use of inside information regarding contents of the fund's portfolio or mispricing of the portfolio.

Though the sources of potential harm from market timing have been identified, precise measures of the magnitude of harm remain elusive. Researchers found that dilution from market timing amounts to 61 basis points in international funds that impose permissible redemption fees, compared with 166 basis points for international funds that do not impose such redemption fees.³⁷ For region-specific funds the numbers were 138 versus 232.³⁸ These results imply that redemption fees reduce or compensate for market timing and dilution—at least so long as the fees are collected by the funds rather than by the funds' advisers.

Therefore, measurable harm from some forms of market timing does not seem great. On the other hand, despite limited harm to continuing holders, there is evidence that violators have gained much.³⁹ Complicating the picture is the possibility that it may simply be impossible to provide accurate measures of the costs of market timing resulting from factors such as impairment of managers' ability to follow a coherent investment strategy.⁴⁰

B. Regulatory Passivity as Tacit Approval

Even if costs of market timing appear either small or difficult to measure, when they are magnified as an industry-wide practice, the stakes rise significantly. The stock market bubble increased the appetite of fund managers, intermediaries and investors, and such appetite sometimes reached the scale of insatiable greed. Relaxation

³⁷ Zitzewitz, *supra* note 15, at 265. *See id.* at 248, 249-50, 262-65 (citing other studies).

³⁸ *Id.* at 262.

³⁹ *Id.*

⁴⁰ The SEC monitors the percentage of households owning mutual funds, which may be a proxy for the relative effectiveness of its securities law enforcement responsibilities. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 48 (2005), *available at* <http://www.sec.gov/about/secpar/secpar2005.pdf> (noting use of percentage of households owning mutual funds as one such "indicator"); U.S. SECURITIES AND EXCHANGE COMMISSION, 2004 PERFORMANCE AND ACCOUNTABILITY REPORT 61 (2004), *available at* <http://www.sec.gov/about/secpar/secpar04.pdf> ("Indirect performance measures, including the rate of mutual fund ownership . . . may indicate that investor concerns about the integrity of the securities markets has waned.").

of strict rules, coupled with ambiguities that existed in the rules, offered opportunities for discretion. Sparking systemic cascade effects requires only a few opportunists exploiting gray areas, pushing the envelope and paving the way for imitators. The fund industry's soft spots of flexibility provided ample opportunities for just such rogues to infect it.

The SEC knew of the excessive purchases and redemptions of mutual fund investors. However, it seems to have assumed, perhaps reasonably, that fund managers had self-interest in preventing harmful turnover of investments.⁴¹ After all, fund size determines managerial compensation and fees paid by advisers who hired them. This view presumed an alignment of interest between managers and investors. Regulators could then rely on the market to solve problems that might arise from market timing; if high turnover threatened damage to a fund, its managers would take actions necessary to prevent it.

However, theories do not always materialize in practice. Developments in the 1990s opened the doors of discretion wide. Managerial flexibility and discretion—and the freedom of the intermediaries—offered opportunities for abuse on which too many managers capitalized. When no regulatory action or market discipline followed such abuse of discretion, competitors followed suit, and a cascade of market timing spread. Opportunities to abuse power increased, while constraints against abuse of trust were relaxed.

Management companies (that is, mutual fund advisers) that were later accused of allowing market timing argued that regulators knew of the practice yet did not disallow it. In principle, such arguments are patently weak. Regulators have limited resources and are unable to ferret out all violations, especially in large enterprises or in numerous small privately-held service providers. Besides, regulatory inaction does not justify violations of law.

In the case of mutual fund market timing, however, it can be argued that regulators not only knew of the practice but also condoned it under certain conditions. For example, the SEC allowed advisers to update “stale prices,”⁴² permitting changes in portfolio valuations to correct prices that became stale as a result of important events that occurred after 4:00. The purpose of the permission was

⁴¹ Zitzewitz, *supra* note 15, at 249 (stating that a 1981 no-action letter “suggests that . . . the SEC understood the nature of the problem”).

⁴² *See id.* at 247.

to encourage correct valuation of the portfolios, especially the portfolios of international funds. Fund advisers and managers abused this discretion by giving information about the changes to preferred investors and allowing them to take advantage of the new prices at the expense of other investors.

The SEC also permitted mutual funds to accept investors' orders after the cut-off time in the case of intermediaries such as broker-dealers, banks and retirement plan administrators.⁴³ It made sense to allow a longer period for aggregating the investors' orders. At the same time, this permission showed that the SEC knew that market timing was occurring on a wide scale. In fact, the SEC further allowed and facilitated the practice by extending the cut-off time for insurance companies' mutual funds and for 401(k) investors. Again, its implicit assumption appeared to be that the private sector itself would correct problems arising from such practices. In this context, the SEC must have thought that shareholders would solve the problem: if all shareholders are allowed to redeem and purchase without limit, and all shareholders know of this privilege, only those who will take advantage of the practice will buy shares in the fund. All shareholders will impose costs on other shareholders and will gain according to their investment skills and research. However, the SEC's implicit assumptions have not been validated. After all, if all shareholders impose costs on the fund they deplete the fund's assets, and this makes it more costly to implement a coherent investment policy, then what investors gain from market timing may be lost in the lower value of their fund shares. And yet, it transpired that about thirty large fund complexes—including insurance companies and banks—succumbed to the allure of benefits from allowing market timing.⁴⁴

⁴³ See Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288 (Dec. 11, 2003), 68 Fed. Reg. 70,388, 70,389 (Dec. 17, 2003) (citing Staff Interpretative Position Relating to Rule 22c-1, Investment Company Act Release No. 5569 (Dec. 27, 1968)).

⁴⁴ See, e.g., Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,418 (Apr. 16, 2004), 69 Fed. Reg. 22,300, 22,300 (Apr. 23, 2004); Peter Elkind, *The Secrets of Eddie Stern*, FORTUNE, Apr. 19, 2004, at 106 (noting that one manager "had market-timing agreements with 30 mutual fund companies").

C. Modern Illustration

Contemporary market-timers were both large investors, such as hedge funds, and small investors, such as individuals holding 401(k) plan investments. Chief beneficiaries were mutual fund advisers—both independent fund managers and institutional fund managers such as banks and insurance companies. Brokers and unregulated service providers who counted and collated orders facilitated market timing schemes and were duly rewarded. The exploitation spread throughout the infrastructure of the mutual fund services industry, from advisers (whether independent or owned by banks or insurance companies) to portfolio managers to brokers and service providers. The chain necessary to administer mutual fund services had become contaminated.

The strategy may have initiated with Edward Stern, a hedge fund manager.⁴⁵ Though he may not have invented market timing, he appears to be one of the first managers to conceive of its financial potential. Neither he nor the hedge fund that he managed was regulated; instead, both were subject to market discipline by sophisticated investors. However, these would-be market disciplinarians were not harmed. Stern was to serve these investors well, and they had no reason to supervise his activities or to complain about them.

Stern contacted the entity (call it “Trust”) that was collating shareholders’ orders. Trust was neither regulated nor supervised by insurance companies, banks or others who represented investors in their programs; it was supposed to act only as a “calculator-messenger.” Since Trust had no discretionary authority, why then should the authorities regulate it and its kind? On the other hand, Trust was given enormous power—it had the ability to change the date of orders and even eliminate orders. For a price, and later as a partner, Trust complied with Stern’s wishes and changed the timing of its orders to fit market movements and arbitrage needs of Stern’s fund. Both Stern and Trust made money from this scheme, but that was not enough.

As money rolled in, Stern contacted a mutual fund adviser managing a fund. If the manager allowed Stern to market-time, he

⁴⁵ Factual aspects of this case appear in *SEC v. Tredway*, 2005 U.S. Dist. LEXIS (S.D.N.Y. Jan. 4, 2005); for media descriptions, see, e.g., Elkind, *supra* note 44, at 106; Landon Thomas, Jr., *Big Fine over Trader’s Mutual-Fund Moves*, N.Y. TIMES, Sept. 4, 2003, at C1.

would benefit the *management company*, the entity that owned the adviser. Stern would not pay the fund manager, because the parties presumably understood such payments to be illegal. But Stern would benefit the fund manager by depositing “sticky assets” in another fund of the management company. Sticky assets are the opposite of redeemable assets. They stay under management, allowing the management company assured fees, which are calculated as a percentage of the assets under management.

With the consent of investors, there is nothing wrong with investing in sticky assets. Although investors cannot waive their redemption rights, they are not required to exercise them. Stern’s promises could not be enforced in court, but then neither could the management company’s promise to allow Stern to engage in market timing. Stern and the management company thus effectively held an extra-legal enforcement power over each other. After this success, Stern contacted other management companies and advisers, who agreed to similar arrangements, sometimes against the strong protests of the portfolio managers. The management company and advisers gained, and the investors and their portfolio managers (who were not compensated) lost.

The last step in this evolution was when the managers, not the management company or the adviser, began engaging in market timing for their own benefit. Six of Putnam’s managers did just that.⁴⁶ Although they earned far greater sums legitimately, it seems that they did not think much of gaining another \$700,000 by playing the market timing game themselves, at the expense of fund investors whom they were expected to serve.⁴⁷

Thus, the corruption spread from Stern to Trust to the management-company, the adviser, and to the manager personally. Each agreed to the scheme for his benefit and the benefit of certain investors, all at the expense of others. Rewards for these arrangements were not surprising: for Trust they were cash; for the management company they were fees from sticky assets; and for managers they were the benefits of market timing directly.

⁴⁶ See, e.g., Gretchen Morgenson, *Defections Lead to a Shake-Up at Putnam*, N.Y. TIMES, Nov. 4, 2003, at C3.

⁴⁷ Jay Fitzgerald, *Putnam Abuses May Hit \$10M*, BOSTON HERALD, Mar. 13, 2004, at 23.

D. Broader Meaning

The similarities between historical and contemporary mutual fund scandals principally concerned the benefit that management companies and advisers, and sometimes individual managers, gained from the practice of market timing. The main difference is that most of the contemporary participants who received benefits did not profit directly, but more indirectly. In any event, the expected protection of long-term shareholders by fund portfolio managers and their supervisors did not materialize. Like Ponzi-scheme con artists, disloyal fiduciaries accepted pay to allow one group of shareholders to benefit at the expense of other shareholders.⁴⁸

The story told in the preceding section reflects many types of abuse of trust. The amounts that the fiduciaries gain are not necessarily large, but the deeper problem is that managers who develop a habit of pursuing personal benefits at the incremental expense of shareholders face increasing temptation and pressure to collect more. After all, each of the thousands of shareholders loses little. This behavior also signals to subordinates within the organization that it is acceptable to behave in this manner. Superiors who are aware of the practice but still do nothing about it send a similarly troubling signal. The result is a rising culture of deceit. It may not be a major problem in terms of dollars when amounts are small but these amounts become a major problem when they snowball into cataclysm and inevitably grow to sizable sums. However, aggregate sums are large for institutional investors, who bring to the funds pools of small investors' savings. For the pension fund as such, losses may rise to staggering amounts.

To be sure, rampant market timing can be enticing only in years of market booms. In such years the victimized shareholders also benefit, even though the benefit is less than that to which they would be entitled. Besides, the victimized shareholders are numerous as compared to the predators. Thus, each victim loses less than the predator gains. The predator investors, being fewer, benefit far more. During such periods, victimized shareholders, even if they are aware of their losses, are likely to be more generous, as profits come in. Shareholders may even assume that the managers (though probably not their fellow-investors) take more than their share, but

⁴⁸ Cf. Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, J. ECON. PERSP., Spring 2004, at 161, 173-76 (treating late trading and market timing as means of compensation, though one in violation of the manager-investor contract).

may still make no objections because they feel magnanimous and care less.

When lean years follow, the difference between shareholders and managers—and especially those select shareholders who gained at the expense of the other shareholders—emerges loudly and clearly. At this point, shareholder ire rises, and regulators and other enforcement apparatus, including the press, join in condemnation.⁴⁹

It has been suggested that an investor's trust in his money managers varies with the results of their service, even though the results do not necessarily show either ability or honesty. During a bubble period, however, regulation is watered down. Enterprises managed by less honest persons exploit such laxity. When market prices fall, the dishonesty is discovered and investor trust erodes. It is at this point that regulators tighten the prohibitions in the hope of regaining investors' trust and avoiding a "run" on the securities markets.⁵⁰ The precise damage resulting from violations of tainted management or the harm to the system from such a practice is impossible to measure, but it is real and provokes a range of solutions.

IV. Solutions: Old and New

In 2003, New York State's Attorney General, Eliot Spitzer, uncovered serious market timing practices. He and other state prosecutors, rather than the SEC, responded.⁵¹ One explanation for the relative eagerness of the attorneys general is that they are prosecutors rather than regulators. At the SEC, the roles of regulation, compliance and prosecution are functionally separated. They require a delicate balance.

⁴⁹ For a sampling of media reports that captured the public rebuke, enforcement investigations and fallout, see Beth Healy, *Putnam Agrees to \$110M Settlement: Trading Penalty is 10 Times More than Investor Restitution*, BOSTON GLOBE, Apr. 9, 2004, at D1; Jeffrey Krasner, *SEC Boston Chief Quits Over Putnam: Office Failed to Act on Market Timing*, BOSTON GLOBE, Nov. 4, 2003, at A1; Jeffrey Krasner & Andrew Caffrey, *SEC Missed a Chance in its Probe of Putnam*, BOSTON GLOBE, Nov. 16, 2003, at A1; Randall Smith & Tom Lauricella, *Spitzer Alleges Mutual Funds Allowed Fraudulent Trading*, WALL. ST. J., Sept. 4, 2003, at A1..

⁵⁰ Tamar Frankel, *Regulation and Investors' Trust in the Securities Markets*, 68 BROOK. L. REV. 439, 440 (2002).

⁵¹ See, e.g., Jonathan Peterson, *SEC Keeps Timing Fees Optional*, L.A. TIMES, Mar. 4, 2005, at C1.

The mutual fund industry will not usually innovate or step into an uncharted area without some assurance from the SEC. The results of violating a law can be severe.⁵² As a result, over successive generations of mutual fund industry leaders, a practice developed of addressing novel issues to the SEC's Division of Investment Management (the "Division") and seeking assurance, usually in the form of a "no-action letter." The SEC benefits from this exercise by gaining information about the industry's plans and concerns and educating itself about the marketplace.⁵³

In contrast, the prosecutors' focus is not on the industry or its well-being, but only on violations of law. Their focus, being sharper and narrower, is to seek successful prosecution. Prosecutors may offer culprits reprieve in exchange for cooperation, if cooperation leads to successful prosecution of other culprits. Prosecutors may settle to meet budget constraints. Regulators and prosecutors complement each other but do not substitute for each other.

The Division has, as it should have, a better understanding of the industry, as well as concern for the industry's well-being. The industry seeks the Division's opinion and guidance because it trusts the Division to act primarily as a regulator and not as a prosecutor. It trusts that the regulators would not act as a strict enforcer of every possible violation, however small, of the very detailed law to which the industry is subject, however trivial. Regulators seek to design preventive measures and react to violations by changing the rules.

What regulators adopted in the 1990s, however, was an approach that viewed prohibitions of law narrowly. If specific activities were not prohibited, they were widely assumed to be permitted. Thus, someone could interpret the law to say that because market timing under certain conditions was not prohibited, the benefits from allowing market timing also do not run afoul of the law. Under this narrow interpretation, it was easy to forget that managers are fiduciaries and protectors of all investors. The fact that the activities were allowed in reliance on the managers to flexibly protect all shareholders was not considered, or perhaps considered irrelevant. There was no specific prohibition, and that was the end of the story.

⁵² 15 U.S.C. § 80a-46(a) (2000).

⁵³ 1 FRANKEL & SCHWING, *supra* note 3, § 2.12.

There is always a danger that regulators may become “captives” of industry.⁵⁴ The danger grows with the industry’s size and power. In retrospect, the Division may have relied on and trusted the mutual fund industry more than it should have done. A method by which regulation is viewed literally and specifically may have led the industry to seek out the gray areas when it should not have. However, the history of the industry suggests that the regulators’ trust was not unwarranted. The industry, like corporate top management, lawyers and accountants, became captive to the greed and culture of the 1990s, which may have started a decade or more earlier.

A. Enforcement

The enforcement efforts by state attorneys general provoked significant questions concerning the relation between their offices and the federal enforcement apparatus, as well as the role of private enforcement efforts. Each means of enforcement can contribute different benefits to addressing market timing issues.

1. Federal Preemption

State prosecutions bring to the fore the issue of the relationship between state and federal laws regulating mutual funds. Federal preemption can be asserted by the parties or the SEC under clear statutory language. It can also be asserted if the federal

⁵⁴ The literature on regulatory capture shows that associated risks can be more theoretical than real. See David B. Spence & Frank Cross, *A Public Choice Case for the Administrative State*, 89 GEO. L.J. 97, 122-23 (2000). This is particularly so concerning the SEC. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* xv (rev. ed. 1995) (“Few have suggested seriously that the SEC has been a ‘captive’ of the industries it regulates. . . . Such a suggestion cannot be sustained by a reasonable reading of the Commission’s history.”); John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT’L L. 531, 543-44 (2001) (suggesting that the SEC “remains a highly respected government agency, even among political constituencies otherwise inclined to doubt the value or abilities of government regulators”). Cf. *supra* Part III.B (using the subtitle “Regulatory Passivity” for our discussion of the SEC’s outlook during the late 1990s and early 2000s).

regulatory scheme is extensive and might be undermined by differing state laws or varying interpretations of relevant federal law.⁵⁵

When Congress passed the National Securities Markets Improvement Act of 1996 (NSMIA), the House conference noted that “the system of dual federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation” and that in many cases the system is “redundant, costly, and ineffective.”⁵⁶ NSMIA does not explicitly preempt state antifraud provisions that set different standards for a wrong, recovery or intent, such as negligence.⁵⁷ Recent events may signal return of the dual system.

2. State Settlements

Instead of being litigated, most disputes are settled before court hearings begin.⁵⁸ In the mutual fund market timing disputes pursued by state prosecutors, settlements included not only criminal punishments (imprisonment, fines), but also agreements for structural changes and reduction of fees that fund advisers charge investors.⁵⁹ These settlements create problems because they bring together the function of regulating the mutual fund industry and the function of prosecuting violations of law.

⁵⁵ See JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW § 9.4, at 377-78 (7th ed. 2004) (stating that congressional intent to preempt may be clear from the language of the statute, or “may be clear from the pervasiveness of the federal scheme, the need for uniformity, or the danger of conflict between the enforcement of state laws and the administration of federal programs, or the state law ‘stands as an obstacle to the accomplishment of the full purposes and objectives of Congress’”); National Securities Markets Improvement Act of 1996, sec. 102(a), § 18(a), Pub. L. No. 104-290, 110 Stat. 3416, 3417-18 (codified at 15 U.S.C. § 77r(a) (2000)); *id.* sec. 102(b), § 18(a), Pub. L. No. 104-290, 110 Stat. at 3418 (codified as amended at 15 U.S.C. § 77r(b) (2000) (defining “covered securities”). The definition of “covered securities” in the Act includes investment company securities.

⁵⁶ H.R. CONF. REP. NO. 104-864, at 39 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3920.

⁵⁷ See Rutheford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 201 n.143 (1997).

⁵⁸ See, e.g., Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991); Marc Galanter & Mia Cahill, “Most Cases Settle”: *Judicial Promotion and Regulation of Settlements*, 46 STAN. L. REV. 1339 (1994); Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374 (1982).

⁵⁹ See, e.g., Settlement Agreement (Sept. 13, 2004) (settlement between PA Distributors LLC and California Attorney General), *available at* http://ag.ca.gov/newsalerts/2004/04-105_settlement.pdf.

Regulation should be distinguished from prosecution. Regulations are prospective rules. They are usually enacted under a procedure that allows affected parties to comment on the rules.⁶⁰ Prosecution deals with violated rules. Settlements, however, fall in between these categories; they involve broad prosecutorial discretion (and sometimes broad discretion of the accused) and are the result of negotiations under the cloud of uncertain litigation outcomes.⁶¹ Thus, prosecutors may agree to a lighter sentence in exchange for the defendant's assistance in prosecuting other parties.⁶² They may impose preventive measures to avoid violations in the future.

Settlements can potentially venture far afield into the regulatory area. Even though settlements are not considered precedents, they can operate as a functional equivalent in many ways ranging from precluding claims to guiding future interpretation and negotiations.⁶³ They signal to other industry members the importance that authorities place on certain business conduct or professional behavior, and whether the authorities will feel constrained to treat other offenders similarly. Even without being legally binding, settlements have an impact, especially since most claims end in settlements.⁶⁴ Thus, settlements by state authorities that conflict with federal policy present issues on the fringe of preemption.

It is not necessarily the case that federal regulators always resent or object to the activities of state prosecutions. Federal regulators may lack resources necessary to enforce certain laws. Some regulators may desire broader state law prohibitions as compared to congressional prohibitions that may be less stringent. Federal regulators may support preemption in such cases actively or

⁶⁰ See, e.g., Administrative Procedure Act, 5 U.S.C. § 553 (2000).

⁶¹ See, e.g., Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982); Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979).

⁶² See R. Michael Cassidy, "Soft Words of Hope": *Giglio, Accomplice Witnesses, and the Problem of Implied Inducements*, 98 NW. L. REV. 1129 (2004).

⁶³ See, e.g., Margaret Meriwether Cordray, *Settlement Agreements and the Supreme Court*, 48 HASTINGS L.J. 9 (1996); Leandra Lederman, *Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements?*, 75 NOTRE DAME L. REV. 221 (1999).

⁶⁴ See, e.g., Alexander, *supra* note 58; Galanter & Cahill, *supra* note 58; Resnik, *supra* note 58.

passively. The laws themselves may implicitly or explicitly contemplate such deference.

A settlement agreement reached by California in a case concerning the PIMCO mutual fund family illustrates.⁶⁵ It hinges on a section of the NSMIA providing that:

[e]xcept as otherwise provided in this section, no law, rule, regulation of order, or other administrative action of any State . . . requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transaction . . . shall directly or indirectly prohibit, limit or impose any consideration upon the use of . . . any offering document . . . [which includes a prospectus].⁶⁶

NSMIA also provides that a state will “retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer in connection with securities or securities transactions.”⁶⁷ This section is ambiguous. It is not clear whether a state is permitted to bring an enforcement action with respect to fraud, deceit or unlawful conduct only by brokers and dealers. The express inclusion of the words “broker or dealer” may deny a state’s right to pursue an action against an issuer. The language concerning “fraud or deceit” apparently means that states may bring such actions under state laws defining the concepts of fraud and deceit, which may differ from the meanings of such concepts under federal law.⁶⁸

In the PIMCO case, California’s claim related to fraud by non-disclosure of information that was not required under federal law. The relevant California statutes defined fraud more broadly

⁶⁵ See *SEC v. PIMCO*, 341 F. Supp. 2d 454 (2004) (providing additional factual background in context of motion to dismiss claims against two executives in this mutual fund complex).

⁶⁶ National Securities Markets Improvement Act of 1996, sec. 102(a), § 18(a), Pub. L. No. 104-290, 110 Stat. 3416, 3417-18 (codified at 15 U.S.C. § 77r(a) (2000)).

⁶⁷ *Id.* sec. 102(a), §18(c), Pub. L. No. 104-290, 110 Stat. at 3419 (codified at 15 U.S.C. § 77r(a) (2000)).

⁶⁸ See Campbell, *supra* note 57, at 200 n.140 (1997) (commenting that the words “by a broker or dealer” are modified only by “unlawful conduct,” implying that states may enforce the prohibition on fraud in a prospectus).

than federal law.⁶⁹ The SEC cooperated with California in the case and in reaching its settlement.⁷⁰ Accordingly, the case suggests the broadest interpretation of the foregoing language. It underscores that NSMIA is not fully preemptive, and leaves states with authority to prosecute fraudulent activities under certain conditions.⁷¹

The SEC's cooperation with the California Attorney General may point to a more nuanced approach to federal-state relations, which does not involve preemption, but cooperation and competition among state and federal regulators.⁷² States are not likely to compete among themselves; they are likely to focus on events, mutual funds and investors within their respective jurisdictions. But there may develop a three-party power struggle between the SEC, select state regulators and the fund industry. In these situations, both the law and the settlements reached become less settled.

The mutual fund industry seems to have lost power because it must deal not only with the SEC but also with state prosecutors. The SEC has lost power because it no longer holds full hegemony in shaping the law and its enforcement, as it did in the past. If this pattern continues, select states—particularly New York, Massachusetts and California—may significantly influence the law governing mutual funds. We believe that these states will face pressures similar to those created by state corporation law.

⁶⁹ CAL. CORP. CODE § 25216(a) (West Supp. 2004); *id.* § 25401 (West 1977); *see also* Tom Petrino & Josh Friedman, *Pimco to Pay \$20.6 Million in Settlements*, L.A. TIMES, Sept. 16, 2004, at C1 (noting that state charges “took a broader sweep”).

⁷⁰ Complaint, *People v. PA Distributors LLC* (Cal. Super. Ct. Sept. 15, 2004), http://ag.ca.gov/newsalerts/2004/04-105_complaint.pdf; *see also* Tom Petrino & Josh Friedman, *Pimco to Pay \$20.6 Million in Settlements*, L.A. TIMES, Sept. 16, 2004, at C1 (noting findings of SEC and state regulators “after a joint probe”). PIMCO agreed to pay \$9 million to settle the state action (\$5 million to the state general fund and \$4 million to cover the cost of the action to the attorney general) and \$11.6 million to settle the SEC action (\$6.6 million to the stock funds and a \$5 million civil penalty to the Treasury). PIMCO neither admitted to nor denied the charges. *Id.*

⁷¹ *See* Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS. 169 (1997); Howard M. Friedman, *The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers*, 53 BUS. LAW. 511 (1998); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998).

⁷² *See* Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L. J. 107 (2004).

Mutual funds may gain flexibility by shopping for reincorporation among states offering preferred law.⁷³ States may reply to this competition, as California and New York have in corporation law, by imposing their laws on a mutual fund, regardless of its state of incorporation, if it impacts the state's residents.⁷⁴ Such competition would be reminiscent of the pattern that appeared in the late 1980s when many states, led by Maryland and Delaware, launched statutory competition against Massachusetts, then wielding hegemony for business trusts, by enacting laws providing for more assurance to such trusts and enticing many mutual fund complexes to reorganize their funds in their states.⁷⁵

Accordingly, the law governing mutual funds regarding state settlements is at least as unpredictable and muddled as before. However, this result is not all bad.⁷⁶ Lack of predictability, while being a serious problem for law enforcement efforts, may also be a

⁷³ Competition among states for mutual fund chartering business could ensue. Evaluating the systemic desirability of such a race would likely entail replicating the long-standing debate in corporate law concerning whether state competition for corporate charters is optimal. For contemporary contributions to this debate, see ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATION LAW* (1993); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L. J. 401 (1994); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

⁷⁴ See William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 314-15 (1997) (discussing New York's and California's "pseudo foreign corporation" laws); 17 WILLIAM MEADE FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 8386, at 236-51 (rev. vol. 1998) (discussing the power of states to exclude or restrict foreign corporations).

⁷⁵ MD. CODE ANN., CORPS. & ASS'NS § 2-501 (LexisNexis 2005); Delaware Business Trust Act, 66 Del. Laws 279 (1988) (codified as amended and renamed Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12, § 3801-3820 (2006); see also John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 187-188 (1997) (discussing enactment by Maryland during the 1980s, Delaware in 1988, and 16 other states subsequently of permissive business trust statutes, with Delaware's bid enticing mutual funds to reorganize as Delaware business trusts); Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325 (2001) (explaining limitations on the appeal of the Delaware statute as due, in part, to limited benefits to the trust form of business to organizations that operate nationally).

⁷⁶ See Charles M. Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54 (1989) (explaining the desirability of a certain level of uncertainty in law).

strong deterrent to market timing and similar foggy areas, and especially to fiduciaries' allowing of market timing, since risk of violating law has increased with uncertainty. Similarly, uncertainty has increased the risks of punishment, including damages. This is an issue raised more directly by private actions of investors against these parties, as discussed next.

3. Private Actions

Market timing revelations prompted investor lawsuits against holding companies, advisers and managers. Plaintiffs alleged engagement in, approval of, or benefits from market timing, or hiding related acts from investors who did not participate in these activities. Two particular issues are noteworthy: remedies and the burden of proof.

Assuming the defendants breached their fiduciary duties to the mutual funds, or even directly to their investors, they owe the funds and/or investors damages.⁷⁷ They must also account for their ill-gotten profits, which are not difficult to establish. On the damages side, however, it is difficult to calculate the costs of the excess purchase-and-redemption transactions that market timing produced.

Suppose as a result of market timing, which the violators permitted, or in which they participated, fund portfolio value was diluted. Should violators pay continuing shareholders the difference between the current net asset value of their shares and the net asset value of an undiluted portfolio? If, as a result of publicity, managers or advisers lost significant sums under management, and if continuing investors thereby were charged significantly higher fees and costs of managing the funds, should violators pay these investors their losses?

Both questions raise issues of causation and burden of proof, which are problematic when dealing with marketable securities. Did market timing cause the fallen net asset value, or did other factors such as poor portfolio management cause damage to investors? Did

⁷⁷ See, e.g., Kathleen Clark, *Do We Have Enough Ethics in Government Yet?: An Answer from Fiduciary Theory*, 1996 U. ILL. L. REV. 57, 72-73 (noting the "wide range of remedies available for breach of the [fiduciary] obligation"; remedies "seek to deprive the fiduciary of any benefit from the breach, not just to compensate the beneficiary for any injury from the breach"; citing cases).

market timing and the legal proceedings against the violators cause the flight of assets from the violators, or was investor flight due to poor portfolio management or other reasons?

If market timing were conceived of as a securities law violation, then traditional models of securities law litigation may help determine whether market timing caused fallen net asset value. Section 11 of the Securities Act of 1933 (“Section 11”), a sort-of strict liability standard, shifts the burden, from plaintiffs to defendants, of proving that misrepresentations caused lower securities prices. Under this approach, defendants could show that the plaintiff knew the truth.⁷⁸ However, Rule 10b-5, adopted pursuant to the Securities Exchange Act of 1934, is a fraud-based standard that imposes a stricter burden of proof hinging on concepts of scienter.⁷⁹ Is mutual fund market timing more analogous to violations of Section 11 or Rule 10b-5?

Market timing is similar to Section 11 misrepresentation in that the results of market timing enrich those investors possessing information, while causing losses for the remaining, uninformed shareholders. Still, market timing is different than misrepresentation in that, unless the uninformed investors also engaged in the same practice, they could only lose and never gain from the activities of the informed shareholders. Presumably, the uninformed investors could engage in the same practice, the way shareholders could sell shares of Enron Corporation in time to gain, while buyers of these shares would lose if they kept them. Thus, the difference between the two scenarios is that in market timing the trading shareholders know that they are gaining at the expense of the other shareholders, and each shareholder could do the same. In regular securities markets, trading shareholders do not know that they will gain at the expense of buyers, and buyers have the same choice to sell rather than to buy.

⁷⁸ 15 U.S.C. § 77k (2000); 9 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4249-54 (3d ed. 2004) (stating that plaintiff need not prove reliance “unless he or she bought after the issuer had made generally available to its security holders an earnings statement covering a period of at least a year beginning after the effective date”; “even then[,] ‘reliance may be established without proof of the reading of the registration statement by such person’”; damages are reduced to the extent that *defendant* proves they are not caused by his or her misconduct); *id.* at 4258-63 (stating that the issuer’s liability is generally absolute unless plaintiff knew of untruth or omission, or, for certain nonissuer defendants, if one of several “reasonable care” defenses apply).

⁷⁹ 17 C.F.R. § 240.10b-5 (2004).

In mutual fund market timing cases, the issue is whether the outflow of assets under management and the increased financial burden on remaining shareholders was due to violations by fund managers or merely to inept portfolio management. The cost of proving one or the other may be enormous, especially if there are numerous escaping shareholders.

Even escaping institutional investors may be reluctant to testify about their motives—to show that they withdrew funds as a result of suspicions or to protect themselves from liability to their pension participants for lack of vigilance in supervising the violating advisers. Besides, some investors may have withdrawn their investments for reasons unrelated to either lack of trust or unsatisfactory performance. Thus, as in the case of Section 11 claims, the cost of proving causation is high and the proof is highly diffuse and speculative. But unlike Section 11, the market timing violation is not misrepresentation in the sale of securities, but breach of fiduciary duties under common law and federal statutes.

In these circumstances, the issue is resolved by allocating the burden of proof. Public policy should then guide the decision of whether the burden should shift from the plaintiff to the defendant. In our view, the burden should shift for the following reasons. The assumption should be that once it is shown that the defendant violated its fiduciary duties under common law, the Investment Advisers Act or the Investment Company Act, investor trust in the defendant has eroded. It can easily be shown that those advisers who were prosecuted for allowing or participating in market timing lost large amounts of investors' money (even in cases that settled). Those advisers found to be "clean" have acquired such investors' money for management. Large sums of money have moved from one group of advisers to the other.⁸⁰

What weight should be given to the fact that investors removed money from advisers for poor performance, thereby causing the plaintiff investors injury? The very fact of market timing can reduce the performance of a fund. In addition, when violation of law has been shown, then the assumption should be that the violation caused direct as well as indirect damage to plaintiffs. The burden should move to the defendant to prove that performance lagged for

⁸⁰ See, e.g., Mike Foster, *US Survives Market-Timing Scandal*, EFINANCIALNEWS.COM, Oct. 10, 2004, LEXIS, News Library, Curnws File (noting "exit of investors" from firm involved in scandal).

reasons other than market timing, and that the investors who removed their money knew about the violations but did so for reasons other than the violations.

Any argument that investors left an adviser because of poor performance rather than loss of trust should be scrutinized. The analysis of this argument can reveal relevant attitudes. Some scholars argue that investors do not care about fraudulent money managers, and only care about performance.⁸¹ And if fraudulent managers make money for investors by illegal means, investors would be happy to entrust their money to these managers. In this story, honesty is irrelevant; only money counts.

However, this argument is flawed. Investors are exposed to risks of capital losses and income declines if managers are incompetent, and if the economy and other external factors reduce value and income. Investors are also exposed to risk of loss from dishonesty, such as when portfolio performance is lower had market timing not been practiced, or if managers embezzle investors' money for their own use. To be sure, investors aim for optimal performance, but they also care, perhaps just as much, about risks of loss from fraud or sub-par performance. They would not entrust their money to a known embezzler. They remove their money from advisers who have proven to be disloyal. Thus, they might remove their money from advisers who are dishonest to other investors.

Simplifying investors' motivations to a focus on returns is misleading.⁸² Doing so conflates stealing with incompetence and reduces the difference between them. However, dishonesty may threaten the financial system more than lack of ability. That is because while competing on competence is likely to remedy incompetence, competing on dishonesty is likely to increase dishonesty. The focus on "performance" at all costs undermines public policy aimed at preventing fraud.

Public policy should not be dictated by the notion that, so long as managers make money for investors, it does not matter how

⁸¹ See, e.g., Jeffrey Nesteruk, *Corporations, Shareholders, and Moral Choice: A New Perspective on Corporate Social Responsibility*, 58 U. CIN. L. REV. 451, 470 (1989) ("Shareholders . . . are primarily investors wanting only a return on their investment.").

⁸² An old rhetorical joke wonders: would you rather entrust your money to an honest idiot or to a dishonest genius? The joke is rhetorical because it contains essentially a false dichotomy by identifying the tails of the population distribution curve. Reasonable investors seek fair and competent money managers, of which many competitors abound.

they make the money. Managers who steal from one group of investors to enrich themselves and another group of investors are engaging in Ponzi schemes, which are unproductive, illegal asset redistributions.⁸³ Therefore, rather than put incompetence and dishonesty under the same umbrella, they should be clearly and emphatically distinguished, because investors may withdraw from markets lest they belong to the losing group in Ponzi schemes. Judicial administration of private lawsuits alleging wrongs due to market timing should reflect these public policies when shaping doctrines of causation and assigning burdens of proof.

B. External Regulation

In the wake of the early 2000s' mutual fund scandals, many generally applicable regulatory reforms were adopted and several specific reforms were imposed on particular funds by settlement. While these reforms addressed a wide range of matters, including fees and corporate governance, the following discussion focuses on reforms addressed to market timing specifically. Approaches include constricting discretion and compelling disclosure.

1. Limiting Discretionary Timing of Orders

One SEC-proposed reform to block late-trading that exploits market timing would require that investors' orders reach the funds before 4:00 for them to be settled at a given day's price.⁸⁴ This reform eliminates exceptions for insurance companies and 401(k) plans. Investors must place orders with brokers well before 4:00 so that they will reach mutual funds before that hour. If orders do not reach the fund before the cut-off time, they will be settled at the price prevailing on the following day. Consequently, under the new cut-off approach, fund advisers may opt to improve the efficiency of order-collation in order to serve investors wishing to cut it close to 4:00. As of February 2006, this amendment has not been adopted.

⁸³ See generally TAMAR FRANKEL, *TRUST AND HONESTY: AMERICA'S CULTURE AT A CROSSROAD* (2005).

⁸⁴ Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288 (Dec. 11, 2003), 68 Fed. Reg. 70,388, 70,389-90 (Dec. 17, 2003).

2. Curtailing Discretionary Valuation

Rule 2a-4 under the Investment Company Act instructs advisers on using “current market value” to measure price.⁸⁵ Under this Rule, a fund can determine closing net asset value using measures informed by pending news, not the last trading price. The Act requires net asset value calculations to be made at current market values. This method is easy and objective for liquid assets, such as widely traded U.S. blue chip stocks and bonds. In contrast, discretionary judgment may be necessary to value many other securities, like thinly traded stocks, various put and call options that do not trade frequently (or do not trade at all) or even foreign stocks when the last closing price is already stale at the time a fund’s net asset value is calculated.⁸⁶ The Act requires fund directors to establish a process for valuation of securities for which market prices are not available.⁸⁷ The SEC provides guidance and disclosure requirements on these matters, narrowing board discretion.⁸⁸

3. Fair-Value Measures

The traditional valuation regime under section 2(a)(41) of the Investment Company Act addresses stale prices by requiring the use of fair-value pricing when significant events occur or other methods otherwise in accordance with a fund’s policies.⁸⁹ That is, instead of relying on actual market prices when these are stale, it is permissible to estimate current fair market value in lieu of using such actual, but old, prices. Appealing as this sounds in principle, allowing funds discretion to establish a fair value estimate, in general or in relation to an equally discretionary concept of significant events, is inappropriate in an era when discretionary valuation exercises are

⁸⁵ 17 C.F.R. § 270.2a-4 (2005).

⁸⁶ *See supra* Parts II.B.1 & II.B.2 (discussing problems mutual fund administration faced as a result of globalization and proliferation of derivative financial instruments).

⁸⁷ 15 U.S.C. § 80a-2(a)(41) (2000).

⁸⁸ Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118, 35 Fed. Reg. 19,986 (Dec. 23, 1970).

⁸⁹ Inv. Co. Inst., SEC No-Action Letter, 2001 SEC No-Act. LEXIS 543 (Apr. 30, 2001).

being curtailed.⁹⁰ This remains the case despite efforts to use disclosure to limit associated abuses of discretion.

4. Disclosure

Disclosure is an appealing regulatory and market device to enhance fairness and compliance with law. For mutual funds and market timing, disclosure centers on conflicts of interest, fair-value pricing and purchase-and-redemption transactions. Specifically with regard to conflicts of interest, the SEC adopted rules requiring mutual funds to disclose: (1) how many of their own fund's mutual fund managers own fund shares and (2) whether fund managers have a stake in the funds' performance.⁹¹

While giving fund managers a stake in the funds they manage was viewed as a desirable way to align investor and manager interests, market timing scandals have shown that funds are still vulnerable to improper behavior by managers who invest in their own funds. Critics of the new SEC disclosure rules argued that the information required of the disclosure rule is not sufficiently specific. It covers only disclosure of the dollar range into which the managers' investments fall, rather than the specific amounts or what portion of a manager's investments the amount represents.⁹² Besides, rather than merely disclose, mutual funds should be more effective in pricing and enforcing the rules that bar frequent trading. Then disclosure would not be necessary.

As to disclosure concerning fair-value pricing, another SEC rule requires mutual funds and managed separate accounts that offer variable annuities to disclose in fund prospectuses the circumstances under which a fund will use fair-value pricing and the effects of such

⁹⁰ For discussion of various alternative approaches to fair value pricing of mutual fund shares, see Conrad S. Ciccotello et al., *Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age*, 7 VA. J.L. & TECH. 6 (2002).

⁹¹ Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Investment Company Act Release No. 26,533 (Aug. 23, 2004), 69 Fed. Reg. 52,788 (Aug. 27, 2004); see also Christopher Oster, *Forcing Managers to Reveal Fund Stakes*, WALL ST. J., Aug. 2, 2004, at R1.

⁹² Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, 69 Fed. Reg. at 52,793.

a policy.⁹³ The purpose of this provision is to show clearly that funds are required to use fair-value prices whenever market quotations for their portfolio securities are unreliable or not readily available. Policy analysts generally support this amendment. However, they “expressed concern that requiring specific disclosure of the circumstances under which [fair-value pricing will be used] might help arbitrageurs to identify circumstances in which they could take unfair advantage of a fund’s pricing policies.”⁹⁴ The response emphasized that the adopted or current requirements “do not require disclosure of the specific methodologies and formulas that a fund uses to determine fair value prices.... [A] fund’s disclosure need not be so specific [as to preclude a fund from] adjust[ing] the triggering events from time to time in response to market events or other causes.”⁹⁵

This rule requires disclosure of: (1) the risks to fund shareholders from frequent purchases and redemptions, (2) a fund’s policies and (3) procedures with respect to such. The rule elaborates as follows:

These risks may include . . . dilution in the value of fund shares held by long-term shareholders, interference with the efficient management of the fund’s portfolio, and increased brokerage and administrative costs. Disclosure should be specific to the fund, taking into account its investment objectives, policies, and strategies. If the fund’s board of directors has not adopted any such policies and procedures, the fund’s prospectus must include a statement of the specific basis for the view of the board that [they are unnecessary]⁹⁶

Mutual funds must “describe with specificity the restrictions they place on frequent purchases and redemptions, if any, and the circumstances under which any such restrictions will not apply.”⁹⁷ According to the SEC, “[c]ommentators generally supported the

⁹³ Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,418 (Apr. 16, 2004), 69 Fed. Reg. 22,300, 22,304 (Apr. 23, 2004).

⁹⁴ Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. at 22,305.

⁹⁵ *Id.*

⁹⁶ *Id.* at 22,301-02.

⁹⁷ *Id.* at 22,301.

proposed requirements, and agreed that additional disclosure would enable investors to assess mutual funds' risks, policies, and procedures in this area and determine if a fund's policies and procedures are in line with their expectations."⁹⁸ Commentators disagreed on whether funds should be required to disclose with specificity their policies, procedures, and restrictions on purchases and redemptions.⁹⁹

Critics argued that disclosure would encourage uniform application of the restrictions, but would also aid those attempting to avoid detection. The SEC noted in response that funds should retain some flexibility to address new issues as they arise. Therefore, the SEC removed the "proposed requirement that a fund describe its policies and procedures for deterring frequent purchases and redemptions of fund shares."¹⁰⁰ Instead there is a new requirement "that a fund's disclosure regarding whether its restrictions to prevent or minimize frequent purchases and redemptions are uniformly applied must indicate whether each such restriction applies to trades that occur through omnibus accounts at [intermediaries]."¹⁰¹

The SEC required "that a mutual fund describe any arrangements with any person to permit frequent purchases and redemptions" and that the description must include the identity of such persons.¹⁰² According to the SEC, "[s]everal commentators objected to this proposed requirement [and argued that] specific identification of these investors may violate such investors' privacy [and] would not be useful to investors."¹⁰³ In response, the SEC noted that disclosure of persons who have such arrangements with a fund is necessary. The SEC modified the requirement to permit a fund that has an arrangement with a group of individuals, such as the participants in a defined contribution plan, to identify the group rather than identify each individual. The listing can also be placed in the Statement of Additional Information (SAI) rather than in the prospectus. This gives less exposure to the information.¹⁰⁴

⁹⁸ *Id.* (footnote omitted).

⁹⁹ *Id.* at 22,302.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 22,302-03.

¹⁰² *Id.* at 22,303.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

The disclosure rule is broad. As adopted, the amendments to the related mutual fund registration form apply to all mutual funds, including insurance companies' separate accounts that issue variable annuity and variable life insurance contracts, and to exchange-traded funds, which do not offer the small shareholders redeemable securities. According to the SEC, "[s]ome commentators argued that exchange traded funds ... should be excluded from the proposed disclosure requirements ... because, unlike traditional mutual funds, [the exchange-traded funds] sell and redeem their shares at net asset value only in large blocks," and because they are listed on stock exchanges.¹⁰⁵ The SEC responded that "in those cases when an [exchange-traded fund] purchases and redeems its shares in cash rather than in [securities], the risks for long-term shareholders of funds are similar to the risks that long-term mutual fund shareholders face."¹⁰⁶

5. Governance

In addition to disclosure, another standard reform effort focuses on governance. For advisers to mutual funds and other diffuse organizations, governance efforts center on codes of ethics and monitoring. As to ethics codes, the SEC adopted Rule 204A-1 under the Investment Advisers Act.¹⁰⁷ The Rule requires registered investment advisers to adopt codes of ethics.¹⁰⁸ The codes must establish standards of conduct and require compliance with federal securities laws.¹⁰⁹ Codes of ethics must also address personnel trading, requiring the advisers' personnel to report their personal securities holdings and transactions, including those in affiliated mutual funds, and obtain pre-approval of certain investments. The SEC also amended record-keeping rules to require advisers to keep copies of their codes of ethics and records relating to its

¹⁰⁵ *Id.* at 22,303-04.

¹⁰⁶ *Id.* at 22,304.

¹⁰⁷ Investment Adviser Codes of Ethics, Investment Company Act Release No. 26,492 (July 2, 2004), 69 Fed. Reg. 41,696 (July 9, 2004) (codified at 17 C.F.R. § 275.204A-1 (2005)).

¹⁰⁸ 17 C.F.R. § 275.204A-1(a).

¹⁰⁹ The Code must include "[p]rovisions requiring supervised persons to report any violations of [the] code of ethics promptly to [the] chief compliance officer or, provided [the] chief compliance officer also receives reports of all violations, to other persons . . . designate[d] in [the] code of ethics . . ." 17 C.F.R. § 275.204A-1(a)(4).

administration. The SEC amended client disclosure requirements to require advisers to describe their codes of ethics to clients.¹¹⁰

Some believe that funds whose boards include more independent directors and lower expense ratios are more likely to have adopted “short-term trading fees and fair-value pricing.”¹¹¹ Nonetheless, there is little proof of a causal relationship between independent boards and greater protections against market timing.

Eric Zitzewitz concludes that there seem to be conflict of interest problems in fund management using market timing to increase fund size. Research by Chevalier and Ellison indicates other reasons for conflicts by suggesting that “\$1 of dilution reduces future inflows by roughly another \$1.”¹¹² This implies that some fund managers seek short-term (perhaps personal) benefits, sacrificing a fund’s long-term prospects. Another possibility is that fund management employees directly benefit from allowing arbitrage and prefer fees and limitations rather than fair valuation, since the former can be applied selectively.

C. Internal Reform

One difficulty that market timing issues pose relates to the conflicting purposes of redemption. On one hand, redemption is a great benefit for investors in mutual funds. It provides shareholders with liquidity and ensures them a *pro rata* share of fund assets on demand, rather than a fickle market price. On the other hand, both small and large investors can use market timing to impose higher expenses on other shareholders and dilute the value of other investors’ shares. To balance these trade-offs, it is reasonable to restrict those active investors or charge them to cover excess expenses imposed on others. That amount was determined to be 2% of their purchase and redemption, when made within five days of each other.¹¹³ The payment is designed to cover the cost of purchases and redemptions and to compensate less active shareholders for these costs.

¹¹⁰ See Part II of Form ADV.

¹¹¹ Zitzewitz. *supra* note 15, at 275-77.

¹¹² *Id.* at 278 (citing Judith A. Chevalier & Glenn D. Ellison, *Risk Taking by Mutual Funds as a Response to Incentives*, 105 J. POL. ECON. 1167 (1997)).

¹¹³ Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375A (Mar. 5, 2004), 69 Fed. Sec. 11,762, 11763 (Mar. 11, 2004).

The 2% charge, however, does not necessarily deter “trading” shareholders if trading benefits are greater than such charge. There are difficulties in targeting benefits of trading shareholders; after all, there is nothing wrong with “benefit,” in and of itself. The issue is *how* they managed to benefit. Are they preferred shareholders, compared to others? What role is played by luck, public information or other legal means compared to the role of inside information and its use in violation of law? Were trading shareholders permitted to place orders later than other shareholders, or to withdraw their orders in violation of the law? If so, trading shareholders may be culpable.

Finding the wrong in the haystack of possibilities is thus quite complex. If these trading investors received inside information from fiduciaries and benefited from purchasing and redeeming on the basis of that information, they might be liable for violating Rule 10b-5 and other provisions that prohibit such activities. But if they did so with the consent of the sources of such information, liability is less clear.¹¹⁴

Those who facilitate investors’ cancellation of orders in violation of Rule 22c-1 or who facilitate investors’ placing of orders and receiving the prior price violate the law. A key question that follows is whether the investors are also violators: while the Rule does not apply to them directly, the complicated area of aiding and abetting liability may apply.¹¹⁵ Suppose the fund adviser or intermediaries awarded such investors preferred treatment, and suppose further that the permitting parties awarded the permission for pay in violation of their fiduciary duties. Then to what extent have these investors violated law? Numerous factors bear on this question, including whether contracts awarding such preferences are binding and whether preferred investors are akin to parties that bribe government officials or other fiduciaries.¹¹⁶ These questions are not speculative. Indeed, insurance company issuers of variable annuities (*i.e.*, mutual funds that include some insurance components) that

¹¹⁴ See *United States v. O’Hagan*, 521 U.S. 642 (1997).

¹¹⁵ See generally 9 LOUIS LOSS & JOSEPH SELIGMAN, *SECURITIES REGULATION* 4469-90.8 (2d ed. rev. 2004).

¹¹⁶ See John C. Coffee, Jr., *Modern Mail Fraud: The Restoration of the Public/Private Distinction*, 35 AM. CRIM. L. REV. 427 (1998) (distinguishing breaches of fiduciary duty by private and public officials and discussing cases addressing those who induce associated breaches); see generally George D. Brown, *Putting Watergate Behind Us: Salinas, Sun-Diamond, and Two Views of the Anticorruption Model*, 74 TUL. L. REV. 747 (2000).

contracted with future investors to provide such preferences have been sued by these same investors when the companies ceased to honor the investors' market timing privileges, in breach of the contracts.¹¹⁷

Fund managers can detect market timing if trades were directly relayed to them. However, this task becomes more complex if the trade orders are cumulated, as in "omnibus" accounts held and managed by brokers, insurance companies or order collators. The only way fund managers can demand to control these intermediaries is by binding contract. At the same time, this arrangement presents a potential problem because these intermediaries may also provide advisers with investment assets to manage. Therefore, a fund manager's interest in confronting and "regulating" intermediaries to avoid market timing violations may conflict with his or her desire to receive and manage assets controlled by these same intermediaries. In other words, brokers, insurance companies and order collators, are both competitor and client to fund managers.

Further questions regarding this problematic relationship appear. For example, is it enough for the fund managers to establish their relationship with the intermediaries by entering into contracts? Do fund managers have a duty to monitor and enforce these agreements? What should the contract with the intermediaries provide? How much of the burden of preventing market timing should the adviser bear and how much should the intermediaries bear? Post-scandal settlements have imposed a heavier burden on advisers than before to monitor their intermediaries and ensure that they do not permit market timing.

If a fund is related to a bank or an insurance company, yet additional issues arise. To what extent should the fund or parent company be responsible for indirectly aiding market timing? For instance, a bank may lend to a "trader" the amounts necessary to trade in the shares of the fund that the bank manages through its subsidiary. What precisely should the lending agreement between the bank and the trader stipulate, and how closely should the bank regulate the trader and enforce the agreement?

¹¹⁷ See, e.g., *Windsor Sec., Inc. v. Hartford Life Ins. Co.*, 986 F.2d 655 (3d Cir. 1993); *Am. Nat'l Bank & Trust Co. v. Allmerica Fin. Life Ins. & Annuity Co.*, 304 F. Supp. 2d 1009 (N.D. Ill. 2003); *First Lincoln Holdings, Inc. v. Equitable Life Assurance Soc'y of the United States*, 164 F. Supp. 2d 383 (S.D.N.Y. 2001).

Navigating the foregoing questions is difficult. As fund managers are faced with potential liabilities for their intermediaries' market timing activities, the rule of caution emerges. Fund managers must choose their intermediaries prudently and conduct requisite due diligence investigations before contracting for services. Once chosen, the intermediaries must be required to maintain adequate internal control systems in order for fund managers to effectively monitor their performance.

D. "Industry" Reform

The Investment Company Institute ("ICI") is the mutual fund sector's leading organizational representative. Historically, it served as a functional trade organization on behalf of the sector, and continues to do so today. ICI faces little to no oversight. One structural strategy for addressing the problems of market timing could be to redefine ICI's status and mission to that of a self-regulatory organization ("SRO") akin to the New York Stock Exchange and the NASDAQ stock markets or a standard-setter akin to the Financial Accounting Standards Board or the Public Company Accounting Oversight Board.

For years, the SEC attempted to induce the investment adviser community to establish a self-regulatory organization, but without success. Pressure for such an organization increased when the number of advisers grew to more than 15,000.¹¹⁸ A number of reasons contributed to the sector's reluctance to embrace the SRO or standard-setting models. One reason was that the mutual fund sector is not homogeneous, encompassing advisers of every size and description, such that it is not clear how an SRO can regulate them. Furthermore, advisers are not subject to any formal mechanisms that provide badges of assurance to the investing public. For example, while some advisers carry private insurance to provide investor-client protection, the sector as a whole lacks blanket protections such as those insurance schemes provided to other financial service sectors by the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation, or the Pension Guaranty Benefit Corporation.¹¹⁹ Thus, SEC regulation remains an important

¹¹⁸ *SEC to Ask Congress for Legislation to Permit the Creation of Advisers' SROs*, 21 SEC. REG. & L. REP. (BNA) 871, 871 (June 16, 1989).

¹¹⁹ Tamar Frankel, *The Pros and Cons of a Self-Regulatory Organization for Advisers and Mutual Funds*, INVESTMENT LAW., Sept. 1994, at 3, 5.

assurance for investors that sector self-regulation or standard-setting simply cannot provide.¹²⁰

In 1996, Congress, acknowledging the burdens on the SEC and the absence of a self-regulatory organization in the mutual funds sector, divided the regulatory responsibilities for the sector between the SEC and the states.¹²¹ Congress gave the SEC the right to regulate large investment advisers and the state governments the right to regulate small investment advisers. However, ICI has played a role in protecting the sector's reputation as well as its turf. In that regard, ICI has long represented the sector in negotiating its own regulation. Even so, it manifestly failed to achieve optimal regulation in the 1990s, when the sector was rocked by scandals. While aspirations for self-regulation appeared when a new ICI president was installed,¹²² it is unlikely that the ICI's traditional role of a trade organization laced with some regulatory overtones will change.

As a normative matter, and wholly apart from the issue of whether the ICI assumes a role as SRO or remains as a trade group, ICI could lead changes in the sector's self-conception. We have deliberately referred to mutual funds collectively as a sector in the preceding discussion, but to be more precise, is it an industry or a profession? Investment managers present themselves as professionals, but often understand themselves as businesspeople. As a result, the mutual funds sector is not as shareholder-centric as the rest of American corporate culture and nor is the applicable law so focused.

Consider the views of legendary mutual fund man John C. Bogle. In various speeches, Mr. Bogle laments a loss of animating spirit among the mutual fund sector: lost *mutuality* in mutual funds, lost *trusteeship*, lost *fiduciary* duty, and loss of the *stewardship* model that traditionally characterized the mutual fund sector as a

¹²⁰ *Id.* at 4-5.

¹²¹ National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, §§ 301-308, 110 Stat. 3416, 3436-40 (codified as amended in scattered sections of 15, 29 U.S.C.); see Tamar Frankel, *Regulation and Investors' Trust in the Securities Markets*, 68 BROOK. L. REV. 439, 441-42 (2002).

¹²² Paul Schott Stevens, *America's Mutual Funds: The Road Ahead*, Address at the National Press Club (June 15, 2004), available at http://www.ici.org/statements/remarks/04_npc_stevens_spch.html.

profession.¹²³ The changes are manifest in industry vernacular, where people are called “customers” and not “clients,” though sometimes “investors.”¹²⁴ This view is reinforced by broader cultural phenomena, including an increasing devotion to the securities markets as a solution to social challenges.¹²⁵

E. “Market” Reform

A provocative theoretical solution to the challenges of market timing is to retreat entirely from regulatory efforts and rely on market devices to exact corrective responses. This approach is championed by Dean Emeritus Henry Manne of George Mason University.¹²⁶ He contends that New York’s Attorney General Eliot Spitzer was wrong to campaign for fund reform through prosecution, and should have left the market alone.¹²⁷ Dean Manne criticizes the research of Professor Eric Zitzewitz, who calculated that market timers made profits of \$4.9 billion annually at the expense of long-term investors.¹²⁸ Manne, in contrast, argues that market timing did not hurt investors, but helped them.

According to Dean Manne mutual funds are competitive, and information about them abounds.¹²⁹ When preferred investors dilute

¹²³ See, e.g., John C. Bogle, Founder and Former Chairman, The Vanguard Group, Address to Boston College Law School: Re-Mutualizing the Mutual Fund Industry - The Alpha and the Omega (Jan. 21, 2004), http://www.vanguard.com/bogle_site/sp20040121.html; see also John C. Bogle, *Re-Mutualizing the Mutual Fund Industry -- The Alpha and the Omega*, 45 B.C. L. REV. 391 (2004) (essay based on lecture).

¹²⁴ See, e.g., John C. Bogle, Founder and Former Chairman, The Vanguard Group, Address to Boston College Law School: Re-Mutualizing the Mutual Fund Industry - The Alpha and the Omega (Jan. 21, 2004), http://www.vanguard.com/bogle_site/sp20040121.html.

¹²⁵ See, e.g., Michael Levenson, *Some Skeptical as Bush Sells Social Security Plan*, BOSTON GLOBE, Feb. 17, 2005, at A1 (noting President Bush’s proposal to partially privatize Social Security by allowing workers to invest some of their payroll taxes in individual retirement accounts in which “government-hired managers would invest”).

¹²⁶ Dean Manne is not alone in his vision. Other apostles include the law professor-bloggers Larry Ribstein and Stephen Bainbridge. See, e.g., ProfessorBainbridge.com, http://www.professorbainbridge.com/2003/11/ribstein_on_mut.html (Nov. 24, 2003) (posting of Professor Bainbridge; noting his view that “no new laws are needed” regarding market timing and Professor Ribstein’s apparent agreement with that view).

¹²⁷ Henry G. Manne, *What Mutual-Fund Scandal?*, WALL ST. J., Jan. 8, 2004, at A22.

¹²⁸ Zitzewitz, *supra* note 15, at 249.

¹²⁹ Manne, *supra* note 127.

the share value of other investors, the latter will discover their losses. Dissatisfied, they will move their money elsewhere. The resulting investor flight adversely affects the fund managers, who will then demand that market timers pay them for lost fees. Further, managers will have to compensate investors for the dilution by charging lower management fees or higher redemption fees. Market timers will pay more to managers and make more money. Everyone is better off.

In Manne's opinion, regulation has unnecessarily turned market timing into a black market.¹³⁰ Everyone would be better off if we allow some investors to gain at the expense of other investors, compensate the losing investors for their losses, and allow managers to gain by freedom to transact in accordance with unbridled market desires. Dean Manne continues:

If the industry had never been regulated, it is doubtful that we would be seeing any of this. Differential pricing and services would be commonplace, and it is even possible that a derivatives market relating to fund shares would have developed. Different firms would adopt different strategies . . . and the market would have settled on a correct equilibrium. There would be no scandal. . . . The fools are the ones who thought they had uncovered a vast swindle when in fact all they had really done was demonstrate that beneficial market forces are always at work.¹³¹

As powerful as Dean Manne's argument may appear as an aspirational theory, the story overlooks many realities. Dean Manne does not consider the first losses that investors suffer before they discover harmful trading and move their money elsewhere. He does not consider that the public disclosure on which his argument relies is not voluntary but compelled by law, and that such disclosure does not include market timing transactions.

Though Dean Manne suggests that lower mutual fund share prices would reveal to investors the existence of a market timing scheme, that is an enormous theoretical assumption belied by empirical realities. Prices are black boxes, derived from innumerable forces that are notoriously difficult to untangle even for publicly

¹³⁰ *Id.*

¹³¹ *Id.*

traded shares of common stock, let alone mutual fund shares. Declines in mutual fund share prices are not necessarily related to market timing, and it is impossible for investors to discern the precise causes of share price changes.

Dean Manne's argument also does not appreciate the possibility that investors do not monitor and compare prices of various funds daily. Dean Manne does not consider that "moving money" costs time and money, sometimes including heavy taxes. His argument ignores trading restrictions that some investors face from tax deferral programs and other constraints. These detailed facts clutter the grand vision, as reality so often interferes with the success of abstract economic models that work well in classrooms but do not travel well to real markets.¹³²

In this story, Dean Manne also uses airline industry deregulation as an unfortunate example.¹³³ There are many debates on whether the theory behind airline deregulation is accurate. The market and its equilibrium did not do the job perfectly, as expected, and the government had to step in to correct the sub-optimal outcome.¹³⁴ This suggests that beneficial market forces are to be welcomed and used when possible, but they do not always work.

Markets can benefit participants, but they do not necessarily protect small, unsophisticated investors who wield neither inside information nor control. Yet these small investors, participating in mutual funds in large numbers, are the ones bringing most of the money to mutual fund markets. The mutual fund as an institution relies upon these investors for sustenance, so protecting these investors ought to be a paramount concern. Reliance on markets alone to provide that protection can threaten the mutual fund's survival as an institution.

¹³² An old quip contrasting theories of efficient capital markets with observations about actual market action states that markets look much more efficient from the banks of the Charles River than from the banks of the Hudson River. Today, one must be even further away from the Hudson than the Charles to accept the theory over the reality.

¹³³ Manne, *supra* note 127; *cf.* Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.).

¹³⁴ See, e.g., Michael E. Levine, *Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy*, 4 YALE J. ON REG. 393 (1987).

F. Some Realism

Many of the true problems of market timing stem from corruption. Generally, the interests of fund advisers and portfolio managers coincide with those of passive investors—that is, provided advisers and managers do not receive any benefits (bribes) to act in conflict with investor interests. To an extent, regulators cannot be faulted for the persistence of corruption because the culture of specific prohibition and reduced fiduciary duties permeates many professions and institutions, including the legal profession, Congress and some courts.¹³⁵ What market timing demonstrates is failure of a professional culture more than failure of particular parties.

Market timing is not direct stealing or embezzlement. In many cases, market timing is not even a violation of law, such as Rule 22c-1. It may not even amount to a conflict of interest between the market timer and the adviser or other fiduciaries. However, market timing in the late 1990s and early 2000s was shrouded in ambiguity, allowing some investors to benefit at the expense of other investors.

The variations and permutations of market timing reveal the exploitation of gray areas. They also demonstrate a view that whatever the law does not specifically prohibit is permitted. If one cannot benefit from using other people's money one way, there are still many other ways that lead to similar results. No set of rules can specify, clarify or identify all the possible ways to market time, and also stamp out the ways that people try to maneuver around specific prohibitions.

The impossibility of closing all of these loopholes is not the only cause for the SEC's laxity in regulating market timing and portfolio fair-value determinations. The regulator's trust and reliance on advisers and other fiduciaries in mutual funds to heed the spirit and language of the law also explain the SEC's leniency. It is this trust and reliance that were abused. Advisers and portfolio managers were the best regulators of this area, though only if they themselves did not benefit from market timing. Once they began to exploit

¹³⁵ Leading examples of this trend appeared amid the corporate accounting debacles of the early 2000s. In those cases, managers sought accounting and legal advice that were reached by finely parsing applicable industry standards and laws so that they can effect transactions in ways to achieve the most favorable income report while in fact, the resulting treatments were misleading or worse

market timing, and once they engaged in fierce competition with one another, the abuses became pandemic.

The SEC adopted myriad rules to stem the abuses. The SEC, the Department of Justice and state prosecutors brought cases. Yet it is doubtful whether all these rules and enforcement actions would prevent violations of other investors' rights. A first reason, as mentioned above, is that no one can anticipate creative circumvention of law. A second reason reflects the contemporary development of mutual funds.

1. Institutions

Many mutual fund complexes are currently owned by holding companies that originated as banks, investment banks, broker-dealers and insurance companies. Thus, companies such as Merrill Lynch and Travelers have subsidiaries that are advisers that manage and serve large numbers of mutual funds. Most of these holding companies also control broker dealers; some control banks, insurance companies or both. Banks reentered the investment management business only in the 1990s, with the removal of most limitations of the 1930s-era Glass-Steagall Act.¹³⁶

However, even before banks were allowed to offer investment management services and establish mutual funds, banks were not far removed from trust services. Traditionally, most banks had trust departments and, as of the 1980s, established subsidiaries that were registered as investment advisers.¹³⁷ Even so, senior banking management and their regulators had a somewhat different approach to investment management than mutual funds and their advisers because the main focus of banks is financial viability, as required to protect depositors.

¹³⁶ Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999). From the 1930s until 1999, the three principal financial fields of insurance, commercial banking and securities were held distinct by the federal Glass-Steagall Act. In 1999, the Gramm-Leach-Bliley Act removed those barriers. See Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks*, 2002 U. ILL. L. REV. 215.

¹³⁷ *Bd. of Governors of the Fed. Reserve Sys. v. Inv. Co. Inst.*, 450 U.S. 46, 55 (1981) (noting that bank trust departments perform activities similar to those of investment advisers); Am. Nat'l Bank, Fed. Banking L. Rep. (CCH) ¶ 99,732, at 87,178, 87,181-83 (Sept. 2, 1983) (allowing national banks to operate a subsidiary registered as an adviser).

Banks are debtors, not fiduciaries. They are regulated to act as “prudent debtors,” which in fact is a contradiction in terms. Debtors are usually not restricted in how they manage businesses in which they invest borrowed money. In the case of banks, however, higher profits are deemed to be beneficial to society and protected by regulators. That is because banks are basically debtors of the depositors. It is not surprising that bank regulators fought to remove the Glass-Steagall Act for years.¹³⁸ They sought higher profits for banks, and they sought to stem the flight of funds from banks to securities markets, thereby protecting depositors from bank failures.

Mutual fund advisers, in contrast, are fiduciaries. Their profits and capitalization play a far less important role in the regulatory scheme. To be sure, fund directors, when negotiating advisory fees, may consider the financial viability of advisers. But that is a far less important consideration than it is in bank regulation. As a result, mutual fund regulators care little, if at all, whether fund managers are well-capitalized or whether they will be prosperous.

When banks gained permission to establish and manage mutual funds, they converted many of their trust functions to those of mutual fund advisers. With this change in business model, it became unclear whether bank decision-makers focused more on protecting their investors or in governing their fund managers. A number of managers at the holding company level were ready to allow market timing in exchange for fee benefits measuring in millions of dollars annually. It is unclear whether bank managers understood the implications of allowing certain participants, such as hedge fund managers, to benefit at the expense of other shareholders. It would be natural, however, for bank managers to focus on what the bank and its shareholders would gain. The malaise then spread to other fund managers who first enriched their company and later themselves.¹³⁹ Without measuring the weight of different cultures, they undoubtedly played a role in the use and abuse of discretion.

The culture of banks, insurance companies and broker-dealers is fundamentally different from that of advisers. The only enterprises that are similar to advisers are bank trust departments. Regulation of advisers and trustees is essentially consumer-

¹³⁸ William M. Isaac & Melanie L. Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATH. U.L. REV. 281, 282 (1988) (citing studies and public statements of regulators).

¹³⁹ See, e.g., Elkind, *supra* note 44, at 106.

protection oriented, offering investors protection against abuse of fiduciary duties.¹⁴⁰ As debtors, banks and insurance companies are regulated to ensure their financial integrity and ability to meet their financial obligations. When the predominant culture of the holding company is that of a bank or an insurance company, it is difficult to shift away from the perception that bank profits are in the interest of investors.

Regulation of broker-dealers presents similar classification difficulties. Some broker-dealers are fiduciaries while others are not, depending on the investors' degree of reliance on their brokers and the investors' ability to fend for themselves. Regardless, all of these nuanced but crucial perceptions dwell under one roof, and are subject to a relatively uniform corporate standard of behavior and incentives. The firewall among these units within a holding company is insufficient if the culture of all units is uniform. The nature of competition among broker-dealers should be different than that among an adviser's employees or a trust department's employees. This leads to a second source of the drive to look for loopholes and roundabout benefits.

2. Duty

A common formulation of mutual fund realities runs as follows: when mutual fund advisers issue shares to the public, managers of these advisers face a conflict of interest, especially if the mutual fund's holding company is a public company. On the one hand, management owes its shareholders a fiduciary duty to maximize the company's profits. On the other hand, management owes its mutual funds and their shareholders a fiduciary duty to minimize those very same profits, which are substantial costs from the perspective of the mutual funds and their shareholders.

However, this common formulation is based on false premises and requires clarification. First, fiduciaries are required to act for the benefit of their beneficiaries only with respect to the entrusted powers or property. Second, fiduciaries are not required to violate the law in the interest of their beneficiaries. In fact, they are prohibited from doing so, like everyone else.

¹⁴⁰ See I TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS* §1.02[A][3], at 1-44 (2d ed. 2001 & Supp. 2002) (stating that the Investment Advisers Act is "based on the central premise that investment advisers are fiduciaries of their clients").

Third, investors in businesses involving trust and fiduciary services are not entitled to demand that their executives violate their fiduciary duties to their beneficiaries. In other words, an investment in a trust business carries with it limitations of fiduciary duties, akin to an investment in any other business that carries with it limitations imposed by law. For example, no reasonable investor in a pharmacy expects the pharmacy to maximize profits by promoting sales of narcotics to drug addicts or pursuing other violations of law. Similarly, no reasonable mutual fund investor expects advisers to extract illegal profits from the funds and its investors or act in any other illegal way for the purpose of enhancing investor value.

Fourth, fiduciaries facing a conflict of interest may address the situation in various ways. In the case of a mutual fund manager wishing to trade with the fund he manages, he may seek an exemption from the SEC. If he wants to charge fees for his services, he must negotiate with a group of disinterested directors. Even then, his fees must be reasonable. These limits are known or should be known to those who invest in such an enterprise. Investors cannot reasonably complain if the adviser abides by the law and its related duties. However, investors can complain if fines imposed on advisers who violated their fiduciary duties reduce the mutual fund's value.

3. Coda

Market timing is a symptom of problems with mutual funds, and not a disease in itself. Its roots may reside in the vernacular: "fund industry." This is a modern conception of the mutual fund institution as an industry; its original forms were characterized as a mutual fund profession. This conception reflects numerous deeper cultural norms that contribute to market timing and kindred phenomena.¹⁴¹

One problem is that an "unclear" and "unspecific" regulator's permission to change the pricing or postpone the timing of orders was used to justify the actions of many fund managers in collecting benefits for preferred shareholders and allowing them to

¹⁴¹ See *supra* Part IV.D (discussing the normative role that ICI may play in reinvigorating traditional professional values among the mutual fund sector).

benefit at the expense of other shareholders.¹⁴² Too many legal experts justified this approach to fiduciary law and viewed fiduciary relationships as contracts with all of its contract trimmings.¹⁴³

Many managers believed that it was acceptable to extract more benefits from their control of investors' money because there was no specific and direct prohibition on correcting stale pricing or allowing other timing.¹⁴⁴ The problem appears in cascade effects: one rogue manager of a hedge fund bribed an unregulated "trust" to benefit him; and others, who found out about the new "technique," copied the process. All this was done during a period when money managers earned unprecedented amounts.

The problem, however, is not just about an approach to legal interpretation and legal design of rules. It is the creeping, insidious new "industry" culture that should worry lawyers, regulators, investors and managers alike. It is the habit of a cost-benefit analysis that has little regard for the law.¹⁴⁵ It is a tacit understanding that it is fine to do whatever you can do to maximize profit, utility or other *desiderata*—so long as you are not caught, or are capable of paying the consequences of a violation.

The problem includes suggestions that it is acceptable to rationally calculate the odds and compare the penalties of the law to the profits from breaking it. It is best if you prepare defenses in advance and seek the gray areas providing some refuge in case you are caught. It is best to have a theory to support the behavior and especially if that theory is backed by personal market ethical underpinnings of "let each person fend for himself."

The plaintiff who gained a contract to market time and is suing the insurance company for breaching the contract does not care that his profits will be gained at the expense of other shareholders, and he may not even be ashamed to proclaim such a preference. If recent history is any indicator, both investors and their fiduciaries

¹⁴² See *supra* Part III.B (discussing the perception among fund insiders that regulatory passivity amounted to tacit approval).

¹⁴³ This approach to fiduciary law influenced much legal scholarship and judicial opinion. This approach conceptualized the corporation as a nexus of contracts in which all rights and duties are consensual and changeable, including fiduciary duties.

¹⁴⁴ See FRANKEL, *supra* note 83, at 147-48 ("A literal, precise interpretation of a rule invites trusted persons . . . to search for ways to . . . escape a rule without openly breaking it.").

¹⁴⁵ A broad illustration of this epiphenomenon appears in certain neoclassical forms of law and economics scholarship that attempts to conceptualize all of human life in terms of market exchanges, including decisions to comply with or violate law.

have taken this route and emasculated the law. Law can be enforced over only a small percentage of people. If both fiduciaries and their beneficiaries *expect* violations and condone them, they will get violations, and finally get used to them as a way of life.¹⁴⁶

V. Conclusion

Market timing teaches useful lessons applicable to mutual fund fiduciaries and other financial sector participants. Market timing teaches regulators as well. The key point is that problems of market timing are a function of inherent features of the mutual fund as an institution. As a result, problems associated with market timing cannot be removed. Neither legislative, administrative, regulatory, prosecutorial, organizational, structural nor market remedies can do so. These formidable lessons thus only begin the inquiry. Ultimately, solutions are cultural and systemic, not discrete. Specific prohibitions do not plug loopholes. Not all cracks can be sealed.

How does one change the tendencies that have evolved during the fat years, and stem them in the lean years? “Sermons from the mount” to cynical audiences fall on deaf ears. Monetary incentives strengthen prevailing attitudes that treat professional services as moneymaking enterprises. Inducing people to curtail greed by feeding their greed spins a spiraling circle. Accordingly, money managers must be convinced that integrity is not only the best policy but also good business. They cannot do it alone, and they cannot rely on regulators to do it for them. Whether mutual fund advisers are organized as a professional group or a self-regulatory group is of limited consequence. What is needed is a joint effort from all participants to monitor each other to resurrect the mutual fund profession’s good name and to put the financial system on solid ground.

¹⁴⁶ See generally FRANKEL, *supra* note 83.