TrendMacrolytics

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POLITICAL PULSE

Another Scandal

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Spitzer's new front is probably a non-event -- but here are the risks you might not have considered.

The mild reaction by markets so far to news of a new scandal unearthed by **New York's** vigilante **attorney general Eliot Spitzer** is both a sign of the economy's improved propensity to bear risk, and of the extent to which scandal and regulatory intervention are now discounted in prices. Can you imagine the reaction if this news had come out one year ago?

That said, it is definitely not good that Spitzer has now opened up a new front in his usurpation of federal securities regulation. So far Spitzer has only announced a settlement with a hedge fund said to be involved in illegal trading with several mutual funds -- but the next step will be for Spitzer to go after the mutual funds, and that's an incursion deep into the heart of what ought to be the **Securities and Exchange Commission's** turf. When Spitzer makes that move, other states attorneys general are sure to follow -- and after them, the plaintiff's bar. With its widespread customer base and deep pockets, the mutual fund industry is, obviously, an especially attractive political and economic target for regulatory and tort actions. Shooting at that target will involve demagogical charges that will be calculated to diminish public confidence in the market -- and in free markets, in general.

As someone who has spent many years deep inside the infrastructure of the mutual fund industry, there are a several things in particular that worry me about where Spitzer's investigations might lead.

Most serious, the charge in this case that a hedge fund manager was explicitly treated differently from other shareholders -- in terms both of his ability to trade after hours, and in his access to fund holdings information -- has not only fraud implications but also tax implications. The **Internal Revenue Code** exempts mutual funds from corporate income tax (by passing tax liabilities through to their shareholders, funds have always avoided "double taxation" of dividends and capital gains). Among the many anti-abuse provisions of the Code with which funds must comply in order to earn this exemption is a requirement that all shareholders be treated equally in all respects. If it were shown that a fund had not treated all shareholders equally, it would be at risk of losing its tax exempt status -- effectively a death sentence for a fund. If the loss of tax exempt status were retroactive, the fund (and, realistically, its sponsoring company) could be on the hook to the **Internal Revenue Service** for what could be truly astronomical sums. This overhanging regulatory risk may make what would otherwise be clean and definitive settlements by fund companies with Spitzer, other states, and the SEC dangerously incomplete.

I also worry about what Spitzer might catch if he goes on a fishing expedition. Beyond the apparently clear-cut abuses in the case announced by Spitzer today, the fund industry is rife with longstanding and widespread practices and conventions that are, on the face of it, abusive or potentially abusive. Here are three -- and it's not an exhaustive list.

First, trading mutual fund shares after the market close -- the heart of Spitzer's charges against the hedge fund today -- is standard operating procedure in much of the 401(k) and "mutual fund marketplace" business. In both cases, administrators impose a 4:00 PM deadline on participants to place their orders. Of necessity, the administrator can only transmit those orders to the mutual funds *after* 4:00 PM. In fact, in the case of 401(k) plans, the administrator often requires that the day's unit value be provided by the funds before the order can be placed -- necessitating a delay of several hours. This means that 401(k) plan or "mutual fund marketplace" administrators are, effectively, additional potential focal points for abuse beyond the fund companies themselves -- and potentially less well-regulated ones.

Second, it is an economic reality that fund participants -- like the hedge fund charged today by Spitzer -- who frequently trade fund shares impose asymmetrical costs on fund participants who simply buy and hold, even when the frequent trading is not otherwise abusive. A handful of funds charge transaction costs to approximately correct this. But most just impose informal limits on the frequency of trading. The informality of these limits, their poor disclosure to fund shareholders, and the lack of rigor with which they are applied will be fertile ground for claims of abuse.

Third, it's a well-kept secret of the mutual fund industry that daily fund net asset values do not accurately reflect the true value of the fund's holdings. Because of the necessity to provide the NAV within hours of the market close, most funds calculate NAVs using today's prices applied against yesterday's portfolio holdings. This creates another opportunity for effectively trading after the close for investors given inside information about fund holdings, as apparently was the case with the hedge fund charged today by Spitzer.

Bottom line -- the market seems to have discounted for this at the moment, but there's plenty of Pandora's Box risk in terms of unexpectedly large settlement costs, intrusive and costly new regulations *a la* **Sarbanes Oxley**, the further institutionalization of de-federalized securities regulation, and loss of public confidence in markets. TM