

June 28, 2000

## **MEMORANDUM IN SUPPORT OF RULEMAKING PETITION**

### **SUMMARY**

Mutual funds have become this country's investment vehicle of choice. With half of U.S. households investing in mutual funds today, the importance of mutual funds to Americans' financial security has never been greater. It therefore is more important than ever to ensure that investors have the information they need to make informed investment decisions, and that they are adequately protected against fraudulent sales practices and other abuses. It is critical that investors and their advisers know how mutual funds are actually investing their money so that they can assess whether the securities in which funds actually invest are consistent with the risks that investors have chosen to assume.

Unfortunately, existing portfolio disclosure requirements are inadequate to meet these needs. Existing reporting rules require mutual funds to publicly report their portfolio holdings only twice a year after a delay of up to sixty days. This means that investors are left making decisions that are critical to their financial security on the basis of portfolio data that may be up to 8 months old. In today's rapidly moving markets, where a fund's investment style or focus can change dramatically in a matter of weeks, existing disclosure rules often leave investors flying blind.

To the extent that funds are required to publicly disclose their portfolio holdings, the information is inaccessible and difficult to analyze. Although portfolio holdings are filed electronically on EDGAR, they are not filed in a format that allows for easy access and data manipulation. Nor do they include widely used identifiers, such as ticker symbols, that would facilitate analysis of funds' true investment styles.

Finally, current SEC rules facilitate portfolio fraud by permitting fund managers to use misleading fund names and to conceal fund portfolio holdings from shareholders and the investing public. Funds and fund managers engage in deceptive labeling and promotion, portfolio pumping, and window dressing to improve the appearance of their relative investment performance and stock picking acumen. Portfolio fraud misleads investors regarding the true risks posed by their investments, imposes added costs on investors, and undermines investor confidence in the integrity of the financial markets.

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**I. BACKGROUND**

During the last two decades, mutual fund ownership has expanded dramatically.<sup>1</sup> Between 1980 and 1999, the percentage of U.S. households investing in mutual funds grew from 6% to 47%.<sup>2</sup> Today, 83 million Americans in 48 million households own mutual fund shares.<sup>3</sup> Americans have invested 49% of their IRA assets and 45% of their 401(k) assets in mutual funds<sup>4</sup> and, more importantly, they make their own investment

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<sup>1</sup> Over the last decade, U.S. investors also have shifted from investments in stocks to investments in mutual funds. From 1990 to 1999, U.S. investors were net sellers of equity holdings other than mutual funds, disposing of 2.5 trillion of equity holdings, and net purchasers of mutual fund shares in the amount of \$1.2 trillion. Mutual Fund Fact Book, Investment Company Institute 42 (May 1999).

<sup>2</sup> *Id.* at 45. Mutual fund shareholders represent a broad cross-section of Americans. The average mutual fund shareholder is 44 years old and of moderate financial means, and has \$25,000 in mutual fund investments. *Id.* at 44.

<sup>3</sup> *Id.* at 41.

<sup>4</sup> *Id.* at 51. Mutual fund firms controlled 47% of 401(k) assets in 1999, up from 26% in 1993. Frank Stanton, Mutual Funds Capture Bigger Share of 401(k) Market, Morningstar.com (June 2, 2000) (citing study by the Spectrem Group).

decisions for these accounts. Mutual funds have assumed a central role in ensuring the financial security of tens of millions of Americans.

At the same time, increasing numbers of mutual fund investors have little investing experience. Self-directed defined contribution plans are replacing defined benefit plans at a rapid rate, thereby adding to the already large pool of novice investors.<sup>5</sup> Participants in these plans are expected to make investment decisions that will determine their standard of living in retirement, yet studies show that many of them do not grasp fundamental facts regarding fund operations, fees, or investing styles.<sup>6</sup>

Mutual funds are only required to publicly report their portfolio holdings twice a year in their semiannual reports.<sup>7</sup> These reports must be sent within sixty days of the end of a fund's fiscal year and fiscal second quarter.<sup>8</sup> Mutual funds are not otherwise required to publicly disclose their portfolio holdings.

Although funds are free to publicly disclose their holdings more frequently, few do so. Of the 25 largest fund complexes, 18 disclose their portfolios only semiannually.<sup>9</sup> These 18 complexes alone represent more than 50% of mutual fund assets. Only two of these complexes provide monthly portfolio disclosure. In contrast, some funds disclose their holdings on a daily basis, and one fund reports its holdings throughout the day.<sup>10</sup>

## **II. THE CASE FOR REFORM**

### **A. Inadequate Information**

#### **1. Inadequate Information To Make Informed Investment Decisions**

The paucity of fund portfolio information prevents investors and their advisers from making fully informed investment decisions. Even the most diligent investors often cannot determine what they are buying when they invest in many mutual funds. Large

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<sup>5</sup> Frank Stanton, Self-Directed 401(k) Options on the Rise, Morningstar.com (May 25, 2000); see also, Mercer Bullard, As 401(k) Plans Spread, Information Gap Becomes More Glaring, TheStreet.com (May 27, 2000).

<sup>6</sup> Only 50 percent of 401(k) participants realize that they are responsible for the investment decisions in their 401(k) plans. 401(k) Quiz Reveals Most Retirement Savers Unknowledgeable, Mutual Fund Market News (May 30, 2000)(summarizing results of poll conducted by JP Morgan/American Century Retirement Plan Services).

<sup>7</sup> Investment Company Act Section 30 and Rule 30d-1 under the Act.

<sup>8</sup> Investment Company Act Rule 30d-1.

<sup>9</sup> David Dietz, What's the Big Secret About Mutual Fund Holdings? TheStreet.com (Apr. 26, 2000).

<sup>10</sup> The Community Intelligence Fund and the OpenFund make their trades publicly available on an almost real-time basis. Bruce Fraser, Are "Naked" Funds Worth the Wait? CNBC.com (Apr. 20, 2000).

cap funds regularly invest a large percentage of their assets in small cap companies, substantial positions in foreign stocks frequently find their way into domestic stock funds, and new age tech stocks often dominate blue chip portfolios. Existing portfolio disclosure requirements leave investors in the dark about how their money is being invested.

The cost of inadequate information is high. Investors may suffer unexpected losses when their funds assume risks that they did not contemplate when investing in the funds. When investors cannot make informed decisions about the mutual funds in which they invest, their confidence in the integrity of mutual funds and the securities markets is undermined.

The portfolio of the Legg Mason Value Trust provides a useful illustration of the problems posed by misleading fund names and the difficulty of determining how a fund is investing its shareholders' money. The traditional understanding of value investing is defined in the prospectus for the Vanguard Windsor Fund as follows:

Value funds generally emphasize stocks of companies from which the market does not expect strong growth. The prices of value stocks typically are below-average in comparison to such factors as earnings and book values.<sup>11</sup>

As suggested by this definition, the average price-to-earnings ratio for funds in Morningstar's value category in 1999 was 24.32, and the average price-to-book ratio was 4.44.

Notwithstanding its name, the Legg Mason Value Trust's price-to-earnings ratio in 1999, according to Morningstar, was 43% higher than the value category average, and its price-to-book ratio was 186% higher than the value category average.<sup>12</sup> As one commentator noted, "these measures are much more in line with growth-style funds."<sup>13</sup>

During the recent bull market, the performance of value stocks has lagged far behind that of growth stocks. It therefore is not surprising that the Value Trust's growth stock investments have placed it in the top 1% of all "value" funds over the last 3-, 5- and 10-year periods. Investors who have recently invested in the Value Trust in anticipation of a rebound in value stocks, however, have received a harsh lesson in the elasticity of

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<sup>11</sup> Vanguard Windsor Fund prospectus, at p. 4.

<sup>12</sup> According to Morningstar, the Value Trust's 1999 price-to-earnings ratio was 34.76, and its price-to-book ratio was 12.72.

<sup>13</sup> Fraser, *supra*. Vanguard defines growth funds as "focus[ing] on companies believed to have above-average potential for growth in revenue and earnings. Reflecting the market's high expectations for superior growth, the prices of such stocks are typically above-average in relation such measures as revenue, earnings, book value, and dividends." Vanguard Windsor Fund prospectus, at p. 4.

fund names and the concept of value investing.<sup>14</sup> Like many growth funds, Value Trust is down 3.68% so far this year. In contrast, the average value fund is up 1.25%, leaving Value Trust in the bottom 8% of all “value” funds for the year.

Utility funds provide another useful illustration of this problem. Weisenberger analysts recently noted that the funds in its utilities category were going up when the Dow Jones Utility Index was going down, and vice versa. Weisenberger traced the discrepancy to a group of utility funds that had invested an average of 66% of their assets in communications companies such as Nextel and Nokia. Utility funds that invested in traditional, high dividend paying utility companies generally tracked the performance of the Dow Jones Utility Index, while the deviant group more closely tracked the Dow Jones Communications Index. Investors in the deviant group “who have the old-world view of utility funds could find themselves unwittingly knee-deep in some of the best-known telecom names.”<sup>15</sup>

While investors may benefit when mutual fund managers have the investment discretion to offer a wide array of investment options, investors are harmed when their reasonable expectations regarding the investment focus of their funds are betrayed. Fund managers should have the flexibility to invest primarily in traditional utility stocks, or in a mix of utility and communications stocks, but they also should provide investors with the information that they need to tell the difference. In today’s fast-paced markets, where mutual funds on average turn over almost their entire portfolios every year, semiannual disclosure of portfolio holdings is woefully inadequate to enable investors to determine what they buying.

Mutual funds in reality often are nothing more than market-timing devices with no meaningful restraints on their managers’ investing freedom. In a highly publicized incident in late 1995, it was discovered that Jeffrey Vinik, the portfolio manager for Fidelity Magellan, had shifted 32% of the stock fund’s assets into bonds and cash.<sup>16</sup> This was a stark contrast to Fidelity equity funds reputation “for their full-throttle investing style involving minimal cash holdings and 95%-plus equity positions.”<sup>17</sup>

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<sup>14</sup> See also Dan Culloton, Value Investing Janus Style, Morningstar.com (June 20, 2000) (noting that the Janus Strategic Value Fund “as of the end of April, . . . had about 4.1% of [its] assets in computer-chip maker Advance Micro Devices, which has a P/E ratio of 63.8, nearly twice that of the S&P 500.”).

<sup>15</sup> Sarah O’Brien, These Are Not Your Father’s Utility Funds, InvestmentNews.com (June 19, 2000) (“It’s been pet peeve of mine for the last couple of years,” says Steve Kaye, a certified financial planner with American Economic Planning Group in Watchung, N.J. “It’s misleading to investors.”).

<sup>16</sup> Andrew Bary, Is Fidelity Reverting to Form, Selling Bonds, Buying Stocks? Barron’s at MW10 (Feb. 26, 1996); see also Charles Jaffe, Keep Surprises to a Minimum: Make Sure Changes in Philosophy, Managers Are in Line With Portfolio, Boston Globe at 94 (Mar. 24, 1996) (“You invest with the safe, kindly Jekyll Fund. Soon, it starts acting like the volatile, wicked Hyde Fund.”).

<sup>17</sup> Bary, *supra*.

Similarly, in late 1997 the Brandywine Fund shifted more than 70% of its assets into cash, much to the dismay of many of its shareholders.<sup>18</sup> Not only did the fund's performance lag the S&P 500 by 29 percentage points,<sup>19</sup> the fund's massive sales of portfolio securities resulted in a capital gains distribution equal to 17% of the fund's assets,<sup>20</sup> leaving many investors with a substantial tax liability on an investment that had lost money. Not surprisingly, investors fled the fund, dropping its assets from \$8.4 billion on January 1, 1998, to \$4.9 billion on January 1, 1999, according to Morningstar.

Vinik and a colleague at Fidelity Management Research also made headlines when they touted stocks in the press that they were secretly liquidating from Fidelity funds.<sup>21</sup> Sometime after Fidelity's Magellan Fund sold half of its stake in Goodyear in 1994, Vinik said of the company's prospects, "[t]heir cost-cutting has been excellent, they're doing well overseas, and the margins have been able to maintain themselves." Fidelity's semiannual report subsequently disclosed that Magellan had liquidated its position in Goodyear. Fidelity ultimately paid \$10 million to settle claims that Vinik had manipulated Goodyear's stock.<sup>22</sup>

Shortly before September 4, 1995, Harry Lange, Fidelity's lead analyst in the technology sector at the time, made upbeat comments about Apple Computer.<sup>23</sup> According to the Fidelity's June 1995 semiannual report, its funds held 13.3 million Apple shares, amounting to 11% of the company's outstanding stock. At the end of September, the same month in which Lange had praised Apple, Fidelity's position had dropped to 3.1 million shares, or 2.5% of Apple's stock. In this case, the information about Magellan's holdings in Apple was available only because the fund released its top ten holdings on a quarterly basis. Even then, for three months investors were led to believe one thing by the semiannual report and comments by Lange, while Fidelity was doing the opposite.

The lesson of these anecdotes is that a fund's investments may change frequently and dramatically, often in ways that may be inconsistent with investors' expectations and even contradict recent statements by the fund's portfolio manager. Indeed, Fidelity's defense of Vinik's statements about Goodyear supports the case for increased portfolio disclosure:

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<sup>18</sup> Avi Stieglitz, Exclusive Brandywine Getting Back into Tech, *TheStreet.com* (Apr. 7, 1998). The author of this memorandum was a shareholder in the Brandywine Fund at that time.

<sup>19</sup> Morningstar Quicktake Report: Brandywine, *Morningstar.com*.

<sup>20</sup> Avi Stieglitz, Capital Gains Hall of Shame, *TheStreet.com* (Jan. 13, 1998).

<sup>21</sup> Robert McGough, Fidelity Fund Managers Spoke Highly of 2 Other Stocks That Were Unloaded, *Wall Street Journal* at C1 (Dec. 15, 1995).

<sup>22</sup> Joseph Nocera, He's Innocent! Records Prove Magellan's Vinik Wasn't Manipulating Anything, *Fortune* (May 25, 1998).

<sup>23</sup> McGough, *supra*.

"At Fidelity, being active managers like we are, fund managers like Jeff are making relative valuations of any stock all the time,' says William Hayes, head of Fidelity's equity division. 'They can be adding to or reducing positions any time. The crux of active management means just that. All these inputs are coming in every day, even by the hour, and it can affect your opinions on things.'"<sup>24</sup>

The dynamic nature of the markets and active trading strategies makes it imperative that investors receive information that enables them to make informed decisions about what they are buying. Semiannual reporting of fund portfolios simply cannot meet this need.

## 2. Increased Diversification Risk

The disclosure of portfolio information is growing in importance as more investors seek to reduce risk by diversifying their investment portfolios. "Ten years ago, people simply shopped for outstanding returns; now, they pick funds to fill slots in a diversification plan."<sup>25</sup> Numerous studies have demonstrated that an investor's most important decision is not which fund to invest in, but rather how to allocate his or her assets. A study by Brinson Partners, for example, concluded that an investor's asset mix determines more than 90% of a portfolio's long-term performance. Unfortunately, the limited availability of information about portfolio holdings makes it difficult to know whether a portfolio is truly diversified or dangerously concentrated, and thus unnecessarily exposes investors to significant risks.

### a. Style Drift

One diversification risk is that a fund is not investing in accordance with its purported style or classification. In 1999, Craig Israelsen conducted a study of "style drift, or the propensity of some mutual funds to migrate from one classification within the Morningstar Style Box."<sup>26</sup> Israelsen found that, of the 580 funds studied, only 131 had no style drift and only half had no or minimal style drift. He defined "minimal style drift" as occurring when a fund did not shift between more than two adjacent style boxes, as illustrated below (boxes 1 and 2 would be adjacent; 1 and 5 would not):

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<sup>24</sup> Id.

<sup>25</sup> Gregory Millman, First, Pop the Hood, U.S. News Online (Feb. 3, 1997) (paraphrasing John Rekenhalter, Research Director, Morningstar Inc.). In recent years, "more and more investors have invested in investment companies to meet their retirement goals. These investors typically place greater emphasis on allocating their investment company holdings in well-defined types of investments . . ." Investment Company Names, Investment Company Act Release No. 22530 (Feb. 27, 1997) ("Names Release").

<sup>26</sup> Drift Happens: For Planners Who Seek to Create Portfolios That Tap Into Different Equity Styles, Style Drift Can Present a Significant Concern, Financial Planning Interactive (Nov. 1, 1999).

Figure 1

Morningstar Equity Style Box		
Large-Cap Value 1	Large-Cap Blend 2	Large-Cap Growth 3
Mid-Cap Value 4	Mid-Cap Blend 5	Mid-Cap Growth 6
Small-Cap Value 7	Small-Cap Blend 8	Small-Cap Growth 9

Remarkably, 291 funds – more than half – experienced significant style drift. Israelsen found that one fund moved from box #9 (Large-Cap Value) to box #1 (Small-Cap Growth) in one year, from 1994 to 1995. In 1997 and 1998, the fund moved to box #5, and in 1999 it returned to box #1. Based on Israelsen’s findings, this fund’s peripatetic style is not unusual.

Israelsen’s findings also suggest that the greater the style drift, the less chance that it will be noticed. The funds with the most extreme style drift were substantially smaller than the funds with the least style drift (\$792 million vs. \$2,159 million). Because smaller funds are less likely to be tracked by fund analysts and the financial press, it is less likely that these funds’ extreme style drift will be exposed.

This is not to say that a fund’s migrating among Morningstar Style Boxes is necessarily bad for investors,<sup>27</sup> provided that the fund’s name and prospectus do not suggest that the fund will adhere to a particular style. Rather, what harms investors is their inability to determine what style, if any, the fund follows. Israelsen concluded that monitoring a fund’s investment style is difficult for financial planners; it is prohibitively difficult for average investors.

#### b. Portfolio Overlap

A second diversification risk is that a group of funds with purportedly different investment styles will have substantially overlapping portfolios. As noted in a recent newsletter, “Many investors are discovering, to their surprise, that there is a significant amount of overlap in the securities their funds own, making their portfolios even more vulnerable to a correction in one of these issues . . . . ‘Over the past few years, portfolio overlap has become increasingly common as more and more investors have focused on a

<sup>27</sup> It is worth noting, however, that the funds with the least style drift bested the funds with the most extreme style drift in a number of categories, including: annualized return (21.88% to 20.02%), portfolio manager tenure (8.05 years to 5.68 years), tax efficiency (86.69 to 83.61), annual expense ratio (1.08% to 1.33%), and annual turnover ratio (61.2% to 103.7%). *Id.*

relatively small number of stocks.”<sup>28</sup> The steady increase in market volatility over the last four decades<sup>29</sup> has made portfolio overlap an even greater threat to investors, because higher volatility has doubled the number of stocks an investor must hold to benefit from diversification.<sup>30</sup>

The problem of overlap and stale portfolio data is illustrated by the holdings of four of Janus’s largest equity funds. According to Morningstar, an equally weighted investment in Janus Fund, Janus Mercury, Janus Twenty, and Janus Growth & Income Janus would have 45% of its value represented by investments in only 15 companies, with 12% in Nokia and Cisco Systems alone. A Janus shareholder who had reasonably assumed that Janus offered different funds to provide exposure to different types of investments would be at significant risk in the event that a small number of stocks suffered large losses.

It is not the overlap, however, that is most problematic. It is the lack of information available to shareholders to enable them to determine whether a group of funds are, in fact, simply clones designed to increase sales, rather than genuinely dissimilar investment options. The analysis provided above of the Janus funds’ portfolios is based on their October 31, 1999 holdings. An investor buying a fund today would be in the dark about the funds’ current portfolio overlap until the beginning of July 2000, two months after the funds file their semiannual reports for the period ending April 30. An investor attempting to compare a Janus fund with a fund that used a calendar fiscal year would have even greater difficulty determining potential overlap, as the date of the two sets of portfolio holdings could be as much as four months apart.

## **B. Limited Utility of Publicly Available Information**

Even the often-stale portfolio information currently provided to investors is of limited utility. Fund filings are difficult to download electronically into a format for analysis, and portfolio holdings are not provided on the SEC’s Electronic Data Gathering, Analysis, and Retrieval system (“Edgar”) in an easily accessible language such as Extensible Markup Language (“XML”).<sup>31</sup> Nor do the filings provide the identifiers that would be necessary to enable the development of inexpensive or free software to analyze

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<sup>28</sup> The Babson Report (Winter 1999) (quoting David Diesslin, CFP, MBA, President, Diesslin & Associates, Inc.).

<sup>29</sup> John Campbell, Martin Lettau, Burton Malkiel, Yexiao Xu, Have Individual Stocks Become More Volatile? (May 25, 2000).

<sup>30</sup> Walter Updegrave, Diversification Now More Than Ever, Money.com (June 7, 2000) (quoting Yexiao Xu on whether investors need to hold more stocks to benefit from diversification and minimize market risk: “We figure you need at least twice as many, 40 to 50 stocks.”).

<sup>31</sup> XML is a standard markup language that facilitates the creation of software applications. Providing portfolio holdings on the Internet in XML would make it easier for programmers to create inexpensive or free applications that, for example, analyzed fund portfolio holdings for purposes of evaluating style drift, portfolio overlap, or forms of portfolio fraud, as discussed further below.

fund portfolios, such as the funds' ticker symbols, cusip numbers, and industry classification codes.

Indeed, Edgar is not even organized so as to facilitate finding filings by particular funds. Edgar classifies funds by the name of the registrant, which has no necessary connection to the name of the fund, and filings are listed according to esoteric codes (a proxy is a "14A") rather than as functional names such as "prospectus" or "annual report." While these impediments can usually be overcome by a former SEC staff member, they are inconsistent with Edgar's mission "to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the [SEC]."<sup>32</sup>

While financial data providers often provide useful analysis relating to fund style drift and overlap, this information would be far more likely to filter the marketplace if it were provided in a format that facilitated analysis of fund portfolio holdings. The Internet and software technology developments have made sophisticated analysis of the significance of financial data feasible for millions of investors and their advisers. User-friendly disclosure of portfolio holdings would promote the development of inexpensive, software that investors and their advisers could employ to monitor style drift and portfolio overlap, rather than having to rely on -- and pay for -- large financial data providers to analyze the data and publish their conclusions. The Commission must ensure not only that critical information is publicly available, but also that the information can be used to enable investors to make informed investment decisions.

### **C. Portfolio Abuses**

As discussed above, current portfolio disclosure rules prevent investors from obtaining the information they need to make informed investment decisions. These rules also facilitate portfolio fraud, in the form of deceptive labeling and promotion, window dressing, and performance pumping. Anecdotal and empirical evidence suggests that portfolio fraud is widespread and harmful to investors. As competition in the mutual fund industry increases, the pressure to engage in portfolio fraud also will increase, thus making it imperative that the Commission act now to improve disclosure of fund portfolio holdings.

#### **1. Deceptive Labeling and Promotion**

The most egregious form of portfolio fraud is the deceptive labeling and promotion of mutual funds. Funds routinely describe themselves as investing according to a particular investment style or in a particular asset class, while secretly investing outside of their investment style in order to improve their performance relative to their

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<sup>32</sup> Important Information About Edgar, U.S. Securities and Exchange Commission at <http://www.sec.gov/edaux/wedgar.htm>

peer group. Investors who are taken in by deceptive labeling are unwittingly gambling with their financial security.

Empirical evidence suggests some funds “deliberately mislead investors about the strategy they pursue.”<sup>33</sup> Stephen Brown, a business school professor at New York University, and Will Goetzmann, a business school professor at Yale, found evidence that funds change their investment styles in order to boost their performance relative to their peer groups.<sup>34</sup> They considered 48 funds that changed their purported investment styles and found that the switch improved their benchmark-adjusted performance by a full percentage point.

Brown and Goetzmann also attempted to determine whether funds actually invest according to their categories. They analyzed the monthly returns of 276 funds, grouping them based on their actual investment returns and the correlation of the returns to changes in major indices and other economic indicators. The economists then compared these groupings to their style categorizations.

They found large discrepancies between funds’ purported and actual investment styles. For example, they found that only 57% of the so-called “growth” funds fit that category; in reality, 17% were more like small-cap funds, 12% were more like value funds, and 6% were more like market-timing funds. Similarly, Brown and Goetzmann found that fewer than two-thirds of international funds actually fit that category. These findings illustrate the large differences that can exist between the way that funds hold themselves out to investors, and the way that the funds invest their shareholders’ money.

The current system of fund classification encourages funds to try to perform at the top of their peer group by investing outside of their investment categories. As stated by Brown and Goetzmann,

“Once a fund is classified into a particular category, there is little incentive to pursue an investment strategy that will ensure that future fund performance will be close to the category average in the future. Sirri and Tufano (1992) and Goetzmann and Peles (1996) report evidence that mutual fund investors flock to superior performers in each fund category. Given this information, fund managers are not rewarded by maintaining strategies consistent with their industry classification.”<sup>35</sup>

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<sup>33</sup> A Question of Style: Mutual Funds, *The Economist* (July 15, 1995) (discussing Stephen Brown & William Goetzmann, *Mutual Fund Styles*, Western Finance Association (June 1995)).

<sup>34</sup> Brown and Goetzmann found “evidence suggesting that such [style] misclassification may be intentional, in that it works to improve ex post relative performance measures, on average.” Stephen Brown & William Goetzmann, *Mutual Fund Styles*, 43 *Journal of Financial Economics* 373, at 374 (1997).

<sup>35</sup> *Id.* at 395. The citations are to Erik Sirri & Peter Tufano, *The Demand for Mutual Fund Services by Individual Investors*, Working Paper, Harvard Business School, Cambridge, MA (1992); and William Goetzmann & Nadav Peles, *Cognitive Dissonance and Mutual Fund Investors*, 20 *Journal of Financial Research* (1996).

Thus, fund managers have “an incentive to ‘game’ the styles to improve relative ex post rankings,”<sup>36</sup> thereby exploiting investors’ overemphasis on short-term performance to increase sales of fund shares.

The Commission often has exhorted investors to consider factors other than funds’ performance returns, noting that “[o]ver the long-term, the success (or failure) of your investment in a fund also will depend on” a wide variety of factors.<sup>37</sup> The best way to promote the consideration of nonperformance factors would be to require funds to report their portfolio holding more frequently and in an easily accessible format so that the marketplace can determine which funds are engaging deceptive labeling and promotion, and thereby hold these funds accountable for portfolio fraud by withholding assets.

## 2. Misuse of Fund Ads

The emphasis in fund ads on ratings provided by Morningstar, Lipper and others has exacerbated the effects of deceptive labeling and promotion. As noted by Chairman Levitt:

“Today, it seems you can’t open a newspaper or read a magazine without seeing ads promoting the stellar performance of ‘hot’ mutual funds. And how many funds have we all seen claiming to be the ‘number one performing fund’ -- some boasting returns of over 100 percent.”<sup>38</sup>

Fund distributors have become obsessed in finding the right rating category to fit a fund, rather than ensuring that the fund fits its stated style.

The tyranny of ratings is aptly illustrated by a series of ads run by the Kaufman Fund in 1998. Initially, the fund ran an ad claiming that it was the top-rated “Diversified Equity Fund” over the preceding ten years, based on research by the Mutual Fund Forecaster.<sup>39</sup> In fact, the fund was the third-rated fund in the category. Undeterred, the fund changed the ads to tout its number one rating for the “Small Company” category in the trailing ten-year period. The fund subsequently lost this title to a competitor. As if attempting to prove that every fund can be number one if it just finds the right category,

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<sup>36</sup> Brown & Goetzmann, *supra* at 375.

<sup>37</sup> Mutual Fund Investing: Look at More Than a Fund’s Past Performance, U.S. Securities and Exchange Commission, at <http://www.sec.gov/consumer/mperf.htm>. These factors “include the fund's sales charges, fees, and expenses; the taxes you may have to pay when you receive a distribution; the age and size of the fund; the fund's risks and volatility; and recent changes in the fund's operations.” *Id.*

<sup>38</sup> Remarks at the Mutual Fund Directors Education Council Conference (Feb. 17, 2000).

<sup>39</sup> Alison Moore, “Exclusive” Kaufman Claims Top Spot, but Fund Trackers Say Not! *TheStreet.com* (Oct. 16, 1998).

the ads were altered to claim the crown of “#1 Small Company Aggressive Growth Fund,” which placed it at the top of a 32-fund category.

The heavy emphasis on ratings in fund ads magnifies the importance of enabling investors to test funds’ fidelity to their categories. Fund ads lead investors to believe that top-rated funds outperformed their peers because of their managers’ superior stock picking ability, when in fact the funds may have achieved superior performance simply by investing in a type of security outside of its stated style.<sup>40</sup> Outperforming peer groups has been shown to be critical to bringing new shareholders into a fund,<sup>41</sup> which increases the pressure to find ways to achieve a top rating.

The increasing importance of a fund’s performance relative to a putative peer group creates even greater incentives for the fund’s managers to engage in deceptive labeling and promotion by exploiting the misclassification of their funds. Requiring more frequent disclosure of portfolio holdings would help reduce the incidence of such portfolio fraud, and improve the integrity of fund ratings and classifications.

### 3. Misleading Fund Names

Compounding the problem of style manipulation is the more straightforward deception of using misleading fund names. Funds often use names that suggest a particular investing style, while actually investing according to a completely different style. This form of portfolio fraud may mislead investors into taking much greater risks than they intended, with potentially devastating results for their financial security.

In recognition of the problem of misleading names, in October 1996 Congress granted the SEC specific authority to prohibit this kind of fraud.<sup>42</sup> The Commission responded promptly, proposing a rule less than 4 months later that would prohibit a fund from using a name that suggested that it invested in a particular security unless it invested at least 80% of its assets in that type of security. The Commission found that “some fund names can leave investors with the wrong impression about the fund’s safety,”<sup>43</sup> but over

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<sup>40</sup> See text accompanying notes 11-14, *supra*.

<sup>41</sup> See Jayendu Patel, Richard Zeckhauser, and Darryll Hendricks, *Nonrational Actors and Financial Market Behavior*, 31 *Theory and Decision* 257 (1991) (finding that a fund’s relative ranking within its peer group was more closely tied to new purchases of fund shares than the fund’s absolute performance).

<sup>42</sup> Pub. L. No. 104-290, 208, 110 Stat. 3416, 3432 (1996) (amending Investment Company Act Section 5(d)). The Commission stated that, “[I]n adopting amended section 35(d), Congress reaffirmed its concern that investors may focus on an investment company’s name to determine the company’s investments and risks, and recognized that investor protection would be improved by giving the Commission rulemaking authority to address potentially misleading investment company names.” Names Release, *supra* note 25.

<sup>43</sup> “The SEC and the Mutual Fund Industry: An Enlightened Partnership,” Remarks by Arthur Levitt, Chairman, SEC, before the General Membership Meeting of the Investment Company Institute (May 19, 1995). In its own words, the Commission proposed the names rule “to guard against the use of misleading investment company names and to implement Congress’s intent in amending section 35(d).” Names Release, *supra* note 25.

four years later, the Commission has yet to fulfill Congress's mandate by taking final action on the rule.

The proposed rule would do no more than require what honest dealing would seem to demand: that "an investment company with a name that suggests a particular investment emphasis invest in a manner consistent with its name."<sup>44</sup> In contrast, the SEC's current position permits a fund to commit a mere 65 percent of its assets in the investments suggested by its name.<sup>45</sup> This allows a fund to invest a substantial portion of its assets in investments that are simply inconsistent with the fund's name – as long as the fund's intentions are disclosed somewhere in the depths of its prospectus.

Should the Commission adopt the fund names rule, it should strengthen the rule in two respects. First, the Commission should narrow the exception from the rule for so-called "temporary investments." Second, it should make the rule applicable to all misleading fund names.

The Commission's proposed "temporary investments" exception threatens to eviscerate the names rule. Under this exception, it appears that a fund could invest up to 100% of its assets in securities that are not consistent with the fund's name "to avoid losses in response to adverse market, economic, political or other conditions." This exception is excessively broad, as the purpose of virtually any investment decision can be explained as an attempt to "to avoid losses in response to adverse market, economic, political or other conditions." An investor's expectation that a fund will invest consistent with its name does not include an expectation that a fund will deviate from its purported investment type whenever a fund manager's view of "market conditions" warrants it. The Commission should severely restrict the temporary investment exception in terms of its duration and the specific extent to which the 80% standard may be violated.

A second weakness in the SEC's proposal is that it apparently would allow unfettered use of a wide range of misleading names. The Commission notes that certain names, including "balanced," "index," and "small, mid, or large capitalization," could have different meanings for different investors. On the ground that "a reasonable investor could conclude that these names suggest more than one investment focus," the proposed rule would not prohibit the use of these names unless the SEC staff had provided guidance as to how they were to be used.

This approach ignores the fact that funds use these names for the very reason that they evoke a commonly understood meaning. The theory that a name is not misleading merely because some investors could reasonably interpret it to mean something other than its commonly accepted meaning is to miss the point of regulating names altogether. The purpose of regulating fund names is to prevent fund names from

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<sup>44</sup> Names Release, supra note 25.

<sup>45</sup> Id.

misleading investors by suggesting investments in securities with which the name is most commonly associated, while the fund actually invests in different types of securities. The Commission apparently believes that a fund name should be permitted as long as the name could conceivably evoke more than one understanding about the type of securities in which the fund will invest.

One example of this problem of misleading fund names is the Legg Mason Value Trust, as discussed above.<sup>46</sup> Another example is Fidelity's "Asset Manager" fund. This fund name implies a diversified fund that invests in a mix of stocks and bonds and is suitable for "people saving for retirement or college or a house."<sup>47</sup> When investors charged into this diversified fund after it posted stellar returns in 1993, the fund's manager bet nearly one quarter of the fund's assets on Latin American stocks and bonds. The Latin American markets crashed, and the conservative "Asset Manager" fund and its shareholders lost 6.6% in 1994.

The names "Value Trust" and "Asset Manager" strongly suggest certain types of investments, as do "balanced," "index," and "small, mid, or large capitalization." Funds should not be allowed to use these names and then invest differently from the way most investors would reasonably expect them to invest. This prohibition will not limit a fund's investing flexibility. Rather, as stated by the Commission, "[a]n investment company seeking maximum flexibility with respect to its investments would be free to select a name that does not connote a particular investment emphasis."<sup>48</sup> The Commission should adopt the names rule and provide guidance regarding when funds' investments are so out of line with the types of investment their names suggest that the Commission will deem the funds to be in violation of the rule.

#### **4. Portfolio Pumping**

Portfolio pumping occurs when a fund manager buys shares of stocks the fund already owns on the last day of the year. This drives up the price of the stocks, and inflates the fund's one-year performance results. Fund managers know that they will not have to update these inflated results in their prospectuses for up to 16 months. They also know that portfolio pumping will increase their bonuses. Finally, they know that, although their funds' performance may be reduced when the stocks decline in value on the first trading day of the new year, they may be working somewhere else by the end of the following year, and a bonus in hand is preferable to an uncertain payment in the future.

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<sup>46</sup> See text accompanying notes 11-14, *supra*.

<sup>47</sup> Kimberly Blanton, A Flying Fund Lands With a Thud: Asset Manager Bets, And Loses Big, On Latin securities, *Boston Globe* 77 (Jan. 22, 1995).

<sup>48</sup> Names Release, *supra* note 25.

A recent Wharton School study demonstrated the phenomenon of portfolio pumping.<sup>49</sup> The study found that the best performing funds generally posted their best returns on the last trading day of the year, and their worst returns on the first trading day of the New Year. The hottest stocks generally peaked during the last hour of the last trading day of the year, and dropped within 30 minutes of the opening of the next trading day. The study also found that prices peaked on the last day of the quarter, and dropped again on the first day of the next quarter, suggesting that portfolio pumping may also be an end-of-quarter phenomenon.

As Jason Zweig has noted, a “fund’s ‘annual’ return can be completely distorted by how the fund performed on one single day.”<sup>50</sup> A 1997 study by Money magazine reviewed the performance of 1,550 diversified US stock funds from 1985 to 1995. The study found, among other things, that 69% of the funds that lagged the S&P 500 by 1 basis point or less on the year’s next-to-last day beat the market for the year based solely on their last day performance, as did 62% of the funds that lagged the market by as much as 25 basis points and 49% of the funds that lagged the market by as much as 50 basis points. For example, the Alger Small Cap B fund lagged the market by 0.57 percentage points on December 30, 1993, but it beat the market for the year by 2.82 percentage points. The fund gained 3.08 percentage points on the last day of the year, “transforming [it], literally overnight, from a market loser to a market beater.”

Until the last day of the year, these funds lagged the market by up to 1.97%. All of them reversed their fortunes on the last day of the year. The last column shows how they fared on the first day of the New Year.

Year-end	Fund	Fund’s return (+ or -) S&P 500			
		Until last day of year	Last day of year	For full year	On first day of New Year
1995	American Century Giftrust	-1.25%	1.58%	0.89%	-0.68%
	Galaxy Small C	-1.06	1.65	0.57	-0.19
	Stratton Growth	-0.59	0.62	0.25	0.66
	Colonial Select Value A	-0.28	0.62	0.57	-0.21
1994	Heartland Value	-1.97	2.37	0.40	-0.58
	IDS Progressive A	-1.57	1.62	0.06	-0.47
	MAS Small Cap Value Inst.	-1.16	2.01	0.87	-1.06
	Crabbe Huson Equity	-0.76	1.04	0.29	-0.01
1993	Founders Discovery	-1.39	2.02	0.82	-0.76
	United New Concepts A	-0.75	1.37	0.76	-0.87
	Alger Small Cap A	-0.57	3.08	2.82	-1.91
	Wasatch Growth	-0.55	1.53	1.13	-1.24

Sources: Micropal Inc.; Professor Mark Carhart, University of Southern California (adapted from table appearing in Zweig, *supra*.)

<sup>49</sup> Mark Carhart, Ron Kaniel, David Musto, Adam Reed, Mutual Fund Returns and Market Microstructure (June 2, 1999); see also Jason Zweig, Watch Out for the Year-End Fund Flimflam, Money (Nov. 1997).

<sup>50</sup> Zweig, *supra*.

Portfolio pumping not only distorts fund performance results, it also reduces returns of shareholders who make periodic purchases. Pension plans, for example, often invest participants' contributions to funds on the last day of each quarter. If a fund manager engages in portfolio pumping, pension plan participants may often buy shares at an artificially higher price.

Molly Baker provides an illuminating view of portfolio pumping in her book, *High-Flying Adventures in the Stock Market*, in which she describes the daily life of Jerry Frey, a portfolio manager of the Delaware Investments Select Growth Funds. In one section, Baker describes fund managers' primary concern that:

“their work might not show up in the one number that counts: bonus. If [the] DelCap [Fund] fell below the top 50 competitive funds on December 31, there would be no performance bonus for an entire year's work on the fund. Thanks for the effort, better luck next year.”<sup>51</sup>

Baker explains how managers' obsession with annual performance is evidenced by portfolio pumping, which she calls “marking up your portfolio.”

“The practice is a little like the seemingly inordinate number of police ticketing speeders on the last day of the month, just to make a quota. In the stock market, it's called ‘marking up your portfolio.’ Managers want the stock they already own to close the day at the highest price they possibly can. It's the last day of the year, and all those closing prices at 4:00 will go into calculating the most important number of the year: performance as of December 31. It leads many on Wall Street to think, ‘If we can juice it a little, why not?’ . . .

The game of marking up stocks and marking up portfolios will only become more heated as the hours tick by. As more managers step in with orders to buy at higher prices, other managers of hedge funds – those who want to bet that a stock will go down – will come in with their sell orders, hoping to make the stocks close down for the day. In the very last minutes of the year, the stock market is little different from the schoolyard game of alternating grips on a baseball bat with an opponent, to see who has the last grasp when there is no wood left. In the market, the hands are changed to orders changing hands, and at four o'clock one player will be holding the last order. Time will be up. The game will be over.”<sup>52</sup>

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<sup>51</sup> Molly Baker, *High-Flying Adventures in the Stock Market* 235-36 (2000).

<sup>52</sup> *Id.* at 257-58. Charles Biderman, editor of a mutual-fund tracking service, observes that during the last two weeks of December, “a lot of fund managers will be very aggressive buyers of stocks they're already in, maybe even buying calls on stocks or leveraging, to drive their stocks higher and increase net asset value before Christmas and January.” Leslie Norton, *On Tech Stocks and Window Dressing*, *Barron's* at 33 (Dec. 11, 1995).

After an afternoon of frenetic trading on December 31, the “DelCap Fund was up 2.55% for the day, enough to move the fund to the forty-eighth spot for the year. . . . Jerry and his team had locked in the bonus . . . .”<sup>53</sup>

What’s good news for Jerry, however, is not such good news for pension plan participants investing on the last day of the year. These plan participants paid an extra 2.55% for their shares. Just as predicted by the Wharton study, the DelCap Fund’s share price -- and the value of plan participants’ portfolios -- dropped .43% on the first trading day of the New Year. As explained by Baker, “[m]utual fund managers, stock analysts, and company executives spend twelve months working toward one number: year-end performance.”<sup>54</sup> The only question that matters is: ““Where did you end up on December 31?””<sup>55</sup>

Some critics argue that portfolio pumping cannot benefit fund management because the short-term gains it produces are invariably given back when stock prices revert to normal. They contend, notwithstanding empirical evidence to the contrary, that portfolio pumping is unlikely to occur because a rational economic actor would see that it held out no hope of long-term gains.

This theoretical view of fund managers and investors ignores the reality of how managers and markets behave, the demonstrable net costs and individual losses imposed by portfolio pumping, and the importance of faith in the integrity in mutual funds and the securities markets. As described by Baker, fund managers often are short-term actors who are more focused on the immediate prospects for an end-of-year bonus (perhaps “irrationally” so), than on their funds’ long-term performance. It is more consistent with human behavior to assume that fund managers will choose a possibility of immediate gain over the prospect of a later, equal loss, not to mention that the time value of money makes today’s bonus worth more than the bonus lost when next year’s performance gives back the one-day increase caused by portfolio pumping.

Furthermore, it is wrong to assume that fund managers’ bonuses are structured as fulcrum fees. Bonuses are more likely to be triggered by extreme performance results, like the bonus structure described by Baker under which only a top-50 performance would put the manager in the money. It therefore would be “rational” for a fund manager to use portfolio pumping in a given year to push the fund’s performance over the bonus hurdle. The fact that the one-day performance may be given back is irrelevant except in the unlikely event that it again makes the difference the following year between receiving and not receiving a bonus.

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<sup>53</sup> Baker, supra at 267.

<sup>54</sup> Id. at 11.

<sup>55</sup> Id.

Portfolio pumping also imposes net costs on investors. The widely-documented frenetic trading that occurs at the end of each quarter and year imposes unnecessary trading costs on funds, and diverts managers' attention from their fiduciary responsibility to seek long-term gains for their shareholders. While the effect of portfolio pumping on fund performance may have no net affect on investors' returns as a group, that is little consolation to investors and pension plan participants whose timing put their purchases on the losing side of a December 31 surge or an early January decline. For example, an investor who invests on December 31 and sells after the fund's share price reverts to normal will suffer a loss as a direct result of portfolio pumping. It is likely that the investor would be unmoved by the argument that portfolio pumping is harmless because, as a group, investors would experience no net change in their circumstances.

Finally, portfolio pumping also undermines investors' faith in the integrity of the securities markets. Portfolio pumping essentially entails buying and selling stocks not because they are good investments, but in order to manipulate fund performance results. As noted above, individual shareholders may correctly suspect that they incurred losses because of portfolio pumping, although the net effect on investors may be zero. Even if portfolio pumping did not create net losses to investors, it would still create the negative impression that funds are not managed in the long-term interests of their shareholders, but rather in the short-term interests of their managers.

Although the harm caused by portfolio pumping is clear, it is difficult for regulators to deter it. To prove a violation of the securities laws, the Commission would have to prove fraudulent intent. This would require refuting the claim that a stock was purchased simply because it was a good investment, an argument that would be supported by the fact that the fund already held the stock in its portfolio. As noted by a former Director of the SEC's Division of Investment Management:

“We have seen, during the course of our inspections of funds, evidence that some managers engaged in a transaction to manipulate performance at year-end.’ For example, he says, a fund group that almost never used options traded heavily in them on the last day of the year. ‘But,’ he adds ruefully, ‘it’s extremely difficult for us to show that the manager intended to manipulate the returns. He can simply say, ‘I liked the stock.’”<sup>56</sup>

The best way to deter portfolio pumping would be to require more frequent disclosure of fund portfolio holdings. This would allow the market to decide whether portfolio pumping was occurring, and whether it warranted punitive action in the form of declining sales and increasing redemptions of a fund's shares.

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<sup>56</sup> Zweig, supra note 49 (quoting Barry Barbash).

## 5. Window Dressing

Window dressing occurs when a portfolio manager buys or sells portfolio securities just before or after the date on which a fund's holdings are publicly disclosed. This occurs, for example, when a company that is not held by a fund receives extensive publicity for its exceptional performance. The manager buys stock in the company just before the fund's portfolio is publicly disclosed to create the impression that the fund had not, in fact, missed out on this investing opportunity.

Thus, it is no coincidence that the number of funds that held Qualcomm on December 31, 1999 rose 65% from June 30, 1999, in light of Qualcomm's 2,619% return in 1999.<sup>57</sup> Of course, it is difficult to determine which funds bought Qualcomm in July, and which funds bought it in December, because funds are required to publicly disclose their portfolios only semi-annually. For shareholders of many of these funds, window dressing with Qualcomm stock may have been quite costly, as the price of the stock has dropped 67% this year, according to Morningstar.<sup>58</sup> One fund manager confessed, "It's one I thought I needed to own," admitting that "he felt like he was late to the party when he started by buying shares in October and late November."<sup>59</sup>

Conversely, when a company's market price collapses, a fund manager may erase the company from the fund's portfolio to avoid publicly revealing his mistake. As described by Brown and Goetzmann, "[w]indow dressing' is a common end-of-period ploy of fund managers to throw out poor performers . . ."<sup>60</sup> Thus, window dressing is intended to convey a false impression of the investing acumen of fund managers.

Empirical evidence suggests that window dressing is commonplace. David Musto, a professor at Wharton School, found that money market funds typically hold more low risk government securities at public disclosure dates than at other times.<sup>61</sup> The study shows that money market managers window dressed their funds to make them

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<sup>57</sup> Source: Morningstar Inc. (approximately 531 funds owned Qualcomm on June 30, 1999, and approximately 876 owned Qualcomm on December 31, 1999). The difference between these figures may understate the incidence of window dressing with Qualcomm stock, as many of the 531 funds that owned the stock on June 30 may have sold it at its peak, which would mean that far more than 345 funds purchased it after that date.

<sup>58</sup> Morningstar Quicktake Report: Qualcomm, Morningstar.com.

<sup>59</sup> Ian McDonald, A Must to a Bust: Scores of Funds Get Burned on Big Qualcomm Bets, TheStreet.com (June 15, 2000) (noting that one in five of the 177 funds posting triple-digit returns in 1999 owned Qualcomm; and that today one in three large-cap growth funds owns shares, as do 29% of all large-cap funds).

<sup>60</sup> Brown & Goetzmann, supra note 34 at 377.

<sup>61</sup> Investment Decisions Depend on Portfolio Disclosures (Aug. 21, 1997).

appear safer and more conservative than they are in fact. Another 1991 study found that window dressing accounts for portfolio rebalancing by pension fund managers.<sup>62</sup>

Notes one commentator, “most window dressers won’t admit to doing it, because it smacks of market manipulation. But the practice is widespread.”<sup>63</sup> As an SEC official recently conceded: “We know that it happens.”<sup>64</sup> A former Director of the SEC’s Division of Investment Management has suggested that window dressing “would rise to the level of fraud under the securities laws” if it was done “simply to make the performance appear better.”<sup>65</sup>

Although window dressing may seem like market manipulation, it, like portfolio pumping, presents a difficult problem of proof for regulators. Stock picking is an inherently subjective exercise, which complicates proving that a manager’s motives in making a particular trade were fraudulent.<sup>66</sup> Even with strong statistical evidence that a fund manager was window dressing on a regular basis, the Commission might have difficulty carrying its burden of proof.

If regulators are unable to deter window dressing, at least additional portfolio disclosure would make mutual funds more answerable to market forces. The disclosure of fund portfolios on a more frequent basis would better equip financial press, consumer advocates, and investors and their advisers to better determine whether managers were engaging in window dressing. As noted by one financial planner, “[t]he reticence [about disclosure] is that they do a lot of trading close to the quarter-end to have good stocks in the fund, and they don’t want to tell you what they are doing.”<sup>67</sup> Such disclosure is the only practicable means of deterring fraudulent window dressing by fund managers.

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<sup>62</sup> Brown & Goetzmann, *supra* note 34 at 376 (citing Josef Lakonishok, Andrei Shleifer, Richard Thaler & Robert Vishny, Window Dressing by Pension Fund Managers, *American Economic Review* 81 (1991)).

<sup>63</sup> Norton, *supra* note 52 (“By definition, 50% of my fellow managers are under the market, and will need extra zip in performance’ at year-end, says one highly regarded manager, who has bailed out of chip stocks. ‘What fund manager wants to go in to a General Motors pension fund meeting and defend being double weighted in semiconductors? You’d be spending an hour or two explaining why this group is dead and justifying why you’re in it. You want to put your best foot forward on companies under accumulation. You’d want to own an Internet stock or two, because the news is good and that’s a cool place to be invested.’ Once that justification is over, it’s likely that semiconductor stocks will pop in a bear market rally.”).

<sup>64</sup> Sandra Sugawara, Putting a False Face on Fund Performance? A Curtain of Secrecy Hides ‘Window Dressing’ Most Observers Agree, *Washington Post* at H01 (Jan. 9, 2000) (quoting Robert Plaze, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission).

<sup>65</sup> *Id.* (quoting Barry Barbash).

<sup>66</sup> *Id.* (quoting Plaze and Barbash commenting on difficulty of proving fraudulent intent in connection with window dressing).

<sup>67</sup> David Dietz & Ian McDonald, What’s the Big Secret About Fund Holdings? *TheStreet.com* (April 26, 2000) (quoting Joel Davis, a financial planner with American Express Financial Advisors).

### **III. AN ENTRENCHED INDUSTRY**

The mutual fund industry has resisted all attempts to reform portfolio disclosure rules. Most recently, the Investment Company Institute, the principal trade organization for fund management companies, reiterated its position that current disclosure requirements “remain appropriate,” notwithstanding substantial evidence that investors do not have the information they need to make informed investment decisions, and that fund managers are using inadequate disclosure requirements as a screen for portfolio fraud.<sup>68</sup>

The mutual fund industry has objected to reforming portfolio disclosure rules because there purportedly has been no market demand for more information about portfolio holdings, and additional portfolio disclosure would (1) be too costly, (2) enable traders to use information about fund trading activities to benefit themselves to the detriment of funds and their shareholders, and (3) expose funds’ proprietary trading strategies to their competitors.

Not only are these concerns greatly outweighed by the need for investors to be able to make informed investment decisions and for the prevention of portfolio fraud, they also are factually incorrect and misguided. A 1999 poll of 2,500 online investors by the Montgomery funds found that **97%** wanted more information about fund portfolio holdings.<sup>69</sup> Furthermore, even if investors were not actively interested in additional fund portfolio disclosure, this would be no excuse for failing to take steps to protect them against portfolio fraud.

The practical problems cited by the industry also are without merit. Portfolio holdings can now be widely disseminated on the Internet at little cost. Requiring the actual filing of this information with the Commission only in conjunction with funds’ semiannual reports would minimize any added filing costs. Permitting funds to post their monthly portfolio holdings after a 60-day delay will prevent traders from exploiting a fund’s trading activity by frontrunning fund trades.

Finally, there simply is no evidence that disclosure of holdings on monthly intervals with a 60-day lag would enable traders to determine fund managers’ proprietary trading strategies. Even if this were a problem for a small minority of funds, that is no justification for continuing to keep investors in the dark about information they need to help make informed investment decisions. If certain funds would be harmed by additional disclosure, they could request the Commission to grant them an exemption from enhanced disclosure requirements.

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<sup>68</sup> Letter from Matthew P. Fink, President, Investment Company Institute, to Donald L. Luskin, President & CEO, MetaMarkets Investments LLC, and H. Davis Nadig, Executive Vice President, MetaMarkets Investments LLC (May 11, 2000).

<sup>69</sup> Dawn Smith, Should Fund Portfolios Be Secret? SmartMoney.com (April 20, 2000).

The ICI also has opposed the Commission's proposed fund names rule. The ICI argues that funds should be permitted to change their investment focus without shareholder approval, and to diverge from this focus to assume "temporary defensive positions" in a wide range of circumstances.<sup>70</sup> As discussed above, permitting a broad exception for temporary defensive positions would, in effect, eviscerate the SEC's proposal. Funds that choose to advertise their investment focus in their names should be required to live up to their billing.

Permitting funds to change their investment focus without shareholder approval also would undermine the purpose of the fund names rule. Investors who invest on the basis of a fund's name at a minimum should be able to decide whether the implied focus of the fund's investments should be changed. The ICI's position is inconsistent with legal requirements that far less fundamental investment policies be changed only upon shareholder approval.<sup>71</sup> For example, a fund that does not concentrate its investments (*i.e.*, invest more than 25% of its assets) in a particular industry must obtain shareholder approval to change this policy.<sup>72</sup> In light of this requirement, it follows that a fund also should have to obtain shareholder approval to change a policy not to invest less than 80% of its assets in a particular type of security.

#### **IV. TOWARD TRUTH IN MUTUAL FUND INVESTING**

The inadequacy of information about mutual fund portfolio holdings provided by existing portfolio disclosure rules deprives investors of the information they need to make informed investment decisions. Funds often invest outside of the stated investment styles, thereby exposing their shareholders to unanticipated risks. The inability of investors to measure funds' portfolio against an appropriate benchmark index makes it impossible to gauge a fund manager's success or failure in picking stocks. The tyranny of fund ratings in fund ads exacerbates this problem. Finally, funds often contain overlapping portfolio holdings, even funds offered by a single fund management company, which undercuts investors' attempts to minimize risk by diversifying their portfolios.

Existing portfolio disclosure rules also help to conceal a wide variety of forms of portfolio manipulation. Misclassification of funds through the use of misleading fund names and other strategies enables fund managers to generate misleading relative performance results. The secrecy surrounding fund portfolio holdings facilitates portfolio

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<sup>70</sup> Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (June 9, 1997).

<sup>71</sup> *See, e.g.*, Investment Company Act Sections 13(a)(1) (requiring shareholder approval to change from a diversified to a non-diversified fund) and 13(a)(2) (requiring shareholder approval to change policies regarding borrowing and lending money, issuing senior securities, underwriting securities, and real estate and commodities investments).

<sup>72</sup> Investment Company Act Section 13(a)(3).

pumping and window dressing, thereby misleading investors, adding unnecessary costs, and undermining the integrity of mutual funds and the securities markets.

Improving trust in mutual fund investing lies not in private law suits or SEC enforcement actions. Often it is not possible to meet the burden of proof necessary to show intent to deceive in connection with investment decisions, notwithstanding the anecdotal and statistical evidence of portfolio fraud. Regulating category definitions also is unlikely to succeed, even assuming that regulators were in the best position to define fund categories, as fund managers always will be able to find ways to invest outside the category without being reclassified.

The path to improving trust in mutual fund investing lies in trusting market forces. Enhanced disclosure requirements would allow the market to measure, judge and eliminate portfolio fraud through investment decisions by millions of investors. More frequent public disclosure would provide the best mechanism for determining when fund managers are operating outside of their purported investment styles or engaging in deceptive labeling and promotion, window dressing or portfolio pumping. In contrast, existing portfolio disclosure requirements facilitate portfolio fraud by creating the impression that fund portfolios are publicly available while affording managers enough leeway to engage in uninhibited manipulation.

As noted above, funds currently are required to disclose their portfolios only twice a year. These requirements are inadequate to enable investors to make informed investment decisions, or to deter portfolio fraud. In order to enable investors to know what they actually buying when they invest in a mutual fund, mutual funds should be required to publicly disclose their holdings on a monthly basis. This will enable investors, academics, the financial press and others to review fund portfolios after the fact for evidence of style drift and portfolio manipulation, and thereby deter such practices. If certain funds can demonstrate that they may be harmed by disclosing their portfolios on a monthly basis, the Commission should exempt them from monthly disclosure to the extent necessary to address their concerns. In addition, the Commission should consider requiring funds to file portfolio holdings with the Commission frequently enough to enable to SEC staff to determine whether fund managers are engaging in portfolio fraud.

Finally, it is imperative that the Commission require funds to provide portfolio information in a way that is easy to access and analyze. All too often, well-intended disclosure requirements are ineffective because consumers cannot use the resulting information to make better investment decisions. Electronic communications have virtually eliminated the cost of publicly disseminating data, the Internet has virtually eliminated the cost accessing it, and software technology has made sophisticated analysis of the significance of financial data feasible for millions of investors and their advisers. The Commission therefore should require funds to post their portfolio holdings on a free Internet site in XML or other easily manipulated language, and attach to each holding the security's ticker symbol, cusip number, and security industry code. To accommodate investors who do not have Internet access, funds should be required to provide paper copies of portfolio information upon request.

Electronic disclosure holds out the best hope for the democratization of mutual funds. Electronic disclosure of portfolio holdings would promote the development of inexpensive, user-friendly software that investors and their advisers could employ to monitor deceptive labeling and promotion by individual funds, rather than having to rely on -- and pay for -- large data providers to analyze the data and publish their conclusions. Electronic disclosure also would enable large data providers to provide detailed comparative data regarding the relative investment integrity within classes of funds. The Commission must ensure not only that critical information is publicly available, but also that the information can be used to serve its purposes: to enable investors to make informed investment decisions, and to protect investors against fraud.