Funds and Games

By Paul Krugman

You're selling your house, and your real estate agent claims that he's representing your interests. But he sells the property at less than fair value to a friend, who resells it at a substantial profit, on which the agent receives a kickback. You complain to the county attorney. But he gets big campaign contributions from the agent, so he pays no attention.

That, in essence, is the story of the growing mutual fund scandal. On any given day, the losses to each individual investor were small—which is why the scandal took so long to become visible. But if you steal a little bit of money every day from 95 million investors, the sums add up. Arthur Levitt, the former Securities and Exchange Commission chairman, calls the mutual fund story "the worst scandal we've seen in 50 years"—and no, he's not excluding Enron and WorldCom. Meanwhile, federal regulators, having allowed the scandal to fester, are doing their best to let the villains get off lightly.

Unlike the cheating real estate agent, mutual funds can't set prices arbitrarily. Once a day, just after U.S. markets close, they must set the prices of their shares based on the market prices of the stocks they own. But this, it turns out, still leaves plenty of room for cheating.

One method is the illegal practice of late trading: managers let favored clients buy shares after hours. The trick is that on some days, late-breaking news clearly points to higher share prices tomorrow. Someone who is allowed to buy on that news, at prices set earlier in the day, is pretty much assured of a profit. This profit comes at the expense of ordinary investors, who have in effect had part of their assets sold off at bargain prices.

Another practice takes advantage of "stale prices" on foreign stocks. Suppose that a mutual fund owns Japanese stocks. When it values its own shares at 4 p.m., it uses the closing prices from Tokyo, 14 hours earlier. Yet a lot may have happened since then. If the news is favorable for Japanese stocks, a mutual fund that holds a lot of those stocks will be underpriced, offering a quick profit opportunity for someone who buys shares in the fund today and unloads those shares tomorrow. This isn't illegal, but a mutual fund that cared about protecting its investors would have rules against such rapid-fire deals. Indeed, many funds do have such rules—but they have been enforced only for the little people.

In some cases fund managers traded for their own personal gain. In other cases hedge funds, which represent small numbers of wealthy investors, were allowed to enrich themselves. In return, it seems, they found ways to reward the managers. You make us rich, we'll make you rich, and the middle-class investors who trusted us with their money will never know what happened.

And there's probably more. During last year's corporate scandals, each major company that came under the spotlight turned out to have engaged in some original scams. By analogy, it's a good guess that the mutual fund industry was cheating its clients in other ways that haven't yet come to light. Stay tuned.

Oh, and about that corrupt county attorney: last year it seemed, for a while, that corporate scandals—and the obvious efforts by the administration and some members of Congress to head off any close scrutiny of executive evildoers—would become a major political issue. But the threat was deftly parried: a few perp walks created the appearance of reform, a new S.E.C. chairman replaced the lamentable Harvey Pitt, and then we were in effect told to stop worrying about corporate malfeasance and focus on the imminent threat from Saddam's W.M.D.

Now history is repeating itself. The S.E.C. ignored warnings about mutual fund abuses, and had to be forced into action by Eliot Spitzer, the New York attorney general. Having finally brought a fraud suit against Putnam Investments, the S.E.C. was in a position to set a standard for future prosecutions; sure enough, it quickly settled on terms that amount to a gentle slap on the wrist. William Galvin, secretary of the commonwealth of Massachusetts—who is investigating Putnam, which is based in Boston—summed it up: "They're not interested in exposing wrongdoing; they're interested in giving comfort to the industry."

I wonder what they'll use to distract us this time?