LATE TRADING AND MARKET TIMING AT PUTNAM INVESTMENTS

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Between 2000 and 2003 several fund managers at Putnam Investments were involved in late trading and market timing trades. These fund managers personally made large windfalls from their actions. The SEC charged Putnam and the managers with civil securities fraud. This case examines late trading and market timing and who loses when these activities take place.

INTRODUCTION

Anne Smith had been managing money at a business associated with Marsh and McLennan, so she wasn't at Putnam every day with the other fund managers. She did, however, commonly hear fund managers bragging about trades that happened as late as 9 p.m., or deals that were made to trade in and out of funds. When she mentioned this to her supervisor, a man with substantial clout within the organization, he just said, "There is nothing wrong with what the fund managers are doing here. Read our prospectus." Having been on Wall Street for a number of years, that answer did not satisfy her.[1]

In 2000 a question arose in the firm about the possibility that six money managers employed by Putnam may have made a series of questionable personal trades. These trades by a select few of the "in crowd" managers within the organization were thought to have been made based on information of a non-public nature and were made on a short-term basis. This type of trading could be classified as market timing, or rapid in-and-out trading, which is banned by many mutual funds because it results in extra fees for long-term investors. If it could be proven that these trades were made, the profits would have been at the expense of the long-term investors in their funds, thereby breaching their fiduciary responsibility as facilitators of client funds.[2]

In addition, for a long period of time there had been a suspicion that favored investors were allowed to trade in and out of holdings, to buy and sell at the best prices, and to make profitable gains despite downturns for other shareholders. This would be even more difficult to prove than the charges of market timing because many trades were made using omnibus accounts, which made it extremely difficult to trace a transaction back to its specific source. If this type of trading did occur, it may very well have been illegal because the American capital markets are assumed to be efficient, meaning all investors operate on equal grounds with the same information, so that each investor has equal opportunity for profit or loss under the system.

INDUSTRY BACKGROUND

Some 95 Million Americans own mutual funds and it is a $7 trillion industry. It is assumed, however, that 0.1% of these investors actually understand the industry's antiquated set-up. Under a 1940 law, each fund is a separate company, but the company is essentially a shell, with directors but no employees. The board which operates the fund contracts out all of the key services, from stock picking to record keeping. In theory, the board can choose any adviser, but in reality, a company usually sets up a fund, appoints a board of directors, and the board then hires the management company that founded the fund. The board has no independent information regarding operations and little authority over the actions of its personnel. A dissatisfied board could fire an adviser, however, this rarely happens because most directors have ties to the adviser.[3] Unfortunately many times the only internal unit that has the capability of looking out for investors lacks the will to do so.

Mutual fund shares are traded based on a forward pricing rule. This means that trades in U.S. open-ended mutual funds are priced at the next net asset value (NAV), which is calculated after an order is placed. Each mutual fund computes and reports its shares' NAV only after the stock markets close each day. There is no continuous pricing of fund shares throughout the trading day. When an investor places an order to buy or sell a fund's shares, the order is executed based on the NAV calculated at the end of that trading day, regardless of what time during the day the order was placed. Trades received after the close of a market should be priced at the next day's NAV.

Late trading, which is illegal, happens when traders place trades after the close of the market, but are able to take advantage of that day's price. It allows traders to make decisions based on news they receive after the close of the markets, while still paying that day's NAV for fund shares. This makes the capital markets inefficient and allows the late-traders guaranteed returns and an unfair advantage over owners of the fund that are not allowed to trade in this manner. The result is the dilution of fund shares for the firm. A firm might allow this dilution, however, because outside deals are made for capital inflows via other financial offerings.

Late trading and market timing typically go hand-in-hand. A market timer takes advantage of the arbitrage opportunity left when NAV's have not been recalculated but movements in the NAV are apparent. International equities with their earlier market closures and assets that are not freely traded are common targets for market timers.

PUTNAM INVESTMENTS

Putnam Investments, the Massachusetts-based unit of Manhattan-based Marsh & McLennan Companies, is the sixth-largest mutual fund company in the United States. In 1925 George Putnam was one of the founders of Incorporated Investors, an open-ended mutual fund, and he founded Putnam Investments in 1937. George Putnam was the great-grandson of Samuel Putnam, who as a justice of the Massachusetts State Supreme Judicial Court in 1830, established the "Prudent Man Rule" in a landmark case. The Prudent Man Rule became the standard for responsible money management. As of March 31, 2004, Putnam Investments managed $227 billion for approximately 11 million individual shareholder accounts and 500 institutional clients.

For much of its history, Putnam had the reputation of being a venerable, conservative, and respected money management firm. Mr. Lawrence Lasser, who was CEO of Putnam in 2003, began his career at Putnam in 1969. He started as an analyst whose job was to identify promising stocks that the fund could buy for its clients. Mr. Lasser rose to the CEO position at Putnam, not as a result of his stock picking ability, but because of his ability to get big brokerage firms like Merrill Lynch and Morgan Stanley to include Putnam Funds on their list of preferred mutual funds for their sales staff. Under Mr. Lasser's leadership, Putnam exchanged its boring investment style for a brassy one that was more dependent on aggressive marketing than astute investment management. The marketing focus became apparent in the early 1990's. Between 1998 and 2003, Mr. Lasser received salary, bonuses, stock options, restricted shares, and a retirement pay package worth $163 million.[4]

ANNE SMITH

Anne Smith had been unhappy in her position with Putnam Investments for several reasons, so after learning about the market timing and late trading at Putnam, she resigned and left the firm. She left feeling as though this would be the end of her responsibility with Putnam with regard to the issues she thought to be improper. It wasn't until a year later that her conscience would get the best of her. This happened by chance when her sister asked her for help with a 401(k) statement, and Anne realized that her sister had invested in some of the funds that had recently made the papers on rumors of questionable trading. Something in Anne snapped. She started thinking about how market timing and late trading affected people like her sister. Then it became an issue that kept her up at night.

When she could no longer stand the weight of what she knew, she decided that something must be done, but whom should she notify about what she knew? She could contact the people on the board at Marsh & McLennan, but after contemplating this option, she knew it would not be fruitful. She could contact the SEC and set in motion a probe that may or may not be brushed under the rug as quickly as it began. Finally, she thought of the person who would come to be known as the Sheriff of Wall Street, the New York Attorney General, Elliot Spitzer. She decided to make the call to Spitzer's office and asked for the head of securities fraud. She left a message giving specifics on what he should look for in trying to unearth the fraud against Putnam shareholders. She told herself that she had done her duty and wasn't going to call back, but because of her convictions, she followed it through to the end.[5]

When Eliot Spitzer first announced charges in early September for improper trading in mutual funds, many prominent fund families insisted that they were not complicit, but rather innocent victims of rapacious trading by hedge funds. However, the scandal spread to nine mutual-fund companies that became entangled in the New York Attorney General's crusade.[6]

THE MARKET TIMING AND LATE TRADING ACTIVITY AT PUTNAM

Suspicion surrounded several managers at Putnam including Omid Kamshad, Chief Investment Officer of International Equities, Geirulv Lode, Senior Portfolio Manager of Global Core Equities, Carmel Peters, Director of Emerging Market Equities, and Justin M. Scott, head of three funds including Specialty Growth and Small Cap Core Equities.[7] These managers were suspected of market timing and late trading in their personal funds and also on behalf of large institutional clients.

A typical timed transaction would consist of one of these managers making trades late in the trading day after the close of foreign markets, or after the close of U.S. markets, based on knowledge of events that transpired during the trading day. For Omid Kamshad it meant that if a significant event happened overseas, which would probably lead to higher share prices the next day, he would bolster his earnings by strengthening his position in the fund that would benefit most from the event. For manager Justin Scott, an announcement of a drop in the Fed Funds rate, or an outstanding earnings number, would result in him purchasing shares of his specialty growth fund, because he knew the NAV the next day would be higher. Likewise he could dump shares on news of a rate hike or a disappointment in earnings and benefit by not taking the brunt of the market's reaction.

Managers inside the company were not the only parties suspected to have been involved in market timing and late trading. In Putnam's case, the company was also accused of allowing others, such as a particular boilermakers' trade union, to benefit from the practice as well. The union was granted this concession because Putnam knew more money would pour into the firms other offerings as a result. In theory this should have hurt the firm, but the expected increase of inflows in other areas would make up for the dilution, so the only ones truly injured would be the people who bought and held the same funds.

THE INVESTIGATION

In October 2003, Putnam became the first investment firm formally accused of wrongdoing in the now widespread scandal over late trading. Regulators subsequently sued Putnam for failing to stop money managers and members of a union's pension plan from taking advantage of long-term investors for their own short-term gains. While the practice of market timing is not illegal per se, most of their mutual funds had policies that prohibited the type of activity required in market timing.[8] Massachusetts Secretary of State William Galvin said that the Putnam case "uncovered a corporate culture that turned a resolute blind eye to the most egregious conduct."[9]

When the suit was decided in 2004, Putnam Investments was ordered to pay $110 million to settle both federal and state allegations of improper trading in this case, which had launched the scandal in the mutual fund industry. Ian Roffman, the lead trial counsel for the SEC in the case, said Putnam shareholders would receive the entire $55 million of the SEC settlement. The figure reflects both the $5 million lost by investors as a direct result of the market timing and the $50 million in management fees paid to Putnam while it violated its own policies against market timing.[10] Many within the industry found it unusual that the settlement in this case was so small in light of those that came after it because high-level executives had engaged in market timing and even higher level executives covered it up.[11]

In March of 2004, Putnam's board of trustees announced what many had expected; that Putnam's general counsel, William Woolverton, along with former Chief Executive Lawrence Lasser and another top executive, had known that market timing was taking place in the firm's funds since 2000. Their stance was that rapid-fire trading of fund shares to profit from pricing inefficiencies may be widely discouraged, but is not illegal and had not been proven to cause harm to long-term investors. It is true that market timing is not illegal, however, mutual fund firms are bound by charter to follow the bylaws they supply to investors, and market-timing was forbidden in Putnam's bylaws.[12]

While executives at Putnam knew ~~of the impro~~per trades in 2000, the fund managers were not punished. It was only after securities regulators in Massachusetts and Washington filed suit against the company that Putnam fired two of the six managers involved and 15 other employees who had a part in the improper trades.

The trading scandal that spread through the $7 trillion industry revealed more than just trading abuses that enriched insiders and big investors at the expense of smaller investors. In case after case, fund boards, including Putnam's, were totally in the dark about the extent or even existence of abuses. The failure of the various boards to protect investors was so complete, said Senator Peter G. Fitzgerald (R-Ill.), that "it's time for a wholesale reorganization. [Fund boards] are a study in institutionalized conflicts that have cost investors dearly."[13] Insider Gregory P. Taxin, Chief Executive of Glass and Lewis, said that he was not surprised to hear of the wrongdoing and that the board of Marsh & McLennan was "pretty cozy." He said, "It is in situations like this where runaway compensation packages and poor attention to shareholder interest abound."

RESULTS OF LATE TRADING AND MARKET TIMING BY PUTNAM

It has been estimated that small investors incurred losses of $700 million or more as a result of the improper trading of Putnam's fund managers. The SEC estimated the personal gains of two particular fund managers to be $1 million each. It was not only the long-term shareholders at Putnam that were hurt. Because the market timing and late trading incidents became public information, shareholders of the firm's parent company, Marsh and McLennan, collectively lost $2.16 billion in market capitalization.[14] Because of these incidents, Putnam's assets under management declined to $227 billion from a high of $277 billion as Putnam customers withdrew $53.7 billion dollars more than they put in after the scandal became public.[15]

CHANGES AT PUTNAM

In response to the charges of market timing and giving preferential treatment to selected investors, Putnam implemented strict restrictions on employee trading, requiring employees to hold their investments in Putnam funds for at least 90 days. They also adopted additional short-term redemption fees and an enhanced fair-value pricing program to prevent rapid trading in funds.

Putnam underwent one of the most comprehensive reviews ever conducted by a mutual fund company. This included an internal review of employee trading going back six years and a full review by the trustees of the funds. In addition, Putnam made a number of senior management changes, including appointing a new Chief Executive Officer, Chief Administrative Officer, Chief Operations Officer, Chief Financial Officer and General Counsel. The company terminated 15 employees for their role in the improper trading, two of whom were top fund managers.[16]

Putnam also implemented a number of voluntary initiatives to limit fund expenses and enhance information disclosures to fund shareholders. These actions should save shareholders an estimated $35 million and provide them with access to more information about fund expenses, the structure of portfolio manager compensation, risk, and employee and trustee ownership in Putnam funds.[17]

Anne Smith's life has been forever changed by this event. Smith said, "The only part that's been rewarding is receiving thank-you letters and e-mails. My doorman says, 'I'm so proud you're in this building.'" Even friends on Wall Street told Smith they were proud to know her. But people on the Street were hurt by her conscience. She fully expected doors to be permanently closed to her because she had been a whistle-blower. Smith said, "It's odd, I think if we want to send investors a message that we're looking out for them, then I should still be employable. But people don't want to hire you because instead of applauding your ethics and integrity, they say they can never really trust you."[18]

SUMMARY

The big loser in market timing and late trading scandals is the small investor. Many mutual fund companies under informed and overcharged their customers for years, and this case illustrates an aspect of the mutual fund industry that needed to be corrected. Late trading and market timing, which bolster the profits of a few large, short-term trading investors, invariably dilute the profits of millions of small, long-term investors. In their rush to increase their asset base and fees, mutual fund managers and owners turned a blind eye to practices that were either illegal or violated their own bylaws.[19]

Fund managers took advantage of the opportunity of a weak control structure. The rationalization for doing so was to make money for themselves as well as keep selected clients happy with their portfolio performance.

The transition at Putnam from a fiscally responsible, old-time money management firm to one that favored marketing prowess over fiduciary responsibility is another failure that can be traced to Lawrence Lasser. Corporate culture and the ethical standards must be driven from the top. Managers in the organization could see the paradigm shift being made in the early 1990's as Lasser made his way to the top. By rewarding improper behavior through Lasser's high compensation, Putnam's board might be viewed as an accomplice to the trading frauds later perpetrated by the firm's top money managers.

DISCUSSION QUESTIONS

1. What is fraud?
2. Could the actions of the Putnam employees described in this case be considered fraud?
3. How would this type of fraud be classified?
4. What is late trading?
5. How are investors harmed by late trading?
6. What is market timing and how does it differ from late trading?
7. If you had been in Anne Smith's position, what would you have done with regard to reporting the late trading activities?

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