Guest Column: Are Advisers Contributing to Fund Rule Avalanche? By Tamar Frankel

The SEC has been prolific in the past few years. By its own initiative, or because of congressional directives, the Commission has issued a record number of rules directed at the mutual funds advisory profession.

From 1975 to 2000 the SEC enacted about 135 substantive rules. However, it has enacted 70 such rules over the five-year span from 2001 to 2006. These rules are progressively more specific, eliminating flexibility, putting the profession in a straight-jacket, and imposing significant costs. The costs of these rules are especially irritating to advisors who have done no wrong.

Professional advisors blame the SEC for being over-zealous, self-interested, and driven by ambitions and self-aggrandizement. Yet, could it possibly be that the professional managers and their advisors are contributing to this rule avalanche?

The pressure for specificity

For the past 30 years mutual fund professionals and lawyers have demanded specific rules from the SEC: “Tell us what to do or not to do. We will obey. But beyond the specific rules, we are free to do or not to do as we please.” Further, these specific rules are interpreted literally. The problems that led to the rules in the first place have become less important or entirely irrelevant.

When specific rules and literal interpretation do not limit all the possible ways in which professional managers can unlawfully and unethically benefit from their control of investors’ assets, some professionals search for the ways which were not specified. Competitors follow suit.

The more innovative competitors uncover new ways to benefit and hide the benefits. When this trend leads to blatant fraud and abuse of trust they finally become public.

Concerned that investors will “run” on mutual funds and the securities markets, Congress and the regulators have reacted, but they have not changed the approach of the current system.

Rather than interpret existing rules as a basis for prohibiting the wrongs, the SEC passes more specific rules, focusing on and prohibiting the ***specific ways in which the previous rules were violated.***

These specific rules obscure the heart of the prohibition: Professional advisers are fiduciaries; they may not engage in conflicts of interest, regardless of how they do it; regardless of the ways in which they hide the transactions. Innovative means of violating the rule do not make the means legal.

Rather than spelling out the prohibited objectives, the SEC spells out the prohibited means, processes, documentation and alike by which the wrongs can be perpetrated.

In these days I am asked time and again: “Where are the words that prohibit …?”

Justifications for specific rules and literal interpretation

Two main arguments justify the demand for specificity and literal interpretation. One is efficiency and the second is the “rule of law.” Another argument goes further to state that there is no need for these rules; the markets will take care of the issues. These justifications are weighty and honorable, but are faulty in the context of professional money management.

Specific rules are arguably efficient because the rules allow professional managers to create and capture value. Specificity increases managers’ freedom to gain more from public clients and investors. That is fine, if professional managers are producers and sellers of products. But they are fiduciaries, who must obey restrictions regarding other people’s money. Economists do not focus on enforcing this restriction, but law does. And the enforcement of specific rules is incredibly inefficient.

Standard-based rules involve some uncertainty, exposing professional managers to legal risks. Specific rules eliminate or reduce uncertainty and risks. Hence, managers can touch the prohibited line.

Gate keepers -- lawyers, accountants and investment bankers -- offer ways to reduce the risk of crossing the line by clamoring for more specificity, looking to form instead of substance, and ignoring the purpose of the rules. When the line is crossed, expect more specific rules to emerge to plug the “leaks.” Thus, not only do specific rules lead to inefficient enforcement; they also lead to more (specific) rules.

The “rule of law,” to which we all subscribe, does not justify specific rules, either. To be sure, people should know the rules. But, the rule for professional managers is clear: ***The money they hold is not their money. It belongs to others.*** Therefore, managers must receive permission to take any amount for themselves.

The form of taking need not be specified, especially if it can be innovative and well hidden. It is still “taking what does not belong to you.”

Nations Bank did not take money from the funds it managed. Rather, it accepted financial benefits from Mr. Stern in exchange for preferring his fund to other investors, at the other investors’ expense. Nations Bank didn’t receive cash from Stern, it received “sticky assets” that brought in cash.

There was no rule that specifically prohibited that, but there was an old rule that prohibited (1) unfair treatment of investors and (2) benefiting from such treatment in whatever way.

So long as the professional managers did not benefit from market-timing, their interests were aligned with those of the investors. But, once the managers began to benefit, they violated a rule that said: "Thou shall not benefit from money that is entrusted to you as a fiduciary without permission of the owners (or their representatives)." If under the "rule of law" this general rule was not sufficiently specific, managers are now blessed with specific rules on market-timing.

Do these specific rules really make the "rule of law" more effective and fair to the managers?

Specific rules come to bite the SEC as well. It is not surprising that the rules brought about attacks on the SEC's authority by honest managers. Some of these specific rules may have imposed on rogue managers the correct measure of control, but not on those who stayed and acted within the law.

Finally, there is the justification for limiting rules in scope and in number. Investors should trust the markets. Investors should take care of themselves. They can sell their shares if they are not satisfied, and they can elect other directors to represent their interests.

However, some cannot take care of their own investments (for lack of knowledge or time). Markets are fickle. Investors may seem satisfied and then "run" and keep away for twenty years or two.

Specific rules hurt professional managers and the regulators

When all is said and done professionals that ignore the problem the rules are designed to resolve will face criminal and civil charges and loss of customers.

"Gimmicks" and smart tricks covered by the specific rules do not resolve, but rather highlight, problems. When outrageous behavior re-appears, there is no escape from attacks on the wrongdoers.

Above all, specific rules will bring more specific rules. Mutual fund professionals who seek specific rules and interpret them literally and circumvent them should expect more specific rules to address the circumvention. That is because the problems posed by those who hold other people's money remain unresolved.