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Managing Uncertainty In The SEC Fair Fund Process: Part 1

By **Alan Friedman** (June 18, 2018, 1:21 PM EDT)

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In part one of this two-part series, we provide the historical background needed to understand fair fund distributions. The U.S. Securities and Exchange Commission uses this process in a wide range of instances, with some cases involving the distribution of hundreds of millions of dollars to eligible investors. As you will see, completing the fair fund process can be arduous. While many variables influence these timelines, good planning and execution can decrease some of the burdens and the costs. In part two of this series, we will offer six specific suggestions for how to manage expectations and even expedite this challenging and uncertain process.

Introduction: How Did Fair Funds Evolve?

Numerous investigations by the SEC end with a resolution that, in part, requires the respondent to make payments to harmed parties. This resolution is often the result of many months or years of discussions, investigations and negotiations. If it is determined to be warranted, the SEC may elect to use a fair fund distribution to equitably allocate agreed payment amounts to eligible investors.

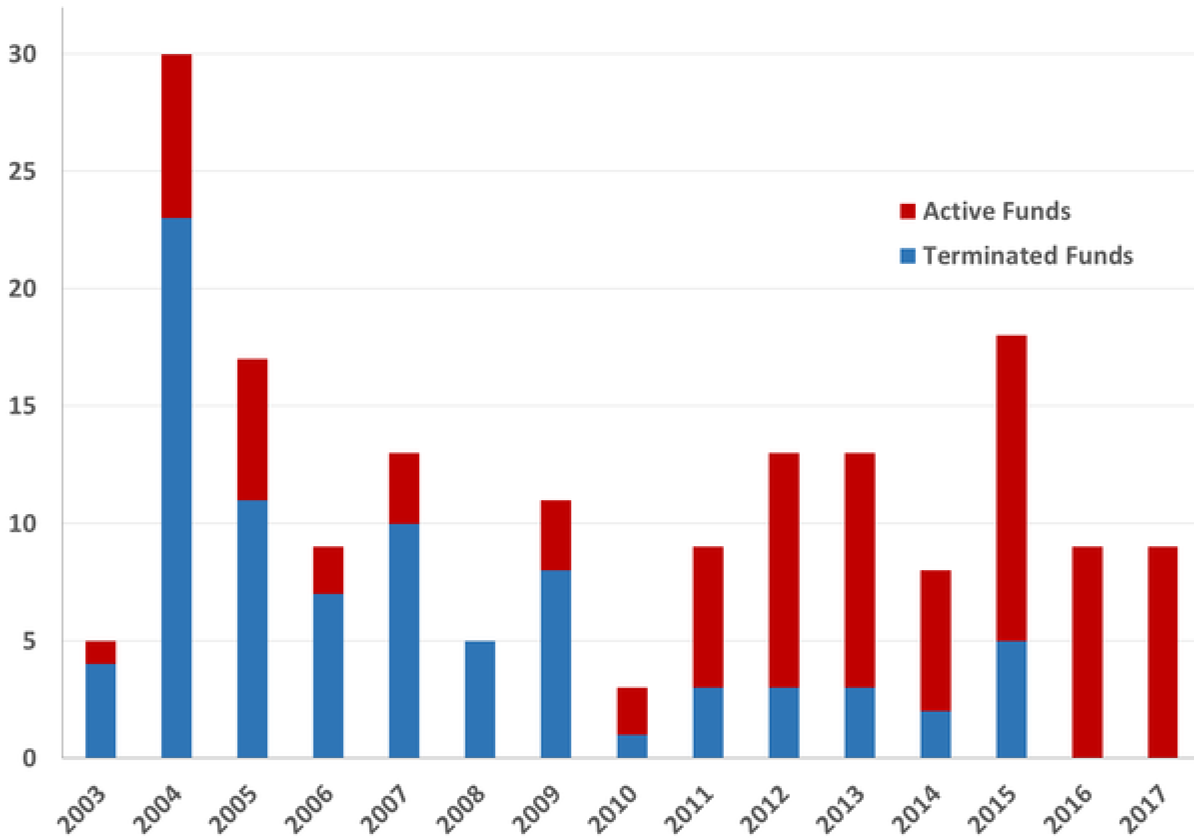
Fair funds were established by the Sarbanes-Oxley Act of 2002, and their use began shortly thereafter.[1]

Distributions include disgorgements (returns of wrongful profits), prejudgment interest and penalties obtained through an SEC action. Prior to Sarbanes-Oxley, the SEC could only distribute the disgorgement portion of a judgment, while penalty amounts were paid to the U.S. Treasury. After Sarbanes-Oxley, the SEC, using the fair fund process, gained the flexibility to also distribute civil penalties to harmed investors.[2]

Between 2003 and 2009, many fair funds resulted from mutual fund market-timing and late-trading cases.[4] However, fair funds have been used by the SEC for a variety of case types, including, for example:

- Asset mispricing and/or incorrect net asset values (NAVs) by mutual funds,
- Excess fees,
- Failure to disclose risks in securities underwritings, and
- Misappropriation of client funds.

Figure 1: Number of Funds Created by Year[3]



The fair fund process generally seeks to compensate harmed parties, which can include hundreds of thousands of payments to individual accounts. The burden of identifying eligible recipients and quantifying harm is placed on the shoulders of the respondent and its advisers. If the respondent is in possession of the required data (e.g. identity of mutual fund investors and trading histories), this usually means that investors are not required to provide documentation to support a claim.[5] Instead, the information available to a respondent is analyzed to determine eligibility and harm amount, with payments sent directly to each investor.[6] This approach can involve significant time and analytical effort, but enables a highly inclusive and efficient distribution.[7] In addition, since the respondent is typically responsible for payment of all significant distribution costs, eligible investors receive a payment unreduced by legal fees and large expenses that can burden alternative approaches.[8]

Since the passage of the Sarbanes-Oxley Act of 2002, SEC has used this process to distribute billions of dollars to harmed investors.[9] Fair fund distributions have ranged in size from a few hundred thousand dollars to hundreds of millions of dollars. Of the distributions listed on the SEC fair fund website,[10] about half have been completed and the associated fair funds formally closed. Typically, the fair fund process takes between six and seven years to complete,[11] but some remain open after 10 or more years.[12] As can be seen in figure 1 above, most of the fair funds created after 2009 are still open as of the date of this article.

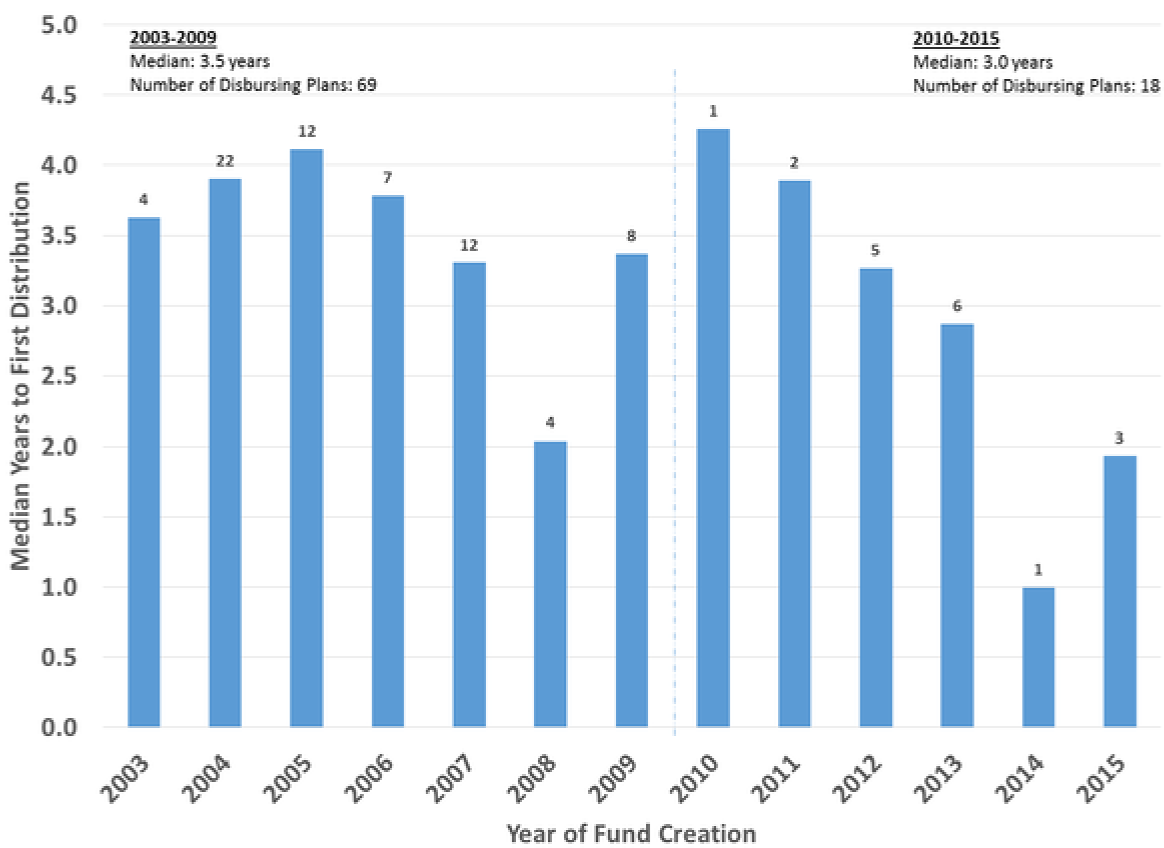
There are many variables that can influence the time required to complete a fair fund, including the underlying case type.[13]

Active Years by Case Type (Terminated Funds Only)

Case Type	**Minimum**	**Median**	**Maximum**
Market Timing	3.20	8.51	14.10
Best Execution	2.29	6.35	13.49
Failure to Disclose	0.89	4.15	9.24
Excessive Fees	2.08	7.30	13.15
All Other	0.70	4.75	12.32
All Funds	0.70	6.39	14.10

As seen above, the market timing cases took the most time to complete, but most cases took years until the fair fund was officially closed. However, since funds are distributed well in advance of the official closing date of the fund, we can also look at another indicator of timing.

Figure 2: Age of Fair Fund at Date of First Distribution, by Year of Fund Creation[17]



Investor Payment Timing

Once the settlement or creation of a fair fund is announced, eligible recipients become aware of the likelihood of receiving monies from the fund. If payments are delayed, the value of those payments declines, and this can become a customer relations issue.[14] A review of the fair funds created between 2003 and 2009, for which we have distribution information,[15] shows that the time between the date of the creation of the fair fund and the date authorizing the first distribution of monies to eligible recipients was approximately 3.5 years.[16] For plans initiated in the years 2010 to 2015, the distribution took approximately three years from the date for plan creation. This information is depicted in figure 2. It should be noted, however, that the number of plans reporting a distribution is lower for the years 2010-2016 (18) compared to 2003-2009 (69). As more of the plans report first distributions, these metrics will change. No plans created in 2016 or 2017 are reported to have begun distributions.

The fair fund process is able to identify harmed individuals and provides compensation without the burden of excessive costs to investors; however, it is also clear that the fair fund process can involve a lengthy period of time to complete.

In our second article, we discuss six specific steps to take to manage the fair fund distribution process, and to reduce the time and effort required to complete them.

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[1] See 15 U.S.C. § 7246(a) and http://www.sec.gov/litigation/fairfundlist-archive.htm.

[2] Section 929B of the Dodd-Frank Act provides, "If, in any judicial or administrative action brought by the Commission under the securities laws, the Commission obtains a civil penalty against any person for a violation of such laws, or such person agrees, in settlement of any such action, to such civil penalty, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of a disgorgement fund or other fund established for the benefit of the victims of such violation."

[3] Includes the 172 Fair Fund matters shown on the SEC website https://www.sec.gov/litigation/fairfundlist-archive.htm and https://www.sec.gov/litigation/fairfundlist.htm. The fair fund mechanism has also been used by SEC in administrative proceedings and in the U.S. court system, for which timing of key activities is not publicly reported. Those fair funds are not included in this analysis. Some of those excluded fair funds were sizeable, such as SEC v. CR Intrinsic ($601 million) in 2014 and SEC v. AIG ($846 million) in 2009.

[4] Between 2003 and 2009, 43 fair funds were created to deal with mutual fund market timing/late trading issues.

[5] Some fair funds require eligible recipients to provide documentation of eligibility (e.g. SEC v. CR Intrinsic).

[6] In certain cases, individual investors may provide information to support an appeal for an increased payment amount.

[7] On average, the fair fund distribution process distributes about 90 percent of fair fund monies to harmed parties, with about 10 percent (residual amounts) transferred to government agencies.

[8] See for example: Mayer Brown, “Do Class Actions Benefit Class Members? An Empirical Analysis of Class Actions” available at https://www.mayerbrown.com/files/uploads/Documents/PDFs/2013/December/DoClassActionsBenefitClassMembers.pdf.

[9] The 172 fair funds shown on the SEC fair funds website involved distributions totaling approximately $7 billion. The fair fund mechanism has also been used by SEC in administrative proceedings and in the U.S. court system where timing of activities is not publicly reported. Those fair funds are not included in this analysis.

[10] https://www.sec.gov/litigation/fairfundlist-archive.htm and https://www.sec.gov/litigation/fairfundlist.htm.

[11] Time to complete is calculated as the elapsed time between the date of the order instituting administrative cease-and- desist proceedings and the date of the order terminating the fair fund. Payments to eligible investors are made in advance of formal termination of a fair fund, sometimes by months or years.

[12] There were 12 terminated fair funds with 10 or more years of activity. Additionally, there are currently 19 fair funds that have been active for 10 or more years as shown at: https://www.sec.gov/litigation/fairfundlist.htm.

[13] Sixty-eight out of 85 of the terminated funds were included in this analysis based on information availability.

[14] Gretchen Morgenson, “SEC Inertia on Paybacks Adds to Investor Harm,” New York Times, Jan. 13, 2017, available at https://www.nytimes.com/2017/01/13/business/fair-game-gretchen-morgenson-investors-regulators-.html.

[15] Excludes terminated funds for which a distribution date is not specified, as well as active funds for which no distribution is reported to have been made.

[16] Measured in years from the date of the cease-and-desist order to the date of the first order authorizing disbursement.

[17] Note that the data labels indicate the number of funds for which disbursement information is reported in each year.