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SEC Probes Mutual-Fund Firms After Settlement in Kickback Case

By **TOM LAURICELLA***October 26, 2006; Page A1*

The Securities and Exchange Commission has launched an investigation of 27 mutual-fund companies that the agency says have accepted kickbacks totaling hundreds of millions of dollars in recent years.

The investigation centers on alleged arrangements in which independent contractors agreed to pay rebates to mutual-fund companies in order to win lucrative contracts for jobs like producing shareholder reports and prospectuses. The probe stems from a \$21.4 million settlement the SEC reached last month with Bisys Fund Services Inc., an administrative-services provider owned by **Bisys Group Inc.**

Regulators say Bisys, which is based in Roseland, N.J., paid a total of \$230 million in kickbacks between July 1999 and June 2004 as part of an effort to win work from mutual funds. Bisys settled the civil charges without admitting or denying wrongdoing.

While the alleged kickbacks would have taken only a tiny toll on individual investors, perhaps shaving a few hundredths of a percent a year off their fund accounts and returns, the latest investigation comes as the fund industry is struggling to rebuild its reputation after a series of trading scandals that triggered regulatory crackdowns and fines totaling more than \$1 billion.

Critics have long complained about fund companies using shareholder money for their own benefit. For example, funds are allowed to use trading commissions, which are deducted from shareholder funds, to pay for research that may not benefit individual fund investors. They can also levy fees on their investors for marketing, although attracting more investors benefits the fund company and not necessarily its existing shareholders. Both these practices are highly regulated to prevent abuses. Nonetheless, regulators and other observers say the latest scandal is part of a distressing pattern of fund companies misusing shareholder

money.

"This is far worse conduct" than previous fund-trading scandals, said Mercer Bullard, a law professor at the University of Mississippi who specializes in mutual-fund matters. "Receiving a kickback that comes indirectly out of the pockets of shareholders is the functional equivalent of embezzlement."

In part based on information from Bisys, the SEC has sent letters to some of the 27 fund companies asking them to provide details about their ties to Bisys, according to people familiar with the probe. They didn't identify any of the companies. However, the investigation is unlikely to include many of the very largest fund companies, which tend to have in-house units that handle administrative functions.

Most of Bisys's clients were bank-run funds, many of which tended to be smaller firms with several billion of dollars under management. A handful of banks, however, do rank among the larger fund managers.

The SEC says the alleged kickbacks involving Bisys and other service providers worked with the help of secret side agreements. The service providers charged shareholder accounts for administrative services but, unbeknownst to the funds' investors or independent board members, the providers agreed to rebate part of that money to fund advisers, who would then use it to cover their marketing expenses. In exchange for the kickbacks, the advisers would recommend to their funds' boards that the service providers' contracts be renewed.

At issue in the probe is whether fund companies misused their investors' money and misled their boards about why they were hiring certain service providers, according to people familiar with the probe. "These matters raise questions about whether there was a breach of duty to shareholders," said Philip Khinda, an attorney who represents a number of fund boards that have been investigating their funds' arrangements with Bisys.

In its complaint against Bisys, the SEC described the actions of one fund company, which it referred to as "Adviser A," that allegedly demanded millions of dollars in kickbacks in return for recommending that Bisys's contract be renewed. Another 26 fund families had similar deals -- some written, and some only oral -- with the firm, the SEC said.

The agency didn't identify any of the fund companies in the complaint but, according to people familiar with the investigation, "Adviser A" is AmSouth Funds, which was then a unit of AmSouth Bancorp of Birmingham, Ala.

AmSouth Bancorp declined to comment on whether or not it is the company referred to as "Adviser A," but it said it is cooperating with the SEC.

In 2005, after the alleged arrangement with Bisys had ended, the AmSouth Funds, which then totaled \$5.5 billion in assets, were sold to Pioneer Investments. A spokesman for Pioneer declined to comment.

The SEC's Bisys complaint says a senior executive at "Adviser A" told Bisys in 1999 that if it didn't agree to a kickback arrangement, one of its competitors would. Indeed, the SEC alleged in its complaint that "other administrators" besides Bisys cut such deals.

Bisys's main competitor is **SEI Investments** Co. A spokesman for SEI, which is based in Oaks, Pa., said that as a matter of policy the company wouldn't comment on whether it had received inquiries from the SEC nor on whether it had similar rebate agreements with fund companies.

Bisys accepted the deal with "Adviser A," and over the next five years, funds totaling \$17.3 million were deducted from shareholder accounts at the fund company, according to the SEC. The money was used by "Adviser A" mainly to cover marketing costs that would normally come out of its own pocket. The adviser also used some of the money to pay the initiation fee and monthly dues at a country club, the SEC's complaint says.

In the arrangement with "Adviser A," Bisys would be paid 0.20% of fund's assets, the SEC said. However, Bisys kept only roughly one-quarter of that amount. About one-third was paid to "Adviser A" in an above-board contract, the SEC says, while the remainder was kicked back to the adviser through a "marketing budget."

In its settlement with the SEC, Bisys agreed to terminate such agreements and change its policies. It disciplined or fired a number of employees.

Last summer, AmSouth gave its own version of its dealings with Bisys. At the time, it disclosed that the SEC had informed the bank it intended to bring civil charges against it related to the service provider. It said that the probe related to "past arrangements under which Bisys used a portion of the fees paid to it by the fund family to pay for marketing and other expenses."

The mutual-fund industry has been dogged by scandals in recent years. In 2003, it came under fire after revelations that a number of big companies let favored clients conduct short-term trading, earning profits at the expense of ordinary shareholders. The following year, regulators cracked down on fund companies that used stock-trading commissions, which are deducted from shareholder accounts, to pay for marketing activities the companies would otherwise have had to cover themselves.

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