STAR CREATION: THE MANIPULATION OF MUTUAL FUND PERFORMANCE THROUGH INCUBATION

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Imagine that a stockbroker who sends a mass mailing to 20,000 investors predicting the direction of ABC Corporation’s stock price over the next month. Half of the letters say the stock price will rise, the other half say that it will fall. As luck would have it, ABC’s price rises over the next month.

The broker then sends another mass mailing to the 10,000 investors who received the first letter accurately predicting ABC’s rise. The new letter reminds them of the broker’s prediction about ABC’s stock and makes a new prediction about DEF’s stock for the next month. As before, half of the letters say that DEF’s stock will rise, the other half that it will fall. Over the next three months, the broker sends mass mailings making similar contradictory predictions about GHI’s stock, then about JKL’s stock, and finally about MNO’s stock. The next month, the broker sends a final letter to the 625 investors who received an unbroken stream of five accurate predictions. The letter points out how much they would have made had they relied on the broker’s predictions and offers his services – for a large fee. Impressed with his track record, many of the recipients invest through the broker.¹

Did the broker commit fraud under U.S. securities law? Technically, the letters were truthful. The 625 investors in the broker’s final solicitation had actually received five consecutive accurate predictions and could have profited from these predictions. But the misleading nature of the broker’s conduct is obvious. The investors were never told that the broker simultaneously had made contradictory, incorrect predictions to other investors. The broker only disclosed his successes, not his failures, and so misled investors into believing that he had stock-picking skill.

This article reveals that the process by which many mutual fund companies bring new funds to market deceives investors much as our enterprising broker did. Through a process known as “incubation,” a fund company creates a number of start-up funds (“incubator funds”), typically seeded with the company’s or its insiders’ own money, that are allowed to operate outside of the public eye for up to

¹ See DANIEL R. SOLIN, THE SMARTEST INVESTMENT BOOK YOU’LL EVER READ 45-46 (2006) for a version of this story.
several years. During their incubation periods, these funds are not marketed to the public, although they are registered with the SEC because only post-registration performance data can subsequently be reported and advertised. After incubation, the company actively markets the strong performers, their strong returns highlighted in advertising to attract investors. The weak performers are quietly terminated, their existence hidden from the public.

Fund companies mislead investors by marketing high-performing incubator funds without mentioning the process by which they were culled from their low-performing brethren. By highlighting successful incubation funds and not disclosing the failure rate in the incubation process, fund companies make it appear that the high-performing funds’ managers have special stock-picking abilities – and that the high returns are likely to continue. Studies show, however, that after being sold to the public, these high performers generally do not continue to outperform other funds. Strong performance during an incubation period is often simply a matter of chance.

To make matters worse, some fund companies artificially inflate the returns of their incubator funds. For example, they overallocate “hot” initial public offerings – which are very likely to rise quickly in price – to their incubator funds. They also underallocate fund company-level costs to their incubator funds, relative to their larger, more mature funds. In addition, they keep their incubator funds very small during incubation, making it easier for a few good stock picks to generate high fund returns. But this favorable treatment is not clearly disclosed and does not continue after the funds are sold to the public.

Although fund incubation misleads investors, the SEC has paid little attention to the issue. The agency has challenged only a couple of extreme cases of undisclosed fund subsidization despite evidence that it is widespread. In addition, it has allowed companies to choose to actively market only their high-performing incubator funds without disclosing the misleading selection bias that results. Fund incubation deserves much more scrutiny. Fund marketing that highlights only incubator fund successes without also revealing failures is inherently misleading.

This article fills a vacuum in the legal literature and identifies and addresses an important regulatory challenge.
It is the first article to examine comprehensively both how incubation misleads investors and the SEC’s desultory response thereto. It also provides a better regulatory approach to the problem of incubation. Section I presents background information about the size and scope of the mutual fund market, which provides a primary vehicle for U.S. retirement savings. It also describes how investors flock to funds with high past performance. Section II, drawing on studies from the finance literature, examines how fund companies use incubation to create and then market new funds with artificially strong performance. Section III describes the limited and inadequate steps the SEC has taken to regulate the misleading marketing of incubator funds. Finally, Section IV proposes and discusses additional steps that the SEC could take to prevent the misuse of incubator funds.

I. The Mutual Fund Market

A. Importance of Mutual Funds

A mutual fund pools multiple investors’ money into a single investment portfolio managed by a fund management company. An investor who purchases shares of the fund is entitled to the proportionate return from the assets held by the fund. Thus a fund shareholder does not own the fund assets directly, but rather owns a piece of the mutual fund. Funds vary considerably, including in the types of financial assets they hold, their investment objectives and strategies, and their fees and expenses. The SEC is the primary regulator of the mutual fund industry, but no government agency guarantees or insures shareholders’ fund investments.

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3 Id.
4 Id.
5 Id.
6 Id.
As of the end of 2007, U.S. mutual funds held $12 trillion in assets and 24% of all outstanding equity of U.S. public companies. Investors have a great number of funds to choose from—8752 as of the end of 2007. Although no single fund family dominates the mutual fund market, the five largest fund families control 38% of the industry’s total assets. Some fund families, such as Fidelity Investments and the Vanguard Group, offer more than a hundred funds.

Ownership of mutual funds is widespread. Of the 116 million households in the United States, almost 52.5 million (or 45%) own mutual funds, far more than hold individual securities, such as stocks and bonds. In addition, most households that hold mutual funds have moderate income and wealth. The median household income of mutual fund investors is $74,000, and two-thirds of households that own mutual funds have incomes of less than $100,000, and 26% have incomes below $50,000. In addition, fund-owning households have median total financial assets of only $175,000 and a median of $100,000 invested in mutual funds.

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8 Id. at 11 fig.1.4. [NOTE: WILL UPDATE IN SPRING WHEN NEW DATA IS RELEASED]
9 Id. at 15 & fig.1.8.
10 Id. at 21 fig.2.2.
13 INVESTMENT COMPANY INSTITUTE, PROFILE OF MUTUAL FUND SHAREHOLDERS 6 fig.1.3 (Spring 2008), http://www.ici.org/stats/res/rpt_profile08.pdf.
14 Id.
15 2008 FACT BOOK, supra note 7, at 71 fig.6.2.
Mutual fund ownership is so widespread largely because mutual funds have become a primary way that Americans save for retirement. Primarily as a result of the rapid growth of mutual fund investments in defined-contribution retirement plans and Individual Retirement Accounts, mutual funds’ total share of retirement assets increased from 5% at the end of 1990 to 24% in September 2008. Mutual funds now constitute almost a quarter of America’s retirement savings.

Consistent with the long-term investment horizon of many fund investors, 39% of mutual fund holdings are in equity funds, with most of the rest in money market funds (40%) and bond funds (18%). Equities tend to have higher returns in the long run, but greater risk in the short run, than bonds and money market securities.

In summary, our nation relies upon mutual funds. Ownership of mutual funds has become widespread, as almost half of American households own mutual funds and the typical mutual fund investor has only moderate income and financial assets. Mutual funds constitute a significant portion of our savings and are a particularly important part of our retirement system. Thus, it is important that investors are not misled when choosing among mutual funds.

B. Performance-Chasing by Fund Investors

As documented in the last section, mutual funds have become a very important vehicle for investment and retirement savings in the United States. Because of their importance, mutual funds have attracted much attention from scholars. As a result, an extensive body of research

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exists examining how investors choose among the vast number of available funds. Unfortunately, these studies paint an unflattering portrait of the typical mutual fund investor. This research finds that fund investors generally are uninformed and lack financial sophistication. For example, most fund investors are unaware of the investment objectives, composition, and risks of their funds. In addition, most investors are ignorant of the level of fees and expenses charged by their funds, and these costs are often not an important factor in their fund choices.\footnote{For a survey of these studies see Alan R. Palmiter & Ahmed E. Taha, \textit{Mutual Fund Investors: Divergent Profiles}, 2008 Colum. Bus. L. Rev. 934, 974-94 (2008).}

Although investors pay little attention to a fund’s objectives, risk, and costs, they pay great attention to a fund’s historical returns. Studies find that this may be the most important factor to the typical fund investor.

1. **Investors chase past returns**

Surveys uniformly identify the importance of a fund’s past returns to investors. Capon, Fitzsimons, and Rice conducted a telephone survey of almost 3,400 households that invest in mutual funds.\footnote{Noel Capon, Gavan J. Fitzsimons, & Russ Alan Prince, \textit{An Individual Level Analysis of the Mutual Fund Investment Decision}, 10 J. FIN. SERVICES RES. 59 (1996).} They found that a fund’s “investment performance track record” is the most important factor in investors’ choice of funds.\footnote{\textit{Id.} at 66.} Also, a survey sponsored by the Investment Company Institute – the trade association of the mutual fund industry – of 737 randomly-selected mutual fund investors found that 69% reviewed a fund’s “historical performance” before investing.\footnote{INVESTMENT COMPANY INSTITUTE, \textit{UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION} 1 (Aug. 2006), http://ici.org/pdf/rpt_06_inv_prefs_full.pdf (last visited Feb. 21, 2009) [hereinafter ICI, INVESTOR PREFERENCES].}

Experiments involving investors have similar findings. An experiment by Wilcox asked fund investors to choose among hypothetical stock mutual funds differing in up to six characteristics: (1) the fund company’s name, (2) the fund’s
load, (3) the fund’s annual management fee; (4) the fund’s return during previous year, (5) the fund’s average annual return during the previous 10 years, and (6) the fund’s beta.\textsuperscript{23} The experiment found that a fund’s returns over the past ten years and over the past year were the two most important factors to investors.\textsuperscript{24}

Studies of investors’ actual behavior confirm that investors flock to mutual funds with the highest past returns. For example, Del Guercio and Tkac examined fund flow – the aggregate amount that investors put into or withdraw from a particular fund during a particular period – for a large sample of equity mutual funds.\textsuperscript{25} They found that a fund’s past return has a strong positive effect on flow.\textsuperscript{26} In addition, this positive relationship was strongest for funds with the highest past returns, indicating that investors especially chase the highest-performing funds.\textsuperscript{27} Similarly, Sirri and Tufano’s study of flow into equity mutual funds found that having higher returns garnered a fund more flow. This was especially true for the highest performing quintile of funds, showing again that investors pursue funds with the strongest past performance.\textsuperscript{28}

2. **Past returns are poor predictors of future returns**

Although investors chase funds that have produced the highest returns, there is little reason for them to do so. The finance literature finds only “weak and controversial


\textsuperscript{24} Id. at 650.


\textsuperscript{26} Id. at 525. They used the fund’s excess return (the extent to which it outperforms the S&P 500) as the measure of the fund’s return. Id. at 539.

\textsuperscript{27} Id. at 525.

evidence that past performance has much, if any, predictive ability for future returns.”

In other words, little evidence of returns persistence exists; top performing funds generally do not continue to significantly outperform other funds.

Furthermore, even to the extent some persistence exists, it may not be meaningful to investors picking among mutual funds because of the transaction costs, such as loads and capital gains taxes, that would be incurred in chasing recent high performers. In a survey of studies on returns persistence, Cuthbertson, Nitzsche and O’Sullivan find some evidence of small performance persistence by the highest performing funds, but conclude that “it seems likely that such costs [e.g., loads, rebalancing costs and taxes] would outweigh” the extra returns that investors could gain by chasing this performance persistence.

Even in situations in which past performance will definitely not be predictive of future returns, investors still irrationally chase performance. In an experiment involving many Wharton MBA and Harvard College students – a group likely more sophisticated than typical fund investors – Choi, Laibson, and Madrian asked participants to allocate an investment among four S&P 500 index funds with different

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29 Wilcox, supra note 23, at 651.


31 Nicolas P.B. Bollen & Jeffrey A. Busse, Short-Term Persistence in Mutual Fund Performance, 18 REV. FIN. STUD. 569, 587-88 (2004). Many mutual funds charge front-end or back-end (deferred) loads that investors must pay when they buy or sell fund shares, respectively. Also, to discourage short-term trading, many mutual funds impose fees on investors who sell shares soon after buying them. In addition, when an investor sells mutual fund shares for a gain, the investor must pay capital gains taxes. Investors who sell fund shares less than one year after buying them pay a higher capital gains tax rate than do investors who hold the shares for more than one year.

expense ratios. Participants would maximize their expected compensation for participating in the experiment by choosing the fund with the highest future return, which for index funds is the fund with the lowest expense ratio. In the experiment, however, the higher-expense funds had higher reported past annualized returns, but only because they had different inception dates than the other funds. Participants nonetheless chose the index funds that had the higher past returns, even though these higher-expense funds would necessarily underperform the lower-expense funds in the future.

In summary, in choosing a mutual fund, investors put far too much emphasis on high past performance, a factor with little ability to predict future returns. The tendency of investors to chase high past returns, however, has important implications for mutual fund companies because management fees are based on the amount invested in the fund.

3. Fund companies advertise strong past performance

Because investors chase past returns, it is unsurprising that mutual fund companies often advertise strong past performance. Huhmann and Bhattacharyya found that almost 42% of mutual fund advertisements in Barron’s and Money magazine over a two-year period mentioned a fund’s high or increasing returns, and an additional 26% of the advertisements explicitly discussed a fund’s risk-adjusted returns.

Similarly, Mullainathan and Shleifer examined mutual fund advertisements that appeared in Money and BusinessWeek over a nine-year period and ten-year period,

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34 Id. at 4, 21.
35 Id. at 4.
36 Id.
respectively. They found that funds’ past returns were mentioned, on average, in 62% of equity mutual fund advertisements appearing in *Money*, and in 59% of equity mutual fund advertisements appearing in *BusinessWeek*. Moreover, they found a high correlation (greater than 0.7) between the percentage of equity fund advertisements that mention past returns and the recent performance of the stock market in general.

In addition, Swensen examined the extent of mutual fund advertising from 1997 to 2003 in the first quarter of the *Wall Street Journal’s Mutual Funds Quarterly Review*, a quarterly mutual-fund supplement in the *Wall Street Journal*. He found that the space dedicated to mutual fund advertisements was highly positively correlated to stock prices. For example, during the bull market from 1998 to 2000, mutual fund advertisements constituted between 40-44% of the nearly fifty page *Reviews*. Then, as the bull market ended, fund advertising was significantly reduced, reaching only 16% of the thirty-four page *Review* in 2003. In addition, performance advertisements – advertisements that present a fund’s past returns – plunged from being 61% and 56% of all fund advertisements in the high-performance years of 1999 and 2000, to being only 28% and 26% in the low-performance years of 2001 and 2002. Thus, total pages of performance advertisements dropped by approximately 83% from 12.1 pages in 1999 to 2.0 pages in 2003.

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39 *Id.* at fig. 5. These averages were calculated by counting the percentage of equity fund advertisements each quarter that mentioned the fund’s returns, and then averaging these quarterly measures.

40 In particular they found that the correlation of one quarter lagged S&P 500 returns with the percentage of equity fund advertisements that mention past returns was 0.71 for *Money* and 0.74 for *BusinessWeek*. *Id.*


42 *Id.* at 168 tbl.5.4.

43 *Id.* In 1998, the Review had 48 total pages, 44% of the space was mutual fund advertisements, and 44% of these advertisements were performance advertisements, so there were a total of 12.1 performance advertisement pages (48 pages x .44 x .44 = 12.1). In 2003, the Review had 34 total pages, 16% of the space was mutual
Mutual fund companies are especially likely to advertise particular funds that have performed well. Jain and Wu examined fund flows into 294 equity mutual funds that advertised in Barron’s or Money magazine. They found that advertised funds outperformed non-advertised funds with the same investment objective by an average of approximately 6% over the twelve months prior to the advertisements. The advertised funds also outperformed other benchmarks, such as the S&P 500 index, although by less. Similarly, Koehler and Mercer examined equity mutual fund performance advertisements that appeared in BusinessWeek and Fortune magazines over a four-year period. They found that mutual fund companies tend to advertise their funds that have performed the best.

Fund advertising is effective. In Capon, Fitzsimons and Prince’s survey, fund investors stated that advertising was their second most important source of information about funds. Also, Jain and Wu found that advertised funds experience approximately 20% greater flow than do similar funds that do not advertise. In addition, they found that

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45 Jain & Wu, supra note 44, at 943-46 & tbl.II.


47 In particular, the advertised funds’ median one-year, five-year, and ten-year performance was at the 80th, 100th, and 100th percentile, respectively, of all company-operated equity funds that share the same investment objective. The advertised funds also had a median one-year, five-year, and ten-year performance at the 79th, 88th, and 88th percentile, respectively, of all company-operated equity funds, irrespective of the investment objective. Id. at 9.

48 Capon et al., supra note 20, at 66 tbl.1.

funds that are advertised more often receive even more flow.50

Similarly, Gallaher, Kaniel and Starks examined the effect of advertising on flows into approximately 100 fund families. They found that the effect of advertising on flows into fund families is convex: “High relative levels of advertising are significantly related to high fund flows at the family level, while variations of relative levels of advertising within the low advertising group do not have a significant impact on flows to the family.”51 In other words, fund investors respond to advertising inundation.

In summary, by advertising funds that have performed well, mutual fund companies encourage and exploit investors’ tendency to chase strong past performance. Advertising of high past returns attracts investment, thus increasing the management fees that investors pay these fund companies, even though these high returns generally do not persist.

II. Incubation of Mutual Funds

Given the importance that investors place on past performance, fund sponsors have a great incentive to create and market funds with a record of strong returns. Through fund incubation – the process of creating new funds outside of the public eye and then selling only the strong performers to the public – companies can generate new funds with misleadingly high returns. In addition, incubator funds are often subsidized to falsely create an even more impressive performance record. This section describes the incubation process and its prevalence, the superior performance of incubator funds before they are sold to the public relative to how they perform after, and the reasons for this performance differential.

A. Process and Prevalence of Fund Incubation

50 Id.
51 Gallaher et al., supra note 44, at 31.
In general, mutual fund incubation involves the creation by a fund company of an investment fund, typically with a small amount of seed money supplied by the company or its insiders. After a period of usually between several months and several years, the fund company decides – largely based on the fund's performance – whether to terminate the fund or actively market it to the public. Before a fund can be sold publicly, it must be registered with the SEC. Sometimes fund companies wait to register a fund until they decide to open the fund to the public; this is called “private incubation.” Sometimes fund companies initially register the fund, but don’t actively market it until they see how the fund performs; this is called “public incubation.” This article refers to both approaches as “incubation.”

Fund incubation, which publicizes high-performance successes and hides low-performance failures, is necessarily opaque. Because fund sponsors do not disclose that high-performing new funds were culled from low performers – and actually try to hide the low performers from public view – determining the prevalence of incubation is difficult.

Nonetheless, several indications exist that fund incubation is common. Fund companies often terminate the registration of a fund before it is offered to the public, or delay in offering a registered fund to the public. The most plausible explanation for such cases is that the fund company was waiting to see whether the fund's performance would be strong enough to market to the public. Thus, these cases are strong evidence of incubation.

1. Fund terminations before going public indicate incubation

One indicator of possible incubation is the deregistration of a fund before its shares are sold to the public. When a registered fund is terminated, the fund sponsor may file an application for deregistration with the SEC under section 8(f) of the Investment Company Act of 1940. Deregistration of

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53 Id.
a fund before it was offered to the public indicates disappointing pre-public performance. Such deregistrations are not rare. For example, Evans and Chiang found that at least 49 funds applied for deregistration from July 1997 to July 2000 before going public.\textsuperscript{55} Counting only such deregistered funds, however, greatly understates the prevalence of incubation. Deregistration notices only reveal those unsuccessful, registered incubator funds that fund companies decided to not take public. They do not include registered incubator funds that continue to operate, but have not yet been taken public. Nor do they include successful incubator funds that have been taken public and are still in operation.

2. A long lag between inception and ticker symbol indicates incubation

Another indicator of fund incubation is a long lag between the fund’s inception and the fund sponsor’s obtaining a ticker symbol for the fund. Fund sponsors can effectively avoid making even registered funds available to the public by not seeking a ticker symbol for the fund. Although a fund could legally be sold to the public after it is registered, as a practical matter the public is unable to buy the fund until it receives a ticker symbol.

The practice of delaying obtaining a ticker symbol appears to be widespread. For example, looking at approximately 800 publicly available domestic equity mutual funds that began operations after 1996 and received a ticker symbol before 2007,\textsuperscript{56} Evans found that 39\% of these funds had more than twelve-month lags between their inception date and when they received a ticker symbol, and 10\% had a lag of at least 34 months.\textsuperscript{57}

The effect of withholding a ticker symbol is dramatic. Evans examined funds with more than a twelve-month lag

\textsuperscript{55} They found these applications for deregistration in the Dow Jones News Archive. Craig Wisen & Kevin Chiang, \textit{Explaining the Initial Returns of Mutual Funds}, 15 \textit{J. INVESTING} 53, 54 (Summer 2006).

\textsuperscript{56} Domestic equity funds have as their objective to invest primarily in the stock of American companies. Evans, \textit{supra} note 52, at 8.

\textsuperscript{57} \textit{Id.} at 9.
between their inception date and when they received a ticker symbol, comparing their size before and after they obtained a ticker symbol. He found that the median size of such funds during their incubation period (or pre-ticker symbol) was only $6.4 million; the median size after incubation (or post-ticker symbol) was $52.9 million – more than eight times as large.\(^{58}\)

3. A long lag between inception and reporting to data providers indicates incubation

Registered funds can also be kept from the public view by not reporting their existence to mutual fund data providers such as Morningstar.\(^{59}\) Morningstar relies upon fund sponsors to notify it about the creation of a new fund. Thus, another sign of incubation is a long delay between when the fund began operations and when information about the fund appears in Morningstar.

When a fund first appears in Morningstar, its returns since its inception date are included. Therefore, the length of these “back returns” is a measure of how long the fund sponsor waited to report the fund to Morningstar. Lengthy delays in reporting a fund appear common. Ackerman and Loughran examined the 95 domestic equity mutual funds that entered Morningstar's fund database in the month of January from 2000-2003.\(^{60}\) Of these, 73% (or 69) reported at least six months of back returns, and 49% (or 47) reported at least twelve months of back returns.\(^{61}\)

Other evidence of incubation is a fund company delaying reporting the existence of a registered funds to the Center for Research in Securities Prices (“CRSP”), another creator of databases of mutual fund information. The CRSP Survivor Free Mutual Fund Database contains information about

\(^{58}\) Id. at 10. The mean fund size showed similar growth, from $32.2 million during the incubation period to $243.1 million after incubation. Id.

\(^{59}\) Id. at 5-6.

\(^{60}\) Carl Ackerman & Tim Loughran, Mutual Fund Incubation and the Role of the Securities and Exchange Commission, 70 J. BUS. ETHICS 33, 34 (2007).

\(^{61}\) Id. at 35 & tbl.2.
approximately when a fund began operations and approximately when it was terminated. Like Morningstar, it relies upon fund sponsors to inform it of the existence of a new fund. Wisen and Young found that relatively new funds make up a very low percentage of terminations in this database. For example, from 1993 to 1999, only 9% to 12% of the terminated funds in the database were less than 18 months old. In contrast, 40% to 43% of the terminated funds were 18 to 36 months old. One possible explanation for this difference is that fund sponsors delay reporting many new funds to CRSP and that many new funds are terminated before their existence is ever reported to CRSP.

B. Performance of Incubator Funds

During their incubation period, incubator funds that are eventually taken public outperform comparable seasoned funds, but don’t continue to outperform them after being sold to the public. Given how incubation period performance is manipulated, however, the marketing to investors of incubator funds based on their incubation period returns is inherently misleading.

1. During incubation, incubator funds outperform other funds

Studies have uniformly found that, during their incubation, incubator funds significantly outperform comparable older funds. In Evans’ large sample of domestic equity mutual funds, the “incubated” funds – those with at least 12 months between their inception date and when they received a ticker symbol – had a 15.3% higher annualized return during their incubation period than did never-incubated funds during their own first three years of operations. When adjusted for risk, the difference in

63 Id. at 54. Other possible explanations are that new funds are terminated less frequently because they perform better than older funds or because fund sponsors often give a grace period to new funds before deciding to terminate them. Id.
64 Evans, supra note 52, at 11 & tbl.2.
annualized returns was smaller although still significant, ranging from 1.9% to 5.5%, depending on which risk-adjusted measure was used.\textsuperscript{65}

Ackermann and Loughran define incubation period returns as returns occurring before the fund appeared in Morningstar. Using a sample of 95 domestic equity funds that appeared in Morningstar’s database for the first time in the month of January from 2000 to 2003, they found that funds had a statistically significant 1.8% better return than the overall stock market\textsuperscript{66} in their last month of incubation (i.e., the month prior to appearing in Morningstar), and a 3.6% better return than the market during their last twelve months of incubation.\textsuperscript{67}

Taking an even broader look at the performance of new funds, Wisen and Chiang compared the performance of “new” and ”seasoned” domestic growth funds that appeared in Morningstar's database from 1994 through 1999. They defined new funds as those that were no more than 9 months old, and seasoned funds as those more than 12 months old. They found that the new funds had higher risk-adjusted returns than even the smallest quartile of similar, seasoned funds. The new funds’ outperformance ranged from 0.27% to 0.85% per month, depending on whether they were large-capitalization, medium-capitalization or small-capitalization funds.\textsuperscript{68} These results likely understate the true difference between new and seasoned fund returns because the study included only seasoned funds still operating at the end of 1999; seasoned funds terminated before then were not

\textsuperscript{65} Id.
\textsuperscript{66} They compared funds’ returns to the average return of the CRSP value-weighted market index over the same period. Ackerman & Loughran, \textit{supra} note 60, at 35, & tbl.2.
\textsuperscript{67} Id. Because only 47 funds in their sample had at least twelve months of back-returns, the 3.6% difference between these returns and the overall stock market was not statistically significant. Id.
\textsuperscript{68} New large-capitalization growth funds outperformed similarly-sized seasoned large-capitalization growth funds by 0.27% per month; new middle-capitalization growth funds outperformed similarly-sized seasoned middle-capitalization growth funds by 0.85% per month; and new small-capitalization growth funds outperformed similarly-sized seasoned small-capitalization growth funds by 0.70% per month. Wisen & Chiang, \textit{supra} note 55, at 59 exh.4. To adjust for risk, they use a four factor model that controls for market risk, capitalization, valuation, and momentum factors. Id. at 53, 58, 59 exh.4.
included. Because funds that perform poorly are more likely
to be terminated than those that perform well, a
survivorship bias exists in the data, inflating the average
returns of the seasoned funds.  

The Wisen and Chiang data, however, do not distinguish
between new funds sold to the public after an extended
incubation period and those brought to market soon after
inception. As a result, the new fund returns represent a mix
of incubation and post-incubation returns. In addition,
because incubation periods can extend beyond a year, some
of the seasoned funds’ returns likely include incubation
period returns. However, the new funds’ returns contain
much more incubation period returns than do the seasoned
funds’ returns, thus the new funds’ higher returns are
evidence that incubator period returns are generally higher
than later returns.

The strong performance of incubator funds may be
increasing. Arteaga, Ciccotello and Grant compared the
performance of “new” and “established” aggressive growth
mutual funds that appeared in the Alexander Steele Mutual
Fund Database from 1988 to 1997. They found that “new”
funds (defined as those in their first full year of opera
tions) generally outperformed the “established” funds. They
further found that the outperformance of new funds
increased during the period studied and was particularly
high toward the end. For example, new funds outperformed
established funds by a statistically significant 5.9% in 1996
and 4.4% in 1997. As in Wisen and Chiang’s study, the
data used by Arteaga, Ciccotello and Grant do not allow
them to determine whether a fund had been incubated before
being sold to the public. As a result, the new fund returns
very likely are a mix of incubation and non-incubation period
returns. In addition, because incubation periods can extend
beyond a year, some of the “established” funds’ returns likely
include incubation period returns. However, the “new”
funds’ returns contain much more incubation period returns

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69 Id. at 56, 59 exh.4.

70 The database was compiled by the Kiplinger Investment
Grant, New Equity Funds: Marketing and Performance, 54 FIN.

71 Id. at 46 tbl.2.

72 Id. at 45 tbl.1.
than do the “established” funds’ returns, thus the new funds’ higher returns are evidence that incubator period returns are generally higher than later returns.

In summary, there is significant evidence that, at least among funds that are eventually sold to the public, funds in their incubation period outperform older, comparable funds.

2. After incubation, incubator funds do not continue to outperform other funds

Although during their incubation period, incubator funds that are eventually taken public outperform comparable funds, they generally do not continue to do so afterward. The same studies that identify high incubation-period returns generally find lower returns once these incubator funds are sold to the public.

As noted above, in his study of domestic equity funds, Evans found that incubation period returns were 15.3% higher (annualized) than those of similar never-incubated funds. However, in the three years after being taken public, incubator funds had approximately a 3.5% lower annualized return than did never-incubated funds during their own first three years of existence.\(^73\) When adjusted for risk, the incubated funds outperformed the never-incubated funds slightly – from 0.2% to 2.6% annualized, depending on which risk-adjusted measure was used – but only under one of the four risk-adjusted measures was this difference statistically significant.\(^74\)

Similarly, Ackermann and Loughran’s sample of domestic equity funds did not continue their strong performance after incubation. Recall that these funds outperformed the market by 3.6% in their last twelve months of incubation (i.e., the twelve months prior to appearing in Morningstar) and by 1.8% in their last month of incubation.\(^75\) In the first month after inclusion in Morningstar, however, they outperformed the market by only a statistically insignificant 0.6% and then quickly fell behind,

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\(^{73}\) Evans, *supra* note 52, at 10 & tbl.2.
\(^{74}\) *Id.*
\(^{75}\) Ackerman & Loughran, *supra* note 60, at 35 tbl.2.
underperforming the market by a statistically significant 4.2% in the first year after their inclusion in Morningstar.\textsuperscript{76}

Lack of performance persistence also held true for the aggressive growth funds studied by Arteaga, Ciccotello and Grant. They found that “new” funds (defined as those in their first year of operations) did not continue to outperform “established” funds, but instead reverted to the mean. In their study, only 48.6% of the “new” funds that outperformed “established” funds in their first full year of operations also outperformed them in the next year.\textsuperscript{77}

In addition, they were able to definitively identify five mutual funds as incubator funds and determine the exact dates that these funds commenced operations and when they were opened to the public. They found that these five funds outperformed the S&P 500 by an average of 8.0% (annualized) during their incubation period, but underperformed the S&P 500 by an average of 4.0% (annualized) after they were opened to the public.\textsuperscript{78} Although a very small sample, the experiences of these five funds again demonstrates that strong incubation period performance generally does not continue after a fund is opened to the public.

In summary, funds that are eventually taken public have strong performance during their incubation periods. However, this performance generally does not continue after the funds are opened to the public. The next section of this article discusses why strong incubation period performance does not persist.

3. Incubator funds’ strong performance doesn’t continue for multiple reasons

Why do new funds sold to the public have superior performance during their incubation period, but only middling performance afterward? Two likely explanations

\textsuperscript{76} Id.
\textsuperscript{77} Arteaga et al., supra note 70, at 45-46 & tbl.3.
\textsuperscript{78} Id. at 47-48 & tbl.5. The five funds were the John Hancock Global Marketplace, Putnam New Value, State Street Aurora, Transamerica Premier, and VanKampen American Capital Growth funds. Id. at 48 tbl.5.
exist. First, fund sponsors often give incubator funds preferential treatment during their incubation periods. Second, a selection bias exists: funds that have strong incubation period performance are more likely to be sold to the public. However, strong incubation performance is usually just a matter of luck, and this luck generally does not continue after the incubation period ends. This section discusses both explanations.

**a. Fund companies often give incubator funds preferential treatment during incubation**

New funds sometimes are subsidized during incubation by the fund company to generate investor-attracting higher returns. The first type of subsidy is the overallocation by the fund sponsor of oversubscribed initial public offerings (“hot IPOs”) to its incubator funds. Because an incubator fund is very small, even a small allocation of hot IPO shares can significantly boost its returns. Thus, by allocating hot IPO shares to an incubator fund, the sponsor can increase the fund’s returns during the incubation period.

Evidence exists that incubator funds are overallocated hot IPOs, artificially boosting their incubation period returns. In their study comparing the returns of “new” growth funds (which include more incubation period returns) to those of comparable “seasoned” growth funds, Wisen and

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79 For many reasons, a corporation’s first sale of stock to the general public (i.e. its IPO) is often underpriced intentionally to ensure that the stock’s price will immediately rise. Sean J. Griffith, Spinning and Underpricing: Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings, 69 Brook. L. Rev. 583, 590-623 (2004). Because the IPO is offered at too low of a price, people offer to buy more IPO shares than are available; in other words, the IPO is oversubscribed. Someone who is able to buy the stock at the initial price (its “offering price”) is therefore virtually assured of a profit in the short-term because the excess demand for the IPO will cause the stock’s price to rise immediately after the IPO is issued. Id. at 593 n.29. A mutual fund sponsor who receives an allocation of such an oversubscribed IPO at its offering price can choose how to distribute the IPO shares among the funds it sponsors. Edward Wyatt, It’s a Fund, Bringing Up Baby Mutuals, N.Y. TIMES, Mar. 16, 1997, at Sec.3, available at 1997 WLNR 4877783.

80 Arteaga et al., supra note 70, at 44.
Chiang found the new funds’ returns were more sensitive to IPOs’ first-day returns than were seasoned funds’ returns.\textsuperscript{81} This greater sensitivity indicates that new funds contained a greater percentage of IPOs than did seasoned funds.\textsuperscript{82} As we discuss below, the SEC has pursued a couple of egregious cases of overallocation of hot IPO’s to new funds. Wisen and Chang’s study, however, indicates that the overallocation of hot IPOs is a more widespread problem than the infrequency of the SEC’s enforcement actions suggests.

Another way that fund sponsors subsidize incubator funds is by underallocating the fund company’s costs to them. All else equal, a fund with lower fees and expenses will have higher returns. Evidence exists that fund companies underallocate 12b-1 fees to incubator funds.\textsuperscript{83} Wisen and Chiang found that fund families allocated only 8.6\% of the average new fund’s annual fee to 12b-1 fees, while generally 14.4\% of annual fees for fund families were 12b-1 fees. This suggests fund sponsors favored incubator funds by allocating less of the sponsor’s 12b-1 fees to them.\textsuperscript{84}

Another way that fund companies boost the returns of their incubator funds is by keeping them very small during incubation. To the extent that strong incubation performance reflects stock-picking skill,\textsuperscript{85} managers have difficulty in continuing to exhibit this skill after the fund’s

\textsuperscript{81} An IPO's first-day return is the increase in the stock price on the first day it is traded publicly. Thus, an IPO's first-day returns is a measure of degree to which IPO's are underpriced; the more underpriced an IPO is, the more its price will rise when it is first publicly traded. Wisen & Chiang, supra note 55, at 60, 61 exh.5.

\textsuperscript{82} In particular, they found that new large-cap and mid-cap growth funds' returns were approximately twice as sensitive to IPO first-day returns as were seasoned large-cap and mid-cap growth funds' returns. New small-cap growth funds' returns had approximately the same sensitivity as did seasoned small-cap growth funds' returns, with the exception of the smallest small-cap growth funds. Id. at 61 exh.5.

\textsuperscript{83} 12b-1 fees are used to market funds. A fund family that imposes 12b-1 fees on investors has discretion in how to allocate these fees among the family's funds. Id. at 63.

\textsuperscript{84} Id. Recall that Wisen and Chiang define a “new fund” as a fund during the first 12 months after its inception. Thus, these “new funds” likely include many funds during their incubation period. Id.

\textsuperscript{85} In the next section of this article we point out that strong incubation-period performance generally reflects good luck rather than skill. See infra pp. 26-31.
size grows dramatically when the fund is marketed to the public.

Successful incubator funds typically grow markedly when they are sold to the public. Evans found that after obtaining a ticker symbol, which allowed them to be sold to public, incubator funds grew by an average of approximately 700%. 86

Managers of larger funds may have greater difficulty producing superior returns than do managers of small funds because they have fewer investment options. For example, a small amount of money can be easily invested in a stock with a low market capitalization. However, investing a much larger sum in the same stock is difficult – there may not be enough shares on the market and, even if there are, if it is a thinly traded stock, a large purchase would have to be made at a much higher price than would a small purchase. 87

Indeed, a study by Chen, Hong, Huang, and Kubik found a significant, negative relationship between fund size and returns for funds that invest in small-capitalization stocks. 88

The fact that many mutual funds close – i.e. refuse to accept new investors upon reaching a certain size – indicates that many fund companies believe that increasing fund size makes strong performance less likely. Even though management fees are directly related to fund size, and even though there are great economies of scale in managing mutual funds, 89 these companies believe that at some point a fund’s size becomes a too large of a drag on its returns. 90

Other evidence exists that larger fund size makes strong performance more difficult to achieve. 91 Barras, Scaillet, and Wermers examined the lifetime performance of 2,076 active

86 Evans supra note 52, at 9, 29 tbl.I.
87 Joseph Chen, Harrison Hong, Ming Huang, & Jeffrey D. Kubik, Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization, 94 AMER. ECON. REV. 1276, 1277 (2004).
88 Id.
89 Id. at 1276-77.
managed domestic equity funds that existed at any time between 1975 and 2006. They found that a small, yet statistically significant, percentage (2.4%) of domestic equity funds exhibit short-run investing skill after expenses, yet only a statistically insignificant percentage (0.6%) exhibit skill in the long run. This difference might be explained by investors flocking to funds that outperformed in the short-run, forcing their fund managers to invest much more than before, and thus being unable to continue to outperform in the long run.

b. Fund companies select strong-performing incubator funds to sell to the public

The criteria by which incubator funds are selected to be marketed to the public is another reason that incubator funds appear to perform better during their incubation period than after. Luck is a major factor in the performance of mutual funds. Funds often perform well over a particular time period — including during incubation — because of simple luck, not because of the fund manager’s stock-picking skill. Because fund sponsors generally choose to take public those funds that had strong incubation period returns, new funds that are sold to the public have been lucky, as a group. However, their luck — and their corresponding high returns — generally does not continue after they are taken public. Funds companies’ method of marketing incubator funds hides the large role the luck plays in incubation returns. They market a disproportionate number of the lucky, successful incubator funds and do not inform investors that those funds were culled from many unsuccessful incubator funds that are hidden. Thus, investors are unable to infer the great role that luck plays in an incubator fund’s performance.

Luck’s role in mutual fund performance should not be underestimated. Because thousands of equity mutual funds

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92 Id. at 18-19, 35 tbl.II, 36 tbl.III.
93 Id. at 2 (noting that their empirical finding of little long run skill is “supportive of the long-run equilibrium theory of Berk and Green,” which predicts that funds that exhibit short-run skill will receive so much new investment that they will not be able to continue to outperform other funds in the long run).
exist, a very large number of funds would outperform market indexes even if all fund managers were picking their portfolios randomly. A recent study by Barras, Scaillet, and Wermers quantified the role of luck.\textsuperscript{94} As noted above, they examined the lifetime performance of 2,076 active managed domestic equity funds that existed at any time between 1975 and 2006. They found that, after expenses, only 2.2% of funds had statistically significant, long-term, abnormal positive returns.\textsuperscript{95} However, when luck was accounted for – i.e. the fact that out of 2,076 funds, many would outperform solely because of luck – only 0.6% of funds actually exhibited skill in their long-term performance.\textsuperscript{96} This result was not even statistically significant, meaning that there is not persuasive evidence that any funds are skillful enough to outperform their benchmarks in the long-run.\textsuperscript{97} A little more evidence of short-run skill exists. Specifically, a statistically significant 2.4% of the funds exhibited skill over five-year periods.\textsuperscript{98}

Although luck plays a major role in fund performance, this role is hidden from investors in newly-public incubator funds. Studies find that fund sponsors are much more likely to take public their strong-performing incubator funds than their weak-performing incubator funds. For example, Evans compared a sample of 172 incubator funds eventually opened to the public to a sample of 55 incubator funds that were terminated before ever being opened to the public.\textsuperscript{99} He found that the opened funds had over 13% higher annualized returns during their incubation periods than did the non-

\textsuperscript{94} Id.
\textsuperscript{95} Id. at 16, 35 tbl.II.
\textsuperscript{96} Id. at 35 tbl.II.
\textsuperscript{97} Id. at 16.
\textsuperscript{98} Id. at 36 tbl.III.
\textsuperscript{99} Richard B. Evans, Does Alpha Really Matter? Evidence from Mutual Fund Incubation, Termination and Manager Change 7, 30 tbl.1 (June15, 2006) (unpublished manuscript, available at http://faculty.darden.virginia.edu/evansr/pdf/do_mf_risk_adjust.pdf). In the study, Evans defined incubator funds as funds that both (1) had a lag between their inception date and the first time they were reported to the Morningstar and CRSP mutual fund databases (in other words, there existed an incubation period), and (2) had, during that incubation period, the fund family as its principal shareholder, owning more than 25% of the fund. Id. at 6.
opened funds. Even controlling for other factors, a fund’s return during its incubation period was a major factor in the decision to open it to the public. A one percent increase in incubation returns increased by 8 to 11% the probability that the fund was opened to the public.

The speed with which fund companies provide fund data to fund database vendors provides further evidence that fund companies select strong performing incubator funds over weak performers for sale to the public. Wisen and Chang’s study measuring the lag between a fund’s inception date and its first appearance in Morningstar indicates that fund companies quickly bring their strong performers to the public’s attention, but wait to publicize weaker performers. They found that, during the six months following their inception, new funds that were “timely additions” to Morningstar (i.e., those first listed within fifteen months of their inception) were much more likely to have outperformed than underperformed similar, seasoned funds. In contrast, “retroactive additions” (new funds first listed in Morningstar more than fifteen months after their inception) were

100 Id. at 7, 30 tbl.1. Interestingly, the incubated funds that were eventually sold to the public had an average annualized risk-adjusted return during their incubation period only about 2-4% higher (depending on the measure of risk-adjusted return) than did incubated funds that did not go public. Id. This is evidence that fund sponsors understand that investors pay little attention to a fund’s risk.

101 Id. at 8, 34 tbl.2. Other factors controlled for were the fund family’s size, whether the family already had a fund with the same investment objective, the amount of time the fund had incubated, the fund’s risk-adjusted return, and the total amount of flow industry-wide into funds with that investment objective. Id. The incubated fund’s risk-adjusted return -- unlike the total return -- had no statistically significant effect on the decision to open a fund to the public. Id.

102 Wisen & Chiang, supra note 55, at 60. Recall that Morningstar relies upon the fund sponsor to notify it regarding the existence of a new fund. Thus, by delaying this notification, a fund sponsor can delay a new fund’s inclusion in Morningstar. Id.

103 Wisen and Chiang examined the returns of timely additions in fourteen Morningstar categories (such as large-cap growth) in each of the six months following the funds’ inceptions, for a total of 84 category-months. In 16 of these category-months, the timely additions’ returns were statistically significantly different from those of similar, seasoned funds. For 15 of those 16 category-months the new funds outperformed the seasoned funds; in only one category-month did they underperform the seasoned funds. Id. at 60, 62 & exh.6.
approximately as likely to have underperformed as outperformed similar, seasoned funds.\(^{104}\) Thus, even among incubator funds eventually taken public, fund companies are quicker to publicize strong performers than weak performers.

Because fund companies are more likely to market their high-performing than low-performing incubator funds to the public, fund investors see a disproportionate number of successful incubator funds. Investors are not informed that the incubator funds they are offered have been culled from many less successful incubator funds. Without this context, investors underestimate the large role that luck plays in strong incubation period performance.

A recent experiment illustrates how investors are misled if they see only a fund sponsor's successful funds. Koehler and Mercer provided participants with an advertisement that highlighted the strong past returns of two of a fund company’s growth funds.\(^{105}\) One version of the advertisement noted that the advertised funds were only two of the company’s thirty funds. Another version of the advertisement stated that they were the company’s only two funds. A third version did not state how many funds the company had. Participants were then asked their perception of the fund company’s quality and the likelihood and amount that they would invest in a new growth fund being introduced by the company.\(^{106}\)

Compared to those who viewed the other versions of the advertisement, participants who version the advertisement disclosing that the fund company had thirty funds rated the fund company’s quality lower, were less willing to invest in the company’s new fund, and were willing to invest only a smaller amount in the new fund.\(^{107}\) In other words, they were less impressed by two advertised high-performing funds

\(^{104}\) They examined the returns of retroactive additions in the same fourteen Morningstar categories in each of the six months following the funds' inceptions, again for a total of 84 category-months. In only five of these category-months were the retroactive additions' returns statistically significantly different from those of similar, seasoned funds. Also, in only three of these five category-months did the retroactive additions outperform the seasoned funds; in the other two category-months they underperformed the seasoned funds. Id.

\(^{105}\) Koehler & Mercer, supra note 46.

\(^{106}\) Id. at 9-11.

\(^{107}\) Id. at 12-13.
because they knew that they were selected from a pool of thirty funds run by the company.

Importantly, participants who saw the advertisement that did not state how many funds the company had acted like participants who saw the advertisement stating that the fund company had only two funds. They rated the fund company's quality the same, had the same willingness to invest in the new fund, and were willing to invest the same amount in the new fund. In other words, investors who were not told how many funds existed acted as if they had been told that there were only two funds. This indicates that unless investors are told that advertised high-performers were culled from lower-performers, they will act as if no such selection occurred.

In summary, luck plays a major role in the success of incubator funds. However, luck's role is hidden from investors because fund companies are much more likely to market their successful incubator funds than their unsuccessful incubator funds to the public. As a result, investors see a disproportionate number of the successful funds, causing them to attribute this success to the fund managers' skill rather than luck.

* * *

In conclusion, incubation appears to be widespread, and tools for creating new funds with a strong performance record are readily at hand. By subsidizing incubator funds, keeping them small, and then selectively choosing which funds to sell to the public, fund companies are able to report and market high incubation period returns. Investors, who generally flock to funds with high returns, are drawn to these new funds.

However, marketing high incubation returns misleads investors. If the new fund does not continue to be subsidized as it was during incubation, investors will have been “baited and switched.” Investors are also often misled by high incubation returns of small funds because these returns are unlikely to continue as the fund grows. Even more importantly, fund companies’ tendency to take public their

\[108 \text{Id.}\]
strong-performing rather than their weak-performing incubator funds misleads investors by hiding the element of luck that strongly undergirds incubation period performance. By concealing how funds are selected for sale to the public, fund companies mislead investors regarding the importance of incubation period returns.

III. SEC Regulation of Incubation

Using performance results generated through an undisclosed incubation process is deceptive and violates federal securities laws, which uniformly prohibit the sale of securities using materially untrue or misleading information. Specifically, Rule 156 promulgated under the Securities Act of 1933 explains that performance data presented without context in mutual fund sales literature can be misleading under the antifraud provisions of the securities laws.

Representations [in sales literature] about past or future investment performance could be misleading … where [p]ortrayals of past income, gain, or growth of assets convey an impression of the net investment results achieved by an actual or hypothetical investment which would not be justified under the circumstances, including portrayals that omit explanations, qualifications, limitations, or other

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Section 34(b)(1) of the Investment Company Act, echoing the language of Section 17 of the Securities Act and Rule 10b-5 of the Securities Exchange Act, states:

It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this title …. It shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.

statements necessary or appropriate to make the portrayals not misleading.\textsuperscript{110}

Despite the prohibitions against misleading disclosures in fund prospectuses, shareholder reports and sales literature, no SEC rule specifically addresses fund incubation. In fact, none of the agency’s releases dealing with performance data even mentions the term “incubation.”

This section of this article begins with a description of the SEC’s regulation of the strategies that fund companies have used to inflate the performance of incubator funds – specifically, allocating hot IPOs to them, subsidizing them with lower fees and expenses, and keeping them very small. The SEC has done little to address these practices. We then examine the SEC’s limited and insufficient approach to preventing investors from being misled by how fund companies select which funds to market to the public.

A. SEC Regulation of Special Treatment of Incubator Funds

Despite data studies revealing likely widespread inflation of incubation period performance through special treatment of incubator funds, the SEC has taken little action against this abuse. The SEC has brought only two enforcement actions against funds for manipulating the performance of new funds. Both were brought almost ten years ago and dealt with artificial boosting of fund returns with large allocations of hot IPO’s. The SEC has not taken action against the subsidization of incubator funds through the underallocation of company level fees. Nor has the agency required disclosure of the effect of increasing fund size on returns, even though it has generally acknowledged that funds are managed differently before and after registration.

1. SEC enforcement actions target only extreme allocations of hot IPOs

The SEC’s actions against the Van Kampen Investment Advisory Corp. and The Dreyfus Corporation are the only enforcement actions the SEC has brought for manipulation of new funds’ performance. Both of these cases involved artificially inflating new funds’ returns through large allocations of hot IPOs. In each enforcement action, the SEC concluded that marketing of funds to the public based on performance results that are unlikely to continue is inherently misleading – and thus a violation of Section 34(b) of the Investment Company Act and other securities laws. These enforcement actions also indicate that were the SEC to fully investigate fund incubation it would conclude that the marketing of incubator funds is often misleading.

Van Kampen (1999). In a 1999 enforcement action, the SEC censured and fined the Van Kampen Investment Advisory Corp. “for failing to disclose material facts concerning the impact of hot IPOs on their ‘incubator’ Growth Fund’s 1996 performance.”111 The Van Kampen Growth Fund began operating as an incubator fund in late December 1995 with seed money provided by Van Kampen and individuals affiliated with Van Kampen.112 During its incubation period, the fund usually had net assets of only between $200,000 and $380,000.113

For 1996, the great bulk of its incubation period, the Growth Fund was the best performing fund in its category according to Lipper Analytical Services.114 Its 62% total return was 20 percentage points higher than any other fund in its category.115 Partly as a result of its high performance, Van Kampen decided to take the fund public.116

The fund was opened to the public in early February 1997, approximately 14 months after its inception. The

111 SEC Press Release, Van Kampen Investment Advisory Corp. and Former Senior Official Censured and Fined for Disclosure Violations Regarding “Incubator” Growth Fund http://www.sec.gov/news/press/pressarchive/1999/99-111.txt (Sept. 8, 1999). Van Kampen and its former Chief Investment Officer were censured and fined $100,000 and $25,000, respectively. Id.
113 Id.
114 Id. at 358.
115 Id.
116 Id.
fund’s sales literature highlighted its 62% return and that it was the best performing fund in its Lipper category. The fund’s semi-annual shareholder report also reported the 62% return. Likely because of this strong performance, investors flocked to the fund, causing its assets to skyrocket quickly to over $100 million.

Unknown to investors, however, much of the high incubation returns were from hot IPOs that Van Kampen had allocated to the fund. An internal Van Kampen analysis found the Growth Fund’s 1996 return would have been about one-third lower if the fund had purchased the IPOs on the secondary market (i.e., at the true market price), rather than having them allocated to the fund. Moreover, more than 50% of the fund’s 1996 return came from IPOs.

The Growth Fund’s prospectus, shareholder report, and advertising failed to disclose the great impact of IPOs on the fund’s performance. On the contrary, Van Kampen representatives made statements to the press that explicitly denied that IPOs had a large effect on the fund’s performance.

The SEC found that disclosing the fund’s incubation period performance without also disclosing the effect of the hot IPOs on this performance had made the registration statement and shareholder reports materially misleading, in violation of Section 34(b) of the Investment Company Act and Section 206(2) of the Investment Advisers Act of 1940. The SEC reasoned that “disclosure that a large portion of the Growth Fund’s return was attributable to its investments in IPOs would have been material to an investor’s decision

117 Id. at 359.
118 Id. at 360.
119 Id. at 358 n.3. The SEC defined “hot IPOs” as “securities that trade at a premium over their initial public offering price immediately after the initial public offering.”
120 Id. at 359.
121 Id. at 359 n.4. The SEC produced the 50% figure by calculating the fund’s actual gains on the IPO shares. We believe, however, that Van Kampen’s one-third figure better measures the subsidy that the fund received – if the fund had been forced to buy the IPOs in the secondary market, the fund would not have received an advantage over other investors.
122 Id. at 361.
123 Id.
124 Id. at 361-362.
whether to invest in the Growth Fund, particularly in light of the fact that, given the growth in the fund’s total assets, it was questionable whether the fund could continue to experience, by investing in hot IPOs, substantially similar performance as the fund had previously experienced.”

**Dreyfus (2000).** In a second enforcement action, in 2000, the SEC charged The Dreyfus Corporation for failing to disclose the large role that IPOs played in one of the fund company’s new mutual funds. The SEC censured and fined both the company and an employee who managed four Dreyfus funds including one very small, new fund – the Dreyfus Aggressive Growth Fund (“DAG”). The DAG’s prospectus during its first fiscal year had stated that “[i]f . . . other [mutual funds advised by Dreyfus] desire to invest in, or dispose of, the same securities as [DAG], available investments or opportunities for sales will be allocated equitably to each investment company.” Despite this claim, IPOs and especially hot IPOs were not allocated equitably among the four funds. Proportionate to their sizes, DAG received approximately 37 times the allocation of IPO’s than did the other three funds.

As a result of its large IPO allocation, DAG was the top ranked fund of the 175 funds in Lipper’s Capital Appreciation category at the end of its first fiscal year, with a total return of 81.7%. The first-day returns from IPOs contributed approximately 70.3 percentage points – or 86% – of that total return. Dreyfus advertised DAG’s high first-year return and top Lipper ranking, but in the advertisements it did not disclose the IPOs’ impact on this performance. Unsurprisingly, investors flocked to this high performance, increasing DAG’s size from $2 million at its inception to more than $154 million only eight months later.
The SEC found that, by failing to disclose the great effect that the IPO allocation policy had on DAG’s returns, Dreyfus had breached its fiduciary duty to investors to disclose all material facts.\textsuperscript{135} The SEC noted that disclosure was required because it was ‘questionable whether DAG could replicate its prior performance through continuing to invest in IPOs as the fund grew larger.’\textsuperscript{136} In addition, it found that DAG’s prospectus was materially false and misleading in claiming that IPOs were allocated equitably among Dreyfus’ funds.\textsuperscript{137}

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In summary, while salutary, the SEC’s enforcement actions against Van Kampen and Dreyfus must be kept in perspective. They represent the only cases in which the SEC has challenged using hot IPOs to artificially boost a new fund’s returns. The SEC seemed unaware of – and certainly not curious about – how widespread the practice may be. As discussed before, new funds’ returns in general are more sensitive than seasoned funds’ returns to IPO first-day returns, indicating that new funds’ portfolios often contain a greater percentage of IPOs than do other funds.\textsuperscript{138} Thus, the Van Kampen and Dreyfus cases likely are only extreme examples of a not uncommon practice.

2. The SEC hasn’t addressed the underallocation of fund company fees and expenses to incubator funds

Incubator funds can also be subsidized by underallocating fund company fees and expenses to them. Indeed, Wisen and Chiang have found that newer funds – which include incubator funds – have less 12b-1 expenses allocated to them by their fund companies.\textsuperscript{139} This artificially boosts these funds’ returns and misleads investors because this subsidization does not continue as the fund

\textsuperscript{135} Id. at 644.
\textsuperscript{136} Id.
\textsuperscript{137} Id.
\textsuperscript{138} Wisen & Chiang, supra note 55, at 60, 61 exh.5,
\textsuperscript{139} Id. at 63.
ages. Despite this, we could find no case of an SEC enforcement action against this practice.

The SEC, however, does regulate a similar practice. Sometimes a fund management company will temporarily waive or reimburse part of a new fund’s expenses to boost the fund’s returns. This practice is most commonly used for money market funds, because even small differences in expenses can significantly affect a money market fund’s return relative to those of other money market funds. If a fund company does this, the SEC requires that the fee table at the front of the fund prospectus present the expenses “that would have been incurred absent expense reimbursement or fee waiver arrangements.” The actual operating expenses – which include the effect of the reimbursement or waiver – may only be disclosed in a footnote to the fee table. In addition, if the actual operating expenses are disclosed, the company must also disclose “the period for which the expense reimbursement or fee waiver arrangement is expected to continue, or whether it can be terminated at any time at the option of the Fund.”

Thus, investors are alerted that when the temporary subsidization ends they will receive lower returns.

Although underallocation of 12b-1 fees to incubator funds can mislead investors in the same way, the SEC does not impose a similar disclosure requirement on such underallocation. Yet the underallocation of fees is arguably worse than fee waivers and expense reimbursements. When a fund sponsor waives fees or reimburses expenses, only the
fund company makes less profit. However, when a fund company underallocates fees to one of its funds, it also is overallocating these fees to its other funds. Thus shareholders of those other funds – not the fund companies – pay for this practice.

3. The SEC does not require disclosure of how fund size affects performance

Successful incubator funds, endowed with a strong performance history, typically grow dramatically when sold to the public. Even if strong incubation performance reflects some stock-picking skill, however, it becomes more difficult for the manager to continue to exhibit this skill after the fund grows. For example, it is much harder for a large fund than a very small fund to significantly boost its returns by investing in small, thinly traded stocks.

The SEC does not require disclosure of the effect of increasing fund size on performance. Nonetheless, the agency has recognized this effect, at least in the context of allocation of hot IPOs. When the SEC censured and fined Van Kampen for not disclosing the large role that hot IPO’s played in its new Growth Fund’s high returns, the SEC noted that “given the growth in the fund’s total assets, it was questionable whether the fund could continue to experience, by investing in hot IPOs, substantially similar performance as the fund had previously experienced.”

Because during its incubation phase the fund generally had assets of only a few hundred thousand dollars, even a small allocation of hot IPOs could – and did – greatly affect the fund’s performance. However, when the fund was marketed to the public and grew to over $100 million, a dramatically larger allocation of hot IPO’s would have been necessary to significantly influence the fund’s returns.

In addition, the SEC has acknowledged that “funds are likely to be managed differently before [than after] they are offered to the public.” However, the SEC has not discussed whether it believes that the change in the fund’s size is one of the reasons that funds are managed differently after they are taken public.

145 Investment Company Act Rel. No. 16254 (Feb. 2, 1988)
In summary, nothing requires a small fund to warn investors that its growth may hamper future returns. A very small incubator fund invested in small capitalization stocks that was registered with the SEC may advertise its high incubation returns without disclosing that the fund is likely to grow dramatically, making it difficult for the high returns to continue.

B. SEC Regulation of Selective Marketing of Incubator Funds

1. The SEC generally prohibits funds from using their pre-registration performance data

A fund prospectus must contain a bar chart and table presenting the fund’s returns over the past ten calendar years or the life of the fund, whichever is shorter. In the instructions for preparing this chart and table, the SEC explicitly requires that all of the reported returns be “only for periods subsequent to the effective date of the Fund’s registration statement.”

Likewise, advertisements may disclose performance data arising only after registration. Rule 482 promulgated under the Securities Act of 1933 specifies that any advertising of fund performance must include performance data for “the time period during which the registration statement was in effect.” Advertisement of pre-registration performance is not permitted. Curiously, when the SEC proposed its advertising rule, it seemed unaware of the potential for incubation and misleading use of manipulated pre-registration performance data. The original proposal would

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147 17 C.F.R. § 230.482 (d)(3) (requiring that any “quotation of the company’s performance contained in an advertisement” be limited to “[a]verage annual total return for one, five and ten year period except that if the company’s registration statement under the Act has been in effect for less than one, five, or ten years, the time period during which the registration statement was in effect is substituted for the period(s) otherwise prescribed”).
have permitted performance data beginning when a fund started “in business,” thus permitting advertising of returns attained before a fund was registered. Two prescient commentators, however, urged that the SEC permit only post-registration performance data to be advertised. In its final release accompanying Rule 482, the SEC adopted these commentators’ suggestion because “funds are likely to be managed differently before they are offered to the public.”

In summary, although fund companies generally cannot advertise or report fund performance data that precedes the effective date of the fund’s registration, the SEC rules on disclosure and advertising of performance data treat the possibility of incubation as an afterthought. The SEC releases accompanying these rules do not mention incubation, referring only in general terms to the possibility that funds may be managed differently after they are registered.

2. The SEC sometimes allows funds to market performance data from other accounts and funds

Funds are generally prohibited from using pre-registration performance data in prospectuses, reports, and advertising. The SEC staff, however, has issued a number of no-action letters permitting new funds to report and advertise the returns from other, related funds and investment accounts. In doing so, the staff has assumed that investors are not misled when performance data comes from other funds or accounts that were both (1) managed in a manner similar to the new fund and (2) not created for the purpose of generating performance results.

During the 1990s the SEC staff went moved from permitting new funds to use performance data of predecessor funds and accounts, to allowing such data from similar funds and accounts. In addition, the SEC staff extended this permission to allow such data to be used not only in prospectuses but also in fund advertising. The SEC staff seemed oblivious to the possibility that fund companies could

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be misleading investors by selectively choosing which related funds or accounts to use. Selection biases such as these are at the heart of a major problem with incubation.

**a. Funds can use performance data of predecessor investment accounts**

In a 1995 no-action letter, the SEC's Division of Investment Management permitted Massachusetts Mutual Life Insurance Company (“MassMutual”) to include prior returns of unregistered separate investment accounts when MassMutual converted the accounts into registered mutual funds.149

MassMutual had converted seven separate investment accounts (“SIAs”) exempt from registration under the Investment Company Act into new mutual funds.150 Each of the resulting seven mutual funds had an “investment objective, policies and practices designed to correspond to” those of its predecessor SIA.151

The SEC permitted MassMutual to include each SIA’s prior returns as the corresponding mutual fund’s historical returns in its prospectus, statement of additional information, and sales material, thus adopting the SIA’s prior, pre-registration performance as its own.152 MassMutual agreed to include the disclosure that “the quoted performance data includes the performance of the

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150 The SIAs were investment vehicles for pension plans qualified under the Internal Revenue Code § 401, and thus exempted from the Investment Company Act’s definition of “investment companies.” Id. at *1 n.2. Each SIA held a portfolio of securities, which were contributed to a new mutual fund in exchange for shares of the fund. As a result of the transaction, each SIA owned shares of a mutual fund that owned the same portfolio of securities that the SIA had previously owned directly. In addition, Mass Mutual provided $107,000 of initial capital to each new fund. Id. at *14.
151 Id. at *1.
152 Id. at *7. These prior returns were adjusted to reflect the deduction of fees and expenses that would have been applicable to the mutual fund. Id. at *4-5.
SIAs for periods before the Trust’s registration statement became effective.”

The SEC staff gave two primary reasons for granting the no-action letter. First, MassMutual had represented that each fund would be “managed in a manner that is in all material respects equivalent to the management of the corresponding SIA.” Second, the SIAs “were created for purposes entirely unrelated to the establishment of a performance record.”

The SEC suggested that these reasons were consistent with the intent of its rules that normally prohibit the use of pre-registration returns. In one of the few and perhaps most lucid explanations of the dangers of incubation, the staff explained that Rule 482(d)(3)’s prohibition against advertising pre-registration returns was partly intended to “preclude [a fund] adviser from establishing a number of funds for the purposes of generating performance data, and then registering those ‘incubator funds’ with the best performance records so that the newly registered funds can use that performance.” In addition, quoting the SEC release accompanying Rule 482, the staff reiterated that the general prohibition against advertising pre-registration returns

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153 Id. at *4 n.5. They also included the disclosure that “the SIAs were not registered under the 1940 Act and therefore were not subject to certain investment restrictions that are imposed by the Act,” and the disclosure that “if the SIAs had been registered under the 1940 Act, the SIAs’ performance may have been adversely affected.” Id.

154 Id. at *7. The SEC cited a number of MassMutual representations as evidence that the mutual funds were being managed the same as their predecessor SIA’s. MassMutual was the investment adviser for all of the funds and the SIA’s. Also, each fund that had sub-advisers had the same sub-advisers as its predecessor SIA. In addition, each fund had management practices, investment policies, investment objectives, guidelines, and restrictions that were “in all material respects” equivalent or identical to those of its predecessor SIA. Id. at *2-3.

155 Id. at *3. The evidence the SEC staff cited for this conclusion was the long length of time between the establishment of the SIAs and their conversion into mutual funds. The SEC noted that “[t]wo of the seven SIAs have existed for more than 20 years, and two others have existed for more than 10 years. Of the other three SIAs, one was established in 1987, one in 1989, and one in 1991.” Id.

156 Id. at *6.
performance is justified because “funds are likely to be managed differently before they are offered to the public.”

In February 1997, sixteen months after the MassMutual no-action letter, the SEC again publicly explained its policy toward incubator funds. Dr. William Greene, then a Department Chair at the NYU Stern School of Business, wrote the SEC asking whether a mutual fund sponsor could create a number of incubator funds for the purpose of creating performance track records – taking only the highest performing funds public and advertising their high returns. In response, Jack W. Murphy, the Associate Director of the SEC’s Division of Investment Management, wrote that such a scenario would “raise serious concerns under the antifraud provisions of the federal securities laws.”

Murphy stated (without citation) that the SEC had “consistently, for close to thirty years, expressed severe reservations” regarding incubator funds. He reiterated the SEC’s two concerns about incubator funds. First, that they might be managed differently after going public than they were during their incubation period. Second, that a fund sponsor might adopt the strategy suggested by Dr. Greene: create similar, multiple incubator funds and take only the most successful one public without disclosing the performance of the other funds.

Murphy also wrote that the SEC’s no-action letter to MassMutual had been misrepresented by some of the media. He emphasized that MassMutual had represented to the SEC that each of its new mutual funds would be managed in “substantially the same manner as its predecessor account” and that each of the funds’ predecessor accounts were “created for purposes entirely unrelated to the establishment of a performance record.”

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157 Id. at *6 n.8.
158 Letter from Jack W. Murphy, Associate Director (Chief Counsel), Division of Investment Management, Sec. & Exch. Comm'n to Dr. William Greene, Stern School of Business (Feb. 3, 1997), available at 1997 SEC No-Act. LEXIS 316.
159 Id. at *3.
160 Id. at *1.
161 Id. at *2.
162 Id. at *2-3.
b. Spun-off funds can use performance data of predecessor funds

In 2000, the SEC staff issued a no-action letter permitting Janus Capital Corporation to include in the registration statements, advertisements, sales literature, and prospectuses of new funds the previous performance of registered funds from which the new funds were spun off.\textsuperscript{163} One class of a number of registered Janus funds had been created only for investments in qualified retirement plans.\textsuperscript{164} Janus sought to make those funds also available for investments from non-qualified retirement plans, and thus spun off that class into new funds that could accept such investments.\textsuperscript{165}

The SEC accepted Janus’s argument that the use of the prior performance information would not “implicate[] the primary concerns against permitting a fund to present performance information prior to the effective date of the fund’s registration statement” because the spin-off was not for the purpose of presenting the prior performance information and the new funds were subject to the same investment restrictions that were imposed on the predecessor funds, which were also registered investment companies.\textsuperscript{166} The SEC staff concluded that the new funds “effectively will operate as a continuation of the [old funds] such that the performance history of the [old funds] may be carried forward.”\textsuperscript{167}

In a footnote to the no-action letter, the SEC staff noted that it believed that a fund that is spun-off from another fund might actually be required to disclose the performance of the predecessor fund, “for example, as supplemental, non-standardized performance information in the fund’s

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\textsuperscript{164} Id. at *2.
\textsuperscript{165} Id. at *4.
\textsuperscript{166} Id. at *14
\textsuperscript{167} Id. at *17-18. Janus represented that, when presenting the new funds’ performance, it would disclose that each new fund had been previously organized as another fund, the date that each new fund commenced operations, and that the reported information included performance of the predecessor funds. Id. at *5.
\end{flushright}
registration statement, advertisements or sales literature.”\textsuperscript{168} In addition, the letter noted that if Janus had sought to spin-off only a portion of a predecessor class of funds – rather than an entire class of funds, then the staff might have reached a different conclusion regarding allowing the performance data to be used.\textsuperscript{169}

c. New funds’ prospectuses can include performance data of similar non-predecessor funds and private accounts

Although the MassMutual and Janus situations involved predecessor funds, the SEC has also allowed a new mutual fund to report the performance of other mutual funds and accounts that were not predecessors to the fund.

In 1996, the SEC staff granted a no-action letter in Nicholas-Applegate Mutual Funds, permitting new mutual funds to include in their prospectuses performance information from private accounts managed by the funds’ adviser that had substantially similar investment objectives, policies, and strategies as the new mutual funds.\textsuperscript{170} Unlike MassMutual, these private accounts were not converted into the mutual funds. Indeed, the private accounts continued to operate after the fund was created. Because the private accounts were not predecessors of the mutual fund, the fund was prohibited from reporting the private accounts’ historical performances as the new funds’ own performance. However, the new funds were permitted to report the private accounts’ performance in addition to their own performance.\textsuperscript{171}

Close to the same time, the SEC staff granted a no-action letter in Bramwell Growth Fund, permitting a mutual fund to include in its prospectus the performance of another mutual fund with substantially similar investment objectives and policies for which the fund’s portfolio manager previously served as portfolio manager.\textsuperscript{172} Because the other

\textsuperscript{168} Id. at *18 n.19.
\textsuperscript{169} Id. at *18.
\textsuperscript{171} Id. at *5-6.
fund was not a predecessor of the manager’s current fund, the performance could only be reported in addition to the current fund’s own performance, as in Nicholas-Applegate. Also, both Bramwell and Nicholas-Applegate were limited to including the information about similar funds’ and private accounts’ returns in the fund prospectus.

d. New funds’ advertising can include performance data of similar non-predecessor funds and private accounts

In 1997, the SEC staff granted a no-action letter in ITT Hartford Mutual Funds permitting advertisements and supplemental sales literature of new mutual funds to include returns of corresponding funds with similar investment objectives, policies, and strategies as the new funds. The corresponding funds (“Insurance Funds”) were registered and used in the company’s variable insurance products, while the new funds were open to all investors. Tax laws prevented the Insurance Funds from being converted into the new mutual funds.

On the same date, the SEC granted a no-action letter in GE Funds allowing new mutual funds’ advertisements and supplemental sales literature to include returns of corresponding registered institutional funds and private institutional accounts. These corresponding institutional funds and accounts had investment objectives and policies substantially similar to those of the new mutual funds, but, unlike the new mutual funds, they were only open to institutional investors.

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In summary, the SEC staff has shown much willingness to permit fund companies to use performance data of certain

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173 Id. at *5-6.
175 Id. at *1-2.
177 Id. at *14
other mutual funds and private accounts regardless of whether they were predecessors of the new funds. The staff has recognized – at least in response to a hypothetical question – that advertised performance data can be manipulated through a selection process that chooses to use only strong performing funds’ returns. But it has not fully recognized that other funds’ and accounts’ performance data can be manipulated in the same way. In none of the requests for no-action letters, for example, did fund companies seek to report and advertise poor performance data by “similar” funds and accounts.

The SEC incorrectly assumes that investors won’t be misled if the other funds and accounts were managed in a similar way to the new fund and were not created for the purpose of producing a strong performance record. However, investors can still be misled if they are unaware of how the fund companies choose which other funds and accounts to use. For example, a fund company could establish a number of private investment accounts because of demand from certain customers for such private accounts. Even if the account managers possessed no stock-picking skill, some of the accounts would likely perform well just because of luck. Because the accounts were not created for the purpose of creating a performance track record, the SEC would permit the manager to convert the strong-performing accounts into mutual funds and advertise the performance of the predecessor private accounts. However, unless investors are also told of the weak-performing private accounts that were not converted into mutual funds, investors would be deceived into believing that the managers of the converted funds have stock-picking skill.

Without disclosing the performance data of all the accounts and funds from which new funds could have been converted or spun off, fund companies provide investors only a partial, biased picture of the performance pedigree of a new fund. The risk of deception is present whenever a fund company can select which funds to bring to market without fully disclosing the selection process.

3. The SEC does not regulate “public” incubation
As discussed above, the SEC generally prohibits funds from marketing their pre-registration returns. Because funds must register with the SEC before they can be sold to the public, this prohibition prevents many incubator funds from marketing returns achieved before the fund was publicly available.

However, fund companies can create an incubator fund, register it with the SEC, yet not advertise nor obtain a ticker symbol for it. Thus, although the fund would technically be public because it is registered with the SEC, it would be effectively private. Without a ticker symbol, the public would be unable to buy the fund, and without it being advertised, few potential investors would know about the fund anyway. Indeed, some major fund companies have used such an approach.\textsuperscript{178}

Because such an incubator fund was registered during its incubation period, the SEC’s general prohibition against marketing pre-registration performance does not apply to it. However, because it is not actively marketed, the public will not be aware of the fund during its incubation period. As a result, if the fund company chooses to actively market only the funds that have performed well during their public incubation periods, investors will be unaware that the lesser-performing funds existed, and thus investors are likely to be misled into believing that the high-performing funds reflect managerial skill rather than luck. The SEC, however, has not taken any steps to protect investors from such misleading public incubation.

\textbf{IV. Preventing the Abuse of Incubation}

Incubator funds’ returns can mislead investors in multiple ways. First, when the returns result from special treatment by the fund company (such as high hot IPO allocations, low fee allocations, or being kept very small), it is deceptive not to disclose that the special treatment will not

\textsuperscript{178} Wyatt, \textit{supra} note 79 (giving examples of large fund companies that registered new mutual funds with the SEC but kept them hidden from the general public until the funds had a strong performance record that could be advertised).
continue in the future. Second, when the fund sponsor chooses to market high-performing rather than low-performing incubator funds, it deceptively creates the impression that the high performance reflects managerial skill rather than luck. This section discusses how the SEC should address each of these problems.

A. Special Treatment of Incubator Funds

Fund companies often subsidize incubator funds to increase their early returns through the overallocation of hot IPOs and the underallocation of fund family fees or expenses. In addition, incubator funds are kept very small, often giving them an advantage over larger funds.

1. The SEC should treat overallocation of hot IPOs as inherently misleading, or at least require its disclosure

In fining and censuring two fund companies for failing to disclose that returns of particular new funds were dramatically boosted through hot IPOs, the SEC has addressed only two extreme examples of a not uncommon practice. As we have seen, studies show that new funds’ returns are generally more sensitive than seasoned funds’ returns to IPO first-day returns, providing clear evidence that new funds’ portfolios contain a greater percentage of IPOs than do other funds.

At the very least, the SEC should require all funds to disclose what percentage of their incubation returns come from IPOs, and especially from hot IPO’s. However, such disclosure still may not prevent investors from being misled. Surveys show that fund investors are uninformed about their mutual funds. For example, a high percentage of investors don’t know the type of mutual funds they own. 179 Capon, Fitzsimons, and Rice found that 72% of the surveyed investors didn’t know if their primary fund invests in domestic or international securities, and 75% didn’t know whether the fund invests in equity or fixed income

179 Capon et al., supra note 20, at 77.
securities. Thus, investors might not read or appreciate the significance of a disclosure that an incubator fund’s returns were boosted by a large allocation of hot IPOs.

A better approach, therefore, would be for the SEC to bring enforcement actions against fund companies that significantly reduce the allocation of IPOs to their funds after their incubation periods. Because these funds incubation returns are achieved using hot IPOs and these allocations did not continue, the high incubation returns reported by the funds are misleading to investors. The appropriate remedy would be for the fund company to compensate the fund (and any investors who may have sold their shares) for any shortfall in post-incubation returns due to the reduced allocation of IPOs.

1. **The SEC should require funds to disclose any fee or expense subsidization**

Fund companies also subsidize incubator funds by underallocating 12b-1 and other company-level fees and expenses to them. This temporarily boosts the return of their incubator funds and reduces the returns of their older funds. However, the SEC has never brought an action against a fund company for such an underallocation.

It would not be difficult for the SEC to address this problem. The SEC could require funds to disclose such underallocation – and to report what performance would have been had the incubator fund’s fees and expenses not been subsidized. Mutual funds already must disclose when the fund company waives fees or reimburses expenses, so that investors do not erroneously believe that the lower fee or expense level is permanent. The SEC could require similar disclosure for incubator funds that receive a less than proportional allocation of 12b-1 or other fees and expenses.

In addition, by definition, the underallocation of fees to one fund requires the overallocation of fees to other of the company’s funds. Thus, disclosure should also be required to investors of those other funds that they are subsidizing incubator funds in which they likely are not investing. Again,

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180 *Id.* at 68.
disclosure of the effect of this subsidization on the other funds’ returns would make clear the extent of this practice.

2. The SEC should require disclosure of the effect of fund size on performance

Incubator funds are typically kept very small. As discussed above, this often gives them an advantage relative to much larger funds. However, when a strong-performing incubator fund is marketed to the public, its resulting dramatic growth makes it difficult for the fund to continue to generate high returns. This is another way that investors are misled by incubation period returns.

One approach to addressing this problem would be to require funds reporting or disclosing incubation returns to include a warning such as “These returns were achieved when the fund was very small. It generally is more difficult for a fund to achieve high returns as it grows.” Such a warning is especially appropriate for funds, such as small capitalization equity funds, that face declining investment options as the fund size increases.

B. Selective Marketing of Incubator Funds

Investors are also misled by the selective marketing of incubator funds. Funds with strong incubation performance are actively marketed to the public while funds with weak track records are never seen. This creates the illusion that managerial skill, rather than luck, is behind the high-performing funds. A number of possible solutions to this problem exist.

1. The SEC could require disclosure of the existence and performance of all incubator funds

One approach would be to require fund companies to disclose the existence and returns of all of their incubator funds. For example, when an incubator fund is taken public
and reports and advertises its incubation period returns.\textsuperscript{181} The fund’s prospectus and advertising could also disclose the returns of the fund company’s other incubator funds over the same time period. Such disclosure would provide a context for the incubation returns of the newly public fund, indicating whether the new fund’s returns were representative of the returns of all of the company’s incubator funds.

However, such a policy would pose several difficulties. First, there would be questions of which funds should be disclosed. For example, in the MassMutual case, separate accounts were converted into mutual funds. Similarly, in ITT Hartford, certain insurance funds were copied into new mutual funds. Thus, to be comprehensive a fund company would have to disclose, for example, the returns on all its separate accounts and insurance funds as well. Such an approach might overwhelm already confused investors.

In addition, even if the returns of non-public incubator funds were disclosed, investors might not understand the implications. The message intended by including the returns of other incubator funds is that the advertised high-performing incubator fund may have been just lucky. If other company’s other incubator funds did not perform well, the existence of one high-performing fund should not be considered significant evidence of managerial skill. However, this message is subtle, and investors might not reach that conclusion. Even though studies have found little evidence that funds that have performed well in the past continue to perform well, investors flock to high-performing funds.

Koehler and Mercer’s recent experiment, however, suggests that providing investors with such context may be helpful.\textsuperscript{182} Recall that in their experiment they provided participants with a fund company’s advertisement that highlighted the strong past returns of two of the company’s funds. One version of the advertisement stated that the advertised funds were only two of the company’s thirty funds. Another version stated that those were the company’s

\textsuperscript{181} Recall that the SEC generally does not allow pre-registration incubation returns to be reported, but has created some exceptions to this policy.

\textsuperscript{182} Koehler & Mercer, supra note 46.
only two funds. A third version of the advertisement did not state how many funds the company had. A fourth version (the control) did not mention the funds’ past returns at all. Investors were then asked their perception of the quality of the fund company and the likelihood and amount that they would invest in a new fund being introduced by the company.  

Participants who saw the version that stated the fund company had only two funds and those who saw the version that did not state how many funds existed responded similarly. However, participants who viewed the advertisement disclosing that the fund company had 30 funds rated the fund company’s quality lower, were less willing to invest in the company’s new fund, and were willing to invest only a smaller amount in the new fund. In fact, they did not respond differently from participants who viewed the control advertisement, which lacked any information about past performance. In other words, they “gave little weight to the excellent (but selected) performance data that they saw in the ad.”

Thus, informing investors about the number and performance of the funds from which the offered fund was selected may lead investors to discount high incubation performance. Giving context for the high incubation returns may make investors less likely to attribute these returns to skill, and thus less likely to be misled.

Of course, the purpose of the disclosure could be made more explicit. For example, advertisements of incubation period returns could include a warning that

This fund was selected to be marketed by its sponsor from a number of other new funds it operates, many of which did not have as high returns. Studies show that a new fund’s strong initial performance usually does not persist. A new fund’s performance is often a matter of chance.

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183 Id. at 9-11.
184 Id. at 12-13.
185 Id.
186 Id. at 15.
2. The SEC could prohibit use of incubation period performance data

Another possible solution is to prohibit funds from reporting and advertising performance data from their incubation periods. This would prevent much of the current abuse of incubator funds. A fund sponsor would have no incentive to create an incubator fund for the purpose of creating a strong track record if it could not market that track record. Similarly, it would eliminate the incentive to overallocate hot IPO’s or underallocate fees to incubator funds because the resulting higher returns could not be advertised.

A primary objection to banning advertising of incubation period returns is likely to be that investors want to know these returns. Many investors considering investing in a newly-public fund will be interested in the fund’s past returns. However, this does not justify giving them this information.

Investors desire information about these returns because they believe high past returns foretell high future returns. However, this belief is erroneous. Studies show that incubator funds that outperformed comparable funds during their incubation period do not continue to do so after. Thus, rather than provide valuable information to investors, the high incubation period returns actually mislead them.

3. The SEC should broadly define “incubation”

Regardless of which steps are taken to regulate incubator funds, the SEC must use a broader definition of “incubation.”. Any regulation could be largely circumvented if incubation period returns are only defined as those occurring before a fund is registered with the SEC. For example, the SEC restricts the advertising of incubation returns by generally prohibiting the advertising of pre-registration returns. However, a fund company can circumvent this restriction by creating an incubator fund, and registering it with the SEC, yet not advertise or obtain a ticker symbol for it. Although the fund would technically be public because it is registered with the SEC it would be
effectively private, hidden from potential investors. Indeed, major fund companies have sometimes used this approach.\textsuperscript{187}

To prevent such circumvention, the SEC must define incubation more broadly. A fund’s incubation period should be defined as the period until the fund is actively marketed to the public. Returns achieved before the fund acquires a ticker symbol and the fund is advertised should be subject to the same regulations as returns achieved before the fund was registered with the SEC.

V. CONCLUSION

Because returns are key to investors, mutual fund companies promote their funds on the basis of past performance. Manipulation of performance data is thus an important regulatory concern. Although how funds calculate and present performance data is closely regulated, the SEC has failed to recognize fully how fund companies deceptively create new funds with strong performance records.

The incubation of mutual funds, a process in which new funds are initially operated outside of public view but only some of them are later selected to be marketed to the public, can be manipulative and misleading if the selection process is not disclosed. Like the enterprising stockbroker who sends out a series of contradictory stock predictions, mutual fund companies that market only their high-performing incubator funds create the illusion of investment acumen.

Moreover, fund companies further mislead investors by favoring incubator funds in ways that do not continue after the funds are sold to public. By allocating them hot IPOs, subsidizing their fees and expenses, and keeping them unsustainably small, fund companies artificially boost the returns of their incubator funds. That is, fund companies mislead by failing to disclose that their new stars will soon be treated like all other funds in the fund company’s constellation.

Studies find that an incubator fund’s strong initial performance generally do not continue after the fund is sold to the public. Why don’t high incubation returns persist?

\textsuperscript{187} Wyatt, supra note 79.
First, the returns-boosting special treatment that many incubator funds receive doesn't continue after the fund is sold to the public. Second, strong incubation returns are largely a matter of luck, and luck generally doesn't continue either. For these reasons, investors who chase high incubation returns will usually be disappointed.

The SEC indirectly regulates incubation – without mentioning the term – by generally prohibiting pre-registration returns from being reported or advertised. This does not, however, prevent fund companies from quietly incubating registered funds. Nor has the SEC prevented companies from giving special treatment to their incubator funds.

Just as troublesome is the SEC's willingness to allow fund companies to market performance data of predecessor investment accounts, and even of similar funds, without requiring disclosure of the many accounts and funds whose performance data is not being used. If fund companies can select which performance data to highlight, investors will be misled if they do not understand the selection criteria.

What can be done to protect investors? At the very least, fund companies should be required to disclose the special treatment they give their incubator funds how they selected which incubator funds to market to the public. This disclosure must provide the context in which the funds’ returns should be viewed. For example, it must include the number of other incubator funds that the company operates yet chose not to sell to the public. A clearer disclosure might also explicitly warn investors that high incubation period returns are largely a matter of luck, and that fund companies generally only choose to market their high performing incubator funds.

However, disclosure may not be enough. The special treatment that incubator funds receive and the way they are selected to be marketed make incubation period returns inherently misleading. No amount of disclaimers, explanations and contextual information can fully cleanse its misleading character. Given that strong incubation performance generally doesn’t continue, arguably this performance should not be permitted to be marketed at all.

Fund incubation, the fund industry's dark and unsavory secret, deserves a fuller examination in the full light of day.