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Star Creation: Mutual Fund Incubation

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Despite the danger that investors may be misled by the advertising of incubator funds, these funds have received little attention from the SEC. In this paper, we argue that incubator funds are worthy of much more scrutiny. In addition, the concern the SEC has expressed has been directed at only certain types of incubator funds. However, such a focus ignores that mutual fund companies can, and do, escape this scrutiny by creating de facto incubator funds that, although equally misleading, are outside of the SEC's focus. Therefore, we conclude that the SEC's focus needs to be broader, encompassing all attempts to market a fund's performance before the fund was truly made available to the general public.

In summary this article examines the misuse of incubation funds by mutual fund companies and how this misuse can be reduced. Section 2 provides some context by presenting information about the size and scope of the mutual fund market. Mutual funds have become Americans' primary method of saving for retirement, thus misconduct by mutual fund companies has become very important. The section also discusses how investors choose which mutual funds to buy. An extensive empirical academic literature has demonstrated that investors flock to funds that have had very high returns in the past. This investor behavior makes investors susceptible to the misuse of incubation funds. Section 3 examines how fund companies create incubation funds and how they can give them artificially strong performance records to mislead investors. It also examines the limited steps the SEC has taken to prevent this abuse. Section 4 proposes and discusses additional steps that the SEC can prevent the misuse of incubation funds. Section 5 summarizes and concludes the article.