

**MEMO# 18818**

May 3, 2005

## **SEC SETTLES MARKET TIMING CASE WITH BROKER-DEALER AND FORMER OFFICERS AND FILES CHARGES AGAINST TWO MORE FORMER OFFICERS**

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [18818] May 3, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 18-05 BROKER/DEALER ASSOCIATE MEMBERS No. 7-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 39-05 COMPLIANCE ADVISORY COMMITTEE No. 35-05 SEC RULES MEMBERS No. 56-05 SMALL FUNDS MEMBERS No. 39-05 RE: SEC SETTLES MARKET TIMING CASE WITH BROKER-DEALER AND FORMER OFFICERS AND FILES CHARGES AGAINST TWO MORE FORMER OFFICERS The Securities and Exchange Commission has issued orders making findings and imposing disgorgement, civil money penalties, and compliance reforms in two administrative proceedings against a registered broker-dealer and its former chief operating officer and vice president of mutual funds ("Respondents").<sup>1</sup> The broker-dealer and officers consented to the entry of the SEC Orders without admitting or denying the SEC's findings. The actions involved allegations that the Respondents facilitated market timing in mutual funds. In a related matter, the SEC also filed a civil action in federal court charging two additional former officers of the broker-dealer's New York office ("New York Employees") with fraud based on a mutual fund market-timing scheme.<sup>2</sup> The settlements and complaint are summarized below. I. SEC Orders A. Findings According to the SEC Orders, between August 2002 and October 2003, the New York Employees engaged in an illegal market-timing scheme on behalf of two hedge fund customers. 1 See In the Matter of Fiserv Securities, Inc. and Dennis J. Donnelly, SEC Release No. 34-51588, Admin. Proc. File No. 3- 11907 (April 21, 2005); In the Matter of Charles J. Addeo, SEC Release No. 34-51589, Admin. Proc. File No. 3-11908 (April 21, 2005) ("SEC Orders"). The SEC Orders also censure Fiserv and impose a cease and desist order on Addeo. Copies of the SEC Orders are available on the SEC's website at <http://www.sec.gov/litigation/admin/34-51588.pdf> and <http://www.sec.gov/litigation/admin/34-51589.pdf>. 2 See Securities and Exchange Commission v. Thomas J. Gerbasio and Raymond L Braun, Jr., Civil Action No. 05-1833 (BWK) (E.D. Pa. April 21, 2005) and SEC Litigation No. 19197 (April 21, 2005). Copies of the complaint and litigation release are available on the SEC's website at <http://www.sec.gov/litigation/complaints/comp19197.pdf> and <http://www.sec.gov/litigation/litreleases/lr19197.htm>, respectively. 2 Additionally, between December 2000 and October 2002, another employee, a senior vice president of the broker-dealer's mutual fund department, engaged in a late trading and market- timing

scheme in his personal trading accounts. The SEC Orders found that the vice president of mutual funds participated in both market-timing schemes. The SEC Orders state that these employees defrauded hundreds of mutual funds and their shareholders by engaging in deceptive practices designed to circumvent the funds' restrictions on market timing. In response to hundreds of notifications from mutual funds, including "kick-out letters" rejecting market-timing trades, the New York Employees, assisted by the vice president, employed a variety of deceptive acts and practices to conceal their identity from the funds. In addition, the senior vice president, who also received kick-out letters as a result of trading his own accounts, employed similar deceptive practices, and engaged in illegal late trading. According to the SEC Orders, the broker-dealer and the former chief operating officer violated Section 15(b) of the Securities Exchange Act of 1934 for failing reasonably to supervise the New York Employees, the senior vice president, and the vice president, with a view to preventing their violations of the federal securities laws. Specifically, the SEC Orders state that the broker-dealer failed to adopt adequate policies and procedures to monitor market timing or late trading. In addition, the broker-dealer failed to implement appropriate policies and procedures to ensure that abusive trading was discontinued at the funds' requests to curb it. The SEC Orders state that the chief operating officer failed to review the trading activities engaged in by the New York Employees on behalf of their customers, was aware of correspondence from the mutual funds seeking to restrict market timing trading, and failed to follow up and investigate this red flag. Finally, the SEC Orders note that the vice president willfully violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder for fraudulent conduct in connection with the purchase or sale of securities.

**B. Remedial Efforts** The broker-dealer has taken the following voluntary remedial actions:

- Ceased and prohibited all market making activity;
- Hired a law firm to review and revise its written supervisory procedures to aid in the detection and prevention of market timing;
- Adopted and implemented new supervisory and operational procedures designed to detect and prevent illegal mutual fund market timing and late trading; and
- Completed a comprehensive review of its clearing and operations functions by an outside consultant.

**C. Required Undertakings and Sanctions** To settle this matter, the Respondents have agreed to the following undertakings and sanctions.

**3 • Ongoing Cooperation** – The Respondents have agreed to cooperate fully with the SEC in any investigations, litigations or other proceedings relating to or arising from the matters described in the SEC Orders;

- **Independent Compliance Consultant** – Within one year of the date of the SEC Orders, the broker-dealer will retain an Independent Compliance Consultant not unacceptable to the SEC staff to conduct a comprehensive review of its supervisory, compliance, and other policies and procedures designed to detect and prevent violations of the federal securities laws related to mutual fund late trading and market timing. The broker-dealer will require that the Independent Compliance Consultant complete its review and provide its recommendations in a report to the broker-dealer and the SEC staff no later than 17 months from the date of entry of the SEC Orders;
- The broker-dealer will pay \$5 million in disgorgement and a civil money penalty of \$10 million;
- The chief operating officer will pay a civil money penalty of \$50,000 and is suspended from association in a supervisory capacity with any broker or dealer for a period of nine months; and
- The vice president will pay a civil money penalty of \$30,000 and is suspended from association with any broker or dealer for a period of 12 months.

**II. SEC Complaint** The SEC's complaint, which contains factual allegations similar to those in the SEC Orders, alleges that the New York Employees violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder by engaging in fraudulent conduct in connection with the purchase and sale of securities. According to the complaint, the SEC seeks permanent injunctions, disgorgement and civil money penalties. Without admitting or denying the allegations of the Complaint, one of the New York Employees settled his involvement in this action by consenting to \$133,576 in

disgorgement. The final judgment against him waives payment of all but \$20,000, and does not impose a civil penalty. Jane G. Heinrichs Assistant Counsel

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