

**MEMO# 17150**

February 27, 2004

# **SEC AND NEW YORK FILE ENFORCEMENT ACTIONS AGAINST FUND ADVISER AND DISTRIBUTOR RELATING TO MARKET TIMING**

[17150] February 27, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 27-04 SEC RULES MEMBERS No. 32-04 SMALL FUNDS MEMBERS No. 25-04 RE: SEC AND NEW YORK FILE ENFORCEMENT ACTIONS AGAINST FUND ADVISER AND DISTRIBUTOR RELATING TO MARKET TIMING The Securities and Exchange Commission and the Attorney General of New York announced the filing of federal and state civil enforcement actions against a registered investment adviser and its affiliated distributor.\* The enforcement actions are generally predicated on the same alleged misconduct – namely, that the defendants fraudulently permitted select investors to engage in market timing activity in certain mutual funds managed by the adviser. In particular, the complaints allege that, from 1998 through October 2003, the distributor entered into secret arrangements permitting certain investors to engage in frequent short-term trading in several mutual funds and that some of the arrangements involved the investment of “sticky assets” in the particular fund(s) to be timed or in other mutual funds managed by the adviser. The complaints state that the defendants entered into and/or approved these arrangements despite the fact that they knew or had reason to know that the investors were engaged in market timing. The complaints also cite several e-mail communications to illustrate that many of the funds’ portfolio managers, a number of the distributor’s executives, and each of the senior executives responsible for the adviser’s advisory activities during the relevant period knew or recklessly disregarded that such short-term or excessive trading caused potential or actual harm and disruption to the funds. According to the complaints, many of the secret arrangements and the trades made pursuant to them were directly contrary to representations in the funds’ prospectuses that certain funds did not permit market timing or other short-term or excessive trading because of its harmful effects on the funds. Other special arrangements and trades allegedly were contrary to representations that certain funds would allow no more than three or four exchanges per \* See SEC v. Columbia Mgmt. Advisors, Inc. and Columbia Funds Distrib., Inc., Civil Action No. 04 CV 10367-GAO (D. Mass. Feb. 24, 2004); State of NY v. Columbia Mgmt. Advisors, Inc. and Columbia Funds Distrib., Inc., Index No. \_\_\_\_ (N.Y. Sup. Ct. Feb. 24, 2004). A copy of the SEC’s complaint is available on the SEC’s website at <http://www.sec.gov/litigation/complaints/comp18590.htm>, and a copy of the Attorney General’s complaint is available on the Attorney General’s website at [http://www.oag.state.ny.us/press/2004/feb/feb24b\\_04\\_attach.pdf](http://www.oag.state.ny.us/press/2004/feb/feb24b_04_attach.pdf). 2 fund per year. The complaints allege that, during the relevant period, the defendants failed to disclose to fund

shareholders and the funds' independent trustees: (1) the existence of the special arrangements and the potential harm they posed to the relevant funds; and (2) the conflicts of interest resulting from the arrangements. The complaints further allege that the adviser, aided and abetted by the distributor, breached its fiduciary duty to shareholders in the relevant funds by failing to disclose the arrangements and the conflicts of interest they created and by placing its own interest in generating fees above the interests of long-term fund shareholders. The SEC's complaint charges the adviser and the distributor with violations of: (1) the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934; and (2) Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder, which prohibits a fund affiliate from participating in a joint transaction with the fund without an SEC order. The complaint also charges: (1) the adviser with violating, and the distributor with aiding and abetting violations of, the antifraud provisions of the Investment Advisers Act of 1940; (2) the adviser with violating Section 34(b) of the Investment Company Act, which prohibits material misstatements or omissions in any registration statement filed with the SEC; and (3) the distributor with violating an antifraud provision of the Exchange Act. The SEC has demanded a jury trial and is seeking: (1) injunctive relief, including an injunction pursuant to Section 36(a) of the Investment Company Act that would prohibit the adviser from serving as an investment adviser to any registered investment company; (2) disgorgement; (3) restitution of investor losses; (4) penalties; and (5) such other equitable relief as the court deems just and appropriate. The Attorney General's complaint charges the adviser and the distributor with violations of New York's Martin Act, General Business Law, and Executive Law. The Attorney General is seeking: (1) injunctive relief; (2) disgorgement of all profits, including fees collected; (3) restitution and damages; (4) penalties and costs; and (5) such other relief to plaintiff as the court deems just and proper in the circumstances. Rachel H. Graham Assistant Counsel

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