INVESTMENT COMPANY INSTITUTE

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MASSACHUSETTS FILES ADMINISTRATIVE ACTION AGAINST BROKER-DEALER FOR MARKET TIMING AND LATE TRADING OF MUTUAL FUNDS

[16877] December 15, 2003 TO: COMPLIANCE ADVISORY COMMITTEE No. 108-03 INVESTMENT ADVISER MEMBERS No. 41-03 SEC RULES MEMBERS No. 185-03 SMALL FUNDS MEMBERS No. 84-03 RE: MASSACHUSETTS FILES ADMINISTRATIVE ACTION AGAINST BROKER-DEALER FOR MARKET TIMING AND LATE TRADING OF MUTUAL FUNDS The Massachusetts Securities Division has filed an administrative complaint against a broker-dealer for market timing and late trading of mutual funds.1 The Complaint seeks issuance of a permanent cease and desist order, an administrative fine, and compensation of mutual fund shareholders for losses attributable to the alleged market timing and late trading. The allegations set forth in the Complaint are summarized below. The Complaint alleges that, from 1998-2003, the broker-dealer failed to reasonably supervise the branch manager and registered representatives at the broker-dealer's Boston branch and knowingly furthered a fraudulent scheme involving market timing and late trading by the employees at the Boston branch.2 According to the Complaint, the scheme would not have been successful but for the complicity of the broker-dealer's management. It further alleges that senior executives of the broker-dealer knew of and encouraged the dishonest and unethical practices surrounding mutual fund trading at the Boston branch and were reluctant to "pass up the substantial profits generated by courting these multi-million dollar hedge fund accounts." 1 See In the Matter of Prudential Securities Inc., (Mass. Reg. Docket No. E-2003-075, Dec. 11, 2003) (the "Complaint"). A copy of the Complaint can be found on the Division's website at: http://www.state.ma.us/sec/sct/sctpdf/prucomp.pdf. The Exhibits accompanying the Complaint, which include internal memoranda, e-mails, correspondence, trading records, etc., are available on the Division's website at: http://www.state.ma.us/sec/sct/sctpdf/pruexhibits.pdf. 2 The employees allegedly involved in this scheme are the subject of a pending enforcement proceeding brought by the Division in November. In addition to the Division's proceeding against these employees, the Securities and Exchange Commission filed a civil action against them in November. See Institute Memorandum to Compliance Advisory Committee No. 96-03, Investment Adviser Members No. 40-03, SEC Rules Members No. 154-03, and Small Funds Members No. 65-03 [No. 16766], dated Nov. 11, 2003. 2 MARKET TIMING ALLEGATIONS The Division alleges that the broker-dealer knew of systemic problems associated with market timing misdeeds by its employees and identified the representatives who committed them, but failed to make reasonable compliance inquiries and prevent such practices even though mutual fund

companies regularly sought assistance from the broker-dealer to stop market timers "from pillaging their funds."3 The practices the broker-dealer's employees allegedly engaged in relating to marketing timing included: manipulating representatives' identification numbers;4 obtaining multiple account numbers5 or tax identification numbers; journaling money from one account that had been detected as market timing to another, which had not; intentionally placing trades through multiple accounts below breakpoints to give the appearance that these trades and exchanges were not intended for market timing purposes; and placing orders in wrap accounts to avoid detection. LATE TRADING ALLEGATIONS As regards late trading activity, the Complaint alleges that the broker-dealer knew, or should have known that its registered representatives in the Boston branch were routinely late trading mutual fund shares for their offshore hedge fund clients in conjunction with their market timing activity. According to the Complaint, the broker-dealer facilitated late trading through its failure to implement any reasonable procedures to prevent late trading of mutual fund shares. The activity by the Boston branch employees allegedly included permitting clients to confirm or alter proposed trades after 4:00 p.m. The broker-dealer allegedly facilitated this activity by authorizing a fax machine and time stamp machine that was dedicated to the employees involved in this scheme. The Complaint notes that trade information could be provided to the broker-dealer's New York office, which processed trades for the Boston branch, as late as 4:45 p.m. and such orders "were never rejected and the mutual fund orders would be entered with that day's NAV." The Complaint alleges that branch managers and/or mutual fund exchange personnel never questioned the employees involved in this scheme as to when the orders were actually received, nor did they require any evidence that they had been received before 4:00 p.m. Tamara K. Salmon Senior Associate Counsel 3 The Complaint alleges, however, that the broker-dealer, which had proprietary mutual funds, prohibited market timing within its own funds. (For purposes of this prohibition, it defined market timing as more than one trade per quarter or more than four trades per year.) According to the Complaint, the broker-dealer "sought to avoid unnecessary turnover and disruption in its own funds because it lost money for the company and [its] shareholders. However, they did not have the same regard for non-proprietary mutual funds because trading excessively in those funds made money for themselves and their clients." See Complaint at ¶29. 4 Allegedly the three employees at the Boston branch involved in market timing had over 62 different combinations of identification numbers assigned to them. 5 Allegedly, some of the clients of the Boston branch had from 25 to 60 different account numbers, "each for the distinct purpose of avoiding detection while market timing mutual funds."
