

MEMO# 14143

November 21, 2001

U.S. DISTRICT COURT DISMISSES MARKET TIMER'S COMPLAINT REGARDING RESTRICTIONS ON TRANSFERS AMONG FUNDS

[14143] November 21, 2001 TO: SEC RULES MEMBERS No. 78-01 VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 3-01 RE: U.S. DISTRICT COURT DISMISSES MARKET TIMER'S COMPLAINT REGARDING RESTRICTIONS ON TRANSFERS AMONG FUNDS The United States District Court for the Southern District of New York recently issued an opinion and order ("opinion") denying a motion for a preliminary injunction and granting, with prejudice, a motion to dismiss a complaint filed by a market timer against an insurance company. The complaint challenged restrictions that the insurance company imposed on transfers among mutual funds that were investment options for a variable annuity product.¹ More specifically, following multiple instances of trading by the market timer in violation of the funds' policies, the insurance company imposed a requirement that the market timer make transfer requests by regular mail. The market timer's motion for a preliminary injunction sought to compel the insurance company to accept transfer requests via telephone, fax and other electronic means. A copy of the opinion is attached and it is summarized below. In the opinion, the court discusses the "very clear and undisputed paper trail" documenting the insurance company's relationship with the market timer, consisting of a prospectus for the variable annuity, the deferred annuity contract, and some written correspondence. It notes that the dispute arises out of alleged oral statements which the market timer claims insurance company officials made to him. The opinion generally describes the market timing strategy at issue and explains that by engaging in such a strategy, a market timer "realizes a free profit without having faced any serious risk or provided benefit to the overall condition of the annuity portfolio." In the court's view, a market timer's "rapid and substantial transfers are anathema to fund managers because the market timer's profit from quickly cashing out of a fund portfolio comes at the expense of the long term investors in the fund." The opinion cites a Third Circuit case that recognized the "deleterious effects of market timing practices on funds designed for long term investors" (*Windsor Secs., Inc. v. Hartford Life Ins. Co.*, 986 F.2d 655 (3d Cir. 1993)). It also references the discussion of the harmful effects that arbitrage activity can have on shareholders remaining in a fund in the SEC staff's April 30, 2001 letter to the ICI providing valuation guidance. ¹ *First Lincoln Holdings v. The Equitable Life Assurance Society*, 164 F.Supp. 383 (S.D.N.Y. 2001). ² The opinion states that a party seeking preliminary injunctive relief must demonstrate (1) that it will be irreparably harmed in the absence of an injunction and (2) either (a) a likelihood of success on the merits or (b) sufficiently serious questions going to the merits of the case to make them a fair ground for litigation, and a balance of hardships tipping decidedly in its

favor. In denying the market timer's motion for a preliminary injunction, the court found that the market timer did not suffer irreparable harm, as it would be possible to calculate money damages and thus there was an adequate remedy at law. The opinion further notes that "the equities do not tip in [the market timer's] favor, the deleterious nature of market timing to long term fund investors (to whom the defendant owes certain fiduciary duties) having already been discussed extensively." The opinion then addresses the insurance company's motion to dismiss the complaint, which alleged three causes of action: violation of Section 10(b) of the Securities Exchange Act of 1934, common law fraud, and breach of contract. According to the court, the breach of contract claim could not succeed because the prospectus and annuity contract were unambiguous, providing no guarantees with respect to available trading vehicles and no promise of a right to make trades via telephone, fax or internet. Moreover, there was no provision in the annuity contract limiting the insurance company's discretion regarding the imposition of rules and policies on trading. The court further found the market timer's fraud claims to be "totally without merit." The allegation that the insurance company made oral representations that market timing would be permissible when it did not intend to make good on such representations did not support a claim of federal securities fraud. Even if the representations were made, this would be a breach of contract claim. The common law fraud claim also failed, because the prospectus and annuity contract "explicitly vest [the insurance company] with discretion to curtail market timing and prohibit such practices." Accordingly, these documents demonstrated that the market timer "could not have justifiably relied on the alleged representations of [insurance company] officials when the terms of the instrument itself made clear that such trading practices were prohibited." Frances M. Stadler Deputy Senior Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 14143, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14143. Attachment (in .pdf format)