

**MEMO# 18167**

November 12, 2004

# **MUTUAL FUND INVESTMENT ADVISER SETTLES SEC AND NEW YORK ENFORCEMENT ACTIONS RELATING TO MARKET TIMING AND LATE TRADING**

[18167] November 12, 2004 TO: BOARD OF GOVERNORS No. 73-04 CHIEF COMPLIANCE OFFICER COMMITTEE No. 22-04 COMPLIANCE ADVISORY COMMITTEE No. 107-04 SEC RULES MEMBERS No. 160-04 SMALL FUNDS MEMBERS No. 119-04 RE: MUTUAL FUND INVESTMENT ADVISER SETTLES SEC AND NEW YORK ENFORCEMENT ACTIONS RELATING TO MARKET TIMING AND LATE TRADING The Securities and Exchange Commission has issued an order making findings and imposing disgorgement, penalties, and compliance reforms in an enforcement proceeding against an investment adviser to a group of mutual funds ("Funds").<sup>1</sup> The adviser consented to the entry of the SEC's Order without admitting or denying the SEC's findings. In addition, the Attorney General of New York announced a settlement with the adviser of related state charges.<sup>2</sup> Both actions involved allegations that the adviser permitted market timing and late trading of the Funds. The SEC's Order and the Attorney General's announcement are summarized below.

I. SEC Order

A. Findings The SEC Order finds that from at least 2000 through October 2002, the Funds' prospectus prohibited market timing, and the adviser enforced this policy by employing a "timing cop" to monitor and block excessive trading. Notwithstanding this policy, the SEC Order states that the adviser entered into undisclosed agreements in 2001 and 2002 allowing certain large investors to engage in market timing in certain of the Funds. According to the SEC 1 See In the Matter of Fremont Investment Advisors, Inc., SEC Release Nos. IA-2317 and IC-26650, Admin. Proc. File No. 3-11726 (Nov. 4, 2004) ("SEC Order"). The SEC Order also censures and imposes a cease and desist order on the adviser. Copies of the SEC Order and accompanying press release are available at <http://www.sec.gov/litigation/admin/ia-2317.htm> and <http://www.sec.gov/news/press/2004-153.htm>, respectively. 2 See Fremont Investment Advisors Settles Market Timing Case (press release issued by Office of New York State Attorney General Eliot Spitzer, Nov. 4, 2004) ("Press Release"). A copy of the Press Release is available on the Attorney General's website at [http://www.oag.state.ny.us/press/2004/nov/nov4a\\_04.html](http://www.oag.state.ny.us/press/2004/nov/nov4a_04.html). 2 Order, one of these agreements included a requirement that the investor place a \$10 million long-term investment (or "sticky asset") in another Fund. The SEC Order finds that the adviser never disclosed the market timing agreements with shareholders or the independent directors of the Funds. The SEC Order further finds that in 2001 an employee of the adviser, without management's knowledge, improperly authorized a brokerage firm to place mutual fund orders after the market close, while still receiving the current day's price. As a result of the

conduct generally described above, the SEC Order finds that the adviser willfully violated:

- the antifraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 by entering into arrangements with market timers that were not disclosed to the Funds' board of directors or shareholders;
- Section 34(b) of the Investment Company Act of 1940, by making material misstatements and omissions in the Funds' prospectuses;
- Section 17(d) of the Investment Company Act and Rule 17d-1 under that Act for effecting transactions in connection with joint arrangements in which the Funds were participants without filing an application with the SEC and obtaining an SEC order approving the transactions; and
- Rule 22c-1 under the Investment Company Act, which requires orders for mutual funds shares placed after the market close to receive the next day's fund price.

**B. Undertakings**

- **Ongoing Cooperation** – The adviser has 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 Order.
- **General Compliance** – The adviser has agreed to the following undertakings:
  - o **Senior-Level Person:** The adviser will hire a full-time senior level person whose responsibilities will include compliance matters related to conflicts of interests and who will report directly to the adviser's chief compliance officer ("CCO").
  - o **Policies and Procedures Review:** The CCO or a member of his/her staff will review compliance with the policies and procedures established to address compliance issues under the Investment Advisers Act and the Investment Company Act. Any violations will be reported to the adviser's president.
  - o **Quarterly Compliance Reporting:** The CCO will report to the independent directors of the Funds at least quarterly any breach of fiduciary duty or the federal securities laws of which the CCO becomes aware. Any material breach will be reported promptly.
  - o **Corporate Ombudsman:** The adviser will establish a corporate ombudsman to whom it employees may convey concerns about ethics matters or questionable practices. The adviser must review any matters relating to the Funds' business that are brought to the ombudsman's attention, along with any resolution of such matters, with the independent directors of the Funds with such frequency as the independent directors may instruct.
- **Periodic Compliance Review** – At least once every other year, commencing in 2005, the adviser will undergo a compliance review by a third party that is not an interested party of the adviser. The third party will issue a report of its findings and recommendations to the CCO and to the compliance or audit committee of the board of directors of the Funds.
- **Independent Distribution Consultant** – Within 180 days of the SEC Order, the adviser will retain an independent distribution consultant acceptable to the SEC staff and to the majority of the independent directors. The consultant will develop a plan to distribute the total disgorgement and penalties ordered to compensate the Funds' shareholders for losses attributable to market timing during the relevant period. The adviser will require that the independent distribution consultant submit the distribution plan to the adviser and the SEC staff within 250 days of the SEC Order. Following the issuance of an SEC Order approving a final plan of disgorgement, the independent distribution consultant and the adviser will take all necessary and appropriate steps to administer the final plan.
- **Certification** – No later than 24 months after the entry of the SEC Order, the chief executive officer of the adviser will certify to the SEC in writing that the adviser has fully adopted and complied in all material respects with the undertakings and the recommendations of the Independent Compliance Consultant, or will describe any material non-adoption or non-compliance.
- **Recordkeeping** – Any record of the adviser's compliance with the undertakings will be preserved for at least six years from the end of the fiscal year last used, the first two years in an easily accessible place.

**C. Disgorgement and Civil Penalties**

- The adviser will pay \$2.146 million in disgorgement and a civil money penalty of \$2 million.

**II. Settlement of Charges by Attorney General**

According to the Press Release, coordinated investigations by the Attorney General's office and the SEC revealed that from January 2001 to October 2002, the adviser permitted preferred investors to engage in

improper, frequent short-term trading in the Funds at the expense of the Funds' shareholders. The Press Release states that one of the agreements required the timer to invest sticky assets in a Fund. The Press Release further states that the agreements were not disclosed to long-term investors and that the Funds' prospectus disclosed that investors were limited to no more than five exchanges in any 12-month period. In addition 4 to the market timing, the Press Release notes that the adviser's employee allowed a brokerage firm to place mutual fund orders after the market close, while still receiving the current day's price. The Press Release describes the settlement agreement as follows: • the adviser will pay \$2.146 million in restitution and disgorgement and \$2 million in civil penalties, which payments were negotiated jointly by the Attorney General's office and the SEC, and • the adviser has agreed to significant corrective measures designed to create greater board and adviser accountability and to prevent the kinds of abuses that gave rise to the investigation. Jane G. Heinrichs Assistant Counsel

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