

MEMO# 17134

February 24, 2004

MUTUAL FUND DISTRIBUTOR SETTLES NASD CHARGES OF MARKET TIMING SUPERVISION VIOLATIONS

[17134] February 24, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 25-04 SEC RULES MEMBERS No. 30-04 SMALL FUNDS MEMBERS No. 24-04 RE: MUTUAL FUND DISTRIBUTOR SETTLES NASD CHARGES OF MARKET TIMING SUPERVISION VIOLATIONS The NASD has announced the settlement of charges against a distributor for failing to prevent market timing of its affiliated mutual funds ("funds") due to the distributor's inadequate supervisory systems.* In settling the matter, the distributor neither admitted nor denied the NASD's allegations or findings. The settlement, which is attached, is briefly described below. The NASD found that from at least 2001 through August 2003, the distributor's supervisory procedures and systems were not reasonably designed to ensure compliance with the funds' policies relating to market timing and fund exchanges. In particular, the NASD found that certain customers of NASD member firms were able to exchange fund shares beyond the limits set forth in the funds' prospectuses by, for example, using multiple accounts to evade a "block" that the distributor had placed on exchange activity in a particular account. The NASD determined that the distributor knew or should have known of such conduct, which was in violation of the distributor's Selected Dealer Agreement with the member firms, but that the distributor nevertheless continued to do business with those firms. According to the NASD, the distributor's procedures and systems were deficient in several areas, including that: (1) they failed to provide for adequate follow-up to the "block letters" that the distributor sent to member firms; (2) the distributor lacked an effective system to monitor fund exchange activity by accounts under common ownership, despite language in the funds' prospectuses limiting exchanges for "each account or group of accounts under common ownership or control;" and (3) after learning of noncompliance with fund exchange restrictions, the distributor failed to take effective remedial measures. The NASD further found that the distributor failed to preserve and maintain, in accordance with applicable SEC and NASD rules, all internal e-mail communications that were sent but later deleted. * See NASD Fines State Street Research Investment Services \$1 Million for Market Timing Supervision Violations; Firm Ordered to Pay More Than \$500,000 in Restitution (press release issued by NASD, Feb. 19, 2004) ("Press Release"), available at http://www.nasdr.com/news/pr2004/release_04_010.html. 2 The distributor agreed to the following sanctions: (1) a censure; (2) a \$1 million fine; (3) restitution of more than \$500,000 to the funds; (4) certification in writing that, for the relevant time period and to the best of its knowledge based on reasonable inquiry, it has disclosed to the NASD all exchanges of fund shares that exceed prospectus limits; (5) certification, within 90 days of the settlement, that it has reviewed its procedures regarding market timing and has

systems and procedures in place that are reasonably designed to ensure that fund prospectus exchange limits are enforced; and (6) certification in writing, within 180 days of the settlement, that it has established systems and procedures reasonably designed to achieve compliance with the laws and regulations concerning the preservation of e-mail communications. The Press Release states that NASD's investigations into conduct relating to this case and other market timing violations are continuing. Rachel H. Graham Assistant Counsel Attachment (in .pdf format) 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 17134, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17134.

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