

MEMO# 17621

June 3, 2004

BROKER-DEALER SETTLES NASD CHARGES OF FACILITATING DECEPTIVE MARKET TIMING IN VARIABLE ANNUITIES

[17621] June 3, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 58-04 SEC RULES MEMBERS No. 82-04 SMALL FUNDS MEMBERS No. 62-04 RE: BROKER-DEALER SETTLES NASD CHARGES OF FACILITATING DECEPTIVE MARKET TIMING IN VARIABLE ANNUITIES The NASD has announced the settlement of charges against a registered broker-dealer for: (1) facilitating deceptive market timing in variable annuities by two hedge fund managers; (2) failing to supervise the activities of the firm with regard to market timing activity; and (3) failing to establish and maintain a reasonable supervisory system and written supervisory procedures to prevent late trading of mutual funds.* In settling the matter, the broker-dealer 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 April 2002 through September 2003, the broker-dealer and four of its brokers enabled two hedge fund managers to carry out frequent transfers among variable annuity sub-accounts without being detected by the affected insurance companies and mutual funds. According to the NASD, the broker-dealer (including members of its compliance department) knew about the hedge fund managers' market timing strategy and received at least ten letters from insurance companies expressing concern about excessive trading and restricting the trading in annuities held by the managers' hedge funds. The NASD determined that the broker-dealer, through its brokers, nevertheless continued to sell variable annuity products to the hedge fund managers. The NASD also determined that the broker-dealer did not take effective steps to stop market timing activity on the part of its brokers or clients. In particular, the NASD found that the broker-dealer did not maintain adequate written supervisory procedures addressing market timing or excessive trading, nor did it implement any supervisory system to monitor the activity of its associated persons with regard to market timing. The NASD further found that the broker-dealer's supervisory personnel failed to respond to clear "red flags" that would have alerted them to the deceptive practices carried out by the hedge fund managers and the brokers (e.g., e-mail correspondence referring to the use of different tax ID numbers or annuitants in response to letters from insurance companies). * See NASD Fines Davenport & Co. in First Case of Deceptive Market Timing in Variable Annuities (press release issued by NASD, June. 1, 2004), available at http://www.nasdr.com/news/pr2004/release_04_038.html. 2 With respect to late trading, the NASD found that between at least July 2002 and September 2003, the broker-dealer routinely received trading instructions from customers after 4:00 p.m. EST and executed those trades as if the instructions had been received prior to 4:00 p.m. According to the NASD, the broker-dealer had converted its trading platform to a new

system and, to lessen the effect of disruptions associated with the conversion, the broker-dealer decided to set the system so that it would accept mutual fund trades until 4:30 p.m. EST. The NASD found that the broker-dealer placed no restrictions on the entry of orders during the 30-minute period after the market close, and that its written procedures neither stated that late trading was prohibited nor prevented the cancellation or modification of orders after the market close. The broker-dealer agreed to the following sanctions: (1) a censure; (2) a fine of \$450,000; and (3) restitution of approximately \$288,000 to the affected mutual funds. The press release states that the NASD's investigation of individual brokers and other entities involved in this market timing activity is 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 17621, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17621.

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