

MEMO# 17061

February 6, 2004

MASSACHUSETTS SECURITIES DIVISION ACTION AGAINST MUTUAL FUND FIRM RELATING TO MARKET TIMING

[17061] February 6, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 16-04 SEC RULES MEMBERS No. 22-04 SMALL FUNDS MEMBERS No. 16-04 RE: MASSACHUSETTS SECURITIES DIVISION ACTION AGAINST MUTUAL FUND FIRM RELATING TO MARKET TIMING On February 4, 2004, the Enforcement Section of the Massachusetts Securities Division filed an administrative complaint against a mutual fund firm and three of its subsidiaries alleging violations of the anti-fraud provisions of the Massachusetts Uniform Securities Act.¹ The complaint alleges that the respondents permitted market timing investments in their mutual funds in exchange for a quid pro quo investment in a hedge fund. The complaint is further summarized below. Alleged Facts The complaint charges that in 2001, certain fund executives negotiated an arrangement with an investor to provide market timing capacity to trade certain mutual funds in exchange for leaving a substantial investment in a hedge fund on a long-term basis. The complaint alleges that this “sticky asset”/quid pro quo arrangement was never disclosed to mutual fund investors and is in direct violation of the funds’ prospectuses. According to the complaint, the prospectus for one of the funds being timed specifically prohibited market timing and the prospectuses for the other funds being timed suggests that market timing would be discouraged. The complaint further alleges that the arrangement, which involved the use of a single- participant 401(k) plan account, allowed the investor to circumvent the funds’ market timing controls, utilize Fund/SERV to place trades as late in the day as possible, and avoid a 2% redemption fee. The complaint notes that the principal fund employee involved was placed on administrative leave in December and subsequently left the company. 1 See In the matter of Franklin Resources, Inc., et al., Docket No. E-2004-007 (Feb. 4, 2004). A copy of the complaint is available on the Secretary of the Commonwealth’s website at <http://www.state.ma.us/sec/sct/sctft/ftidx.htm>. 2 Alleged Violations of Massachusetts Law The complaint alleges that the arrangement violated the anti-fraud section of the Massachusetts Uniform Securities Act by: 1) failing to disclose material information within the mutual fund prospectuses; 2) being in direct contradiction to the policy disclosed in the mutual fund prospectuses; 3) by permitting certain shareholder(s) to engage in activity that violated the policy disclosed in the prospectus, violating other shareholder’s expectation as to how that policy would be applied, and causing harm to the performance and value of its funds and to the ultimate return of long-term shareholders; and 4) by breaching the respondents’ fiduciary duty to their shareholders. Requested Relief The complaint requests that the respondents be ordered to disgorge illegal profits back to fund shareholders, cease and desist from further violations of the Uniform Securities Act, and pay an administrative

fine in an amount to be determined. It further requests that the Director or Hearing Officer deciding the case take such other actions that may be in the public interest and necessary and appropriate for the protection of Massachusetts investors. Robert C. Grohowski
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