INVESTMENT COMPANY INSTITUTE

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NASD SANCTIONS MUTUAL FUND DISTRIBUTOR FOR FAILING TO DETECT MARKET TIMING AND MAINTAIN REQUIRED E-MAILS

[18089] October 11, 2004 TO: BROKER/DEALER ADVISORY COMMITTEE No. 28-04 BROKER/DEALER ASSOCIATE MEMBERS No. 5-04 CHIEF COMPLIANCE OFFICER COMMITTEE No. 13-04 COMPLIANCE ADVISORY COMMITTEE No. 97-04 SEC RULES MEMBERS No. 150-04 SMALL FUNDS MEMBERS No. 111-04 RE: NASD SANCTIONS MUTUAL FUND DISTRIBUTOR FOR FAILING TO DETECT MARKET TIMING AND MAINTAIN REQUIRED E-MAILS The NASD has announced the settlement of charges against a mutual fund distributor for failing (1) to maintain supervisory procedures and systems that were reasonably designed to detect market timing and excessive mutual fund exchanges and (2) to maintain and preserve all internal e-mail communications. 1 These violations and the sanctions agreed to by the distributor are summarized below. FAILURE TO ADEQUATELY DETECT MARKET TIMING According to the AWC Letter, the fund distributor distributes mutual funds through affiliated and unaffiliated broker-dealers. The NASD found that from at least October 2000 to October 31, 2003, the distributor violated NASD Conduct Rules 3010 and 21102 by failing to have supervisory procedures that were reasonably designed to detect market timing and excessive mutual fund exchanges. The deficiencies cited by the NASD included the following: • The distributor's legal and compliance departments were not involved in monitoring excessive trading; • The distributor left the primary review of its excessive trading surveillance data and reports to its wholesalers and non-compliance personnel; 1 See NASD Fines Sentinel Financial Services $700,000 For Failing to Prevent Market Timing (press release issued by NASD, October 7, 2004), which is available at http://www.nasdr.com/news/pr2004/release_04_066.html, and In Re Sentinel Financial Services Company, NASD Letter of Acceptance, Waiver, and Consent (October 2004) (the "AWC Letter") (copy attached). 2 NASD Conduct Rule 3010 governs a broker-dealer's supervision of its activities; NASD Conduct Rule 2110 governs a broker-dealer's standards of commercial honor and principles of trade. 2 • Although the distributor made efforts to track and prevent excessive trading activity, its systems were inadequate to permit it to do so with respect to all excessive trading (e.g., they were unable to identify excessive trading spread over more than one account for the same customer); • While the distributor might have detected market timing after it had occurred, its supervisory systems were not adequate to prevent and detect transactions prior to their occurring; • The distributor's systems failed to provide for adequate follow-up and review of excessive trading, which enabled some customers to establish new customer accounts to continue trading in the affected funds; and • The distributor's systems and procedures were not adequate to

ensure that notices were sent in a timely manner to customers engaging in excessive trading – i.e., prior to their trading. As a result of the above inadequacies, customers of some selling broker-dealers were able to violate the funds' policies regarding excessive trading activities. These policies permitted the funds to reject or restrict trades from a customer with a history of either excessive trading (generally six or more exchanges within a 12-month period) or trading that was disruptive to the funds. The NASD also found that in about 1998 or 1999, the distributor entered into understandings with two registered representatives of other broker-dealers that permitted them to market time certain funds. While these understandings predated the funds' adoption of policies relating to market timing, trading continued pursuant to those understandings after adoption and in contravention of the funds' policies. FAILURE TO MAINTAIN E-MAILS According to the AWC Letter, the distributor failed to maintain and preserve, for a period of not less than three years, all internal e-mail communications. In particular, the distributor failed to retain all e-mails that were deleted by registered persons. Such conduct violated Rule 17a-4 under the Securities Exchange Act of 1934 and NASD Conduct Rules 31103 and 2110. SANCTIONS Without admitting or denying the NASD's allegations or findings, the distributor consented to the imposition of a censure and a fine of $700,000. The distributor further agreed to comply with undertakings to certify to the NASD within prescribed time periods that it has: • Paid at least $659,674 to compensate the three affected mutual funds for losses attributable to excessive trading from October 2000-October 2003; • Disclosed to the NASD all instances of exchanges of fund shares that violated the funds' excessive trading policies; • Put systems in place to ensure that fund prospectus policies are enforced; and 3 NASD Conduct Rule 3110 requires, in part, all broker-dealers to comply with the SEC's recordkeeping rule, Rule 17a-4. 3 • Established systems and procedures that are reasonably designed to achieve compliance with SEC and NASD rules concerning the preservation of electronic communications. Tamara K. Salmon Senior Associate 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 18089, or call the ICI Library at (202) 326-8304 and request the attachment for memo 18089.