MEMO# 17347

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SEC AND NEW YORK ATTORNEY GENERAL REACH AGREEMENTS WITH FIRMS OVER LATE TRADING, MARKET TIMING CHARGES

[17347] April 2, 2004 TO: BOARD OF GOVERNORS No. 27-04 COMPLIANCE ADVISORY COMMITTEE No. 40-04 INVESTMENT COMPANY DIRECTORS No. 18-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 35-04 SEC RULES MEMBERS No. 50-04 SMALL FUNDS MEMBERS No. 38-04 RE: SEC AND NEW YORK ATTORNEY GENERAL REACH AGREEMENTS WITH FIRMS OVER LATE TRADING, MARKET TIMING CHARGES The staff of the Securities and Exchange Commission and the New York Attorney General's Office jointly negotiated a settlement agreement in principal with one of the nation's largest banks of securities fraud charges arising from arrangements to permit timing in mutual funds advised by a bank subsidiary and for facilitating market timing and late trading of numerous other mutual funds through the bank's broker-dealer subsidiary.1 The SEC staff and the NYAG's Office also jointly negotiated a settlement agreement in principal with the investment adviser and distributor for a group of mutual funds for securities fraud charges arising from arrangements to permit market timing in the funds by certain customers.2 The details of the two settlement agreements in principle are summarized below.3 In each case, the SEC noted that its investigation is continuing. AGREEMENT WITH BANK The SEC staff and the NYAG's Office alleged that two of the bank's subsidiaries – its registered mutual fund adviser and its registered broker-dealer/underwriter – engaged in securities fraud. The charges stem from arrangements made by the investment adviser to permit a hedge fund to engage in market timing activities involving the mutual funds managed 1 See SEC Reaches Agreement in Principal to Settle Charges Against Bank of America for Market Timing and Late Trading (March 15, 2004), which is available from the SEC's website at http://www.sec.gov/news/press/2004-33.htm. See also, Spitzer, SEC Reach Largest Mutual Fund Settlement Ever (March 15, 2004) ("NYAG Release"). The NYAG Release is available from the NYAG's website at http://www.oag.state.ny.us/press/2004/mar/mar15c_04.html. 2 See SEC's Division of Enforcement Announces Agreement to Settle Civil Fraud Charges Against Fleet's Columbia Mutual Fund Adviser and Distributor for Undisclosed Market Timing (March 15, 2004), which is available from the SEC's website at http://www.sec.gov/news/press/2004-34.htm. See also NYAG Release, supra note 1. 3 The NYAG Release notes that in a separate agreement, the bank and the parent company of the fund adviser and distributor agreed to reduce the fees they charge investors by $160 million over a five-year period. 2 by the adviser, and by the broker-dealer, who facilitated market timing and late trading activities by the hedge fund and others. The bank: (i) agreed to pay $375 million, consisting of $250 million in restitution and $125 million in penalties;

(ii) agreed to consent to a cease and desist order including securities fraud charges, without admitting or denying the Commission's findings; (iii) represented that it will exit the securities clearing business by the end of the year; (iv) agreed to implement certain election and retirement procedures for the mutual funds' trustees that will result in the replacement of eight of the funds' trustees within one year4; and (v) agreed to certain undertakings that will strengthen the mutual funds' and broker-dealers' oversight of compliance with the securities laws. AGREEMENT WITH FUND ADVISER AND DISTRIBUTOR In the second agreement, the SEC staff and NYAG's Office alleged that the registered investment adviser and registered broker-dealer distributor for a group of mutual funds engaged in abusive market-timing activities. According to the SEC, the adviser and distributor allowed certain preferred mutual fund customers to engage in short-term and excessive trading, while at the same time representing publicly that such trading was prohibited. Specifically, the SEC alleged that: (i) from at least 1998 through 2003, the distributor secretly entered into arrangements with at least nine companies and individuals allowing them to engage in frequent short-term trading in at least seven of the funds; (ii) in connection with certain of the arrangements, the adviser and distributor accepted so-called "sticky assets" – long-term investments that were to remain in place in return for allowing the investors to actively trade in the funds; (iii) the adviser knew and approved of all but one of the arrangements and allowed them to continue despite knowing such short-term trading could be detrimental to long-term shareholders in the funds; and (iv) the adviser and distributor acted improperly in entering into and accepting the short-term trading arrangements, because they were contrary to disclosures made in funds' prospectuses. The investment adviser and distributor both agreed to: (i) pay $70 million in restitution; and (ii) pay $70 million in civil penalties; (iii) an order requiring both the adviser and distributor to cease and desist from violations of the antifraud and other provisions of the federal securities laws; (iv) governance changes designed to maintain the independence of the funds' trustees and ensure the adviser's and distributor's compliance with the securities laws and their fiduciary duties; (v) retention of an independent consultant to review compliance policies and procedures of the adviser and distributor, and recommend changes or enhancements, which must be implemented by both entities; and (vi) continued cooperation with the SEC staff in its ongoing investigation. Barry E. Simmons Associate Counsel 4 According to the NYAG Release, the trustees approved a two percent redemption fee on sales of the firm's international funds held for less than 90 days – but the approved measure exempted a hedge fund from the redemption fee, which subsequently conducted extensive market timing of two of the funds in question.
