

MEMO# 17930

August 31, 2004

NASD SANCTIONS BROKER-DEALER AND OFFICERS FOR FACILITATING DECEPTIVE MARKET TIMING PRACTICES OF MUTUAL FUNDS

[17930] August 31, 2004 TO: BOARD OF GOVERNORS No. 55-04 BROKER/DEALER ADVISORY COMMITTEE No. 25-04 BROKER/DEALER ASSOCIATE MEMBERS No. 4-04 COMPLIANCE ADVISORY COMMITTEE No. 84-04 PRIMARY CONTACTS - BROKER DEALER ASSOCIATE MEMBERS PRIMARY CONTACTS - MEMBER COMPLEX No. 79-04 SEC RULES MEMBERS No. 121-04 SMALL FUNDS MEMBERS No. 93-04 RE: NASD SANCTIONS BROKER-DEALER AND OFFICERS FOR FACILITATING DECEPTIVE MARKET TIMING PRACTICES OF MUTUAL FUNDS The NASD has announced the settlement of charges against a broker-dealer, its President, and its former Chief Operating Officer for facilitating deceptive market timing practices of mutual funds and failing to have an adequate supervisory system to prevent and detect market timing and possible late trading.* In settling the matter, each of the Respondents neither admitted nor denied the NASD's allegations or findings. The settlement, which is attached, is briefly described below. The NASD found that from January 2001 through August 2002, the broker-dealer helped four hedge fund clients engage in deceptive market timing practices. The NASD found that the broker-dealer received a total of at least 77 notices from about 30 different fund families informing the broker-dealer that market timing was not welcome or permitted by the funds and that the activity in question must cease. Notwithstanding these notices, the hedge fund clients repeatedly avoided attempts by thirteen mutual fund companies to stop the clients' activities. The NASD found that the hedge fund clients transacted at least 1,000 mutual fund trades, totaling nearly \$400 million, after the broker-dealer had received notices that the fund companies considered the timing strategy of the clients to be disruptive and contrary to the interests of long-term investors. The NASD further found that the broker-dealer failed to prevent the hedge fund clients from continuing to trade the funds through deceptive means. For example, after an account was restricted by a mutual fund company for market timing, the hedge fund client evaded subsequent detection by shifting the prohibited activity to another * See NASD Orders First-Ever Suspension of Mutual Fund Business and \$600,000 in Sanctions Against National Securities Corp. for Deceptive Market Timing Practices (press release issued by NASD, February 19, 2004) ("Press Release"), available at http://www.nasdr.com/news/pr2004/release_04_055.html; In re National Securities Corporation, Michael A. Bresner, and David M. Williams, NASD Letter of Acceptance, Waiver and Consent (Aug. 2004). 2 account that it controlled. In other instances, the client continued to time the fund through the very same account that had been restricted by the fund company, which resulted in the issuance of additional notices or warnings until the

account finally complied with the market timing restriction. According to the NASD, the broker-dealer's President and COO failed to ensure that the broker-dealer had an adequate supervisory system designed to prevent and detect deceptive market timing practices and failed to respond to red flags that pointed to the deceptive practices. The NASD also found that the broker-dealer's written procedures were completely silent with respect to the prevention and detection of deceptive market timing activities and that the broker-dealer had no supervisory system or written procedures designed to prevent or detect late trading despite the fact that (i) selling agreements with various mutual fund companies required the firm to monitor such activities to ensure fair pricing and (ii) market timing orders by the hedge fund clients were routinely transmitted to the broker-dealer's trading desk after 4:00 p.m., which should have raised red flags that late trading might be occurring. The NASD further found that the broker-dealer failed to preserve and maintain, in accordance with applicable Securities and Exchange Commission and NASD recordkeeping rules, all internal e-mail communications. As a result of the conduct generally described above, the NASD found that the Respondents variously violated NASD Conduct Rules 2110, 3010, and 3110 and SEC Rule 17a-4 of the Securities Exchange Act of 1934. The broker-dealer agreed to the following sanctions: (1) a censure; (2) a \$300,000 fine; (3) restitution of almost \$300,000 to the funds that were affected by the deceptive market timing; (4) a 30-day suspension from opening new mutual fund accounts for new clients; (5) certification, within 30 days of the settlement, that it has reviewed its procedures regarding market timing and late trading and has systems and procedures in place reasonably designed to ensure compliance with the laws, regulations, and rules concerning market timing and late trading and to ensure that prospectus fund exchange limits are enforced; and (6) certification, within 30 days of the settlement, that it has established systems and procedures reasonably designed to achieve compliance with the laws, regulations, and rules concerning the preservation of e-mail communications. The President agreed to a \$25,000 fine and a one-month suspension from acting in a principal capacity and the former COO agreed to a \$25,000 fine and a four-month suspension from acting in a principal capacity other than as a financial and operations principal. The Press Release states that the NASD's investigation of individual brokers and others involved in this case is continuing. Jane G. Heinrichs Assistant Counsel Attachment (in .pdf format) 3 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 17930, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17930.