

MEMO# 18641

March 11, 2005

NYSE AND NEW JERSEY SETTLE WITH BROKER-DEALER RELATING TO MARKET TIMING

[18641] March 11, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 7-05
BROKER/DEALER ASSOCIATE MEMBERS No. 3-05 CHIEF COMPLIANCE OFFICER COMMITTEE
No. 24-05 COMPLIANCE ADVISORY COMMITTEE No. 22-05 SEC RULES MEMBERS No. 37-05
SMALL FUNDS MEMBERS No. 24-05 RE: NYSE AND NEW JERSEY SETTLE WITH BROKER-
DEALER RELATING TO MARKET TIMING The New York Stock Exchange and the Attorney
General of New Jersey announced the settlement of related disciplinary actions to resolve
allegations that a broker-dealer failed to reasonably supervise certain of its registered
representatives in connection with market-timing activities.* In both actions, the broker-
dealer consented to the findings without admitting or denying guilt. The settlements are
summarized below. New York Stock Exchange Action Findings According to the NYSE
Decision, from January 2002 to October 2003, the broker-dealer employed a team of
brokers who engaged in deceptive practices to effect short-term trading of mutual funds for
a hedge fund client, which was in violation of the broker-dealer's policies and potentially
detrimental to other mutual fund shareholders. Specifically, the NYSE Decision finds that,
during the period January through April 2002, the brokers executed over 3,700 short- term
mutual fund transactions in multiple accounts held for a single hedge fund client. When
some of the mutual funds began to complain about the market timing, the broker-dealer
instructed the brokers to refrain from engaging in market timing transactions in the client's
accounts. In response, and after consulting their managers, the brokers facilitated the
opening of accounts for the hedge fund client at various mutual funds with themselves as
the broker of record. They then moved the mutual fund positions held at the broker-dealer
to these new * See Merrill Lynch, Pierce, Fenner & Smith Incorporated, NYSE, Exchange
Hearing Panel Decision 05-27 (March 7, 2005) ("NYSE Decision"), which is available at
<http://www.nyse.com/pdfs/05-027.pdf> and In the Matter of Merrill Lynch, Pierce, Fenner &
Smith Incorporated, State of New Jersey, Office of the Attorney General, Consent Order
(March 7, 2005) ("NJ Order"), which is available at
<http://www.state.nj.us/lps/newsreleases05/merrilllynchconsentorder3-05.pdf>. 2 accounts
held outside of the broker-dealer and continued to execute frequent trades on the hedge
fund's behalf in them. According to the NYSE Decision, the brokers later moved the
positions back to fee-based accounts at the broker-dealer. The NYSE Decision finds that,
notwithstanding these trading patterns and the receipt of commissions paid by the mutual
funds in connection with the brokers' trading prior to November 2002, the broker-dealer
failed to recognize that its brokers were engaging in short- term trading of mutual funds in
outside accounts. The NYSE Decision further finds that the broker-dealer eventually did
become aware of the brokers' trading in the outside accounts in November 2002 based on

market timing complaints from several mutual funds. The brokers were then instructed to stop effecting trades at the various mutual funds. According to the NYSE Decision, however, the broker-dealer took no additional steps to ensure that the brokers complied with that instruction. The brokers continued to execute trades on behalf of the hedge fund in outside accounts until at least April 2003. The NYSE Decision also finds that the same group of brokers purchased a multi-million dollar variable annuity and other insurance policies on behalf of the same hedge fund client. Based on the client's instructions, the brokers facilitated frequent transactions in the sub-accounts underlying these products. According to the NYSE Decision, the broker-dealer failed to make or maintain any record of those transactions, including confirmations received from the annuity companies. The NYSE Decision states that, in October 2003, the broker-dealer terminated three of the brokers and fined their managers for failing to adequately supervise certain activities in connection with the conduct described above. As a result of the conduct generally described above, the NYSE Decision finds that the broker-dealer violated:

- NYSE Rule 342 by failing to reasonably supervise certain business activities, establish and maintain appropriate procedures for supervision and control with respect to certain business activities involving the trading of mutual funds, and failing to review and maintain certain incoming and outgoing communications with the public; and
- NYSE Rule 440 and Section 17(a) of the Securities Exchange Act of 1934 and Rules 17a-3 and 17a-4 under that Act for failing to maintain books and records relating to trading in variable annuity product sub-accounts.

Undertakings According to the NYSE Decision, the broker-dealer agreed to the following undertakings:

- Global Compliance Alert: The broker-dealer agreed to issue a Global Compliance Alert communication detailing the broker-dealer's policies and procedures with respect to the review and retention of incoming and outgoing correspondence and fax transmissions. The Global Compliance Alert will also advise financial advisors that correspondence and fax transmissions with respect to a client's reallocation of the sub-accounts of variable products will be maintained in accordance with the broker-dealer's policies and procedures. 3
- Outside Accounts: The broker-dealer agreed to implement a policy and procedure addressing how financial advisors should deal with instructions from clients to trade mutual fund positions in accounts held outside of the broker-dealer.
- Client Reallocation Requests: The broker-dealer agreed to develop technology to allow the recording of client reallocation requests regarding the underlying sub-accounts of non-proprietary variable annuity products.
- Tax Identification Numbers: The broker-dealer agreed to implement a procedure that will provide tax identification numbers to the National Securities Clearing Corporation when transmitting orders to mutual fund companies on behalf of its clients.

Sanctions

- The broker-dealer was censured.
- The broker-dealer was fined \$13,500,000, which was waived in consideration of a \$10,000,000 fine paid to the State of New Jersey and a payment totaling \$3,500,000 in furtherance of a settlement with the State of Connecticut.

New Jersey Action The New Jersey Order, which contains factual allegations that generally mirror those in the NYSE Decision, finds that the broker-dealer's conduct violated the recordkeeping and supervision requirements of the New Jersey securities laws. The New Jersey Order requires the undertakings similar to those described in the NYSE Decision. According to the New Jersey Order, the broker dealer will pay a \$10,000,000 civil monetary penalty. Jane G. Heinrichs Assistant Counsel