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REPORT

Mutual Funds

The Mutual Fund Crisis—Beginning to See a Resolution

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Over the last several weeks, the Securities and Exchange Commission has adopted rules and published a spate of rulemaking proposals that will result in nothing less than a fundamental restructuring of regulation and practices in the mutual fund industry. In doing so, the SEC has assumed the leadership role in the massive and comprehensive campaign to clean up perceived fund industry abuses—principally late trading, deceptive market timing, and sales practice issues—kicked off by New York Attorney General Eliot Spitzer on September 3, 2003.[1]

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At this point in the regulatory effort, it is possible to see the outlines of the resolution of the industry's issues. This article describes the detailed regulatory fixes proposed so far for each of the major problem areas uncovered. The article also describes the various civil and criminal sanctions that have been levied by state and federal authorities on industry players to date, as the number of enforcement cases continues to rise.

A. SEC's Late Trading Proposal. Late trading is ''the illegal practice of permitting a purchase or redemption [sale] order received after the 4 pm pricing time [for computation of a mutual fund's net asset value or 'NAV'] to receive the share price calculated as of 4 pm,'' thus allowing the trader to ''exploit events occurring after 4 pm, such as earnings announcements,'' and profit ''at the expense of long-term investors in the fund.''[2] The SEC has concluded that ''late trading of fund shares is not isolated, nor is it limited to any one type of fund or intermediary.''[3]

[1] For background, *see* S. Crimmins, D. Gourevitch, and J. Del Raso, ''The Mutual Fund Probes—What We Can Tell So Far,'' Sec. Reg. & Law Rep. (BNA), Nov. 3, 2003, p. 1834.

[2] ''Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares,'' File No. S7-27-03 (Dec. 11, 2003), available at http://www.sec.gov/rules/proposed/ic-26288.htm (cited below as ''SEC Late Trading Release''), text at note 5.

[3] SEC Late Trading Release, text at note 17.

To deal with late trading, the SEC issued a December 11, 2003 release proposing a ''hard close'' for mutual fund purchase and redemption orders.[4] Under this proposal, for an order to receive that day's NAV-based price, the order will have to be received by the fund itself, its designated transfer agent, or a registered clearing agency[5] by the ''pricing time'' (typically 4 pm Eastern) specified for calculation of the fund's NAV. A fund will be required to have a written contract with its transfer agent requiring the agent to maintain a record of the time it received each order, and an order will be ''deemed to be irrevocable'' as of the pricing time.

This differs from present practice by effectively excluding so-called ''intermediaries'' (brokerage firms, banks, administrators of retirement plans, etc.) from the list of those who can receive an order by pricing time and still get the customer that day's NAV-based price. Intermediaries receive orders from many investors, typically net the orders against each other, and then transmit an ''omnibus'' order to the fund's transfer agent or to the clearing agency that sends orders to the transfer agent.[6] This exclusion of intermediaries reflects the reality that, as revealed by the regulators' ongoing fund probes, there have been situations where intermediaries have enabled customers' late trading by, for example, blending their late trades with legitimate trades in the net order information the intermediaries send to the transfer agents or clearing agency after 4 pm.[7]

The SEC is concerned, however, that this proposed cure for late trading may cause intermediaries to require that investors place their orders earlier in the day (perhaps by 2 pm) to allow time to process and get orders to the transfer agent by 4 pm. Indeed, if orders must reach funds or transfer agents by 4 pm, some intermediaries (such as 401(k) plan administrators) may be unable to fully process any orders the same day they are received. The SEC responds that most individuals are long-term investors who will not mind a short delay, and that investors who need quick processing will seek out fund complexes that allow submission of orders directly to transfer agents. But the SEC has asked for public comment on a suggestion that intermediaries be allowed to continue to accept orders up to the 4 pm pricing time if the intermediary maintains a time-stamping process for orders that cannot be altered or modified after the order is entered.[8] Efforts are also underway to deal with this problem by ramping up the NSCC's ability to receive orders as a registered clearing agency.[9]

B. SEC's Market Timing Proposal. Market timing is ''the frequent buying and selling of mutual fund shares in order to take advantage of the fact that there may be a lag between a change in the value of a mutual fund's portfolio securities and the reflection of that change in the fund's share price.''[10] Half of the major fund complexes recently surveyed by the SEC had arrangements with certain shareholders to allow them to engage in market timing.[11] The SEC has noted that while ''market timing itself is not illegal,'' it can harm mutual fund investors by giving timers redeeming their temporarily overvalued shares a windfall at the expense of long-term investors, and by causing advisers to maintain a larger percentage of the fund's assets in cash or to prematurely liquidate certain portfolio securities to meet higher redemption levels.[12]

On December 11, 2003, the SEC issued a release proposing new disclosure requirements as an initial effort to combat abuses involving market timing.[13] The SEC's proposal will require mutual funds to disclose to investors in prospectuses the following information relating to market timing: (i) a description of the risks timing presents for fund shareholders; (ii) whether or not the fund discourages timing; (iii) whether or not the fund accommodates timing; (iv) any policies and procedures the fund has for detecting and deterring timing, including limits on the volume or number of transactions, exchange or redemption fees, minimum holding periods, and rights to reject, limit, delay, or impose other conditions on transactions; and (v) if the fund has any arrangement with any person to permit timing, the identity of that person, and any resulting compensation or consideration received by the fund, its adviser or any other party, including any agreement to maintain assets in the fund or related funds.

The proposal will also require disclosure of the circumstances where the fund would use ''fair value pricing,'' instead of market quotations, in valuing portfolio securities. Such fair value pricing is required where market quotations are unavailable or are not reliable.[14]

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[4] The proposal would amend Rule 22c-1 under the Investment Company Act [17 CFR 270.22c-1], the SEC's so-called ''forward pricing'' rule that requires mutual funds to sell or redeem shares only ''at a price based on the current net asset value of such security which is next computed after receipt of'' the customer's order.

[5] There is only one registered clearing agency, the National Securities Clearing Corporation (''NSCC''), which operates an automated system called the Mutual Fund Settlement, Entry and Registration Verification Service (''Fund/SERV''). SEC Late Trading Release at notes 10-13.

[6] While requiring forward pricing, the present Rule 22c-1 does not now require that the order must be received by the fund, its transfer agent, or a registered clearing agency to get that day's pricing. Instead, present Rule 22c-1 ''contemplates that the time of receipt of the order by the retail dealer is controlling.'' Staff Interpretive Position, Investment Company Act Rel. No. 5569 (Dec. 27, 1968). Under current practice, intermediaries typically process orders in the early evening but still get their customers the 4 pm NAV-based price. SEC Late Trading Release, note 15 and text.

[7] SEC Late Trading Release, text at note 18.

[8] SEC Late Trading Release, notes 23 and 24 and text. If ultimately adopted, the SEC's release proposes a one-year transition period to accommodate necessary changes in processing systems. SEC Late Trading Release, text at note 31.

[9] Diana Henriques, *Fidelity Seeks a Clearinghouse for Trades*, N.Y. Times, December 26, 2003, at C1.

[10] ''Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings,'' File No. S7-26-03 (Dec. 11, 2003), available at http://www.sec.gov/rules/proposed/33-8343.htm (cited below as ''SEC Market Timing Release''), note 10.

[11] SEC Market Timing Release, note 18.

[12] SEC Market Timing Release, text at note 13. As discussed below and in our earlier article, timing will be prosecuted when it is accomplished through fraudulent means.

[13] The new disclosure proposed in the release will be required by amendments to Form N-1A, the registration form used by mutual funds.

[14] The SEC notes that ''fair valuation'' is ''the process of determining the current market value of a security when market quotations are not readily available (such as when there are no market quotations for the security or if the market quotations for the security are unreliable). When market quotations for a

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Appropriate use of fair value pricing further deters market timing by eliminating the pricing anomalies that timers seek to exploit.

The SEC recognized, however, that while this enhanced disclosure may be a good start in combating market timing, more is needed. For this reason, SEC Chairman William H. Donaldson has promised that the agency will soon consider "additional proposals to combat market timing abuses." These will include "a proposal that would require mutual funds to impose a mandatory redemption fee on market timers."[15] Reports are that this proposal may come soon, and that it will likely involve a mandatory 2 percent redemption fee on shares sold within five days of purchase. Such a redemption fee would deter much market timing by often making it unprofitable, and otherwise would raise cash to compensate holders for such timing as persisted.

The SEC's release on market timing also contained a proposal to address the separate but related problem of selective disclosure of mutual fund portfolio holdings—information critically important for timers. Under the SEC's proposal, funds will have to disclose their policies and procedures concerning disclosure of the fund's portfolio securities to third persons. This disclosure will include: (i) application of the policies to different categories of persons (individuals, institutions, intermediaries distributing fund shares, service providers, rating organizations, affiliated persons); (ii) confidentiality provisions and trading restrictions; (iii) policies concerning receipt of compensation or other consideration by the fund, its adviser or other parties; (iv) persons who may authorize disclosure of the fund's portfolio securities; and (v) the board's oversight and procedures used to determine that disclosure of portfolio securities is in the fund's best interests.

C. SEC Focus on Compliance Programs and Officers. Also in December, the SEC adopted final rules requiring mutual funds and their registered investment advisers to have written policies and procedures reasonably designed to prevent securities law violations, to review those policies annually for adequacy and effectiveness, and to appoint a chief compliance officer to administer the policies and procedures.[16] These protective measures must be in place by October 5, 2004.

The SEC is not mandating particular provisions, but instead is requiring that the particular policies and procedures adopted be scaled and tailored to fit each fund or adviser's operations. The list of issues such policies and procedures must address includes the following: (i) portfolio management (allocation of investment opportunities, portfolios consistent with stated investment objectives, etc.); (ii) trading practices (best execution, soft dollar arrangements, etc.); (iii) proprietary and personal trading; (iv) disclosures in account statements and advertisements; (v) safeguarding client assets; (vi) record creation and maintenance; (vii) marketing services; (viii) valuation of client holdings; (ix) client privacy; and (x) business continuity plans.[17]

The SEC's new compliance rules also require funds to adopt policies and procedures to ensure that the fund complies with its obligation to "fair value" portfolio securities when a reliable "market quotation" is not "readily available." This can happen, for example, where a price-moving event occurs after the market close for a foreign security, but before the fund's 4 pm (Eastern) pricing time. Under the new rule, the fund must have policies and procedures to monitor for the need to fair value securities, to set criteria for determining when market quotations are no longer reliable, and to provide a method for fair valuing portfolio securities. The SEC hopes that fund attention to fair value obligations will reduce the arbitrage opportunities exploited by market timers.[18]

D. SEC Governance Proposals. On January 15, 2004, the SEC issued a release proposing rule amendments to enhance the independence and effectiveness of mutual fund boards.[19] With a clear Sarbanes-Oxley flavor, the proposals will: (i) increase from 50% to 75% the number of fund directors required to be independent; (ii) require that fund boards be led by an independent chairperson; (iii) require boards to perform annual self-evaluations of their effectiveness and their committee structure; (iv) require independent directors to meet at least quarterly in separate sessions not attended by interested fund persons; (v) give independent directors the authority to retain staff, and possibly requiring that the independent directors have an independent legal

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security are not readily available, a fund is required to calculate its NAV by using the fair value of that security, as determined in good faith by the fund's board." SEC Market Timing Release, note 11. As described below, on December 17, 2003, the SEC adopted a rule requiring mutual funds to have policies and procedures for fair valuing their portfolios.

[15] Chairman William H. Donaldson, Opening Statement at Open SEC Meeting on December 3, 2003, available at: http://www.sec.gov/news/speech/spch120303whd.htm (cited below as "Donaldson December 3rd Statement"), as modified by Opening Statement at January 14, 2004 Meeting, available at http://www.sec.gov/news/speech/spch011404whd.htm (cited below as "Donaldson January 14th Statement").

[16] The new rules are Rule 38a-1 under the Investment Company Act, and Rule 206(4)-7 under the Investment Advisers Act. "Final Rule: Compliance Programs of Investment Companies and Investment Advisers," File No. S7-03-03 (Dec. 17, 2003), available at http://www.sec.gov/rules/final/ia-2204.htm (cited below as "SEC Compliance Programs Release"). Interestingly, while this rule fits well into the broad regulatory changes now emanating from the SEC, the agency originally proposed this rule on February 5, 2003, well before the much-publicized mutual fund probes began in September.

[17] SEC Compliance Programs Release, text at notes 12 through 22 and 37. Mutual funds must also consider the policies and procedures of the service providers who carry out the fund's operations—including the fund's advisers, principal underwriters, administrators, transfer agents, etc. In doing so, a fund may adopt policies and procedures that encompass the activities of *both* the fund itself and *certain* of the fund's service providers, while approving the policies and procedures (and providing for oversight) of the fund's *remaining* service providers. Or the fund may adopt policies and procedures covering *solely* the activities of the fund, while approving the policies and procedures of *all* of the fund's service providers. SEC Compliance Programs Release, text at notes 29 through 32.

[18] SEC Compliance Programs Release, text at notes 39 through 47. As noted above, the SEC's Market Timing Release separately proposes to require disclosure of the circumstances in which a fund will use fair value pricing instead of market quotations.

[19] "Proposed Rule: Investment Company Governance," File No. S7-03-04 (Jan. 15, 2004), available at http://www.sec.gov/rules/proposed/ic-26323.htm. The proposal would make amendments to exemptive rules under the Investment Company Act.

counsel; and (vi) require funds to retain materials the board considered in approving the advisory contract.

Building on its January 15 release, the SEC on February 11 proposed that fund boards be required to explain their selection of the investment adviser and their approval of amounts paid under the advisory contract.[20] The proposal will require shareholder reports to discuss (i) the nature, extent, and quantity of the services to be provided by the adviser; (ii) the investment performance of the fund and its adviser; (iii) the cost of services to be provided and profits to be realized by the adviser; (iv) the extent to which economies of scale would be realized as the fund grows; and (v) whether fee levels reflect these economies of scale.

To further ensure the integrity of fund governance, the SEC on January 20, 2004, issued a release proposing rule changes to require registered advisers to adopt codes of ethics to (i) set forth standards of conduct, (ii) safeguard nonpublic information, and (iii) require advisers' access persons to report their personal securities transactions.[21] The code of ethics also would require access persons to obtain the adviser's approval before investing in IPOs or private placements.

E. SEC Response to Sales Practice Issues. On February 11, 2004, the SEC announced a proposal to prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker-dealer.[22] The SEC also proposed banning a related practice in which a fund uses one broker-dealer to execute the transactions, but directs a part of the brokerage commission to a different broker-dealer as compensation for selling fund shares. The SEC fears that these arrangements may compromise best-execution of orders, cause advisers and brokers to circumvent limits on sales charges, increase portfolio turnover in order to generate commissions to use as compensation for selling funds, and influence broker-dealer recommendations to customers. Under the proposed rule, funds using selling broker-dealers to execute securities transactions (and their boards of directors) would be required to adopt policies and procedures to prevent: (i) selection of executing brokers for a fund based on their distribution efforts; and (ii) agreements for a fund to direct brokerage commissions in exchange for distribution.

The SEC has also recently addressed another sales practice issue that directly impacts retail customers. The SEC on December 17, 2003, issued a release proposing enhanced disclosure concerning eligibility for discounts on so-called ''front-end sales loads'' (sales charges imposed on certain fund shares at the time of purchase).[23] These discounts kick in at specified ''breakpoints'' as a customer's purchase gets larger. In calculating whether the customer is hitting a breakpoint for a particular purchase, some funds give customers ''rights of accumulation,'' which let the customer count shares already owned in some or all funds in a fund family, shares the customer promises (in a ''letter of intent'') to purchase by a specified future date, and/or shares held by certain relatives. All this can get complicated, as evidenced by a recent joint SEC, NASD and NYSE study revealing that of 5,515 transactions examined that appeared eligible for a reduced sales charge, 1,757 did not receive a breakpoint discount or appeared to have incurred other unnecessary sales charges.[24]

The SEC's December proposal will require a fund to put its description of breakpoint arrangements in its prospectus. Currently the description can go in either the prospectus or the fund's statement of additional information (or ''SAI''). The change will help ensure that investors get the description, as the prospectus is given to investors, while the SAI is simply available upon request. To make things easier, the description will now also have to include a ''brief summary of shareholder eligibility'' to ''assist investors and financial intermediaries in better understanding the ways in which investors may take full advantage of breakpoint opportunities.''[25] The prospectus will also have to spell out how the fund values an account in calculating breakpoints, for example, historical cost, net amount invested or offering price.[26] Finally, the SEC will pressure funds to ''provide accessible website disclosure regarding the availability of breakpoint discounts to complement the prospectus disclosure.''[27]

F. The Regulators Disagree: Fee Reduction or Disclosure? On February 11, 2004, the SEC adopted rules requiring funds to improve disclosure of fund expenses and holdings.[28] The funds will have to disclose semi-annually fund expenses in a dollar amount per $1,000 invested and the same expense figure assuming a 5 percent return. Funds also will have to identify their portfolio holdings to the SEC each quarter in tabular and graphic formats. While this enhanced disclosures concerning fees, combined with other new disclosure requirements described above, will apparently satisfy the SEC as federal regulator of the securities markets, it does not satisfy New York State Attorney General Eliot Spitzer.

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[20] ''Proposed Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies,'' File No. S7-08-04 (Feb. 11, 2004), available at http://www.sec.gov/rules/proposed/33-8364.htm.

[21] ''Proposed Rule: Investment Adviser Code of Ethics,'' File No. S7-04-04 (Feb. 12, 2004), available at http://www.sec.gov/rules/proposed/ia-2209.htm.

[22] Available at http://www/.sec.gov/news/press/2004-16.html. The Commission also requested comment (i) on whether Rule 12b-1 continues to serve the purpose for which it was intended and whether it should be repealed; (ii) on the practice of using 12b-1 fees as a substitute for sales load; and (iii) on whether distribution-related costs should be deducted directly from shareholder accounts rather than from fund assets.

[23] ''Proposed Rule: Disclosure of Breakpoint Discounts by Mutual Funds,'' File No. S7-28-03 (Dec. 17, 2003), available at http://www.sec.gov/rules/proposed/33-8347.htm (cited below as ''SEC Breakpoint Discounts Release''). The proposal would amend Form N-1A, the registration form for mutual funds.

[24] SEC Breakpoint Discounts Release, text at notes 8 and 9, *citing* ''Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds'' (Mar. 2003).

[25] SEC Breakpoint Discounts Release, text following note 17.

[26] SEC Breakpoint Discounts Release, text at note 19.

[27] SEC Breakpoint Discounts Release, text at note 28. The proposal does this by requiring funds to disclose whether they have such website information. The release comments that ''[m]odernizing the disclosure system under the federal securities laws involves recognizing the importance of the Internet in fostering prompt and more widespread dissemination of information.''

[28] Available at http://www/.sec.gov/news/press/2004-16.html.

Spitzer wants the funds to simply cut their fees. Indeed, Spitzer has made a reduction in fund management fees a major goal of his enforcement initiative.

Spitzer maintains that the fees mutual funds pay to management companies are too high.[29] As fund directors are usually affiliated with the fund's management company, Spitzer maintains that ''fund directors do not—and cannot—negotiate hard on the fees,'' in the typical situation where ''the chairman of the mutual fund is also the chairman of the advisory company.''[30] Spitzer would impose a fiduciary duty on fund directors to negotiate management fees that are ''reasonable''—determined by what institutional investors pay for similar services and the cost of services provided. He also suggests requiring ''most favored nation clauses'' in fee contracts, and putting certain contracts (such as back-office and administrative services) out for bid.

These conflicting approaches broke into public view in the separate settlements the SEC and Spitzer reached with Alliance Capital Management, LP. On December 18, 2003, the SEC filed a settled cease-and-desist proceeding against Alliance. The SEC alleged that an Alliance fund manager negotiated agreements with market timers to provide them with ''timing capacity'' in exchange for ''sticky assets.'' [31] Alliance's single largest market timer received $220 million in timing capacity. However, in its prospectuses, Alliance gave the impression that Alliance discouraged and sought to prevent market timing in its funds. In settlement with the SEC, Alliance agreed to pay $150 million in disgorgement and $100 million as a fine for a total payment of $250 million. [32]

Breaking ranks with the SEC, Spitzer struck a deal requiring Alliance to cut its management fees 20 percent and freeze the cut for at least five years.[33] Spitzer valued the fee reduction at $70 million per year, or $350 million over five years. But within hours of the announcement of Spitzer's settlement, all five SEC Commissioners criticized Spitzer's fee cut in an unusual joint statement: ''We determined—unanimously—that such relief [Spitzer's fee cut] would not serve our law enforcement objectives in this case.''[34] The Commissioners attacked Spitzer's settlement as an example of government price setting, as lacking a nexus between the misconduct (market timing) and the penalty (fee reduction), and as failing to compensate the injured investors. The rift remains unresolved. Spitzer has made reductions in advisory fees a touchstone of his settlements with mutual funds, while the SEC has sought restitution, disgorgement, and fines.

On January 15, 2004, Spitzer opened a second front in his efforts to force mutual funds to reduce their fees. He enlisted the state treasurers of New York, California, and North Carolina to use their financial leverage as leaders of their state's public pension funds to pressure mutual funds and fund managers to reduce fees, make fund boards more independent, and improve disclosure.[35] The state officials unveiled broad new guidelines for mutual funds that they called the ''Mutual Fund Protection Principles'' and vowed that ''compliance with the principles would be a significant fact in determining whether a mutual fund would have the right to do business with their respective states.''[36]

The state treasurers' Mutual Fund Protection Principles go further than the SEC's proposals in key respects. While the SEC has focused on improving disclosure of management fees, the Mutual Fund Protection Principles mandates that the fees be ''reasonable,'' contain breakpoints providing for ''meaningful'' economies of scale and be based on a comparison with fees at other funds and fees charged institutional clients. The

[29] In support of his view that management fees are too high, Spitzer cited a study that mutual funds pay an average 25 basis points more for advisory services than pension funds, even where the adviser provides identical advisory services to both the pension and mutual fund. The study, authored by John Freeman and Stewart Brown, is entitled ''Mutual Fund Advisory Fees: The Cost of Conflicts of Interest,'' 26 Journal of Corporation Law 609 (Spring 2001). On January 6, 2003, the Investment Company Institute released its own study, ''The Expenses of Defined Benefit Pension Plans and Mutual Funds'' which it said refuted the Freeman & Brown study.

[30] Spitzer's November 4, 2003 testimony before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on his campaign to reduce mutual fund fees, available at http://www.oag.state.nys.press/statement/hearinghouse-testimony.pdf. On November 20, 2003, in testimony before the Senate Banking and Affairs Committee, Spitzer charged that retail investors in Putnam mutual funds paid 15 basis points—or 40%—more than Putnam's institutional investors. In dollar terms, the fee disparity meant that in 2002, Putnam's mutual funds paid $290 million more in advisory fees than they would have paid had they been charged the same rate as Putnam's institutional investors for advisory services. Available at *http://www.oag.state.ny.press/statement/hearingsenate-testimony.pdf*.

[31] At one point in 2003, Alliance Capital had over $600 million in approved timing relationships. The SEC's cease-and-desist order is available at http://sec.gov/litigation/admin/ia-2005.htm.

[32] In its SEC settlement, without admitting or denying liability, Alliance agreed to designate a compliance officer reporting to its board, establish a corporate ombudsman to receive complaints from company employees, and create board committees on ethics and internal compliance committees.

[33] Spitzer's announcement is available at http://oag.state.ny.us/press/2003/dec/dec18c_03.html.

[34] Available at http://www.sec.gov/news/press/2003-176.htm.

[35] Available at http://www.oag.state.ny.us/press/agpress04.html (Jan. 14, 2004).

[36] California Treasurer Phil Angelides chided the SEC for failing to move quickly and aggressively enough: ''We moved first and we are still waiting for the SEC to catch up with us,'' he said. ''We want to keep the pressure on.'' The states carry considerable weight with money managers because of the size of their investments. The California Public Employees' Retirement System (CalPERS), and Teachers' Retirement System (CalSTRS), on whose boards Angelides sits, are the nation's first and third largest public pension funds, respectively, with combined assets of $250 billion.

Principles also require funds to furnish their boards with an itemized list of investment advisory service fees, expenses (marketing, advertising, operations, administration), overhead and profit. [37]

G. Will the Public and Congress Be Satisfied? Key consumer groups have sharply criticized the SEC's adopted and proposed rules as not going far enough. On January 12, 2004, Consumers Union (publisher of *Consumer Reports* magazine), the US Public Interest Research Group and other organizations jointly attacked the SEC for past disregard of mutual fund abuses and for now failing to prohibit directed brokerage arrangements between mutual funds and brokerage firms, opposing Spitzer's campaign to reduce advisory fees, and failing to hold independent directors responsible for misconduct by mutual funds.[38]

Congress likewise has expressed concern over how to adequately respond to the mutual fund problems. While there has been recent Senate interest in mutual fund legislation, the most focused attention has come from the House. In a letter to SEC Chairman Donaldson, Representative Richard Baker, chairman of the House Financial Services subcommittee on capital markets, praised the SEC proposals as ''an important first step'' but warned that Congress still needed to enact new laws to require more fund disclosure and give more power to independent directors.

Representative Baker authored the Mutual Fund Integrity and Fee Transparency Act, H.R. 2430 (the ''Baker Bill''), which passed the House of Representatives on November 19, 2003 by an overwhelming vote of 418 to 2. There is a substantial overlap in the approaches taken in the SEC rulemaking and the Baker Bill, which may in the long run lead Congress to simply defer to SEC rulemaking to deal with the issues:

- The Baker Bill and the SEC rulemaking parallel each other in (i) increasing disclosure of mutual fund fees, costs and marketing arrangements;[39] (ii) enhancing corporate governance; and (iii) giving more power to independent directors of mutual funds.

- The SEC rulemaking is stronger than the Baker Bill in (i) imposing a ''hard close'' (while the Baker Bill would permit after-hours trading if the intermediaries received the trades by 4 pm), (ii) requiring that three-quarters of a fund's board be independent (with the Baker Bill requiring two-thirds); and (iii) requiring an independent board chairman—a provision Baker said was omitted from bill because he could not garner sufficient support from his colleagues to include it.[40]

- The Baker Bill is similar to the SEC rulemaking in (i) requiring funds to adopt and disclose an ethics code, as well as disclose any violations or waivers; (ii) requiring funds to appoint a chief compliance officer reporting to the independent directors; (iii) requiring funds to adopt policies and procedures to protect whistle blowers; and (iv) requiring disclosure of ''directed brokerage'' to broker-dealers that distribute the fund's shares, the fund's policies and practices about ''soft dollar'' payments for research, and revenue sharing with mutual fund distributors. The fund also would have to disclose discounts on front-end sales loads for which investors may be eligible, including the minimum purchase required to obtain such discounts. The bill also would require funds to disclose their costs, such as the estimated dollar amount of operating expenses for each $1,000 invested in the fund, the structure of, or method used to determine the portfolio manager compensation, the portfolio's turnover rate described in a manner that facilitates comparisons between funds, and the fund's transaction costs, including brokerage commissions, set forth in a manner that facilitates comparison among funds.

H. Criminal and Civil Sanctions to Deal With Problems. No doubt feeling continuing public and Congressional pressure, the SEC has vowed to continue an ''intensive investigation of funds, advisers, broker-dealers, and others,'' to ''aggressively pursue and punish'' violators, and ''to see that the full weight of the law is brought to bear against those who have betrayed mutual funds and fund investors.''[41] As described below, the continuing barrage of late trading, market timing, and sales practices cases from all concerned regulators over the past several weeks confirms this resolve, and shows an intensive enforcement effort that sweeps across all parts of the fund industry.[42]

Breakpoint Settlement. On February 12, 2004, 15 brokerage firms settled SEC and NASD charges that they failed to deliver mutual fund break point discounts. The firms agreed to pay $21.5 million in fines and restitution to customers.[43] As noted above, break point discounts

[37] In addition, the Mutual Fund Protection Principles require (a) that three-quarters of the fund board and chairman be independent and not have or have had within the past five years any material business or employment relationship with the fund, adviser or service provider; (b) that the independent directors of the funds meet annually with the chief compliance officer outside the presence of management; (c) that funds disclose portfolio managers' compensation at least annually and the method and factors used to reach it; (d) that portfolio managers and senior managers of the fund adviser reveal the number of shares that they have bought, sold and own in their funds; (e) that portfolio managers, as well as research, marketing, and senior executives, of funds and their advisers hold shares for at least 12 months (to deter short-term trading); (f) that funds disclose quarterly their security holdings and disclose contemporaneously any information about the fund's holdings or characteristics provided to third parties, including consultants; and (g) that funds disclose trading costs, soft dollar arrangements and the investment professionals as well as any turnover.

[38] Available at *http://www.funddemocracy.com*.

[39] The Baker bill also would broaden the definition of ''interested persons,'' that is, persons not deemed to be independent'' to include anyone ''unlikely to exercise an appropriate degree of independence'' because of (1) a material business or professional relationship with the fund or a fund affiliate, or (2) a close familiar relationship with any natural person who is affiliated with the fund.

[40] In his letter to Donaldson, Baker praised the proposal for an independent chairman and said it should be included in any new legislation ''to ensure that future regulatory actions do not weaken or eliminate this important reform proposal.''

[41] SEC Compliance Programs Release, text at note 7.

[42] Our earlier Analysis & Perspective article cataloged the enforcement actions and settlements during the opening weeks of the mutual fund probe. Sec. Reg. & Law Rep. (BNA), Nov. 3, 2003, p. 1834.

[43] The press release is available at http://www.sec.gov/news/press/2004-17.htm. The settling firms are Wachovia Securities, LLC, UBS Financial Services, Inc., American Express Financial Advisors, Inc., Raymond James Financial Services, Inc., Legg Mason Wood Walker, Inc., Linsco/Private Ledger Corp., H.D. Vest Investment Securities, Inc., Bear, Stearns & Co., Inc., Lehman Brothers, Inc., Cresap, Inc., SWS Financial

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are volume discounts applicable to front-end load sales charges on Class A mutual fund shares. In an industry-wide joint examination, the SEC and NASD found that one out of five customers did not receive breakpoints to which they were entitled, for a total of $86 million in overcharges. The NASD directed the firms to refund overcharges to customers. The NASD and SEC then brought cases against the firms they deemed liable for more serious violations. As part of the settlement, the firms agreed to review all front-end load mutual funds trades in excess of $2,500; provide written notification of the problems to customers; and advise the customers that they may be entitled to a refund.

MFS. On February 5, 2004, Massachusetts Financial Services Co. simultaneously settled charges brought by the SEC, the New Hampshire Bureau of Securities Regulation, and the New York Attorney General's Office by agreeing to pay $175 million in restitution and a $50 million penalty. MFS also agreed to reduce its management fees by $125 million over five years.[44] As part of the settlement, MFS also agreed to strengthen its compliance department and enhance the independence of its board of trustees. MFS's CEO John W. Ballen and its chief equity officer Kevin R. Parke agreed to six- and nine-month suspensions, respectively, as well as a penalty of $250,000 each and disgorgement of $50,000 each. However, in a rare public dissent by a Commissioner, Cynthia Glassman complained that the suspensions were too short. In its public filings, MFS allegedly claimed that it discouraged marketing timing, while allegedly permitting widespread timing in some of its mutual funds. Ballen and Parke allegedly helped to determine which MFS funds could be used for market timing.

Franklin Templeton. On February 4, 2004, Massachusetts Secretary of the Commonwealth William Galvin charged Franklin Resources with fraud in a scheme that allowed a wealthy Las Vegas investor, Daniel G. Calugar, to market time $45 million in Franklin mutual funds in exchange for a $10 million investment in a Franklin hedge fund.[45] Franklin Resources is the parent of Franklin Advisers, Inc., Franklin Templeton Distributors, Inc. and Templeton/Franklin Investment Services, Inc., which operate under the trade name of Franklin Templeton Investments. ''This case is another example of mutual funds having one standard for the ordinary investor and an entirely different one for someone able to move millions . . . through it in market timing trades,'' Galvin said.

Flynn (CIBC). On February 2, 2004, New York Attorney General Spitzer dispatched officers to the Larchmont, N.Y. home of Paul Flynn, a former managing director of Canadian Imperial Bank of Commerce. The officers arrested Flynn and brought him to Manhattan for arraignment later that day at the New York Criminal Courts Building at 100 Centre Street. The complaint alleged that he had arranged CIBC financing for two hedge funds, Canary Capital Partners LLC and Samaritan Asset Management, that enabled them to engage in late trading and market timing through Security Trust Company, a processor of mutual fund orders (described below). The complaint also alleged that Flynn wrote a memo describing the procedures being used to disguise trades. Spitzer did not stop with a charge under New York's securities fraud statute, the Martin Act, but additionally charged Flynn with grand larceny, a crime that (unlike other white collar offenses in New York) carries a mandatory prison term—a sentence that can range up to 25 years. And as New York State lacks facilities to hold white-collar offenders, such a mandatory sentence means confinement with the general prison population in a New York state prison. Spitzer announced that his case against Flynn ''sends the message that those who arrange funding for illegal trading will be held accountable, as are those who make the trades.''[46] The SEC filed a parallel civil administrative proceeding the same day, seeking a monetary fine and an order barring Flynn from the securities industry. The SEC's release quoted one of its senior officials as saying that the case ''should alert management at financial institutions that they will be held directly accountable when they knowingly finance fraud.''[47]

Cantella. On January 21, 2004, Massachusetts Commonwealth Secretary William Galvin filed an administrative complaint against Cantella Securities Inc. for failing to supervise two ''inexperienced'' registered representatives in their sale of interests in two hedge funds, thereby causing ''tremendous losses'' to investors.[48] The complaint charged that many of the investors were ''unsophisticated, non-accredited investors, many of whom lost their entire retirement savings due to this investment.'' Galvin seeks an order directing a rescission offer to all affected customers, an administrative fine, and a cease and desist order.

Waddell & Reed. On January 14, 2004, the NASD charged Waddell & Reed Inc., with engaging in an aggressive campaign to switch customers from one variable annuity fund to another in order to generate commissions and fees and without regard to the suitability of the transactions.[49] The NASD alleged that Waddell & Reed earned $37 million in commissions from the switching campaign while its customers lost $10 million in commissions. The NASD also charged the firm's former president Robert Hechler, and its national sales manager Robert Williams. In addition to other sanc-

Services, Kirkpatrick, Pettis, Smith, Polian, Inc., Southwest Securities, Inc., David Lerner, Inc., and Brecek & Young Advisors, Inc.

[44] The press releases are available at www.oag.state.us/press/2004/feb/feb05a_04. and www.sec.gov/litigation/admin/ia-2213.

[45] The press release is available at http://www.state.ma.us/sec/sct/sctft/ftidx.htm

[46] Available at www.oag.state.ny.us/press/2004/feb/feb03b_04.

[47] Available at http://www.sec.gov/news/press/2004-12.htm.

[48] *Matter of Cantella Securities Inc.*, Massachusetts Securities Division Docket No. E-2004-02 (Jan. 21, 2004), available at http://www.state.ma.us/sec/sct/sctcan/canidx.htm.

[49] The NASD's press release is available at *http://www.nasdr.com/news/pr2004/release_04)004.html*. According to NASD: Between January 2001 and August 2002, Waddell switched hundreds of customers from variable annuities issued by United Investors Life Insurance (UILIC) to very similar annuities provide by Nationwide Insurance, Co. Waddell initiated a campaign to switch customers from UILIC to Nationwide, after Waddell failed to obtain an agreement from UILIC to share its fees with Waddell. Nationwide, on the other hand, agreed to share some of its fees with Waddell. In addition, Waddell switched 700 customers into a Nationwide annuity that was more expensive and offered far fewer benefits and less flexibility than another Nationwide annuity that provided a lower payout to Waddell's sales force.

tions, the NASD is seeking disgorgement of commissions and compensation to customers.

Alliance and Security Brokerage. On December 18, 2003 the SEC obtained a settlement with Alliance Capital Management, Inc. that ordered it to pay $250 million—including $150 million in disgorgement and $100 million in penalties—for allegedly permitting Security Brokerage, Inc. and its president and majority owner Daniel Calugar (and others) to engage in market timing.[50] The money will be distributed to investors harmed by these timing arrangements. As described above (Section F), Spitzer also required Alliance in a parallel settlement to cut its management fees by 20 percent and freeze them at the lowered rate for at least five years.[51] On December 22, 2003, the SEC charged Security Brokerage and Calugar with defrauding mutual fund shareholders in a late trading and market timing scheme that yielded profits of $175 million.[52] The SEC charged Caluglar with late trading for submitting orders to the NSCC after 4 pm, and with illegal timing of Alliance and MFS funds with knowledge that, in their prospectuses, Alliance discouraged and MFS prohibited timing. Calugar is charged with making long-term investments (so-called ''sticky assets'') in Alliance hedge funds in exchange for permission to time Alliance mutual funds. On filing its case, the SEC sought and obtained a court order freezing the defendants' assets. The SEC also seeks disgorgement of illegal gains, a monetary penalty and injunctive relief.

Connelly (Alger). On December 17, 2003, a state court judge in New York sentenced James P. Connelly, Jr., former vice chairman and chief mutual fund officer of Fred Alger & Co., Inc., to a term of one to three years for one count of tampering with physical evidence, a Class E felony; as noted above, with New York State lacking white-collar facilities, such a sentence means confinement with the general prison population for the specified term.[53] Connelly was charged with directing subordinates to delete e-mail containing information about improper trading arrangements with a Texas hedge fund, and with coaching subordinates on how to answer lawyers' questions. The sentence was the first in the mutual fund investigations, and its severity reflects how seriously the court and regulators viewed the tampering charge. Connelly had previously settled SEC charges that he approved agreements permitting certain investors to market time funds managed by Alger in return for commitments by the customers to maintain at least 20% of their investments in Alger in buy-and-hold positions (so-called ''sticky assets''). The SEC settlement included a lifetime bar from the securities industry and a $400,000 civil penalty.[54]

Littell and Meckel (Marque). On December 15, 2003 the SEC settled fraud charges against Robert Littell, the director of investments of Marque Millennium Group, an unregistered investment adviser to three hedge funds. It also settled failure to supervise charges against Wilfred Meckel, the adviser's founder and principal.[55] The alleged violations occurred between 1997 and 2000, and the adviser ceased operations in 2001. Based on charges of misrepresenting fund performance and facts concerning the funds' management structure, auditor retention and risk management techniques, the SEC barred Littell from association with any investment adviser, imposed a $15,000 fine (after considering his financial statement) and ordered him to cease and desist from violations of the antifraud provisions. Based on charges of failure to take reasonable supervisory actions, the SEC suspended Meckel from acting in a supervisory capacity with an investment adviser for six months and censured him (after noting that Meckel had already paid $600,000 to reimburse hedge fund investors for losses). In discussing the failure to supervise charge, the SEC's release noted that it was the first against the principal of an unregistered investment adviser to a hedge fund, and stressed that ''[r]eliance on what a hedge fund employee says, without independent verification, is not good supervision.''[56]

Heartland. On December 12, 2003, the SEC filed fraud charges against Heartland Advisors, Inc., the Milwaukee-based investment adviser managing the Heartland Group complex of mutual funds, for failure to adjust the prices on bonds held by two high-yield municipal bond funds managed by Heartland, despite indications that the bonds could only be sold at substantial discounts. When the bonds were finally repriced, the funds' NAVs dropped substantially.[57] In addition to charging that Heartland misrepresented the funds' NAVs, the SEC charged Heartland with misrepresenting that it was actively managing the funds to minimize share price fluctuation, and with misrepresenting that it was limiting the percentage of unrated high yield bonds, when the vast majority of the bonds were unrated and relatively illiquid. The SEC's case also names a number of Heartland officials. Separately, the SEC settled an administrative proceeding against certain Heartland independent directors,[58] commenting that ''though the directors inquired about the pricing and liquidity issues that came to their attention, they did not go far enough in following through and resolving those issues.''[59]

Mutuals.com. On December 4, 2003, the SEC filed a civil complaint against Mutuals.com, a Dallas invest-

[50] Matter of Alliance Capital Management, L.P., A.P. No. 3-11359 (Dec. 18, 2003), available at http://www.sec.gov/litigation/admin/ia-2205.htm.

[51] Spitzer's announcement is available at http://oag.state.ny.us/press/2003/dec/dec18c_03.html.

[52] *SEC v. Daniel Calugar and Security Brokerage, Inc.*, Civil Action No. CV S-03-1600-RCJ (D. Nev. Dec. 22, 2003), available at http://www.sec.gov/litigation/litreleases/lr18524.htm.

[53] *See http:www.oag.state.ny.us/press/2003/oct.oct16a_03.html.* Connelly had been credited for a leading role in Alger's recovery after the September 11, 2001 World Trade Center attacks that claimed the lives of 20 of its 24 fund managers and analysts. ''Fund Executive Pleads Guilty to Tampering,'' N.Y. Times, Oct. 17, 2003.

[54] *Matter of James Patrick Connelly Jr.*, SEC Rel. No. 33-8304 (Oct. 16, 2003), available at http://www.sec.gov/litigation/admin/33-8304.htm.

[55] *Matter of Littell and Meckel*, A.P. No. 3-11357 (Dec. 15, 2003), available at http://www.sec.gov/litigation/admin/ia-2203.htm.

[56] Available at http://www.sec.gov/news/press/2003-172.htm.

[57] *SEC v. Heartland Advisors, Inc.*, 03-C-1427 (E.D. Wisc., Dec. 12, 2003), available at http://www.sec.gov/ligation/litreleases/lr18505.htm.

[58] *Matter of Hammes*, A.P. No. 3-11351 (Dec. 11, 2003).

[59] Available at http://www.sec.gov/news/press/2003-171.htm.

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ment adviser, its CEO, president and compliance officer, and two affiliated broker-dealer firms, for allegedly helping hedge funds and institutions engage in market timing and late trading in thousands of trades in hundreds of mutual funds.[60] The deceptive practices charged included formation of the two affiliated broker-dealers to conceal market timing; concealment of the timing by changing account numbers, registered representative numbers, branch identification numbers, tax identification numbers and clearing firms; and concealment of late trading by omitting portions of the trading information provided to clearing agents. Upon the filing of the case, defendants consented to appointment of a special monitor to oversee defendants' business operations, including the management of the Mutuals.com mutual funds.

Invesco. On December 2, 2003, the SEC filed a fraud case against Invesco Funds Group and its president and CEO Raymond Cunningham.[61] The complaint charges that, although prospectuses represented that Invesco fund investors could exchange between funds only four times a year, Invesco allowed certain hedge funds (including Canary Capital Partners LLC) and other select customers to engage in market timing. According to the complaint, Invesco actively marketed what it internally called ''market timing capacity'' to hedge funds and certain other customers; the customers paid for this capacity with ''sticky money'' (an agreement to maintain a minimum investment in Invesco funds not being timed); and Invesco appointed an employee to be head of its ''timing desk'' and responsible for monitoring and policing these market timing agreements. Among other relief, the SEC is asking the court to direct Invesco to disgorge ''all management fees related to the violations'' and pay an additional penalty, and to direct Cunningham to disgorge ''all benefits derived from his employment at Invesco including salary, bonuses, stock, and remuneration or compensation of any kind.'' [62] In a parallel suit in New York state court, Spitzer is additionally asking for ''restitution and damages caused'' by defendants' illegal acts, as well as an order restraining defendants from ''directly or indirectly engaging in the sale, offer to sell, purchase, offer to purchase, promotion, negotiation or distribution of any mutual funds.''[63]

Security Trust. On November 25, 2003, federal and state regulators charged Security Trust Company, N.A. with fraud for allegedly facilitating late trading and market timing in substantial amounts. Security Trust, a bank offering trust and custody-related services, acted as a processor of mutual fund trades for retirement plan participants (including an electronic trading platform for retirement plan participants to trade mutual funds). New York's Spitzer filed criminal charges against Security Trust's former chief executive officer, its former president and a former senior vice president. Spitzer charged the executives with securities fraud, grand larceny and falsifying records—with the most serious charge (grand larceny) carrying a possible sentence of eight years to 25 years in state prison.[64] On December 9, 2003, the senior vice president entered a guilty plea.

The SEC's complaint[65] charged Security Trust with assisting the Canary Capital hedge funds to engage in hundreds of late trades in almost 400 different mutual funds, principally by misrepresenting to the mutual funds that it was acting not for a hedge fund but for retirement plans that were allowed extra time after the market close to process trades submitted before the close. The complaint further charged that Security Trust helped the Canary hedge funds engage in market timing by a variety of techniques, including the use of numerous mutual fund accounts to test which funds were not policing for timing, processing the hedge funds' trades through omnibus accounts, and using sub-accounts within the accounts of various retirement plan customers. The SEC further charged that this facilitation garnered Security Trust inflated custodial fees and profit sharing, totaling about $5.8 million. And in related regulatory action, the Office of the Comptroller of the Currency issued an order directing the orderly dissolution of Security Trust by March 31, 2004.[66]

Pilgrim Baxter. On November 20, 2003, the SEC filed market timing fraud charges against a registered investment advisor, Pilgrim Baxter & Associates, Ltd., its co-founder and former president and chief investment officer Gary Pilgrim, and its other co-founder and former CEO and chairman Harold Baxter.[67] Both resigned the week before the SEC filed its action. The SEC charged that Gary Pilgrim allowed a hedge fund (Appalachian Trails) in which Gary Pilgrim owned a substantial interest to market time a fund that Pilgrim himself managed. The SEC further charged that Baxter passed non-public portfolio information to a brokerage friend who used the information to market time Pilgrim-managed funds. Spitzer brought parallel civil charges that additionally ask for ''restitution and damages caused'' by defendants' illegal acts, as well as an order restraining defendants from ''directly or indirectly engaging in the sale, offer to sell, purchase, offer to purchase, promotion, negotiation or distribution of any securities.''[68]

Morgan Stanley. On November 17, 2003, the SEC announced that Morgan Stanley had agreed to pay $50 million in disgorgement and penalties to settle charges related to two distinct firm-wide failures.[69] The first alleged problem arose from its ''Partners Program'' that had a select group of mutual funds pay Morgan Stanley substantial fees for preferred marketing. The firm, in

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[60] *SEC v. Mutuals.com, Inc.*, 03-CV-2912D (N.D. Tex., Dec. 4, 2003), available at http://www.sec.gov/litigation/litreleases/lr18489.htm.

[61] Available at http://www.sec.gov/ligigation/complaints/comp18482.htm.

[62] The New York Attorney General's Office simultaneously filed a companion case against Invesco and Cunningham seeking, in addition to the injunctive relief and damages sought by the SEC, disgorgement of management fees. The complaint is available at http://www.oag.state.ny.us.2003/dec/dec02a_03.html.

[63] *New York v. Invesco Funds Group, Inc.*, available at http://www.oag.state.ny.us/press/2003/dec/dec02a_03.html.

[64] *New York v. Seeger*, available at http://www.oag.state.ny.us/press/2003/nov/nov25a_03.html.

[65] *SEC v. Security Trust Co., N.A.*, CV-03-2323 PHX JWS (D. Ariz., Nov. 25, 2003), available at http://www.sec.gov/news/press/2003-164.htm.

[66] Available at http://www.sec.gov/news/press/2003-165.htm.

[67] *SEC v. Pilgrim*, 03-CV-6341 (E.D. Pa., Nov. 20, 2003), available at http://www.sec.gov/litigation/litreleases/lr18474.htm.

[68] *New York v. Pilgrim Baxter & Associates, Ltd.*, available at http://www.oag.state.ny.us/press/2003/nov/nov20a_03.html.

[69] *Matter of Morgan Stanley DW Inc.*, A.P. No. 3-11335 (Nov. 17, 2003), available at http://www.sec.gov/litigation/admin/33-8339.htm.

turn, paid its brokers and branch managers increased compensation for selling these preferred funds. The second problem, according to the SEC, arose from Morgan Stanley's failure to disclose the higher fees involved in large purchases ($100,000 or more) of Class B shares. Massachusetts Commonwealth Secretary Galvin had previously charged Morgan Stanley with not disclosing contests and higher commissions for brokers in its Back Bay Boston branch to sell certain Morgan Stanley owned and affiliated mutual funds. Galvin seeks disgorgement of "potentially millions of dollars of commissions."[70]

Putnam. On November 13, 2003, the SEC reached a partial settlement of fraud charges against Putnam Investment Management LLC for allegedly failing to disclose timing by Putnam professionals in their own accounts and failure to maintain adequate internal controls and supervision.[71] While the SEC's enforcement program has traditionally sought disgorgement of a defendant's illegal gains, the Putnam settlement instead opted to require the firm to pay restitution to customers injured by market timing or excessive trading by the firm's employees. The settlement requires an "Independent Assessment Consultant" to calculate the restitution Putnam will pay. Additionally, the settlement holds open for later determination, by further settlement or at a hearing, the question of civil penalty and other monetary relief to be imposed.[72] Although the SEC initially described the Putnam settlement as a template for future resolutions, most subsequent settlements have included penalties and disgorgement, in addition to requiring improved compliance and corporate governance.[73]

Prudential. On November 4, 2003, the SEC announced fraud charges against five brokers and a branch manager formerly with Prudential Securities, Inc. for market timing for customers over two years.[74] The SEC charged that the defendants set up additional brokerage accounts for the customers, and used multiple broker identification numbers, to thwart efforts by mutual fund companies to block market timing. The SEC's complaint charged the brokers with violating the antifraud provisions, and also with aiding and abetting their customers' uncharged fraud violations. Separately, on November 4, 2003, Massachusetts Commonwealth Secretary Galvin sued Prudential Securities for failing to supervise brokers in its Boston branch who participated in market timing, and seeking, among other relief, an order directing Prudential Securities to compensate mutual fund shareholders for their resulting losses. Galvin also brought suit against two branch managers and three brokers seeking, among other things, administrative fines and revocation of registration.[75]

I. Conclusion. The $7 trillion mutual fund industry should come out of its present crisis with investor confidence restored by the restructuring of regulation and practices presently underway. This restructuring combines both changes aimed at particular abuses—a "hard close" to stop late trading and disclosures and possibly redemption fees to combat timing—as well as fundamental changes in the duties and structure of industry participants to guard more generally against unanticipated abuses in the years to come. And in the short term, we must expect a continuing flow of enforcement actions to deal with the problems targeted in the ongoing federal and state probes.

[70] Available at http://www.state.ma.us/sec/sct/sctms/msidx.htm.

[71] Available at http://www.sec.gov/litigation/admin/ia-2192.htm.

[72] The settlement imposes several structural changes that reflect the SEC's recent rulemaking proposals. In order to assure that violations of the federal securities laws and breaches of fiduciary duty are discovered and reported, (i) the Chief Compliance officer must report violations directly to the independent trustees of the fund boards; (ii) the Code of Ethics Oversight Committee must report ethics breaches to the fund boards; (iii) the Internal Compliance Controls Committee must report on compliance matters to the fund boards; (iv) the firm must have an independent consultant review its policies and procedures for detecting violations; and (v) the firm must have an independent third party review policies and procedures impacting the funds at least every two years.

[73] In a press release, Spitzer attacked the SEC settlement for failing to require Putnam to reduce its fees and warned that his office would not use the settlement as a template. Putnam should have been required to adopt structural changes that "ensure that investors are charged the lowest possible management fees," he said. "This agreement completely fails to address this critical governance," he said. Spitzer's press release is available at *http://www.oag.state.ny.us/press/statements/putnam.html*. The SEC's related federal court litigation against two Putnam portfolio managers remains pending.

[74] *SEC v. Martin J. Druffner,* C.A. No. 03-12154-RCL (D. Mass., Nov. 4, 2003), available at http://www.sec.gov/news/press/2003-149.htm.

[75] Available at http://www.state.ma.us/sec/sct/sctpru/pruidx.htm.

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