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REPORT

MUTUAL FUNDS

The Mutual Fund Probes—What We Can Tell So Far

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On September 3, 2003, New York Attorney General Eliot Spitzer issued a press release announcing that he had obtained evidence of ''widespread illegal trading schemes that potentially cost mutual fund shareholders billions of dollars annually.'' The announcement followed an investigation of mutual fund trading practices by Spitzer's office that, according to his release ''quickly became focused'' on two specific practices—''late trading'' and ''market timing.''[1] The same day, Securities and Exchange Commission Chairman William H. Donaldson issued his own release labeling the conduct unearthed by Spitzer reprehensible and citing the importance of the SEC's ongoing review of hedge funds and mutual funds.[2]

Over the past two months, the pace of the regulators' response has been breathtaking. The SEC and Spitzer have together announced a series of coordinated criminal and civil actions against fund violators, clearly signaling with joint releases bearing both the federal and state regulators' logos that they are now working together to clean up problems in the fund industry.[3] Spitzer has issued dozens of subpoenas to numerous fund entities, and has confirmed that his focus extends

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[1] Available at http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

[2] Available at http://www.sec.gov/news/press/2003-106.htm.

[3] Despite recent sniping between Spitzer and the SEC, this coordination may signal a change from the rivalry that some perceived between federal and state regulators not long before when Spitzer took a leading role in dealing with issues relating to analysts' conflicts. Massachusetts Secretary of State William F. Galvin, who is investigating market timing in several matters involving major firms, is likewise coordinating his efforts with the SEC in this area, as demonstrated by the Massachusetts and SEC filings against Putnam Investment Management LLC on October 28, 2003, available at http://www.state.ma.us/sec/sct/sctptn/ptnidx.htm.

 ISSN 0037-0665

beyond funds, their managers, and their large investors. Indeed, he has promised to bring ''a significant number of criminal cases'' against intermediaries—brokerages, banks, trust companies, financial advisers, plan administrators, and others involved in selling funds to investors.[4]

With broader regulatory jurisdiction, the SEC has proceeded on many fronts, culminating in last week's filing of the SEC's first case against a large mutual fund company, Putnam Investment Management LLC.[5] SEC Chairman Donaldson began the agency's effort in September by sending letters to major fund and brokerage industry associations requesting all their members to assure compliance with policies governing late trading and market timing. The SEC examination staff sent detailed information requests on these subjects to numerous broker-dealers, transfer agents and over 80 of the largest mutual fund complexes, and the staff has indicated it is presently evaluating these responses and making referrals to the SEC's Enforcement Division for follow-up. More recently, the SEC has also promised rulemaking proposals designed to prevent recurrence of the practices now under scrutiny.[6]

Fund industry representatives have expressed strong support for the regulators' quick actions and pledged full cooperation.[7] And the stock markets are also joining the effort.[8] Two days after Spitzer's release launching the mutual fund probe, the NASD issued a Notice to Members cautioning them against late trading and market timing violations, and reminding them that they could be found liable for ''facilitating'' such violations while acting as an intermediary.[9]

All this in only two months! As discussed below, the securities regulators' new focus on the mutual fund industry is, without question, a serious enforcement initiative that will impact many industry participants and that will be with us for some time to come. But even at this early date, it is possible to begin to see where this initiative is going. Industry participants and their counsel need to be familiar with this new and intense effort in order to be prepared to take the steps that regulators are demanding, and to be ready to respond to the substantial private litigation that is already following in the wake of the regulators' probe.[10]

A. Late Trading

Mutual funds are usually valued once a day, at 4 pm (Eastern), when the U.S. stock markets close. The price, known as the Net Asset Value or ''NAV,'' generally reflects the closing price of the securities that comprise a fund's portfolio, plus any cash the fund holds. A fund will buy or sell its shares at the NAV. Unlike a stock, the price of a mutual fund does not change throughout the day. Instead, orders placed during the day up to 4 pm receive that day's NAV and orders placed after 4 pm receive the next day's NAV. This is the rule of ''forward pricing.''[11]

''Late trading'' refers to the practice of placing orders to buy or sell mutual funds after 4 pm, but receiving the price based on the NAV set as of 4 pm for orders placed before 4 pm. Late trading thus enables the trader to profit from market events after 4 pm that are not reflected in the 4 pm NAV. The late trader uses market-sensitive information learned after 4 pm to purchase (or sell) mutual fund shares at prices set at 4 pm, before the information was available. A variation of late trading involves the practice of placing orders before 4 pm but reserving the option to confirm or cancel the orders after 4 pm.[12]

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[4] Statement by N.Y. Attorney General Spitzer, quoted in ''Spitzer Casting a Very Wide Net,'' New York Times, Oct. 12, 2003. More recently, Spitzer commented that ''[t]he number of entities that will be held liable both civilly and criminally is substantial. It will be double digits, no question about it.'' Statement by N.Y. Attorney General Spitzer, quoted in ''Brokers Fired,'' Financial Times, Oct. 24, 2003, p.21. On October 23, 2003, Spitzer appointed David Brown as the new chief of his Investment Protection Bureau. After two decades with Wall Street law firms and banks, Brown joined Spitzer's office just five months ago, and during this time, ''has led [Spitzer's] investigation of illegal trading practices in the mutual fund industry.'' Release available at http://www.oag.state.ny.us/press/2003/oct/oct23c_03.html.

[5] Matter of Putnam Investment Management LLC, SEC Admin. Proc. No. 3-11317 (Oct. 28, 2003), available at http://www.sec.gov/litigation/admin/ia-2185.htm; SEC v. Scott et al., U.S. Dist. Ct., D. Mass., Civil Action No. 03-12082-EFH (Oct. 28, 2003), available at http://www.sec.gov/litigation/complaints/comp18428.htm. SEC release on Oct. 28, 2003 filing against Putnam available at http://www.sec.gov/news/press/2003-142.htm.

[6] The SEC's multifaceted response was recently surveyed in a speech by Paul F. Roye, SEC Director of Investment Management. Mr. Roye quoted Napoleon Bonaparte that ''the art of policing is, in order to punish less often, to punish more severely,'' and commented that ''the alleged conduct we are examining, if proved true, calls for severe punishment in my view.'' Advanced ALI-ABA Course of Study on Investment Management Regulation, Oct. 16, 2003 (Washington, DC), available at http://www.sec.gov/news/speech/spch101603pfr.htm. *See also* Speech by SEC Enforcement Director Stephen M. Cutler before National Regulatory Services Investment Adviser and Broker-Dealer Compliance Conference, Sept. 9, 2003 (Charleston, SC), available at http://www.sec.gov/news/speech/spch090903smc.htm.

[7] Investment Company Institute Statement, 9/25/03, available at http://www.ici.org/issues/mrkt/arc-sec/03_news_exec_stmt.html.

[8] Recent press reports show activity by both the NASD and the New York Stock Exchange. ''30 Firms Face NASD Fund-Trading Probe,'' Washington Post, Oct. 29, 2003, p. E1.

[9] ''NASD Reminds Member Firms of their Obligations Regarding Mutual Fund Transactions and Directs Review of Policies and Procedures,'' NASD Notice to Members 03-50 (Sept. 5, 2003), available at http://www.nasdr.com/pdf-text/0350ntm.txt.

[10] Numerous private actions have been filed making claims for damages suffered as a result of conduct under investigation by the regulators. As indicated on the website of one major securities class litigation firm, ''Milberg Weiss is proceeding on behalf of classes of investors who purchased Janus [complaint filed 9/9/03], Strong [complaint filed 9/9/03], One Group [complaint filed 9/9/03], Nations [complaint filed 9/8/03], Alliance [complaint filed 10/2/03], Putnam [complaint filed 10/21/03] and Morgan Stanley [complaint filed 10/16/03] mutual funds who are trying to recover some of the money that was allegedly taken from the funds, by bringing lawsuits under the federal securities laws and the Investment Advisers Act of 1940.'' http://www.milberg.com.

[11] Investment Company Act Rule 22c (17 C.F.R. 270.22c-1(a)).

[12] Speech by Paul F. Roye, SEC Director of Investment Management, Advanced ALI-ABA Course of Study on Investment Management Regulation, Oct. 16, 2003 (Washington, DC), available at http://www.sec.gov/news/speech/spch101603pfr.htm. Like insider trading, the practice of late trading gives a select few the opportunity to profitably trade on information not available to other contemporaneous traders.

  SRLR ISSN 0037-0665

The criminal focus of Eliot Spitzer's mutual fund probe reflected in these recent cases sets it apart from his recent probe of Wall Street analysts.

According to Attorney General Spitzer, ''allowing late trading is like allowing betting on a horse race after the horses have crossed the finish line.'' Spitzer contends that the practice violates both New York's exceptionally broad securities fraud statute (the Martin Act) and its grand larceny statute.[13] On the federal level, late trading violates Rule 22c-1(a) under Section 22(c) of the Investment Company Act of 1940 and constitutes a fraud in violation of Section 17(a) of the Securities Act of 1933, Sections 10(b) and 17(a) of the Securities Exchange Act of 1934 and Exchange Act Rules 10b-5, 17a-3 and 17a-4.

Spitzer kicked off his mutual fund cleanup campaign with a civil case charging hedge fund Canary Capital Partners, two related entities, and Edward Stern, the hedge fund's managing principal, with late trading in four leading mutual fund families, Bank of America's Nations Fund, Banc One, Janus, and Strong.[14] In a civil settlement with Spitzer, Canary agreed to pay $30 million in restitution and a $10 million penalty.[15]

On September 16, 2003, Spitzer upped the stakes and brought contested criminal charges against Theodore C. Sihpol, III, a broker with Banc of America Securities LLC.[16] Spitzer contends that Sihpol acted as an intermediary for Canary's late trading. Specifically, Spitzer charges that Canary faxed or emailed proposed trades before 4 pm with the understanding they would not be executed unless confirmed by telephone after 4 pm; that on receiving the proposed trades, Sihpol time-stamped order tickets as entered before 4 pm; that Canary phoned Sihpol after 4 pm and told him which trades it wanted and which it did not; and that Sihpol then entered the trades by hand, using order tickets time stamped before 4 pm and discarding the tickets for the trades Canary no longer wanted. The SEC filed related civil charges, also being contested.[17]

Significantly, Spitzer charged Sihpol with first degree grand larceny,[18] as well as with state securities fraud (the Martin Act).[19] The grand larceny charge is a particularly serious threat for Sihpol because it carries a minimum sentence of one to three years of imprisonment in a New York state prison, and a maximum of eight-and-a-third to twenty-five years.[20] In contrast, most New York state white collar statutes provide for sentences that do not mandate imprisonment.[21] In its related civil case, the SEC charged Sihpol with violating, aiding and abetting and causing violations of the antifraud, mutual fund pricing and broker-dealer record-keeping provisions of the federal securities laws.[22] The SEC seeks civil penalties, disgorgement, and other relief, including a bar of Sihpol from the securities industry.[23]

In contrast, just two weeks later, a guilty plea by Steven Markovitz, a trader with Millennium Partners, L.P., resulted in criminal charges brought only under the Martin Act, and not under the grand larceny statute

[13] Release, 9/3/03, available at http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html. *See* N.Y. General Business Law § 352-c (Martin Act); N.Y. Penal Law § 155.42 (grand larceny).

[14] *State of New York v. Canary Capital Partners, LLC, et al.*, Sup. Ct., N.Y. Co. (Sept. 3, 2003), available at http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf. The complaint is notable in that, among other things, it asks for a court order barring the defendants from virtually any future contact with mutual funds (''That defendants be restrained and enjoined from engaging in the sale, offer to sell, purchase, offer to purchase, promotion, negotiation and distribution of any mutual funds''). While the settlement did not impose this relief on these defendants, it is a signal that Spitzer may seek this relief in future mutual fund cases. This goes well beyond the SEC remedy of barring a defendant from association with an investment adviser or investment company, under Section 203(f) of the Investment Advisers Act of 1940, and Section 9(f) of the Investment Company Act of 1940.

[15] Release, 9/3/03, available at http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

[16] *People v. Sihpol*, Crim. Ct., N.Y. Co., available at http://www.oag.state.ny.us/press/2003/sep/sihpol_complaint.pdf.

[17] *Matter of Theodore Charles Sihpol III*, Admin. Proc. No. 3-11261 (Sept. 16, 2003), available at http://www.sec.gov/news/press/2003-117.htm.

[18] N.Y. Penal Law § 155.42, a Class B felony.

[19] N.Y. General Business Law § 352-c(6), a class E felony.

[20] The Spitzer and SEC joint release pointedly refer to the fact that ''If convicted of the first charge [the grand larceny count], the defendant would face a mandatory term in state prison.'' Joint release available at http://www.oag.state.ny.us/press/2003/sep/sep16a_03.html, and at http://www.sec.gov/news/press/2003-117.htm.

[21] Conditions in New York state's prison system are viewed as much harsher than in their federal counterparts, particularly for white collar offenders. New York state, unlike the federal government, has no special prison facilities for white collar offenders; instead, white collar offenders are thrown in with the general prison population. Just last year, Vanguard Group founder John C. Bogle commented in another context that ''The first time a white-collar criminal goes to Attica [a New York state facility] is the last time you'll have any corporate crime.'' ''Bush Plan Unlikely to Stir Fear in Corporate America,'' Associated Press, July 10, 2002.

[22] Securities Act § 17(a); Securities Exchange Act §§ 10(b) and 17(a); Exchange Act Rules 10b-5, 17a-3 and 17a-4; and Rule 22c-1 under Investment Company Act § 22(c).

[23] On October 21, 2003, Sihpol filed suit against Bank of America in Delaware Chancery Court seeking an order compelling the bank to advance his defense expenses in the ongoing criminal and civil proceedings against him. Sihpol's complaint contends (i) that he is entitled to advancement of his expenses under Article VIII of the bank's by-laws (providing indemnification for ''civil, criminal, administrative or investigative'' proceedings, including advancement of ''expenses incurred in defending'' such proceedings, ''to the fullest extent authorized'' by Delaware law) and under the Delaware statute, 8 Del. Code § 145; (ii) that when Sihpol demanded advancement of expenses, the bank's counsel responded that because the bank ''had decided to cooperate fully'' with Spitzer, any request for advancement of Sihpol's expenses ''would be vetted with the [New York] Attorney General''; (iii) that the bank later said it ''had vetted the request for advancement'' with Spitzer's office and was ''awaiting a response''; and (iv) that the bank finally responded that it ''will not be advancing attorney's fees'' for Sihpol, though bank counsel admitted that the bank's by-laws and the law ''are fairly clear.'' Complaint for Advancement, *Sihpol v. Bank of America Corp.*, Del. Ch. Court No. 005-N (filed Oct. 21, 2003).

with its mandatory prison requirement.[24] The case charged Markovitz with placing late trades with several mutual funds on behalf of Millennium, one of the nation's largest hedge fund operators, with over $4 billion under management. Markovitz also settled related SEC charges, without admitting or denying liability, that he violated the antifraud provisions and aided and abetted and caused violations of the mutual fund pricing provisions of the federal securities laws.[25] He consented to a bar from association with an investment adviser or investment company and a cease and desist order. The SEC also seeks disgorgement and civil penalties in amounts to be determined later.

The criminal focus of Spitzer's mutual fund probe reflected in these recent cases sets it apart from his recent probe of Wall Street analysts, in which leading brokerage firms paid an unprecedented $1.4 billion to settle civil charges of conflicts between their research and investment banking departments. Likewise, these recent cases demonstrate that the mutual fund probe is quickly gathering momentum, and that Spitzer and the SEC are attempting to move beyond any friction or turf battles that might have hindered cooperation in the past.

B. Fund Timing

Market timing involves short-term, ''in-and-out'' trading of mutual fund shares designed to exploit inefficiencies in the way mutual fund companies price their shares. The timer sees that the NAV price of the fund has become stale and no longer reflects the values of the stocks held in the fund. The timer then buys at the stale NAV price, and sells the next day or later at an updated NAV price. International funds are particularly vulnerable to market timers, because the markets trading their portfolio securities typically close several hours before or after the 4 pm (Eastern) NAV measuring point, resulting in temporary pricing anomalies that timers can exploit through in-and-out trading of fund shares.

Because mutual funds are typically long-term investments, many funds discourage or prohibit market timing—limiting the number of a customer's trades each year, imposing ''early redemption'' fees to wipe out timers' profits, or exercising discretion to cancel timers' trades altogether. But Spitzer's investigation revealed that some funds have apparently bent the rules to allow timing by certain favored customers. Again offering a gaming analogy, Attorney General Spitzer commented that ''allowing timing is like a casino saying that it prohibits loaded dice, but then allowing favored gamblers to use loaded dice, in return for a piece of the action.''[26]

The SEC has recently explained that excessive short-term trading hurts mutual fund investors because it can (i) ''dilute the value of mutual fund shares,'' where ''fund shares are overpriced and redeeming shareholders receive proceeds based on the overvalued shares''; (ii) ''raise transaction costs for the fund''; (iii) ''disrupt the fund's stated portfolio management strategy''; (iv) ''require a fund to maintain an elevated cash position''; and (v) ''result in lost opportunity costs and forced liquidations'' for the fund.[27] While observers have pointed out that timing is not per se illegal, we have seen that in certain situations timing can provoke regulators to bring charges under the antifraud provisions of federal and state securities laws.

In dealing with timing, regulators appear particularly interested in prosecuting cases where funds allegedly allow certain customers to engage in timing in return for some consideration from the timer to the fund complex or the adviser. On October 16, 2003, James P. Connelly Jr., vice chairman and chief mutual fund officer at Fred Alger Management, settled SEC charges, without admitting or denying liability, that he approved agreements permitting certain investors to market time funds managed by Alger. [28]

Significantly, the agreements allegedly included commitments by the customers to maintain at least 20% of their investments in Alger in buy-and-hold positions (so-called ''sticky assets''). Alger allegedly allowed one such customer—a hedge fund—to time $50 million in one Alger fund in return for a $10 million buy-and-hold position in another Alger fund. Later, the customer allegedly got an additional $30 million worth of timing capacity in exchange for an additional $12 million buy-and-hold position. The settlement with Connelly included a lifetime bar from the securities industry and a $400,000 civil penalty. He also pled guilty to a New York state felony charge of tampering with evidence, a crime punishable by up to four years in prison.[29]

Likewise, any personal benefit obtained by individual portfolio managers or other professionals at the expense of fund shareholders is squarely in the regulators' radar. On October 28, 2003, the SEC and the Massachusetts Securities Division filed coordinated civil fraud cases against Putnam Investment Management LLC, the investment adviser for the Putnam Family of Funds, and two former Putnam portfolio managers, Jus-

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[24] *People v. Markovitz*, Information No. 5327-03 (Oct. 2, 2003). N.Y. Attorney General's release announcing guilty plea available at http://www.oag.state.ny.us/press/2003/oct/oct02a_03.html.

[25] Securities Act § 17(a); Securities Exchange Act § 10(b); Exchange Act Rule 10b-5; Rule 22c-1 under Investment Company Act § 22(c). *Matter of Steven B. Markovitz*, Admin Proc. No. 3-11292 (Oct. 2, 2003), available at http://www.sec.gov/news/press/2003-132.htm.

[26] Release, Sept. 3, 2003, available at http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

[27] SEC Complaint, ¶ 14, in *SEC v. Scott et al.*, U.S. Dist. Ct., D. Mass., Civil Action No. 03-12082-EFH (Oct. 28, 2003), available at http://www.sec.gov/litigation/complaints/comp18428.htm. The Investment Company Institute has similarly observed: ''The rapid buying and selling of mutual fund shares may be disruptive to the efficient management of the fund portfolio and cause the fund to experience higher trading costs in connection with buying and selling portfolio securities. In addition, market-timing activity could cause a fund to hold more cash than otherwise preferred by the fund's managers to accommodate swings in cash flow. Moreover, time-zone arbitrage may dilute the value of shares held by long-term investors.'' ICI Release, ''Questions and Answers About Mutual Funds and Market Timing, Late Trading, and Related Issues,'' available at http://www.ici.org/new/faqs_timing.html.

[28] *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.

[29] The Attorney General's complaint charges that, when its subpoena required Alger to identify clients that had engaged in late trading, Connelly falsely told outside counsel that Alger had no such clients and directed deletion of emails responsive to the subpoena. *People v. Connelly*, Crim. Ct., N.Y. Co., available at http://www.oag.state.ny.us/press/2003/oct/connelly_complaint.pdf.

  SRLR ISSN 0037-0665

tin M. Scott and Omid Kamshad.[30] The SEC charged that these portfolio managers fraudulently engaged, for their own personal accounts, in excessive short-term trading in Putnam funds for which they exercised investment authority and ''had access to non-public information regarding, among other things, current portfolio holdings, valuations and transactions not readily available to all fund shareholders.''[31] The SEC alleged that Putnam fraudulently failed to disclose potentially self-dealing transactions by these portfolio managers and others to the funds and their boards, and further that Putnam failed to supervise these portfolio managers and others, lacked policies and procedures reasonably designed to prevent misuse of non-public information, and failed to adequately enforce its code of ethics. The SEC and Massachusetts charges against both Putnam and the portfolio managers were filed as contested cases.

Another focus in timing cases is on situations where allowing timing violates representations made to investors—typically in the fund prospectus or statement of additional information—that the fund seeks to deter timers and imposes trading limits to prevent market timing. So far, however, such claims have only been made in conjunction with other and more serious forms of timing-related violations. Thus, the SEC's settled proceeding against Connelly, the Alger official accused of approving certain alleged agreements allowing timing in return for keeping a certain percentage of assets invested with Alger, also charged that the timing violated the statement of additional information incorporated in the prospectus to the effect that investors would be limited to six trades per year.[32]

Similarly, the Massachusetts Securities Division's proceeding against Putnam, in addition to paralleling the SEC's self-dealing charges involving the two portfolio managers discussed above, also charges that Putnam allowed certain mutual fund shareholders, including certain union retirement plan participants, ''to engage in market timing activity in direct contradiction to the prospectus disclosure'' for the funds in question. The state complaint contends that this violated representations in Putnam mutual fund prospectuses to the effect that Putnam ''would not tolerate excessive exchange activity or market timing,'' a policy designed ''to protect long-term investors from the negative effects of excessive trading, including . . . dilution of share value, negative tax consequences, increased transaction costs, and loss of fund investment opportunities.''[33]

C. Continuing Focus on Mutual Fund Sales Practice Issues

As reflected above, the primary focus of the mutual fund probe recently launched by Spitzer and the SEC is on late trading and abusive market timing practices. However, the story does not end there. Both the SEC and state securities regulators are also investigating a variety of sales practice violations in distributing mutual funds to investors. Often, these violations result from activities of intermediaries who deal directly with the public.

Representations concerning performance and valuation were the basis for parallel civil and criminal fraud charges filed October 29, 2003, by the SEC and the U.S. Attorney's Office in Manhattan against Edward J. Strafaci, the Director of Fixed Income Money Management at Lipper & Company, L.P., an investment adviser.[34] The government charges that, as portfolio manager of certain Lipper convertible hedge funds, Strafaci overstated the value of convertible bonds and preferred stock held in the funds, disregarding prices obtained in recent sales and the views of his traders, and thus overstated performance figures to present and prospective investors.

Regulators are also taking a hard look at special compensation received by a firm or its representatives for selling certain funds. In mid-October 2003, Morgan Stanley disclosed that it had received a ''Wells'' notice from the SEC advising that ''the staff . . . is considering recommending enforcement action in connection with the Company's mutual fund sales practices . . . based upon, among other things, (i) the Company's alleged failure to disclose the sources, types and amounts of compensation received by it from investment companies for selling their products; (ii) the Company's al-

[30] The SEC's release, commenting that the filings ''reflect the joint efforts'' of the SEC and Massachusetts state regulators, is available at http://www.sec.gov/news/press/2003-142.htm. The SEC and Massachusetts coordinated filings are *Matter of Putnam Investment Management LLC*, SEC Admin. Proc. No. 3-11317 (Oct. 28, 2003), available at http://www.sec.gov/litigation/admin/ia-2185.htm; *SEC v. Scott et al.*, U.S. Dist. Ct., D. Mass., Civil Action No. 03-12082-EFH (Oct. 28, 2003), available at http://www.sec.gov/litigation/complaints/comp18428.htm; and *Matter of Putnam Investment Management, Inc., et al.*, Mass. Sec. Div. Docket No. E-2003-061, available at http://www.state.ma.us/sec/sct/sctptn/ptnidx.htm.

[31] The SEC's complaint charged that Kamshad engaged in 38 short-term trades between 1998 and 2003, resulting in ''hundreds of thousands of dollars in gains,'' that a Putnam official met with Kamshad concerning his frequent trading in 2000, that Kamshad said he would cease that type and level of activity, and that the official then sent a memo of the conversation to Scott, one of Kamshad's superiors. The complaint further charged that that Scott engaged in 35 short-term trades between 1998 and 2000, also resulting in ''hundreds of thousands of dollars in gains.'' Complaint (¶¶ 20, 21, 26, 27), *SEC v. Scott et al.*, U.S. Dist. Ct., D. Mass., Civil Action No. 03-12082-EFH (Oct. 28, 2003), available at http://www.sec.gov/litigation/complaints/comp18428.htm.

[32] *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.

[33] *Matter of Putnam Investment Management, Inc., et al.*, Mass. Sec. Div. Docket No. E-2003-061, available at http://www.state.ma.us/sec/sct/sctptn/ptnidx.htm.

[34] *SEC v. Strafaci*, 03-CV-8524 (CSH) (S.D.N.Y., Oct. 29, 2003), http://www.sec.gov/news/press/2003-143.htm.

leged failure to disclose adequately its compensation arrangements for financial advisors; and (iii) the Company's alleged favored sale or distribution of shares of specified investment companies based upon brokerage commissions received or expected from such investment companies.'' [35]

Regulators are also continuing to focus on suitability issues in mutual fund shares. In July 2003, the SEC announced settled charges with Prudential Securities concerning inadequate systems to monitor and enforce policies and procedures dealing with sales of different classes of mutual funds. Without admitting or denying the charges, Prudential paid disgorgement of $82,000 and a $300,000 civil penalty, following sale of ''B'' shares when customers making sizeable purchases could have used ''breakpoint'' discounts to buy ''A'' shares carrying lower annual fees.[36] And, Morgan Stanley in October disclosed a second ''Wells'' notice advising that the SEC staff is ''also considering recommending enforcement action based upon, among other things, the Company's alleged sales practices in connection with Class B investment company shares.'' [37]

Earlier in 2003, the NASD completed a sweep of 43 broker-dealers to survey the extent to which they were failing to deliver breakpoint discounts—available for large purchases or purchases linked to other shares owned in a fund family—that cut front-end charges for ''A'' share purchases. The SEC had asked the NASD (working with the Securities Industry Association and the Investment Company Institute) to report on this, and in July 2003, the SEC reported the results of the sweep, including the finding that nearly one in three transactions in front-end load mutual funds that appeared eligible for a breakpoint discount did not receive one. The sweep found that most such problems did not appear intentional.[38]

It appears that regulators will continue to focus on possible sales practice violations impacting mutual funds at the same time that they pursue the new charges of late trading and abusive market timing. Regulators will expect firms to be looking for such problems where they may exist and to take appropriate remedial actions.

D. SEC Rulemaking Initiatives

On October 9, 2003, the SEC announced that it was preparing for public comment a number of rulemaking proposals specifically designed to prevent recurrence of the problems uncovered in the ongoing investigations by Spitzer and the SEC staff.[39] The actual proposals are to be published for comment during November 2003.

To deal with late trading, the SEC is considering proposing a rule that would require a fund itself—and not an intermediary such as a broker-dealer or other third party—to receive a customer's order before the NAV pricing calculation (typically at 4 pm) in order to receive that day's price. Orders received by the fund after the calculation would get the next day's price. This would effectively eliminate late trading through intermediaries. Also, the SEC is considering proposals to require funds to adopt additional procedures and controls to prevent late trading.

To deal with market timing, the SEC is considering proposals to require funds to make explicit disclosure to investors in fund offering documents concerning the fund's market timing policies and procedures, to require the funds to then comply with those policies and procedures, and to reinforce fund directors' obligations to see to it that the funds so comply. The proposals would also require funds to fair value their securities under certain circumstances, in order to minimize the opportunities for market timing.[40]

On September 30, 2003, Chairman Donaldson gave a Senate committee a summary of the SEC's other rulemaking activities pertaining to mutual funds. Earlier that month, he reported, the SEC adopted rule amendments to enhance fund advertising requirements, including requirements that the fund tell investors to fo-

[35] Morgan Stanley Form 10-Q, filed October 14, 2003, p.72, available at http://www.sec.gov/. The firm also disclosed that in July and August 2003, the Massachusetts Securities Division had filed contested administrative complaints alleging that the Company ''filed false information in response to an inquiry from the Division pertaining to mutual fund sales practices,'' and ''failed to make disclosures of incentive compensation for proprietary and partnered mutual fund transactions.'' Additionally, on September 16, 2003, the firm paid $2 million to settle NASD charges arising from 29 sales contests to promote Morgan Stanley mutual funds and certain variable annuities. The NASD release announcing the settlement quoted Mary L. Schapiro, NASD's Vice Chairman, that ''It is not acceptable for NASD-regulated firms to hold contests for prizes that promote the sale of one fund, especially their own, over other mutual fund products.'' Available at http://www.nasdr.com/news/pr2003/release_03_039.html.

[36] Available at http://www.sec.gov/news/press/2003-82.htm. The SEC also filed contested administrative charges against a former Prudential sales representative and a former branch manager.

[37] Morgan Stanley Form 10-Q, filed October 14, 2003, p.72, available at http://www.sec.gov/.

[38] The SEC's release is available at http://www.sec.gov/news/press/2003-84.htm. The NASD's report is available at http://www.nasdr.com/breakpoints_report.asp.

[39] Available at http://www.sec.gov/news/press/2003-136.htm. The Investment Company Institute has announced that it ''strongly supports'' the SEC's plan to propose ''tough new regulatory requirements addressing the late trading and abusive short-term trading of mutual fund shares.'' Release, 10/9/03, available at http://www.ici.org/issues/mrkt/arc-sec/03_news_sec_late-stmt.html. Also, on October 30, 2003, the ICI proposed a firm 4 pm deadline for all mutual fund trades to be reported to mutual fund companies, and a mandatory industry-wide minimum 2% redemption fee on mutual fund sales for a minimum of 5 days after purchase. http://www.ici.org/new/03_news_exec_comm.html#TopOfPage.

[40] Some favor a more aggressive approach that the SEC may find attractive as it pursues its rulemaking in this area. On October 27, 2003, fund industry leader and Vanguard founder John C. Bogle proposed (i) barring funds from accepting trades after 2:30 pm (Eastern), and (ii) imposing a 2% redemption fee on shares held under 30 days. ''Vanguard's Bogle Urges SEC to Adopt Market-Timing Rules,'' Wall Street Journal, Oct. 27, 2003. And writing recently in Forbes (''Scandal and Reform,'' Oct 13, 2003, p.44), Bogle made additional suggestions for reform: (i) Buttress fund directors' independence. (ii) Require the board chairman to be independent of the management company, so that fees can be negotiated at arm's length. (iii) Allow only one management company representative on the fund's board. (iv) Give the board their own staff to assure objectivity of the information they get. (v) Spell out management fees in dollars for fund investors. (vi) Itemize amounts going to marketing, administration and investment advice. (vii) Disclose the manager's profit. (viii) Disclose the compensation paid to each fund executive.

   ISSN 0037-0665

cus on the fees being charged, and that the fund provide more balanced and timely performance information.

If problems are found to exist at an entity, regulators will want to know whether management satisfied its fiduciary duties to investors by responding appropriately, including taking steps to bring problems to the attention of law enforcement.

The SEC has also proposed rules for ''funds of funds'' (funds that own shares of other funds) to provide greater transparency of expenses. During 2002-03, the SEC included mutual funds in its Sarbanes-Oxley Act rulemaking to assure that the act's corporate governance and financial integrity requirements would not be limited just to operating companies. Donaldson also reported on possible future rulemaking for mutual funds, including greater disclosure of breakpoint discounts; enhanced disclosure of fund operating expenses; revision of mutual fund confirmation forms to include information on revenue sharing and incentives to sell in-house funds; and a mutual fund compliance rule that would require comprehensive compliance policies and procedures and designation of a chief compliance officer for the fund.[41]

Finally, on September 29, 2003, the SEC released its staff report on ''The Implications of Growth of Hedge Funds.''[42] The report contains a number of recommendations for enhanced regulation of hedge funds, including a recommendation that hedge fund advisers be required to register under the Investment Advisers Act. The report also voiced concern over the SEC's lack of information about hedge funds and their advisers, lack of uniform hedge fund disclosure, valuation and conflict of interest issues, increased hedge fund participation by less sophisticated investors, and increased enforcement actions involving hedge fund advisers.

E. Conclusion

As SEC Chairman Donaldson recently noted, the mutual fund industry acts as a fiduciary for 95 million Americans (54 million American households) invested in mutual funds. It holds $6.5 trillion in assets.[43] When serious regulatory problems surface in this industry, securities regulators will respond in force.

After two months of the mutual fund probe, it is now clear that we are at the beginning of a massive regulatory effort that will involve fast-paced investigations leading to substantial criminal and civil regulatory actions. Many of the criminal prosecutions will be at the state level, primarily in New York, where the threat of incarceration can be particularly daunting. But the civil remedies meted out by the SEC and other regulators can also spell dire financial and career consequences for those appearing on their radar screens. Regulators will continue to concentrate on late trading and abusive timing activities that appear to have been far more pervasive than originally imagined, and they will also continue to focus on sales practices abuses that impact individual mutual fund investors. And the SEC will continue to consider and adopt comprehensive regulations to prevent future problems in the fund industry.

Regulators assessing alternatives in dealing with particular firms and their managements will likely evaluate the level of integrity and responsibility that they show during the investigative process. Regulators will, of course, ask about controls, policies and procedures, and compliance efforts. But in the present environment, they will also ask whether management proactively investigated their operations to surveil for the types of problems discussed above without waiting to see red flags. If problems are found to exist at an entity, regulators will want to know whether management satisfied its fiduciary duties to investors by responding appropriately, including taking steps to bring problems to the attention of law enforcement.[44] In short, this is a time for action, not avoidance.

[41] Testimony of SEC Chairman William H. Donaldson before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Sept. 30, 2003, available at http://www.sec.gov/news/testimony/ts093003whd.htm.

[42] Release available at http://www.sec.gov/news/press/2003-125.htm. Full staff report available at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

[43] Testimony of SEC Chairman William H. Donaldson before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Sept. 30, 2003, available at http://www.sec.gov/news/testimony/ts093003whd.htm.

[44] In announcing its so-called Seaboard Doctrine on giving entities credit for acting responsibly and cooperating with law enforcement, the SEC stressed that the entity's response should begin ''immediately'' after it learns it has a problem. The response should include immediate cessation of the misconduct and a ''thorough review of the nature, extent, origins and consequences'' of the problem. ''Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions,'' Exchange Act Rel. No. 44969 (10/23/01) (SEC policy statement issued in connection with settlement of a case involving Seaboard Corporation, *Matter of Gisela de Leon-Meredith*, Exchange Act Rel. No. 44970 (Oct. 23, 2001)). *See* S. Crimmins, ''New SEC Policy on Cooperation May Present Opportunities for Counsel and Issuers,'' BNA Securities Regulation & Law Report, Vol. 33, No. 43 (Nov. 5, 2001). In federal criminal matters, the Justice Department takes a similar position, as reflected in its so-called Thompson Memorandum, ''Principles of Federal Prosecution of Business Organizations'' (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm (consideration given to ''the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents''; ''the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies''). *See also* United States Attorneys' Manual, at § 9-27.230.