Testimony Concerning Recent Commission Activity To Combat Misconduct Relating to Mutual Funds

by Stephen M. Cutler,
Director, Division of Enforcement,
U.S. Securities & Exchange Commission

Before the Senate Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs

November 3, 2003

Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee:

I. Introduction

Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission concerning alleged abuses relating to the sale of mutual funds. With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $7 trillion in assets, mutual funds are a vital part of this nation's economy and millions of investors' financial security. For that reason, I share the outrage and disappointment of Chairman Donaldson, and so many others, at the misconduct that recently has come to light. It is intolerable when investment professionals -- who have a duty to serve the best interests of their customers -- instead put their own interests first. That way of thinking is antithetical to the responsibilities investment advisers, broker-dealers, and their employees owe to mutual fund investors. Mutual fund investors have a right to expect fair treatment, and when they do not receive it, we at the Commission will demand it on their behalf.

Accordingly, the Commission has undertaken an aggressive agenda to identify and address problems in the mutual fund industry. That agenda has both an enforcement component, which I will discuss, and a regulatory component, which my colleague Paul Roye, Direct of Investment Management, will address.

The enforcement piece of the Commission's agenda relating to mutual funds currently is focused on four types of misconduct, each of which may result in the interests of financial services firms or their employees being placed above the interests of investors. I will touch on each briefly, and then turn to the Commission's response to the recent revelations of serious misconduct relating to the trading of mutual funds.

The first area of priority, which I will discuss in detail in a moment, is late trading and timing of mutual fund shares.

Our second area of priority focuses on sales practices. In particular, what are prospective mutual fund investors being told about revenue sharing arrangements and other incentives doled out by mutual fund companies to brokers selling their funds? Do customers understand that their broker is being paid to sell a particular fund? And when these payments are being made from fund assets, do customers understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office? Such fees may increase costs to investors as well as create conflicts of interest between investors and the financial professionals with whom they deal. The Commission's Office of Compliance Inspections and Examinations is

conducting a series of examinations of industry practices in this area, and the Division of Enforcement has investigations underway exploring possible abuses.

Our third area of priority in the mutual fund arena is the sale of different classes of mutual fund shares. Many mutual funds offer multiple classes of shares in a single portfolio. For each class of shares, a mutual fund uses a different method to collect sales charges from investors. Class A fund shares are subject to an initial sales charge ("front-end load"); discounts on front-end loads are available for large purchases of Class A shares. Since the sales fee is paid up front, Class A shares incur smaller "rule 12b-1 fees," a fee the mutual fund pays for distribution costs, including payments to the broker-dealers and their registered representatives selling fund shares.

Class B shares, by contrast, are not subject to an up-front sales charge. Instead, they become subject to a sales charge (a "contingent deferred sales charge" or "CDSC") only if, and when, they are redeemed before the end of a specified holding period. Class B shares usually automatically convert to Class A shares after a specified number of years. Because Class B share investors only pay a CDSC, if any, at the time that they redeem their shares, the funds pay higher rule 12b-1 fees on Class B shares to defray the associated distribution expenses. As a result, brokers typically earn larger commissions on Class B shares than on Class A.

The Commission's examiners have made this an area of priority for review in examinations. In addition, the Commission has brought two enforcement actions

involving the sales of Class B shares to investors who were not made aware by their registered representatives that they could purchase Class A shares of the same mutual fund at a discount. For example, on July 10, 2003, the Commission brought a case against Prudential Securities in connection with the sale of Class B shares. Prudential had in place policies and procedures requiring reps to advise their clients of the availability of different classes of mutual funds and fully explain the terms of each. Prudential branch managers were also expected to approve all purchases greater than $100,000 and confirm the suitability of the choice of fund class. The Commission found, however, that Prudential failed to adopt a sufficient supervisory system to enable those above the branch manager to determine whether these policies and procedures were being followed. Under Prudential's system, branch office managers were solely responsible for ensuring that registered representatives followed the firm's mutual fund policies and procedures. As a result, when the rep's branch manager failed to abide by and enforce Prudential's policies and procedures, the firm had no way of detecting the lapse. In resolving the Commission's action, Prudential was censured and agreed to pay disgorgement and a civil penalty. The Commission's action against the registered representative and branch manager, which charges them with fraud, is pending.

The final priority area is to address the abuse of so-called "breakpoints." Breakpoints are the specified investment levels at which the discounts available on front-end loads for large purchases of Class A shares increase. Earlier this year, examiners at the SEC, NASD, and NYSE completed an examination sweep and outlined the results in a report, "Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding

Discounts on Front-End Sales Charges on Mutual Funds."[1] Together with the NASD, we have under active investigation instances in which it appears that investors were entitled to receive breakpoint discounts based on the size of their purchase of Class A shares, but where the firms failed to provide discounts.

This brief overview of the Commission's enforcement agenda with respect to mutual funds is intended to give you a sense of the scope of our activities. I recognize, however, that today's hearing was prompted by recent revelations involving late trading and timing of mutual funds. Accordingly, I will now turn to that subject.

II. SEC Response to Misconduct Relating to Mutual Funds

As you well know, the conduct of mutual funds and the financial intermediaries with and through which they do business, recently came to the public's attention when New York Attorney General Eliot Spitzer announced an action involving abusive mutual fund trading practices by a hedge fund, Canary Capital Partners, LLC. The Canary action identified two problematic practices – late trading of mutual funds and timing of mutual funds. Late trading refers to the practice of placing orders to buy or sell mutual fund shares after the time at which the funds calculate their net asset value ("NAV") -- typically 4:00 p.m. Eastern Time ("ET") -- but receiving the price based upon the prior NAV already determined as of 4:00 p.m. Late trading violates the federal securities laws concerning the price at which mutual fund shares must be bought or sold and defrauds

[1] The report is available at: http://www.sec.gov/news/studies/breakpointrep.htm.

innocent investors in those mutual funds by giving to the late trader an advantage not available to other investors.

"Timing" abuses refer to excessive short-term trading in mutual funds in order to exploit inefficiencies in mutual fund pricing. Although market timing itself is not illegal, mutual fund advisers have an obligation to ensure that mutual fund shareholders are treated fairly and that one group of shareholders (i.e., market timers) is not favored over another group of shareholders (i.e., long term investors). In addition, when a fund states in its prospectus that it will act to curb market timing, it must meet that obligation.

Abusive market timing can dilute the value of mutual fund shares to the extent that a trader may buy and sell shares rapidly and repeatedly to take advantage of inefficiencies in the way mutual funds prices are determined. Dilution could occur if fund shares are overpriced and redeeming shareholders receive proceeds based on the overvalued shares. In addition, short-term trading can raise transaction costs for the fund, it can disrupt the fund's stated portfolio management strategy, require a fund to maintain an elevated cash position, and result in lost opportunity costs and forced liquidations. Short-term trading can also result in unwanted taxable capital gains for fund shareholders and reduce the fund's long-term performance. In short, while individual shareholders may profit from engaging in short-term trading of mutual fund shares, the costs associated with such trading are borne by all fund shareholders.

Following the announcement of the Canary Capital case, the Commission put in motion an action plan to vigorously investigate the matter, assess the scope of the problem, and hold any wrongdoers accountable. Specifically, the Commission is proceeding on three fronts, utilizing its enforcement authority, its examination authority, and its regulatory authority. I will address the first two areas of the Commission's efforts.

A. Recent Enforcement Efforts Relating to Mutual Fund Trading

In the enforcement area, we are working aggressively to pursue wrongdoing, and are doing so in close coordination with State regulators, including Mr. Spitzer and Mr. Galvin in Massachusetts. Thus far, the Commission has brought actions against persons associated with three different types of entities – a broker-dealer, a hedge fund, and two mutual funds – each of which can play a role in disadvantaging long-term mutual fund investors. Our actions to date address allegations of both late trading and market timing. I will briefly summarize those actions.

On September 16, the Commission filed a civil action against Theodore Sihpol, a salesperson at Bank of America Securities ("BOA"), who was Canary Capital's primary contact at Bank of America. Specifically, the Commission issued an administrative order instituting proceedings in which the Division of Enforcement (the "Division") alleges that Sihpol played a key role in enabling certain hedge fund customers of BOA to engage in late trading in shares of mutual funds offered by Bank of America, including the Nations Funds family of funds and other mutual funds. Based on the conduct alleged in

the Commission's Order, the Division alleges that Sihpol violated, and aided and abetted and caused violations of, the antifraud, mutual fund pricing and broker-dealer record-keeping provisions of the federal securities laws. In its action, the Division is seeking civil penalties, disgorgement and other relief, which may include permanently barring Sihpol from the securities industry.[2] Simultaneous with the issuance of the Commission's order, Sihpol surrendered in connection with Attorney General Spitzer's filing of a two-count complaint charging him with larceny and securities fraud.

Less than three weeks later, the Commission and the New York Attorney General announced criminal and civil actions against Steven B. Markovitz, formerly an executive and senior trader with the prominent hedge fund firm Millennium Partners, L.P. In the New York Attorney General's criminal action, Markovitz pleaded guilty in State Supreme Court to a violation of New York's Martin Act. The SEC's administrative order finds that Markovitz committed securities fraud. In partial settlement of the SEC's action, without admitting or denying the SEC's findings, Markovitz consented to cease and desist from violations of certain provisions of the federal securities laws, and to be permanently barred from associating with an investment adviser or from working in any capacity with or for a registered investment company. The SEC also is seeking disgorgement and civil penalties in amounts to be determined later.

According to the criminal charges and the SEC findings, Markovitz engaged in late trading of mutual fund shares on behalf of Millennium, one of the nation's largest

---

[2] In connection with the SEC's order, a hearing will be scheduled before an administrative law judge to determine whether the allegations contained in the order are true and to provide Sihpol an opportunity to respond to them.

hedge fund operators, with more than $4 billion under management. With the assistance of certain registered broker-dealers, Markovitz placed mutual fund orders after 4:00 p.m. ET, but obtained the prices that had been set as of 4:00 p.m. ET. By SEC rule, Markovitz's post-4:00 p.m. orders should have received the prices set on the following day. This illegal trading allowed Millenium to take advantage of events that occurred after the markets closed.

In its first action against a mutual fund executive for permitting market timing, on October 16, the Commission and the New York Attorney General announced the arrest, conviction, and lifetime industry bar of James P. Connelly, Jr., former Vice Chairman and Chief Mutual Fund Officer of Fred Alger & Company, Inc., a prominent mutual fund firm. Connelly pled guilty to the crime of Tampering with Physical Evidence. The criminal charges against Connelly stem from his repeated efforts to tamper with an ongoing investigation of illegal trading practices in the mutual funds industry, including by directing subordinates to delete emails called for by subpoenas.

In its administrative order, the SEC found that Connelly approved agreements that permitted select investors to "time" certain mutual funds managed by Alger, a practice that violates an adviser's fiduciary duties and adversely affects the value of the fund being timed. In this case, the timing arrangements were also inconsistent with Alger's public disclosures in prospectuses and Statements of Additional Information filed with the SEC. According to the Commission's order, Connelly was involved in timing arrangements at Alger from the mid-1990s until 2003. By early 2003, Connelly was

requiring that investors seeking timing capacity agree to maintain at least 20% of their investment at Alger in buy-and-hold positions, sometimes referred to as "sticky assets."

In settling the SEC action, Connelly neither admitted nor denied the SEC findings. The Commission's order directs Connelly to cease and desist from future violations of various provisions of the federal securities laws; bars him from association with any broker, dealer or investment adviser; bars him from serving in various capacities with respect to any registered investment company; and imposes a $400,000 civil penalty.

Most recently, on October 28, the Commission brought actions against Putnam Investment Management LLC ("Putnam") and two former Putnam Managing Directors and portfolio managers, Justin M. Scott and Omid Kamshad, in connection with the personal trading by those Managing Directors in Putnam mutual funds. The Commission filed a civil injunctive action against Justin M. Scott and Omid Kamshad charging each of them with securities fraud. The complaint alleges that Scott and Kamshad, for their own personal accounts, engaged in excessive short-term trading of Putnam mutual funds for which they were portfolio managers. According to the complaint, Scott and Kamshad's investment decision-making responsibility for those funds afforded them access to non-public information about the funds, including current portfolio holdings, valuations and transactions. The complaint further alleges that Scott and Kamshad's short-term trading violated their responsibilities to other fund shareholders, that Scott and Kamshad failed to disclose their trading and that, by their trading, they potentially harmed other fund shareholders.

The Commission issued an administrative order instituting proceedings against Putnam in which the Division of Enforcement (the "Division") alleges that Putnam engaged in securities fraud by failing to disclose to the funds or to the fund boards the potentially self-dealing transactions in fund shares by Scott, Kamshad and other employees. The Division further alleges that Putnam failed to supervise Scott, Kamshad and other employees, that it failed to have policies and procedures reasonably designed to prevent the misuse of non-public information and that it failed adequately to enforce its code of ethics.[3]

Against the individual defendants the Commission is seeking injunctive relief, disgorgement, penalties, and such equitable relief as the court deems appropriate. As to Putnam, the Division is seeking relief in the form of a cease-and-desist order, disgorgement, a penalty, and such other relief as the Commission deems appropriate.

B. The Commission's Use of Examination Authority

As I noted, the Commission's response to the revelations of misconduct in the mutual fund area is multi-pronged. The second area of authority that we are utilizing aggressively is the Commission's examination authority, which entitles us to obtain promptly information and records from regulated entities. Accordingly, immediately following the Canary announcement, relying on the Commission's examination powers, the Commission's staff sent detailed information requests to 88 of the largest mutual fund complexes in the country and 34 broker-dealers, including prime brokerage firms and

[3] In connection with the SEC's administrative order, a hearing will be scheduled before an administrative law judge to determine whether the allegations contained in the order are true and to provide Putnam an opportunity to respond to them.

other large broker-dealers. These written requests sought information on each entity's policies and practices relating to market timing and late trading. In the case of mutual funds and broker-dealers, we have obtained information regarding their pricing of mutual fund orders and adherence to their stated policies regarding market timing. We also have sought information from mutual funds susceptible to market timing regarding their use of fair value pricing procedures to combat this type of activity.

The examination staff is still analyzing the information received as a result of these requests, and in many cases has sought additional details. Some firms' responses are still incomplete. Nevertheless, some firms' responses have warranted aggressive follow-up, and thus, Commission examiners have been dispatched to conduct onsite inspections and interviews at a number of firms. Responses from some other firms have already led to referrals to the enforcement staff for further investigation. All told, SEC staff across the country are looking at the activities and practices of dozens of firms.

Although we are continuing to receive and analyze information in response to our requests, based on the information analyzed to date, we are in a position to provide you the following *preliminary* results. It is important to be clear that these results are *preliminary* and are under active review by our staff.

1. Preliminary Results Involving Late Trading

a. Conduct of Broker-Dealers

The staff sent letters to 34 broker-dealers requesting extensive information. The responses indicate the following:

- **Most broker-dealer firms have policies or procedures prohibiting late trading:** More than 75% of responding broker-dealers reported that they have policies that prohibit accepting or confirming a customer order to purchase or redeem mutual fund shares to be filled at the 4:00 p.m. NAV if the customer order was placed after the close of trading at 4:00 p.m. Many firms, however, noted exceptions to these policies that allow orders entered after 4:00 p.m. to be filled at that day's NAV. Reasons identified for exceptions included order back-logs, errors or mistakes in order entry, and systems problems.

- **Several broker-dealers appear to have allowed customers to place or confirm orders after 4:00 p.m.** More than 25% of responding broker-dealers reported that customers have placed or confirmed mutual fund orders after 4:00 p.m., and received the 4:00 p.m. NAV. For example:

  - **Two broker-dealers allowed customers to place orders until 4:15 p.m.:** One firm reported that it permitted customers to place mutual fund orders up to 4:15 p.m. for all funds that had not supplied it with an earlier cut-off time.

The other firm permitted customers to place orders up to 4:15 p.m. if they had been speaking with a registered representative prior to 4:00 p.m.

- **One broker-dealer allowed customers to cancel orders between 4:00 p.m. and 4:15 p.m.:** This firm reported that its processing system permitted certain registered representatives and operations personnel to enter or correct orders until 4:15 p.m.

- **One broker-dealer permitted customers to trade until 4:30 p.m.:** This firm reported that it had an informal agreement that provided six introducing broker-dealers with trade-input capability until 4:30 p.m.

- **One broker-dealer allowed customers to confirm orders until 4:45 p.m.:** This firm reported that it allowed several customers to place orders during the regular trading day that were then subject to confirmation by the customers until 4:45 p.m.

- **One broker-dealer allowed customers to place orders until 5:30 p.m.:** This firm reported that its electronic order entry system permitted customers to place orders for non-proprietary mutual funds until 5:30 p.m. and still receive that day's NAV.

As noted, our examination and enforcement staff is aggressively examining or investigating each of these situations to determine the facts surrounding the trading and whether the trading violates the federal securities laws.

b. Conduct of Mutual Funds

The 88 mutual fund groups responding to the staff's requests have a total of $ 5.7 trillion in assets, which is approximately 90% of the fund industry's total assets, and have about 4,100 individual funds or portfolios under management. Again, Commission staff is following up on these responses to ascertain specific facts, but preliminary results indicate:

- **Most funds make disclosures of order receipt deadlines:** More than 95% of the responding fund groups make disclosures regarding the time their NAV is calculated, and also state in those disclosures that an order must be received by an agent of the fund before the NAV is calculated in order to receive that day's NAV.

- **Contracts require 4:00 p.m. cutoff:** Virtually all of the funds that sell shares through intermediaries appear to have contractual arrangements with each intermediary requiring the intermediary to observe the typical 4:00 p.m. ET cutoff time for the flow of orders to receive that day's NAV.

- **Most funds reported no knowledge of late trading by intermediaries:** Almost 90% of responding fund groups said they were not aware of any late trading in their shares.

- **Some emails provided by responding funds groups indicate there may have been late trading:** Emails submitted by approximately 10% of the responding funds contained references to situations that possibly involved late trading, and we are following up on these emails.

- **Most fund groups allow intermediaries to send orders after 4:00 p.m.:** More than 80% of the responding fund groups reported that they allow late processing of share orders that were received by an intermediary before the daily order cutoff (not in violation of the law).

- **Most, but not all, fund groups report no late trading was approved by their staff:** Three fund groups reported, or the information provided indicated, that their staffs had approved a late-trading arrangement with an investor. SEC staff is following up on these reports.

2. Preliminary Results Involving Market Timing

a. *Conduct of Broker-Dealers*

- **Documents provided by almost 30% of responding broker-dealers indicate that they assisted market timers in some way**:

- Documents provided by three broker-dealers indicated that they broke up customer orders into smaller sizes in order to avoid detection by funds or the firm's own internal surveillance.

- Documents provided by four broker-dealers indicated that they advertised, marketed or solicited market timing services.

- Documents provided by three broker-dealers indicated that they entered into arrangements or set up special accounts with customers to facilitate market timing activities.

- **Many broker-dealers were aware of timing activities by their customers:** Almost 70% of responding broker-dealers reported being aware of timing activities by their customers.

b. Conduct of Mutual Funds

- **Almost all funds have some kind of anti-market timing policy:** More than 90% of responding funds with long-term investment objectives have policies aimed at identifying and deterring the disruptive effects excessive short- term trading in fund shares could have on such funds' performance and expenses. (Money market funds usually do not have market timing policies and prohibitions

and do not restrict the purchase and redemption activities of shareholders. Money fund NAVs cannot be arbitraged because their NAVs are a constant $1 per share.)

- **Most funds had some prospectus disclosure concerning market timing:** More than 80% of responding funds made disclosures in their prospectus or Statement of Additional Information ("SAI") regarding the adverse impact market timing could have on the fund, and the fund's policy of monitoring for such trading by shareholders and taking remedial actions to stop such trading.

- **Most market timing policies are discretionary**: Typically, a fund group's market timing policy, and its disclosure concerning that policy, provides the fund or its agents enough flexibility to allow some short term trading in situations that are deemed to be not disruptive to the fund, such as shareholders following asset allocation investment strategies.

- **Market timing is a very popular strategy:** Many fund groups' responses expressed the view that there are numerous institutional and individual investors who pursue market timing, often through intermediaries and omnibus accounts, and who attempt to conceal their identities from funds. As a result, they suggested there must be constant monitoring of shareholder activity coupled with follow-up actions when disruptive market timing activity is identified.

- **Most fund groups have some kind of monitoring program:** More than 90% of responding fund groups appear to have active programs to monitor shareholder activity, identify shareholders that may be placing excessive numbers of short term trades, and take action to stop future trading.

- **About half of the fund groups appear to have some kind of agreement or arrangement with frequent traders:** 50% of responding fund groups appear to have one or more arrangements with certain shareholders that allow these shareholders to engage in market timing – i.e., these shareholders have been given "market timing capacity." The market timing of persons with these arrangements appears to be inconsistent with the groups' policies, and in some cases, the fund groups' prospectus disclosures and/or fiduciary obligations. We are aggressively following up on these arrangements.

    - **Quid pro quo arrangements**: Although the information provided in this area is limited, it appears that many of the persons proposing a special arrangement to get market timing space offered to invest so-called "sticky" or long-term assets in one or more funds in the complex. In most of the situations where sticky assets were discussed, the funds in which these assets were to be invested were not the same funds to be market timed by the person involved in the arrangement.

- **No disclosure**: None of the funds that appear to have special market timing arrangements has specifically disclosed the existence of the arrangements in their prospectuses or SAIs.

3. Preliminary Results Involving Disclosure of Portfolio Holdings

Another area in which the staff's inquiries have exposed possible abuse is the selective disclosure of mutual fund portfolios. Most funds regularly provide portfolio information to service providers, such as custodians, administrators, securities lending agents, pricing services, and rating agencies, with the understanding that such portfolio information will not be used to make investment decisions to place orders for fund shares. In general, such disclosures are appropriate and necessary to the operation of the funds. However, our *preliminary* results in this area, based on responses by mutual fund groups, suggest the possibility of inappropriate selective disclosure of fund portfolios:

- **One-third of funds indicated some questionable disclosures of portfolio information:** More than 30% of responding funds appear to have disclosed portfolio information in circumstances that may have provided certain fund shareholders the ability to make advantageous decisions to place orders for fund shares, and that warrant follow-up investigation. For example, funds frequently stated that portfolio information was provided to consultants without further descriptions of who these consultants were and for what reasons portfolio information was given to them. The funds did not report that they had any

knowledge that such information was used by these entities to improperly trade or recommend trades in funds' shares.

This information, too, is being probed further by Commission staff.

III. Conclusion

The Commission's investigation of mutual fund trading abuses is continuing on multiple fronts. I want to emphasize that we will aggressively pursue those who have violated the law and injured investors as a result of illegal late-trading, market-timing, self-dealing, or any other illegal activity we uncover. Those responsible for these practices *will* be identified and *will* be held fully accountable.

Wherever possible, the Commission also will seek recompense for investors in connection with mutual fund fraud. We will, of course, continue to work closely and cooperatively with state officials who also are taking steps to protect investors.

I would be happy to answer any questions that you may have.