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Time running out on SEC prosecution of market timing

By **David Hoffman**
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The Securities and Exchange Commission is prosecuting what many industry experts believe to be among the final cases it will bring regarding illegal market timing in mutual funds.

"It would certainly appear that way," said Michael Rosella, New York-based chairman of the investment management practice at Paul Hastings Janofsky & Walker LLP, an international law firm with headquarters in Los Angeles.

The prosecution of market timing "has been going on for a long time, but we haven't seen a flurry of new cases."

The latest case, currently being heard by Carol Fox Foelak, an SEC administrative-law judge, involves three former employees of Janus Capital Group Inc. of Denver.

The SEC has accused Warren Lammert, Lars Soderberg and Lance Newcomb of allowing New York-based brokerage firm Trautman Wasserman & Co. Inc. and others to market-time Janus funds at the expense of long-term investors.

The hearing, which began this month, could end as early as next week.

Market timing first made headlines four years ago on Sept. 3, 2003, when then-New York Attorney General Eliot L. Spitzer announced he had "obtained evidence of widespread illegal trading schemes that potentially cost mutual fund shareholders billions of dollars annually."

The SEC jumped into the fray Dec. 18 of that year when it an-nounced an enforcement action against Alliance Capital Management LP, accusing the New York firm of allowing illegal market timing of its funds.

Alliance quickly settled with the SEC, agreeing to pay $250 million in fines.

Other SEC enforcement action would soon follow.

The SEC's intent was to "wake up the industry" to a practice that harmed long-term investors, said Barry Barbash, a partner with Willkie Farr & Gallagher LLP who works in the firm's Washington office and New York headquarters.

"They did that," he said. "My sense is, the cases are getting close to running their course."

There may be other cases that have yet to be resolved, but it's hard to see the SEC bringing new market-timing cases, said Mr. Barbash, who formerly headed the SEC's division of investment management.

The agency has "tightened" its procedures with regard to prosecuting new cases to bring more "integrity" to the process, he said.

A call to Douglas Scheidt, associate director and chief counsel of the SEC's division of investment management, was not returned.

There has been criticism of some of the market-timing cases brought by the SEC from legal experts who claim that many of the cases brought by the commission were poorly conceived. Market timing is not illegal, they argue.

But the SEC contends that in many cases, facilitating such activity is illegal and constitutes fraud when a fund's prospectus suggests that market timing is prohibited.

"The fraud arguments basically say the prospectus is misleading," said Richard M. Phillips, a San Francisco-based senior partner with international law firm Kirkpatrick & Lockhart Preston Gates Ellis LLP.

Some of those arguments are strong, but others are not, he said.

"In some of them, the language of the prospectus is not all that clear," Mr. Phillips said.

Luckily for the SEC, most accused of fraud — whether companies or individual executives — have decided to settle with the commission rather than fight.

They didn't want to be "dragged" into a fight that could further tarnish their reputations, Mr. Rosella said.

That has worked to the benefit of the SEC, which has been able to extract more than $3 billion in fines, said Niels Holch, executive director of the Coalition of Mutual Fund Investors in Washington.

"It's a terrific accomplishment," he said. And it may be one of the reasons the SEC is nearing the end of prosecution phase of the market-timing scandal, Mr. Holch suggested.

The SEC must now concentrate on distributing the money to investors harmed by market timing, he said.

The latest disbursement occurred Sept. 12, when the SEC announced it had distributed $69 million — the last of three disbursements totaling $267 million — to investors harmed by fraudulent market timing in the former PBHG Funds, once managed by the now-defunct Pilgrim Baxter & Associates Ltd. of Wayne, Pa.

Dispersing the money to in-vestors has proved to be more complicated and time-consuming than many initially thought, Mr. Holch said.

One way the SEC is trying to address that is by creating a central office charged with disbursing funds to investors, he said. Currently, that function is handled by the regional offices that prosecuted the individual market-timing cases, Mr. Holch said.

It's unlikely that the fund from which money is paid will grow much now that the SEC appears to be winding down its prosecution of market timing, industry experts said.

Whether or not the SEC is successful in its prosecution of the three former Janus employees, the case is unlikely to add substantially to the total amount of fines collected.

Janus itself already paid $226 million in 2004 to settle the allegations of market timing.

An independent consultant tapped to analyze the extent of the harm concluded that investors lost $21 million because of market timing at Janus.

There is no guarantee that the administrative-law judge will rule in the SEC's favor, of course.

On Dec. 28, Judge Nathaniel M. Gorton of the U.S. District Court for the District of Massachusetts dismissed with prejudice SEC claims brought against two former executives of the former Columbia Funds Distributor Inc. of Boston in connection with undisclosed market-timing arrangements in the Columbia Funds.

The judge ruled that the SEC failed to prove that the executives committed fraud by allowing market timing. The same can happen to the former Janus executives.

As part of their defense, lawyers for the executives claim that the fund prospectuses give their clients the ability to allow market timers into the funds. Such a defense could prove persuasive, Mr. Phillips said.

Also, as the stigma of market timing fades, more people accused of market timing may be willing to test that defense, Paul Hastings' Mr. Rosella said. That may be one more reason why the market-timing case the SEC has brought against the former Janus employees will be one of its last, he said.

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