

UNITED STATES OF AMERICA  
BEFORE THE  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933

Release No. 8668 / March 16, 2006

SECURITIES EXCHANGE ACT OF 1934

Release No. 53490 / March 16, 2006

INVESTMENT COMPANY ACT OF 1940

Release No. 27262 / March 16, 2006

ADMINISTRATIVE PROCEEDING

File No. 3-12238

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In the Matter of	:	ORDER INSTITUTING
	:	ADMINISTRATIVE AND CEASE-AND-
	:	DESIST PROCEEDINGS, MAKING
BEAR, STEARNS & CO., INC., and	:	FINDINGS, AND IMPOSING REMEDIAL
BEAR, STEARNS SECURITIES CORP.,	:	SANCTIONS AND A CEASE-AND-
	:	DESIST ORDER PURSUANT TO
Respondents.	:	SECTION 8A OF THE SECURITIES ACT
	:	OF 1933, SECTIONS 15(b) AND 21C OF
	:	THE SECURITIES EXCHANGE ACT OF
	:	1934, AND SECTIONS 9(b) AND 9(f) OF
	:	THE INVESTMENT COMPANY ACT OF
	:	1940

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**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), Section 15(b) and Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”), against Bear, Stearns & Co., Inc. (“BS&Co.”) and Bear, Stearns Securities Corp. (“BSSC”) (collectively, “Respondents”).

**II.**

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the “Offer”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of

these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Order”), as set forth below.

### III.

On the basis of this Order and Respondents’ Offer, the Commission finds<sup>1</sup> that:

#### A. Summary

1. This case involves two types of illegal mutual fund trading practices: Late trading and deceptive market timing. The Respondents are BS&Co., an introducing broker-dealer whose customers buy and sell securities, and BSSC, a clearing firm that clears trades for BS&Co., other introducing brokers and prime brokerage customers. Between 1999 and 2003, Respondents facilitated a substantial amount of late trading and deceptive market timing.

2. At BS&Co., certain brokers in the Private Client Services Division (“PCS”) facilitated illegal mutual fund trading by knowingly processing large numbers of late trades for certain market timing customers, predominately large hedge funds, and by helping market timing hedge funds evade detection by mutual funds that did not want market timing business. Upon detecting market timing trades, mutual funds often blocked further trading by market timers by reference to the available identifying information accompanying the trade, such as the account number, registered representative (or “RR”) number or branch code. To evade these blocks, BS&Co. took affirmative steps to hide from mutual funds the identity of customers that were known market timers by, for example, assigning multiple account numbers to customers so that the mutual funds could not identify them as customers whose trades they had previously blocked, or by assigning multiple RR numbers to registered representatives at BS&Co. to try to conceal the identity of the traders.

3. BSSC, the clearing firm, cleared all of these trades through its Mutual Funds Operations Department (the “MFOD”), the department within BSSC that was responsible for all mutual fund clearing. In addition to clearing trades for customers of the PCS brokers, BSSC cleared trades for prime brokerage customers (*i.e.*, hedge funds that cleared trades directly through BSSC) and for customers of its correspondent firms (*i.e.*, introducing brokers that cleared customer trades through BSSC). BSSC facilitated deceptive market timing by its prime brokerage customers and customers of its correspondents by providing them with deceptive devices, such as multiple account and RR numbers and alternative branch codes, to avoid detection by mutual funds.

4. At the center of BSSC’s mutual fund clearing operation was the MFOD “timing desk,” which the MFOD established in 1999 to manage the increasing flow of market timing trades through BSSC. Part of the purpose of the timing desk was to monitor and block accounts

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<sup>1</sup> The findings herein are made pursuant to Respondents’ Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

from trading in mutual funds that did not want market timing trades. But, in practice, the timing desk employees and their supervisors acted as consultants and trouble shooters for the PCS brokers, BSSC's correspondent firms and BSSC's prime brokerage customers engaged in market timing and late trading. Tape recorded conversations with customers show that the timing desk employees touted BSSC's abilities to assist timers. The timing desk helped timers negotiate BSSC's own blocking system and evade the blocks and restrictions imposed by the mutual funds, and helped customers and their brokers understand how to ensure that their rapid mutual fund trades would not be detected by the mutual funds. The timing desk also knowingly or recklessly processed thousands of late trades.

5. Respondents' conduct benefited their customers and customers of correspondent firms by enabling those customers to generate hundreds of millions of dollars in profits from these trading tactics at the expense of mutual fund shareholders.

## **B. Respondents**

6. **BS&Co.** is a Delaware corporation with its headquarters and principal place of business in New York City. It is a wholly owned subsidiary of The Bear Stearns Companies Inc. ("BSC"), a Delaware corporation and a public company headquartered in New York. BS&Co. provides brokerage, investment banking, securities and asset management services to individual and institutional customers. BS&Co.'s PCS Division services high-net-worth individuals, money managers, and small institutions. BS&Co. has approximately 500 PCS registered representatives in eight domestic branch offices. BS&Co. is, and during the relevant period was, registered with the Commission as a broker-dealer.

7. **BSSC** is a Delaware corporation with its headquarters and principal place of business in New York City and a wholly owned subsidiary of BS&Co. BSSC provides securities and futures clearing, securities lending, financing and related services. In all, BSSC processes approximately 7% of the New York Stock Exchange volume cleared daily through the National Securities Clearing Corporation ("NSCC"). BSSC's Global Clearing Services Division ("GCS") provides trade processing, clearance, financing and other services to correspondent broker-dealers and prime brokerage customers. BSSC is, and during the relevant period was, registered with the Commission as a broker-dealer. BSSC is, and during the relevant period was, the clearing firm for BS&Co. BSSC's MFOD cleared mutual fund trades for BS&Co., as well as BSSC's correspondents and prime brokerage customers.

## **C. Facts**

### **1. Background**

8. "Market timing" includes: (i) frequent buying and selling of shares of the same mutual fund or (ii) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing can harm other mutual fund shareholders because it can dilute the value of their shares. Market timing, while not illegal per se, can also disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur considerable extra costs associated with excessive trading and, as a result, cause damage to other shareholders in the funds. Market timing may be illegal, for example, if deception is used

to induce a mutual fund to accept trades that it otherwise would not accept under its own market timing policies.

9. “Late trading” is the practice of placing orders to buy, redeem, or exchange mutual fund shares after the time as of which mutual funds calculate their net asset value (“NAV”), typically 4 p.m., but receiving the price based on the prior NAV already determined as of 4:00 p.m. Rule 22c-1(a) under the Investment Company Act (the “forward pricing rule”) prohibits late trading. Late trading enables the trader improperly to obtain profits from market events that occur after 4 p.m., such as earnings announcements and futures trading, that are not reflected in that day’s NAV. By being able to late trade, customers of Respondents and correspondent firms obtained trading advantages over the other shareholders of the targeted mutual funds.

**a. The Clearing Process**

10. All of the trades at issue here were cleared either directly or indirectly by the MFOD. Trades were processed in one of two ways. The broker or customer could fax an order directly to the MFOD, which would then input the trade into BSSC’s electronic mutual fund order entry platform, the Mutual Fund Routing System (“MFRS”). This was the manner in which the PCS brokers processed trades.

11. Alternatively, correspondents and prime brokerage customers input trades directly into MFRS without manual assistance from BSSC. Beginning in the mid- to late 1990s, as BSSC gave correspondent firms and prime brokerage customers with mutual fund trading business direct access to MFRS, they could enter mutual fund trades remotely from their offices. The effect, in the case of prime brokerage customers, was to put the order entry system directly in the hands of the ultimate customer, who traded at will without an intermediary broker. Because MFRS accepted orders until 5:45 p.m. and processed those trades as if they had been received before 4:00 p.m. without regard to when they were actually received, prime brokerage customers had the ability to late trade unchecked.

12. Trades entered into MFRS were processed through NSCC’s Fund/SERV system. Networking agreements between BSSC and the mutual funds set forth the parties’ responsibilities regarding the processing of trades through the Fund/SERV system. All mutual fund trades entered into BSSC’s MFRS were batched and transmitted to NSCC approximately seven times per day until approximately 8:00 p.m., according to NSCC protocol. NSCC then sent the orders to the appropriate mutual fund companies for execution.

13. NSCC permitted firms to use a number of different formats to transmit trades. These formats, known as Networking Levels, offered the firms the option to transmit different levels of detail about the customer.

14. BSSC used “Networking Level 3,” which identified orders by account number, RR number, and branch code but did not transmit the information underlying these codes, such as the customer’s name or tax ID, the RR’s name, or branch name or location. The system afforded customers a degree of anonymity, in that the identity of the ultimate customer was not transmitted to the mutual funds.

**b. BSSC's Obligations as a Dealer in Mutual Fund Shares**

15. Because BSSC functioned as a dealer in mutual fund shares, it had various obligations with respect to the timeliness of orders. Mutual funds are sold pursuant to dealer agreements. During the relevant period, BSSC maintained dealer agreements with several hundred mutual funds, and, accordingly, was a dealer in mutual fund shares subject to the requirements of the forward pricing rule. In general, BSSC's correspondents did not have their own dealer agreements with mutual funds and relied on BSSC's dealer agreements to be able to sell mutual fund shares to customers.

16. BSSC's dealer agreements and certain networking agreements contained provisions requiring that shares be sold in accordance with the federal securities laws.

17. Rule 22c-1(a) under the Investment Company Act requires investment companies issuing redeemable securities, their principal underwriters and dealers, and any person designated in the fund's prospectus as authorized to consummate transactions in securities issued by the fund to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem. Mutual funds generally determine the daily price of mutual fund shares as of 4:00 p.m. ET. In these circumstances, orders received before 4:00 p.m. must be executed at the price determined as of 4:00 p.m. that day. Orders received after 4:00 p.m. must be executed at the price determined as of 4:00 p.m. the next trading day.

18. Dealer agreements contained some version of the following provision:

You are to offer and sell such shares only at the public offering price which shall currently be in effect, in accordance with the terms of the then current prospectus of the Funds.

Mutual funds are required to disclose in their prospectuses the time as of which the NAV is set for purposes of determining the price at which shareholders may buy or redeem mutual fund shares.

19. As a result, most dealer agreements required BSSC to transmit for processing at that day's NAV only orders received by a broker by 4:00 p.m.

20. Some dealer and networking agreements were even more explicit. For example, a networking agreement between BSSC and one mutual fund company states that:

Instructions shall be deemed to have been received (and price protected) as of the day on which Instructions were placed by the Firm [defined as BSSC] with [the mutual fund company] ("Trade Date"), if such Instructions are received by the Firm from Client prior to 4:00 p.m. Eastern Standard Time ("EST") on a business day on which the New York Stock Exchange is open ("Close of Trading") and transmitted to NSCC no later than 6:00 p.m. EST on such Trade Date ("Cut-Off"). ... Firm warrants that all Instructions Firm transmits to the Funds for processing were received by Firm by Close of Trading.

21. Dealer agreements permitted BSSC to submit for that day's NAV only orders that were received by the correspondent brokers or received from BSSC's prime brokerage customers during market hours, usually by 4 p.m.

22. Despite the foregoing provisions in its dealer and networking agreements, and its legal obligations as a dealer under the forward pricing rule, BSSC did not implement any controls to detect or prevent late trading by correspondents or prime brokerage customers with MFRS.

**c. The Timing Desk**

23. As described above, the center of the MFOD clearing operation was the timing desk. In response to increased market timing activity, in 1999, BSSC created the timing desk to manage the flow of market timing trades through BSSC. Eventually, part of that task involved blocking accounts from trading in mutual funds that did not want market timing trades. The timing desk also assisted market timers' mutual fund order entry, handled rejected or stopped-for-timing trades, forwarded to timers mutual funds' letters or emails complaining about abusive trading or requesting that timing be stopped ("stop notices") and, in some cases, provided specific advice on the market timing business.

24. As a practical matter, the timing desk was a facilitator of unlawful trading. The timing desk entered late trades for BSSC and PCS customers and assisted with the next-day cancellations of unprofitable trades. It communicated directly with prime brokerage customers when assisting them with their market timing trades, including entering late trades after 4:00 p.m. It also advised BSSC correspondents and customers and the PCS brokers about strategies that might work to evade detection by mutual funds, as well as about factors that mutual funds perceived as indications of timing. For example, the timing desk advised timers on dollar size thresholds above which mutual funds were more likely to detect timing, as well as on branch codes and RR numbers that were most likely to be blocked by mutual funds.

25. The MFOD took other action to promote market timing. For example, even though dealer agreements required BSSC to sell mutual funds pursuant to the terms of the funds' prospectuses, timing desk employees and their supervisors actively encouraged timers to work out timing arrangements with mutual funds and generally lifted BSSC's systematic blocks, regardless of account history or fund prospectus provisions, if a registered representative or customer claimed that a mutual fund had given him permission to time. These purported arrangements were oral and often negotiated with mutual fund salespeople. Indeed, some of these purported arrangements were no more than advice from mutual fund wholesalers to timers on ways to avoid detection by the mutual funds' timing police.

26. The timing desk knew that many of these arrangements were not legitimate, as it received stop notices from mutual funds about trading by the very individuals or entities that claimed to have arrangements.

27. The timing desk also communicated directly with mutual funds concerning the mutual funds' stop notices. These communications went beyond mere ministerial matters and included substantive discussions regarding timers' trading and strategies. Indeed, on July 18,

2003, in a telephone conversation with a BSSC employee about a potential new market timing customer, an MFOD supervisor described the timing desk as employees who negotiate with mutual funds and “keep the clients in play.”

28. Some market timers even expressed their appreciation to timing desk employees by giving them gifts such as spa gift certificates, event tickets and meals. For example, in a recorded telephone call, a timing desk employee thanked a hedge fund customer for “good seats” to an event:

Timing Desk: Oh, I got your e-mail. . . . Thank you.

Hedge Fund: You’re welcome. I hope – they’re supposed to be here tomorrow and he’s like, “They’re pretty good seats. They’re like 25 rows up.” He’s like (inaudible) seats.” I’m like, “That’s what I want.”

Timing Desk: You’re so good to me.

Hedge Fund: Hey, no – you’re so good to me. It works both ways.

29. In the over four–year period of the activity described in this Order, BSSC received thousands of stop notices from mutual funds. BSSC forwarded these stop notices to timers and, as discussed in greater detail below, blocked the accounts identified in particular mutual funds’ stop notices from trading in those funds. BSSC did not, however, implement effective measures to stop the violative trading except when the complaining mutual fund threatened to cancel its dealer agreement with BSSC. In that circumstance, the firm was able to, and did, put a swift end to all unwanted trading in the affected funds.

30. As described further below, despite repeated notices from mutual funds that Respondents were allowing ongoing deceptive market timing and that their purported market timer control procedures were ineffective, Respondents took no steps to alter their procedures or to implement effective measures to stop deceptive timing. Likewise, they had no procedures in place to stop late trading, which they knew or recklessly disregarded was occurring.

## **2. Late Trading**

31. In the relevant period, certain PCS brokers knowingly submitted a large number of late trades for certain market timing hedge fund customers to the MFOD. All of these trades were cleared through BSSC, which knowingly or recklessly allowed them in violation of Rule 22c-1(a) under the Investment Company Act. Moreover, BSSC knowingly or recklessly facilitated late trading by certain prime brokerage hedge fund customers and by customers of certain other correspondent firms that cleared through BSSC.

32. The ability to enter trades after 4:00 p.m. was an important benefit to at least some market timers.

33. Accordingly, in discussions with market timers, Respondents touted their late trading capabilities. For example, in a tape-recorded telephone conversation on August 1, 2003,

the administrative head of PCS (the “PCS Administrative Head”) and the head of MFOD (the “MFOD Head”) spoke with a well-known market timing broker who was being recruited to join PCS. In addition to discussing Networking Level 3 and BSSC’s blocking system, the parties discussed the “cut-off” time for orders:

PCS Administrative Head: He’s got questions and wanted to go through our processes because obviously, the ability for him to trade and our ability to accommodate his business is a key component of his making a decision of whether or not he can come here or not.

\* \* \*

Broker: ... Is there anything else you can think of that might - that I could use – any information that might be beneficial to me hearing now?

MFOD Head: Well, just to let you know – just to get you aboard – we probably do the best clearance there is on the Street on market timing, because it is infrastructurally built that we have, you know, very good experienced people here.

\* \* \*

Broker: What’s the cut-off time?

MFOD Head: MFRS, you have plenty of time to do trades [laughing]. Pretty much a quarter to six, 5:45 to enter a trade.

34. In another tape-recorded telephone call, on June 19, 2003, an MFOD supervisor explained to a prospective market timing hedge fund customer the ability to enter orders directly into the system until 5:30 p.m.:

The trading system, if you guys were to do your own trading from your desktops, it’s up and running til about 5:30 at night. I’d like to think that all the mechanisms and the operational programs that we have help support this business as good as any broker dealer on the Street.

35. On August 29, 2003, in another tape-recorded call, the MFOD Head spoke with a BSSC correspondent broker who was interested in bringing a market timing business to BSSC. The MFOD Head explained that the BSSC correspondent would be able to input trades until 5:30 p.m.

36. Discussed below are specific examples of late trading by three groups of customers and Respondents’ role with respect to that late trading. The three groups of customers are (i) customers of the PCS brokers; (ii) customers of certain of BSSC’s correspondent firms; and (iii) certain of BSSC’s prime brokerage customers, which were predominately hedge funds.



**a. Customers of the PCS Brokers**

37. From January 2001 through September 2003, the PCS brokers had the MFOD enter a large number of trades in MFRS after 4:00 p.m. on behalf of certain customers. These trades received the same day's NAV. The PCS timing brokers submitted customers' mutual fund orders by faxing orders to the MFOD timing desk, which entered the trades into MFRS. BS&Co. accepted orders from these PCS hedge fund customers after 4:00 p.m. and processed and submitted the orders as if they had been received before 4:00 p.m. so the orders would receive that day's NAV. In addition, the timing desk canceled, added or modified trades for the PCS timing brokers after 4:00 p.m.

38. In August 2002, a hedge fund in Texas (the "Texas Hedge Fund") became a PCS market timing customer. In October 2002, the Texas Hedge Fund approached a PCS broker ("PCS Broker A"), about bringing more of its market timing business to Respondents. The Texas Hedge Fund principals explained that they had heard that Respondents had the ability to enter mutual fund trades after 4:00 p.m. The Texas Hedge Fund principals explained that they needed until 4:50 or 5:00 p.m. to make their trading decisions because their trading strategy depended on information from the futures market, which closes at 4:15 p.m. and re-opens at 4:45 p.m.

39. On or about October 28, 2002, one of the Texas Hedge Fund principals asked PCS Broker A whether the Texas Hedge Fund could place trade orders after 4:00 p.m. PCS Broker A responded in an email, "[I] have a lunch tomorrow with the head of our fund department to discuss the 'late' entry for large cap trades. Will let you know how that goes."

40. At the meeting that followed, the MFOD Head said that he had to look into whether someone would be available until 4:45 p.m. to enter the orders but otherwise did not think sending trades down after 4:00 p.m. would be a problem.

41. After the meeting, PCS Broker A sent an email to his partner and the Texas Hedge Fund indicating that the MFOD Head believed his department would be able to enter the trades at 4:50 p.m.

42. On December 31, 2002, PCS Broker A again emailed the MFOD Head, notifying him that the Texas Hedge Fund was going to begin its large cap trades, and stating that "most of the times they will know by 4:15 whether or not they will be trading the funds, but may need the 4:50 cutoff on some occasions."

43. The Texas Hedge Fund subsequently implemented its large cap late trading strategy. Generally, the Texas Hedge Fund sent a tentative trade plan to the PCS brokers prior to 4:00 p.m. The PCS brokers, however, had no authority to execute the contemplated trades until they received a subsequent, post-4:00 p.m. confirmation from the Texas Hedge Fund.

44. Four months after the Texas Hedge Fund began implementing its late trading strategy, PCS Broker A sent the following email to the MFOD Head:

Just wanted to provide you with an update on the Large Cap model/later cutoff model we had spoke [sic] about in the

fall/winter. Our client initially placed 10 million, spread across 4 MFS funds, and has subsequently increased that position substantially. Just wanted to thank yourself, and the mutual fund dept for helping us implement their model. We have another account or two that may have an interest in doing it as well, with an earlier cutoff, and will keep you posted as to how that is going.

45. From January 2003 to September 2, 2003, Respondents accepted over 2,300 trades from the Texas Hedge Fund after 4:00 p.m., but processed those orders as if they had been received before 4:00 p.m. Many of these orders were placed by the customer after 4 p.m.

46. Respondents also falsified internal order tickets and MFRS data to reflect a pre-4 p.m. order time without regard to when an order was received.

47. Prior to May 2003, BSSC did not require MFOD employees to enter into MFRS the time at which a mutual fund order was received. In response to certain Commission rule amendments, in May 2003, BSSC modified MFRS to add a field for the time at which an order is taken and required the MFOD staff to fill in that field for orders received from PCS brokers. As a result, the MFOD could not enter a mutual fund order into MFRS without filling in the order taken time field.

48. This created a problem: orders are supposed to be received before 4:00 p.m. in order to receive that day's NAV, but PCS brokers were receiving customer orders after 4:00 p.m. and submitting the orders to the MFOD after 4:00 p.m. Respondents resolved the problem by simply entering false order time information into MFRS. An MFOD supervisor advised PCS brokers and timing desk employees to record 3:59 or 4:00 p.m. as the order taken time, regardless of the time when the mutual fund order was in fact received from a customer. As reflected in the following recorded telephone call on May 8, 2003 with a PCS broker, the MFOD supervisor stated:

Because you're sending trades down some days after what's considered a legitimate time, 4 o'clock New York time, we want, we want to make sure that you know that we need to populate a time prior to 4:00 p.m. New York time. What I'd like for you to do, we're going to populate either 4:00 p.m. or 3:59.

\* \* \*

[Y]ou know, obviously, you should have them before 4 ... Obviously, we aren't going to receive it most of the time before four, but it has to be written – the written time has to be before 4:00 p.m. New York time, so that if the auditors come to us, and, you know, they want to see something, we have that you took, you took the trade before 4:00 p.m.

49. The PCS brokers wrote 3:59 or 4:00 p.m. on mutual fund order tickets, including tickets for orders received after 4:00 p.m. For example, PCS brokers entered 3:59 or 4:00 p.m. on orders submitted by the Texas Hedge Fund after 4:00 p.m.

50. Subsequently, PCS brokers stopped recording any order taken time on trade tickets. The MFOD supervisor directed the timing desk employees to fill in the order taken time with 3:59 p.m. or 4:00 p.m. for trade sheets sent to the MFOD after 4:00 p.m.

51. Between May 12, 2003 and September 10, 2003, over one thousand PCS mutual fund orders were entered into MFRS after 4:00 p.m., with an order taken time of 3:59 or 4 p.m. Some of these orders were in fact received from customers after 4 p.m.

**b. Correspondent Brokers**

52. BSSC also made MFRS directly available to its correspondents, thereby giving them the ability to enter trades for their customers until 5:45 p.m. and, in one case, until 8 p.m. Certain of these correspondent brokers, including Brean Murray & Co., Inc. (“Brean Murray”), Kaplan & Co. (“Kaplan”) and a third correspondent, based in Florida (“Florida Correspondent”), permitted their market timing customers to place mutual fund orders after 4:00 p.m. These correspondents placed tens of thousands of late trades on behalf of their customers. BSSC knew that these correspondent brokers were using MFRS to enter customer orders received after 4:00 p.m. In at least two instances, BSSC assured correspondent brokers that BSSC would be able to accommodate the late trading business.

53. For example, in May 2001, after receiving an inquiry from a timing customer about placing mutual fund trades after 4:00 p.m., a PCS timing broker complained in an email to his supervisors:

I have learned from one of our market timing clients that they are being allowed to input mutual fund trades with a firm that clears through Bear Stearns up until 4:45 pm. This enables that clearing firm to attract domestic model money which is what we all want. Not only does this put us at a huge competitive disadvantage to the firms Bear Stearns clears for, but it is my understanding that such a practice is not legal. How can our mutual fund department allow such a thing?

54. One of the PCS supervisors forwarded this email to the MFOD Head and his supervisor, the Assistant Cashier. These managers did nothing in response to this notice.

55. Despite this and other facts discussed below, BSSC knowingly allowed its correspondents to use their direct access to MFRS to submit tens of thousands of late trades.

**(i) Brean Murray**

56. Brean Murray is a broker-dealer that cleared orders, including mutual fund orders, through BSSC. Brean Murray did not have its own dealer agreements with mutual funds.

57. Two Brean Murray brokers conducted market timing trading on behalf of hedge funds managed by Canary Investment Management Inc. (“Canary”).

58. Canary principals told one of these Brean Murray brokers that, through another BSSC correspondent firm, they had the ability to submit mutual fund orders after 4:00 p.m., and they asked whether they could get the same ability to trade past 4:00 p.m. through Brean Murray.

59. The two Brean Murray brokers discussed Canary's request with several BSSC managers, including a Managing Director ("BSSC Managing Director A") and the MFOD Head. These managers told the Brean Murray brokers that BSSC would be able to accommodate Canary's request.

60. Over the next several months, Brean Murray brokers sent to the MFOD a series of emails listing the account numbers for new timer accounts and requesting to "please code these accounts for late trading." In response to one of these emails a BSSC employee wrote back, "They are coded on my end."

61. During the relevant period, the Brean Murray brokers and their assistants entered thousands of trades into MFRS after 4 p.m. which orders received that day's NAV. Nearly all of those orders had been received by the Brean Murray brokers after 4:00 p.m.

(ii) **Florida Correspondent**

62. The Florida Correspondent cleared only its mutual fund business through BSSC. It chose BSSC because BSSC assured the correspondent that it could support the kind of rapid, large-scale, anonymous, and late mutual fund trading that the Florida Correspondent's first market timing customer ("Florida Customer A") was seeking. From December 2000 through September 2003, the Florida Correspondent entered over 19,000 trades in MFRS after 4:00 p.m. The vast majority of these trades were received by the Florida Correspondent after 4:00 p.m.

63. Florida Customer A approached the Florida Correspondent in or about August 1998 seeking a suitable clearing platform for Florida Customer A's market timing strategy. Florida Customer A explained that the trading strategy required a clearing platform that could offer, among other things: next day settlement for mutual fund trades; the ability to protect Florida Customer A's identity from the mutual funds; the ability to handle rapid trading; leverage on mutual fund positions; and, most notably, the ability to accept orders based on post-4:00 p.m. trading decisions.

64. In discussions with BSSC, the Florida Correspondent learned that BSSC would be able to meet all of Florida Customer A's requirements.

65. On January 7, 1999, the Florida Correspondent and BSSC entered into a clearing relationship, and the Florida Correspondent began clearing Florida Customer A's market timing trades through BSSC.

66. Initially, the Florida Correspondent faxed trading instructions to the timing desk before 4:00 p.m. and then called to communicate the Florida Customer A's final trading decision by confirming, changing or canceling the trades after 4:00 p.m. On occasion, the timing desk called the Florida Correspondent after 4:00 p.m. to find out the final trading instructions and was told that the customer had not yet communicated those instructions.

67. Later in 1999, the Florida Correspondent received access to MFRS and began entering trades directly into the system. The Florida Correspondent routinely entered Florida Customer A's trades in MFRS after 4:00 p.m.

68. In the summer of 2001, BSSC Managing Director A met with a Florida Correspondent employee at Respondents' offices in New York. During that meeting, the Florida Correspondent employee explained that his customers used information that became available after the close of the markets to gain a trading advantage. BSSC Managing Director A took no action to stop the unlawful trading that BSSC was facilitating.

**(iii) Kaplan**

69. Kaplan is a broker-dealer in Boca Raton, Florida that cleared mutual fund trades through BSSC. From December 2000 through September 2003, Kaplan entered over 21,000 mutual fund trades in MFRS after 4:00 p.m.

70. Larry Powell ("Powell") and Delano "DJ" Sta.Ana ("Sta.Ana") (collectively "the Kaplan Brokers") headed Kaplan's market timing group. The Kaplan Brokers began entering trades through MFRS in January 2000. The Kaplan Brokers routinely permitted their customers to submit orders after 4:00 p.m. In fact, the vast majority of their customers' orders were received by them after 4:00 p.m.

71. BSSC was aware that Kaplan was using MFRS to process trades that Kaplan received after 4:00 p.m. For example, the Kaplan Brokers or their sales assistants called the timing desk when they encountered difficulty entering trades into MFRS after 4:00 p.m. and told the timing desk that the trades had just been received.

72. In the spring of 2001, Sta.Ana learned from a conversation with the timing desk that the MFOD could enter trades into MFRS even after 5:45 p.m. He then asked his BSSC relationship manager for the ability to enter trades after 6 p.m.

73. In May 2001, BSSC provided Kaplan with a MFRS modification that gave Kaplan the ability to enter mutual fund trades until approximately 8:00 p.m. and still receive that day's NAV.

74. Between May 4, 2001 and August 26, 2003, the Kaplan Brokers and their assistants entered several hundred trades after 5:45 p.m.

75. The MFOD staff also permitted the Kaplan Brokers and their trading assistants to cancel, or "bust," unprofitable trades on the following trading day. The MFOD responded to such requests by attempting to obtain price-protected cancellations from the mutual funds; in many instances, these efforts succeeded.

**c. Prime Brokerage Customers**

76. BSSC facilitated late trading by some market timing hedge funds that were prime brokerage customers by affording them direct access to MFRS. MFRS permitted these customers to enter mutual fund orders after 4:00 p.m. and still receive that day's NAV. Between

January 2001 and September 2003, these prime brokerage customers entered over 11,000 mutual fund orders through MFRS after 4:00 p.m. BSSC forwarded all orders received after 4:00 p.m. through NSCC to the mutual funds to receive that day's NAV, as if they had been received before 4:00 p.m. The MFOD also offered to assist prime brokerage customers in canceling unprofitable trades the next day.

77. On June 17, 2002, one prime brokerage customer had the following recorded conversation with a timing desk employee at approximately 5:23 p.m. when the customer was unable to enter a mutual fund trade because of a supposed "closed for timing" block:

Hedge Fund: They won't – I can't enter it. It won't let me enter it. It says, "timer account – fund closed for timer accounts." So there's three trades I'm trying to get in.

Timing Desk: Hold on. Let me open the system up for you.

Hedge Fund: What the heck, I'm like freaking. Oh, no.

\* \* \*

Timing Desk: Wait, I'm trying to see if I need to open it at the account level or the security level. Bear with me.

Hedge Fund: Hey, no problem. You're helping me. Are you kidding? Bear with me.

\* \* \*

Timing Desk: Okay. What I'm going to do is I'm going to open that fund family for these account numbers. . . . So that you don't have to call every time. It will just be coded.

\* \* \*

Hedge Fund: I'm like – they always tell me I got to have these trades in by 4:30 [CT, 5:30 p.m. ET]. Am I going to be okay?

\* \* \*

Timing Desk: That's 5:30 my time, right?

Hedge Fund: Right.

Timing Desk: You got to quarter to 6:00, hon.

Hedge Fund: Your time?

Timing Desk: Yup. . . . 5:45.

Hedge Fund: Okay, 5:45.

Timing Desk: Actually, if you have a problem and somebody's here later than that, we could probably help you out, if you know what I mean.

Hedge Fund: Yeah, I understand, thank you.

78. In another recorded telephone conversation on August 21, 2001, the same prime brokerage customer called the timing desk too late to cancel a trade from the previous day. The same timing desk employee explained to the customer that the timing desk would help her to "drop" trades the morning after execution, as long as she called early enough:

Timing Desk: You should have called me *earlier*. Something like that call in the *a.m.*

Hedge Fund: Okay, well -

Timing Desk: In the future, what you do -

Hedge Fund: Okay.

Timing Desk: What you do in the future, if there's a trade that you put through, and you realize the next morning, hon, you know - I don't want to say what, you know -

Hedge Fund: Yeah, capisce [Italian for "I understand"]

Timing Desk: Yeah. Call, call me, call me or [another timing desk employee] very early in the morning. . . .

### **3. Deceptive Market Timing**

79. In addition to facilitating late trading by customers, Respondents facilitated deceptive market timing.

80. As an initial matter, BSSC's clearing platform provided timers with a degree of anonymity. As noted at the outset, BSSC used "Networking Level 3" for the transmission of order information to mutual funds. Under Networking Level 3, the following information concerning an order was conveyed to a mutual fund: type of transaction (i.e. buy or sell and a fund CUSIP), the number of shares, the RR number under which the trade was placed, a number identifying the branch office from which the trade originated and an account number. Mutual fund companies could not see the name or tax identification number of the account holder or the name of the RR placing the trade.

81. Respondents facilitated deceptive market timing by offering timers a number of devices that helped hide their identity from mutual funds, including: (1) opening new account numbers for blocked customer accounts and, in some cases, journaling funds from a blocked

account to another account so the timer could continue timing the same mutual fund with the same money in a new account; (2) creating new RR numbers to disguise timers from mutual funds; (3) assigning new branch codes to timers' accounts; and (4) suggesting that timers trade in smaller amounts in order to avoid being detected as timers by mutual funds.

82. BSSC and BS&Co. were aware of these devices and facilitated their use. Indeed, in May 2001, a mutual fund company advised Bear Stearns as follows:

We are aware of many situations where when we stop the exchange activity in an account, the representative will simply sell the position out and transfer the balance to another account. Then the exchange activity starts again, until reaching ten exchanges. Since the brokerage account number has changed in this scenario, and we do not have any account registration, we have no means of monitoring the fact this is the same shareholder.

83. Despite this notice, Respondents did not implement any policies or procedures to prevent or stop the deceptive trading practices.

**a. BSSC's Timer Control Systems**

84. In 2000, in response to complaints from mutual funds, BSSC began to develop an internal system for blocking timer trades. The development of the internal system began with the MFOD calling brokers whose customers' trades had been rejected by mutual funds and informing them that they had been stopped from trading in a certain fund. The system then evolved into a database of timer accounts maintained by BSSC's programmers. In the spring of 2000, the system was modified to allow the MFOD to block all accounts in the timer database from trading in a particular fund. The impetus for this change was one mutual fund company's termination, on May 16, 2000, of its dealer agreement with BSSC. On May 23, 2000, that mutual fund company agreed to reinstate the dealer agreement based on a signed promise by a Bear Stearns Senior Managing Director and co-head of BSSC Operations that, within the following three weeks, BSSC would program and implement a "systematic block ... for known timers."

85. MFRS programming was then changed to enable the creation of a "closed for timing" list. Any mutual fund that informed BSSC that it did not want market timing activity was supposed to be placed on the "closed for timing" list. The MFOD also continued to forward the stop notices to the brokers or to prime brokerage customers responsible for that trading.

86. In July 2001, BSSC redesigned the blocking system to allow trading in the purportedly "closed for timing" funds by certain accounts that represented to Bear Stearns that they would engage in more limited trading. This was accomplished by creating a "*Non-Timer Timer*" or "*Exempt*" (hereinafter referred to as "*Exempt*") category of timing accounts.

87. Although the accounts coded as *Exempt* were contained within BSSC's database of timer accounts, BSSC permitted the *Exempt* accounts to trade in mutual funds on the "closed for timing" list. If a particular "closed" fund specifically identified one of those accounts as a



source of unwanted timing, BSSC would block the offending *Exempt* account from trading the complaining “closed” fund, but not any other accounts used by the same timer. Thus, the timer control systems developed by BSSC did not stop known timers from trading in mutual funds that had requested that timing be stopped, but were designed to stop only the specific accounts that had been identified by a particular fund as unwanted market timers from trading in that fund. This system also permitted the same timers to continue timing in “closed” mutual funds by simply opening new accounts with Bear Stearns’ assistance.

88. The criteria for coding accounts as *Exempt* were never reduced to writing, and the unwritten criteria were not applied uniformly. Generally, however, the MFOD coded known market timers’ accounts as *Exempt* if the broker or the customer represented to the MFOD that he or she would abide by mutual funds’ prospectus limits on timing or would employ a “less active” strategy or had obtained permission from the mutual fund to engage in such trading. Without investigation, the MFOD simply accepted such representations.

89. Although BSSC permitted *Exempt* accounts to place trades in funds on the “closed for timing” list, BSSC did not allow *Exempt* accounts to trade in funds that had threatened to terminate BSSC’s dealer agreements regardless of the timers’ representations about how frequently they would trade. The funds that threatened to or did terminate BSSC’s dealer agreements because of market timing became known as “endangered.” Eventually all accounts in the timer database were blocked from trading any fund that was “endangered.”

90. In a telephone conversation on August 1, 2003, the MFOD Head described the distinction between the “endangered” and the “closed” funds as follows:

Right now, for most market timers that don’t have capacity with the funds, we tell them, “These are the funds you can't do.” And the reason why they can't do them is because in the past they came to us and told us, “You know, we're going to shut down your dealer agreement, we're going to stop reciprocal business, we don't want the market time business.” So the firm has made a decision not to market time those funds. ... Then we have other funds that we – those first set of funds we call what is called the “endangered list.” ... Most of our other funds, we have what's called just a “stop list,” where the funds have told us to stop, but they haven't been as aggressive as the endangered list.

91. The “endangered” list was first created in July 2002 and contained approximately fourteen fund families. On September 3, 2003, there were 46 fund families on BSSC’s “endangered” list. BSSC periodically distributed the “endangered” list to all known timers instructing them not to invest in those funds.

92. BSSC had no written procedures regarding the treatment of mutual fund complaints, and the MFOD employees were left to decide how to handle these issues with little or no guidance from senior management, and with no guidance from compliance. In fact, BSSC’s compliance officer did not know how the blocking system worked and was unaware that a “closed for timing” list existed.

93. In its communications with mutual funds placed or about to be placed on the “closed for timing” list, BSSC told certain mutual fund representatives that it would stop all timing in those funds by known timers or active traders. BSSC did not explain that its system for blocking timer accounts consisted of two tiers of blocks – a limited block for funds on the “closed for timing” list and a comprehensive block for funds on the “endangered” list. BSSC also did not explain that a wide category of known timers – namely, accounts coded as *Exempt* – would be allowed to time the “closed” funds.

94. The MFOD managers knew that the *Exempt* accounts were engaging in unwanted market timing. When the MFOD received a stop notice from a mutual fund about timing in a particular *Exempt* account, BSSC forwarded the stop notice to the appropriate broker or customer, but would not re-classify the account.

95. Generally, after receiving such a stop notice, the MFOD would only block the offending account from trading the complaining fund. The remaining funds on the “closed for timing” list, however, would remain open to the *Exempt* accounts, including the offending account.

96. This system of categorizing funds and coding accounts ultimately permitted continued market timing. For example, on January 14, 2002, one mutual fund company wrote to an MFOD employee:

As we have discussed, and as stated in the prospectus (see page 54) the [mutual fund company] do[es] not allow investments by market timers.

It has been brought to my attention that a broker who clears through Bear has been timing [a fund in that family] ...

Therefore, please prohibit this broker and every affiliated account (wrap or otherwise) from ALL [mutual fund company’s] Funds. Please notify the broker, and any other brokers who may intend to time our funds, that we will be closely monitoring the funds for such trading activity, and taking appropriate actions.

Despite this request, BSSC did not place the fund family on the “closed for timing” list. Rather, an MFOD employee wrote an email to the brokers for the stopped account stating: “As per the below email, no more purchases or exchanges will be allowed into [this mutual fund company’s funds].”

97. When a different correspondent began to submit market timing trades to this fund family, this mutual fund company actually terminated its dealer agreement with BSSC. In an email dated June 14, 2002, the mutual fund company’s representative described the funds’ intent to cancel their dealer agreement with BSSC as follows:

It is with regret and disappointment that I am notifying you that we are terminating our dealer agreement with Bear ....

As you know, our funds do not allow market timers and instituted a redemption fee ... to further discourage this activity. As we have discussed, you indicated that you are not able to prevent reps from timing until after the fact; however, you said that you were able to ban these brokers from any activity in the future. Unfortunately, even though this restriction was supposed to be in place, it has come to my attention some of these brokers are still timing our International Funds. Furthermore, the reps are coding the trades as wrap accounts so as to avoid redemption fees. Consequently, the fund is not able to recoup any of the transaction costs incurred because of this trading, which affects our long-term shareholders.

98. Later in 2002, this mutual fund company reinstated its dealer agreement with Respondents. The funds were subsequently placed on the “endangered” list. In or about October 2002, a senior BSSC executive tried to buy shares of a fund in this fund family but was mistakenly told that he could not do so because the dealer agreement had been terminated. While attempting to resolve the situation, the BSSC executive wrote to the mutual fund company, “Bear Stearns ‘is on your side’ and stops any client market timers as soon as we spot a transaction.” In fact, BSSC did not look for market timing activity.

99. In addition, in June 2002, an MFOD supervisor sent an email to this mutual fund family explaining why timing was continuing in its fund: “[d]ue to the lesser amount of their trades, it was difficult for us to track these transactions. To correct this, we are lowering minimums for tracking all active trading.” In fact, BSSC did not track active trading in any way, let alone based on any “minimums.”

**b. BSSC’s Timer Control Systems Did Not Stop Timers**

100. As a result of BSSC’s flawed system, many customers and customers of correspondents were able to continue to market time mutual funds that requested in unambiguous language that BSSC stop timing in their funds.

101. For example, BSSC added one mutual fund family (“Fund Family A”) to its “closed for timing” list on June 29, 2001, because, as that fund family’s representative explained in an email to BSSC, “market timing can negatively affect the mutual fund investment process and excessive and unpredictable trading hinders a fund manager’s ability to pursue the fund’s long term goals.” On July 26, 2001, a timing desk employee informed Fund Family A: “We did shut down the fund to known timers.” Yet between August 2001 and September 2003, Fund Family A sent the MFOD multiple emails about timing from *Exempt* accounts.

102. On October 18, 2001, Fund Family A complained about timing from an account traded by a PCS broker in Chicago. The broker had sent this account number, among others, to the MFOD Head on July 24, 2001, with a note thanking the MFOD Head for letting the broker “try to salvage” his “timing business with a 2 exchange model.” Based on a decision made by the MFOD Head and PCS managers, the broker’s accounts – including this account – were coded in BSSC’s systems as *Exempt*. Subsequently, Fund Family A notified the MFOD that this

account engaged in unwanted trading. In response, BSSC blocked the account from further trading in Fund Family A, but did not change the account's *Exempt* coding.

103. In all, between August 2001 and September 2, 2003, Fund Family A sent stop notices on over 40 occasions. In those stop notices, it identified over 50 market timing accounts that were coded in BSSC's timer database as *Exempt*. Furthermore, approximately 23 of the identified *Exempt* accounts were traded by the Chicago PCS broker – who, in fact, had only one timing customer.

104. Another example is Fund Family B, which was placed on the “closed for timing” list in April 2001 after it sent the following email to the MFOD:

Please use this e-mail as notice to Bear Stearns regarding the market timing policy of [Fund Family B]. [Fund Family B] do[es] not allow short term or excessive trading in ANY of our Funds .... We would appreciate it if you could block any representatives that are market timers. We have forwarded to you in the past 3 months numerous messages and accounts that we have recognized with market timing activity. Please use this information to block any and all of these representatives from doing business with [Fund Family B] currently and in the future.

105. Despite this request, BSSC did not block all *Exempt* accounts from trading in Fund Family B. Rather, BSSC forwarded this letter to all brokers that had market-timing business. In or about the Fall of 2002, BSSC “re-opened” Fund Family B, as well as approximately 140 other “closed for timing” mutual fund families to Kaplan and its customers. BSSC accomplished this, in part, by coding certain Kaplan accounts as *Exempt*. Not surprisingly, Kaplan's customers began timing the funds again.

106. In yet another example of continued timing in funds that were “closed,” a BSSC executive actively participated in bringing to BSSC the timing business of a New York based hedge fund (“New York Hedge Fund”). On March 18, 2003, the New York Hedge Fund wrote to a BSSC relationship manager:

Kindly accept this correspondence as our request to engage in Mutual Funds Trading. As you know, ... our Chief Executive Officer [(“the New York Hedge Fund CEO”)], has been engaged in discussions with [the BSSC executive] regarding the product.  
...

[The New York Hedge Fund CEO] has informed me, based on his discussions with [the BSSC executive]; Bear Stearns will provide us the platform to trade any Mutual Fund which Bear Stearns has a contract. This would include all the fund families which you forwarded to me on March 13, 2003 designated as “Fund Families Closed for Timing” . . . .

As we discussed, our trades will be usually around \$100,000 to \$200,000 in size and we will abide by all round trip limitations of the various funds. We further discussed in broad terms an outline for the size, type, and number of accounts we would utilize. ... I am also under the belief each transaction will only be identifiable to the funds by our Bear Stearns account number.

107. The relationship manager sent an email to a BSSC Senior Managing Director, describing the New York Hedge Fund's strategy as "day trading" of mutual funds. In response, the BSSC Senior Managing Director asked: "Have we reviewed the mutual fund list to confirm that the trading will not jeopardize the firm's relationship with the funds?" Another BSSC employee responded, "We have had [the New York Hedge Fund] in contact with [the MFOD Head] on several occasions. [The New York Hedge Fund] understands who is on the 'Do Not Touch List' and have agreed to play ball."

108. BSSC opened 10 accounts for the New York Hedge Fund before it even began trading. BSSC coded the accounts as *Exempt*, based on the New York Hedge Fund's representation that "we will abide by all round trip limitations on the various funds." Thus, BSSC did not stop the New York Hedge Fund from trading the funds that were purportedly "closed for timing" and only prohibited it from trading funds on the "endangered" list.

109. The New York Hedge Fund began trading on June 30, 2003. On July 8, 2003, a mutual fund company canceled one of its trades for market timing. Four other mutual fund companies stopped New York Hedge Fund's trades on July 9, July 21, July 29, 2003, and August 14, 2003. All of these mutual funds had appeared on the "closed for timing" list by February of 2001.

**c. BSSC Helped Customers and Correspondents Deceive Mutual Funds**

110. BSSC facilitated deceptive market timing by assigning timers multiple account numbers and RR numbers and alternative branch codes to help them avoid detection by mutual funds. BSSC was aware that the multiple account numbers, RR numbers and branch codes it was providing were used for deceptive purposes.

111. The timing desk specifically advised customers and correspondents about the deceptive strategies described above. For example, the MFOD advised timers that BSSC was using a default RR number, 055, to indicate trades executed by prime brokerage customers through BSSC. The MFOD also advised timers that funds would often block all trading from that RR number and suggested that certain customers open alternative RR numbers to avoid being blocked for timing.

112. For example, in an email dated November 27, 2001, one timing desk employee advised a known timer, a BSSC prime brokerage customer, as follows:

I suggest that you somehow get a new Bear account number with a different RR #. Almost all clearing firms have the #055. When the fund sees this RR# they automatically assume that it is one

broker. We tell them it is not, but since we do not give them RR info, they shut us down.

113. This timing desk employee also advised that customer:

Have you thought about trying to establish a relationship with the fund companies that you would like to trade with that have stopped us for timing? You may be a bit more successful doing that since it seems to work. The only catch is that they will [k]now you and you may have to comply with some of their exchange rules as far as frequent exchanges is concerned [sic].

114. Later, the timing desk employee again advised that same customer: “You can just get a new RR# if that is better for you. One advise [sic] is NOT to get #099. That is another RR# that is widely used.”

115. The timing desk employee also advised another market timing customer that a certain mutual fund family had a ten exchange per year limit but that after he reached his ten exchange limit in one account, he could “buy [this mutual fund family] in another account until you reach your 10 exchange limit.”

116. In another example, an internal email from one of BSSC’s correspondents located in New York (the “New York Correspondent”) describes a call with another timing desk employee:

spoke to [timing desk employee] just now to find out that when an account is stopped, and [timing desk employee] emails us the account and symbol for the fund, does that mean all funds for that fund family are stopped or only that specific fund. [Timing desk employee] said that it matters only what account and rep # we used, because if we want to trade in that fund family again, we have to use a different account AND rep number, otherwise they’ll catch it again.

117. The New York Correspondent had over 200 mutual fund market timing accounts, over 150 of which were for one ultimate customer, a New York hedge fund (the “New York Hedge Fund 2”). As noted above, Mutual Fund Family A had supposedly been “closed for timing” since June 29, 2001, because, as Mutual Fund Family A explained in an email to BSSC, “market timing can negatively affect the mutual fund investment process and excessive and unpredictable trading hinders a fund manager’s ability to pursue the fund’s long term goals.” Despite this clear instruction, BSSC not only permitted the New York Correspondent to engage in market timing in Mutual Fund Family A in 2003; when Mutual Fund Family A blocked the New York Hedge Fund 2’s trading, the New York Correspondent followed BSSC’s advice and switched account numbers to continue the unwanted timing.

118. On February 25, 2003, Mutual Fund Family A notified BSSC that three accounts were market timing and asked BSSC to stop those accounts from further trading in 26 different funds of that fund family, including Mutual Fund Family A’s high yield fund. Mutual Fund

Family A specifically asked that the accounts be coded “so that they are prohibited from purchasing or exchanging additional shares in all [funds of Mutual Fund Family A].” The three accounts belonged to the New York Hedge Fund 2 and were traded by the New York Correspondent. Despite this request, on February 27, 2003 – two days later – the New York Hedge Fund 2 purchased Mutual Fund Family A’s high yield fund in three different accounts.

119. Set forth below is a description of particular instances in which BSSC facilitated deceptive market timing by prime brokerage customers and correspondents.

(i) **Prime Brokerage Customers**

120. BSSC provided multiple RR numbers, branch codes and account numbers to its prime brokerage customers to facilitate deceptive market timing.

121. BSSC provided at least two large prime brokerage customers with unique RR numbers to assist them in getting around blocks put into place by mutual funds or to avoid “flagging” to the mutual funds that certain transactions were likely coming from a market timer.

122. BSSC also provided at least one prime brokerage market timer (the “California Hedge Fund”) with accounts in an alternative branch range, enabling it to time or to continue to time in funds that had previously blocked its trades or that were attempting to stop timing trades associated with those timers’ existing branch codes.

123. BSSC’s prime brokerage customers, including market timers, generally had accounts with branch code “102.” Some mutual funds began to notice that a large volume of market timing trades placed through BSSC occurred in accounts with that branch code, and began tracking and/or blocking accounts with that branch code.

124. For example, in an email dated December 14, 2000, a representative of one mutual fund family informed the MFOD that the California Hedge Fund’s account would be frozen because it had “continued with its disruptive trading.” The mutual fund family representative continued, “The representative involved, Rep 055 at Branch 102, has been warned and frozen in numerous accounts prior to this.” The email was forwarded to one of the California Hedge Fund’s principals.

125. By May 2001, at least six other mutual fund companies identified the California Hedge Fund’s accounts with branch code 102 as timing accounts.

126. In May 2001, the California Hedge Fund’s principal sent an email to BSSC stating he would like to discuss the following issues in an upcoming meeting:

acquiring new ‘bin #'s’. these are the account #'s that are transmitted to mutual fund families. we want bin #'s that are outside the 102 account range and therefore deemed traditional ‘timer’ activity. the new bin #'s should be in a range in which traditional mutual fund flows come from.

127. At about the same time as the meeting, the California Hedge Fund's principal also contacted a BSSC manager in San Francisco ("San Francisco Director") and, again, explained that the California Hedge Fund would like to obtain accounts outside the 102 range to avoid being viewed as a market timer.

128. The San Francisco Director asked the MFOD Head whether getting accounts with a branch code other than 102 might help a customer avoid the problem of being viewed as a market timer. The MFOD Head acknowledged that it would.

129. After this conversation, BSSC gave the California Hedge Fund accounts with branch code 105. Several senior BSSC managers participated in internal discussions about the opening of 105 accounts for the California Hedge Fund; BSSC ultimately issued a number of accounts for the California Hedge Fund in this range.

130. Branch code 105 was generally used for "accommodation" accounts for prime brokerage customers and normally would not have been given to an institutional customer to trade mutual funds. To accommodate the California Hedge Fund's request, BSSC made special modifications to certain internal systems so that the California Hedge Fund would be able to continue using leverage to trade in the 105 accounts, which were normally not set up for such trading.

131. BSSC provided the California Hedge Fund with accounts in the 105 range with the understanding that the purpose of the accounts was to evade mutual funds' anti-timing blocks. For example, in one email dated May 29, 2001, the San Francisco Director explained to the relationship managers for this customer, "since 102 range gets targeted for mutual fund timing we are looking to open 105 which will slide under the radar."

132. The California Hedge Fund used the 105 accounts to place over 1,200 mutual fund trades.

133. BSSC's prime brokerage customers received new account numbers directly from BSSC's GCS new accounts department. BSSC provided one prime brokerage customer with a market timing business, a Chicago hedge fund (the "Chicago Hedge Fund"), with dozens of account numbers. The MFOD's August 12, 2003 "Timer List" of known market timing accounts included 67 accounts for the Chicago Hedge Fund. In an email regarding a request for additional accounts, the Chicago Hedge Fund's relationship manager specifically noted that the accounts were for the customer to trade mutual funds. The Chicago Hedge Fund used its multiple accounts to circumvent mutual funds' restrictions on market timing.

**(ii) BSSC's Correspondents**

134. BSSC also assigned multiple accounts, RR numbers and accounts in the "professional range" to customers of correspondents. These accounts and RR numbers allowed those customers to evade mutual funds' trading restrictions.



(a) **Kaplan**

135. BSSC generally designated to a particular correspondent a certain range of account numbers, which became that correspondent's so-called retail range. However, to facilitate timing, BSSC allowed customers of correspondents to open market timing accounts outside those correspondents' retail ranges, under branch code 103. Branch code 103 was reserved for professional accounts. Unlike accounts in correspondents' retail ranges, accounts with branch code 103 had to be issued by BSSC's GCS new accounts department.

136. BSSC correspondent Kaplan used multiple 103 accounts for deceptive market timing on behalf of its customers. In many instances, when a mutual fund blocked or stopped a trade from a certain account number or indicated to BSSC that it would block all trading from a particular account number, a Kaplan registered representative would simply contact a BSSC employee who would contact the BSSC new accounts department and ask that the offending account be "cloned." Kaplan would then place trades in the same mutual fund for the same customer using the new account number.

137. Some mutual funds began to recognize Kaplan's branch number "755" as a branch code associated with a large quantity of timing trades and began to block all trades bearing that branch code. To get around this problem, Kaplan's customers who otherwise would have traded in Kaplan's branch 755 began to open 103-range accounts with BSSC.

138. Through email and internal reports circulated to the highest levels of BSSC, BSSC management knew that BSSC was issuing accounts in the 103 branch range to assist Kaplan's customers in market timing.

139. In an email to his supervisors dated June 18, 2003, a BSSC employee made clear that Kaplan was using multiple account numbers to avoid detection by mutual funds:

the bulk of the 103's that have been opened in florida are for bd kaplan secs. they open the accounts not for reporting or technology but to keep 1 step ahead of the mutual fund companies. it has something to do with the account # string which is part of the bin # that is reported to the mutual fund companies when a trade is executed.

140. For example, on January 28, 2003, Fund Family B sent a stop notice to BSSC about timing in its high yield fund by two accounts belonging to the same Kaplan market timing customer. A MFOD clerk forwarded this notice to one of the Kaplan Brokers with the notification that the "accounts are stopped for timing."

141. In February 2003, the Kaplan Brokers sought to open accounts for this customer in the "103" range. Kaplan's relationship manager at BSSC forwarded the request to a BSSC Managing Director, who questioned why a "103" account should be opened. Kaplan's relationship manager replied, "This is the day timing group which trades Mutual Funds."

142. A BSSC Managing Director approved the opening of the "103" accounts.

143. On March 14, 2003, BSSC issued a new account for this customer and on March 19, 2003, Kaplan was able to purchase Fund Family B's high yield fund for this customer using the new 103 account number and a different RR number.

144. In another example, on April 14, 2003, April 24, 2003, and May 16, 2003, Kaplan requested that BSSC open a total of 30 new 103 accounts for one of its timing customers. In processing each request, a BSSC employee sent an email stating, "client needs multiple trading accounts for trading strategy trading mutual funds."

145. BSSC granted all three requests. On July 24, 2003, a mutual fund company identified one of these 30 accounts as a timing account and informed BSSC that the account would be frozen. On August 18, 2003, however, the same Kaplan customer bought \$2.681 million worth of that mutual fund company's shares using five of the other 29 accounts. Those positions were sold the very next day, August 19, 2003.

146. Furthermore, on August 22, 2003, the same customer bought an additional \$2.7 million worth of that mutual fund company's shares in yet another five of the 30 accounts. Those positions were all sold on August 25, 2003.

147. At the time of these trades, that mutual fund company's family of funds was on BSSC's "closed for timing" list.

148. BSSC also assigned the two Kaplan Brokers more than 35 RR numbers.

149. In an April 2001 email, a BSSC relationship manager explained that one Kaplan Broker was using "multiple rr #'s to throw off the mutual fund companies in an attempt to avoid being kicked out of the funds." Despite this explanation, BSSC subsequently gave this Kaplan Broker additional RR numbers, which he then used to place market timing trades.

**(b) Florida Correspondent**

150. By December 1999, BSSC understood that the Florida Correspondent was engaged in unwanted market timing that was harming mutual funds. A December 17, 1999 internal BSSC report explained that several mutual funds had asked that the Florida Correspondent not trade their funds.

151. In a December 1999 email, the MFOD Head explained to the BSSC relationship manager for the Florida Correspondent that a mutual fund was rejecting the Florida Correspondent's trades, that the mutual fund did "not want them timing," and that the Florida Correspondent was planning to "set up new A/C's and time small amounts of [that mutual fund]." This information was forwarded to the head of broker-dealer services for GCS, counsel for BSSC and the MFOD Head's supervisor. Thereafter, the Florida Correspondent's customers, with BSSC's assistance, opened numerous accounts to continue to deceptively time mutual funds, many of those in the 103 range.

152. An email from a BSSC relationship manager, dated July 16, 1999, regarding Florida Customer A explained:

under the 1 entity they would like to open 5 sub accounts. they trade mutual funds and would like the account # sequence to be non-sequential. it has something to do with not wanting the mutual fund companies that they are trading to make a connection between the 5 accounts. the account is part of the BIN # that is provided to the funds on each transaction.

153. By August 16, 1999, Florida Customer A had 6 new account numbers, but the numbers were sequential. The relationship manager again requested that a BSSC employee:

change some of the #'s you supplied and provide new one which are [sic] out of sequence. the clients reason [sic] for this has to do how [sic] he trades mutual funds and the way we deliver information to the various funds.

154. As of October 15, 1999, Florida Customer A had at least three non-sequential accounts. By February 25, 2000, Florida Customer A also had an additional non-sequential account.

155. From December 2000 through June 2001 BSSC issued Florida Customer A at least 22 additional new accounts. Florida Customer A used these accounts to deceptively time a number of mutual funds that had previously complained to BSSC about market timing activity.

156. For example, in 1999, a mutual fund family sent a stop notice to BSSC about particular accounts that had engaged in market timing and asked that Respondents permanently bar those customers and representatives from trading this family's funds. On March 8, 2000, this fund family sent a detailed letter explaining that market timing was "unwelcome and potentially costly" and that the fund family had tightened its prospectus language regarding timing. On November 1, 2000, the fund family again wrote to BSSC to explain that there had been additional abusive trading and that the fund family had a "no tolerance" policy towards market timing.

157. Nevertheless, the following month, Florida Customer A began timing this fund family's international growth fund. Between December 6, 2000 and January 25, 2001, Florida Customer A made 15 exchanges in this fund family's funds. The fund family canceled Florida Customer A's sixteenth attempted timing exchange on January 30, 2001. Florida Customer A sold its position on February 14, 2001.

158. On February 22, 2001, the Florida Correspondent asked BSSC to open additional accounts in BSSC's professional range. BSSC granted the request and, the next day, assigned Florida Customer A four additional account numbers.

159. On March 19, 2001, Florida Customer A again attempted to time the same mutual fund family's international growth fund but this time the fund rejected the trading.

160. On March 22, 2001, this mutual fund family sent BSSC another stop notice, complaining about the "constant market timing" coming through Bear Stearns and again referencing the anti-timing policy set forth in its prospectus.

161. Despite this fund family's clearly expressed "no tolerance" policy, it did not appear on BSSC's "closed for timing" list until May 2001.

162. In fact, on March 21, 2001, a different market timer contacted the MFOD to ask if this fund family's funds were closed for timing. In spite of the numerous stop notices and the explicit statement that the fund family had a "no tolerance" policy towards market timing, this timer was informed by BSSC's MFOD that the "fund family is not closed for timing."

163. Finally, on May 8, 2001, the fund family threatened to terminate its dealer agreement with Bear Stearns:

[I]f you and your associates do not shut down the timing activity immediately, we will ban the entire Bear Stearns relationship from investing in our funds. This activity causes considerable harm to our portfolios and quite frankly, forces us to waste critical time and energy on a few, very unprofessional investors.

What troubles me the most is when I hear stories ... that we call to stop the activity. *Your associates are not willing to work with us and seem to be cooperative with the timers by allowing them to close the identified accounts and open new ones.* Here are your instructions - once we have identified a timer, this individual is PERMANENTLY banned from our fund complex. No new funds, accounts or any other tricks these professionals (I use the term lightly here) may dream up.

(Emphasis added.)

164. After this communication, the mutual fund family was added to the "closed for timing" list.

165. In August 2001, in response to an email regarding the fact that the Florida Correspondent was withdrawing funds from BSSC accounts because of "lack of capacity for market timing," the San Francisco Director wrote to two other BSSC Directors suggesting the following:

its [sic] been my experience for mf timers in gcs that its [sic] the mutual funds that dictate whether the account can trade with them based on their strategy. many of the funds dont [sic] want market timers and bear stearns simply relays the message to the customer.

some ways in which we have "addressed" this to keep the customer happy is to change the rr number on the trades or to open additional acct numbers in the family since the mf companies target certain office ranges and rr #'s and classify them as timers.

166. A BSSC Managing Director who was copied on the same email replied, "great idea thanks" and suggested that the idea be "floated" by the Florida Correspondent, as a possible

way to “win the business back.” In fact, the Florida Correspondent was already using these deceptive tactics.

**c. The PCS Brokers Deceived Funds**

167. Certain of the PCS brokers also facilitated deceptive market timing by using multiple account and RR numbers and branch codes to help certain PCS timing customers avoid detection by mutual funds. PCS managers approved the issuance of multiple account and RR numbers to the PCS brokers, even though the managers knew or were reckless in not knowing that the devices would be used for market timing.

168. Respondents were aware that PCS registered representatives were deceptively using multiple accounts and RR numbers for their market timing customers’ strategies. For a period of time, a senior PCS manager required that one PCS broker (“PCS Broker B”) regularly submit for review a list of his market timing accounts showing their assets invested and margin balances.

169. In addition, sometime in April or May 2001, the MFOD Head informed BS&Co.’s Global Compliance Coordinator that the MFOD had received significant complaints from mutual funds regarding the use of multiple account numbers and multiple RR numbers for customers engaged in market timing. BS&Co.’s Global Compliance Coordinator brought that complaint to the attention of senior managers in PCS.

**(i) Multiple Account Numbers**

170. The PCS brokers used over 340 account numbers to facilitate market timing by approximately 14 market-timing customers.

171. In the case of one market timing hedge fund customer, the PCS brokers used over 50 different account numbers for 6 entities associated with the customer. The brokers understood that the purpose was to deceive the mutual funds.

172. In June 2003, a mutual fund company sent BSSC a stop notice about this customer’s market timing activity and requested:

Please block bin number ... and if there’s anyway [sic] to keep this FC out and from reregistering the account and then starting all over again I’d appreciate it. Rep Code is RL6. This account has been blocked at least twice in the past and just switches accounts and starts in all over again.

The notice was forwarded to the broker for the account. Despite this notice, the same PCS broker continued to trade in this mutual fund company’s funds for the customer, using different accounts with different RR numbers.

173. The PCS brokers also specifically advised customers to stay “under the radar” by trading in smaller dollar amounts using different accounts. The PCS brokers opened multiple

accounts for timing customers in order to spread timing money across those accounts, instead of placing single large trades, which would have served as “red flags” to mutual funds.

174. As an example, a PCS customer based in Chicago opened additional accounts because a PCS broker suggested spreading mutual fund trades across accounts to limit the dollar size of the trades and avoid trade rejections. On April 17, 2001, this customer made six purchases of \$500,000 worth of an international value fund’s shares in six different accounts, thereby concealing what was actually a single trade of \$3 million. In another example, on April 10, 2001, the same customer made a series of identical purchases for 6 different accounts, acquiring identical positions in 9 mutual funds for each of the accounts.

### **(ii) Use of Multiple RR Numbers**

175. As early as 1999, the PCS brokers used new RR numbers to deceive mutual funds about the source of their customers’ market timing trades. Senior managers in PCS approved numerous written requests for new RR numbers that stated that the reason for the request was “mutual fund trading.” Once the new RR numbers were issued, the PCS brokers used them to trade mutual funds that had previously blocked trades placed with their existing RR numbers.

176. For example, on December 21, 1999, PCS Broker A requested a new RR number that he shared with PCS broker B to disguise PCS Broker B’s market timing activity. The form requesting the new RR number specifically stated that PCS Broker B’s name should not be shown on the account statements. The new RR number was issued to PCS Broker A and was then used to time funds in a mutual fund family that had previously complained to Respondents’ about PCS Broker B’s timing trades. Although the RR number was assigned to PCS Broker A, PCS Broker B, with senior management’s knowledge and approval, received 95 percent of the commissions.

177. By May 15, 2001, senior managers in PCS had approved over 50 RR numbers for the four New York based PCS brokers with market timing customers. In mid-2001, BS&Co. stopped issuing new RR numbers to these PCS brokers, and PCS managers instructed the brokers not to do anything that would jeopardize Bear Stearns’ relationships with mutual funds but permitted them to continue using the more than 50 RR numbers they had already received.

178. These brokers continued to use the more than 50 RR numbers to deceptively time mutual funds. For example, on March 2, 2001, a mutual fund company informed BS&Co.’s compliance department that certain of the PCS brokers’ accounts that had been previously identified as “excessive timers” “have or will have stop transfers to prohibit exchange activity” including two accounts belonging to a timing customer of PCS Broker B. Nevertheless, on July 25, 2001, PCS Broker B’s group was able to purchase \$387,002.50 worth of that mutual fund company’s shares in that customer’s new account with a different RR number – and sold that position less than two weeks later on August 6, 2001.

### **Violations**

179. As a result of the conduct described above, BSSC willfully violated, willfully aided and abetted, and caused violations of Section 17(a) of the Securities Act, which prohibits fraudulent conduct in the offer or sale of securities. More specifically, BSSC facilitated late

trading by certain prime brokerage customers and customers of certain correspondent broker-dealers, including BS&Co., by forwarding to NSCC, to receive that day's NAV, tens of thousands of trades received by the correspondent broker-dealer or BSSC (in the case of hedge fund prime brokerage customers) after 4:00 p.m., as if such orders had been received by the relevant broker-dealer prior to 4:00 p.m. In addition, BSSC facilitated the deceptive market timing activity of certain prime brokerage customers and of customers of certain correspondent broker-dealers by providing these entities with deceptive devices such as multiple account numbers and multiple RR numbers to enable them to avoid detection by mutual funds.

180. As a result of the conduct described above, BS&Co. willfully violated, willfully aided and abetted, and caused violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer or sale, or in connection with the purchase or sale of securities. More specifically, BS&Co. accepted a large number of late trades from certain PCS customers after 4:00 p.m. and submitted those orders as though the customers had placed the orders prior to 4:00 p.m., thereby ensuring that those trades received that day's NAV. BS&Co. also used multiple deceptive devices to facilitate its PCS customers' market timing of mutual funds. For example, BS&Co. issued customers multiple account numbers and used multiple RR numbers to enable those customers to avoid detection by mutual funds.

181. As a result of the conduct described above, Respondents willfully violated, willfully aided and abetted, and caused violations of Section 15(c) of the Exchange Act and Rule 15c1-2 thereunder, which prohibit a broker or a dealer from effecting transactions in, or inducing or attempting to induce, the purchase or sale of securities (other than on a national securities exchange of which it was a member) by means of a manipulative, deceptive, or other fraudulent device or contrivance.

182. As a result of the conduct described above, BSSC willfully violated Rule 22c-1(a), as adopted under Section 22(c) of the Investment Company Act, and BS&Co. willfully aided and abetted, and caused BSSC's violations of Rule 22c-1(a), which requires certain mutual funds, persons designated in such issuers' prospectuses as authorized to consummate transactions in any such security, their principal underwriters, or dealers in the funds' securities, to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem.

183. As a result of the conduct described above, Respondents willfully violated, willfully aided and abetted, and caused violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder. Specifically, by preparing inaccurate records by, among other things, falsifying PCS order tickets, Respondents willfully violated, willfully aided and abetted, and caused violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder.

184. In determining to accept the Offer, the Commission considered the remedial acts undertaken by Respondents and the cooperation afforded the Commission staff.

## **Undertakings**

185. Ongoing Cooperation. In determining to accept the Offer, the Commission has considered the following undertaking by Respondents. Respondents shall cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, Respondents have undertaken:

- (a) To produce, without service of a notice or subpoena, any and all documents and other information requested by the Commission's staff;
- (b) To use their best efforts to cause their employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;
- (c) To use their best efforts to cause their employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and
- (d) That in connection with any testimony of Respondents to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Respondents:
  - (i) Agree that any such notice or subpoena for Respondents' appearance and testimony may be served by regular mail on their attorney, and
  - (ii) Agree that any such notice or subpoena for Respondents' appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

186. Independent Compliance Consultant (BSSC). BSSC shall retain, within 30 days of the date of entry of the Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by BSSC and BSSC shall require the Independent Compliance Consultant to conduct, in the areas of BSSC's business which involve prime brokerage and correspondent clearing, a comprehensive review of BSSC's supervisory, compliance, and other policies and procedures designed to detect and prevent violations of the federal securities laws and the rules of the National Association of Securities Dealers, Inc. and the New York Stock Exchange ("SRO rules") by BSSC and its employees and to detect, prevent or disclose conflicts of interest related to the federal securities laws and the SRO rules of BSSC and its employees. BSSC shall require the Independent Compliance Consultant to begin his or her review by evaluating BSSC's existing policies and procedures designed to detect and prevent violations of the federal securities laws and the SRO rules, including all measures adopted by BSSC in response to recommendations made by BSSC's outside counsel, Wilmer Cutler Pickering Hale and Dorr LLP, in the following areas: policies and procedures relating to mutual fund trade clearing and processing including the obligations of a dealer in mutual fund shares, supervisory structures and the licensing of personnel, employee and customer access to technology including order entry systems, the assignment of RR numbers, new accounts and new branch codes to customers and correspondents, communications between employees and



customers, and the provision of training for employees regarding relevant regulatory requirements, including the training and education review described in paragraph 187 of these undertakings. BSSC shall require the Independent Compliance Consultant to determine whether BSSC's existing policies and procedures can reasonably be expected to detect and prevent violations of the federal securities laws and the SRO rules by BSSC and its employees in the areas described in this paragraph and to detect, prevent or disclose conflicts of interest of BSSC and its employees related to the federal securities laws and the SRO rules, and to recommend changes or additional policies, procedures or controls, if necessary. BSSC shall cooperate fully with the Independent Compliance Consultant and shall provide the Independent Compliance Consultant with access to its files, books, records, and personnel as reasonably requested for the review.

187. BSSC shall provide or continue to provide, at its own expense, effective training and education to certain of its directors, officers and employees designed to minimize the possibility of future violations of the federal securities laws and the SRO rules by BSSC. Completion of such training shall be mandatory for (i) all BSSC employees who participate in any way in the clearing or processing of trades or who have customer service responsibilities or who communicate with BSSC customers ("Covered Employees") and (ii) all BSSC employees who supervise Covered Employees (collectively, the "Mandatory Participants"). As part of the review described in paragraph 186 of these undertakings, the Independent Compliance Consultant shall evaluate BSSC's current training and education for the Mandatory Participants in the following areas: proper internal controls and procedures relating to the assignment of RR numbers, new accounts and new branch codes to customers and correspondents; the obligations imposed by the federal securities laws and the SRO rules; how to recognize indications of potential violations of the federal securities laws and the SRO rules; and the obligations assumed by, and the responses expected of, BSSC's directors, officers and employees upon learning of improper, potentially illegal or illegal acts relating to BSSC's clearing business. BSSC shall require the Independent Compliance Consultant to determine whether BSSC's current training and education is sufficient to minimize future violations of the federal securities laws and the SRO rules and to determine whether any additional training or education is necessary. To the extent the Independent Compliance Consultant determines that additional training or education is warranted, BSSC shall commence providing such training and education within 60 days of the proposal date of the Alternative Procedures described in paragraph 189. Following the completion of the required training and education for all Mandatory Participants, BSSC shall continue to provide such training and education on an annual basis for all those who became Mandatory Participants during the preceding twelve months.

188. BSSC shall require, at the conclusion of the review, which in no event shall be more than 180 days after the date of the appointment of the Independent Compliance Consultant, the Independent Compliance Consultant to submit a Report to BS&Co.'s board of directors, BSSC's operations committee, and the staff of the Commission. BSSC shall require the Independent Compliance Consultant to address in the Report the issues described in paragraphs 186 and 187 of these undertakings, and to include a description of the review performed, the conclusions reached, the Independent Compliance Consultant's recommendations for changes or additions to BSSC's policies and procedures and a procedure for implementing the recommended changes or additions to BSSC's policies and procedures.

189. BSSC shall adopt all recommendations with respect to BSSC contained in the Report of the Independent Compliance Consultant; provided, however, that within 30 days after receipt of the Independent Compliance Consultant's report, BSSC shall in writing advise the Independent Compliance Consultant, BS&Co.'s board of directors and the staff of the Commission of any recommendations that it considers to be unnecessary or inappropriate. With respect to any recommendation that BSSC considers unnecessary or inappropriate, BSSC need not adopt that recommendation at that time but shall contemporaneously propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose (the "Alternative Procedures").

190. As to any recommendation with respect to BSSC's policies and procedures on which BSSC and the Independent Compliance Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 30 days of the proposal date of the Alternative Procedures. In the event that BSSC and the Independent Compliance Consultant are unable to agree on an alternative proposal, BSSC will abide by the determinations of the Independent Compliance Consultant.

191. BSSC: (i) shall not have the authority to terminate the Independent Compliance Consultant, without the prior written approval of the staff of the Commission; (ii) shall compensate the Independent Compliance Consultant, and persons engaged to assist the Independent Compliance Consultant, for services rendered pursuant to the Order at their reasonable and customary rates; and (iii) shall not be in and shall not have an attorney-client relationship with the Independent Compliance Consultant and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Compliance Consultant from transmitting any information, reports, or documents to the Commission.

192. BSSC shall require that the Independent Compliance Consultant, for the period of the engagement and for a period of two years from completion of the engagement, shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with BSC, Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. BSSC shall require that any firm with which the Independent Compliance Consultant is affiliated in performance of his or her duties or of which he or she is a member, and any person engaged to assist the Independent Compliance Consultant in performance of his or her duties under the Order not, without prior written consent of the staff of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with BSC, Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

193. Compliance and Oversight Structure. BSSC shall maintain, beginning within 30 days after the entry of this Order, a compliance and oversight infrastructure having the following characteristics:

- (a) BSSC agrees to maintain a Director of Compliance whose responsibilities shall include the administration of policies and procedures adopted by BSSC which are reasonably designed to prevent violations of the federal securities laws, the SRO rules and the standards of conduct established by BSC's board of directors. The Director of

Compliance shall report directly to a committee of BSC's board of directors comprised of independent directors (the "Independent Board Committee").

(b) BSSC shall establish an Internal Compliance Controls Committee ("Compliance Committee") to be chaired by BSSC's Director of Compliance, which Compliance Committee shall have as its members senior executives of BSSC's operating business units. The Compliance Committee shall review compliance issues throughout the business of BSSC, endeavor to develop solutions to those issues as they may arise from time to time, and oversee implementation of those solutions. The Compliance Committee shall provide reports on material internal compliance matters to the Independent Board Committee with such frequency as the Independent Board Committee may instruct, and in any event at least quarterly.

(c) BSSC shall require the Director of Compliance to report promptly to the Independent Board Committee any material violation of the federal securities laws or the SRO rules of which he or she becomes aware in the course of carrying out his or her duties.

194. Independent Compliance Consultant (BS&Co.). BS&Co. shall retain, within 30 days of the date of entry of the Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by BS&Co. and BS&Co. shall require the Independent Compliance Consultant to conduct, in the area of mutual fund trading, a comprehensive review of BS&Co.'s supervisory, compliance, and other policies and procedures designed to detect and prevent breaches of fiduciary duty and violations of the federal securities laws and the SRO rules by BS&Co. and its employees and to detect, prevent or disclose conflicts of interest of BS&Co. and its employees related to the federal securities laws and the SRO rules. This review shall include, but shall not be limited to, a review of policies and procedures relating to the retail sale and retail brokerage order processing of mutual funds, account opening procedures, the assignment of RR numbers, and the provision of training for employees regarding relevant regulatory requirements. BS&Co. shall require the Independent Compliance Consultant to determine whether BS&Co.'s existing policies and procedures can reasonably be expected to detect and prevent violations of the federal securities laws and the SRO rules by BS&Co. and its employees as described in this paragraph and to detect, prevent or disclose conflicts of interest of BS&Co. and its employees related to the federal securities laws and the SRO rules. BS&Co. shall require the Independent Compliance Consultant to recommend changes or additional policies, procedures or controls, if necessary. BS&Co. shall cooperate fully with the Independent Compliance Consultant and shall provide the Independent Compliance Consultant with access to BS&Co.'s files, books, records, and personnel as reasonably requested for the review.

195. BS&Co. shall require, at the conclusion of the review, which in no event shall be more than 180 days after the date of the appointment of the Independent Compliance Consultant, the Independent Compliance Consultant to submit a Report to BS&Co., the Independent Board Committee and the staff of the Commission. If the Independent Compliance Consultant retained by BS&Co. is not the same Independent Compliance Consultant retained by BSSC, the Independent Compliance Consultant for BS&Co. shall consult with the Independent Compliance Consultant for BSSC to consider and reconcile any areas of duplication or conflict in the

recommendations before submitting his or her Report to BS&Co. BS&Co. shall require the Independent Compliance Consultant to address in the Report the issues described in paragraph 194 of these undertakings, and to include a description of the review performed, the conclusions reached, the Independent Compliance Consultant's recommendations for changes or additions to BS&Co.'s policies and procedures and a procedure for implementing the recommended changes or additions to BS&Co.'s policies and procedures.

196. BS&Co. shall adopt all recommendations with respect to BS&Co. contained in the Report of the Independent Compliance Consultant; provided, however, that within 30 days after the receipt of the Independent Compliance Consultant's report, BS&Co. shall in writing advise the Independent Compliance Consultant, BS&Co.'s board of directors, the Independent Board Committee and the staff of the Commission of any recommendations that it considers to be unnecessary or inappropriate. With respect to any recommendation that BS&Co. considers unnecessary or inappropriate, BS&Co. need not adopt that recommendation at that time but shall contemporaneously propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose (the "Alternative Procedures").

197. As to any recommendation with respect to BS&Co.'s policies and procedures on which BS&Co. and the Independent Compliance Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 30 days of the proposal date of the Alternative Procedures. In the event BS&Co. and the Independent Compliance Consultant are unable to agree on an alternative proposal, BS&Co. will abide by the determinations of the Independent Compliance Consultant.

198. BS&Co.: (i) shall not have the authority to terminate the Independent Compliance Consultant without the prior written approval of the staff of the Commission; (ii) shall compensate the Independent Compliance Consultant, and persons engaged to assist the Independent Compliance Consultant, for services rendered pursuant to the Order at their reasonable and customary rates; and (iii) shall not be in and shall not have an attorney-client relationship with the Independent Compliance Consultant and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Compliance Consultant from transmitting any information, reports, or documents to the Commission.

199. BS&Co. shall require that the Independent Compliance Consultant, for the period of the engagement and for a period of two years from completion of the engagement, shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with BSC, Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. BS&Co. shall require that any firm with which the Independent Compliance Consultant is affiliated in performance of his or her duties or of which he or she is a member, and any person engaged to assist the Independent Compliance Consultant in performance of his or her duties under the Order not, without prior written consent of the staff of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with BSC, Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

200. Respondents shall establish, within 30 days after the entry of this Order, a Compliance Hotline and appoint an appropriate compliance or legal officer(s) to be available to answer questions, on an anonymous basis, about business practices or ethical issues and to receive complaints from employees regarding any conduct that may be a cause for concern. Employees shall be provided with the email address and telephone number for the Compliance Hotline. Respondents will also provide all employees with quarterly compliance alerts identifying areas of interest and providing the email and telephone numbers for the Compliance Hotline. Respondents will establish a mechanism to investigate matters brought to the attention of the Compliance Hotline, and these matters will be brought to the attention of the Director of Compliance. Respondents will make and retain, for a period of five years, records of all inquiries to the Compliance Hotline. On a quarterly basis, the Director of Compliance will provide the Compliance Committee and the Independent Board Committee with a report identifying the inquiries to the Compliance Hotline, any action taken in response to the inquiry, and the resolution of such inquiry.

201. Independent Distribution Consultant. Respondents shall retain, within 10 days of the date of entry of the Order, the services of an Independent Distribution Consultant not unacceptable to the staff of the Commission. The Independent Distribution Consultant's compensation and expenses shall be borne exclusively by Respondents. Respondents shall cooperate fully with the Independent Distribution Consultant and shall provide the Independent Distribution Consultant with access to their files, books, records, and personnel as reasonably requested for the review.

202. Respondents shall require that the Independent Distribution Consultant develop a Distribution Plan for the distribution of the \$250 million in disgorgement and penalty, and any interest or earnings thereon, according to a methodology developed in consultation with Respondents and acceptable to the staff of the Commission.

203. Respondents shall require that the Independent Distribution Consultant submit a Distribution Plan to Respondents and the staff of the Commission no more than 100 days after the date of entry of the Order.

204. The Distribution Plan developed by the Independent Distribution Consultant shall be binding unless, within 130 days after the date of entry of the Order, Respondents or the staff of the Commission advises, in writing, the Independent Distribution Consultant of any determination or calculation from the Distribution Plan that it considers to be inappropriate and states in writing the reasons for considering such determination or calculation inappropriate.

205. With respect to any determination or calculation with which Respondents or the staff of the Commission do not agree, such parties shall attempt in good faith to reach an agreement within 160 days of the date of entry of the Order. In the event that Respondents and the staff of the Commission are unable to agree on an alternative determination or calculation, the determinations and calculations of the Independent Distribution Consultant shall be binding.

206. Within 175 days of the date of entry of this Order, Respondents shall require that the Independent Distribution Consultant submit the Distribution Plan for the administration and distribution of disgorgement and penalty funds pursuant to Rule 1101 [17 C.F.R. § 201.1101] of

the Commission's Rules Regarding Disgorgement and Fair Fund Plans. Following a Commission order approving a final plan of disgorgement, as provided in Rule 1104 [17 C.F.R. § 201.1104] of the Commission's Rules Regarding Disgorgement and Fair Fund Plans, Respondents shall require that the Independent Distribution Consultant, with Respondents, take all necessary and appropriate steps to administer the final plan for distribution of disgorgement and penalty funds.

207. Respondents shall require that the Independent Distribution Consultant, for the period of the engagement and for a period of two years from completion of the engagement, not enter into any employment, consultant, attorney-client, auditing or other professional relationship with BSC, Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. Respondents shall require that any firm with which the Independent Distribution Consultant is affiliated in performance of his or her duties under the Order not, without prior written consent of the staff of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with BSC, Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

208. Certification. No later than twenty-four months after the date of entry of the Order, the presidents of BS&Co. and BSSC shall certify to the Commission in writing that BS&Co. and BSSC have fully adopted and complied in all material respects with the undertakings set forth in paragraphs 186-207 and 209, and with the recommendations of the Independent Compliance Consultant(s) or, in the event of material non-adoption or non-compliance, shall describe such material non-adoption and non-compliance.

209. Recordkeeping. BS&Co. and BSSC shall preserve for a period not less than six years from the end of the fiscal year last used, the first two years in an easily accessible place, any record, except electronic mail as set forth below, of BS&Co.'s and BSSC's compliance with the undertakings set forth in paragraphs 186-207, provided that if a longer period of retention is required for any such record by Exchange Act Rule 17a-4 or any other federal or self-regulatory organization recordkeeping requirement, such record shall be preserved for the period required by the rule. BS&Co. and BSSC shall preserve for a period not less than three years from the end of the fiscal year last used, the first two years in an easily accessible place, any electronic mail record of BS&Co.'s and BSSC's compliance with the undertakings set forth in paragraphs 186-207, provided that if a longer period of retention is required for any such record by Exchange Act Rule 17a-4 or any other federal or self-regulatory organization recordkeeping requirement, such record shall be preserved for the period required by the rule.

210. Deadlines. For good cause shown, the Commission's staff may extend any of the procedural dates set forth above.

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offer. Accordingly, it is hereby ORDERED, effectively immediately, that:

- A. Pursuant to Section 15(b)(4) of the Exchange Act, BS&Co. and BSSC are hereby censured.
- B. Pursuant to Section 8A of the Securities Act, Sections 21C of the Exchange Act, and Section 9(f) of the Investment Company Act, Respondents shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Sections 15(c) and 17(a) of the Exchange Act and Rules 15c1-2 and 17a-3(a)(6) thereunder and Rule 22c-1(a) under the Investment Company Act.
- C. Pursuant to Section 21C of the Exchange Act, BS&Co. shall cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.
- D. Disgorgement and Civil Money Penalties. BS&Co. and BSSC shall, within 20 days of the entry of this Order, pay, on a joint and several basis, disgorgement in the total amount of \$160,000,000 ("Disgorgement") and civil money penalties in the amount of \$90,000,000 ("Penalties"), for a total payment of \$250,000,000.

1) Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) wired, hand-delivered, or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22132; and (D) submitted under cover letter that identifies BS&Co. and BSSC as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter, wire transfer instruction, money order, or check shall be sent to Mark K. Schonfeld, Regional Director, Securities and Exchange Commission, Division of Enforcement, Northeast Regional Office, 3 World Financial Center, New York, NY 10281.

2) There shall be, pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund established for the funds described in Section IV. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that they shall not, in any Related Investor Action, benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor in this proceeding that is proportionately attributable to the civil penalty paid by Respondents ("Penalty Offset"). If the court in any Related Investor Action grants such an offset or reduction, Respondents agree that they shall, within 30 days after entry of a final order granting the offset or reduction, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be

deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed against Respondents in this proceeding. For purposes of this paragraph, a “Related Investor Action” means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order in this proceeding.

E. Respondents shall comply with the undertakings set forth in paragraphs 186 through 209 above.

F. Other Obligations and Requirements. Nothing in this Order shall relieve Respondents of any other applicable legal obligation or requirement, including any rule adopted by the Commission subsequent to this Order.

By the Commission.

Nancy M. Morris  
Secretary