**COMMONWEALTH OF MASSACHUSETTS**
**OFFICE OF THE SECRETARY OF THE COMMONWEALTH**
**SECURITIES DIVISION**
**ONE ASHBURTON PLACE, 17TH FLOOR**
**BOSTON, MASSACHUSETTS 02108**

| | | |
|---|---|---|
| IN THE MATTER OF: | ) | |
| | ) | |
| MARTIN J. DRUFFNER | ) | |
| JUSTIN F. FICKEN | ) | |
| SKIFTER AJRO | ) | DOCKET NO. E-2003-059 |
| MICHAEL VANIN | ) | |
| ROBERT SHANNON | ) | |
| | ) | |
| RESPONDENTS. | ) | |

## ADMINISTRATIVE COMPLAINT

## I. PRELIMINARY STATEMENT

The Enforcement Section of the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth (respectively, "Enforcement Section" and "Division") files this complaint ("Complaint") in order to commence an adjudicatory proceeding against the above-named Respondents for violating the Massachusetts Uniform Securities Act, M.G.L. c. 110A ("Act"), and 950 C.M.R. 10.00 *et seq*. ("Regulations").

The Enforcement Section seeks an Order of the Division requiring Respondents to permanently cease and desist from violations of the Act, pay an administrative fine in an amount and upon such terms as the Director or Hearing Officer may determine, and revoke Respondents' registrations. In addition, the Enforcement Section requests that the Director or Hearing Officer take any other appropriate actions which may be in the public interest and necessary for the protection of Massachusetts investors.

## II. SUMMARY

This is an enforcement action arising from multiple violations of state securities laws by the registered representative Respondents: Martin Druffner ("Druffner"), Justin F. Ficken ("Ficken") and Skifter Ajro ("Ajro") (collectively, "Respondents" and/or the "Druffner Group") and by the branch manager Respondents: Michael Vanin and Robert Shannon (collectively, "Respondents"). From 1998-2003, the registered representative Respondents have unlawfully transacted business in the Commonwealth by engaging in a fraudulent scheme to enrich themselves and their offshore hedge fund clients at the expense of mutual fund shareholders. From 1998-2003, the branch manager Respondents have unlawfully transacted business in the Commonwealth by knowingly encouraging and actively furthering the fraudulent scheme and by failing to reasonably supervise their registered representatives. Senior Prudential executives knew and encouraged this activity and were reluctant to pass up the profits generated by courting multi-million dollar accounts.

The Respondent's market timing scheme involved the complicity of certain mutual fund employees, including but not limited to, wholesalers and back office personnel and certain Prudential Securities, Inc. ("Prudential") employees. The mutual fund employees violated their fiduciary duty to their shareholders by providing the Druffner Group with the knowledge and ability to circumvent the mutual fund company's market timing controls. Such controls exist to prevent market timers, such as the Druffner Group, from increasing transaction costs on the fund, forcing fund managers to maintain high cash positions, forcing fund managers to liquidate holdings to meet redemption needs, disrupting stated portfolio goals, and eating away at long-term shareholder's rightful gains. Essentially the long-term mutual fund shareholders bore the costs to the fund caused by the market timing and short-term trading activity of the Druffner

Group, whose enormous success relied in part on the knowing assistance of mutual fund employees.

Prudential knew of and had the ability to terminate the Druffner Group's activity at any time by terminating their representative identification numbers/financial advisor numbers[1] ("Rep Id/FA number"), but failed to do so. This failure resulted in the Druffner Group obtaining at least 62 different FA numbers to conceal their identity and circumvent market timing controls. In addition, Prudential management determined and controlled access to the ability to issue new Rep Id/FA numbers, to open additional accounts and to journal money between accounts. Prudential also has the ability to block representatives from trading at the CUSIP and fund family level. As part of Prudential's supervisory procedures, branch managers and compliance regularly received copies of all correspondence from the mutual funds regarding warnings and terminations for violations of the funds prospectus disclosure that were sent to their registered representatives. This correspondence culminated in approximately 25-30,000 warning and/or termination letters company-wide from the mutual fund companies this past year. Despite the incredible influx of these letters, Prudential never took any action to curtail the root of the warnings — the deceptive and unethical business practices by the Druffner Group in contravention of fund rules.

In January 2003, Prudential's market timing policy clearly stated that Prudential does not support and will not tolerate excessive short-term trading by their representatives and that representatives must adhere to mutual fund guidelines. Although Prudential's policy documented a series of disciplinary actions that would be taken in response to market timing

[1] Prudential refers to representative identification numbers ("Rep Ids") internally as Financial Advisor numbers ("FA numbers").

activities, not once were any of these actions taken in response to excessive market timing and short-term trading in violation of fund rules by the Druffner Group or the Boston Branch office.

Branch managers at the Boston Branch not only failed to address the deceptive practices surrounding the market timing activity by the Druffner Group, but actively encouraged and furthered it by enabling the representatives to obtain absurd amounts of new FA numbers and account numbers. Prudential management welcomed the business and sought to accommodate the Druffner Group's market timing business by allotting the representatives additional assistants, a personal fax machine and designated staff in the wire room available on a daily basis to assist with the late day volume of trades and exchanges. The heavy distribution of resources to the Druffner Group worked to the detriment of the retail customers of the Boston Branch.

In addition, the branch managers failed to reasonably supervise their registered representatives. Not only did the branch managers encourage and further the Druffner Group's fraudulent scheme, but they failed to enforce any firm or mutual fund market timing policies or restrictions. Furthermore, branch managers failed to implement any controls to prevent abuses that market timing could lead to, including illegal after hours trading. As one mutual fund company employee noted, "it was like a seven-headed snake — you cut off one head and another one would grow back." For the sake of enriching themselves and their hedge fund clients, the branch managers and registered representatives engaged in fraudulent tactics and financially harmful trading activity and no one stopped them.

## III. JURISDICTION AND AUTHORITY

1. The Massachusetts Securities Division is a division of the Office of the Secretary of the Commonwealth with jurisdiction over matters relating to securities, as provided for by the Act. The Act authorizes the Division to regulate: 1) the offers and/or sales of securities; 2) those

individuals offering and/or selling securities; and 3) those individuals transacting business as investment advisors within the Commonwealth.

2. This proceeding is brought in accordance with sections 101 and 204 of the Act and its Regulations. Specifically, the acts and practices constituting violations occurred primarily in the Commonwealth of Massachusetts.

3. The Division brings this action pursuant to the enforcement authority conferred upon it by section 407A of the Act and M.G. L. c. 30A, wherein the Division has the authority to conduct an adjudicatory proceeding to enforce the provisions of the Act and all Regulations and rules promulgated thereunder.

4. The Division specifically reserves the right to amend this Complaint and/or bring additional administrative complaints to reflect information developed during the current and ongoing investigation.

## IV. RELEVANT TIME PERIOD

5. Except as otherwise expressly stated, the conduct described herein occurred during the approximate period of January 1, 1998 up to and including the present ("relevant time period").

## V. RESPONDENTS

A. The Druffner Group

6. Martin Druffner, Central Registration Depository ("CRD") Number 2075497, was a registered representative of Prudential Securities from April of 1996 until July of 2003. Druffner then became a registered representative of Wachovia Securities until September 29, 2003 when he was permitted to resign. Druffner holds the National Association of Securities Dealers ("NASD") Series 7 and Series 63 licenses.

7. Justin Ficken, CRD Number 4059611, was a registered representative of Prudential Securities from October 1999 until July of 2003. Ficken then became a registered representative of Wachovia Securities until September 29, 2003 when he was permitted to resign. Ficken holds the following NASD licenses: Series 7, Series 63 and Series 65.

8. Skifter Ajro, CRD Number 2180169, was a registered representative of Prudential Securities from April 2001 until July of 2003. Ajro was then a registered representative of Wachovia Securities until he was permitted to resign on September 29, 2003. Ajro holds the following NASD licenses: Series 7 and Series 63.

B. Branch Managers

9. Michael Vanin, CRD Number 1323030, is a registered representative of Cantella & Co., Inc, CRD Number: 13905. He was a registered representative of Prudential Securities from August 1989 until November of 2001. Vanin served as branch manager of the Prudential Boston Branch until November of 2001. Vanin holds the following NASD licenses: Series 3, Series 5, Series 7, Series 8, Series 15, Series 24 and Series 63.

10. Robert Shannon, CRD Number 731092, was a registered agent of Prudential Securities from September of 1996 until July of 2003. Shannon then became a registered representative of Wachovia Securities until September 29, 2003 when he was permitted to resign. From December of 2000 until he resigned Shannon was the branch manager of the Boston Branch Office of Prudential/Wachovia. Shannon holds the following NASD licenses: Series 3, Series 7, Series 8 Series 63, and Series 65.

## VI. OTHER INVOLVED AND RELATED ENTITIES

11. Prudential Securities, Inc. ("Prudential") CRD number 7471, is a broker-dealer registered in Massachusetts. Prudential's main business address is One New York Plaza, 15th Floor, New York, NY 10292-2015.

12. Prudential Boston Branch Office ("Boston Branch") CRD branch number 7, with offices located at 100 Federal Street, 31st Floor, Boston, MA 02110.

## VII. OTHER INVOLVED AND RELATED INDIVIDUALS

13. Michael Rice is the former President of Wachovia Securities. He joined Prudential Securities in September of 1997 and has been employed with Wachovia since June of 2003. He holds the following NASD licenses: Series 3, Series 4, Series 7, Series 8, Series 24 and Series 63.

14. Steven Spector CRD Number 1222083, was a registered agent of Prudential Securities from September 1983 until July of 2003. Spector is currently a registered agent of Wachovia Securities. Spector holds the following NASD licenses: Series 7, Series 3 and Series 63.

## VIII. BACKGROUND

A. Market Timing and Short-Term Trading

15. Market timing, for the purposes of this Complaint, is defined as frequent, short-term trading involving dollar amounts beyond variable thresholds determined by each individual mutual fund company. Frequent short-term trading increases transaction costs, may generate unwanted taxable gains distributions if fund managers are forced to liquidate holdings to meet redemption needs, may force fund managers to maintain higher cash positions, disrupt portfolio strategies and ultimately deprive long-term shareholders of potential profits.

16. Mutual fund families have varying definitions for market timing in their prospectuses, and leave it in their own discretion as to whether to invoke prohibitions against timing or excessive trading. It is the responsibility of the mutual fund complex to state their anti-timing rules clearly and Prudential's responsibility to ensure that their employees adhere to prospectus requirements. Mutual fund complexes employ various methods to curb rapid-fire traders and make funds more unattractive to timers. These methods include: assessment of redemption fees, creating prospectus disclosures that may reserve the right to restrict purchase and exchange options, limiting the number of round trips[2] per year in a single fund, not permitting telephone exchanges in the hours approaching market close, and even delaying exchanges for a 24 hours to eliminate any arbitrage opportunities. Generally, factors that determine market timing thresholds are frequency of trading activity and trade volume.

17. When it has been determined that an account(s) has been involved in short-term trading activity that is disruptive to the fund, warning calls are routinely made to notify the registered representative of the disruptive activity and to inform them continuing activity, may result in termination of his/her trading privileges within a fund or family of funds. In most instances, the wholesaler is notified first and then a letter or e-mail follows to Prudential. If excessive trading or exchange activity continues beyond the warning call or letter, the registered representative is advised that continued market timing activity has negatively affected the fund performance and the trading privileges of the registered representative are terminated. The wholesaler is contacted and a formal termination letter follows.

18. Restricting trading activity can occur at both the Rep Id/FA number[3] level and the account level. When a Rep Id/FA number is terminated, internal information systems

---

[2] One round trip is a purchase and sale of shares in a single fund.

automatically restrict the ability of the representative to open up new accounts under the specified Id. For existing accounts on which the representative is the broker of record, the system will not allow further exchanges. Restricting trading activity at the account level is achieved by placing blocks on the account number to prevent further exchanges.

19. The decision to restrict a Rep Id/FA number or impose restrictions at the account level is based largely upon an assessment of the representative's intent, and/or history of market timing and whether long-term or short-term assets are involved. If the representative is a known market timer, trade restrictions generally are placed at the Rep Id/FA number level, thus restricting all accounts associated with that Rep Id/FA number. A market timing representative is well aware of the potential consequences with regard to his Rep Id/FA number.

20. Entry of a trading restriction on a particular Rep Id/FA number by no means prevents a determined representative from market timing. Representatives employ many tactics intended to circumvent these restrictions. These tactics include setting up new Rep Ids/FA numbers, utilizing joint Rep Ids/FA numbers, entering incorrect representative information, using unclean Rep Ids/FA numbers, transferring assets to new account numbers, setting up dummy accounts and limiting transaction value to avoid detection.

21. Within the mutual fund industry, financial success is measured by how much money is under management. A mutual fund management company makes its profit from fees it charges the fund for financial advice, asset management and other services. These fees typically represent a percentage of the assets in the fund, so the more assets in the family of funds, the more money the manager makes. Some of the same mutual fund companies that publicly decry market timing activity are nevertheless making deals with timers, welcoming large investors such as hedge funds into their funds, and bypassing the market timing police.

22. Mutual fund company's market timing police can be easily overruled by management and special arrangements to market time can be made available. Market timers understand this perfectly, and frequently offer the manager more assets in exchange for the ability to time. As an additional inducement for allowing the timing, fund managers are often offered "sticky assets". These assets are typically long-term investments made not in the mutual fund in which the timing activity was permitted, but in an alternative fund that guarantees a steady flow of fees to the manager and the mutual fund company.

B. Initiation of Formal Investigation

23. In July 2003, the Division received information from a former Prudential registered agent of Prudential's Boston Branch alleging that: certain brokers were engaged in market timing activity; that Prudential knew of the activity; that members of management were actively involved in trying to skirt mutual fund company rules against market timing; and that Prudential had failed to take any action to stop it.

24. The former registered representative further indicated that a flood of trades and exchanges were routinely placed by these brokers on a daily basis between 3:30 and 4:00 p.m. The trading volume was so excessive that certain operations employees were instructed to only work on putting these trades through even if it meant neglecting retail customer orders.

25. The former registered representative alleged that several Prudential brokers made a multi-million dollar business out of trading in and out of mutual funds to make quick profits at the expense of long-term shareholders and their clients included sophisticated investors which were primarily large international/offshore hedge funds.

26. The former representative also alleged that he and other non-market timing Prudential registered representatives who ran a "clean" business were mistreated, while the market-timers in

the Boston office were given preferential treatment including, re-assigned accounts, assistants and bonuses.

27. Furthermore, the former representative alleged that Prudential management was not concerned whether market timing tactics at the Boston Branch were ethical or not — it was imperative for Prudential to keep revenue up because of the merger with Wachovia Securities on July 1, 2003.

28. Based on this initial information and additional evidence obtained by the Division regarding Prudential's Boston Branch, on September 3, 2003 the Division forwarded Prudential a subpoena duces tecum for records and authorized a formal investigation into Prudential to determine whether certain business practices had violated provisions of the Act.

## IX. FINDINGS OF FACT

A. <u>The Druffner Group</u>

29. Beginning in 1996, Respondent Druffner became a financial advisor at Prudential. His moderate business involved primarily retail clients with some large corporate customers.

30. In 1998, Respondent Druffner received an unsolicited client referral from Michael Sassano ("Sassano"), a college friend of Druffner, then employed with Canadian Imperial Bank of Commerce ("CIBC"). Sassano's client, Chronos Asset Management ("Chronos"), an investment advisor/hedge fund funded by CIBC, already had additional accounts at Bear Stearns, AG Edwards and Brown Brothers Harriman. Sassano indicated that Chronos now sought a Prudential broker for mutual fund transactions.

31. Multiple accounts were opened by Druffner on behalf of Chronos and approved by Boston branch manager Vanin. In addition to new account forms, offshore/international

accounts for Chronos required multiple approvals from four or five department heads, including the regional manager Rick Capozzi.

32. Shortly thereafter, Druffner began to facilitate mutual fund market timing trading on behalf of Chronos, whereby Chronos would fax in active/live trades and exchanges between 3:30 and 4:00 p.m. directly to Druffner to execute. As was inherent in this market timing strategy, trades were entered as close to 4:00 p.m. as possible.

33. In 1999, Sassano referred Head Start hedge fund to Druffner, whose clients included Dresner Bank, CIBC and Credit Lyonnais. Total accounts managed by Head Start amounted to at least 50 for the benefit of the financial institutions. Multiple Head Start offshore/international accounts required additional approval beyond the branch manager to at least three or four other department heads at Prudential.

34. The rapid-fire trading of mutual funds was done through various accounts established by Head Start and Chronos, hedge funds devoted to timing mutual funds. The Druffner Group deliberately created the large number of accounts to conduct market timing activity without detection.

35. Druffner began to experience a dramatic increase in production as a result of his market timing clientele. In 1999, he generated approximately $600,000 in commissions.

36. In 2000, Druffner added Respondent Ficken and Respondent Ajro to help him service these accounts and execute trade and exchange requests.

37. By 2001 with the addition of Ficken and Ajro, commissions increased to approximately $1.7 million.

38. At all times, the commission split for the group remained: Druffner 70%, Ficken 20% and Ajro 10%.

39. By 2003, the Druffner Group generated at least 3 million dollars in commissions.

40. As members of the Druffner Group became more seasoned timers, they engaged in a more complicated scheme and course of business to expand their client's timing capacity in various mutual funds.

41. Sneaking through the defenses of fund companies and internal Prudential controls, the Druffner Group manipulated Rep Id/FA numbers, obtained multiple account numbers, journaled money from one account to another and milked wholesalers for information on how to avoid the market timing police, in order to stay on top.

42. As a result, Druffner became the largest producer at the Boston Branch and one of Prudential's highest producing brokers in the country.

B. Timing Under the Radar

*1. Rep Ids/FA Numbers*

43. The Druffner Group regularly traded w/ unclean Rep Ids/FA numbers, whereby trades entered would not match to a mutual funds internal information system. (*See* Exhibit 1)

44. The Druffner Group intentionally circumvented mutual fund company controls by establishing new Rep Ids/FA numbers after termination in a particular fund (*See* Exhibit 2)

45. The Druffner Group knowingly established multiple joint Rep Ids/FA numbers in order to conceal the identity of either themselves or their clients. (*See* Exhibit 2)

46. Additionally, the Druffner Group entered trades and exchanges under the Boston Branch "House" Rep Id/FA number to obscure their identity and thwart market timing police. (*See* Exhibit 3)

47. The Druffner Group regularly entered Rep Ids/FA numbers with the financial advisor as "UNKNOWN" in order to conceal their identities. (*See* Exhibit 4)

48. Another tactic utilized by the Druffner Group to avoid detection included trading w/ Rep Ids/FA numbers other than their own. (*See* Exhibit 1)

49. All three individual members of the Druffner Group were issued an "Also" number and regularly used "Also" numbers to execute trades and avoid detection. (*See* Exhibit 1, Druffner's "Also" number is M5)

50. The Druffner Group purposefully attached different branch prefixes, such as 041, OBB, ERS, TMT, TMU, BTL, and ERE to expand the number of Rep Ids/FA numbers at their disposal. These prefixes represented locations other than the Boston Branch including North Miami and the West Indies. (*See* Exhibit 5)

51. The most restrictive block that could be placed by a mutual fund company is a block by name, thereby blocking all Rep Ids/FA numbers associated with that name.

52. As a result, the Druffner Group intentionally misspelled names, added dashes and/or spaces to their names in order to beat detection systems. (*See* Exhibit 6)

53. Although having multiple Rep Ids/FA numbers or an "Also" number is not per se inappropriate or illegitimate, the Druffner Group methodically used multiple variations of these numbers to deliberately deceive and circumvent market timing restrictions.

*2. Account Numbers*

54. The Druffner Group employed similar tactics with respect to account numbers. The registered representatives regularly redeemed accounts after being warned, then established multiple accounts for the same client.

55. If a mutual fund company blocked trading privileges by account number rather than Rep Id/FA number, the Druffner Group often set up new account numbers after termination and continued to execute transactions within that account until detected.

56. The Druffner Group similarly implemented the same strategy with regard to CUSIP numbers and BIN numbers.

57. Multiple account numbers were established for the Druffner Group's clients, some ranging from 25 to 50 different accounts, for the distinct purpose of avoiding detection while market timing mutual funds.

*3. Journaling Funds*

58. The Druffner Group also utilized these various multiple accounts to "re-position purchases after being stopped" by the market timing police.

59. If a particular account number was identified for market timing, the Druffner Group would transfer or "journal" shares into a new account after being warned or terminated and thus avoid further detection.

60. Prudential allowed the Druffner Group to maneuver funds amongst their client accounts in order to avoid detection by mutual fund market timing police.

*4. Trading Below Thresholds*

61. Many market timing detection systems are based upon large swings of assets into and out of a particular fund. This is an indication that market timers may be moving large amounts of money among funds to take advantage of market inequities.

62. While market timing can occur in any fund, attention is drawn to any fund that experiences large and frequent transactions. As a result, mutual fund companies have established various thresholds for trades, depending on the nature and size of a fund, which would "trigger" potential market timing activity.

63. The Druffner Group remained in close contact with the mutual fund wholesalers and employees. The Druffner Group was well aware of the various trade thresholds at different

mutual funds and deliberately entered trades below those breakpoints in increments of $100,000 or $250,000 or $1 million dollars to give the appearance that these trades and exchanges were not intended for market timing purposes.

### *5. Wrap and Omnibus Accounts*

64. Fund companies cannot always unravel combined orders coming into their systems under wrap accounts to determine exactly which client or financial adviser is behind the trade or exchanges. These wrap accounts submit "batch orders" to the mutual fund company, which obscure the identity of the individual orders of the representatives.

65. The Druffner Group not only placed trades below certain thresholds, but also placed orders in wrap accounts to avoid detection.

66. Additionally, the Druffner Group transferred accounts to a different customer type, such as an omnibus account, in order to avoid getting hit with short term trading fees.

## C. Role of the Wholesalers/Mutual Fund Companies

67. Mutual fund company wholesalers are those employees whose job it is to sell the mutual fund to institutions and brokers. Generally there are two types of wholesalers: an internal wholesaler from inside the mutual fund company operations who works with the external or outside wholesaler who is essentially a field representative that visits clients and sells the products face to face.

68. Naturally there exists a conflict between the wholesalers, whose sole responsibility is to get as much money invested in the mutual fund as possible, and the mutual fund company, who has a fiduciary duty to make sure that the money coming in will remain long-term and benefit the shareholders.

69. This conflict is exacerbated by the pay structure of the wholesalers whose primary source of income depends upon the amount of mutual fund assets they have sold.

70. The wholesalers are the link between the mutual fund company and their clients. Wholesalers establish and maintain the relationship between the client and the mutual fund company. As one broker put it, "There was an internal and an external [wholesaler] and I guess you could say they are our bridge to the mutual fund company, meaning that if we had a question, concern or a problem, not what it was we would typically – these are the people who were assigned to us or the firm to handle these questions or concerns." (Peffer Tr. at 61)

71. The degree to which the wholesaler relationship with the client is valued is shown by certain mutual fund company procedures. Mutual fund company market timing police are careful to initially inform the wholesaler of the client of any market timing warnings or terminations prior to contacting the registered representative so as not to lose or damage the relationship. In addition, the wholesaler can influence what types of sanctions the market timing police might impose and most importantly, whether or not a client should be allowed back into a fund after a sanction has been applied.

D. Suggestions/Recommendations

72. As employees, wholesalers know how the mutual fund company operates. They are also aware of internal policies and procedures including market timing policies and procedures.

73. The Druffner Group stated that "there were a lot of conversations with numerous different wholesalers that gave you different advice of how to place this type [market timing] business with the mutual fund companies without creating a disruption." (Peffer Tr. at 68-69)

74. The following is a list of examples of this "advice" given to the Druffner Group by the wholesalers or other employees of the mutual fund company ("MFC") on how to circumvent the fund's market timing police, policies and procedures:

1. MFC/Wholesaler 2 told them to "use another rep number" when Rep Id/FA numbers had been blocked. (Druffner Tr. at 132) MFC/Wholesaler 2 also told them "Just get new rep numbers." "You can feel free to exchange into this "fund." (Ficken Tr. 133-134) In addition, the Druffner Group stated that this wholesaler "knew we were actively trading their funds and was promoting it." (Peffer Tr. at 116-117)

2. MFC/Wholesaler 3 advised the Druffner Group of "the dollar amounts to trade in certain funds – larger cap funds that he didn't think was going to cause a problem to the fund complex." (Druffner Tr. at 135-136) In addition, he recommended that if they were to "continue this type of business to do it in the wrap program, which would be our PruChoice platform, because basically, they . . . were getting a batch order from the back office and they didn't know where the order was coming from." (Peffer Tr. at 66)

3. MFC/Wholesaler 4 advised the Druffner Group that, "you would be better off, you know, with different accounts, you know, more accounts. Keep your orders at a smaller dollar level." (Peffer Tr. at 158-163)

4. MFC/Wholesaler 6 advised the Druffner Group of "the dollar amounts to trade" with the fund and to "[k]eep it under a million dollars." Wholesaler 6 also referred additional market timing clients to the Druffner Group. (Druffner Tr. at 174 and Peffer Tr. at 163)

5. MFC/Wholesaler 7 gave the Druffner Group the name of the Head of the back office operations so that Ficken's number could be "reinstated." After Ficken's number was reinstated the Druffner Group "did business" in those funds solely under Ficken's unblocked number. (Druffner Tr. at 178)

6. MFC/Wholesaler 8 suggested to the Druffner Group, "either purchase the day after a holiday or the Friday before a long weekend because, likely the market timing police wouldn't be paying attention on those days. Further when [the mutual fund company], when they were working on launching a new fund, all attention would be paid on getting ready with this new fund, that the police wouldn't be paying attention to us purchasing the older, more established fund." (Ficken Tr. at 147-148) This wholesaler further stated that "there were really no problems with our – anything we did in the fund complex." (Druffner Tr. 179)

7. MFC/Wholesaler 10 made it clear to the Druffner Group that, "a small group of funds were free to be exchanged in and out without any fear of being flattened."

(Ficken Tr. at 118-119) In addition, this wholesaler "would let us know which funds there was no problem with market timing. He would let us know whether or not any particular funds was slowing down, taking new market timing assets. He would let us know whether or not we were not being considered any sort of problem." (Ficken Tr. at 119-120) This was also a mutual fund company that "had a very liberal policy on a couple of their funds" meaning that the Druffner Group could trade as "many round trips as you would like." (Druffner Tr. at 204)

8. MFC/Wholesaler 12 told the Druffner Group to, "slow down the activity . . . do one round trip per month, stay away from the small funds" because "[the Druffner Group] had given her a lot of business, so she didn't want to see us get closed down." (Druffner Tr. 244)

9. MFC/Wholesaler 13 told the Druffner Group, "They [market timing police] were going to block you if you continue this type of business. These are the funds that you can trade that wouldn't create a problem." (Druffner Tr. at 113)

10. MFC/Wholesaler 15 e-mailed the Druffner Group with a "list of funds that could be traded, market timed." (Druffner Tr. 115-116). Even though this was a mutual fund company that "clearly states in their prospectus that they don't allow market timing." the Druffner Group stated that they could "produce a document to you that states that there's a select group list of funds they don't have a problem with exchanging." (Ficken Tr. at 111) Not having a problem was further defined as being able to "invest money and exchange and market time this particular fund with virtually no threat of reject or kick-out." (Ficken Tr. at 113)

11. MFC/Wholesaler 19 informed the Druffner Group if the "exchange activity triggered . . . a light or some sort of report" and would "suggest that I avoid any business in the near future for a particular, you know, joint rep number" and to "steer business to other specific joint rep numbers" that weren't triggering. (Ficken Tr. at 148-149)

12. MFC/Wholesaler 20 suggested to the Druffner Group that they "purchase [the mutual fund company] through two particular funds that they supposedly weren't eyeballing." (Ficken Tr. at 152)

E. Special Arrangements and Agreements

75. The Druffner Group stated that some mutual fund companies were so eager for their money that they would make special arrangements or agreements to allow them to trade.

76. The following is a list of examples of the types of deals made between employees of the mutual fund companies, even after the mutual fund companies had designated members of the

Druffner Group as market timers and had previously extinguished their trading privileges within one or more funds:

1. MFC/Wholesaler 1 agreed to "10 million in a high yield fund" and "four round trips a year." (Druffner Tr. at 96-104)

2. The Druffner Group had a "price protection" agreement with the Head of the market timing police of MFC/Wholesaler 4 where trades that were rejected the day before could be placed the following day at the previous day's price. (Druffner Tr. at 158-163) In addition, the Druffner Group had an agreement that they were "permitted two round trips within a rolling 90-day period with an established 15-day minimum hold in any equity fund a client wished to exchange into" even though this mutual fund company's prospectus stated that they "don't allow market timing." (Ficken Tr. at 66)

3. MFC/Wholesaler 5's market timing policy was faxed to the Druffner Group and consisted of two round trips per 90 day period with a minimum hold of 15 days between trades. The Druffner Group was told, "[i]f you can sign off that you can do it [adhere to the policy], you won't have a problem. We'll lift the block on your rep number." (Druffner Tr. at 170-71)

4. MFC/Wholesaler 7 made an agreement with Ficken "for 20 million dollars to be placed, spread in four accounts, five million in four accounts" to be traded in accordance with the policy which was "ten trades a year, so five round trips a year with a minimum 15-day hold on the activity." (Ficken Tr. at 72)

5. Wholesaler 11 stated with regard to $20 million that was being traded throughout their funds, "Don't bring any fresh assets. You can keep what you have, but don't bring any more." (Ficken Tr. at 117) This was a mutual fund company that did not restrict the "velocity" of trading activity by the Druffner Group in their funds.

6. MFC/Wholesaler 12 told the Druffner Group "not to use the same manager in a 30 day period by account . . . never to hit the same manager per account in a 30 day period." (Peffer Tr. at 81) This arrangement was with regard to "$6million in roughly five different accounts. For any 30 day rolling period I could not hit the same manager in a 30 day rolling per account." (Ficken Tr. at 80)

7. MFC/Wholesaler 16 stated that the "client could actively trade one of their funds if they kept some money that was stable in let's say a bond fund or something like that." (Peffer Tr. at 117)

8. MFC/Wholesaler 17 in response to a request offering "[a]pproximately two round trips per 90 days" agreed "'Absolutely.'" (Ficken Tr. at 123)

F. Conclusion

77. As the examples above show, the Druffner Group took advantage of the wholesalers' desire to bring significant assets into their funds (*i.e.* profitable commissions in their pockets) and used the wholesalers inside knowledge to find out about internal fund company procedures and policies regarding their market timing controls in order to circumvent them.

78. Part of the enormous success of the Druffner Group's market timing and short-term trading activities lay in their ability to obtain information and cooperation of certain mutual fund employees, including wholesalers and back office personnel.

G. After Hours Trading in Mutual Funds

79. Mutual fund share prices are calculated daily as of 4:00 p.m. All mutual fund transactions placed at or before 4:00 p.m. receive that days price. Orders placed after 4:00 p.m. receive the following day's price.

80. The price of the mutual fund is not known during the day until the net asset value ("NAV") is determined after the New York Stock Exchange's closing bell. Orders placed during the day gets that day's NAV. Orders placed after 4:00 p.m. receive the NAV that will be determined at 4:00 p.m. on the following day. This method of pricing shares is known as "forward pricing."

81. Forward pricing levels the playing field in that all investors on a given day are buying mutual fund shares at the same price. Forward pricing is an important protection that is meant to guard against investors who would take advantage of material information received after the closing bell.

82. It is inherent in market timing strategy to place trades as late in the day as possible, meaning as close to 4:00 p.m., in order to take advantage of price inequities, often focusing on price discrepancies involving international funds.

83. After hours trading occurs when an investor is allowed to buy or sell mutual fund shares after the 4:00 p.m. close of the market, but is allowed to receive the 4:00 p.m. price for the shares. Such trading is illegal because it allows investors to take advantage of news emerging after the market closes that could send stock prices higher, or lower the next day. Investors who buy or sell mutual funds after 4:00 p.m. are supposed to be given the following day's NAV price.

H. Trading Activity of Hedge Fund Clients

84. The Druffner Group's clients, mostly hedge fund managers, would fax mutual fund trade orders into the Boston Branch between 6:30 – 9:00 a.m. each day. On average 20 pages of trades would be received from each hedge fund manager. These trades represented the movement of money back and forth between cash and equity mutual fund positions within the hedge fund manager's numerous accounts.

85. However, these transactions were not active or live orders. The orders could not be placed until the Druffner Group received a telephone call from the fund managers either approving or canceling the trades. These calls were received late in the day, anywhere from 3:00 to 3:45 p.m. The hedge fund manager would approve all or certain of the transactions and the orders were at that time ready for execution.

86. The Druffner Group stated that this was ostensibly the procedure for placing the hedge fund managers' mutual fund trades, however, not one individual in the Druffner Group logged in receipt of these orders or made any written notations memorializing the time of day that the

orders were received. Essentially, there were no books and/or records maintained by the Boston Branch to prove that the orders were actually received before 4:00 p.m.

I. Prudential's New York Office Could Enter Trades after 4:00 p.m.

87. The Druffner Group stated that there were many days when mutual fund orders would be placed after 4:00 p.m. This occurred at least two to three times per month.

88. The Druffner Group maintained that the trades were placed and confirmed before 4:00 p.m., but were not entered by the wire room in time. When this happened, the Boston Branch could not enter the trades after 4:00 p.m., but the Prudential New York back office could. When entered by New York, these late trade orders received that day's NAV rather than the following day's NAV.

J. Procedures for Submitting Late Mutual Fund Trade Orders to New York

89. When the Druffner Group needed trades entered after 4:00 p.m., one of the representatives would call Prudential's New York office. The first point of contact was Jessica Coffaro ("Coffaro"), at the mutual fund exchange desk. The Druffner Group would inform Coffaro that certain trades that had been received prior to 4:00 p.m., but had not been executed in time. Shortly thereafter, a list of the trades would then be faxed to Coffaro.

90. Prior to this year, this trade information would be e-mailed directly to New York and it is important to note that no branch official was required to approve or verify the late trades.

91. In mid-2003, Prudential's policy changed requiring the branch manager to initial a trade sheet before faxing it to New York. The trade list could be received in New York as late as 4:45 p.m. Coffaro would bring the sheet to one of her managers, Joseph Barone ("Barone") or Rosario Tramontano ("Tramontano"), for approval. The orders were never rejected. The mutual fund orders would then be entered with that day's NAV.

K. Prudential Lacked Procedures to Detect Late Trading

92. Prudential management knew that abuses surrounding late day market timing could lead to illegal after hours trading. Yet, Prudential failed to implement any meaningful procedures to prevent trading in mutual funds after 4:00 p.m.

93. Members of the Druffner Group were known market timers throughout Prudential management including the Druffner Group's branch managers, administration manager, regional compliance officer, divisional risk officer, divisional compliance officer as well as the president.

94. Prudential's New York Office required no substantial evidence from the Druffner Group to demonstrate that the trades they forwarded after the 4 p.m. market close were actually received by the group before 4 p.m. No one — not the branch manager, Coffaro, Barone or Tramontano, ever questioned when the trade orders were received.

95. Moreover, supervisors Barone and Tramontano, who were ultimately responsible for approving the trades, never required any confirmation that the trades were actually placed prior to 4:00 p.m. and rarely if ever refused to place late mutual fund trades for the members of the Druffner Group.

96. Prudential had no procedures in place to prevent after hours trading by the Druffner Group. Rather, Prudential knowingly entered mutual fund orders after 4:00 p.m. based essentially on the "honor system" for three notorious market timers.

## X. FAILURE TO SUPERVISE

A. Branch Managers

97. Vanin became the Branch Manager of the Prudential Boston Branch in 1996 and remained until 2001. During his tenure, the Boston Branch first began its foray into the practice of market timing of mutual funds that would soon become systemic to the branch.

98. Shannon replaced Vanin as the Branch Manager of the Prudential Boston Branch on December 10, 2001. During his tenure, the market timing activity by the Druffner Group continued and Shannon was instrumental in seeing it prosper and grow.

B. Knowledge and Approval of Market Timing Activity

*1. Vanin*

99. In 1996, Steven Spector ("Spector"), an agent in the Boston Branch, began to market time mutual funds for his clients. His market timing activity proved profitable and late in 1997, Spector proposed formalizing his business activity with Prudential and approached Vanin with his ideas.

100. Ultimately, Spector and Vanin went to Prudential's home office in New York to discuss Spector's market timing plan. At this meeting, Jamie Price, the President of Prudential, Michael Rice, former President of Prudential Securities, the head of New Business Development, as well as legal counsel discussed Spector's business plan.

101. Spector's market timing program was ultimately approved by Prudential's upper management as a new business venture. Spector gained authorization to market time the Prudential family of mutual funds for a fee, which represented a percentage of assets under management.

102. With Vanin's knowledge and approval, the practice of market timing moved beyond the Spector arrangement to other financial advisors within the Boston Branch absent similar formal approval by Prudential.

*2. Shannon*

103. Shannon first became aware of the market timing activity at the Boston Branch when he met with members of the Druffner Group in December of 2001. At that meeting, Druffner

informed Shannon that he was a market timer and explained how his group executed their market timing strategies through various client accounts.

104. Druffner also told Shannon to expect to see frequent warning and/or termination letters for members of his group extinguishing trading privileges as part of his course of business.

105. Druffner assured Shannon that he and his group were following mutual fund policies and Shannon assured him it was on the up and up as long as he was following Prudential's policy.

106. Additionally, Druffner expressed concerns about operations at the Boston Branch and requested further special assistance from the wire room in order to execute his market timing trades and exchanges.

C. Encouragement and Dedication of Resources to Promote Market Timing

*1. Vanin*

107. As the volume of the Druffner Group's market timing activity increased, Vanin dedicated his own branch manager fax machine located in the administrative manager's office to receiving late day orders for the Druffner Group's clients.

108. Vanin remained very involved in the market timing business of the Druffner Group and met with many of their clients to discuss their business strategies and how he could assist them in achieving their goals at the Boston Branch.

109. Furthermore, Vanin accommodated the Druffner Group by securing additional resources and dedicated wire room personnel to assist in entering trades and exchanges at the end of the day.

110. Keenly aware of the personal financial benefits derived from the Druffner Group's market timing activity, Vanin posted a daily banner noting the production levels of each financial advisor at the Boston Branch from the previous day. Druffner's Group remained at the top of the

daily list, generating profits and catapulting the Boston Branch to one of the top producing offices in the company.

2. *Shannon*

111. Shortly after becoming branch manager and in response to requests by the Druffner Group, Shannon dedicated two of the four wire operators to assist the group with entering trades and exchanges at the end of the day.

112. Due to the routine absence of wire room personnel, there were often no more than two people servicing the wire room on any given day. Shannon was aware that this could detrimentally harm the other financial advisors and their clients whose orders would not be entered by 4:00 p.m., but permitted this priority status to the Druffner Group because of the financial rewards associated with their lucrative business.

113. Shannon went so far as to bring members of the wire room staff in his office and instructed the personnel that the Druffner Group was to be given absolute priority above all others between the hours of 3:00-4:00 p.m. each day.

114. The instructions were followed as a Prudential agent told the Division that many times his trades would turned away by the wire room because they were too busy entering exchanges for the Druffner Group. (*See* Peffer Tr. at 109)

115. The Druffner Group's market timing activity dramatically increased with the addition of Ficken and Ajro. At their request, Shannon authorized a personal fax machine to be placed in the group's office.

116. Furthermore, Shannon sought to accommodate the Druffner Group by securing the group additional resources such as two administrative assistants.

117. At the same time, Shannon told other representatives in the Boston Branch that due to budgetary constraints, they would not be able to receive additional assistants and in at least one case had an assistant taken away (*See* Spector Tr. at 82)

D. <u>Failure to Prevent the Issuance of New FA Numbers for the Purpose of Market Timing</u>

*1. Vanin*

118. Vanin readily approved and delegated approval for the issuance of new Rep Ids/FA numbers to the members of the Druffner Group.

119. Obtaining a new Rep Id/FA number at the Boston Branch was as simple as making a verbal request to an administrative assistance or directly to the commissions department. (*See* McCarson Tr. at 19)

120. The sole purpose of obtaining these Rep Ids/FA numbers to conceal the identity of the individual representative or the client as a market timer. Vanin approved or delegated the approval of every number which the members of the Druffner group put before him without question.

121. Vanin was responsible for the issuance of such specious Rep Ids/FA numbers as the Ajro/Druffner number, the Druffner/Ajro number, the Druffner/Ficken number, the Ficken/Druffner number, the Ajro/Ficken number, the Ficken/Ajro number, Druffner/ Ficken /Ajro group number, the Druffner "Also" number, the Ficken "Also" number, the Ajro "Also" number, as well as numerous other variations of the FA numbers used to deceive the market timing police.

122. The purpose of a Rep Id/FA number is to assign commissions and in the case of joint numbers to split commissions among two or more representatives. At all times the overall commission split for the Druffner Group remained: Druffner 70%, Ficken 20% and Ajro 10%

regardless of which Rep Id/FA number the group utilized for an individual trade or exchange. At the end of the month, "we just looked at how much commissions we did…we kept an eye on it and just kind of ball parked it." (Ficken Tr. at 18)

123. Vanin knew the Druffner Group commission split based on his review of the daily commission runs for the Boston Branch. Clearly, Vanin was aware of the fact that the Druffner Group's multiple Rep Ids/FA numbers served no purpose other than to further their market timing strategies.

*2. Shannon*

124. On June 21, 2002, Prudential issued a new policy for obtaining a Rep Id/FA number, Joint Rep Ids/FA numbers and "Also" Numbers. A "FA Production Number Request/Change Form" was required to be completed, a business rationale given for such a request, and approval from both the branch manager and the regional manager. [*See* Exhibit 7]

125. However, at the Boston Branch, the Prudential forms were utilized sporadically and even when used were never in full compliance with form requirements. [*See* Exhibit 7]

126. In fact, the Boston Branch utilized its own "Change of Financial Adviser Request Form," which did not include a rationale for changing Rep Id/FA account assignments and only required the branch manager signature for approval. [*See* Exhibit 8]

127. Essentially the Boston Branch created its own pool of Rep Ids/FA numbers with which to trade in direct violation and avoidance of the Prudential policy which was intended to limit the use of multiple Rep Ids/FA numbers to evade the mutual fund market timing police.

128. As with Vanin, Shannon continued to issue changes in Rep Ids/FA numbers to members of the Druffner Group, without requiring a rationale and for the sole purpose of furthering their market timing strategy.

E. Failure to Prevent the Opening of New Accounts for the Purpose of Market Timing

*1. Vanin*

129. In 1998, Druffner began market timing with the Chronos account. Druffner opened the Chronos account with Vanin. He informed him that Chronos intended to utilize a market timing strategy and wished to initially open up three offshore accounts. Vanin was knowledgeable at this time about market timing due to the Spector arrangement and approved the opening of the Druffner's market timing accounts.

130. In the later part of 2000, the net asset value of the Chronos accounts had grown to 20 million. New Chronos accounts were being opened on a regular basis and culminated with Chronos having at least 60 accounts opened with the Druffner Group. Many of the new accounts were initially approved by Vanin (and subsequently by Shannon), who never questioned Druffner or the members of his group as to the business rationale for opening so many accounts on behalf of one client.

131. Druffner stated to the Division that "[t]here wasn't any detailed due diligence on anything -- you know, on -- find out what was going on, but he [Vanin] would -- he might have asked who is this -- who's this account for…?" (Druffner Tr. at 76)

132. Vanin continued to approve the market timing accounts of the Druffner Group. Shortly after approving the Chronos account, Vanin similarly approved multiple accounts without inquiry for Head Start Asset Management, Pentagon, and Ritchie Capital.

133. While approving multiple account numbers for the Druffner Group, Vanin continued to receive hundreds of warning or termination letters from mutual fund families referencing blocks specifically for account numbers attributed to Druffner's Group.

134. Vanin never took these warning or termination letters seriously and often joked about

them to members of the Boston Branch. (*See* Peffer Tr. at 123 and McCarson Tr. at 72-73)

135. Furthermore, Vanin welcomed the additional revenues generated by the Druffner Group commenting on at least 20 occasions, "thank God for market timing." (Peffer Tr. at 122).

*2. Shannon*

136. Shannon authorized the opening of additional account numbers by the Druffner Group and in fact, prior to the issuance of Prudential's more restrictive market timing policy in January 2003, informed the Group that "now would be a good time to open new accounts."

137. Following the January 2003 policy, "at that point in time, there needed to be a specific reason to open a new account, other than just re-purchasing positions that were stopped." (Ficken Tr. at 176)

138. Shannon knew that various account numbers were used by the Druffner Group to further their client's market timing capacity. For example, by this time Chronos had at least 60 different accounts and accounted for over 170 million dollars under management.

139. Shannon approved the opening of the Greyfish account and specifically re-assigned this account from a non-market timer representative to the Druffner Group for the purpose of market timing and short-term trading in mutual funds.

140. Similar to Vanin, Shannon never questioned the necessity for opening so many multiple accounts for each of these clients.

141. While approving additional account numbers for the Druffner Group, Shannon continued to receive hundreds of warning or termination letters from mutual fund families referencing stops specifically for account numbers attributed to Druffner's Group.

## F. Failure to Detect and Prevent the Journaling of Monies Between Accounts

### *1. Vanin*

142. As stated previously, one of the ways that the Druffner Group avoided detection by the mutual funds' market timing police was to journal money between accounts, moving from an account that had been detected as market timing to one which had not.

143. Vanin routinely approved the journaling of this money, fully aware that its only purpose was to avoid the detection of the mutual fund market timing police.

144. According to Druffner, "No one knocked on my door to ask me why we moved journal money around." (Druffner Tr. at 121)

### *2. Shannon*

145. Shannon similarly approved multiple account numbers for clients of the Druffner Group, knowing that these various account numbers were enabling the group to journal money from one account to another to circumvent market timing detection.

146. Shannon also routinely approved the journaling of money between multiple accounts, fully aware that its only purpose was to avoid the detection of the funds mutual fund market timing police.

## G. Lack of After-Hour Trading Controls at the Branch Level

147. Prudential's recently instituted policy requiring branch manager approval prior to forwarding after 4:00 p.m. trades to the New York back office did nothing to substantiate that the trade orders actually took place prior to 4:00 p.m.

148. Shannon knew of the Druffner Group's market timing activity. He also knew that the hedge fund managers were calling late in the day to place trades. Nevertheless, Shannon never questioned anyone in the Druffner Group as to when the orders were actually received nor did he

require any evidence that the order was in fact received before 4:00 p.m. As with the New York Office, Shannon rarely if ever refused to authorize the after 4:00 p.m. trades submitted to him by the Druffner Group.

149. Clearly, Prudential lacked any internal controls to prevent the possibility of after hours trading at the Boston Branch. Even though Prudential management was aware that the Druffner Group engaged in market timing for most if not all of its clients, it never instituted any controls to ensure that all of the mutual fund trades were actually received prior to 4:00 p.m.

150. Moreover, Prudential management knew that the Druffner Group frequently entered trades through the New York Office after hours, but never made reasonable inquiries as to why this occurred nor restricted the practice.

H. Prudential's Market Timing Policies

151. Prior to 1998, Prudential did not have a formal policy with regard to market timing. However, senior executives at Prudential soon recognized the disruptive nature of market timing and sought to discourage timing activity within their own family of funds.

152. In 1999, market timing activity within Prudential's own PruChoice platform was prohibited. The prohibition applied to all wrap fee programs and defined market timing to include more than one trade per quarter or more than four trades per year. In addition, large purchases and redemptions were to be carefully scrutinized in the PruChoice program.

153. In 2000, Prudential continued to define market timing to be more than one round trip per quarter or more than four round trips per year. In a memo to all Prudential financial advisors, market timing was prohibited in Prudential mutual funds, Target and Strategic Partners funds. "We will continue to monitor excessive trading activity and may refuse purchase orders or

exchanges into our Funds by any person, group or commonly controlled account as described in our Fund prospectuses." [Exhibit 9]

154. On January 8, 2003, Prudential issued a market timing policy whereby "inappropriate timing activities **will continue to be monitored by the product manufacturer**." (emphasis in the original) [Exhibit 10] Prudential will comply with the manufacturer's restriction requests and such restrictions "will be applied to **all** associated FA numbers, including joint and also numbers." (emphasis in the original)

155. The January 2003 market timing policy also stated clearly:

> **Cases involving multiple or subsequent notices, or attempted or actual circumventions of this policy will be reviewed by Law, Compliance and Risk Management for determination of appropriate disciplinary action(s). This includes any attempts to circumvent this policy through the use of manipulative techniques designed to avoid detection of certain trading activity by product manufacturers.** For example, executing transactions through an "also" number or joint production number in order to conceal the identity of the Financial Advisor, or opening new accounts to conceal the identity of the client. **Under any of these circumstances Financial Advisors will be subjected to disciplinary action(s) including, but not limited to, the following:**
>
> - Commission forfeiture,
> - Issuance of a Memo of Education,
> - Issuance of a Memo of Caution,
> - Issuance of a Compliance Directive, and/or
> - Termination of Employment.
>
> (emphasis in the original) [Exhibit 10]

I. Prudential Executives Failure to Implement Policy Change

156. Shannon met with the Druffner Group to discuss the new market timing policy. When the Druffner Group questioned whether this new policy would negatively affect their market timing business, Shannon responded it would be "business as usual" and assured them that their business practices would be consistent with the new policy. (Druffner Tr. at 110)

157. Druffner further had a conversation with Capozzi to clarify Prudential's policy, whereby Capozzi "…said he worked in the New Jersey area. And he had a market timer or group of market timers in his region, or his satellite, I think he said that was doing in excess of 5-10 million in production. When he was at Paine Webber, he understood the business to some extent." (Druffner Tr. at 125-126)

158. Despite this new policy, nothing in the course of business at the Boston Branch changed as a result.

159. At no time were any members of the Druffner Group subject to any of the disciplinary actions set out in the policy and they continued to engage in the deceptive acts and practices associated with their market timing strategies.

160. Shannon continued to approve additional Rep Id/FA numbers, account numbers and journaling of monies.

161. As part of his supervisory responsibilities, Shannon failed to make any reasonable compliance inquiry into the deceptive acts and practices exhibited by the Druffner Group and utterly failed in his responsibility to implement Prudential's new market timing policy.

162. In August of 2003, Druffner attended a due diligence meeting to see the new headquarters of Wachovia in Richmond, Virginia. Druffner met with senior executive Rice about another potential policy change. According to Druffner's testimony, he was told "everything was going fine, just keep your head down and wait until the deal closes." (Druffner Tr. at 124) Rice further explained, "there is other timing going on at Wachovia and that there should be business, same old business." (Druffner Tr. at 124)

163. On September 8, 2003, Wachovia adopted a uniform policy prohibiting mutual fund market timing. [*See* Exhibit 11]

J. Conclusion

164. Branch managers Vanin and Shannon were ultimately responsible for the conduct of the registered representatives at the Boston Branch. [*See* Exhibit 12]

165. Both branch managers knew of the deceptive activities of the Druffner Group and did nothing to stop it.

166. Vanin and Shannon knowingly approved additional Rep Id/FA numbers, account numbers, and the journaling of monies to further the scheme being perpetrated by the Druffner Group to avoid market timing police at the mutual funds.

167. Moreover, Vanin and Shannon indulged their own self-interest in generating additional revenues for the Boston Branch above their supervisory obligations to prevent abusive and deceptive practices occurring in violation of the Act.

## XI. VIOLATIONS OF SECURITIES LAWS

### A. COUNT I: VIOLATIONS OF § 101

168. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1- 167 above.

169. Section 101 of the Act states:

> It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly
>
> (1) to employ an device, scheme, or artifice to defraud;
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

170. Respondents' conduct violated section 101 of the Act because they engaged in a fraudulent scheme to circumvent market timing controls for the benefit of themselves and for their hedge fund clients, to the detriment of long-term mutual fund shareholders.

171. The Branch Manager Respondents' conduct violated 101 of the Act because they knowingly encouraged and actively furthered the fraudulent scheme that their registered representatives were engaged in.

B. COUNT I: VIOLATIONS OF § 204

172. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1- 171 above.

173. Section 204 of the Act states in pertinent part:

> (a) The secretary may by order deny, suspend, or revoke any registration if he finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or its investment adviser:—
>
> (J) has failed reasonably to supervise agents, investment adviser representatives or other employees to assure compliance with this chapter;…

174. The Branch Manager Respondents' conduct violated section 204 of the Act because they failed to reasonably supervise their registered representatives by knowingly permitting and furthering the fraudulent scheme that their registered representatives were engaged in.

175. The Branch Manager Respondents' conduct violated section 204 of the Act because they failed to enforce Prudential policies and procedures restricting market timing activity.

176. The Branch Manager Respondents' conduct violated section 204 of the Act because they failed to implement any controls to ensure that registered representatives did not engage in certain illegal market timing practices such as late trading.

C. COUNT III: VIOLATIONS OF 950 CMR §12.204

177. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1- 176 above.

178. 950 CMR §12.204(a)(28) states in pertinent part that the following is a dishonest and unethical practice:

> Failing to comply with an applicable provision of the NASD Rules of Fair Practice or any applicable fair practice or ethical standard promulgated by the SEC or a self-regulatory organization approved by the SEC.

179. NASD Conduct Rule 2110 states:

> A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

180. Respondents' conduct violated NASD Rule 2110 and 950 CMR 12.204(a)(28) by engaging in a fraudulent scheme that caused financial harm to mutual fund shareholders.

181. NASD Conduct Rule 3010 states in part:

> Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association. Final Responsibility for proper supervision shall rest with the member.

182. Respondents violated NASD Conduct Rule 3010 and 950 CMR 12.204(a)(28) by failing to prevent or detect registered representatives from engaging in a fraudulent scheme.

183. Respondents violated NASD Conduct Rule 3010 and 950 CMR 12.204(a)(28) by failing to enforce firm procedures.

184. Respondents violated NASD Conduct Rule 3010 and 950 CMR 12.204(a)(28) by allowing certain trades to be processed at a priority resulting in a failure to place legitimate retail customer trades.

185. Respondents violated NASD Conduct Rule 3010 and 950 CMR 12.204(a)(28) by failing to implement reasonable supervisory practices to prevent illegal trading activity.

186. Accordingly, by failing to comply with 950 CMR 12.204(a)(28) and the provisions of the NASD Rules of Fair Practice, Respondents engaged in unethical and dishonest conduct or practices in the securities business.

## XII. STATUTORY BASIS FOR RELIEF

187. Denial, Revocation, Suspension, Cancellation and Withdrawal of Registration

Section 204 (a)(2)(B) of the Act provides in pertinent part:

> (a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant, or in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser: —
>
> (B) has willfully violated or willfully failed to comply with any provision of this chapter or a predecessor chapter or any rule or order under this chapter or a predecessor chapter;

188. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 187 above.

189. Respondents' conduct as alleged in the Complaint above constitutes willful violations of the Act and it is in the public interest for the Secretary to impose an administrative fine, revoke Respondents' registration and take any other appropriate action necessary to protect Massachusetts investors.

190. Denial, Revocation, Suspension, Cancellation and Withdrawal of Registration

Section 204 (a)(1) and (2) (G) of the Act provides in pertinent part:

> (a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant, or in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person

occupying similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser: —

(G) has engaged in any unethical or dishonest conduct or practices in the securities, commodities or insurance business;

191. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 190 above.

192. Respondents' conduct as alleged in the Complaint above constitutes dishonest or unethical conduct or practices in the securities and insurance businesses and it is in the public interest for the Secretary to impose an administrative fine and take any other appropriate action necessary to protect Massachusetts investors.

193. Violations, Cease and Desist Orders and Costs

Section 407A(a) of the Act relates provides in pertinent part that:

(a) If the secretary determines, after notice and opportunity for a hearing, that any person has engaged in or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule or order issued thereunder, he may order such person to cease and desist from such unlawful act or practice and may take affirmative action, including the imposition of an administrative fine, the issuance of an order for accounting, disgorgement or rescission or any other relief as in his judgment may be necessary to carry out the purposes of [the Act].

194. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 193 above.

195. Respondents directly and indirectly have engaged in acts, practices and courses of business as set forth in this Complaint above and it is the Division's belief that the Respondents will continue to engage in acts and practices similar in subject and purpose which constitute violations if not ordered to cease and desist.

## XIII. PUBLIC INTEREST

For any and all of the reasons set forth above, it is in the public interest and will protect Massachusetts investors to:

1) Obtain a cease and desist order barring the Respondent from further violating the Act;

2) Order Respondents to pay an administrative fine in an amount and upon such terms and conditions as the Director or Hearing Officer may determine;

3) Revoke Respondents' registrations; and

4) To take such other actions which may be in the public interest and necessary and appropriate for the protection of Massachusetts investors.

## XIV. RELIEF REQUESTED

WHEREFORE, the Enforcement Section of the Division requests that the Director or Hearing Officer take the following actions:

A. Find that all the sanctions and remedies detailed herein are in the public interest and necessary for the protection of Massachusetts investors;

B. Find as fact the allegations set forth in paragraph 1 through 195, inclusive, of the Complaint;

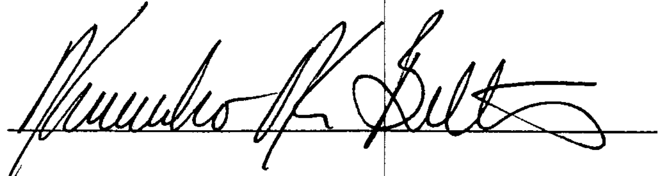
C. Enter a permanent order against Respondents ordering them to cease and desist from further violations of the Act;

D. Impose an administrative fine on Respondents in such amount and upon such terms and conditions as the director or Hearing Officer may determine;

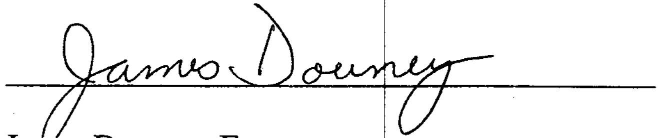
E. Revoke Respondents' registrations; and

F. Take such further action as may be deemed just and appropriate for the protection of investors as provided by M.G.L. c. 110A, § 407A.

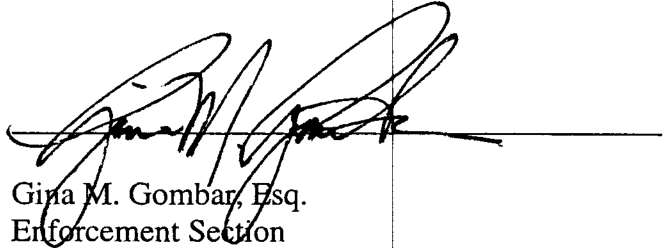
**ENFORCEMENT SECTION**
**MASSACHUSETTS SECURITIES DIVISION**



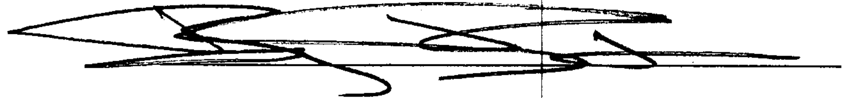
Kimiko Butcher, Esq.
Enforcement Section



James Downey, Esq.
Enforcement Section



Gina M. Gombar, Esq.
Enforcement Section



Bryan Lantagne, Esq.
Chief of Enforcement

Massachusetts Securities Division
One Ashburton Place, 17th Floor
Boston, Massachusetts 02108
(617) 727-3548

Dated: November 4, 2003.