INITIAL DECISION RELEASE NO. 316
ADMINISTRATIVE PROCEEDING
FILE NO. 3-11390

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:	
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	:	INITIAL DECISION
PAUL A. FLYNN	:	August 2, 2006
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	:	

APPEARANCES: Richard G. Primoff, Jennifer Loach, and Daniel Goldfried for the Division of Enforcement, Securities and Exchange Commission

Frank C. Razzano and Peter B. Paris of Dickstein Shapiro LLP, for Respondent Paul A. Flynn

BEFORE: Robert G. Mahony, Administrative Law Judge

INTRODUCTION

The Securities and Exchange Commission (Commission) issued its Order Instituting Proceedings (OIP) on February 3, 2004, pursuant to Section 8A of the Securities Act of 1933 (Securities Act), Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act), Section 203(f) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (ICA).[1]

The OIP alleges that from 2001 to 2003 (the relevant period), Respondent Paul A. Flynn (Flynn), while employed as Managing Director of Equity Investments at Canadian Imperial Bank of Commerce (CIBC), substantially assisted Security Trust Company, N.A. (STC), and two hedge fund clients to engage in late trading and deceptive market timing of mutual fund shares. The hedge fund clients were Samaritan Asset Management (Samaritan) and Canary Capital Partners, LLC (Canary) (collectively, the Hedge Funds).

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[1] The proceeding was stayed from February 20, 2004, to November 22, 2005, at the request of the Attorney General for the State of New York, due to a parallel criminal proceeding against Flynn. See 17 C.F.R. § 201.210(c)(3). That proceeding was dismissed prior to trial.

The OIP further alleges that as a result of his conduct, Flynn willfully aided and abetted and caused violations by STC, the Hedge Funds, and others, of Section 17(a) of the Securities Act, Exchange Act Section 10(b) and Rule 10b-5, and Rule 22c-1 under the ICA.

Market Timing and Late Trading

The share price of mutual funds is based on their net asset values (NAV). Market timing involves frequent purchases and sales of mutual fund shares, often with the intent of earning arbitrage profits if the NAV of the mutual fund differs from the value of its underlying portfolio holdings. This discrepancy in valuation may occur if the prices used to calculate the daily NAV became stale. See DH2, Inc. v. SEC, 422 F.3d 591, 592 (7th Cir. 2005); In re Mutual Funds Investment Litig., 384 F. Supp. 2d 845, 852 n.1 (D. Md. 2005); SEC v. PIMCO Advisors Fund Mgmt., LLC, 341 F. Supp. 2d 454, 458 (S.D.N.Y. 2004).

Mutual funds generally calculate their NAVs at 4:00 p.m. Eastern time by using the closing prices of their portfolio securities on the exchange or market on which the securities principally trade. DH2, 422 F.3d at 592; Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8343, 2003 SEC LEXIS 2937 at *5-9 (Dec. 11, 2003) (Disclosure Regarding Market Timing). Mutual funds that invest in overseas markets are particularly vulnerable to market timers because of time zone differences between the foreign markets on which international funds' portfolio securities trade and the United States markets that generally determine the time as of which the NAV is calculated.[2] Market timing opportunities are not, however, limited to international funds. Mutual funds that invest in small-cap securities and other types of investments that are not traded frequently also can be the targets of market timers. Disclosure Regarding Market Timing, 2003 SEC LEXIS at *11-12; David Ward, Protecting Mutual Funds from Market-Timing Profiteers: Forward Pricing International Fund Shares, 56 Hastings L.J. 585, 586 (Feb. 2005).

Although market timing is not per se illegal, the practice can harm a fund's shareholders in several ways. For example, market timing may dilute the value of long-term shareholders' interests in a mutual fund if the fund calculates its NAV using closing prices of its portfolio securities that are no longer accurate. Market timing also may cause a fund to manage its portfolio in a disadvantageous manner, such as maintaining a larger percentage of its assets in cash or liquidating certain portfolio securities prematurely to meet higher levels of redemptions due to market timing. Additionally, a mutual fund also may incur increased brokerage and trading costs, as well as tax liabilities, related to the frequent purchases and redemptions associated with market timing. PIMCO Advisors, 341 F. Supp. 2d at 458; First Lincoln

[2] For example, in the case of a United States-based mutual fund that invests primarily in securities traded on the London Stock Exchange, the fund's daily NAV would be set at 4:00 p.m. Eastern time using stock prices from the close of the London market at 11:00 a.m. Eastern time—that is, stock prices that are five hours old. If favorable news emerged following the close of the London market, market timers could purchase shares in the fund at an understated NAV that did not account for the positive late-breaking news. The market timer would then redeem the fund's shares the next day when the fund's share price would reflect the increased prices in foreign markets. See DH2, 422 F.3d at 593.

Holdings, Inc. v. Equitable Life Assurance Soc'y, 164 F. Supp. 2d 383, 390-94 (S.D.N.Y. 2001); Disclosure Regarding Market Timing, 2003 SEC LEXIS at *13-14. Accordingly, the potential for market timing to harm the interests of mutual fund investors led many mutual funds to adopt policies intended to limit market timing within their family of funds. PIMCO Advisors, 341 F. Supp. 2d at 459. These policies vary from fund to fund.

"Late trading" is placing orders to buy or redeem mutual fund shares after the NAV is calculated, but the transaction price is based on the previously calculated NAV instead of the NAV next calculated after the orders were placed. Disclosure Regarding Market Timing, 2003 SEC LEXIS at *5-9.

FINDINGS OF FACT

The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 97-104 (1981). I have considered and rejected all arguments and proposed findings and conclusions that are inconsistent with this Initial Decision.[3]

Background

CIBC is a financial and bank holding company incorporated and headquartered in Canada. It owns CIBC Delaware Holdings, Inc., a holding company incorporated in Delaware that owns several subsidiaries. (Resp. Ex. 223.) Included among these are Canadian Imperial Holdings, Inc. (CIHI), and CIBC World Markets Corp., a broker-dealer and investment adviser registered with the Commission. See 17 C.F.R. § 201.323.

Flynn joined CIBC in September 1991 as a Director of Foreign Exchange, Structured Products. (Div. Ex. 190; Resp. Ex. 223.) In 1994, at CIBC's request, Flynn moved from Canada to New York to become Managing Director of Structured Finance. (Div. Ex. 190; Resp. Exs. 97, 223.) In 1995, he joined the Equity Arbitrage Group, which is a division of CIHI. (Resp. Exs. 1, 223.) Flynn was a managing director in the Equity Arbitrage Group during the relevant period.[4] (Tr. 69-70; Div. Exs. 88-93, 190; Resp. Ex. 1.) He has never held a securities license in the United States. (Div. Ex. 190.) Flynn did not testify in this proceeding.

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[3] Citations to the transcript of the hearing will be noted as "(Tr. __.)." Citations to the Division of Enforcement's (Division) and Flynn's exhibits will be noted as "(Div. Ex. __.)," and "(Resp. Ex. __.)," respectively. Citations to the Division's and Flynn's posthearing briefs will be noted as "(Div. Post-Hearing Br. at __.)," and "(Resp. Post-Hearing Br. at __.)," respectively. Citations to the Division's and Flynn's reply briefs will be noted as "(Div. Reply Br. at __.)," and "(Resp. Reply Br. at __.)," respectively. Citations to the transcript of the Oral Argument will be noted as "(OA Tr. __.)."

[4] Jeffrey Haas (Haas) was the next senior person to Flynn in the Equity Arbitrage Group. Robert Deutsch (Deutsch) supervised Flynn and Haas. As such, he had the authority to have Flynn cease any activity. (Tr. 70, 73, 98, 105; Resp. Ex. 1.) Keith Wellner (Wellner), an attorney, assisted with the legal structure of deals generated by the group. (Tr. 70-71; Resp. Ex. 129.) Haas, Deutsch, and Wellner were not called to testify by the Division or by Flynn.

CIBC's Trading and Securitization, Credit Risk Management Department (Credit Risk) approves credit for counterparties of CIBC and its related entities. (Tr. 116, 181.) It was formed to handle transactions with clients who did not have traditional banking arrangements with CIBC. (Tr. 118.) Kathryn Lagroix (Lagroix) was a senior manager in Credit Risk during the relevant period.[5] (Tr. 115-16; Resp. Ex. 1.) Toni Lobo (Lobo) was the vice president of Credit Risk and William Shak (Shak) was the general manager. (Tr. 150-51; Resp. Exs. 1, 134.) Lagroix testified as a Division witness; Lobo and Shak were not called as witnesses.

Canary was formed in 1997 and is located in New Jersey. (Tr. 34; Div. Exs. 31, 33, 137.) It owns several hedge funds as subsidiaries. (Div. Ex. 137.) Samaritan was formed in 1996 and is located in Illinois. (Tr. 34; Div. Exs. 36, 153.) Samaritan organized and acted as general partner to several hedge funds.[6] Johnson Capital Management (JCM) served as an investment adviser to Samaritan. (Tr. 251; Div. Exs. 153, 155, 156, 159, 160; Resp. Ex. 80.) No witnesses from the Hedge Funds or JCM testified.

STC was an automated trust service provider for institutional and personal businesses. It was based in Phoenix, Arizona.[7] (Resp. Ex. 220.) STC's departments included retirement, personal trust, operations, accounting, trading, and an intake or conversion department. (Tr. 235.) The bulk of STC's business focused on servicing third-party administrators (TPAs) of retirement plans.[8] (Tr. 230-36; Resp. Ex. 220.) More specifically, STC assisted TPAs with the execution and clearing of mutual fund trades submitted by retirement plan participants to the TPAs. (Tr. 230-36; Resp. Ex. 220.)

Grant Seeger (Seeger) was STC's founder and chief executive officer and Bill Kenyon (Kenyon) was its president. (Tr. 199, 229, 238.) Irene Luntz (Luntz) was head of compliance. (Tr. 199.) Nicole McDermott (McDermott) joined STC in February 2000. (Tr. 227-28.) She worked primarily in STC's retirement department, where she was in charge of relationship management and data administration.[9] In this capacity, she worked with TPAs of retirement plans, as well as any brokers associated with the plans. (Tr. 234-36.) At all times during her tenure with STC, McDermott reported to Kenyon and Seeger. (Tr. 237-38.) McDermott testified as a Division witness. Kenyon, Seeger, and Luntz did not testify.

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[5] Some members of Credit Risk specialize in certain industries; Lagroix specializes in hedge funds. (Tr. 117-18.)

[6] All references to Canary and Samaritan include references to their hedge funds.

[7] STC was initially regulated by the Arizona state banking department. It was regulated by the Office of the Comptroller of the Currency after receiving its national charter in early 2003. (Tr. 324.)

[8] TPAs are administrative agents for retirement plans. (Tr. 234.)

[9] Since graduating college, McDermott has worked extensively with retirement and pension plans. (Tr. 227-29.)

CIBC's Equity Financing Business

Financing of Market Timing Transactions at CIBC

Lagroix first worked with the Equity Arbitrage Group and Flynn in 1998. (Tr. 118-19; Div. Ex. 164; Resp. Exs. 2, 3, 144.) At that time, Michael Sassano, a broker in CIBC World Markets Corp., referred to Equity Arbitrage a leveraged transaction request from a hedge fund that engaged in market timing. CIBC recognized that by providing leverage to hedge funds, thereby increasing the size of the hedge funds' transactions, CIBC brokers could gain increased commissions. (Div. Ex. 84.)

Thereafter, increased marketing efforts to hedge funds and their advisers led to additional business. (Div. Ex. 80.) Numerous transactions were presented by Flynn to Credit Risk, such that it became known as "Paul's business." (Tr. 120; Div. Exs. 4, 5, 18-29, 35-50.) Although Flynn was in charge of this business, he and Haas worked together as if they were partners. (Tr. 69-70, 95-96; Resp. Ex. 17.) Lagroix also viewed Flynn and Haas as partners, as she referred to them collectively as "the business."[10] (Tr. 128, 136-37, 145-46; Div. Ex. 85.)

Credit Risk also referred to it as the "market-timing business," because in reviewing the credit risk for these transactions, many of the hedge funds' offering documents referred to a market-timing strategy. (Tr. 120; Div. Exs. 145-153, 155, 156, 159.) In fact, it was widely known throughout CIBC that these hedge funds were market timing with the borrowed money. (Tr. 91-93; Div. Ex. 85; Resp. Exs. 145, 156.) Nevertheless, this business had "a high level of confidentiality since Mutual Fund Companies discourage the [market timing] of their funds." (Div. Ex. 80; Resp. Ex. 144.)

Lagroix discussed market timing with Flynn numerous times over a five-year period. (Tr. 121.) Both Flynn and Lagroix understood that many mutual funds did not like market timers. (Tr. 124, 134-46.) They also understood that other mutual funds knew about and tolerated the practice because it increased the assets under management. (Tr. 123-25, 137-39.) Credit Risk was concerned that if a mutual fund detected market timing, it could hold onto CIBC's assets, rather than return them. (Tr. 139.)

Like any other arbitrage trading strategy, Lagroix understood that market-timing trades should not stand out. (Tr. 129, 141.) She learned from Flynn or Haas that trades were kept small so that they would not be identified by the mutual funds. (Tr. 145-46.) That is, as Haas stated in an e-mail to Flynn and Credit Risk, a hedge fund's trading success depended on their ability to

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[10] Lagroix authored a document entitled "Haas/Flynn Equity Arbitrage Mutual Fund Swap Business." (Div. Ex. 84.) She characterized this document as a work in progress that she compiled over a five-year period from various sources, including news articles, Web sites, offering memoranda, and conversations with Flynn and Haas. (Tr. 133-35.) She began writing it in order to understand and approve the transactions. It was used later to explain to regulators and auditors what the business was and how Credit Risk looked at it. (Tr. 133-36.) It is unclear what information in this document was provided to her by Flynn.

stay "under the radar." (Div. Ex. 83.) Lagroix and Flynn never discussed actions taken by hedge funds in reaction to mutual funds' disapproval of market timing. (Tr. 125-26.) Lagroix testified that at some point she and Flynn discussed that all mutual fund trades had to be in by 4:00 p.m.[11] (Tr. 180-81.)

In 2003, Lagroix participated in a discussion regarding the legality of market timing. She emphasized that there was nothing illegal about it. (Tr. 170-71.) Lagroix also discussed this subject with Wellner, who informed her that CIBC's clients follow the rules in mutual funds' prospectuses. (Tr. 172-74.)

Structure of the Financing Transactions

The financing transactions were structured as either a mutual fund swap (also referred to as total return swap transactions) or a collateralized loan. (Tr. 67-69; Div. Ex. 84.)

A total return swap transaction functions essentially as follows. (Tr. 67-68, 121.) First, the client selects the assets it wants to own. (Tr. 68.) Most, if not all, of the clients of the Equity Arbitrage Group were hedge funds that sought to purchase mutual fund shares. (Tr. 68-69; Div. Exs. 80, 84.) The hedge fund contributes an amount of money, referred to as its "initial collateral." CIBC then contributed its portion, called the "floating notional," based on an approved financing ratio assigned to the transaction. Both parties' funds were combined in a "managed account" set up in CIBC's name and subsequently used to purchase shares of mutual funds. The hedge fund was assigned the risks and benefits associated with the shares, while CIBC received the cost of providing the financing. These transactions initially had a leverage ratio of four-to-one, with the hedge fund contributing one part and CIBC contributing four parts. (Tr. 68, 121; Div. Ex. 84.)

Loans functioned much like total return swaps but typically had a one-to-one leverage ratio. (Tr. 68, 121-22; Div. Ex. 84.) With loans, CIBC and the hedge fund entered into a credit agreement, whereby CIBC provided a loan (floating loan) to the hedge fund in exchange for interest on that loan. The hedge fund would contribute its own funds (initial collateral) in an amount equal to the loan amount.[12] The entire amount was then placed in a "managed account," which was in the name of the borrower. The hedge fund then pledged to CIBC as collateral the shares and any other proceeds held in the managed account. (Tr. 67-68, 121; Div. Ex. 84.) The hedge fund received the return on the underlying investment, as well as any appreciation or depreciation. (Tr. 121; Div. Ex. 84.) The loans functioned like lines of credit, in that they could be drawn upon and repaid. (Tr. 169-70.)

Credit Risk's Role in Approving Financing

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[11] An April 2002 e-mail authored by Haas and sent to Flynn, among others, mentions that orders for mutual fund shares are required to be submitted by 4:00 p.m. Eastern time. (Div. Ex. 83; Resp. Ex. 26.)

[12] The hedge fund could also elect to post additional collateral, which CIBC would then match up to an approved limit. (Div. Ex. 39.)

With both swap transactions and loan transactions, Credit Risk was required to approve the counterparty credit risk. Hedge funds are generally not creditworthy because they have no hard assets. As a result, when a hedge fund was the counterparty, Credit Risk sought to ensure that the transaction was structured properly, the collateral was properly pledged, and the operational risks were managed so that the leverage ratios were not breached. It had no responsibility for compliance or regulatory matters in connection with the transactions. (Tr. 121-23, 182.) Credit Risk would also obtain approval from the legal department that all the documentation was in place. (Tr. 123; Resp. Exs. 29, 41, 44, 49, 185, 189, 190.) Beginning no later than May 14, 2001, no transaction could commence without prior approval from the legal department. (Resp. Ex. 44.) Flynn did not have final authority to approve the loans or swaps. (Tr. 39, 150-56, 169.)

In addition to approving the counterparty, Credit Risk was required to approve other aspects of the transactions. For example, it approved the hedge funds' investment advisers and broker-dealers. Credit Risk also approved the mutual fund families, specific mutual funds in which the hedge funds could invest, and limited the amount that could be invested in any one mutual fund. (Tr. 94, 182; Div. Exs. 5, 18-33, 35-50, 54-59; Resp. Exs. 4, 26, 110, 120, 121, 156, 192.) Additionally, Credit Risk was required to approve a custodian for the assets. (Tr. 94-95, 147-48; Div. Exs. 5, 18-33, 35-50, 54-59.) The actual approval of the transaction was separate from approving the placement of funds with the custodian. (Tr. 147-48, 167-68.) The purpose of these restrictions was to protect CIBC's capital. (Tr. 95, 108-10, 166.)

The middle office for cash products at CIBC was also involved in this process.[13] (Tr. 64-72; Div. Ex. 81.) It would also review the transaction documents, but only as to the economic terms of the deal. (Tr. 71.) After the deal was consummated, it monitored the portfolio of assets to ensure that the transaction adhered to the required leverage ratio.[14] (Tr. 71-72, 90; Div. Ex. 81; Resp. Ex. 123.) The custodians were responsible for providing to the middle office on a daily basis the market value of the clients' positions, as of the end of the previous day. (Tr. 71-80; Div. Ex. 197; Resp. Ex. 122.)

CIBC's Loans to Canary and Samaritan

During the period 1999 through 2002, CIBC made three loans to Samaritan, and one to Canary. (Div. Exs. 6, 34, 51, 53, 117, 118, 119, 129.) The first Samaritan loan was dated May 28, 1999, and expired in August 2003. (Div. Exs. 51, 117.) The loan proceeds went to the

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[13] Sam Vaccarello (Vaccarello), currently an executive director for the middle office, has been Flynn's friend since 1986. He believes that CIBC and Flynn did nothing illegal in loaning money to hedge funds. (Tr. 65-66, 100-03.) According to Vaccarello, once the hedge funds received the money, they could trade however they wanted. (Tr. 94.) The only concern was whether the hedge funds met the conditions of the agreement. However, Vaccarello believes the bank would care if it knew the money was funding illegal activities. (Tr. 110.)

[14] It also maintained a "market-timing database" to support this business. (Tr. 91-92; Resp. Ex. 122.) Deutsch was "seriously interested" in having Vaccarello's office support this business, and was happy with the results he was getting. (Tr. 103-04.)

Samaritan Multi-Strategies Fund, one of Samaritan's hedge funds. The loan was structured to function in the manner described above, it had an approved limit of $50 million, and Credit Risk approved all aspects of the transaction. CIBC World Markets, CIBC's broker-dealer subsidiary, was designated as the initial custodian for this loan. Samaritan's credit application noted that it engages in market timing. A subsequent credit application, dated August 22, 2000, also has this notation. Samaritan covenanted that it would comply with the requirements of all applicable laws, rules, and regulations of any governmental authority. Flynn signed the agreement on behalf of CIBC. (Div. Exs. 51, 117.)

The second loan to Samaritan was dated January 16, 2001, and expired in April 2002. (Div. Exs. 53, 118.) The third loan to Samaritan was dated March 9, 2001, and expired on March 30, 2002. (Div. Exs. 34, 129.) The second loan went to the Samaritan Balanced Fund and the third loan went to the Samaritan International Equity Fund, both of which were Samaritan's hedge funds. These loans were structured to function in the same manner as the first and had approved limits of $50 million. They also were subjected to Credit Risk's approval process. Samaritan's credit applications noted that it engages in market timing. Samaritan also covenanted that it would comply with the requirements of all applicable laws, rules, and regulations of any governmental authority. Flynn signed the agreements for the second and third loans on behalf of CIBC. (Div. Exs. 34, 53, 118, 129.) None of Samaritan's hedge funds drew on the entire amount available to it (i.e., $50 million) for any of the three loans at issue. (Tr. 169, 184.)

Canary's loan was dated January 15, 2002.[15] (Div. Exs. 6, 50, 119.) The term of the loan was for two years. It had an approved limit of $75 million and was structured to function in the manner described above. Credit Risk approved all aspects of the transaction. STC was appointed as custodian. Canary covenanted that it would comply with the requirements of all applicable laws, rules, and regulations of any governmental authority. Flynn signed the agreement on behalf of CIBC. (Div. Exs. 6, 119.) Canary did not draw on the entire amount available to it. (Tr. 184.)

Canary also received financing from other sources, including JP Morgan. It also conducted some trading with its own assets, free of financing. (Tr. 322.) Similarly, not all of Samaritan's accounts and trades at STC were financed by CIBC. (Tr. 355.)

<u>STC's Trading Platform</u>

According to McDermott, participants in retirement plans were historically prohibited from trading after 11:00 a.m. Eastern time, so the plan's TPA would have sufficient time to assemble the relevant information. There were also problems settling trades with mutual funds because the funds would settle trade date plus one. (Tr. 232-33.) STC's "same-day/late-day" trading platform eliminated settlement and execution issues and allowed TPAs to function more efficiently. (Tr. 230-33; Resp. Ex. 220.)

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[15] In May 2001, CIBC and Canary agreed to the terms for the loan and named STC as the desired custodian. (Div. Ex. 6.)

STC's platform functioned as follows. The TPA would receive trades and contributions from a plan's participants throughout the day, and then, after 4:00 p.m. Eastern time, gather that data on its system. (Tr. 234, 239.) At approximately 6:00 p.m. Eastern time, STC would post on its Web site an "audited price file," which detailed stock prices and mutual fund NAVs for that day. (Tr. 239-41.) The TPA would load the price file into its system and insert the trades and contributions its participants had made during the day. (Tr. 239-40.) Then, the TPA sent STC a trade file with all of the plan participants' trades and contributions. (Tr. 240.) In order to be honored with that day's trades, the TPA was required, under STC's internal deadline, to submit it by 9:00 p.m. Eastern time. (Tr. 233, 240.) The TPA was then free to post the information to its system. (Tr. 240.) STC would load the TPA's trade file to its system, and reformat it so it could be sent to the National Securities Clearing Corp. (NSCC) system, which was referred to as the Defined Contribution Clearing and Settlement (DCCS) system.[16] (Tr. 240, 243.) STC would then submit the reformatted trade file to NSCC for trading. (Tr. 240.) It would also post to its internal system the anticipated results of the trades, and would reconcile any discrepancies the following day. (Tr. 240.) CDSCs and redemption fees associated with retirement plans' trading in mutual funds were waived when such plans traded through STC. (Tr. 242-45.)

STC widely distributed a services brochure that advertised the same-day/late-day trading platform. (Tr. 312-13.) This platform was STC's "distinctive advantage in the marketplace" and no efforts were made to conceal its existence. (Tr. 312-13.) Like DCCS, the same-day/late-day trading platform was intended solely to service retirement plan accounts. (Tr. 331-32.) However, STC's services brochure does not reflect this fact. (Tr. 332-33.)

"Same-day/late-day" meant the participants received that day's price even though the TPA submitted the file late in the day. (Tr. 309.) STC's agreements with TPAs required the TPAs to ensure that the retirement plan's participants submitted their trades by 4:00 p.m. Eastern time, the close of the market. TPAs then assembled this trading information and submitted their trade files later in the night. The participants would still receive that day's price. (Tr. 232-34, 239-41, 308-12.) McDermott expected that all TPA's that submitted trades to STC were ensuring that the participants did not enter trades after 4:00 p.m. Eastern time. (Tr. 233-34, 310-12.) TPAs functioned as a gatekeeper in this regard. (Tr. 311.)

STC is Approved as Custodian for the Four Loans to Samaritan and Canary

By October 1999, Lagroix understood from Flynn and Haas that the market-timing financing business had expanded to the point where it could not be accommodated solely at CIBC World Markets Corp. (Tr. 126-28; Div. Ex. 85; Resp. Ex. 7.) The problem was that market-timing trades could not be hidden from the mutual funds within its usual customer trades.

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[16] The NSCC is a clearing house for trades. It is responsible for receiving trades from various organizations and then placing them with the individual fund companies. (Tr. 241.) DCCS is actually a subset of Fund/Serv, which is NSCC's automated system for processing mutual fund trades. (Tr. 241-42.) DCCS was designed by NSCC to service only retirement plan accounts. (Tr. 241, 331-32.) DCCS allows defined contribution qualified retirement plans to trade without being charged redemption fees or contingent deferred sales charges (CDSC), which are sales charges imposed when mutual fund shares are sold. (Tr. 242-45.)

(Tr. 127-31; Div. Ex. 85; Resp. Ex. 7.) As a result, Credit Risk was asked to approve trading through other intermediaries, with these intermediaries maintaining custody of the assets. (Div. Ex. 85; Resp. Ex. 7.) This request was approved. (Div. Ex. 177.)

Samaritan contacted the Equity Arbitrage Group regarding financing approval for trading at STC in late 2000.[17] (Resp. Exs. 8, 10, 11, 13.) In November 2000, Haas requested that Credit Risk allow assets to be held at STC.[18] (Tr. 147; Resp. Exs. 8-11, 13, 37.) On November 16, 2000, Seeger, at Haas' request, sent various due diligence and corporate services materials to Haas, who forwarded them to Credit Risk. (Tr. 335; Resp. Exs. 165, 166.) The due diligence materials included a press release, a summary financial report for the period ending September 30, 2000, an audited balance sheet of one of STC's corporate owners, and an audit report of STC's internal controls. The corporate service materials included a brochure, a sample client statement, and information concerning STC's same-day/late-day trading platform. (Resp. Exs. 165, 166.)

On November 28, 2000, Haas informed Seeger and Samaritan that Credit Risk would soon decide whether to permit funds to be held at STC. He also indicated that Samaritan's credit agreements would be amended to accommodate trading at STC. (Resp. Ex. 17.) Two days later, Seeger sent Shak a copy of STC's audited financial statements for the period ending December 31, 1999. (Resp. Ex. 9.) On December 28, 2000, McDermott sent Haas a copy of STC's custody agreement with Samaritan and an addendum thereto. (Tr. 316-20; Resp. Ex. 180.) STC required Samaritan to sign the addendum in mid-December 2000, in which Samaritan certified that all trading instructions delivered to STC on any business day would be received by Samaritan from the client shareholders by 4:00 p.m. Eastern time. (Tr. 316-18; Resp. Ex. 180.) Haas signed the securities control agreement, dated January 2, 2001, on behalf of CIBC, while McDermott signed on behalf of STC. (Tr. 346-47; Resp. Ex. 167.)

After reviewing STC's due diligence materials and speaking with Seeger, Credit Risk, acting through Shak, initially approved the request to place funds at STC. At the time of this approval, some funds were transferred into pledged accounts at STC to be used by Samaritan for market timing of mutual funds. (Tr. 167-68; Resp. Ex. 85.)

Lobo was away when Shak approved STC. Following Lobo's return and review, Credit Risk revisited the issue of placing additional funds at STC due to her concerns. (Tr. 150, 155, 157, 167-68.) Credit Risk was concerned about approving STC as a custodian because its capital and assets were approximately $8 million, which was very small compared to the size of the proposed transaction.[19] (Tr. 147, 154, 165; Resp. Exs. 8, 179.) Most of the transactions used

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[17] Prior to this point, Canary and Samaritan had been trading through STC without CIBC's funding. (Tr. 245-59; Resp. Ex. 81.)

[18] Lagroix testified that this request came from "the business," meaning Haas and/or Flynn. (Tr. 147.) However, an e-mail dated November 30, 2000, from Shak to Seeger states that Haas requested approval of STC. (Resp. Ex. 11.)

larger firms, such as Prudential, Smith Barney, and Morgan Stanley. (Div. Ex. 177) Credit Risk was also concerned with: where the assets were held; whether CIBC's collateral would be protected, especially if STC went bankrupt; whether CIBC's assets could always be identified; the effect of fraud; and what would be done with the uninvested cash.[20] (Tr. 150-57, 167-68; Resp. Exs. 9-11, 16, 108.)

The request to have additional funds placed at STC was renewed several times by Flynn. (Tr. 149-50, 155.) Prior to being approved as a custodian for additional CIBC funds, STC sent information to Haas, Flynn, and Lobo concerning its services and safety of its internal controls. (Tr. 327-37; Div. Ex. 108; Resp. Exs. 18, 168.) For example, in June 2001, Seeger sent Lobo and Haas a STC corporate services brochure, which described STC's same-day/late-day platform. (Tr. 336-37; Resp. Ex. 168.) In July 2001, Seeger sent Haas and Flynn the results of an independent audit conducted on the internal controls of the same-day/late-day platform for STC's fiscal year ended on June 30, 2001. (Tr. 327-28; Div. Ex. 108; Resp. Ex. 87.) The audit report indicates that there were no deficiencies. (Tr. 330; Div. Ex. 108.)

The placement of funds at STC was discussed numerous times by Credit Risk, Flynn, Haas and others over the course of approximately one year. (Tr. 148-50, 154-56.) Lagroix does not, however, recall any specific conversation with Flynn until October 2001, after his due diligence trip to STC. (Tr. 149-52.) During this time, she and others in Credit Risk reviewed STC's marketing materials, including a description of its trading platform, and financial statements. Lagroix and Lobo also participated in a conference call with representatives of STC. (Tr. 157.) Lagroix understood that STC's platform would be beneficial to CIBC's clients, but does not recall when she learned this. (Tr. 153-54.) She characterized Flynn as impatient to have STC approved, but no more impatient than any other trader or marketer who wanted approval from Credit Risk. (Tr. 155-56.)

Flynn's Due Diligence Visit to STC

Because of Credit Risk's continued concerns about STC, a due diligence trip to STC's headquarters in Arizona was scheduled for September 2001, with Lagroix, Lobo, Haas, and Flynn planning to attend.[21] (Tr. 154-56; Resp. Exs. 20, 21.) The objectives of this trip were to:

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[19] A March 2001 memorandum authored by Wellner and sent to Haas, Flynn, and Lagroix identifies certain issues that should be addressed before CIBC used a small broker-dealer firm. These issues include the likelihood that the firm would go bankrupt, the likelihood of the firm perpetrating a fraud, and insurance that the firm holds, including excess Securities Investor Protection Corporation coverage and broker's bond. (Resp. Ex. 42.)

[20] STC informed CIBC that it maintained a financial institution bond to protect clients against acts of loss and fraud. (Resp. Exs. 10, 11.)

[21] "The business," meaning Haas, Flynn, and their assistant, made the arrangements for the trip. (Tr. 154-56.) Seeger requested CIBC to prepare an agenda for the visit so he could have the appropriate staff members available. (Resp. Ex. 21.) Flynn prepared the agenda, which Haas circulated to Lagroix, Lobo, and Wellner via e-mail on August 30, 2001. In that message, Haas

(1) understand the key controls that STC has adopted to protect assets under management; (2) determine whether the control environment is adequate from CIBC's perspective, and whether these controls are complied with on an ongoing basis; and (3) determine the effectiveness of the overall operational controls and the reliance CIBC can place on the control environment. (Div. Ex. 86 at 1.)

Following the events of September 11, 2001, Flynn conducted the due diligence trip alone. (Tr. 158.) Approximately three weeks after his return, Flynn prepared a memorandum that summarized his visit.[22] (Tr. 158; Div. Ex. 86; Resp. Exs. 57, 127.) While there, Flynn

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requested comments on the agenda and asked Wellner if there were any additional matters that needed to be covered. (Resp. Ex. 235.)

[22] The portion of Flynn's memorandum that is at issue here states:

> In our first meeting [Flynn and Seeger] spent the first hour discussing the Same Day/Late Day Trading Platform and the benefits this proprietary platform brings to our Mutual Fund Market Timing Clients. Basically this platform allows two significant benefits to our clients.
>
> Firstly, our clients are able to submit trades for same day value to 12:00 [a.m.] Eastern Standard Time based upon published [NAVs]. A pricing list is prepared by the company and submitted to our clients who are then able to run their timing models against actual closing prices instead of the previous day before they submit trades. Standard platforms require trades to be into before 4:00 p.m. submitted by specific account number and broker reference.
>
> Secondly, the company allows our clients to submit trades in a number of methods to reduce the chance that they would appear to be timing a specific mutual fund. The different types of investing are as follows: 1) Traditional account specific fund investing keeping account balances small; 2) Using a number of multiple legal vehicles (i.e. different Tax ID numbers) they rotate the ownership of the mutual fund transferring balances between related accounts; 3) Piggy backing non-12(b)1 accounts (i.e. 401k etc.) to invest in pools of funds on a net basis as specific ownership is not known by the fund; and 4) Piggy backing 12(b)1 accounts w[h]ere a specific agreement is made with a broker to include the additional fund investments. In all piggy backing situations the amount allowed to be piggy backed is 5% of the pooled funds.
>
> During these discussions I asked what specific procedures and processes were in place to ensure operational controls were adequate and understood by Senior Management. (Div. Ex. 79.)

inquired as to the specific procedures and processes that were in place to ensure that operational controls were adequate. He also had discussions about STC's regulators and auditors, their insurance coverage (current and additional), personnel policies, and key controls. Flynn met with Seeger and Kenyon, and representatives of STC's various departments, including compliance, internal auditing, computer controls, distributions, corporate services, and relationship management. (Div. Ex. 86.) During his discussion with Seeger about the trading platform, Flynn inquired as to the specific procedures and processes that were in place to ensure operational controls were adequate and understood by Senior Management. (Div. Ex. 86 at 1-2.) He determined that STC was a well-controlled business and that the business risk to CIBC was moderate to low. (Div. Ex. 86 at 2-4.) In November 2001, Flynn characterized the transactions sought to be placed at STC as low risk, because they were loans. (Resp. Ex. 57.)

The memo discussed two benefits that STC's same-day/late-day trading platform brought for CIBC's mutual fund market-timing clients. First, the market-timing clients are able to submit trades for same-day value until 12:00 a.m. Eastern time based on published NAVs. (Tr. 160; Div. Ex. 86 at 1.) STC prepares a pricing list, which it submits to CIBC's clients, who are then able to run their timing models against the actual closing prices instead of the previous day before they submit their trades. Standard platforms require trades to be in before 4:00 p.m. Eastern time. (Div. Ex. 86 at 1.)

Second, Flynn wrote that STC permitted CIBC's clients to submit trades in several methods to reduce the chances that they would appear to be timing a specific mutual fund. The different methods were: (1) keeping account balances small; (2) using multiple legal vehicles, such as different tax identification numbers; (3) piggybacking non-12b-1 accounts (i.e., 401(k), etc.) to invest in pools of funds on a net basis as specific ownership is not known by the mutual fund; and (4) piggybacking 12b-1 accounts where a specific agreement is made with a broker to include the additional fund investments. In all piggybacking situations, the amount allowed to be piggybacked is 5% of the pooled funds.

Flynn sent the memo to Lagroix, Lobo, Deutsch, and Haas. (Resp. Exs. 57, 127.) Thereafter, Lagroix and Flynn discussed it at Flynn's request.[23] (Tr. 158-59.) Flynn clarified that mutual funds' NAVs are available by 6:00 p.m. Eastern time and are passed on so the hedge fund can decide by 12:00 a.m. (Tr. 161.) Flynn also informed Lagroix that Canary and Samaritan were already using STC's platform to trade and that STC was not seeking additional similar clients for fear of disrupting its business. (Tr. 162-63; Div. Ex. 86 at 1.) Lagroix ensured that CIBC would always be able to identify their money, even if the trades were broken up. (Tr. 164-65.)

Credit Risk Approves STC

Discussions between Credit Risk, Haas, Flynn, Wellner, and STC concerning the safety and control of CIBC's collateral continued for several months after Flynn circulated his memo. (Resp. Exs. 108, 127.) When Deutsch inquired as to the status of STC in November 2001, Flynn informed him that there was a poor response from Credit Risk. (Resp. Ex. 127.) Credit Risk

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[23] Lobo was unable to participate in this discussion. (Tr. 158-59.)

learned from Seeger that all mutual fund shares purchased were held at the fund company, not at STC. It also learned that any residual cash was held at a separate bank account. (Resp. Ex. 108.)

Eventually, STC obtained an insurance policy that allowed CIBC to recover its funds in the event of any fraud or loss. (Tr. 166.) This policy made Credit Risk comfortable placing assets at STC because it no longer was concerned that STC would not have sufficient funds from which CIBC could recover. (Tr. 166.) Consequently, in early 2002, Credit Risk approved the placement of funds at STC. (Div. Ex. 177.)

The necessary documents were already executed for the Samaritan loans. Flynn signed the securities control agreements, dated January 15, 2002, for the Canary loan on behalf of CIBC. (Resp. Ex. 178.) Canary had executed an addendum similar to Samaritan's in October 2000, certifying that all instructions delivered to STC on any business day would be received by Canary from the client shareholders by 4:00 p.m. Eastern time. (Tr. 319-20; Resp. Ex. 227.) Based on these addendums, McDermott expected that the decisions with respect to Canary's and Samaritan's trades were made by 4:00 p.m. Eastern time. (Tr. 316-21.) If Canary had not executed the document, STC would have required it to submit its trade files by 4:00 p.m. Eastern time.[24] (Tr. 378-80; Div. Ex. 61.) McDermott testified that STC was not accustomed to working with hedge funds and its custody agreements with the Hedge Funds excluded the language that STC required of its TPAs. These addendums contain similar language as STC's agreements with TPAs. (Tr. 378-79.)

After approval, STC established accounts in the names of Samaritan and Canary, and the Hedge Funds' collateral was placed in these accounts, along with CIBC's funding.[25] Apart from the amount Shak approved, CIBC's funds were placed at STC by February 15, 2002. (Div. Ex. 197.) For the first loan, there was more than: $22 million in the Samaritan Multi-Strategies Fund accounts at STC on February 15, 2002; $19.6 million on June 24, 2002; $14.6 million on July 25, 2002; and $7 million on August 13, 2003. These sums consisted of approximately 50% CIBC money and 50% Samaritan money. (Div. Ex. 197.) For the second loan, made to the Samaritan Balanced Fund, there was approximately $10.5 million in the accounts at STC on February 15, 2002. Of that amount, approximately $5.1 million represented CIBC funds. (Div. Ex. 197.) For the third loan, made to the Samaritan International Equity Fund, there was approximately $1.7 million in the account at STC on February 15, 2002. Of that amount, approximately $800,000 represented CIBC funds. (Div. Ex. 197.) For the Canary loan, there was more than: $51.1 million in its accounts at STC on February 15, 2002; $46.9 million on June 24, 2002; and $47 million on July 25, 2002. (Div. Ex. 197.) Of these amounts, more than

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[24] In an e-mail string during October 2000, an STC employee expressed concern about providing the price file to Samaritan and Canary before receiving their trade files, and receiving their trade files after the market had closed. (Tr. 263-64; Div. Ex. 60.)

[25] Samaritan's accounts were: n2361a; n2361b; n2361m; n2362a; n2362b; n2362c; n2362d; n2417a; n2417b; and n2508a. Canary's accounts were: n1224a; n1225a; n1226a; n1227a; n1228a; n1228b; n1228c; n1228d; n1228e; n1228f; n1228g; n1268a; n1268b; n1268c; n1268d; and n1268e. (Div. Ex. 177.)

$25 million, $23.9 million, and $24 million, respectively, represented CIBC funds. (Div. Ex. 197.)

STC's Relationship with Canary and Samaritan

Trading Strategies of STC, Canary, and Samaritan

By April 2000, almost one year before STC was approved for trading by CIBC, McDermott learned from Seeger that Canary and Samaritan would be trading through STC's platform. (Tr. 245-59.) She also learned that market timing was a strategy these new hedge fund clients employed. (Tr. 246-50.) After Canary and Samaritan began trading, mutual funds repeatedly contacted STC requesting that the market-timing trades cease and threatening to cut off trading.[26] (Tr. 245-59, 350, 362-63; Resp. Ex. 81.) In response, STC, Samaritan, and Canary began devising trading strategies designed to limit the mutual funds' detection of the market-timing trades and ensure that the Hedge Funds could continue to trade in the mutual funds. (Tr. 253-57, 362.)

McDermott identified four specific strategies, which STC, Canary, and Samaritan began implementing no later than summer 2000. (Tr. 253-59.) These four strategies were developed based on what succeeded and what did not. For example, when one market-timing strategy was detected, STC and the Hedge Funds attempted to develop a new and less visible trading method to enable continued trading in the mutual fund. (Tr. 253-57, 362.) Employees of STC recognized as early as July 2000 that the Hedge Funds' trading activities were endangering its relationships with mutual funds, yet STC continued collaborating with the Hedge Funds to develop more effective market-timing methods. (Tr. 253-57, 362; Div. Exs. 60, 61; Resp. Exs. 81, 82.)

As described by McDermott, the first approach developed was called the "shotgun approach." (Tr. 254.) Here, one account was assigned to Samaritan and another account was assigned to Canary. The Hedge Funds then traded through these accounts. (Tr. 254.) Mutual funds detected these trades immediately. (Tr. 254, 257.)

The second approach was called a "rotating omnibus account." (Tr. 254.) Here, STC would set up five accounts for Canary and five accounts for Samaritan. (Tr. 254; Resp. Ex. 91.) Each set of accounts had the same tax identification number. (Tr. 258.) Each Hedge Fund was allowed to have one purchase and sale in each account per week. (Tr. 254.) If, for example, Canary used the first account to purchase on Monday and sold on Tuesday, it could not use the first account again until next week. (Tr. 254-55.) Because the Hedge Funds would not be buying and selling more than once per week in any given account and the amount of the trades was spread out over the five accounts, they and STC hoped mutual funds would not detect their trades. (Tr. 254-56.)

The third strategy, which evolved from the second, involved rotating tax identification numbers. (Tr. 258.) In this strategy, Canary and Samaritan were each assigned five different

[26] No mutual fund ever cut off trading, despite threatening to do so. (Tr. 362-63.)

accounts. Unlike the second strategy, however, the five accounts for each entity were assigned different tax identification numbers. (Tr. 258; Resp. Ex. 91.)

The fourth approach was termed "piggybacking," and involved trading in or with a retirement plan's trades in one omnibus account. (Tr. 259.) According to McDermott, retirement plans generally have a large and static dollar amount. (Tr. 259.) "Piggybacking" allowed the Hedge Funds to trade with the retirement plan's large asset base. The Hedge Funds were, however, limited to trading a certain percentage of the retirement plan's total asset value in order to prevent or limit detection of their trades. (Tr. 259; Div. Ex. 64BE.)

Generally, when the Hedge Funds wanted to piggyback, they would ask about a specific mutual fund or request a new place to trade. (Tr. 375.) STC would find a retirement plan with enough assets to be able to hide their trades.[27] (Tr. 272-73, 376; Div. Ex. 192.) It would also analyze the retirement plan's trading patterns, so the Hedge Fund could better hide its trades. (Tr. 268-75; Div. Exs. 64BE, 64N.) STC then assigned to Canary or Samaritan an account number that attached it to the retirement account.[28] (Tr. 260, 376.) The process of posting the audited price file and receiving the trade file from the TPAs then occurred, as previously discussed. (Tr. 260.) When STC received the trade files from the TPA and the Hedge Fund, they would be aggregated and sent to NSCC as a single trade file under the name of the retirement plan. (Tr. 260-61, 376.) After STC received settlement from the mutual fund, it would settle the trades in the appropriate accounts. (Tr. 377.) Neither Canary nor Samaritan were retirement plans, but each was aware that it was trading "on the backs" of such plans. (Tr. 261-65, 382.) STC was aware that piggybacking violated "the representations [it has] made to the funds [that enabled STC] to get . . . [CDSC] waivers for retirement plans." (Resp. Ex. 82.)

McDermott testified that when mutual funds detected market-timing trades in the piggybacked accounts, they contacted STC.[29] (Tr. 347-49.) McDermott and others, at Seeger's direction, informed the mutual funds that the accounts contained retirement assets and that STC simply transmitted trades made by another party. (Tr. 348-49.) She also told the mutual funds

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[27] At some point, Seeger proposed making all retirement plan accounts at STC available for piggybacking. (Tr. 273-74; Div. Exs. 64E, 107.) This method would have increased the capacity of the Hedge Funds and decreased the likelihood that the Hedge Funds' market-timing trades would be detected. (Tr. 274-75.) JCM was very interested in this strategy but, ultimately, it was never used. (Tr. 275-76, 282-83; Div. Exs. 64E, 107.)

[28] As identified in note 25, supra, STC had an alpha-numeric system for tracking the piggybacked trades and the accounts in which such trades occurred. (Tr. 266-67.) The numeric portion of the account number for the Hedge Funds would be the same as the account number for the piggybacked retirement plan. (Tr. 267.) The account would have a letter prefix if it was used to piggyback trades. The account would also have a letter suffix if the Hedge Fund used multiple accounts to piggyback. (Tr. 267.)

[29] In fact, almost every mutual fund timed by Samaritan and Canary had contacted STC at one point or another. (Tr. 350.)

that she would inform STC's clients about the funds' trading limits.[30] (Tr. 348-49, 362.) These responses were not accurate. (Tr. 349.)

Seeger told McDermott and others that piggybacking was a form of omnibus trading and a common practice, and she believed him.[31] (Tr. 342-44.) As time passed, however, McDermott and others became concerned that it was "dangerous game to be involved in," because retirement assets were at risk. (Tr. 261-64, 343-44.) She informed JCM of her concerns with this practice. (Tr. 345.) Ultimately, she relayed her concerns to Seeger and Kenyon, who told her that the practice was not illegal. (Tr. 300-01.) She also consulted with Luntz and two of STC's outside directors. (Tr. 300-03.) No one informed her that piggybacking was illegal. (Tr. 300-03.) At the hearing, McDermott classified piggybacking and the other trading strategies employed at STC as business decisions, which sometimes were not great ones, but not violations of the law. (Tr. 383.)

Seeger seemed to be a reputable businessman, but he also had a reputation for bending the rules. (Tr. 342.) No one at CIBC was informed of Seeger's reputation. (Tr. 342.) Although Flynn met with McDermott on his due diligence trip to STC, McDermott does not recall meeting or speaking to Flynn. She never told him that STC's platform should not be used by Canary or Samaritan. (Tr. 337.) Most of McDermott's dealings with CIBC were with Haas. (Tr. 347.) She never informed Haas about any of her concerns regarding the trading platform or piggybacking. (Tr. 347.) She is not aware of anyone at STC who advised CIBC that these Hedge Funds should not use the trading platform. (Tr. 337.)

According to McDermott, Samaritan and Canary expected that all redemption fees would be waived for their piggybacked trades. (Tr. 266, 382.) In some cases, however, these fees were not waived. (Tr. 265-66.) Although the Hedge Funds complained, STC did not attempt to recoup the fees from the mutual funds. (Tr. 266, 277-79; Div. Ex. 64ES.)

As a result of its relationships with Canary and Samaritan, STC earned between $80,000 and $120,000 per month from the asset base fee. (Tr. 290.) It also earned 4% of each Hedge Fund's trading profits. (Tr. 291; Div. Ex. 64BG.) During McDermott's time at STC, it more than tripled its amount of assets under management.[32] (Tr. 275.)

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[30] No one at STC read the mutual funds' prospectuses, so they did not know the funds' limits on purchases and sales until the funds contacted STC about the market-timing trades. (Tr. 361.)

[31] McDermott believed what Seeger told her. For example, in a letter to Samaritan in August 2001, McDermott represented that the piggybacking strategy did not violate any existing regulation to which STC was subject. (Tr. 339-41; Resp. Ex. 228.) McDermott obtained this representation from Seeger. (Tr. 340.)

[32] On March 30, 2004, the United States District Court for the District of Arizona entered a final judgment against STC, with its consent, based on the facts involved in this proceeding. The final judgment ordered, among other things, STC to pay $5.8 million in disgorgement, plus $1,589,045.35 in prejudgment interest, all but $1 million of which was waived based on STC's inability to pay. (Div. Ex. 77.) McDermott consented to entry of an order permanently enjoining

Submission of Trade Files to STC

Like the TPAs of retirement plans, Canary and Samaritan submitted their trade files to STC once per day, and that file contained all of their trading for that day. (Tr. 220.) STC created and produced documents that recorded Canary's trading activity at STC during 2002 and 2003 and Samaritan's trading activity at STC during 2001 through 2003.[33] (Tr. 200, 294-296; Div. Exs. 66-70.) Included therein are trades conducted by Canary and Samaritan in the CIBC-financed accounts. (Div. Exs. 66-70, 177, 197.)

STC also created and produced documents that identify the time Canary and Samaritan submitted their trade files to STC. (Div. Exs. 71-72 (Samaritan), 73 (Canary).) The time reported is the Arizona, or Mountain, time. (Tr. 202-06, 293-96.) Daylight saving time is not observed in Arizona. As such, when daylight saving time is in effect, Mountain time is three hours earlier than Eastern time and two hours earlier when it is not in effect.[34]

During 2002 and 2003, Canary submitted its trade files to STC on 347 days. Of these 347 days, 260 were days on which Canary traded in a CIBC-funded account. Canary submitted its trade files to STC after 4:00 p.m. Eastern time on 257 of these 260 days. (Div. Exs. 66-70, 73.) During 2001 through 2003, Samaritan submitted its trade files to STC on 503 days. Of these 503 days, 363 were days on which Samaritan traded in a CIBC-funded account. Samaritan submitted its trade files to STC after 4:00 p.m. Eastern time on 228 of these 363 days. (Div. Exs. 66-72.)

Frequent Trading at Wasatch and Fidelity funds

Wasatch

Eric Bergeson (Bergeson) testified as a Division witness. Bergeson has been employed with Wasatch Advisors since July 1998, serving as a vice president and the director of marketing since 2001. (Tr. 389-90.) Bergeson oversees all marketing, sales, and client relation activities. He also supervises operations and third-party providers of operational services that support the mutual funds, such as the transfer agent and custodian. (Tr. 390-91.)

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her from future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. (Div. Ex. 78.) McDermott also pleaded guilty to a criminal charge of misrepresenting to mutual funds that the piggybacked accounts were solely retirement accounts. (Tr. 297.)

[33] These trading records identify the quantity of mutual funds' shares that were bought or sold, the net amount of the transaction, and the trade date and settlement date. They also identify the NAV paid or received, but do not identify whether that NAV was determined before or after the Hedge Funds' orders were placed.

[34] In 2001, daylight saving time was in effect from April 1 through October 28. In 2002, it was in effect from April 7 through October 27. In 2003, it was in effect from April 6 through October 26. See 17 C.F.R. § 201.323.

Bergeson testified that there are three methods by which shares of the Wasatch funds can be purchased or sold. (Tr. 392, 445.) The first is where an individual or entity invests directly, without using any intermediary or third party. (Tr. 392, 445.)

The second method is where the investor's order is sent through a financial intermediary. (Tr. 392, 445.) Wasatch refers to these as omnibus relationships, because it receives just one consolidated order and is not able to identify any individual account holder. (Tr. 392, 409.) Wasatch would not see the individuals' accounts on their system; it would see only one aggregated omnibus account representing, for example, Charles Schwab. (Tr. 392, 409) Schwab would maintain all the recordkeeping of the individuals' accounts on their system. (Tr. 392, 409.) Omnibus accounts are a normal and legal business practice. (Tr. 410.)

The third method is a different form of omnibus relationship. (Tr. 392-93, 412, 423.) It involves orders transmitted from intermediaries or third parties through the NSCC, which then transmits the orders to the funds in the late evening. (Tr. 445-47.) Unlike the second method, the fund would see the individual accounts rather than seeing only one omnibus account. (Tr. 392-93.) That is, the individual accounts are maintained on the mutual fund's system, as opposed to the intermediaries' system. (Tr. 411.) However, if a pension or retirement plan had an account, Wasatch would not be able to see the account activity of any individual member of the plan. (Tr. 412, 423, 464-68, 498-99.) STC transmitted orders to Wasatch in the UA Local 467 retirement plan account using this method. (Tr. 393-94.)

Wasatch typically set the NAV of its funds as of the close of trading on the New York Stock Exchange, generally 4:00 p.m. Eastern time. (Tr. 425-26; Div. Exs. 170A-170D.) STC's service agreement with Wasatch required it to calculate, on each day, the net aggregate of all purchase and sales orders it had received prior to 4:00 p.m. Eastern time. The agreement further provided that any orders that STC received after 4:00 p.m. Eastern time shall be transmitted the next day and shall be executed at the NAV calculated at 4:00 p.m. Eastern time on that following day. (Div. Ex. 170E.) Bergeson considered STC to be an "investment professional" through which shares in Wasatch funds could be purchased, as that term is used in Wasatch's prospectuses. (Tr. 404-05; Div. Exs. 170A-170D.)

Wasatch has been actively engaged in trying to prevent frequent trading in its funds for a number of years. (Tr. 396-97.) Starting in approximately 1999, Wasatch worked with entities that had omnibus accounts to identify instances of frequent trading and to prohibit those individuals from further trading in Wasatch's funds. (Tr. 397-99.) This method proved to be ineffective.

Wasatch's 2000 prospectus stated: "You may make four exchanges out of each fund during a calendar year, excluding automatic monthly exchanges. Exchange requests may be subject to other limitations, including those relating to frequency that Wasatch funds may establish to ensure that exchanges do not disadvantage shareholders or the funds." (Tr. 403; Div. Ex. 170A.) It also reserved the right to reject any purchase order. (Div. Ex. 170A.) According to Bergeson, the term "exchange" also encompassed redemptions. (Tr. 414-15, 419.) However, the prospectus later uses the term "redeem" to mean sell. (Tr. 416.) Bergeson admitted that the

language should be clearer. (Tr. 415.) Although the prospectus limited the number of exchanges per year to four, Wasatch made exceptions for pension and retirement plans. This exception was not contained in the prospectus. (Tr. 419-20.)

Wasatch's 2001 through 2003 prospectuses contained the same limiting language set forth above. These documents also stated that Wasatch would impose a 2% redemption fee on sales or exchanges that occurred within 60 days of a purchase. (Tr. 398-401, 405; Div. Exs. 170B-170D.) The purpose of the redemption fee was to "make it cost prohibitive for somebody to [market time] our funds," and to offset the costs borne by long-term shareholders. (Tr. 398, 401.) Wasatch exempted retirement and pension plans from this fee although it was not required to do so. (Tr. 401, 412, 421; Div. Exs. 170B-170D.)

After September 2003, Bergeson discovered that Wasatch had a service agreement with STC, dated February 15, 2001. (Tr. 395-96; Div. Ex. 170E.) He also discovered an unusually high amount of trading activity in one of STC's accounts. (Tr. 395-96, 407.) Specifically, the account records for UA Local 467, a pension plan, evidenced a high frequency of trading one or two days apart with identical share volumes. For example, a purchase of 7000 shares one day, then a sale of the same number of shares a day or two later. (Tr. 395-96, 406-08.) Bergeson characterized the trading in the UA Local 467 account as a "blatant example of market timing," because the same number of shares, to the third decimal point, were purchased and then sold. (Tr. 406-07; Div. Ex. 170G.) He could not, however, characterize the trading as fraudulent. (Tr. 422-23.)

Wasatch did not closely monitor pension or retirement plan accounts and never detected the frequent trading in this particular account. (Tr. 396-97, 400, 407.) No redemption fees were assessed on the trades because it was a pension plan. (Tr. 408.) Given the nature of UA Local 467's account, Wasatch was unable to see who was trading, but it expected that only retirement plan participants traded in the account. (Tr. 407-12, 423-24.)

Samaritan piggybacked the UA Local 467 retirement plan account to market time Wasatch's funds. (Tr. 270-71; Div. Exs. 101, 102.) Samaritan piggybacked this plan in account n2508a, which was a CIBC-financed account. (Div. Exs. 101, 102, 177.) Canary only piggybacked in accounts n2218a and n2299a. (Div. Exs. 101, 102; Tr. 372-73.) Neither of these accounts was funded by CIBC. (Div. Exs. 102, 177.)

<u>Fidelity</u>

Charles Poirer (Poirer) was also called as a Division witness. Poirier is a senior vice president for Fidelity Investments and has worked in Fidelity's client services division for more than seven years. (Tr. 443-44.) This division serves as Fidelity Funds' transfer agent, in that it has recordkeeping and shareholder accounting responsibilities. (Tr. 444-45.) Poirer testified that shares of Fidelity's funds can be purchased in the same three methods as Wasatch's. (Tr. 445-47.) STC transmitted orders to Fidelity in the LAM Research retirement plan account in the same manner as it transmitted orders to Wasatch in the UA Local 467 account. (Tr. 464-68, 498-99.)

Fidelity's prospectuses stated that it normally calculates the NAV of its funds' shares as of the close of business of the New York Stock Exchange, which normally is 4:00 p.m. Eastern time. (Div. Exs. 169, 169A-169O.) Fidelity typically makes its NAV available between 6:00 p.m. and 6:30 p.m. Eastern time. (Tr. 449, 483.) Poirer believes that mutual fund intermediaries must receive orders no later than 4:00 p.m. Eastern time. (Tr. 447-48, 483, 501-02.) If an intermediary receives an order after that time, it should get the next day's NAV. (Tr. 448.) Poirer understands "late trading" to mean placing an order after 4:00 p.m. Eastern time while still receiving that day's NAV. (Tr. 450.)

Fidelity sells its shares through financial intermediaries and investment professionals, such as banks, broker-dealers, and entities similar to STC. (Tr. 446-47, 462; Div. Exs. 169, 169A-169O.) It did not name in its prospectus each intermediary from whom its shares could be purchased because such a large number of names would be impractical. (Tr. 463.) In fact, to Poirer's knowledge, no mutual fund included all the names of investment professionals from whom their shares could be purchased. (Tr. 463.) Instead, other funds included the same general language that Fidelity had in its prospectus. (Tr. 463.)

Poirer testified that in 1999, Fidelity began limiting the frequency of trades in its funds. (Tr. 454.) Fidelity had language in each prospectus from 1999 through 2003 concerning frequent trading, which reads as follows. (Tr. 460-61, 479; Div. Exs. 169, 169A-169O.) Short-term or excessive trading may harm performance by disrupting management strategies and increasing expenses. Accordingly, the fund may reject any purchase orders, including exchanges, particularly from market timers or investors who, in Fidelity's opinion, have a pattern of short-term or excessive trading or whose trading has been or may be disruptive to the fund. (Div. Exs. 169, 169A-169O.)

It had different, undisclosed controls for omnibus accounts versus non-omnibus accounts. (Tr. 455-56.) In non-omnibus accounts in 1999, Fidelity limited purchases and redemptions to $250,000 with a holding period of less than 30 days. (Tr. 456.) It gradually lowered the dollar threshold to $50,000 for domestic funds and $25,000 for international funds by 2003. (Tr. 456.) The threshold currently stands at $1,000. (Tr. 457.) If Fidelity detected market timing in a non-omnibus account, its first response was a warning letter. The second offense resulted in a 90-day account suspension, while the third offense resulted in permanent account suspension. (Tr. 458.)

Market timing in omnibus accounts was more difficult to detect because multiple shareholders are aggregated into one account. From 1999 through 2003, Fidelity limited purchases and redemptions within a 30-day period to $250,000. In 2003, it lowered the dollar threshold to $100,000. If Fidelity detected market timing in an omnibus account, its first response was a warning letter. If multiple warning letters did not result in the cessation of market timing, then Fidelity would freeze the account. Fidelity would also communicate directly with the intermediaries. (Tr. 455-59.)

The language in Fidelity's prospectus is permissive; it may, or may not, reject any trade. (Tr. 476-77.) Fidelity did not include language in its prospectuses about the dollar or holding period thresholds because it believed it would provide a road map to market timers for how to

get under those requirements. (Tr. 462, 478, 488-89.) As a result, no one outside of Fidelity was aware of these limits. (Tr. 477-78.)

STC had several accounts with Fidelity, including LAM Research, a retirement plan. (Tr. 464-65.) Fidelity detected market timing in the LAM Research account, and Poirer's group communicated with STC to have it stopped. (Tr. 464-65.) Because the account was a retirement plan, Fidelity had concerns about freezing the account or rejecting trades, due to ERISA rules.[35] As a result, it opted to communicate with STC in order to cease the market timing.[36] (Tr. 465, 470, 481, 490.) These communications spanned several months and included documents identifying the trades and other account-related information. (Tr. 465, 469-72, 495; Div. Exs. 169R, 169U.) STC assured Fidelity that it would stop it, but the activity never ceased. (Tr. 466, 470-71.) Poirer described it as a frustrating experience. (Tr. 466.)

Fidelity was never informed that nonparticipants were making the market-timing trades in the LAM Research account. (Tr. 472.) It assumed that only plan participants traded in the account. (Tr. 472-74.) If Fidelity had known that nonparticipants were responsible for the trading, it would have taken "very different action." (Tr. 475.) Due to the nature of the LAM Research account, Fidelity could not have known that a nonparticipant was conducting the trades at issue. (Tr. 468, 498-99.)

Samaritan piggybacked the LAM Research retirement plan account to market time Fidelity's funds. (Tr. 270-71; Div. Exs. 101, 102.) Samaritan piggybacked this plan through account n2417a, which was a CIBC-financed account. (Div. Exs. 101, 102, 177.)

CONCLUSIONS OF LAW

The OIP alleges that Flynn aided and abetted and caused violations by STC, the Hedge Funds, and others, of Section 17(a) of the Securities Act, Exchange Act Section 10(b) and Rule 10b-5, and Rule 22c-1 under the ICA, by substantially assisting deceptive market timing and late trading.

To show that a respondent willfully aided and abetted the violation of another, the Division is required to establish three elements: (1) another party has committed a primary violation; (2) the alleged aider and abetter has a general awareness that his or her role was part of an overall activity that was improper or illegal; and (3) the alleged aider and abettor knowingly and substantially assisted the primary violation. See Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000) (collecting cases); Monetta Fin. Srvcs., Inc. v. SEC, 390 F.3d 952, 956-57 (7th Cir. 2004); Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990); PIMCO Advisors, 341 F. Supp. 2d at 467-69; Orlando Joseph Jett, 82 SEC Docket 1211, 1256 & n.46 (Mar. 5, 2004). Proving willful conduct requires a showing of intent to commit the act that constitutes the violation, not intent to violate. Wonsover v. SEC, 205 F.3d 408, 413-15 (D.C. Cir. 2000); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976).

[35] STC had other accounts that were not retirement plans in which trading was frozen by Fidelity due to excessive trading. (Tr. 481.)

[36] Fidelity could have canceled its distribution agreement with STC. (Tr. 465, 481, 490.)

Primary Violations

Deceptive Market Timing in Violation of the Antifraud Provisions

Section 17(a) of the Securities Act proscribes fraudulent conduct in the offer or sale of securities. Exchange Act Section 10(b) and Rule 10b-5 proscribe fraudulent conduct in connection with the purchase or sale of securities. These provisions prohibit essentially the same type of conduct. See United States v. Naftalin, 441 U.S. 768, 773 n.4 & 778 (1979); PIMCO Advisors, 341 F. Supp. 2d at 469. To establish a violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, the Division must show: (1) misrepresentations or omissions of material facts, or other fraudulent devices; (2) made in connection with the offer, sale, or purchase of securities; and (3) that the respondent acted with scienter. Scienter is not required for violations of Sections 17(a)(2) or 17(a)(3) of the Securities Act; instead, negligence is sufficient to establish liability. Aaron v. SEC, 446 U.S. 680, 697 & 701-02 (1980); PIMCO Advisors, 341 F. Supp. 2d at 469; SEC v. Solucorp Indus., 274 F. Supp. 2d 379, 419 (S.D.N.Y. 2003); SEC v. Scott, 565 F. Supp. 1513, 1525-26 (S.D.N.Y. 1983).

Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). It may be established by a showing of recklessness. Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990); David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997). Recklessness is defined as "an extreme departure from the standards of ordinary care . . . present[ing] a danger of misleading buyers or sellers that is either known to the [respondent] or is so obvious that the [respondent] must have been aware of it." Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044-45 (7th Cir. 1977) (citation omitted), cert. denied, 434 U.S. 875 (1977). Proof of scienter can be demonstrated by circumstantial evidence. Herman & MacLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983).

A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision and would view disclosure of the omitted fact as having significantly altered the total mix of information made available. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Courts have interpreted broadly the requirement of Exchange Act Section 10(b) and Rule 10b-5 that violations must occur "in connection with" the purchase or sale of a security. See SEC v. Zandford, 535 U.S. 813, 819-25 (2002); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971); In re Ames Dep't Stores, Inc., Stock Litig., 991 F.2d 953, 964-65 (2d Cir. 1993). The jurisdictional requirements of the antifraud provisions are also interpreted broadly. See SEC v. Softpoint, Inc., 958 F. Supp. 846, 865 (S.D.N.Y. 1997), aff'd, 159 F.3d 1348 (2d Cir. 1998).

Market timing itself is not illegal. DH2, 422 F.3d at 592; Mutual Funds Investment Litig., 384 F. Supp. 2d at 856; PIMCO Advisors, 341 F. Supp. 2d at 458, 468; Disclosure Regarding Market Timing, 2003 SEC LEXIS at *13. Rather, the fraudulent scheme involving

market timing is found in the activities that surround the practice. These include the associated misrepresentations, omissions, or other deceptive devices designed to conceal market timing activity and elude a mutual fund's detection. See SEC v. Gann, 2006 U.S. Dist. LEXIS 9955 at *17-21 (N.D. Tex. 2006); SEC v. Druffner, 353 F. Supp. 2d 141, 146-51 (D. Mass. 2005); Mutual Funds Investment Litig., 384 F. Supp. 2d at 856-65; see also Alan R. Bromberg and Lewis D. Lowenfels, 6 Bromberg & Lowenfels on Securities Fraud and Commodities Fraud § 16:6 (2d Ed. 2004). Accordingly, the relevant inquiry here is whether, while practicing market timing, STC and the Hedge Funds engaged in deceptive practices that violated the antifraud provisions of the federal securities laws. See Gann, 2006 U.S. Dist. LEXIS 9955 at *17-21.

Beginning no later than summer 2000, STC, Canary, and Samaritan began implementing four market-timing trading strategies in response to detection of the Hedge Funds' market-timing trades by mutual funds. The Division alleges that, during the relevant period, these four trading strategies deceived mutual funds because they enabled STC, Canary, and Samaritan to evade mutual funds' efforts to detect and prevent market timing. (Div. Post-Hearing Br. at 27-32, 41-46; Div. Reply Br. at 18-21.) The four strategies were described by McDermott as the "shotgun method," the "rotating omnibus method," the "rotating tax identification numbers method," and the "piggybacking method." The purpose of these strategies was to avoid further detection and enable the Hedge Funds to continue market timing. These strategies evolved based on which methods succeeded and which did not.

According to McDermott, the shotgun strategy allowed Samaritan and Canary to trade through one account each. Trading in this manner was detected quickly by mutual funds. In the rotating omnibus method, the Hedge Funds each had five accounts with the same tax identification number, through which they could trade one time per week, with the trades being spread out over the five accounts. The rotating tax identification numbers strategy was substantially similar, except that each of the five accounts was assigned a different tax identification number. Finally, the piggybacking method involved combining, in one account, the Hedge Funds' market-timing trades with trades from a retirement plan's participants.

While I find McDermott's description of these trading strategies to be credible, the trading records for Canary and Samaritan do not document whether different tax identification numbers were used for their CIBC-financed accounts. These records also do not indicate which CIBC-financed trades were made by the shotgun method. However, the documentary evidence corroborates that STC and the Hedge Funds' employed the rotating omnibus and piggybacking methods while using CIBC-financed accounts.

The rotating omnibus method was intended to deceive mutual funds into accepting market-timing trades by limiting the amount of each trade and the frequency an account was used. This purpose was apparently achieved, as evidenced by the Hedge Funds' trading records, which show numerous omnibus accounts purchasing and redeeming mutual fund shares approximately once per week.

Like the other three trading strategies, piggybacking was developed by STC and Samaritan to defeat mutual funds' detection of market timing. To achieve this goal, STC provided Samaritan with retirement plans' actual trading activity so that it could better disguise

its own trades. Then, STC, in collaboration with Samaritan, blended Samaritan's market-timing trades with the trades of a retirement plan's participants.[37] All trades were then sent to Wasatch in the account of UA Local 467 or to Fidelity in the account of LAM Research. However, Wasatch and Fidelity were unable to isolate the trading activity for any individual in these accounts. This meant they were unable to determine whether a nonparticipant was trading, but, as Bergeson and Poirer testified, they expected that only plan participants were conducting trades. Under these circumstances, submitting trades in this manner was an implicit representation that all trades were from participants in the retirement plan.

Therefore, STC and Samaritan, acting with scienter, falsely represented to Wasatch and Fidelity that Samaritan's trades were made by a retirement plan participant. The failure to disclose Samaritan's true identity was material, as a reasonable investor would view the fact that a hedge fund was deceptively market timing in a retirement plan's account as having altered the total mix of available information. STC allowed Samaritan to piggyback through 2003. It had ample motive to do so, as it received a portion of the trading profits in addition to its usual fees.

Flynn argues that piggybacking did nothing to inhibit Fidelity's detection of market timing, as it detected most, if not all, of Samaritan's trades. However, Fidelity processed these trades only because it believed they originated from a retirement plan participant. Had it been aware of the true identity of the trader, it would have taken very different action.

Flynn further argues that Wasatch did not monitor for frequent trading in its funds, opting instead to assess a redemption fee. Thus, according to Flynn, piggybacking did not deceive Wasatch. I disagree. Bergeson credibly testified that Wasatch monitored for frequent trading in its funds, with retirement accounts subject to somewhat less scrutiny. Even if Flynn were correct, however, only retirement plan participants were exempted from paying Wasatch's redemption fee. Samaritan would not have been entitled to this benefit without piggybacking its trades. Indeed, as McDermott testified, one purpose of piggybacking was that it enabled Samaritan to avoid redemption fees.

Further evidence of STC's scienter is found in its dealings with the mutual funds that detected market timing in piggybacked accounts. When mutual funds' detected the trades and contacted STC, the response they received was deceptive. As McDermott testified, STC's employees falsely informed the mutual funds that the piggybacked accounts only contained retirement plan assets. STC also assured Fidelity that it would stop the frequent trading in the LAM Research account but did not do so. This failure to act establishes STC's intent to continue to hide the scheme from the mutual funds and prevented the mutual funds from taking corrective action. It also undoubtedly enabled deceptive market-timing trading to continue longer than it would have otherwise.

Based on the foregoing, I conclude that the trading strategies discussed above constituted a scheme and involved deceptive practices by STC and the Hedge Funds that violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

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[37] Only Samaritan used this strategy in accounts financed by CIBC.

Rule 22c-1 under the ICA

Rule 22c-1(a) under the ICA, also known as the "forward pricing" rule, requires mutual funds, their principal underwriters, dealers, and any person designated in the fund's prospectus as authorized to consummate transactions in the fund's securities, to sell and redeem fund shares at a price based on the NAV next computed after receipt of an order to buy or redeem. ICA Rule 22c-1(b) generally requires mutual funds to compute their NAVs at least once daily, Monday through Friday, at a specific time or times as set by their board of directors.

Before addressing whether the rule was violated, I will determine whether the rule applies to the alleged primary violators, as charged in the OIP. STC was not specifically designated in Wasatch's or Fidelity's prospectus as authorized to consummate transactions in the funds' shares. Instead, the prospectuses used generic terms like "investment professionals" to denote such entities, because it was impractical to include every intermediary. As Bergeson and Poirer testified, this practice is common, if not universal, in the mutual fund industry, and the generic language covers STC. I credit their testimony and conclude that ICA Rule 22c-1 applies to STC.

I reach a different conclusion regarding the rule's applicability to Canary and Samaritan. ICA Rule 22c-1, by its terms, requires only mutual funds and their intermediaries to sell or redeem mutual fund shares at the NAV next computed after an order is received. Thus, it imposes a legal duty only on certain specified parties. No evidence has been introduced to establish that hedge funds such as Canary or Samaritan qualify as one of the designees set forth in the rule. Accordingly, I conclude that Canary and Samaritan are not covered by Rule 22c-1 under the ICA.[38]

Having concluded that STC is subject to Rule 22c-1, I will now determine whether it violated the terms of that rule. ICA Rule 22c-1(a) requires the sale of mutual fund shares at a price based on the current NAV that is next computed after receipt of an order to purchase or sell. The time of receipt of an investor's order by an intermediary, rather than the time of receipt by the fund or the underwriter, is the time for determining the price the order will receive.[39] See Adoption of Rule 22c-1 under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase, and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders, Investment Company Act Release No. 5519, 1968 SEC LEXIS 171 at *5-7 (Oct. 16, 1968) (Adoption of Rule 22c-1). Thus, an investor's order must be priced based on the mutual fund's NAV that is next computed after the intermediary receives that order.[40]

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[38] The Division agreed with this determination at Oral Argument. (OA Tr. 6-7.)

[39] These intermediaries are then permitted to forward the order information to NSCC or fund primary transfer agent at a later time.

[40] Flynn argues that no late trading occurred because all of the Hedge Funds' orders were requested before 4:00 p.m. Eastern time, as evidenced by the addendums they executed, regardless of when the Hedge Funds actually submitted their trade files. (Resp. Post-Hearing Br. at 80-83.) The addendums certified that all trading instructions delivered to STC on any business day would be received by the Hedge Funds from the client shareholders by 4:00 p.m. Eastern

The parties dispute the meaning of "NAV that is next computed." The Division argues that it means the NAV *as of* the time the mutual fund sets for its calculation. (Div. Post-Hearing Br. at 34-39.) Flynn contends that it means the time at which the mutual fund actually performs or completes its NAV calculation. (Resp. Post-Hearing Br. at 83.)

Under Rule 22c-1(b), mutual funds must calculate their NAVs at least once daily at the specific time or times of their choosing. Mutual funds, including Wasatch and Fidelity, generally calculate their NAVs once each day as of 4:00 p.m. Eastern time, by using the closing prices of the mutual funds' portfolio securities on the exchange or market on which such securities trade. DH2, 422 F.3d at 592; Disclosure Regarding Market Timing, 2003 SEC LEXIS at *5-9. However, Wasatch and Fidelity do not complete their NAV calculation until several hours after the market has closed. (Tr. 425, 449-50, 483.)

Although it may be argued that the phrase "NAV that is next computed" is ambiguous, the Commission has consistently stated that ICA Rule 22c-1 is designed to eliminate or reduce any dilution of the value of outstanding fund shares that may occur through the practice of backward pricing, which involves selling and redeeming fund shares at a price based on a previously determined NAV. Another purpose of the rule is to prevent speculative traders from making short-term trades based on the knowledge that the value of a mutual fund's portfolio securities is not yet reflected in the fund's NAV. Adoption of Rule 22c-1, 1968 SEC LEXIS at *1-4; Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, 27 SEC Docket 1349, 1351 (Apr. 22, 1983). In sum, Rule 22c-1 is intended to reduce riskless short-term trading in mutual funds by eliminating the ability to use late-breaking news to take advantage of NAVs fixed before that news was released to the markets. See United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 710 n.19 (1975); DH2, 422 F.3d at 593.

Because mutual funds use the closing prices of their portfolio securities in calculating the NAV, news released after the markets close would not be reflected in that day's closing price or NAV. Therefore, accepting Flynn's position would undermine the purpose of the rule, as investors could take advantage of news released after the markets have closed. Furthermore, Flynn's argument is at tension with the rule's language, which requires the NAV calculation to be set for a *specific* time or times. Interpreting "NAV that is next computed" to mean when the computation is completed would read that language out of the rule, because the completion time

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time. McDermott testified that STC obtained the addendums because its custody agreements with the Hedge Funds excluded the language that STC required of its TPAs.

This approach does not, however, address the different trading procedures of TPAs and the Hedge Funds. TPAs operate as agents for retirement plans, aggregating the orders submitted by a plan's participants. Thus, the plan's participants, not the TPAs, made the investment decision by 4:00 p.m. The Hedge Funds, through their advisers, made their own investment decisions, which were sent to STC after 4:00 p.m. They did not merely pass along orders submitted to it by its shareholders. Accordingly, I do not credit the addendums as evidence that the Hedge Funds' trading decisions were made by 4:00 p.m. Eastern time.

varies from day to day. (Tr. 425, 449-50, 483.) In contrast, the Division's interpretation is consistent with the rule's language and its purpose. Accordingly, I conclude that the "NAV that is next computed" means the time as of which the mutual fund sets for its calculation. Here, that time is 4:00 p.m. Eastern time.

Therefore, under ICA Rule 22c-1, orders to buy or redeem shares of a mutual fund placed at or before 4:00 p.m. Eastern time on a given day must receive that day's NAV, but orders placed after 4:00 p.m. Eastern time must be priced at the NAV that is calculated the following day. As such, to establish that STC violated Rule 22c-1, the evidence must show that Canary or Samaritan submitted orders to STC after 4:00 p.m., but were allowed to receive the NAV already determined as of 4:00 p.m. that same day.

STC routinely received Canary's and Samaritan's orders after 4:00 p.m. Eastern time. Thus, the remaining question is whether these orders received the NAV calculated as of 4:00 p.m. that same day. The purchase and sale reports identify the price received for each purchase and redemption. These reports do not, however, indicate whether the price received is the NAV previously computed as of 4:00 p.m. or some other NAV. Despite the lack of documentary evidence on this point, the sheer volume of orders that Canary and, to a lesser extent, Samaritan submitted after 4:00 p.m. supports an inference that STC allowed the Hedge Funds to receive the previously calculated NAV. Accordingly, I conclude that STC violated ICA Rule 22c-1.

Late Trading In Violation of the Antifraud Provisions

I have concluded that ICA Rule 22c-1 does not apply to the Hedge Funds. However, I further conclude that STC's and the Hedge Funds' late trading described above was a scheme, practice, or course of business intended to defraud mutual funds and their shareholders. See Mutual Funds Investment Litig., 384 F. Supp. 2d at 856; see also SEC v. U.S. Environmental, Inc., 155 F.3d 107, 111 (2d Cir. 1998) (holding that knowledge of and participation in a fraudulent scheme or other activity proscribed by the securities laws gives rise to primary liability under the antifraud provisions); SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1471 (2d Cir. 1996) (same); PIMCO Advisors, 341 F. Supp. 2d at 468-69 (same).

Submitting orders to mutual funds for execution at that day's NAV is a representation that the orders were received by the intermediary prior to the fund's NAV calculation. That representation by STC and the Hedge Funds was false. Although the Hedge Funds gave STC addendums representing that all trades preceded 4:00 p.m., they knew the addendums were not applicable and that STC allowed them to receive an improper NAV. Accordingly, I conclude that Canary, Samaritan, and STC acted with scienter and willfully participated in the fraudulent late-trading scheme in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

Awareness of Deceptive Market Timing and Late Trading

I have concluded that STC and the Hedge Funds violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder as a result of their deceptive

market timing and late trading. I have also concluded that STC violated Rule 22c-1 under the ICA. The remaining issue is whether Flynn aided and abetted these violations.

The Division's theory that Flynn aided and abetted the primary violations is essentially as follows. Flynn knew that market timing depended on concealment and deception, having financed the practice since 1998. After STC provided CIBC with information about the trading platform, Flynn recognized the late-trading and market-timing opportunities that it offered to Canary and Samaritan. Recognizing these benefits, he repeatedly "pushed" Credit Risk to approve STC during the year preceding his due diligence trip. However, Credit Risk refused his requests due to concerns about the safety and control of CIBC's collateral.

Frustrated by these continued rejections, Flynn proposed the trip to STC. He ultimately traveled alone at an "inconvenient time," to an "inconveniently located business" that had a far smaller asset base than any other custodian used by CIBC. He summarized his findings in a memorandum, which he then circulated to Lagroix, Lobo, Deutsch, and Haas. The Division contends that this memorandum is evidence that Flynn knew that Canary and Samaritan would use CIBC's funding to engage in deceptive market timing and illegal late trading. Ultimately, his "extraordinary" efforts overcame continued resistance by Credit Risk, which approved STC in early 2002.

The "awareness of wrongdoing" element for an aiding and abetting violation is "designed to insure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh . . . administrative penalties." Investors Research Corp. v. SEC, 628 F.2d 168, 177 (D.C. Cir. 1980.) Therefore, it must be established that, inter alia, Flynn had a general awareness that his role was part of an overall activity that was improper or illegal.

Awareness of wrongdoing means knowledge of wrongdoing. Howard v. SEC, 376 F.3d 1136, 1142 (D.C. Cir. 2004). The Commission has held that a showing of recklessness is sufficient to satisfy the scienter requirement for aiding and abetting liability. See Sharon M. Graham, 53 S.E.C. 1072, 1080-85 & n.33 (1998); Russo Sec., Inc., 53 S.E.C. 271, 278-79 & n.16 (1997). The Court of Appeals for the District of Columbia Circuit has held that "extreme recklessness" may support aiding and abetting liability. Extreme recklessness may be found if the respondent encountered "red flags" or "suspicious events creating reasons for doubt" that should have alerted him to the improper conduct of the primary violator, or if there was a danger so obvious that the respondent must have been aware of it. Howard, 376 F.3d at 1143.

Under either test, the evidence in this record fails to establish that Flynn was generally aware of playing any role in STC's or the Hedge Funds' illegal activities.

The three loans to Samaritan that Flynn signed for CIBC during the period May 1999 through March 2001 were expressly for the purpose of market timing, as was Canary's January 2002 loan. Everyone at CIBC was aware that the Equity Arbitrage Group was financing hedge funds' market timing. No one objected to the practice. Flynn knew that some mutual funds discouraged market timing, while others tolerated the practice. He also knew that market timers sought to keep their trades undetected by mutual funds. Yet, before and during the relevant period, no one at CIBC considered the practice to be illegal.

Samaritan and Canary began implementing their trading strategies at STC in summer 2000, several months before Samaritan brought STC to the attention of the Equity Arbitrage Group. Haas initially requested Credit Risk to approve STC as custodian for CIBC funds in November 2000. Seeger, at Haas' request, sent various due diligence and corporate services materials to CIBC. In late 2000 or early 2001, Credit Risk, acting through Shak, approved STC and some CIBC funds were transferred to STC for Samaritan's market timing. There is no evidence that Flynn had any involvement in Shak's decision to approve STC, and he played no role in the development or implementation of the Hedge Funds' trading strategies. Moreover, there is no evidence that these strategies were communicated to him by anyone at STC or the Hedge Funds prior to his due diligence visit in September 2001.[41] Shortly after Shak's approval, Credit Risk revisited the issue of placing funds at STC, due to Lobo's concerns about the safety and control of CIBC's collateral. Following this decision, Flynn requested Credit Risk's approval of STC on several occasions.

During summer 2001, Seeger sent Lobo and Haas a brochure describing STC's trading platform. He also sent Haas and Flynn a "clean" independent audit report on the internal controls of the trading platform, for the period ending June 30, 2001. McDermott testified that this platform was intended to service only retirement plans. However, this fact was not disclosed in the materials that Seeger sent Flynn, Haas, and Credit Risk in November 2000 and summer 2001. McDermott acknowledged that no one at STC ever informed Flynn, Haas, or anyone else at CIBC that the platform was intended solely for retirement plans. Thus, the platform appeared to be available for use by anyone, including hedge funds. According to McDermott, this trading platform took on a different meaning than what was intended. (Tr. 308-09.)

Credit Risk officials, Flynn, and Haas discussed the placement of funds at STC numerous times throughout the spring and summer of 2001.[42] Because of Credit Risk's continued concerns about the safety and control of CIBC's funds, a due diligence trip to STC was proposed in August 2001 and scheduled for September. Seeger requested an agenda for the visit so he could ensure that the appropriate STC staff members were available. Flynn prepared the agenda, which was circulated to Lagroix, Lobo, and Wellner. The objective of the trip was to examine and assess STC's control environment to determine whether CIBC's collateral would be sufficiently protected.

Flynn conducted the trip in accordance with these objectives. He assessed STC's operational controls, insurance coverage, and personnel policies, and met with representatives of

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[41] Lagroix testified that she understood that STC's platform would be beneficial to the Hedge Funds, but that she did not recall when she learned this.

[42] In May 2001, CIBC and Canary agreed to the terms for the loan involved in this proceeding. That agreement identifies STC as the desired custodian, but it does not identify the specific trading methods that Canary was using at STC. (Div. Ex. 6.) While Flynn ultimately signed this loan on behalf of CIBC in January 2002, after Credit Risk approved STC, there is no evidence that he negotiated the terms of the agreement. Haas, in an e-mail dated September 7, 2001, informed Canary that its loan could not be approved until after Credit Risk visited STC. (Resp. Ex. 182.)

STC's departments. Flynn also met with Seeger and discussed STC's trading platform and how Canary and Samaritan were using it because it was the mechanism through which the Hedge Funds would trade with CIBC's money. In sum, representatives of STC informed Flynn about their business, and he documented what they told him.[43] Thereafter, in his October 2001 memorandum, Flynn provided to Credit Risk, which had authority to approve STC, all of the information he obtained. Therefore, Lagroix and Lobo received the same information prior to approving STC that they would have received had they accompanied Flynn to STC.

The four-page memorandum Flynn drafted on October 12, 2001, set forth the results of his visit to STC. According to the Division, the information Seeger gave him about the trading platform is evidence that Flynn knew that STC and the Hedge Funds were violating the securities laws. The Division further contends that the memorandum memorializes Flynn's intent to assist in deceptive market timing and late trading.

Flynn went to STC to review its control environment, not to inquire about trading strategies of which he was previously unaware.[44] Based on Seeger's representations, Flynn's memorandum reported that STC's trading platform allowed Canary and Samaritan to use certain trading strategies that reduced their visibility to mutual funds. This is consistent with Flynn's knowledge about market timing, which is that the trades were intended to be undetected. Flynn's memorandum simply describes the means by which the Hedge Funds were achieving anonymity, a purpose that he and everyone else at CIBC believed was proper. There is no credible evidence that Flynn suspected that the trading methods Seeger described to him were fraudulent.

The record establishes that long before Flynn's visit, STC's staff was concerned about the trading strategies because it had received numerous complaints from mutual funds related to the Hedge Funds' market timing. Flynn was not aware of these concerns or complaints. McDermott did not consider the trading strategies to be illegal in August 2001, shortly before Flynn's visit. Furthermore, Canary and Samaritan covenanted to CIBC that they would abide by all applicable laws and regulations. I conclude that the brief discussion Flynn had with Seeger about the trading strategies did not raise "red flags" as to any illegal or improper conduct by STC or the Hedge Funds. With the benefit of hindsight, these strategies were fraudulent, but Flynn was not aware of any illegalities or improprieties at the time of his visit to STC or thereafter.

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[43] The Division characterizes Flynn's trip as going to "extraordinary lengths" at an "inconvenient time," for an institution that was inexperienced and had a small capitalization, when more capable institutions were available to him in New York City. (Div. Post-Hearing Br. at 3.) I disagree. Flying to Phoenix to conduct an interview of a possible custodian that the Hedge Funds recommended is not an extraordinary act, even shortly after September 11, 2001. In any event, the Hedge Funds could have taken their business elsewhere since CIBC was not the sole source of their financing.

[44] For example, as set forth in the relevant portion of Flynn's memorandum, while Seeger detailed how the Hedge Funds were using STC's platform, Flynn inquired about the platform's operational controls.

As to late trading, the Division asserts that Flynn had actual knowledge that orders were required to be submitted by 4:00 p.m. Eastern time, and his memorandum establishes that he knew that STC and the Hedge Funds were trading well after this time. (Div. Post-Hearing Br. at 47.) The Division's proof on these issues is insufficient to establish that Flynn aided and abetted a late-trading scheme. For example, it relies on an e-mail sent by Haas to Flynn and others on April 11, 2002, that states that "all mutual fund trades have to be in by 4 p.m." This e-mail cannot establish Flynn's awareness of late trading, as it was sent long after his trip and Credit Risk's approval of STC. Additionally, Lagroix's testimony was too vague to support a finding that Flynn was aware of a 4:00 p.m. cut-off time for receipt of mutual fund orders.[45]

As additional proof of Flynn's awareness of late trading, the Division relies on the addendums Canary and Samaritan signed, in which both Hedge Funds certified to STC that they had made their trading decisions by 4:00 p.m. Eastern time. The Division asserts that when Flynn wrote his memorandum in October 2001, he "knew that Canary and Samaritan had gone on the record with false representations to STC" concerning when they would make their trading decisions. (Div. Post-Hearing Br. at 47.) The Division further contends that because the Samaritan addendum was faxed to Haas, and since Haas was "heavily involved" in the STC approval and worked with Flynn, it is reasonable to infer that Flynn was aware of both addendums.[46] There is no evidence that Flynn knew about either addendum.

Flynn was merely obtaining facts for Credit Risk to assuage its concerns about STC's control environment and the safety of CIBC's collateral. He was not at STC to assess and inquire about how the Hedge Funds were using the trading platform. The platform's primary benefit for retirement plans was that it enabled late-day processing of trades for same-day value, which is why it was not a "standard platform." Flynn's memorandum simply described how the platform operates. His description is consistent with McDermott's testimony regarding a TPA's trading. The memorandum does not state that the Hedge Funds were receiving the previously calculated NAV, nor does it establish that Flynn was aware of any late trading by the Hedge Funds.[47]

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[45] Lagroix stated that "There were many discussions about the 4 p.m. deadline. I can't recall exactly when I had a conversation with Mr. Flynn, but I know that I did." (Tr. 180-81.) When asked whether those would have occurred prior to her discussion with him about his memorandum, she replied yes. (Tr. 181.) It is unclear whether "those discussions" refers to Lagroix's discussions with others or to her discussion with Flynn. In any event, this testimony is not sufficient to prove Flynn's awareness of late trading.

[46] The Division has proceeded on the theory that Flynn single-handedly forced Credit Risk to submit to his will and approve STC, but now asserts that Haas was "heavily involved" with Flynn in attempting to have STC approved.

[47] Flynn was not aware that STC's employees had raised concerns about when Canary and Samaritan submitted their trade files. He was also unaware of Canary's apparent unwillingness to submit its trade files by 4:00 p.m. Moreover, following the New York Attorney General's announcement of an investigation into the mutual fund industry in 2003, Flynn drafted a letter to JCM and Samaritan requesting details concerning any arrangements they had that allowed them

Finally, assuming arguendo that Flynn learned of illegal or improper practices during his trip to STC and decided to render his assistance, it would not have served any purpose in furtherance of the scheme to pass that information along to Credit Risk, which had final approval authority over STC. After considering the evidence, the more reasonable explanation is that Flynn was providing Credit Risk, the real decision makers, with all relevant information that he believed would assist their decision. If Flynn had truly recognized and decided to aid improper activities, he surely would have omitted that information from his report.

Substantial Assistance

Lagroix testified that the only conversation she recalls having with Flynn about STC was after receiving his memo detailing the purported benefits of the platform. Had Flynn been persisting to the degree to which the Division suggests, surely Lagroix would have remembered discussing the matter with him prior their conversation after his due diligence trip. Instead, she was clear that Flynn's efforts to have STC approved were not unusual and was standard practice for someone seeking Credit Risk's approval. Furthermore, Credit Risk, which had final authority on the matter, approved STC only after STC obtained an insurance policy that allowed CIBC to recover its funds in the event of fraud or loss. Thus, Flynn's efforts had very little, if any, influence on Credit Risk's decision to approve STC.[48] Based on the record evidence, I conclude that Flynn was not aware of and did not substantially assist the Hedge Funds' and STC's illegal activities.

Causing

Section 8A of the Securities Act and 21C(a) of the Exchange Act specify that a respondent is a cause of another's violation if the respondent knew or should have known that his or her act or omission would contribute to such violation. In order to establish causing liability under these provisions, the Division must prove that: (1) a primary violation occurred; (2) an act or omission by the respondent caused the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. See Robert M. Fuller, 80 SEC Docket 3539, 3545 (Aug. 25, 2003), pet. denied, 2004 U.S. App. LEXIS 12893 (D.C. Cir. Apr. 23, 2004); Erik W. Chan, 55 S.E.C. 715, 725-33 (2002). For the same reasons set forth above, I conclude that Flynn did not act with scienter or negligently cause STC's or the Hedge Funds' primary violations.

CERTIFICATION OF THE RECORD

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to buy or sell mutual funds after 4:00 p.m. Eastern time. (Resp. Ex. 56.) JCM responded by letter, which informed Flynn that JCM had no such arrangements. (Resp. Ex. 194.) If Flynn knew of such an arrangement with STC, this correspondence would have been unnecessary.

[48] The Hedge Funds had been trading through STC's platform for more than one year prior to Flynn's due diligence trip. There is no indication that they needed additional CIBC funds to continue to do so.

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on July 3, 2006, as revised on July 21, 2006.

ORDER

Based on the findings and conclusions set forth above:

IT IS ORDERED THAT this proceeding brought against Paul A. Flynn be, and it hereby is, DISMISSED.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practices, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact, or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

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Robert G. Mahony
Administrative Law Judge