The New York Times

October 29, 2003, Wednesday, Late Edition - Final

SECTION: Section A; Page 1; Column 1; Business/Financial Desk

LENGTH: 1670 words

HEADLINE: Mutual Fund Accused of Fraud In Rapid Trading by Managers

BYLINE: By GRETCHEN MORGENSON

BODY:

Federal and state securities regulators filed civil lawsuits yesterday against Putnam Investments and two of its former fund managers, accusing them of fraud. They are the first lawsuits against a mutual fund company and some of its executives produced by a widening investigation into the trading of fund shares.

Putnam, which has $272 billion under management and is the fifth-largest fund company in the nation, allowed some big investors to trade rapidly in and out of shares, even though its stated policy was to bar such activity, the Securities and Exchange Commission said in its suit.

Regulators also contend that Putnam engaged in securities fraud by failing to disclose to fund shareholders or to its board the series of personal trades by its managers that harmed public shareholders. Improper trading by one fund manager dates back to 1998, regulators said.

The investigation of mutual fund improprieties, which began last month with a single complaint by New York State officials against one hedge fund, is spreading quickly and going in unexpected directions.

"For the first time we are in the heart of the mutual fund business," said Prof. Norman Poser of Brooklyn Law School, an expert in securities law. "I can imagine there are going to be some really big reverberations from these disclosures."

Putnam sought to reassure investors yesterday, including workers who have 401(k) retirement accounts in Putnam funds and big institutions who have voiced concerns that the company had lax controls. The fund company, which is based in Boston and is a unit of the insurance giant Marsh & McLennan, oversees more than 100 mutual funds for more than 12 million shareholders and 401(k) plan participants.

In a statement responding to the allegations by the securities commission and the Commonwealth of Massachusetts, the company said it had not acted fraudulently. "We have been cooperating with both the S.E.C. and the commonwealth," it said. "We will work with them to resolve these issues in an appropriate and expeditious manner."

Putnam recently dismissed the fund managers who were sued by regulators yesterday. The managers are Justin M. Scott, 46, who was chief investment officer of Putnam's International Equities Group, and Omid Kamshad, 41, who was chief investment officer of its International Core Equity Group.

The regulators contend that the men used nonpublic information about their funds' holdings to profit personally through frequent trades. Mr. Kamshad's personal trading continued through March, the commission said, even though Putnam officials said last week that the improper trading by fund executives ended in 2000.

"There are some 95 million Americans who are invested in mutual funds, representing half the households in this country, and they deserve better," said Stephen M. Cutler, director of enforcement at the S.E.C. "We're going to continue to be aggressive in pursuing appropriate enforcement actions where mutual funds abuse the trust of those investors."

William F. Galvin, the secretary of the commonwealth of Massachusetts, also sued Putnam and the fund managers for civil securities fraud. Calling the fund company's practices outrageous and deceitful, Mr. Galvin said: "Mutual should mean equal opportunity for gain and loss. There should not be two classes of investors."

Mutual funds calculate their share prices, known as net asset values, at 4 p.m. based on the value of the securities held in the portfolio. But prices of foreign securities can be hours old because those markets have already closed. Subsequent world events or corporate news can presage moves in those markets when they open, creating a buying opportunity to those who recognize that the securities are mispriced and can trade freely in fund shares.

Fund managers with their intimate knowledge of portfolio holdings are in a better position than anybody to capitalize on these moves. Putnam's policy said that it would police and prevent anyone from carrying out rapid trading, known as market timing.

According to the Massachusetts complaint, the two former fund managers traded shares of Putnam funds when events in United States markets were expected to move overseas stock prices.

The S.E.C. said Mr. Kamshad made 38 quick in-and-out trades in Putnam funds, including at least four funds that he managed or helped to manage. Mr. Scott, who was Mr. Kamshad's direct superior, completed 35 trades in Putnam funds, including some that he helped manage, the agency said. Regulators said that each man realized hundreds of thousands of dollars in gains from the trades.

In 2000, Putnam confronted Mr. Kamshad about his frequent trades. At that time, the complaint stated, the manager said he would stop conducting such trades. But he made 20 more from February 2000 to March 2003, regulators said.

John A. D. Gilmore, a lawyer at Piper Rudnick in Boston who represents Mr. Kamshad, said in a statement: "These actions were filed precipitously. We will defend against the claims asserted in them vigorously and the trades at issue did not violate any rule regulation or statute."

John Sylvia, Mr. Scott's lawyer, did not return a phone call seeking comment.

The S.E.C.'s suit contends that a total of six Putnam employees, including Mr. Scott and Mr. Kamshad, reaped gross profits in excess of $1 million in their personal trades.

Putnam said in its statement that it would "restore any losses deemed to be the result of employee trading activity."

Last Friday, Putnam said it had fired four managers, including the two named in the regulatory suits. At that time, Putnam said that two other employees had engaged in personal trades and were still employed by the firm, noting that they had not traded in funds that they managed.

The suits against Putnam are the latest in a series of regulatory investigations that have rocked the mutual fund industry, which had prided itself in recent years on being scandal-free. But in September, Eliot Spitzer, the New York attorney general, said his office had found that some mutual funds were allowing some big investors to trade rapidly, capitalizing on price discrepancies.

Since then, one mutual fund executive has pleaded guilty, and several dozen fund employees have been fired, at a number of firms. Regulators have taken action against some hedge fund managers, as well.

Late last week, officials at the S.E.C. said that their recent investigation into practices at top fund companies and brokerage firms had found widespread improprieties. The commission said yesterday that its investigation of Putnam was continuing and that a tip to Mr. Cutler about the personal trading by fund managers had set off the inquiry.

According to the suits by the regulators, Putnam had minimal controls to protect shareholders from self-dealing fund managers. Putnam's system for detecting market timing by its own employees, for example, monitored trades during only one quarter of a given year, leaving nine months of every calendar year with no monitoring at all.

In addition, Mr. Cutler said, Putnam's internal monitoring system was so lax that personal trading by employees set off alarm bells only if a worker conducted more than eight transactions a quarter.

Regulators also said that Putnam revised its code of ethics to include a ban on employee market timing of funds in April 2002, two years after it learned that some managers were conducting such trades.

Founded in 1937, Putnam is one of the oldest mutual fund companies in the nation. According to a prospectus from the International Equity Fund, which was managed by Mr. Kamshad, Putnam "has a heritage of investment leadership dating back to Massachusetts Supreme Judicial Court Justice Samuel Putnam, who established the Prudent Man Rule, a legal foundation for responsible money management since 1830."

Many of Putnam's clients will be dismayed by the allegations in the regulatory suits, lawyers said. But whether they will remove their money from Putnam remains to be seen. Investors have largely held on to their investments at the fund companies whose practices have come under scrutiny, including Bank of America, Strong Capital, Janus and Bank One.

Last Friday, even before the regulators filed their suits, the Massachusetts pension plan announced it would convene a special meeting later this week to discuss whether it should fire Putnam as one of its managers. The state pension fund has $1.7 billion under management at Putnam, and Tim Cahill, the fund's treasurer, had placed Putnam on a watch list several months ago because of poor performance.

Putnam manages about $1.2 billion for Calpers, the California state employees pension fund; the money is split evenly between domestic equities and international stocks. Brad Pacheco, a spokesman for Calpers, said that the pension fund's executives would monitor the situation at Putnam closely. "We are concerned about compliance issues at Putnam and how something like this could happen," he said.

Another Calpers official said that Mr. Kamshad was one of the pension fund's managers at Putnam. As a result, the official said that Mark Anson, the pension fund's chief investment officer, would meet with Putnam next week to allay his concerns and to discuss the firm's internal controls.

Experts in laws covering employee pensions and retirement accounts said that the suits against Putnam would probably push sponsors of retirement plans ~ including corporations that offer 401(k) plans to their workers ~ to re-examine relationships they may have with the fund company. A recent Putnam filing noted that the firm has nearly 3,000 institutional and 401(k) clients.

"Plan sponsors need to ask themselves if this is the kind of company or people they want to have their employees' money invested with," said Eli Gottesdiener, a lawyer in Washington who specializes in pension and retirement plan cases. "That is a judgment call and a duty as well."

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GRAPHIC: Photo: William F. Galvin announced the suit by Massachusetts against Putnam yesterday. (Photo by Zava Tzanev for The New York Times)(pg. C2)