

**STATE OF ILLINOIS  
SECRETARY OF STATE  
SECURITIES DEPARTMENT**

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<b>IN THE MATTER OF:</b>	)	
	)	<b>File Number: 03 00908</b>
<b>A.G. Edwards &amp; Sons, Inc.,</b>	)	
<b>(CRD # 4).</b>	)	
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**NOTICE OF HEARING**

TO THE RESPONDENT:   A.G. Edwards & Sons, Inc.  
                                  (CRD # 4)  
                                  One North Jefferson Ave.  
                                  St. Louis, Missouri 63103

C/O Joseph Brooks, Esq.  
Morgan Lewis  
1111 Pennsylvania Avenue, NW  
Washington, DC 20004

You are hereby notified that, pursuant to Section 11.F of the Illinois Securities Law of 1953 (815 ILCS 5/1 *et seq.*) (the "Act") and 14 Ill. Adm. Code 130, Subpart K (the "Rules"), a public hearing is scheduled to be held at 69 West Washington Street, Suite 1220, Chicago, Illinois 60602, on the 7th day of February 2007, at 10:00 AM, or as soon thereafter as counsel may be heard, before George P. Berbas, Esq., or another duly designated Hearing Officer of the Secretary of State.

Said hearing will be held to determine whether an Order shall be entered which would revoke A.G. Edwards & Sons, Inc.'s registration in the State of Illinois and/or granting such other relief as may be authorized under the Act including but not limited to

the imposition of a monetary fine in the maximum amount pursuant to Section 11.F of the Act, payable within ten (10) business days of the entry of the Order.

The grounds for such proposed action are as follows:

**BACKGROUND:**

The Illinois Securities Department has obtained evidence of multiple violations of the Illinois Securities Law of 1953 (815 ILCS 5/1 *et seq.*) (the “Act”) by Respondent A.G. Edwards & Sons, Inc. (“Respondent” or “AGE”). From at least December 2001, Respondent has engaged in a practice of permitting certain clients to engage in a practice known as market timing of mutual funds.

**MUTUAL FUNDS**

A mutual fund is an investment vehicle designed to permit thousands of investors to pool their resources in a fund that, in turn, invests in a large number of securities selected by a professional investment adviser. Each investor has the benefit of that professional advice, shares proportionately in the fund's investment returns (including income paid on the securities and any capital gains or losses caused by sales of securities the fund holds), net of fees and other operating expenses. Historically, an investment in a mutual fund was viewed as an economical way for an investor of modest means to obtain the same quality of professional advice and diversification of investments as a wealthy individual or institution.<sup>1</sup>

**MUTUAL FUND MARKET TIMING**

Buying and selling (including exchanging or redeeming) of mutual fund shares is fundamentally different than buying or selling stocks or bonds in a market such as the

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<sup>1</sup> [http://www.ici.org/funds/abt/ref\\_97\\_mforgan-operat.html](http://www.ici.org/funds/abt/ref_97_mforgan-operat.html)

New York Stock exchange or NASDAQ. In transactions on those exchanges, the price of a stock may change at any time and several times throughout a day. If the market as a whole moves generally, either up or down, many of the individual stocks tend to move along with it. Indeed, to say that the market is “up” is merely a shorthand way of saying that the prices for many of the stocks in that market are up, and that the price of more stocks in general has increased.

Mutual funds differ in two important ways. First, the price is a reflection of the single price attributed to each of the stocks making up the fund at the close of the New York Stock Exchange (the “NYSE”) as of the preceding trading day. This price, for buying or for selling, will not change until the close of the current day. While the overall market or underlying stocks may have substantial changes in their individual values over the course of a trading day, the mutual funds holding them do not reflect those changes and will not reflect them until the close of *that* trading day. Second, unlike the stock of a publicly held company, the typical mutual fund has only one buyer to which an individual shareholder can sell its shares to, and only one seller of its shares. That lone buyer and lone seller is the mutual fund itself. Such a typical mutual fund is always “open for business,” on the terms set forth above; there is always a market in the shares of a mutual fund and the price is always known. At any time, a typical fund will sell shares of itself to the public at the Net Asset Value (the “NAV”) calculated on the preceding close of business of the NYSE, or buy back shares from the public at the same NAV. This practice is widespread throughout the mutual fund industry and adequately meets the needs of long-term investors; this same practice however, does create certain inefficiencies in pricing.

Market timing refers to the practice of short term, in-and-out, buying and selling of mutual fund shares in order to exploit those inefficiencies in mutual fund pricing. Market timing is intended to exploit market inefficiencies when the price of the mutual fund shares (its Net Asset Value, or “NAV”) does not reflect the current market value of the stocks held by that mutual fund. A typical market timed investment can be as short as a day and seldom is longer than a week. Market timing has a detrimental effect on long-term shareholders for whom mutual funds are designed, such as retirees and other buy and hold investors. When a market timer buys mutual fund shares at the stale NAV, it realizes a profit when it sells those shares the next trading day or thereafter. That profit dilutes the value of shares held by long-term investors.<sup>2</sup>

Although mutual fund managers maintain policies and procedures to detect and prevent market timing (e.g., imposing early redemption fees, exercising discretion to cancel market timers’ purchases or even an RRs account), the broker-dealer also has policies and procedures in place to supervise the sale of mutual fund products.

#### MUTUAL FUND LATE TRADING

“Late Trading” refers to the practice of purchasing mutual fund shares at the 4:00 PM Eastern Standard Time (“EST”) price after the market closes (trades are placed after the market close, yet the trader gets to buy in at that day's net asset value (NAV) per share). Generally, orders placed after the close of trade are supposed to be valued at the next day's NAV. The late traders can use information revealed after 4:00 PM EST to guide their trades. This allows late traders to earn expected abnormal returns at the expense of the fund's long-term shareholders. Late trading is prohibited by SEC

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<sup>2</sup> Spitzer quote [http://www.oag.state.ny.us/press/2003/sep/sep03a\\_03.html](http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html)

regulations because it allows a favored investor to take advantage of post-market closing events not reflected in the share price set at the close of the market. Late trading is akin to “allowing betting on a horse race after the horses have crossed the finish line.”<sup>3</sup>

### **ALLEGATIONS**

### **RESPONDENT**

1. A.G. Edwards & Sons, Inc. (CRD #4) (the “Respondent” or “AGE”) is a Delaware corporation with its principal place of business at One North Jefferson Avenue, St. Louis, Missouri 63103.
2. The Respondent has been operating as a broker-dealer since 1887, and has been operating as a broker-dealer in the state of Illinois since July 1, 1942.
3. The Respondent currently has forty-nine (49) branch offices registered in the State of Illinois. In addition, Respondent has over four thousand five hundred (4,500+) registered representatives and over five hundred fifty (550+) investment adviser representatives registered in the State of Illinois.
4. The Allegations in this Notice of Hearing include, but are not limited to, the following AGE Illinois branch offices:
  - a. “Chicago – Loop” – (222 South Riverside Plaza, Suite 300; Chicago, Illinois 60606);
  - b. “Lake Forest” – (1044 North Western Avenue; Lake Forest, Illinois 60045);
  - c. “Lincoln” – (628 Broadway, Suite 1; Lincoln, Illinois 62656); and
  - d. “Skokie” – (5215 Old Orchard Road; Skokie, Illinois 60077).

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<sup>3</sup> Spitzer quote [http://www.oag.state.ny.us/press/2003/sep/sep03a\\_03.html](http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html)

## **JURISDICTION**

5. The Illinois Securities Department (the “Department”) is a division of the Office of the Secretary of State, with jurisdiction over matters relating to securities as provided for by the Illinois Securities Law of 1953 (815 ILCS 5/1 *et seq.*) (the “Act”). The Act authorizes the Department, *inter alia*, to regulate the offer and sales of securities, the registration or exemption from registration of those securities, and those individuals and business entities offering and/or selling securities.
6. This Notice of Hearing is brought in accordance with Section 11.F of the Act and its Rules. The Department has the authority to conduct administrative proceedings to enforce the provisions of the Act and all Rules promulgated thereunder. Specifically, Respondent has locations in the State of Illinois, Respondent’s actions occurred in the State of Illinois, and investors affected by actions of Respondent were and are residents of the State of Illinois.
7. The Department specifically reserves the right to amend this Notice of Hearing and/or bring additional actions.

## **RELEVANT TIME PERIOD**

8. Except as otherwise expressly stated, the conduct described herein occurred during the approximate time period of January 2001 through October 2003 (the “relevant time period”).

## **ALLEGATIONS COMMON TO ALL VIOLATIONS**

9. AGE Registered representatives (“RRs”) engaged in activities to facilitate mutual fund market timing on behalf of certain clients. In order to facilitate the market timing transactions, the RR’s engaged in a series of activities designed to circumvent

mutual fund company restrictions. These activities include, but are not limited to, creating multiple accounts and trading under multiple RR numbers.

10. As of October 23, 2002, Respondent's internal documents identified at least one hundred ten (110) accounts as mutual fund market timing accounts. The aggregate value of these accounts was One Hundred Sixteen Million Seventy-Seven Thousand Two Hundred Ninety-Seven Dollars (\$116,077,297.00).
11. Over a period of ninety (90) days, these market timing accounts executed six thousand twenty-one trades (6,021) and generated Two Hundred Thirty-Nine Thousand Six Hundred Nine Dollars (\$239,609.00) in advisory fees (for that quarter).
12. AGE was engaged in mutual fund market timing activity as early as January 2001. A section of Respondent AGE's intranet site titled "Help for Branch Managers in Regard to Managed Products" discussed granting exceptions to AGE's policy that prohibited active trading.
13. Specifically, this section described four steps that "*must* be adhered to if an account is found to be actively traded and/or if an FC wants *to open an account that may actively trade or market time mutual funds.*" [Emphasis added.]
14. The four steps were:
  1. Branch and Regional Manager may request MPD [Managed Products Division] to grant an exception to the "no active" trading policy.
  2. The client must be profiled as an "Aggressive investor" on the Account Set-up Authorization Form.
  3. Branch Manager and FC agree that all mutual fund orders will be settled on a T+5, versus T+1, settlement basis. Understand that this will not prevent a fund family from targeting the client and possibly the FC as a "timer" and refusing order(s) if it violates the short-term trading guidelines established by the fund. The account will be charged any short-term redemption fee imposed by the fund.

4. *Client must execute a hold harmless letter.* [Emphasis added. The AGE intranet site, which stated the policy, was taken down in April 2002.]
15. The Hold Harmless Letter was created and drafted by Respondent AGE's in-house counsel, and was reviewed and implemented with the knowledge of senior management.
16. The Hold Harmless Letter asserts that the market timing client will "agree to indemnify and hold harmless Edwards . . . from and against any and all claims, causes of action, liabilities, lawsuits, demands, and/or damages, including without limitation, any and all court costs and attorney's fees in any way related to, arising out of or in connection with the purchase, sale or exchange of mutual fund shares."
17. The Hold Harmless Letter confirms that Respondent AGE treated select clients differently than other customers. Respondent AGE granted certain clients the privilege to market time in exchange for collecting the fees from servicing the mutual fund market timing accounts.
18. The Hold Harmless Letter blatantly states, "the Professional Fund Advisor client agreement specifically prohibits such a strategy and that typically Edwards does not allow clients to engage in such a strategy in Edwards' accounts, but an exception to the prohibition in the agreement and to Edwards' general policy has been made."
19. In addition, the language in the Hold Harmless Letter clearly proves that Respondent AGE knew of the detrimental effects of market timing. The Hold Harmless Letter states that the client agrees that, "placement of orders with Edwards for the purchase or sale of mutual fund shares and/or to exchange shares within a fund family involves



- certain risks, including the possibility that the fund companies may not accept orders and/or may direct the closing of our account with the relevant fund company.”
20. Although some of the mutual fund market timers initially refused to sign the Hold Harmless Letter, ultimately, many signed the agreement in order to continue the fraudulent market timing scheme.
  21. For the mutual fund market timers that did not sign the Hold Harmless Letter, Respondent AGE maintained controls in place to stop mutual fund market timing in the non-Hold Harmless Letter compliant accounts.
  22. Despite receiving numerous requests from various mutual fund companies to implement measures to stop market timing within AGE accounts, Respondent AGE did not take steps to stop the market timing activity within the accounts of customers who had signed the Hold Harmless Letter.
  23. In addition to requiring Hold Harmless Letters, AGE branch managers responsible for supervision of RRs failed to adequately respond to repeated evidence of mutual fund market timing activity. This evidence included, *inter alia*, multiple letters from mutual fund companies restricting trading activity, the large number of accounts opened for market timing clients, and the significant volume of trading by market timing clients.
  24. This market timing activity was known and permitted by senior management at AGE. Senior management participated in discussions regarding market timing activity, participated in the drafting and review of the Hold Harmless Letter, discussed whether they could facilitate these transaction in light of their Anti-Money Laundering requirements, and adopted these policies despite discussion about the

- regulatory risk involved in market timing activity. Senior management approval was expressed via development of certain policies, i.e., Hold Harmless Letter, and their lack of action to prohibit the market timing activity.
25. Respondent never disclosed any of this market timing activity in a timely fashion in any public statements or in any SEC filings. On the contrary, AGE had a “public” policy in place prohibiting market timing in mutual funds by its RRs and their clients.
  26. This public policy was described in the Professional Fund Advisor client agreement, which stated that mutual fund market timing was not permitted.
  27. Notwithstanding this “public” policy, Respondent’s “internal” policy permitted select customers to engage in market timing. Throughout the relevant time period, Respondent permitted exceptions and provided guidelines to its RRs on how to evade the “public” market timing policy.
  28. Respondent breached its duty to its own mutual fund customers by permitting select customers to profit at the expense of other investors, caused costs to be incurred by some of its investors who received no benefits from such costs, and effectively undermined the soundness and integrity of the financial markets. The benefits to Respondent AGE included increased fees, activities useful in furthering other beneficial relationships, and other benefits.
  29. Respondent AGE, for its own financial benefit, placed the interest of select clients ahead of its other customers. This was accomplished by allowing select clients to market time mutual funds, all the while publicly decrying the act of market timing.
  30. In addition to mutual fund market timing, prior to Fall 2003, Respondent AGE had inadequate and insufficient procedures in place to detect and prevent late trading.

31. Respondent AGE conducted a review in the Fall of 2003 relating to late trading. The findings were compiled in a March 2004 report.<sup>4</sup>
32. The Chicago – Loop branch office had sixty-five (65) orders over One Million Dollars (\$1,000,000.00) that were transmitted to NSCC *after the market close*.
33. The Lake Forest branch office had two thousand seven hundred fifteen (2,715) orders over Ten Thousand Dollars (\$10,000.00) that were transmitted to NSCC *after the market close*.
34. The Lincoln branch had one hundred thirty-nine (139) orders over Ten Thousand Dollars (\$10,000.00) that were transmitted to NSCC *after the market close*.
35. The Skokie branch had thirty-two (32) orders over One Million Dollars (\$1,000,000.00) that were transmitted to NSCC *after the market close*.
36. Respondent AGE did not have policies in place to review mutual fund trades submitted after the market close.

#### **SANCTIONS UNDER SECTION 8 OF THE ACT**

37. The Illinois Securities Department has jurisdiction over this matter pursuant to the Illinois Securities Law of 1953, as amended, [815 ILCS 5/1 *et seq.*] (the “Act”).
38. Section 8.E(1)(b) of the Act provides, *inter alia*, that the registration of a dealer may be subject to sanctions authorized under Section 8.E(1) if the Secretary of State finds that such dealer has engaged in any unethical practice in the offer or sale of securities.
39. Respondent AGE facilitated and engaged in a scheme to evade market timing controls put in place by mutual fund companies for the benefit of itself and its select clients and to the detriment of long-term mutual fund shareholders.

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<sup>4</sup> The report reviewed mutual fund order transmissions for the period of October 25, 2002 through October 27, 2003.

40. By virtue of the foregoing, Respondent AGE engaged in unethical practices making them subject to sanctions provided for under Section 8.E(1)(b) of the Act.
41. Section 8.E(1)(e)(iv) of the Act provides, *inter alia*, that the registration of a dealer may be subject to sanctions authorized under Section 8.E(1) if the Secretary of State finds that such dealer has failed to maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of its salespersons that are reasonably designed to achieve compliance with applicable securities laws and regulations.
42. Respondent AGE failed to develop or implement adequate supervisory procedures to detect and prevent mutual fund market timing.
43. In addition, AGE branch managers failed to reasonably supervise AGE RRs by knowingly permitting and furthering the fraudulent mutual fund market timing scheme.
44. Prior to October 2003, notwithstanding the activity described in paragraphs 32 through 35, AGE failed to have any policy in place to review mutual fund trades submitted after 4:00 PM EST
45. By virtue of the foregoing, Respondent AGE engaged in actions making them subject to sanctions provided for under Section 8.E(1)(iv) of the Act.
46. Section 8.E(1)(g) of the Act provides, *inter alia*, that the registration of a dealer may be subject to sanctions authorized under Section 8.E(1) if the Secretary of State finds that such dealer has violated any of the provisions of this Act.
47. The allegations contained in paragraphs 9 through 36 state violations of provisions of the Act.

48. By virtue of the foregoing, Respondent AGE engaged in actions making them subject to sanctions provided for under Section 8.E(1)(g) of the Act.

#### **VIOLATIONS OF ILLINOIS LAW**

49. The Illinois Securities Department has jurisdiction over this matter pursuant to the Illinois Securities Law of 1953, as amended, [815 ILCS 5/1 *et seq.*] (the "Act").

50. Section 12.A of the Act provides, *inter alia*, that it is a violation of the Act to offer or sell any security except in accordance with the provisions of the Act.

51. The allegations contained in paragraphs 9 through 36 demonstrate the offer or sale of a security not in accordance with the provisions of the Act.

52. By virtue of the foregoing, Respondent AGE violated Section 12.A of the Act.

53. Section 12.F of the Act provides, *inter alia*, that it is a violation of the Act to engage in any transaction, practice or course of business in connection with the sale or purchase of securities which works or tends to work a fraud or deceit upon the purchaser or seller.

54. Section 12.G of the Act provides, *inter alia*, that it is a violation of the Act to obtain money through the sale of securities by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

55. Section 12.I of the Act provides, *inter alia*, that it is a violation of the Act to employ any device, scheme or artifice to defraud in connection with the sale or purchase of any security, directly or indirectly.

56. Respondent AGE facilitated and engaged in a scheme to evade market timing controls put in place by mutual fund companies for the benefit of itself and its select clients and to the detriment of long-term mutual fund shareholders.
57. Respondent AGE represented to the vast majority of its mutual fund customers that it did not permit market timing despite having knowledge that AGE facilitated market timing on behalf of select clients.
58. Respondent AGE demonstrated knowledge that its actions would be harmful to long-term mutual fund investors. It sought to evade liability its financial responsibility by requiring indemnification from clients who wished to engage in mutual fund market timing.
59. By virtue of the foregoing, Respondent AGE violated Sections 12.F, 12.G, and 12.I of the Act.
60. Section 12.H of the Act provides, *inter alia*, that it is a violation of the Act to sign or circulate any statement, prospectus, or other paper or document required by any provisions of this Act or pertaining to any security knowing or having reasonable grounds to know any material representation therein contained to be false or untrue.
61. Despite AGE having knowledge that some of its customers were engaged in market timing activity, AGE continued to have mutual fund prospectuses delivered to its clients all the while having reason to know that the representations relating to mutual fund timing with in those prospectuses were untrue.
62. By virtue of the foregoing, Respondent AGE violated Section 12.H of the Act.

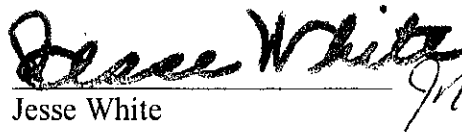
You are further notified that you are required pursuant to Section 130.1104 of the Rules and Regulations (14 Ill. Adm. Code 130)(the "Rules"), to file an answer, special appearance, or other responsive pleadings to the allegations above within thirty (30) days of the receipt of this Notice. A failure to file an answer within the prescribed time shall be construed as an admission of the allegations contained in the Notice of Hearing.

Furthermore, you may be represented by legal counsel; may present evidence; may cross-examine witnesses and otherwise participate. A failure to appear shall constitute a default by you.

A copy of the Rules promulgated under the Act and pertaining to Hearings held by the office of the Secretary of State, Securities Department is included with this Notice.

Delivery of Notice to the designated representative of the Respondent constitutes service upon such Respondent.

Dated: This 1<sup>st</sup> day of December 2006.

  
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Jesse White  
Secretary of State  
State of Illinois

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