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MEMORANDUM OF INQUIRY

UNITED STATES SECURITIES AND EXCHANGE COMMISSION OFFICE OF INSPECTOR GENERAL

PI No. 09-38

Introduction and Summary of Results of Inquiry

The Securities and Exchange Commission ("SEC") Office of Inspector General ("OIG") opened this preliminary inquiry on February 6, 2009, in response to allegations by Peter Scannell ("Scannell"), a former employee at Putnam Investment Management LLC ("Putnam"), of misconduct by current and former SEC officials. Specifically, Scannell alleged that:

(1) For a period of approximately five months, from April 2003 until September 2003, the SEC's Boston District Office ("BDO") ignored Scannell's warnings that certain institutional investors were preferentially allowed to market time[1] Putnam's mutual funds;

(2) The BDO failed to take any action against Putnam until Scannell contacted the Securities Division of the Commonwealth of Massachusetts Office of the Secretary ("Massachusetts Securities Division") regarding his allegations; and

(3) The SEC's ultimate action against Putnam ignored the market-timing conduct that Scannell had brought to the SEC's attention because the BDO staff wanted to protect Putnam.

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[1] Market timing was described by the Massachusetts Securities Division in the action it filed against Putnam as follows:

> Mutual funds are traditionally designed to be long-term investments for buy and hold investors and are therefore favored investment vehicles for Americans' retirement plans. Certain investors, however, have attempted to use mutual funds to generate quick profits by rapidly trading in and out of certain mutual funds. Typically, these so called "market timers" seek to capitalize on stale fund prices, often focusing on price discrepancies involving international funds. Market timers take advantage of price inequities, but do so at the expense and to the detriment of long-term shareholders.

Attached hereto as Exhibit 1 at 2.

The OIG found that BDO staff met with Scannell on April 28, 2003, regarding his allegations of market timing by certain institutional investors in Putman's mutual funds. The BDO staff held several internal meetings to discuss the appropriate response to Scannell's allegations.

The OIG found that BDO senior officials decided to not pursue an investigation of Putnam based on Scannell's allegations (b)(5) [redacted]

(b)(5) [redacted]

The OIG further found that approximately five months after BDO senior officials decided to not pursue Scannell's allegations that Putnam allowed certain institutional investors to market time its funds, the SEC's Director of Enforcement received an anonymous tip that some of Putnam's mutual fund portfolio managers were market timing the very funds they managed for their personal benefit. The SEC did open an investigation of Putnam to pursue that allegation.

Finally, the OIG found that on October 28, 2003, the SEC instituted administrative proceedings against Putnam for allowing two of its portfolio managers and other employees to market time its mutual funds. On the same day that the SEC brought its action against Putnam, the Massachusetts Securities Division filed an action against Putnam based, in part, on the portfolio managers' personal market timing. However, unlike the SEC, the Massachusetts Securities Division also sued Putnam and two of Putnam's institutional investors for the market-timing conduct that Scannell had brought to the SEC's attention.

The OIG's Inquiry

The OIG took the sworn testimony of the following individuals:

(1) Peter Scannell (February 10, 2009);

(2) (b)(7)(C) [redacted]

(3) [redacted]

(4) [redacted]

(5) Stephen Cutler, the former Director of Enforcement, (March 11, 2009).

Additionally, the OIG contacted (b)(7)(C) in the United States Attorney's Office for the District of Massachusetts (July 2, 2009).

The OIG also reviewed the following documents: the Massachusetts Securities Division's Administrative Complaint dated October 28, 2003; the Massachusetts Securities Division's Consent Order dated April 8, 2004; the SEC's Administrative Proceeding File No. 3-11317 *In the Matter of Putnam Investment Management LLC* dated October 28, 2003; the SEC's Action Memorandum *In the Matter of Putnam Investments LLC,* dated October 27, 2003; and the SEC's Litigation Release No. 18428, *SEC v. Justin M. Scott and Omid Kamshad,* Civil Action No. 03-12082, dated October 28, 2003.

Results of the OIG Investigation

Scannell was employed at Putnam from March 13, 2000 until January 31, 2003. Transcript of Testimony of Peter Scannell ("Scannell Tr."), attached hereto as Exhibit 3, at 5-6. At the time he worked for Putnam, Scannell was a National Association of Securities Dealers licensed broker whose duties at Putnam included working with 401(k) plans and other defined contribution plans. *Id.*

Scannell testified to the OIG that certain Putnam investors, including the Boilermakers Union ("Boilermakers") pension fund and the Joint Industry Board of Electricians ("JIB") pension fund (collectively, the "pension funds"), were allowed to frequently market time Putnam's mutual funds. *Id.* at 11-13 and 27. According to Scannell, he and several other co-workers complained to their supervisors about the pension funds' market timing, but nothing was done in response. *Id.* at 29.

I. The BDO Staff Met with Scannell but Decided Not to Pursue an Investigation of his Allegations

After leaving Putnam, Scannell decided to approach the SEC with his complaint about Putnam allowing the pension funds to market time its mutual funds and hired Jody Newman, an attorney at the law firm of Dwyer & Collora, LLP, to assist him in bringing his allegations against Putnam to the SEC. *Id.* at 67. According to Scannell, on March 26, 2003, Newman contacted an attorney at BDO on his behalf.[2] *Id.* at 70. Shortly thereafter, on March 31, 2003, Newman spoke with (b)(7) (b)(7) then a (b)(7)(C) in BDO, and discussed Scannell's concerns. *Id.* at 71. On April 10, Newman spoke with (b)(7)((b)(7)(C) who at the time was the (b)(7)(C) of BDO and (b)(7)(C) immediate supervisor. *Id.* Scannell testified that he did not participate in any of those phone calls. *Id.* at 72.

[2] Scannell did not recall the name of the BDO attorney who Newman initially contacted.

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Scannell testified that on April 28, 2003, he and Newman met with (b)(7)(C) (b)(7)(and (b)(7)(C) a BDO examiner. *Id.* at 75. Scannell recalled the meeting lasted an hour during which he explained how the market timing trades worked. *Id.* at 75-76.

(b)(7)(testified that at the meeting with Scannell, Scannell raised concerns related to the trading activity by the Boilermakers and JIB pension funds.[3] Transcript of Testimony of (b)(7) (b)(7)((b)(7)(C) Tr."), attached hereto as Exhibit 4, at 9. (b)(7)(recalled learning that Scannell was aware of the pension funds moving large amounts of their holdings in and out of Putnam funds. *Id.* (b)(7)(also recalled that Scannell complained that Putnam had "shut down" his own market timing of Putnam's mutual funds. *Id.* at 29, 40-41. According to (b)(7)(C Scannell brought to the BDO meeting excerpts of Putnam's prospectuses. *Id.* at 9. Scannell also provided the BDO staff with a self-prepared spreadsheet showing profit and loss calculations of some of the individuals who had engaged in market timing trades. *Id.* at 9-10.

(b)(7)(testified that after the meeting with Scannell, he and (b)(7)(C) discussed the allegations with (b)(7)(C) then (b)(7)(C) then an (b)(7)(C) and (b)(7)((b)(7)(C) then (b)(7)(C) in BDO Enforcement. *Id.* at 12-14. (b)(7)(stated that from April until early-September 2003, he and his supervisors had several discussions about whether to pursue Scannell's allegations. *Id.* at 22.

(b)(5)

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[3] (b)(7) thought the meeting with Scannell had occurred sometime in March 2003. Transcript of Testimony of (b)(7) (b)(7) (b)(7)(C Tr."), dated July 13, 2009, attached hereto as Exhibit 4, at 8. While (b)(7) remembered that (b)(7 attended the meeting, he did not recall (b)(7)(attending. *Id.* (b)(7)(testified that he had known that Scannell was meeting with the staff, but did not believe that he had attended that meeting. (b)(7)(Tr. at 71.

(b)(5)

According to Scannell, after his April 28, 2003 meeting with the BDO staff, Newman had additional contacts with the BDO staff until late-July 2003, when Newman told Scannell, "you know, they don't want to [meet] any more." Scannell Tr. at 76-77. At that point in time, Newman told Scannell that another attorney in her firm, Michael Collora, would handle the representation going forward. Scannell Tr. at 77.[4]

II. In September 2003, Four Months after Meeting with the BDO Staff, Scannell Contacted the Massachusetts Securities Division

On September 3, 2003, New York State Attorney General Eliot Spitzer filed a complaint against Canary Capital Partners ("Canary"), a hedge fund. The complaint alleged that Canary entered into illegal agreements with multiple, nationally known mutual funds to permit, *inter alia*, market timing by Canary allowing Canary to profit at the expense of other mutual fund shareholders *See State of New York v. Canary Capital Partners LLC et al.*, Complaint (September 3, 2003), attached hereto as Exhibit 5 at pgs. 1-4. Simultaneously with the filing of that complaint, Spitzer announced a $40 million settlement agreement with Canary. *See* Ari Weinberg, *Eliot Spitzer Finds His Canary*, Forbes, September 3, 2003, attached hereto as Exhibit 6.

Scannell testified that on September 8, 2003, five days after Spitzer filed the action against Canary action, he asked Collora to contact the office of William Galvin, the Secretary of the Commonwealth of Massachusetts, and relay his allegations of market timing at Putnam.[5] Scannell Tr. at 79. According to Scannell, on September 11, 2003, he met for four hours with (b)(7)(C) and (b)(7)(C) of Galvin's office. *Id.* at 80. Scannell further testified that he showed them the Putnam prospectuses, and a spreadsheet that showed the pension funds' profits from market timing trades. *Id.*

[4] Scannell fired Collora approximately five months later. Scannell Tr. at 81.

[5] Scannell testified that he discussed his allegations against Putnam several times in late-August 2003 with Spitzer. Scannell Tr. at 78-79.

III. In September 2003, the SEC Began Investigating Allegations that Putnam Employees Market-Timed its Funds

(b)(7)(C) testified that after the Canary action was filed by Spitzer on September 3, 2003, the SEC's interest in market-timing issues was heightened. (b)(7)(C) Tr. at 72-73. Shortly after the Canary action was filed, Stephen Cutler, the SEC's Director of Enforcement at that time, received an anonymous tip that Putnam employees were market timing its mutual funds. (b)(7)(Tr. at 28. (b)(7)(testified, "Shortly after Canary broke, maybe a day or two later, Steve Cutler, who was the head of all of Enforcement, received a tip that with Putnam there were employees who were engaging in their own personal market timing and that we should look at it."[6] (b)(7)(Tr. at 28.

(b)(7)(C) testified that immediately after the tip to (b)(7)(C the BDO sent an examination team to Putnam to pursue the allegation received by (b)(7)(of market timing by Putnam portfolio managers. *Id.* BDO also opened an Enforcement investigation into the allegation on September 12, 2003. *See* NRSI Enforcement Detail-Table of Context, attached hereto as Exhibit 7.

(b)(5)

(b)(5) Senior SEC Enforcement officials in Washington, DC, in consultation with the BDO staff, made the decision to not include Scannell's allegations of market timing in the SEC action. *Id.* at 79-80.

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[6] Scannell does not believe that Cutler received a tip related to market timing by Putnam's own employees. Scannell Tr. at 80-82. He believes that his own attorneys were the source of the tip to Cutler, and that the substance of the tip was that Scannell was planning on contacting Galvin. *Id.* at 80-82, 86. Scannell did not provide any evidence to the OIG to support his belief that his attorneys tipped Cutler in what he believes was an effort to subvert Scannell's attempts to expose Putnam. Nor does he offer any theory why his attorneys would have breached their duty of confidentiality to Scannell.

In an interview with OIG, Cutler stated that the tip he received was that Putnam employees were market timing Putnam's mutual funds. Interview Memorandum of Stephen Cutler (March 11, 2009), attached hereto as Exhibit 8. Cutler's recollection was corroborated by (b)(7) and (b)(7)(C *See* (b)(7) Tr. at 28; (b)(7)(C Tr. at 73.

IV. The SEC and the Massachusetts Securities Division Filed Actions Against Putnam, but only the Massachusetts Action Included Scannell's Allegations

On October 28, 2003, the SEC filed a civil injunctive action against Justin M. Scott and Omid Kamshad, two former Managing Directors and portfolio managers at Putnam, charging each of them with securities fraud in connection with their personal market timing trades in Putnam mutual funds. *See* Exhibit 9. In a related matter, the SEC instituted an administrative proceeding against Putnam alleging that Putnam engaged in securities fraud by failing to disclose to the funds or to the fund boards the potentially self-dealing transactions in fund shares by Scott, Kamshad, and other employees. *Id.*

On November 13, 2003, the SEC reached a partial settlement with Putnam requiring, *inter alia*, that Putnam retain an independent consultant to calculate the amounts necessary to fairly compensate Putnam funds' shareholders for losses attributable to excessive short-term trading and market timing trading activity by Putnam employees. *See* Exhibit 10. On April 8, 2004, Putnam and the SEC reached a final settlement of the SEC's administrative action that required, *inter alia*, that Putnam pay $5 million in disgorgement and a civil money penalty of $50 million. *See* Exhibit 11.

On October 28, 2003, the Massachusetts Securities Division filed an administrative complaint against Putnam, Kamshad and Scott for violating the anti-fraud provisions of the Massachusetts Uniform Securities Act. *See* Exhibit 1. The complaint included the following:

> Although market timing itself is not illegal for the investors, mutual fund advisers have a fiduciary duty to treat all shareholders equitably. This obligation would preclude granting one group of shareholders (*i.e.*, market timers) privileges and rights not granted to all shareholders (*i.e.*, long-term investors). In addition, when a fund's prospectus disclosure indicates that the fund management will act to limit market timing, it cannot knowingly permit such activities.

Id. at 2.

Putnam consented to a simultaneous settlement with the Massachusetts Securities Division pursuant to which Putnam paid $5 million in restitution and a $50 million fine. *See* Exhibit 12 at 13-14. The Massachusetts Securities Division consent order that was entered against Putnam included the following factual findings:

> On September 11, 2003, the Division received information from a Putnam registered agent alleging that individual defined contribution/401K plans ("DC/401K") plan

> participants were moving money excessively between the Putnam International Voyager Fund and the Putnam Stable Value Fund; that Putnam knew of the activity; and had failed to take any action to stop it.
>
> The Putnam registered agent further indicated that trades were routinely placed by Boilermakers Local Lodge No.5 ("Boilermakers") plan participants on a daily basis between 3 and 4 p.m. In fact, according to the information provided by the registered agent, this activity was so prolific that the last hour of the trading day became known internally as "boilermaker hour" at Putnam's Norwood office.

Id. at 2. The consent order made similar factual findings with respect to the JIB pension fund. *Id* at 7-8.

Scannell claimed that, unlike the Massachusetts Securities Division, the SEC did not include the pension funds' market timing activity that he brought to the SEC's attention in its action against Putnam because the BDO staff wanted to protect Putnam. Scannell Tr. at 83-85, 96. Scannell stated that he believes the (b)(7)(C) (b)(7)(C) was fired shortly after the Massachusetts Securities Division filed its complaint against Putnam because (b)(7)(C) and other BDO officials had conspired to protect Putnam by suppressing his allegations. *Id.* at 82. Scannell did not offer any specific evidence to support his theory that BDO officials conspired to silence him other than the timing of (b)(7)(C) departure from the SEC.

The OIG investigation did not find evidence substantiating Scannell's theory that the SEC did not include in its Enforcement action the allegations he raised with them because they were trying to protect Putnam. In fact, while the evidence suggests that the timing of (b)(7)(C) departure may have been related to Scannell and his allegations, we did not find evidence that the SEC was motivated by protecting Putnam or silencing Scannell.

(b)(5)

(b)(5) Moreover, the fact that the SEC did sue Putnam and obtained a $50 million civil penalty against it is inconsistent with the theory that SEC officials were primarily concerned with shielding Putnam from liability.

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While the OIG did find evidence that (b)(7)(C) [redacted] departure from the SEC may have been related to the Putnam matter as Scannell claimed, we did not find that (b)(7)(C) [redacted] was forced to resign to protect Putnam. (b)(7)(C) [redacted] formally resigned from BDO on November 3, 2003. (b)(7)(C) [redacted] (b)(7)(C) [redacted] *See* Exhibit 13.

(b)(7)(C) [redacted]

Conclusion

The OIG investigation found that the SEC's BDO staff did not initially pursue Scannell's April 2003 allegations regarding market timing by the pension funds, other than reviewing the relevant Putnam prospectuses. (b)(5) [redacted]

The OIG also found that in September 2003 the BDO staff did open an investigation of Putnam related to alleged market timing by Putnam employees. The SEC's Putnam investigation was opened because of a tip that the SEC received shortly after the Canary case was filed by Eliot Spitzer. At around the same time that the SEC opened its Putnam investigation, Scannell approached the Massachusetts Securities Division with his allegations regarding market timing by the pension funds.

(b)(5) [redacted]

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Finally, the OIG found that (b)(7)(C) departure from the SEC, while it may have been related to Scannell's allegations, was not related to an effort to protect Putnam or silence Scannell.

In light of the above, the OIG did not find evidence substantiating the allegations of staff misconduct in connection with its Putnam investigation and is providing this report to the SEC's Regional Director of the Boston Regional Office and the Office of the Chairman.

(b)(7)(C)

Submitted: Date: 11/6/09

Concur: Date: 11/6/09

Approved: H. David Kotz Date: Nov. 6, 2009