SECURITIES WEEK

An exclusive report on events and people in the securities and futures industry

PRUDENTIAL MARKET TIMING MEMOS, RULES DID LITTLE TO STOP PRACTICE

Despite internal memos issued by senior management at Prudential Securities to branch managers last January that alerted them to the pitfalls of market timing and late trading on mutual funds little was done to curb the practice, said people familiar with the firm. In fact the practice continued with a winking attitude from senior management until the story exploded over the past several weeks, these same people say.

The issue is especially germane because just last week Pru released 12 employees, including two branch managers, for problems related to market timing. One branch manager, Robert Shannon, was in Boston, and the other, Marshall Dumont was in Garden City, New York. Employees were also released from a New York City Pru office although names could not be determined.

The issue has caught fire due to investigations by New York

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NYSE NOT SEPARATING REGULATORY FUNCTION, BUT THAT DOESN'T MEAN STATUS QUO WILL REMAIN

John Reed, NYSE interim chairman and CEO, said that separating the regulatory function from the business side of the exchange now would be a mistake.

Separating the regulatory function would be the kind of dramatic market structure change that Reed said is not part of his job description. But the Big Board could make a move to ensure there is no perception of conflict in its regulation with a change of the corporate governance structure—which is Reed's focus—along the lines of the Pacific Exchange and last week's SEC action against the Chicago Stock Exchange.

As part of the settlement of an administrative proceeding regarding a failure of the CHX to adequately enforce rules and provide market surveillance, the SEC is requiring the creation of a regulatory oversight committee. The oversight committee is to monitor the regulatory function of the exchange, review

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SUMMARY JUDGEMENT GIVES RARE VICTORY TO EMPLOYEE WITH ORAL CONTRACT

A summary judgment issued two weeks ago by Judge William Pauley in the Southern District of New York gave a rare victory to a claimant alleging his former firm, J.P. Morgan Chase, didn't give him bonuses promised orally by his superior there. The claimant, James Xu, worked at J.P. Morgan's exotic options desk and alleged he was promised a percentage of the trading desk's revenues as bonus compensation for 2000.

Xu was terminated in November 2000 and offered a standard severance package and a payment of $365,000; Xu alleged he should have received bonuses exceeding $1.8 million, based on the more than $40 million the exotic options trading desk generated while he was its head.

In J.P. Morgan's quest to get a sum-

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SEC REPORT EASES FEARS OF RETAIL DEBACLE IN HEDGE FUND SECTOR

The conclusion that retail investors do not have a significant presence in hedge funds was probably the most important finding in an SEC staff report last week, observers believe—especially for the hedge fund industry.

It was the main reason why the study recommended only limited additional oversight for the funds, according to this view.

The study, started early this year, was prompted partly by rising apprehension in Congress and the regulatory establishment that the recent down market had caused retail investors to flock to the alternative funds.

The worst fear was of a sudden tidal wave of losses among millions of unsophisticated investors—a disaster with crushing economic and

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merger. They were still being governed by Pru policy. I understand it contains pretty significant restrictions."

The Wachovia spokesman added that since Pru and Wachovia merged in July it took a little while to get Pru in line with Wachovia's policy; the merger has an 18 month timeline for all integration and this is a single issue among many.

Wachovia is generally acknowledged in the business to have a strict market timing policy.

A Prudential spokesman said the January internal memo made clear Pru is formalizing the policy whereby they enforce the policies of the mutual fund with which they do business.

A second recruiter said that a second branch manager, in New York City, is also embroiled in the timing debacle, but is resisting Pru's efforts to oust him.

"He actually brought what was going on to the attention of Pru about two years ago, and alerted compliance to the problem," the recruiter said. "They've been looking into it ever since. Until this investigation they (Pru) hadn't taken any actions, or had any other firms. You will see more firms dumping people because of it. Smith Barney, UBS and Merrill Lynch are looking into it. Morgan Stanley is already dismissing people. This could be a massive scandal."

The second recruiter agreed with the first that Rice looks to potentially suffer the most out of any Pru manager from this nascent scandal.

"The guy most in jeopardy here is Rice; after all, it happened under his watch."—***DS***

NYSE NOT SEPARATING REGULATORY FUNCTION, BUT THAT DOESN'T MEAN STATUS QUO WILL REMAIN

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regulatory reports and making recommendations to the board. The committee is to meet at least on a quarterly basis with the market regulation department and review its activities and findings with the board on a semi-annual basis.

The oversight committee is to have seven members, five of whom must be public governors of the exchange, and the committee's chairman must be one of those five.

The structure and duties imposed on the CHX and similar to what the PCX has been doing for years. One difference is that all the members of the PCX regulatory oversight committee are public governors with an ability to act independently of management or the board.

Several industry observers see the SEC—particularly in light of the CHX action—as likely to try to move other exchanges to the PCX model of regulatory oversight.

Reed did not specifically say such an idea is under consideration, but his comments following Thursday's board meeting suggest it might be a possible middle road between changing nothing and separating the regulatory function.

Among those who have called for such a separation is Carl McCall, who raised the idea in his letter of resignation from the NYSE board. In his letter, McCall said he hoped the exchange would, "Initiate an immediate examination to identify and evaluate ways to separate the regulatory and trading functions to ensure that they are effective, independent and beneficial to the investing public."

Reed said the first question for the board is the issue of separating the regulatory function, something he said in his best judgment "would be a mistake."

"There is a consensus that we should keep the regulatory function in house," Reed said. "The second question is, do we have a governance structure that somehow compromises that position.

"Our position now is that we want to keep it tightly coupled," Reed added. "Our customers wouldn't view the stock exchange as the stock exchange without that regulatory function."—***JB***

SUMMARY JUDGEMENT GIVES RARE VICTORY TO EMPLOYEE WITH ORAL CONTRACT

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mary judgment on Xu's claims it relied on its written incentive plan, arguing it precluded oral agreements to pay Xu, because the written plan provided the firm with complete discretion how and whether to pay bonuses to employees.

But Judge Pauley rejected this line of thinking. Pauley argued that because the incentive plan is discretionary it cannot be enforced as a contract, and so doesn't preclude a separate oral agreement alleged by Xu.

The firm of Liddle & Robison, in New York, represented Xu.

Jeffrey Liddle, partner at the firm, said that if J.P. Morgan had won the summary judgment the case would have died before it went to trial. As it is, he said, it would go to trial, although no date has been set yet. Xu was not awarded anything in the summary judgment.

Liddle said the judgment was significant because the judge ruled that Xu's contract lacked the principals of bilateralness that are necessary to make contracts legal; that is, Xu wasn't given a chance to agree to the terms offered him by the firm. He was simply told what he would receive.

"What the judge is saying is that all contracts have obligations of mutuality, bilateralness, quid-pro-quo," he said. "You can't just revert to your own interpretation (of the contract), after someone's completed their performance, to which you're going to pay him on...You can't claim he is subject to a contract he has no input on."

In-house attorney Melissa Gold represented J.P. Morgan.

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to be included in the offering will depend on the interest of the company's shareholders in participating in the offering, which will be determined at a later date.

Morgan Stanley will act as the book-running manager for the offering with Goldman Sachs and UBS Securities as senior co-managing underwriters. Citigroup, J.P. Morgan and William Blair & Co., will act as co-managing underwriters.

A registration statement relating to these securities has been filed with the SEC but has not yet become effective. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective.

SUMMARY JUDGEMENT GIVES RARE VICTORY TO EMPLOYEE WITH ORAL CONTRACT

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Gold could not be reached due to maternity leave. Calls to spokesmen at the firm and other attorneys were not returned.

To Jenice Malecki, a securities attorney in New York, the judge's decision was "pretty shocking" and makes it clear to companies that in the future they will have to be more careful about not delivering on promises—oral or otherwise—given to employees.

"For years companies made promises to employees which they refused to honor," she said. "This forces companies to be more clear with respect to their policies and whether or not they intend to enforce policies as actual agreements with employees."

Malecki said that the judge clearly decided the written incentive plan is not a contract, which means that the severance policy in the incentive plan is also not a contract. "Then an oral agreement is not precluded by this thing that's not a contract."

This leaves the question of whether the oral agreement is enforceable or not up in the air, she said. But it clearly is not precluded by the documents J.P. Morgan made Xu sign. The question of whether Xu's oral contract stands up will have to be decided at a later stage.

Malecki was also surprised this decision came from a district as traditionally pro-employer as the Southern District.

"It's a great decision and long overdue," she said. "This sort of thing goes on all the time...Perhaps this will make them think more before they make promises. The lesson to the employee is that after someone makes you a promise you should send them an email and say this is what we discussed, make a contemporaneous record so you can enforce the oral agreement. Clearly the court is saying it will entertain discussions of oral agreements, which is really fabulous."

Willis Riccio, partner at Adler, Pollock & Sheehan, in Providence, R.I., said that the court didn't decide on whether the oral contract is enforceable, as there was not enough evidence.

Riccio was less enthusiastic then Malecki about what the case could mean to employees, but agreed that this could mean firms need to be more careful about what they say in oral contracts.

"A decision on a summary judgment is not always conclusive," he said. "They're just saying the case can go forward...It gives a cullable claim that an oral contract can be enforced. Personally I don't think it'll go much beyond that."—***DS***

SEC REPORT EASES FEARS OF RETAIL DEBACLE IN HEDGE FUND SECTOR

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political consequences.

The SEC study noted that determining whether the average investor was an important factor in the rising growth in hedge funds was one of its primary objectives. It said the subject was particularly relevant since larger numbers of citizens are qualifying to buy the funds because of the sustained growth in wealth and income during the 1990s.

"To date, however, the staff has not uncovered evidence of significant numbers of retail investors investing directly in hedge funds," the report concluded. It listed two possible explanations for this.

One is that most hedge funds may have investment minimums higher than existing SEC rules for buying the volatile risky funds. Hedge funds now may sell only to "accredited investors;" defined in SEC Regulation D as those with a net worth exceeding $1 million, or more than $200,000 in joint income.

Another reason could be hedge fund sponsors may simply be rejecting "minimally qualified" investors, according to the SEC staff report.

The SEC staff study—which the commission is expected to adopt—recommended that hedge funds register under the Investment Advisers Act of 1940. One result is that eligibility requirements for smaller investments would be raised to $1.5 million in net worth, or $750,000 invested with the adviser.

Under the Investment Advisers Act, hedge funds would be required to disclose holdings, but would be allowed to omit data of a proprietary nature—a victory for the funds.

Despite being the target, hedge funds could have some lasting benefit from the SEC staff recommendations, lobbyists believe. While subjecting them to some additional oversight, the SEC staff report could defuse for the present concerns about massive bankruptcies among legions of novice hedge funds investors, according to this view. The alarming prospect has been the topic of numerous congressional hearings and