

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-12238

In the Matter of

BEAR, STEARNS & CO., INC. and
BEAR, STEARNS SECURITIES CORP.,

Respondents.

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MODIFIED PLAN OF DISTRIBUTION

I. BACKGROUND

A. Description

1. This Plan of Distribution (“Plan” or “Distribution Plan”) proposes a methodology for distributing to investors \$250 million (plus accumulated interest net of tax liabilities) paid by Bear, Stearns & Co., Inc. (“BS&Co.”) and Bear, Stearns Securities Corp. (“BSSC”) (collectively, “Respondents”) in settlement of administrative proceedings concerning findings of late trading and deceptive market timing practices in the trading of mutual funds.¹

2. On March 16, 2006 the Respondents consented to the entry of an Order by the Securities and Exchange Commission (“SEC” or “Commission”),² without admitting or denying the Order’s findings. The Order addressed activity between 1999 and 2003 and found, among other things, that the Respondents “facilitated a substantial amount of late trading and deceptive market timing” as a broker-dealer³ and a clearing firm.⁴ The Order stated, “At BS&Co., certain brokers in the Private Client Services Division (“PCS”) facilitated illegal mutual fund trading by knowingly processing large numbers of late trades for certain market timing customers, predominantly large hedge funds, and by helping market timing hedge funds evade detection by mutual funds that did not want market timing business.”⁵ The Order found that BSSC cleared all of these trades for customers of the PCS brokers, as well as “trades for prime brokerage customers (*i.e.*, hedge funds that cleared trades directly through BSSC) and for customers of its correspondent firms (*i.e.*, introducing brokers that cleared customer trades through

¹ The merger between The Bear Stearns Companies Inc. and JPMorgan Chase & Co. will not affect the ongoing implementation of, and payment for, the Distribution Plan.

² Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, March 16, 2006 (Release 33-8668) (“the Order”).

³ BS&Co. is an introducing broker-dealer whose customers buy and sell securities. Order at ¶ 1.

⁴ BSSC is a clearing firm that clears trades for BS&Co., other introducing brokers, and prime brokerage customers. Order at ¶ 1.

⁵ Order at ¶ 2.

BSSC.)”⁶ According to the Order, the Respondents facilitated market timing by assigning multiple account numbers to customers so that mutual funds could not identify them as customers whose trades they had previously blocked,⁷ and by assigning customers multiple registered representative numbers and alternative branch codes to avoid detection by mutual funds.⁸ The Order concluded that the “Respondents’ conduct benefited their customers and customers of correspondent firms by enabling those customers to generate hundreds of millions of dollars in profits from these trading tactics at the expense of mutual fund shareholders.”⁹

3. The Order required the Respondents to pay, on a joint and several basis, disgorgement in the amount of \$160 million and civil money penalties in the amount of \$90 million, for a total payment of \$250 million. The Order called for the establishment of a Fair Fund for these monies, pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002.¹⁰ Pursuant to the Order, the Respondents retained the services of an Independent Distribution Consultant (“IDC”) not unacceptable to the staff of the Commission. The Order required the IDC to submit a Distribution Plan to the SEC to distribute “the \$250 million in disgorgement and penalty, and any interest or earnings thereon, according to a methodology developed in consultation with Respondents and acceptable to the staff of the Commission.”¹¹

4. In accordance with the terms of the Order, Respondents have provided all information requested for its review, including providing access to their files, books, records, and personnel.¹² Respondents are responsible for all costs and expenses associated with the development and implementation of the Distribution Plan, including the compensation of the IDC and of a tax administrator, and the payment of any distribution or consulting service fees that may be reasonably required by the IDC.¹³ Tax

⁶ Order at ¶ 3.

⁷ Order at ¶ 2.

⁸ Order at ¶¶ 2-3.

⁹ Order at ¶ 5.

¹⁰ Order at § IV.D.

¹¹ Order at ¶¶ 202-203.

¹² Order at ¶ 201.

¹³ Order at ¶ 201.

liabilities will be paid according to Rule 1105(e), *i.e.*, first from the interest earned by the Fund, and if the interest is not sufficient, then from the corpus.

5. This submission serves as the proposed Plan of Distribution as required by the March 16, 2006 Order. The Bear Stearns Fair Fund (“Fund”) was established under Section 308(a) of the Sarbanes-Oxley Act to provide for the ultimate distribution of the disgorgement and penalty funds to investors who were harmed by the conduct described in the Order. This Fund has been deposited at the U.S. Treasury Bureau of Public Debt for investment in government obligations. Other than interest from these investments, it is not anticipated that the Fund will receive additional funds. The Plan of Distribution for Fund monies is subject to approval by the Commission.

B. Appointment of Independent Distribution Consultant

6. Paragraph 201 of the Order requires Respondents to retain the services of an Independent Distribution Consultant not unacceptable to the staff of the Commission in this matter. Accordingly, Respondents have retained Francis E. McGovern, Esq., a professor of law at Duke University, to be the IDC for this matter.¹⁴

7. As the IDC, Professor McGovern has been asked to develop a Distribution Plan for the distribution of Fund monies according to a methodology developed in consultation with Respondents and acceptable to the staff of the Commission. In completing this engagement, Professor McGovern has been guided by the terms of the Order. Professor McGovern has developed this Plan in consultation with other Fund Family IDCs retained to implement distributions in other market timing cases, Commission staff, Respondents, and COMPASS LEXECON, an economics consulting firm retained by him in connection with this matter.

8. Under this Plan, Fund monies will be allocated to Eligible Mutual Funds¹⁵ according to a formula designed to capture the proportional dilution in such mutual funds

¹⁴ Professor McGovern is widely published on the topics of alternative dispute resolution and case settlement. Professor McGovern also has broad experience advising courts and parties on settlement mechanisms and fund distribution.

¹⁵ See Defined Terms, Sec. II at ¶ 9.

relative to the dilution in all Eligible Mutual Funds. In other words, the total dilution ascribed to all Eligible Mutual Funds will be calculated, and, then, each Eligible Mutual Fund will be allocated its percentage of such total dilution amount. Allocations of Fund monies will be made from the \$250 million settlement amount paid by Respondents, together with accrued interest less any taxes payable on the interest accrued by the Fund.

I. DEFINED TERMS

1. This Distribution Plan makes use of a number of terms with specific meanings and references. Following is a list of definitions for the specific terms used herein.

“Approval Date” means the date on which the Commission institutes an administrative order approving this Distribution Plan.

“Commission” or “SEC” means the United States Securities and Exchange Commission.

“Contemporaneous Accountholders” means shareholders of Eligible Mutual Funds that held shares during all or part of the Relevant Period.

“Distributable Amount” means: (i) \$250 million *plus* (ii) interest, if any, actually earned on the foregoing amounts through the end of the month prior to the Approval Date *less* (iii) any federal, state, or local taxes imposed on the interest. Amounts sufficient to cover any taxes owed on the interest earned on the Settlement Amount as of the time of the distributions under the Plan shall be set aside and not distributed. Any earnings on the amounts set aside to pay applicable taxes will be transferred to the U.S. Treasury.

“Distribution to Contemporaneous Accountholders” means the method of distribution employed to distribute Fund monies to Contemporaneous Accountholders of certain Eligible Mutual Funds.

“Eligible Mutual Funds” means those mutual funds that may have been affected by the activity described in the Order during all or part of the Relevant Period and are eligible to receive a payment of at least \$1,000 from the Fund.

“Escrow Bank” means Deutsche Bank.

“Fund Family IDC” means the Independent Distribution Consultant retained in connection with another Commission proceeding or a distribution consultant retained in connection with a state enforcement or regulatory proceeding to effectuate a distribution from a market timing settlement fund to accountholders.

“IDC” or “Fund IDC” means Professor Francis E. McGovern, Esq., the Independent Distribution Consultant retained by the Respondents pursuant to the terms of the Order.

“LIFO” means last-in, first-out, an accounting convention used in this Distribution Plan.

“Order” means the Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 against Respondents.

“Plan” means this Plan of Distribution as developed by the Independent Distribution Consultant and approved by the Commission.

“Relevant Period” means January 4, 1999 through October 29, 2003, the period of the conduct described in the Order.

“Respondents” means Bear, Stearns & Co., Inc. and Bear, Stearns Securities Corp.

“Settlement Amount” means the \$250 million paid by the Respondents to the Commission in connection with this Order.

“Tax Administrator” means Damasco & Associates LLP, a certified public accounting firm, appointed by the Commission to administer taxes for the Fund in this proceeding.

“Transaction Database” means the database provided by Respondents to the IDC containing information regarding all mutual fund transactions executed by BSSC during the Relevant Period.

III. ADMINISTRATION OF THE PLAN

A. Appointment of an Administrator for the Fund

10. The Commission’s Order requires that the IDC submit the Distribution Plan “for the administration and distribution of disgorgement and penalty funds pursuant to Rule 1101 [17 C.F.R. §201.1101] of the Commission’s Rules Regarding Disgorgement and Fair Fund Plans.”¹⁶ Accordingly, the IDC has proposed the retention of Rust

¹⁶ Order at ¶ 206.

Consulting, Inc., a services company well experienced in the distribution and administration of market timing fair funds, to act as the Fund Administrator ("Fund Administrator"). The Respondents will pay all fees and costs associated with the administration of the Plan of Distribution, including the fees of the Fund Administrator.

11. The Fund Administrator, working with the IDC, will be responsible for, among other things: assisting in the administration of the Fund, obtaining accurate mailing information for accountholders,¹⁷ preparing accountings, cooperating with the tax administrator in providing the information necessary to accomplish the income tax compliance, distributing money from the Fund to accountholders in accordance with this Plan, and setting up and staffing a call center to address accountholder questions or concerns regarding the distribution.

12. While the distribution is being implemented, the Fund Administrator will file an accounting during the first ten days of each calendar quarter. The Fund Administrator will submit a final accounting for approval of the Commission prior to termination of the Fund and discharge of the Fund Administrator.

13. In lieu of bond, the Fund Administrator maintains and will continue to maintain insurance until termination of the Fund. The current primary insurer, Illinois Union Ins. Co. (ACE USA), is a company which, as of its most recent renewal, was rated ("A+ r XV") by A.M. Best. The Fund Administrator maintains and will continue to maintain until termination of the Fund, errors and omissions coverage in the amount of \$10,000,000. It has a policy limit of \$10,000,000 per occurrence and an overall limit of \$10,000,000 during the life of the policy. The Fund Administrator also maintains an additional \$10,000,000 in excess errors and omissions coverage which is provided by Lloyd's of London. Lastly, the Fund Administrator maintains a crime policy in the amount of \$5,000,000 per occurrence, which provides protection against employee dishonesty, forgery or fraudulent alteration of securities, and electronic and computer crime exposures, which include losses due to transfer, payment or delivery of funds as a

¹⁷ The Fund Administrator will undertake accountholder identification and administrative support efforts only where distributions are made to Contemporaneous Accountholders.

result of fraudulent input, preparation or modification of computer instructions, data or fraudulent electronic transmissions or communications. Under the Plan of Distribution, at no time will there be funds under the custody and control of the Fund Administrator. Documentation of coverage has been provided to Commission staff for review and that coverage has been deemed “not unacceptable.”

14. Because (1) the Fund Administrator will have no custody, and only limited control, of the Fund; (2) the Fund will be held by the U.S. Treasury Bureau of Public Debt until immediately before transmittal of checks or electronic transfers to eligible investors; (3) upon transfer from the U.S. Treasury, funds will be held in an escrow account, separate from Escrow Bank assets, until presentation of a check or electronic transfer, at which time funds will be transferred to a controlled distribution account; (4) presented checks or electronic transfers will be subject to “positive pay” controls before honored by the Escrow Bank; and (5) both the Escrow Bank and the Fund Administrator will maintain, throughout this process, insurance and/or a financial institution bond that covers errors and omissions, misfeasance, and fraud, the Plan proposes that the requirement that a bond be posted pursuant to Rule 1105(c) be waived by the Commission for good cause shown.

B. Appointment of the Tax Administrator

15. The Commission has appointed Damasco & Associates LLP as the Tax Administrator (“Tax Administrator”) of the Fund.¹⁸ The IDC, Fund Administrator, and Respondents will cooperate with the Tax Administrator in providing information necessary to accomplish the income tax compliance, ruling, and advice work assigned to the Tax Administrator by the Commission. The Tax Administrator shall be compensated by the Respondents.

¹⁸ See *Order Appointing Tax Administrator*, SEC Release No. 34-53625, April 10, 2006.

C. Control of the Fund

16. Pursuant to the Order, on April 7, 2006, Respondents paid a total of \$250 million to the SEC. The Fund is currently deposited at the U.S. Treasury Bureau of Public Debt.

17. The Fund constitutes a Qualified Settlement Fund (“QSF”) under Section 468B(g) of the Internal Revenue Code, 26 U.S.C. §468B(g), and related regulations, 26 C.F.R. §§1.468B-1 through 1.468B-5. The assets of the Fair Fund are subject to the continuing jurisdiction and control of the Commission.

IV. DISTRIBUTION METHODOLOGY AND PROCEDURES

A. Objective of the Plan

18. The Order provides that the IDC shall “develop a Distribution Plan for the distribution of the \$250 million in disgorgement and penalty, and any interest or earnings thereon, according to a methodology developed in consultation with Respondents and acceptable to the staff of the Commission.”¹⁹ Accordingly, this Plan is designed to allocate Fund monies among those harmed by the conduct described in the Order during the Relevant Period. This allocation will be based upon an analysis that will reflect an estimate of the proportionate dilution in value of each of the Eligible Mutual Funds during the Relevant Period relative to the dilution in all Eligible Mutual Funds during that period. For example, if the total dilution calculated for all Eligible Mutual Funds during the Relevant Period is \$100, and the dilution calculated for a particular Eligible Mutual Fund during that period is \$10, then the Eligible Mutual Fund will be allocated 10% of the Distributable Amount as its Fund payment.

19. This Plan is designed to compensate those harmed by the practices described in the Order and facilitated by Respondents. While other Fund Family IDCs have access to detailed information regarding the accountholders within their respective fund families, such information is not similarly available to this IDC or the Respondents. Therefore, under this Plan, in the great majority of cases, money will be allocated to the

¹⁹ Order at ¶ 202.

asset bases of Eligible Mutual Funds. In some instances, where practicable and feasible, the IDC may use an existing Fund Family IDC or a Fund Administrator to distribute monies directly to Contemporaneous Accountholders of Eligible Mutual Funds.

20. The IDC believes that the methodology described in this Plan is a fair and reasonable way in which to allocate Fund monies to those Eligible Mutual Funds harmed by the deceptive market timing and late trading practices, as are described more fully in the Order. The realized profits method will be used to allocate Fund monies to each Eligible Mutual Fund.

B. Methodology Used to Develop the Distribution Plan

Transaction Database

21. Respondents provided the IDC with a database containing information regarding all mutual fund transactions (the "Transaction Database") processed by BSSC during the Relevant Period. The Transaction Database identifies for each transaction: the account number, customer name associated with the account number, branch number, registered representative number, the mutual fund traded, date of trade, number of shares traded, and the price at which the trade was executed.

22. All data provided to the IDC and any analyses produced by the IDC are strictly confidential and held exclusively by the IDC and those retained to assist the IDC.

Identifying Market Timers

23. According to the Order, the following three groups of Respondents' customers engaged in late trading and/or deceptive market timing through trades during the Relevant Period:

- a) Certain customers of BSSC's correspondent firms;
- b) Certain of BSSC's prime brokerage customers; and
- c) Certain customers of the PCS brokers.

24. To estimate the effect of the alleged market timing transactions on mutual funds, the IDC identified those customers of the Respondents who fell within the categories described above (collectively, the “Described Market Timers”).

25. The following types of accounts were identified and included in the dilution analysis (“Included Accounts”):

- a) Certain accounts associated with the correspondent broker-dealer firms described in the Order as having a customer engaged in deceptive market timing or late trading at any point during the Relevant Period and identified through branch number, account number and account name;
- b) Accounts of the prime brokerage firms which entered an order for processing in BSSC’s Mutual Fund Routing System after 4 PM at any point during the Relevant Period; and
- c) Accounts associated with any of the registered representative numbers of those PCS brokers described in the Order as having a customer engaged in either late trading or deceptive market timing during the Relevant Period.

26. All transactions associated with the Included Accounts of the market timers were identified in the transaction database. Customers of correspondent brokers and prime brokerage customers were identified based on branch number, account number, and account name. Customers of PCS brokers were identified based on the registered representative numbers. Overall, the IDC identified a total of approximately 1,200 customer accounts of correspondent brokers, 200 prime brokerage customer accounts, and 560 customer accounts of PCS brokers. During the Relevant Period, these Included Accounts were involved in transactions with approximately 3,000 different mutual funds.

Estimating Dilution Losses

27. This Plan uses dilution to measure the harm caused by the trades of the Included Accounts. Dilution is the difference in the wealth of shareholders in a mutual fund with market timer trades compared to the same fund without those trades. “In other

