

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES ACT OF 1933
Rel. No. 8574 / May 23, 2005

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 51725 / May 23, 2005

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2389 / May 23, 2005

INVESTMENT COMPANY ACT OF 1940
Rel. No. 26875 / May 23, 2005

Admin. Proc. File No. 3-9461

In the Matter of

FUNDAMENTAL PORTFOLIO ADVISORS, INC.,
LANCE M. BROFMAN,
and
FUNDAMENTAL SERVICE CORPORATION

ORDER DENYING MOTION FOR RECONSIDERATION

I.

On July 15, 2003, we issued an opinion finding that Fundamental Portfolio Advisors, Inc. ("FPA"), Fundamental Service Corporation ("FSC"), and Lance M. Brofman ("Brofman"), chief portfolio manager for the Fundamental U.S. Government Strategic Income Fund (the Fund), violated or aided and abetted and caused the violation of various provisions of the securities laws

(the "Opinion"). ^{1/} FPA, Brofman, and FSC (collectively, "Respondents") now request reconsideration of our Opinion.

Specifically, the Opinion found that FPA willfully violated, and Brofman willfully aided and abetted and was a cause of, FPA's violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by at least recklessly making material misrepresentations in the Fund's 1993 and 1994 prospectuses and marketing materials, and of Section 34(b) of the Investment Company Act by filing a registration statement that incorporated the Fund's 1994 prospectus and thereby the misrepresentations contained in the prospectus. The Opinion also found that FSC willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-3 and 10b-5 thereunder, and Section 15(c) of the Exchange Act and Rule 15c1-2 thereunder by disseminating the Fund's prospectuses and sales literature that falsely portrayed the Fund as safe and stable and failed adequately to disclose the risks of the Fund. The Opinion found also that FPA willfully violated, and Brofman willfully aided and abetted and was a cause of, FPA's violation of Sections 206(1) and (2) of the Advisers Act by failing to disclose FPA's soft dollar arrangements to the Fund's Board of Directors (the "Board").

Based on our findings, we concluded that it was in the public interest to order each of the Respondents to cease and desist from committing or causing any violations or any future violations of the securities laws and regulations that they were found to have violated; to revoke the registration of FSC; to bar Brofman from association with any broker, dealer, investment adviser, or investment company; and to order Brofman to pay a civil money penalty of \$250,000, and FPA and FSC each to pay a civil money penalty of \$500,000.

II.

We consider Respondents' motion under Rule 470 of the Commission's Rules of Practice. ^{2/} Under that rule, the Commission may reconsider its decisions in exceptional

^{1/} Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Service Corporation, Securities Act Rel. No. 33-8251 (July 15, 2003), 80 SEC Docket 2234. Rule 451(d) of the Commission's Rules of Practice permits a member of the Commission who was not present at oral argument to participate in the decision of that proceeding, if that member has reviewed the transcript of that argument prior to such participation. Although the Opinion did not specifically state, Commissioners Paul Atkins and Roel Campos, who were absent from the oral argument, conducted the required review prior to participating in the decision.

^{2/} 17 C.F.R. § 201.470.

cases. 3/ This extraordinary remedy is designed to correct manifest errors of law or fact, or to permit the presentation of newly discovered evidence. 4/ Respondents may not use Motions for Reconsideration to reiterate arguments previously made or to cite authority previously available. 5/ Respondents' motion does not meet this standard.

The Opinion found that statements in the Fund's prospectuses and marketing materials that the Fund was a safe investment and provided relative stability of net asset value were false and misleading in light of the investment strategy that the Fund commenced in 1993 of investing a large portion of the Fund in inverse floaters. Because inverse floaters are extremely sensitive to interest rate changes and hedging against this risk is exceptionally difficult, the Fund's new strategy created a risk of significant change to the Fund's NAV in response to even moderate changes in interest rates. The Opinion found that this effect was exacerbated by the extent to which the Fund borrowed money to purchase assets. The Opinion concluded that Respondents made no or inadequate disclosure of this shift in investment strategy. None of Respondents' challenges to the Opinion, apart from those that merely repeat arguments already made by them and rejected in the Opinion, are directed at these essential conclusions on which their liability was based.

The Fund's Performance

Much of the argument in Respondents' motion (and indeed, as they concede, much of their brief on the merits and their oral argument) is devoted to their claim that the actual performance of three-year Treasury notes would not have been dissimilar to that of the Fund.

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- 3/ The Comment to Rule 470 states that "[a] motion for reconsideration is intended to be an exceptional remedy."
- 4/ KPMG Peat Marwick LLP, Order Denying Request for Reconsideration, Securities Exchange Act Rel. No. 44050 (Mar. 8, 2001), 74 SEC Docket 1351, 1352-53 n.7. See also John Montelbano, Exchange Act Rel. No. 47624 (April 3, 2003), 79 SEC Docket 3604, 3608 (motion for reconsideration must be based on "matters of record alleged to have been erroneously decided, the grounds relied on, and the relief sought," and is not an appropriate vehicle for adducing new evidence).
- 5/ On a motion for reconsideration, we accept, as do the federal courts, only that evidence the movant could not have known about or adduced before entry of the order subject to the motion for reconsideration. See, e.g., Caisse Nationale de Credit Agricole v. CBI Industries, Inc., 90 F.3d 1264, 1269 (7th Cir. 1996) (moving party must establish that evidence was not only newly discovered or unknown to it, but also that it could not have been reasonably discovered and produced during pendency of matter); see also 12 James Wm. Moore et al., Moore's Federal Practice § 59.30[4] (3d ed. 2000), cited in Carroll v. Nakatani, 342 F.3d 934, 935 (9th Cir. 2003) (specifying federal practice with respect to acceptance of newly discovered evidence on motion for reconsideration).

The Opinion does not make specific findings, however, about the performance of Treasury notes because their performance is not directly relevant to the Opinion's conclusions. 6/

Specifically, Respondents claim that the statement in the opinion that they argued that "the Fund's NAV did not decline by 32% . . . but by 19.8%" is incorrect. Respondents state that they actually argued that, if the Fund had invested in "only three-year US Treasury notes" (emphasis deleted), such

a hypothetical Treasuries-only fund, assuming the same leverage and expense ratio as the actual Fund, would have paid about 2% in dividends and thus would have had about an 18% negative return. Certainly that return is close enough to the return on the actual Fund to validate the duration calculation methodology used by the Fund and to completely rebut the theory of scienter by recklessness.

If Respondents intended their argument to be a comparison between the 32% decline in the Fund's NAV and the 19.8% decline of a hypothetical Treasuries-only fund, such a comparison does not advance their cause. The fact is the Fund's portfolio did not consist only of Treasury notes, so this argument is not relevant. 7/

6/ Respondents also argue that "[t]he rankings of the [] Fund in Morningstar, [Inc]. and Lipper [Analytical Services] are flawed and misleading due to survivorship bias [] since omitted from the 1994 rankings are mutual funds that no longer existed or had changed their names by 1997." Respondents specifically point to the Piper Government Funds, claiming that the Fund outperformed these funds. The significance of this point is unclear. The Opinion noted that Lipper ranked the Fund second to last out of 108 short-term government funds for 1994 and that Morningstar ranked the Fund last among 170 government bond funds. These factual findings were part of the Opinion's description of the Fund's poor performance after it began investing in inverse floaters. The fact that some other funds may have performed even more poorly is not relevant to the Opinion's legal conclusion that the Fund's performance was not consistent with its promises of safety of investment.

7/ Moreover, Respondents' calculation of the hypothetical fund's decline is based on an assumed increase in interest rates of 4.4%. The Opinion found that the highest increase in interest rates during the period under review was 3.4%. Respondents' calculation also factors in the impact of the hypothetical fund's leverage on its decline in value. As we noted in the Opinion, "[t]he substantial amounts of assets purchased [by the Fund] with borrowed funds exacerbated the effect on NAV created by the concentration of assets in inverse floaters." We held that Respondents' disclosures with regard to leverage were insufficient to alert reasonable investors of this effect on the Fund's promise of safety of investment and price stability. Respondents' arguments in their motion that their disclosures concerning leverage were adequate simply reiterate arguments considered and
(continued...)

Calculation of Duration

Respondents' emphasis in their motion on the validity of Modified versus Effective Duration as a model for calculating the Fund's duration is misplaced. Although the Opinion, in the factual discussion, noted the testimony of the Division's experts that Effective Duration is the appropriate model for determining interest rate sensitivity of inverse floaters, the Opinion did not specifically find that any particular method for calculating duration should have been used by Respondents. Rather, the Opinion noted that, by representing that duration would be maintained at three years or less, the Fund, in effect, represented that its price volatility would be in line with the relatively stable performance of a short- or intermediate-term bond fund. The Opinion concluded that the performance of the Fund was so inconsistent with that of the stable performance suggested by Brofman's duration calculations that Brofman was reckless in not questioning the accuracy of those calculations. 8/

Respondents argue that the Opinion incorrectly interchanged the terms "fund duration" and "portfolio duration" and, therefore, erroneously criticized the high duration of the Fund when in fact Respondents represented only that the portfolio would have a duration of three. Respondents note that "portfolio duration" equals the weighted average duration of the individual securities in a fund's portfolio or total assets, whereas "fund duration" is the portfolio duration times the factor by which the portfolio is leveraged. Respondents contend that the "Fund's performance was consistent with that of a fund whose portfolio [duration] was three years" (emphasis in original).

As noted in the Opinion, the duration of a fund where the securities in the fund's portfolio have been purchased with borrowed money will be higher than the duration of a similar fund, with the same portfolio of securities, where no borrowing occurred. 9/ Brofman produced no documentation for his calculation of duration prior to December, 1994. Moreover, as admitted by Brofman and stated in the Opinion, the method that Brofman used to calculate duration was

7/ (...continued)
rejected in the Opinion.

8/ We note that the Opinion inadvertently stated in the factual discussion, at 12, that the Effective Duration for the quarter ending December 31, 1993 was 12.92. This number should read 9.7. Since this number was relied on solely for the purpose of establishing that the duration of the Fund at all times exceeded four, this error does not affect the legal analysis or conclusions in the Opinion.

9/ Opinion at n.27. In that footnote, the word "portfolio" on lines 1, 2, and 8 should read "fund." Similarly, in the sentence in the text of the Opinion to which n.27 is attached, the word "portfolio" should read "fund." These changes do not affect the analysis in the footnote.

inappropriate because it did not factor leverage and should have. 10/ The experts stated that no method of calculating duration that measured price volatility would result in a duration of three. 11/

_____ Respondents argue that the Opinion erroneously concluded that Srikanth Sankaran, the owner of a registered broker-dealer that advised and executed transactions for the Fund, testified that he told Brofman that Modified Duration could not be used to calculate the duration of inverse floaters, when in fact, Brofman claims, Sankaran testified only that the Expert Portfolio Manager, a software package that values fixed-income securities, could not calculate duration for inverse floaters. As Sankaran testified, however, the Expert Portfolio Manager used Modified Duration for its calculations, and could not calculate duration for inverse floaters because its program "couldn't handle all the imbedded options" of those instruments. 12/

Arguments Previously Made

Many of Respondents' arguments for reconsideration are simply reiterations of arguments previously made in their briefs on the merits. 13/ For example, Respondents claim, as they did previously, that Modified Duration measures the interest rate sensitivity of the type of inverse

10/ See Opinion at nn.22 & 23 and related text.

11/ Opinion at nn.25, 26 & 27 and related text.

12/ Respondents also take issue with the Opinion's finding that Sankaran warned Brofman that the objectives of high yield with low risk and stable NAV were inconsistent, on the grounds that this discussion took place before the inception of the Fund and "thus . . . is completely irrelevant to any issues of duration . . ." This factual finding, however, together with Brofman's response that investors would not understand these concepts, was not relied on by the Opinion in its discussion of duration. Rather, the Opinion relied on these facts to buttress its conclusions regarding Brofman's scienter.

13/ Respondents argue, generally, that issuance of the Opinion on July 15, prior to the July 23 availability of the final, corrected copy of the transcript of the June 25 oral argument, "indicates there may have been some procedural or due process shortcomings involved." This assertion is baseless. Respondents submitted their edits to the transcript on July 7, 2003 and the Division submitted its corrections on July 2, 2003. Thus, we were on notice of all corrections submitted by the parties before issuing the Opinion.

Respondents attach to their motion a side-by-side analysis of "Major Errors in the Opinion and Order of the Commission . . ." and "The portions of the Record containing the grounds for the allegations of the error." The allegations of error identified in this document are either repetitions of arguments made in the motion itself, or of arguments made and considered by us in our review on the merits of Respondents' appeal, or simply inaccurately characterize the Opinion.

floaters purchased for the Fund, citing their expert Feinstein's report in the record. Respondents overstate Feinstein's report, which concedes that "Conventional Modified Duration did not necessarily represent a precise estimate of interest rate sensitivity," but opines that, given the alternative duration measures at the time, "it was not unreasonable to target a low Modified Duration and impose additional risk management screens in order to reduce portfolio volatility." The record includes no evidence that Brofman used such risk management screens, and accordingly Feinstein's report does not support Respondents' contention that Modified Duration was an appropriate measure.

Respondents restate their argument that Brofman's reliance on Modified Duration could not be reckless because it was consistent with industry practice. In this regard they restate their claim that The Handbook for Mortgage Backed Securities, which the Opinion noted was sent by Sankaran to Brofman, essentially used Modified Duration for inverse floaters. ^{14/} They imply that the Handbook's use of Modified Duration supports their claim that Modified Duration was the industry standard at the time. The Opinion, however, did not cite to the Handbook for the purpose of discussing the industry standard, but merely noted that the Handbook included a discussion of the volatility of inverse floaters, in partial support of the conclusion that Brofman was on notice that these instruments were highly volatile. ^{15/} The Opinion expressly determined that whether Modified Duration was an industry standard was not germane, because Brofman was specifically on notice that Modified Duration did not reflect the interest-rate sensitivity of the inverse floaters purchased by the Fund. ^{16/}

^{14/} Respondents object that the Opinion incorrectly identified the Handbook as being the 1988 edition rather than the 1992 edition. Both editions discuss inverse floater volatility. We also note that the Opinion states in n.35 that in L.C. Wegard & Co., 53 S.E.C. 607 (1998), aff'd, 189 F.3d 461 (2d Cir. 1999) (Table), the respondent "lacked the requisite scienter to have violated Sections 17(a), 10(b), and 15(c). In fact, we found in that decision that Wegard deliberately assisted in the manipulation at issue there.

^{15/} Moreover, the editor of the Handbook, Division expert Fabozzi, testified that the numbers presented in the Handbook were not Effective Duration calculations and that the Handbook did not otherwise identify its duration calculation methodology.

^{16/} Respondents challenge the Opinion's citation to Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 274 (3d Cir. 1998), for the proposition that "a practice may be universal within the industry and still be fraudulent." Respondents argue that, "ordinary standard methodology that was wrong or even negligent cannot, by definition, be reckless since reckless is an extreme departure from the standards of ordinary care" (emphasis in original). Nothing in Newton v. Merrill is inconsistent with this definition of recklessness. Rather, the language from the case cited in the Opinion stands for the proposition that it is not a defense to fraudulent conduct to argue that other people engaged in equally fraudulent conduct.

In challenging the Opinion's findings concerning the failure to disclose soft dollar arrangements to the Board, Respondents repeat their challenge to the credibility of Fund Board members. 17/ The Opinion noted that the law judge found the testimony of Board members credible, and cited legal precedent supporting our reliance on the credibility determinations of the trier of fact and the evidence in the record corroborating their testimony. 18/

Sanctions

Brofman's \$250,000 penalty was an aggregate amount based on two third-tier penalties for the fraud involving the failures to disclose in connection with the sales of Fund shares in 1993 and 1994, together with the second-tier penalty for the soft dollar violations. With respect to the third-tier penalties, Brofman argues that "even if the Commission mistakenly decides that [he] was reckless in not changing duration methodology, the imposition of two separate \$100,000 monetary penalties for what is actually a single alleged omission" is unwarranted. Respondent asserts that "the [Fund's] April 30, 1993 Prospectus was filed before the Fund bought any inverse floaters (emphasis in original)," and should not be considered in fashioning the civil monetary penalty imposed against him.

17/ Respondents claim that, in denying their motion to adduce additional evidence purportedly relating to the "veracity and motive of those who testified" about the Board's knowledge of soft dollar arrangements, the request "should not have been construed to only refer to Bullock as the Opinion indicates." Respondents misread the Opinion. The Opinion, in ruling that the motion lacked the requisite particularity, correctly notes that of "those who testified" only Bullock is specifically identified.

Respondents also contend that the Opinion mischaracterizes their arguments when it states that: "Brofman argues that the Board was aware of FPA's soft dollar arrangements because such arrangements were common in the industry, and Board Members had attended seminars paid for with soft dollars." Respondents do not explain this contention. Moreover, they state that these factors "do support the arguments that the Board members were aware and involved with the soft dollar arrangements." Thus, Respondents seem merely to disagree with the rejection of this argument in the Opinion.

18/ Respondents also object that the Opinion stated that Brofman admitted that he did not inform the Board of FPA's soft dollar arrangements. Respondents speculate that the Commission misunderstood Brofman's claims during oral argument that correspondence in the record shows that the Board was informed of the soft dollar arrangements. However, the correspondence in the record indicates that certain Board members knew of soft dollar arrangements that existed prior to the period under review. The Opinion specifically acknowledged that Board members had been aware of earlier soft dollar arrangements. The Opinion's finding that the Board was not informed that such arrangements were ongoing during 1994 and 1995 (until May, 1995) is amply supported by the minutes of Board meetings during this time frame.

The fraud in connection with the sales of Fund shares did not, as Brofman claims, involve a single alleged omission. It involved omissions in the prospectuses and sales literature for both 1993 and 1994 in connection with multiple sales of shares during those two years. As we found in the Opinion, these fraudulent omissions caused substantial harm to shareholders. Rather than viewing each sale of shares during 1993 and 1994 as a separate violation, with a maximum penalty for each violation, the Opinion imposed the maximum penalty twice, once for sales in 1993 in connection with the 1993 literature and once for sales in 1994 in connection with the 1994 literature.

Accordingly, IT IS ORDERED that the motion for reconsideration filed by Fundamental Portfolio Advisers, Lance M. Brofman and Fundamental Service Corporation be, and it hereby is, DENIED.

By the Commission.

Jonathan G. Katz
Secretary