MEMORANDUM

TO: Chairman William H. Donaldson

FROM: Lori A. Richards
Office of Compliance Inspections and Examinations

DATE: March 10, 2004

RE: Request by Senator Richard C. Shelby, Chairman
U.S. Senate Committee on Banking, Housing and Urban Affairs

At the November 18, 2003 Senate Banking, Housing and Urban Affairs Committee hearing entitled "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry," Chairman Richard C. Shelby requested that you provide him with a comprehensive report on the Securities and Exchange Commission's examinations of investment companies and investment advisers. At your request, the staff of the Office of Compliance Inspections and Examinations has prepared the attached report.

We recognize that the views expressed in this report may not necessarily reflect your views or those of the other Commissioners.

Attachment: As described

EXAMINATIONS OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS
March 2004

Executive Summary

This report describes examinations by the Securities and Exchange Commission ("SEC" or "Commission") of investment advisers and investment companies. It also describes the changes we are making to examinations generally, and with respect to detecting abusive market timing and late trading activity specifically. Examinations are a critical component in investor protection, and the SEC is taking steps to enhance its ability to detect abusive conduct in a timely manner.

The goals of examinations are to detect compliance problems and violations, and weaknesses in firms' internal control and compliance systems that could lead to violations of the federal securities laws.[1] When examiners identify a problem, they instruct the firm to make corrections, take any necessary remedial action, and improve their compliance in the affected area. Most often, these corrective actions involve improvements in internal controls and compliance practices to ensure that the problem is corrected and does not recur. When examiners identify serious problems, they also refer the matter to the SEC's enforcement staff for further investigation and possible enforcement action by the SEC.[2]

Currently, there are approximately 8,000 mutual funds, with $6.95 trillion in assets, managed by 900 investment company complexes. In addition, there are approximately 8,000 federally registered investment advisers, managing $20.1 trillion in assets (which includes the assets in mutual funds). The fund industry also involves a number of other service providers, including transfer agents, third-party administrators, and broker-dealers doing business with the public.

During most of the period 1998 to early 2003, the SEC's examination program for funds and advisers had approximately 370 members on its staff (including examiners, supervisors, and support staff). Routine examinations were conducted every five years. In 2003, program staffing was increased by one-third, to approximately 495 staff. With this staffing increase, the SEC will conduct more frequent examinations of funds and advisers posing the greatest compliance risks, and conduct more examinations targeted to areas of emerging compliance risk.

The SEC conducts three basic types of examinations: routine (conducted on a periodic basis); cause (conducted when there is reason to believe there is a problem at the firm); and sweep (special reviews focusing on a single issue). Examinations may be announced or unannounced;

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1 Funds and advisers are required to comply with the Investment Advisers Act of 1940 ("Advisers Act") and the Investment Company Act of 1940 ("Investment Company Act").

2 Attached to this report as an appendix is a list of recent enforcement actions brought by the Commission that involve funds and their advisers.

examinations for cause are typically conducted on a surprise basis. Examinations typically conclude with three possible outcomes: a deficiency letter, an enforcement referral, or a letter closing the examination without findings.

Given the number of firms subject to examination oversight and the breadth of their operations, examinations are not audits and are not comprehensive in scope; examiners must select discrete areas of firm operations to review. Examiners focus on areas that appear to pose the greatest risk to investors. New or emerging compliance issues may be addressed through special examination initiatives (including "mini-examination sweeps") or by being treated as priority items in routine examinations.

Prior to the recent revelation of market timing and late trading abuses, examination focus areas included trading by the fund (*i.e.*, the fund's purchases and sales of securities), but did not include a review of trading in the shares of the fund itself. Examiners' focus was on any trading in the fund that might be designed to inflate the returns of the fund inappropriately, or subject the fund to undisclosed risk. The concern was that fund portfolio managers were attempting to attract investors by producing strong returns, which could create an incentive for misconduct in the management of the fund. As a result, examination protocols required that significant attention be focused on portfolio management, order execution, allocation of investment opportunities, pricing and calculation of net asset value, marketing of returns, and safeguarding fund assets from theft. Because examiners' focus was on the fund itself, and not on trading in the fund's shares, examiners did not detect aberrant trading patterns that could be indicative of abusive market timing. Our recent examinations have shown that daily sales/redemptions data can reveal patterns of trading in a fund's shares that may indicate market timing, and we have now made a review of this data a part of every routine examination.[3]

Additionally, our review of funds' books and records did not reveal the covert arrangements that fund executives had with select shareholders allowing them to trade frequently in fund shares. These arrangements appear to have often been evidenced only in e-mail communications and not in written agreements, contracts, or other documents. In the past, routine examinations did not include a random review of employees' internal e-mail communications (unless there was cause to believe that particular communications were relevant to the examination). Now, to aid in detecting any misconduct that might not otherwise be reflected in the books and records kept by the firm and shown to examiners, routine examinations include a review of a sample of fund executives' internal e-mail communications. Additional new examination steps include a review of personal trading records showing trading in the fund shares by select fund executives (even in advance of Commission rules that would require that this information be made available), and a review of procedures to ensure that orders are processed to receive the appropriate day's net asset value.

Recent Commission rule proposals that would require better disclosure of funds' anti-market timing policies and a possible "hard 4 p.m." close for receiving fund orders will aid examiners in detecting abuses of this type in the future. More broadly, the Commission has recently adopted rules to improve compliance by funds and advisers by requiring that they strengthen their own

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3 The staff is conducting numerous cause examinations specifically targeted to review for market timing and late trading.

internal compliance programs. The new rules require that advisers and funds implement and maintain compliance policies and procedures designed to prevent, detect, and correct compliance problems in key areas of their operations. The new rules also require that funds and advisers designate a chief compliance officer to implement those compliance policies and procedures, and, in order to assist the fund board in exercising compliance oversight, to report on compliance matters to the fund's board of directors.

Examination staff have been actively assessing other ways to enhance Commission examinations of funds and advisers, and are deploying other initiatives to improve examinations, including implementing a more formalized risk assessment function, increasing examination frequency for entities posing compliance risk, conducting more targeted examinations, and making greater use of technology, intelligence, and data.

Finally, examination staff will actively participate in the SEC's new risk assessment initiative. The Chairman has proposed the creation of an Office of Risk Assessment designed to better enable the Commission to anticipate, identify, and manage emerging risks and market trends that stand to threaten the Commission's ability to fulfill its mission. This initiative -- the first of its kind at the Commission -- will enable staff to analyze risks across divisional boundaries, focusing on early identification of new or resurgent forms of fraudulent, illegal or questionable behavior or products. This initiative seeks to ensure that senior management at the Commission have the information necessary to make better, more informed decisions. Additionally, by creating a risk assessment function, the agency should be better prepared to determine more quickly whether new business trends and industry practices warrant further attention by the SEC, and by its examiners, and to proactively adjust operations and resources to address these new challenges.

Each of these areas is described in greater detail in this report.

I. The Investment Management Industry

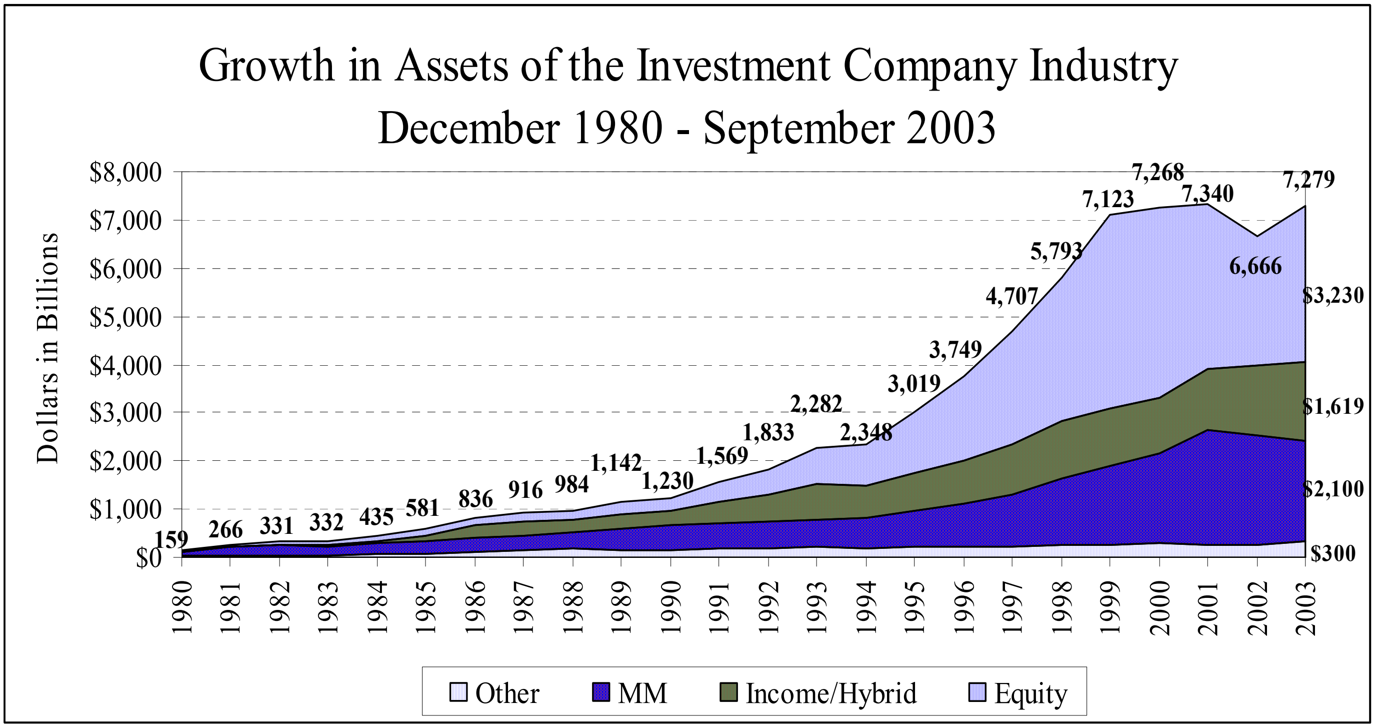
An investment company, managed by an investment adviser, invests shareholder capital in accordance with policies described in its prospectus. Open-end management investment companies, commonly known as "mutual funds," are the largest segment of the investment company industry. Currently, there are approximately 8,000 mutual fund portfolios, with approximately $6.95 trillion in assets under management. Approximately 900 investment company complexes manage these portfolios. In addition to mutual funds, the investment company industry contains several thousand other portfolios, such as exchange-traded funds, closed-end funds, unit investment trusts, and variable products – both variable annuities and variable life insurance.

Investment advisers engage in the business of advising others as to the value of securities or as to the advisability of investing, purchasing, or selling securities. With certain exceptions, only investment advisers with $25 million or more in assets under management may register with the Commission. Approximately 8,000 investment advisers have registered with the Commission. They manage approximately $20.1 trillion in assets, which includes the $6.95 trillion in mutual fund portfolios.

There are a wide variety of investment management portfolios. Investment company portfolios include money market funds, equity funds, bond funds, and hybrid funds combining features of the others. Money market funds include portfolios specializing in taxable money market instruments and tax-free instruments. Equity or stock funds include portfolios offering growth, growth and income, international equities, and equities from specific industry sectors or indexes. Bond funds include portfolios specializing in government bonds, corporate bonds, global bonds, and municipal bonds.

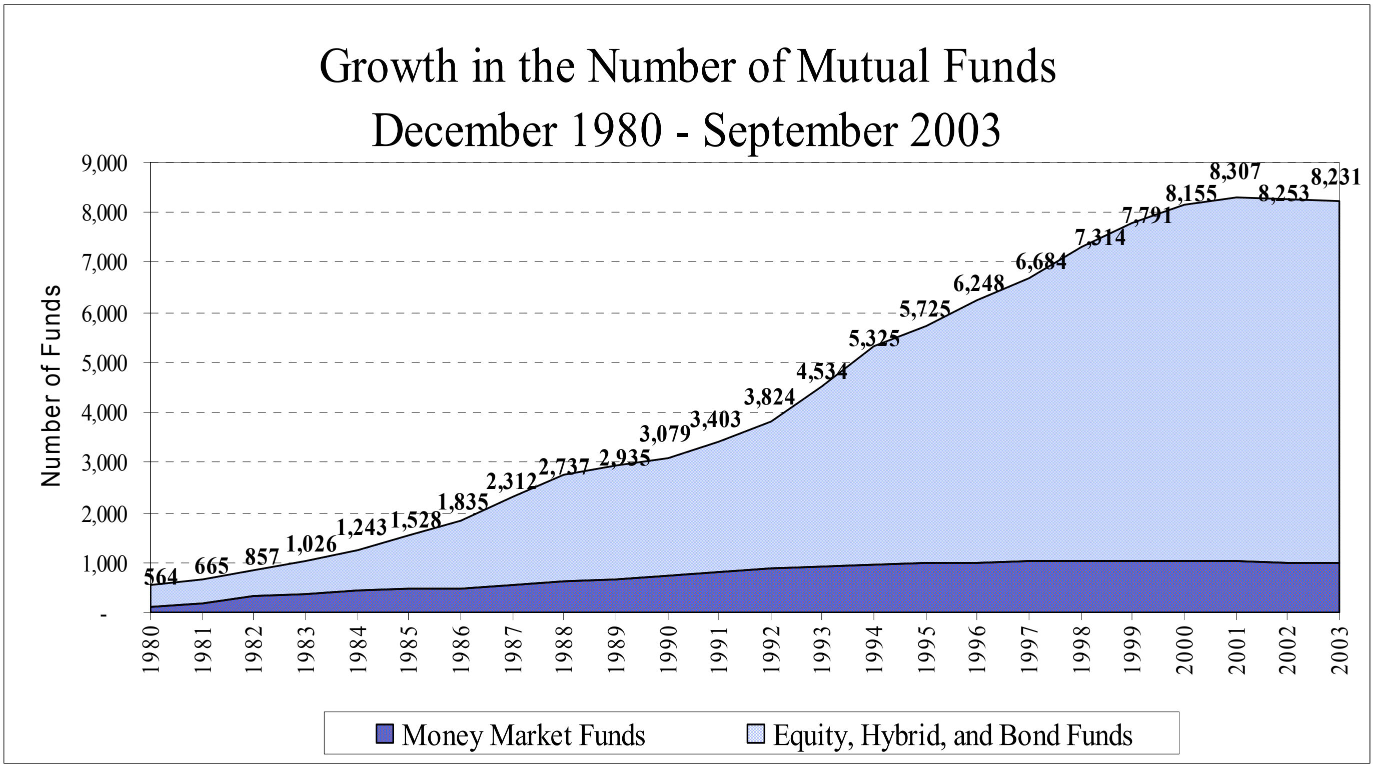
In addition to investment companies and fund portfolios, operation of the fund industry involves a number of other types of entities providing a variety of services. These include transfer agents that process fund shareholders' transactions, third-party administrators that provide back office functions, and approximately 6,800 broker-dealers, many of which sell mutual fund shares to the public or execute transactions for fund portfolios.

As shown in the charts below, the investment management industry has grown over the last 23 years, both in terms of assets under management and the number of funds. In particular, during the 1990s, a strong stock market, a robust American economy, and increased use of defined contribution plans provided a favorable environment for its growth.



Note: Other investment companies include: unit investment trusts, closed-end funds and exchange traded funds.
Source: Statistics compiled using various sources of information.

The number of mutual funds has also increased, as shown by the chart below.



Source: Statistics provided by the Investment Company Institute.

The size, diversity, and growth of the fund industry pose significant regulatory challenges. Indeed, in 1997, the United States General Accounting Office issued a report entitled *Mutual Funds: SEC Adjusted its Oversight in Response to Rapid Industry Growth*.[4] The GAO found that growth in the fund industry had posed a significant challenge to the SEC, met by increasing examination staff, refocusing the scope of its examination reviews, and targeting routine examinations to a minimum of one examination every five years. Since 1997, the fund industry continued to grow**,** from $4.6 trillion to $7.3 trillion in assets under management.[5]

The size and importance of the investment management industry make it a critical focus of the Commission's regulatory oversight. The SEC regulates funds through a multi-faceted program. Working under the direction of the Commission, several offices within the SEC integrate their functional expertise to review fund disclosure, adopt rules governing disclosure and other fund and adviser activities, examine funds and advisers for compliance, serve investors who complain to the SEC about funds and securities professionals,[6] and bring enforcement actions against fund complexes and responsible individuals that have violated the securities laws. This report focuses on examinations of funds and advisers.

II. Recent and Current Initiatives to Enhance Examination Oversight

Examinations are a critical component of investor protection. The SEC has continuously worked to upgrade and enhance its program for examining mutual funds – with the goal of improving examiners' ability to identify and scrutinize transactions and arrangements that place the interests of fund shareholders at risk. Today, examiners are increasing the frequency and depth of examination reviews for high risk firms, better using technology and data in examinations, giving examiners discretion to identify new or emerging areas of compliance risk, conducting more targeted "mini-sweep" examinations to identify risk areas sooner, and working closely with other staff at the Commission to highlight problems detected, and identify possible solutions sooner, among other things. New or recently implemented initiatives and changes to examinations are described below.

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4 United States General Accounting Office, *Mutual Funds: SEC Adjusted its Oversight in Response to Rapid Industry Growth*, GAO/GGD-97-67 (May 1997)**.**

5 From 1997 through 2003, the total assets under management by investment advisers, including funds, increased by 54.6%, from $13 trillion to $20.1 trillion. From 1997 through early 2003, staffing for inspections remained relatively constant, at between 360 and 380 positions.

6 During fiscal year 2003, the Commission received more than 200,000 letters, e-mails, and phone calls from investors. The Commission's staff is considering ways to ensure that tips and complaints indicating violations are handled appropriately.

A. Frequency of Examinations

1. The Five-Year Cycle (1998 to 2003)

From 1998 until early 2003, the SEC conducted routine examinations of mutual funds and advisers on a five-year cycle (prior to 1998, examinations had been much less frequent).[7] In other words, some aspect of every investment company complex and every federally registered adviser would be examined at least once every five years.[8]

2. Formal Risk Assessment (2003)

While the examination program met the five-year goal, the staff was concerned that the five-year cycle was a relatively unsophisticated methodology. Funds and advisers with high-risk business models, poor risk management systems or poor internal controls require more frequent oversight.

During 2003, the examination program improved its process for assessing risk and incorporating that risk assessment into determinations of examination frequency and scope. Specifically, examination methodology was implemented to provide a more formal assessment of firms' internal compliance and control processes by use of a risk evaluation methodology designed to guide examiners in their evaluation of firms' risk assessment, mitigation, and management processes. The methodology requires examiners to evaluate the effectiveness of the firm's controls in each of several key risk areas,[9] and to assess the overall risk and compliance culture of the firm.

The risk assessments prepared through this methodology assist examiners in scheduling the next examination of the fund or adviser. Firms carrying the highest risk will be inspected most often. Thus, this new methodology seeks to predict the likely risk profile of the fund or adviser in the future by identifying those firms that have weak compliance controls, as well as by using other factors. This more formal risk assessment will lead to the new inspection frequency described below.

3. New Inspection Frequency

With the additional staff resources added to the program in late 2003 (discussed later in this report) and the new formal risk profiles, the examination program is moving to a more

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[7] Prior to the adoption of the National Securities Markets Improvement Act in 1996, which allocated regulatory responsibility for smaller advisers to state securities regulators, the examination cycle for advisers had been as infrequent as once every 12 to 24 years.

[8] This goal was incorporated into the Commission's Government Performance and Results Act Performance Plan as an annual performance goal for the overall mission goal of protecting investors, and included in the agency's public *Annual Performance Reports.*

[9] The strategic risk areas covered in these evaluations are: portfolio management, brokerage arrangements and best execution, trade allocations, personal trading, pricing and calculation of net asset value, information resources, safety of client and fund assets, marketing and distribution, fund shareholder transactions, anti-money laundering, and fund corporate governance (a discussion of each area and the areas that the staff probes during examinations is included later in this report).

sophisticated system for scheduling examinations. Instead of examining every fund or adviser at least once every five years, firms will be selected for review on a two-, four-, or five-year cycle. Specifically:

- The largest fund groups (top 20), and funds and advisers presenting a high risk profile will be examined every two years;

- All other fund groups (including their advisers) will be examined every four years; and
- All other advisers (not high risk, not part of a fund group) will be examined every four to five years.

Commission staff is also continuing to evaluate the appropriate frequency of examinations, including more frequent reviews for the highest risk firms, and more "mini-examination sweeps" focused on emerging areas of compliance risk.

In addition, the examination program will participate in an agency-wide formal risk-assessment program designed to identify risks, integrate them across program areas, and then elevate them for management deliberation and appropriate action. We anticipate that this program will aid the agency in identifying and responding to compliance risk areas in a more focused way.

B. Enhancements to the Examination Process

1. New Examination Procedures to Address Market Timing and Late Trading (2003)

Market timing: As noted, our examination protocol in the past did not include a review of trading in the fund's own shares, and examiners did not obtain trading data that would show patterns of trading indicative of market timing. Now, examinations include a request for the fund to prepare and produce to the staff a daily summary of net sales and redemptions for a select period of time.[10] This data will allow the staff to review trading in the fund's shares for indications of aberrant trading, such as abusive market timing. In addition, routine examinations also now include a request for a sample of internal employee e-mail communications, which examination staff will review for indications of wrongful conduct that may not be reflected in the firm's other books and records. Additionally, while current SEC rules do not require fund employees to report to the fund their personal trades in the fund's own shares, in order to review for possible abusive trading by fund insiders, examiners now request that select fund executives produce to examiners their personal securities trading records.[11]

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[10] In adopting the compliance rule on December 17, 2003, the Commission stated that "a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity." *See infra* n.34 and accompanying text. Thus, examiners will expect that funds will create, maintain, and provide records of daily fund transactions to examiners.

[11] The staff is actively examining and participating in enforcement investigations of dozens of fund firms related to possible abusive market timing. Preliminary results from these reviews were reported publicly in testimony by Stephen Cutler in hearings concerning recent Commission activity to combat misconduct relating to

Late trading: Our experience is that omnibus order processing and the creation of false order tickets can make detecting instances of late trading difficult.[12] We are conducting numerous examinations to review for late trading. To aid in this review, in October, the examination staff sent letters to the approximately 300 firms that use the National Securities Clearing Corporation's Fund/SERV system[13] to transmit orders electronically after 4:00 p.m. to fund transfer agents, requesting that these firms[14] voluntarily conduct a review of their policies and procedures to prevent late trading, to identify any instances of late trading, and to report the results to the Commission staff. Preliminary findings indicate that none of the responding firms admit that their systems and controls were inadequate to prevent late trading, though many state that they have made recent changes to enhance their ability to prevent late trades. Approximately half of the responding firms either provided incomplete responses or described situations that may constitute late trading. However, most of those firms describing possible late trades attributed them to human error, system error, or the correction of errors in orders. Examinations of many of these SEC-registered firms will be conducted, and findings with respect to non-registered firms will be brought to the attention of banking and other regulators.

In routine examinations, SEC, NASD and NYSE examiners will review firms' procedures governing order receipt time, order time stamping, and supervisory oversight of fund trade processing.

2. New Examination Procedures to Enhance the Overall Program (1998 to 2004)

Increased use of data analysis: Examiners have been making increased use of computer technology to facilitate review of large volumes of data. This has significantly enhanced the level of oversight possible in critical areas such as portfolio trading and best execution. Examiners are continuing to explore other ways to utilize technological tools to surveil for possible violations, and to identify new sources of information and data that may alert staff to emerging compliance risks and highlight the need for on-site or other review by the staff.

Interviews: Examiners have been making increased use of interviews. Over the years, examiners have frequently sought to interview firm employees. Questions could include specific

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mutual funds by the Senate Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs (Nov. 3, 2003), and by the Senate Committee on Banking, Housing and Urban Affairs (Nov. 20, 2003).

12 In light of this, the Commission has proposed a "hard 4 p.m." order cutoff time for receipt by the fund or its agent of customers orders to receive that day's net asset value, as well as other alternatives to prevent late trading. *See SEC, Amendments to Rules Governing Pricing of Mutual Fund Shares,* Investment Company Act Release No. 26288 (Dec. 11, 2003); *see also* 68 Fed. Reg. 70388 (Dec. 17, 2003).

13 Fund/SERV provides a central processing system that collects order information from clearing brokers and others, sorts all the incoming order information according to the fund, and transmits the order information to each fund's primary transfer agent.

14 These firms include broker-dealers, banks, insurance companies, and pension administrators.

inquiries about the firm's record keeping or accounting practices, or the meaning of specific records. More recently, however, interviews have played a critical role when assessing a firm's control or risk environment.[15]

Policies to facilitate immediate corrective action: Recently, new policies have been adopted to enhance the speedy resolution of any problems examiners found, including by holding exit interviews with senior management of firms (often done by telephone) and providing deficiency letters directly to fund boards of directors.

Requests for reports: Examiners have been making increased use of requests for written reporting by funds and advisers. When this approach is taken, examiners write the firm asking it to provide written answers to the staff's questions and to provide copies of documents substantiating the statements. This allows the staff to monitor compliance in between on-site examinations, obtain information on an expedited basis, and gather information on particular issues across a large number of firms. It also enables examiners to better manage and prioritize a large number of sweep examinations and focus examinations before the on-site portion of the review.

Review of examination findings: All examinations indicating serious problems are reviewed by a committee of staff (comprised of examination, enforcement, and regulatory staff) to ensure that appropriate findings are investigated promptly. In addition, so that any emerging trends are identified and made known promptly, examination findings and trends are shared with other Commission staff on a routine basis.

III. The Commission's Examination Authority

The SEC is authorized to examine the records of investment companies,[16] investment advisers,[17] transfer agents, [18] broker-dealers,[19] and other types of regulated securities firms.[20] By law, the Commission's examinations may be "periodic," "special," or "other,"[21] which, as the relevant statutes explicitly indicate, means that they may be conducted "at any time, or from time to

15 As described later in this report, while many firms agree to voluntary interviews, the authority of the examination staff in this area is unclear.

16 Investment Company Act § 31(b), 15 U.S.C. § 80a-30(b).

17 Advisers Act § 204, 15 U.S.C. § 80b-4.

18 Securities Exchange Act of 1934 (hereinafter cited as "Exchange Act") § 17(b), 15 U.S.C. § 78q(b).

19 *Id*.

20 *See id.* (authorizing SEC to examine national securities exchanges, registered securities associations, registered municipal securities dealers, and registered clearing agencies, among others).

21 Exchange Act § 17(b), 15 U.S.C. § 78q(b); Advisers Act § 204, 15 U.S.C. § 80b-4; Investment Company Act § 31(b), 15 U.S.C. § 80a-30(b).

time."[22] The SEC may perform such "reasonable" examinations as "it deems necessary or appropriate in the public interest for the protection of investors."[23]

The legislative history of the SEC's examination authority demonstrates that examinations are expected to play an important role in the Commission's efforts to enforce the securities laws. An important goal of SEC examinations is to find violations, particularly on-going violations. In 1934, the Senate Committee on Banking and Currency stated that the Commission's authority to conduct reasonable inspections of brokers' records would enable it "to obtain evidence rapidly" when a violation appeared to be in progress.[24]

Congress recognized that examinations have other functions as well. In 1960, in the course of amending the securities laws to give the Commission examination authority over investment advisers,[25] the Senate Committee on Banking and Currency stated that the "prospect of an unannounced visit of a Government inspector is an effective stimulus for honesty and bookkeeping veracity."[26] Thus, beyond finding violations, SEC examinations also serve a prophylactic role.

In 1975, the SEC was given authority to examine "all" records of investment advisers, broker-dealers, transfer agents, national securities exchanges, and securities associations.[27] In describing the amendments, the Committee said that the language of the section conferring examination authority over entities registered under the Exchange Act:

> Makes clear that it is self-executing, *i.e.*, there would be no need for the Commission, as a condition precedent to inspecting any reports, to require by rule that the persons described in [the section] keep any such records. Moreover, the authority to examine records would include the authority to make or require copies of such records."[28]

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22 *Id*.

23 Exchange Act § 17(b), 15 U.S.C. § 78q(b); Advisers Act § 204, 15 U.S.C. § 80b-4.

24 S. Rep. No. 792, 73d Cong. 2d Sess. 13 (1934) (discussing rapid response to indications of manipulation); *reprinted in* 1 Federal Securities Laws, Legislative History, 1933-1982, 708, 720 (BNA eds.) (1983).

25 Advisers Act Amendments of 1960, Pub. L. 86-750, § 6, § 204, 74 Stat. 885, 886 (1960), *codified at* 15 U.S.C. § 80b-4.

26 S. Rep. No. 1760, 86th Cong., 2d Sess. (1960), *reprinted in* 1960 U.S.C.C.A.N. 3502, 3505.

27 S. Rep. No. 94-75, at 119-20, *reprinted in* 1975 U.S.C.C.A.N. 179, 297. While this statement addressed the agency's responsibilities under the Exchange Act, as set forth below, identical amendments were simultaneously made to the Commission's examination authority under the Advisers Act.

28 *Id.* At the same time, the same language was added to the Advisers Act. Securities Acts Amendments of 1975, Pub. L. 94-29, sec. 29(5), *amending* Advisers Act § 204, *codified at* 15 U.S.C. 80b-4; 89 Stat. 97, 138 & 169 (1975).

With respect to mutual funds, the Commission's examination authority is limited to the records that investment companies are required to maintain and preserve.[29] Efforts by the Commission to examine fund records beyond those required to be maintained and preserved must be done on a voluntary basis.[30]

SEC examiners seek to engage firms in a dialogue through interviews, exit conferences, and requests for voluntary preparation of data or analyses that are not specifically required to be maintained. In many instances, firms are willing to engage in this type of voluntary communication and cooperation in providing records and information. Such communications are often subject to negotiation, requests for non-waiver agreements, and other restrictions. Aside from providing their books and records for examination, registrants have no legal obligation to volunteer information about the existence of violations or compliance problems to examiners.[31]

Unlike broker-dealers, investment advisers and mutual funds are not subject to self-regulation and are regulated and examined solely by the Commission.[32] However, like broker-dealers, advisers are potentially liable if they fail to reasonably supervise.[33] Moreover, to improve compliance within funds and advisers, in December, 2003, the Commission adopted a new rule requiring that all funds and advisers implement and maintain written compliance policies and procedures reasonably designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred. Each fund and adviser must review those policies and procedures annually for their adequacy and the effectiveness of their implementation. The new rule further requires that all funds and advisers designate a chief compliance officer to be responsible for administering the policies and procedures and to report annually to the fund's board concerning material compliance matters.[34] This rule is designed to protect investors by ensuring that all funds and advisers have internal programs to ensure compliance with the federal securities laws, and to ensure that fund boards of directors have adequate information to fulfill their obligation to exercise compliance oversight.

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29 Investment Company Act § 31(b), 15 U.S.C. § 80a-30(b).

30 In the mid-1990s, during the 104th Congress's consideration of the National Securities Markets Improvement Act, the Commission proposed an amendment to the Investment Company Act that would have extended its "all records" examination authority to funds.

31 There are criminal penalties for lying to a federal government official or concealing material facts in any matter within the jurisdiction of any agency of the federal government. *See* 18 U.S.C. § 1001.

32 Broker-dealers are subject to self-regulation, which includes routine examinations by the NYSE, NASD, or one of the options self-regulatory organizations. The NYSE examines each of its members that do business with the public every year, and the NASD regularly examines it members according to a schedule based on the member's risk profile.

33 Investment Advisers Act §203(e)(6), *codified at* 15 U.S.C. §80b-3(e)(6).

34 *See SEC, Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26299 (Dec. 17, 2003); *see also* 68 Fed. Reg. 74714 (Dec. 24, 2003).

IV. Examinations of Advisers and Funds

A. Program Staff

The Office of Compliance Inspections and Examinations ("OCIE") provides program management for examinations. Examinations are conducted by staff in OCIE and in the SEC's 11 regional and district offices.[35] From 1998 through early 2003, staffing for examinations of funds and advisers ranged from 360 to 380 positions (including supervisors, examiners, and support staff).[36]

With a budget increase in 2003, staffing for fund and adviser examinations increased by 33%, to 495 positions.[37] In addition, pay comparability legislation allowed the Commission to increase salaries for its staff.[38] This authority has helped reduce substantially the staff attrition and turnover rates previously faced by the SEC.[39]

Examiners have a variety of educational degrees and experience, including, masters of business administration, certified financial analysts, certified public accountants, lawyers, and computer specialists**.** Most recently hired examiners have had experience in the securities industry and/or specialized training. Examiners are trained in entry-level, mid-level, senior, and specialized training programs. A training branch in OCIE coordinates training for the examination program nation-wide.

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35 Regional and district offices of the SEC are located in New York, Boston, Philadelphia, Miami, Atlanta, Chicago, Denver, Fort Worth, Salt Lake City, San Francisco, and Los Angeles.

36 In 1998, there were 360 staff positions dedicated to adviser/fund examinations; in 1999 and 2000, there were 380 positions; in 2001 and 2002, there were 366 positions. These numbers include supervisory, staff, and clerical positions dedicated to adviser/fund examinations and exclude staffing for general and administrative office support. By way of comparison, federal regulators responsible for supervising banking organizations deploy significantly more examination staff relative to the number of organizations they regulate, reflecting the differences between the supervisory model of oversight applied to banks and the risk-based examination model applied to securities firms. The Federal Reserve has approximately 1,235 field examiners (FRB's 2002 Annual Report), and the Office of the Comptroller of the Currency has approximately 1,800 examiners (Wall Street Journal 1/8/04).

37 The Commission's $716 million fiscal 2003 appropriation pursuant to P.L. 108-7 permitted the SEC to begin hiring over 840 new employees, primarily spread amongst the agency's examination, full disclosure, and enforcement programs.

38 The Investor and Capital Markets Fee Relief Act (P.L. 107-123) exempted the SEC from the pay and benefit provisions of Title V of the U.S. Code and allowed the Commission to compensate staff at levels comparable to those provided by the federal government's other financial regulatory agencies.

39 About one-third of the SEC staff left the agency from 1998 through 2000 and the average tenure of an examiner declined from 2.9 years in 1992 to 1.9 years in 1999. *See United States General Accounting Office, "Securities and Exchange Commission: Human Capital Challenges Require Management Attention,*" GAO-01-947 (September 17, 2001).

B. Types of Examinations

The SEC conducts several types of examinations, described below.

Routine Examinations: Routine examinations are scheduled based on the passage of time since a firm has been examined. These examinations are focused in scope (*i.e.*, they are not comprehensive). They may focus on areas that have been identified as posing the greatest compliance risk generally, as well as areas that may pose compliance risk for the particular firm being examined.

Cause Examinations: Cause examinations are based on indications, allegations, or tips regarding wrongdoing or inappropriate conduct at the firm.[40] The goal of a cause examination is to quickly determine whether there is a problem. These examinations are typically unannounced and conducted on a "surprise" basis.

Sweep Examinations: Sweep or "theme" examinations focus on a narrow issue and seek to determine how a sample of the industry is handling that particular issue. Sample sizes can range from hundreds of firms to less than ten, depending on the issue. The goal of a sweep examination is to gather information in a systematic fashion across the industry.

During the period 1998 to 2003, examinations of each type were performed, as follows:[41]

Investment Companies:		**Investment Advisers**:	
1304	Routine Examinations (85%)	8117	Routine Examinations (92%)
155	Cause Examinations (10%)	549	Cause Examinations (6%)
67	Sweep Examinations (4%)	116	Sweep Examinations (1%)

C. Outcomes

Examinations can result in three primary outcomes. These are described below.

Deficiency Letter: A deficiency letter is a summary of examination findings and can include violations of the law as well as supervisory and control weaknesses. Deficiency letters are provided to the firm at the conclusion of the examination and require it to respond within 30 days, documenting the steps it intends to take to correct the deficiencies. Deficiency letters most often result in correction of the problem, and implementation of improvements in compliance policies and procedures to prevent the problem from reoccurring.[42]

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40 Cause examinations may be initiated as a result of a complaint from an investor or a press article, based on information obtained from the review of disclosure documents or other filings, or from other sources.

41 Percentages do not total 100% due to rounding. These numbers understate the actual number of sweep exams as sweep exams are often conducted in tandem with a routine exam, and the exam is classified as primarily routine.

42 Examples of these remedial actions are described below.

Enforcement Referral: When examiners find a violation of the securities laws, they must determine whether it should be referred to the Division of Enforcement staff for further investigation and possible enforcement action. The decision whether a violation is suitable for referral involves judgment and is made on a case-by-case basis in consultation with Enforcement staff. Violations involving fraud, abuse of customers, intentional wrongdoing, or significant investor losses are generally referred for enforcement investigation and possible action.[43]

Letter Closing the Examination: Where the staff makes no findings, at the conclusion of the examination it gives the firm a letter indicating that the examination has concluded without findings.

During this period, examinations concluded with the following primary outcomes:

Investment Companies		**Investment Advisers**	
1303	Deficiency Letters (85%)	7931	Deficiency Letters (90%)
88	Enforcement Referrals (6%)	316	Enforcement Referrals (4%)
135	Closed Without Findings (9%)	535	Closed Without Findings (6%)

D. Scope of Examinations

As noted, given the number of registrants and the range and breadth of their activities, examinations do not review all areas of the law or all business activities of the firm or fund complex. Examiners select areas to review with the goal of focusing their efforts on those activities that are most at risk, from an investor protection view, of harboring significant compliance problems. This process for narrowing and focusing the scope of inspections on higher risk activities is called conducting "risk-based" examinations.

Activities that are not subject to robust internal compliance controls are more likely to be at risk of violations and compliance problems. Thus, to evaluate areas of a firm's activities that may be at risk, examiners begin with an assessment of the firm's internal controls and compliance policies and procedures. Examiners assess the breadth and apparent effectiveness of firms' control processes and then conduct further detailed testing of underlying transactional information in those areas where compliance and control processes appear to be weak or lacking altogether. Regardless of how effective a firm's controls may be, examiners always scrutinize certain fundamentally important information as an overall or forensic check on the efficacy of controls.

E. Areas of Review

Summarized below are major areas that may be reviewed during fund and adviser examinations. It is important to note, however, that examiners may focus on these areas, or any area where they have reason to believe there are compliance risks. In each area where examiners identify problems, examinations typically result in corrective actions being taken by firms. Most frequently, these actions include improvements in internal compliance policies and procedures

[43] A list of recent SEC enforcement actions involving funds is attached as Appendix A.

designed to correct the problem and ensure against its reoccurrence. As described herein, some findings also result in enforcement actions.

Portfolio management: Examiners consider whether the securities recommendations and investments made for clients and funds are consistent with each client's investment objectives, restrictions, and risk tolerance. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser confronts in managing clients' investments; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate and manage these conflicts?
- Are the firm's policies, procedures, and controls effective in light of the portfolio management environment maintained by the firm?
- Are investments suitable for clients and consistent with their objectives, restrictions, and risk tolerance?
- Is leverage consistent with statutory limitations?
- Is non-public information that may be obtained during research on issuers handled consistently with the firm's insider trading prevention policies?
- Are proxies voted in ways that reflect the best interests of clients who own the securities?
- Are decisions to purchase securities in an underwriting in which a fund affiliate is a participant consistent with the law?
- Are investment advisory fees being calculated in ways that are consistent with clients' advisory contracts?
- Does a review of purchases and sales of securities around the end of the reporting period indicate the presence of window-dressing or manipulative trading?

Brokerage arrangements and best execution: Examiners consider whether brokerage arrangements are consistent with disclosures, whether the adviser seeks best execution in placing all trades for clients, and whether the adviser periodically and systematically evaluates the costs and benefits of its brokerage arrangements. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its trading desk staff confront in placing orders and causing clients to pay brokerage commissions; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Are the firm's policies, procedures, and controls effective in light of the brokerage arrangements maintained by the firm?
- Does the firm regularly seek to obtain best execution when placing orders for clients' accounts?
- Does the firm periodically and systematically evaluate the quality and cost of its brokerage arrangements to determine if it is obtaining best execution?
- What does the firm obtain with commission dollars, including research within the safe harbor? Is a fund using its brokerage commissions to pay for distribution of its shares outside of a distribution plan ("Rule 12b-1" plan)? Is the adviser using brokerage to pay for client referrals?

- Are research services obtained with soft dollars consistent with disclosures made to advisory clients?
- Are cross trades among funds consistent with the requirements of the law?
- Does a fund's adviser use forensic analysis of period data to determine if the cross trades implemented during the period were fair to all participating funds?
- Is the firm's process for overseeing the clearance and settlement of its trades effective?

Allocations of trades: Examiners consider whether the adviser has effective policies and procedures for fairly allocating initial public offerings ("IPOs") and block trades among clients, whether these policies are adequately disclosed, and whether actual practices are consistent with both policies and disclosures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its portfolio managers/traders confront in allocating investment opportunities among clients; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have policies and procedures that are likely to result in fair allocations of block and IPO trades among its clients and are those policies and procedures fully disclosed?
- Are the trade allocation procedures actually used consistent with the policies, procedures, and disclosures?
- Are there indications of preferential allocations among accounts (*e.g.*, to favored accounts such as those paying higher fees)?
- Does the adviser use forensic analysis of period data to ensure that the results of its allocations during the period were consistent with its disclosures?
- Does the adviser ensure that all trades are allocated in ways originally intended by portfolio managers and that if changes to allocations are made, there is an effective audit trail that prevents cherry picking?
- Does an adviser that manages hedge funds and other fund clients have controls to ensure that allocations are fair among all clients and consistent with disclosures?

Personal trading: Examiners consider whether funds and advisers have effective codes of ethics that are designed to prevent inappropriate trading in equities by insiders in their personal accounts, whether these policies are fairly disclosed, and whether actual trading practices by insiders comport with the policies and disclosures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in making investment decisions for their personal accounts; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have a code of ethics that includes appropriate controls over and reporting of personal trades in equities by insiders?
- Has the adviser disclosed its personal trading policies to clients and fund boards?
- Are insiders reporting their personal trades in equities on a timely basis? Is the adviser reviewing them on a timely basis and comparing trading of access persons to

trading for clients to determine if there has been front-running or other abusive trading by insiders?

- Are trades of insiders consistent with the code of ethics? Are there indications of front-running, insider trading, or other abusive activity?
- Are there indications of abusive trading fund insiders in the fund's own shares?
- What sanctions have been imposed on insiders who violate the code of ethics?

Pricing of clients' portfolios and calculation of net asset value: Examiners consider whether funds and advisers have effective policies and procedures for determining the value of portfolio holdings and calculating net asset value, whether fund boards of directors have established adequate procedures to calculate fair values when market prices are not available, and whether actual practices are consistent with these policies and procedures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in valuing assets in clients' portfolios and calculating fund net asset values; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does an adviser/fund have effective policies, procedures, and controls with respect to the pricing of portfolio securities and calculating the fund's net asset value per share?
- Has the fund's board of directors established a pricing policy and approved procedures for the use of fair value pricing?
- If the board has established a policy, is it being implemented?
- Does daily sales and redemption activity indicate possible market timing?
- Does the fund monitor for events that may make its market-price based net asset value stale and use fair value pricing in these circumstances to ensure an accurate net asset value?
- Is the process used to identify corporate events such as dividends and stock splits effective?
- Does the fund monitor prices used for individual securities to make sure they fully reflect the value of the security at the time net asset value is being calculated?
- Does the fund monitor changes in its net asset value from day to day to make sure such changes reflect activity in the market place?
- Does the fund check the accuracy of its fair value process by comparing selling prices for securities that were fair-valued to the previous day's fair value?

Information processing and protection (books and records, disclosures, and filings): Examiners consider whether funds and advisers have effective policies and procedures for capturing, compiling, maintaining, and reporting relevant and timely information to clients and regulators, and whether such information is effectively protected from access by unauthorized persons and untimely destruction. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in compiling, maintaining, using, and reporting information; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?

- Are the adviser's/fund's books and records current and contain all of the information required by the recordkeeping rules?
- Are books and records maintained in ways that protect the information in them from unauthorized access and alteration and from unplanned destruction?
- Are books and records being maintained for prescribed periods?
- Is the personal information of clients/shareholders protected from inappropriate uses and disclosures?
- Does the firm protect the personal information of its clients/shareholders from identify theft?
- Are filings with regulators made on time and contain all necessary information?

Performance advertising, marketing, and fund distribution activities: Examiners consider whether funds and advisers have effective policies and procedures to make sure performance claims, advertisements, and other marketing materials contain only appropriate information and whether conflicts of interest have been effectively disclosed. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser, fund, principal underwriter, or their staffs confront in marketing the firm's services, using performance advertising and distributing fund shares; how can clients/fund shareholders be harmed by these conflicts; and how does the adviser/fund disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have effective policies, procedures, and controls that cover all of its advertising, marketing, and distribution activities?
- Are advertisements accurate, complete, and not misleading?
- Is all performance information used in advertisements and other presentations calculated appropriately and is it accompanied with all necessary information to make it not misleading?
- Is the use of solicitors consistent with regulations?
- Are client referral arrangements and related directed brokerage arrangements consistent with disclosures made to referred clients?
- Has the fund's Rule 12b-1 plan been approved annually by its board and is the operation of the plan consistent with the rule?

Safety of clients' and funds' assets: Examiners consider whether funds and advisers have effective policies and procedures for safeguarding their assets from loss, misappropriation, and misuse. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in making sure clients' assets are safeguarded from misuse and loss; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have effective policies, procedures, and controls regarding the custody and safekeeping of assets?

- Has the fund provided its custodian with a current list of authorized persons who can authorize movement of a fund's assets?
- Do authorizations to move fund assets require signatures of at least two persons?
- Are there adequate controls over the creation and use of such authorizations?
- Are the fund's custody arrangements for its foreign securities consistent with SEC rules?
- Does the custodian of advisory clients' assets send periodic statements directly to such clients? Does the adviser alone report to clients?
- If an adviser has self-custody of a client's assets, is it regularly audited by an independent auditor, on a surprise basis?
- Is there a process for regularly reconciling client and fund balances of securities owned with those shown by custodians? Do the books reconcile?

Fund shareholder order processing: Examiners consider whether funds and their agents have effective policies and procedures to ensure that shareholders' transactions are processed timely and accurately, and that actual fund shares outstanding can be reconciled to the number of shares used to calculate the fund's net asset value. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and fund transfer agent confront in processing fund shareholder transactions; how can fund shareholders be harmed by these conflicts; and how does the adviser/fund disclose, mitigate, and manage these conflicts?
- Does the fund/transfer agent have effective policies, procedures, and controls to prevent late trading and ensure the timely and accurate processing of shareholders' orders?
- Does the fund's transfer agent price orders to purchase or redeem fund shares that are received after each day's cut-off deadline using the next day's net asset value?
- Is there a daily reconciliation between the shareholder master and subsidiary ledgers and are differences resolved promptly?
- Are any transactions priced "as of" the net asset value calculated on an earlier day reviewed and approved by fund management?
- What is the process for correcting any errors that occur in net asset value? Why do errors occur?
- Are funds/shareholders being reimbursed for dilution caused by errors in the calculation of shares outstanding or net asset value?
- Is there adequate control over unclaimed dividends and redemption payments?

Anti-money laundering: Examiners consider whether funds have effective policies and procedures to detect and deter money-laundering activities, whether these policies and procedures are regularly tested for continued effectiveness, and whether actual anti-money laundering (or "AML") processes are consistent with the policies and procedures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser, fund, and their staffs confront in establishing and maintaining effective AML programs and how do they mitigate and manage these conflicts?
- Does the adviser/fund have AML policies, procedures, and control mechanisms designed to detect transactions that raise a suspicion of money laundering or terrorism financing?
- Are those policies, procedures, and controls in writing and have they been approved by the adviser's board (or senior management) or the fund's board of directors?
- Do the policies, procedures, and controls reasonably reflect the characteristics of clients, geographic location, distribution systems, and service providers used to conduct its business?
- Where the adviser/fund has delegated the day-to-day operations of its AML program to a service provider, what due diligence has the adviser/fund performed of the service provider's AML program?
- Has the adviser/fund designated an AML compliance officer who is sufficiently experienced and has the requisite position and stature within the organization to ensure that the AML activities are comprehensive and effective?
- Does the adviser/fund have an on-going AML education and training program that is reasonably designed to ensure that all staff concerned with the organization's AML program are able to fully and effectively perform their roles in the program?
- Does the adviser/fund have an annual, independent review of the organization's AML program that is independent of the AML officer and program and is the annual review presented to the organization's board for consideration?
- Does the adviser/fund check client/customer names against government-prepared lists, such as those prepared by the Office of Foreign Asset Control and have due diligence procedures to identify the beneficial owners of any private banking clients to whom the organization provides services?
- Does the adviser/fund have effective procedures to capture and report cash transactions and suspicious activities?

Corporate governance: Examiners consider whether funds have appropriately constituted boards, whether boards meet regularly to consider matters required (*e.g.*, approval of the advisory contract, the independent auditor, fair value procedures), and whether boards appear to be effectively carrying out their fiduciary duties to fund shareholders. The following areas are among those probed during inspections:

- What are the conflicts of interest a fund's board of directors as a whole and individual directors confront in approving contracts and overseeing the activities of the fund; how can fund shareholders be harmed by these conflicts; and how does the board mitigate and manage these conflicts?
- Does a fund's board have policies, procedures, and controls for its activities?
- Is a fund's board properly constituted with independent directors? Do they meet the legal definition of independent?
- Has the board reviewed and approved all fund contracts with service providers?

- Did the board appear to have adequate information on which to base its decision to approve a contract and especially the advisory contract? Are board minutes adequate to reflect whether the board fulfilled its obligations?
- Does the board's audit committee approve and oversee the activities of the fund's outside auditor?
- Are any of the directors derelict in their attendance at board meetings?
- Has the board held required in-person meetings?

Money market funds: Examiners evaluate whether money market funds contain only high quality securities. This involves reviewing the investment process and fund assets to determine whether securities meet the high quality, short-term, dollar denominated tests and that their average maturity is 90 days or less. Examiners also review periodic testing by the fund that is designed to ensure the market-based value of its assets is consistent with using those assets' costs to calculate its daily net asset value. The following areas are among those probed during inspections:

- Do the securities in the money market portfolio meet the quality, maturity, and diversification requirements of the law?
- Are the methods used in determining creditworthiness likely to result in effective credit determinations?
- Have procedures been established to ensure that the dollar-weighted average portfolio maturity does not exceed 90 days?
- If the fund purchases unrated securities, what methods were used to determine that the instruments were comparable in quality to rated securities?
- Has the board established and adopted written procedures to ensure a stable net asset value per share?
- Do the valuation procedures provide for periodic testing of the deviation of the net asset value of the fund based on amortized cost and current market values of securities (shadow pricing)?
- Has the board established and periodically reviewed written guidelines and procedures under which the fund’s investment adviser or officers make such determinations as the board may delegate to them?
- Has the board approved the downgrading of any unrated or second tier security?
- For taxable money market funds, has the board approved the purchase of each unrated security or a single rated security?
- Did a review of sales and purchases prior to and after financial reporting periods indicate window dressing?

F. Priority Areas and Mini-Sweeps

To supplement its overall risk-based approach to inspections, each year the examination staff, in conjunction with other Commission staff, establish priority areas that are reviewed during routine inspections. These priority areas may be selected to evaluate how firms have implemented a recently adopted rule, to probe an activity or an area that presents heightened investor protection issues, or to determine if a new or amended rule may be needed to address new developments or new instruments in the marketplace.

During the past five years, the following priority areas were among those reviewed by examiners: valuation practices of bank loan funds, paying costs of fund distribution, funds of hedge funds, Regulation S-P, investment allocation procedures, Regulation FD, supervisory practices (particularly of "star" portfolio managers or traders), codes of ethics, the "householding" rule, pricing services, internet advisers, practices for assuring the suitability of recommendations, correction of errors in net asset value, fund governance, the fund "Names Rule," handling shares of lost or missing security holders, switching in variable annuity contracts, AML practices, contingency planning and readiness for disasters, fair value pricing practices, performance claims by advisers, Part II of Form ADV, best execution, use of soft dollars, side-by-side management of hedge funds and other accounts, compliance with Sarbanes-Oxley provisions, and processing variable policy holder transactions.

In addition, as noted, examination staff are increasingly conducting "mini-examination sweeps" of a select number of firms, targeted to investigate a particular area. These examinations may help the staff to identify and promptly investigate an area of emerging compliance risk. The examination staff have a number of such sweeps underway currently.

V. Results of Examinations

Examinations help to protect investors in several ways. First, examinations reveal problems that lead to corrective actions by funds and advisers. Most frequently, these corrective actions involve improvements in internal controls and compliance practices to ensure that the problem is corrected and does not recur.[44] Examinations have also revealed serious problems, including fraud. Examinations may also result in funds being returned to investors. Examples of each result are summarized below. Finally, while not a quantifiable result, the prospect of a visit from examiners also helps deter misconduct.

A. Corrective Action by Funds and Advisers

As noted, examiners find violations or deficiencies during 85-90% of fund and adviser examinations. Deficiency letters outline these findings and require corrective action by the firm. Most frequently, these are improvements in compliance policies and procedures. Some examples of this corrective action follow:

- New procedures are implemented to review personal securities trading by employees.
- New "best execution" committee is formed to evaluate the order routing practices of the fund and review execution quality across markets.

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44 In order to aid and encourage firms to improve compliance practices, the staff occasionally issues public reports that describe common examination findings and that may also describe examples of good compliance controls that have been observed in examinations. *See, e.g., Joint Regulatory Sales Practice Sweep* (Mar. 1996); *Inspection Report of the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Fund* (Sept. 1998); *Broker-Dealer Risk Management Practices Joint Statement* (July 1999); *Report of Examinations of Day Trading Broker-Dealers* (Feb. 2000); *Report Concerning the Display of Customer Limit Orders* (May 2000); and *Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (Mar. 2003).

- New written policy is implemented for the allocation of hot initial public offerings; all allocations are reviewed by compliance staff; and new disclosure is made of the policy.

- New disclosure is added to Form ADV and other brochures to provide more complete disclosure of fees and charges.

- New procedure is implemented to ensure that fund shareholders receive a current prospectus when purchasing shares of the fund.

- Compliance exception reporting is enhanced to detect improper ticket charges to wrap fee client accounts.

- New procedures are implemented to ensure that principal transactions are not effected without prior client consent.

- Pricing procedures are revised and appropriate disclosures are made to clients.

- Procedural and systems changes are made to enhance the adviser's fee billing process in order to correct fee calculation errors.

B. Stopping Fraud

Examinations sometimes reveal a fraud in progress, stop the fraud, and lead to enforcement investigation (a full list of enforcement actions involving funds is attached). The following are examples of such examinations:

- An examination revealed that an adviser had fraudulently raised over $31 million from 2,000 investors in an affinity fraud targeting Caribbean Island immigrants. The SEC filed an emergency civil action against the firm, obtained an asset freeze, and subsequently barred the principal from association with any investment adviser. He pled guilty to criminal charges brought by the U.S. Attorney's office and was sentenced to five years in jail and required to pay over $27 million in restitution.[45]

- An examination revealed overpricing in portfolio securities causing the value of the portfolios to be overstated by approximately $300 million, and resulting in the portfolios paying excess management and incentive fees. Also, the performance of the portfolios was materially overstated in offering, marketing and other documents, and in filings with the Commission.[46]

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45 SEC v. A. B. Financing and Investments, Inc., and Anthony Blissett, Litigation Release No. 18338 (Sept. 10, 2003).

46 SEC v. Edward J. Strafaci, Litigation Release No. 18432 (Oct. 29, 2003).

- An examination revealed possible fraud violations involving recommendations of tax avoidance strategies involving over-the-counter swaps and options in transactions with offshore entities that created phantom capital losses for tax purposes, and the use of a grantor retained annuity trust, a wealth transfer device.[47]

- An examination of an investment adviser and its principal revealed significant misrepresentation as to the use of proceeds and misappropriation of investor funds. Investors were not told that one-third of proceeds went to purchase a private residence or were used to pay the adviser's business expenses.[48]

- An examination revealed that the adviser was operating an ongoing Ponzi scheme, with client monies being used to repay earlier investors and for "loans." The adviser had raised $7.6 million from known clients and others.[49]

- An examination revealed that an investment adviser principal misappropriated $500,000 of client assets and misrepresented investments, including loan transactions with exorbitant interest rates and investments in an affiliated partnership.[50]

C. Returning Funds to Investors

While the SEC's examination program does not prosecute investors' financial claims, when examiners discover overcharges, undisclosed fees, or other inappropriate payments by investors, the staff takes steps to have the funds repaid. Some examples follow.

- Examiners found that a principal of an advisory firm misappropriated $18 million of clients' assets by creating false custodian statements that were sent to clients. Following this finding and subsequent enforcement investigation, examiners assisted local criminal authorities. The investment adviser's principal was required to pay $18 million in restitution and received an enhanced prison sentence of 25 years.[51]

- An examination revealed that an investment adviser misappropriated clients' assets. The Commission barred the principal from the securities industry and ordered him to

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47 Examination No. IA2003SFDO069.

48 In the Matter of Christopher A. Lowry, Administrative Proceeding, File No 3-10390 (Aug. 30, 2002).

49 Examination No. IA2000MRO102.

50 In the Matter of James Oh, Administrative Proceeding, File No. 3-10759 (Apr. 18, 2002). *See also* SEC v. James Oh, Litigation Release No. 17428 (Mar. 21, 2002).

51 U.S. v. Thomas D. Abrams, Criminal Action No. 01-8168-CR-GRAHAM/TURNOFF (S.D. Fla. (Sept. 30, 2002).

disgorge over $1.9 million.[52] In a subsequent criminal action, he was sentenced to a five-year prison term and ordered to pay $900,000 in restitution.[53]

- Examiners discovered an adviser overcharging advisory client fees, and required the adviser to review all of its client accounts for fee calculation errors. As a result of the findings, the registrant reimbursed clients over $1.9 million and implemented documentary, procedural, and systems changes designed to enhance its fee billing process.[54]

- Examiners identified that an investment adviser and its president failed to seek best execution for customers by interposing a broker-dealer between clients and a market maker in order to compensate the broker-dealers for client referrals. This practice caused clients to pay approximately $1.7 million in unnecessary commissions. Shortly after completion of the routine examination, the adviser reimbursed $1.7 million to the clients.[55]

- Examiners found that an adviser purchased IPOs for which it was a co-managing underwriter for client accounts, without adequate disclosure to clients. As a result of the exam findings, the adviser refunded $771,077 to advisory clients and limited partners, representing, among other things, lost performance fees associated with these trades.[56]

- In an examination prompted by a media report, examiners found that the firm's president failed to provide documentation on checks and wire transfers from client accounts, and identified misappropriation of over $9 million in client assets and $20 million in unauthorized transfers among client accounts. The SEC brought a civil injunctive action resulting in an order to pay $14.4 million. Criminal action was also brought (resulting in a conviction and a 57-month prison term).[57]

VI. Improving Fund Compliance

While SEC examinations may periodically review certain aspects of a fund's activities, ensuring compliance on a day-to-day basis is the responsibility of fund management, the fund's board, and

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52 In the Matter of Vector Index Advisors, Inc. and Steven H. Adler, Investment Company Act Release Nos. 25268 (Nov. 15, 2001) and 25269 (Nov. 15, 2001).

53 U.S. v. Steven H. Adler, Litigation Release No. 17833 (Nov. 8, 2002).

54 Examination No. IA2002NERO092.

55 In the Matter of Portfolio Advisory Services, LLC, And Cedd L. Moses, Administrative Proceeding File No. 3-10807 (June 20, 2002).

56 Examination No. IA1999NERO111.

57 SEC v. Dana C. Giacchetto and the Cassandra Group, Litigation Release No. 17092 (Aug. 6, 2001).

the investment adviser. The Commission has adopted new rules designed to improve compliance by funds and advisers, with the goal of preventing violations from occurring.

As noted previously**,** in December, 2003, the Commission adopted a new rule requiring all funds and advisers to implement and maintain written policies and procedures reasonably designed to prevent, detect, and correct violations of the federal securities laws, to review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer to be responsible for administering the policies and procedures.[58] The rule requires that the chief compliance officer be responsible to the fund's board, and provide a written report each year to the board concerning material compliance matters. This rule is designed to protect investors by ensuring that all funds and advisers have internal programs for compliance with the federal securities laws, as well as providing fund boards with more information to exercise their compliance oversight responsibilities.

In December 2003, the Commission also proposed a rule that would require enhanced disclosure requirements.[59] These enhancements would require funds to specifically disclose market timing policies and procedures, practices regarding "fair valuation" of their portfolio securities, and policies and procedures with respect to the disclosure of their portfolio holdings. This type of explicit disclosure would shed light on market timing and selective disclosure of portfolio holdings so that investors could better understand the fund's policies and how funds manage the risks in these areas, and would also allow examiners to better determine if the fund's actions are consistent with its disclosures.

The Commission is also considering other ways to enhance compliance by funds and advisers, including by requiring funds and advisers to periodically undergo a compliance audit by an independent third party.[60] Other concepts include the creation of a self-regulatory organization for advisers, and that advisers obtain and maintain fidelity bond protection.[61]

VII. Conclusion

The SEC examines funds and advisers, using a risk-based methodology. Examinations reveal a variety of problems and result in corrective action by funds and advisers, as well as enforcement

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58 *See supra* n.34 and accompanying text.

59 *See SEC, Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings,* Securities Act Release No.8343, Investment Company Act Release No.26287 (Dec. 11, 2003); *see also* 68 Fed. Reg. 70402 (Dec. 17, 2003).

60 *See* Chairman William H. Donaldson, Regulatory Reforms to Protect Our Nation's Mutual Fund Investors, testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Nov. 18, 2003).

61 In February 2003, in tandem with the rule proposal concerning compliance policies and procedures and compliance officers, the Commission sought comment on these concepts. *See SEC, Compliance Programs of Investment Companies and Investment Advisers,* Investment Company Act Release No. 25925, Investment Advisers Act Release No. 2107 (Feb. 5, 2003); *see also* 68 Fed. Reg. 7038 (Feb. 11, 2003). The Commission considers these as viable options. *See Compliance Programs of Investment Companies and Investment Advisers, supra* at n.34.

actions in the most serious cases. Examinations are a critical component in investor protection, and the SEC is taking steps to enhance its ability to detect abusive conduct in a timely manner. The SEC has enhanced its examinations of funds and advisers. In light of misconduct involving market timing, Commission examiners have added new examination steps to routine examinations. In addition, with additional staffing recently added to the examination program, examiners are increasing the frequency and depth of examination reviews for high risk firms, better using technology and data in examinations, giving examiners discretion to identify new or emerging areas of compliance risk, conducting more targeted "mini-sweep" examinations to identify risk areas sooner, and working closely with other staff at the Commission to highlight problems detected, and identify possible solutions sooner.

Appendix A: Enforcement Actions Involving Mutual Funds

APPENDIX A

ENFORCEMENT ACTIONS INVOLVING MUTUAL FUNDS

A. Market Timing, Late Trading, and/or Selective Disclosure

1. SEC v. Invesco Funds Group, Litigation Release No. 18482 (Dec. 2, 2003). The Commission alleged that Invesco, an investment adviser, and its chief executive officer ("CEO"), Cunningham, fraudulently accepted investments by market timers in certain mutual funds in order to earn higher management fees. Invesco entered into specific arrangements with certain investors, which permitted the investors to market time in the funds. The arrangements were contrary to disclosures in the funds' prospectuses. Further, the adviser did not enforce the market timing limitations as described in the prospectuses for shareholders with smaller accounts. The Commission also alleged that the Invesco and Cunningham had a fiduciary duty to act in the best interests of the funds and to provide full disclosure. However, neither disclosed the special arrangements with the shareholders of the funds or the funds' independent directors. The Commission is seeking permanent injunctions, disgorgement, and civil penalties.

2. SEC v. Security Trust Company, Litigation Release No. 18479 (Nov. 25, 2003). Security Trust Company ("STC") is an uninsured national banking association that, among other things, effects mutual fund trades for participants in retirement plans and processes data regarding those trades for the plans' third-party administrators. The Commission alleged that STC and certain principals facilitated late trading in nearly 400 different mutual funds by several hedge funds ("Canary Funds") and also attempted to conceal the Canary Funds' market timing activities from mutual funds using various methods including: (a) shotgun, (b) omnibus, (c) taxpayer ID, and (d) piggybacking. The Commission also alleged that STC had a compensation arrangement with the Canary Funds that included a larger than usual custodial fee and a profit sharing arrangement with respect to the Canary Funds' trades. The Commission is seeking an accounting, disgorgement, and penalties from all of the defendants and a judgment of permanent injunction against the principals.

3. SEC v. Gary L. Pilgrim, Harold J. Baxter and Pilgrim Baxter & Associates, Ltd., Litigation Release No. 18474 (Nov. 20, 2003). The Commission charged Pilgrim Baxter & Associates, Ltd., a registered investment adviser, and certain of its principals (Gary Pilgrim and Harold Baxter) with fraud and breach of fiduciary duty in connection with market timing in certain funds ("PBHG Funds"). Both Pilgrim and Baxter were officers of the adviser. Pilgrim was also an officer of the PBHG Funds and Baxter was a trustee of the Funds. PBHG Funds had a limit of four exchanges out of the Funds into a cash management fund per year. The Commission alleged that the respondents permitted a hedge fund in which Pilgrim and his wife had a substantial interest to engage in market timing of a PBHG Fund that Pilgrim managed. In addition, the Commission alleged that Baxter provided non-public information concerning one PBHG Fund to a close friend in the brokerage business. The friend passed the information on to customers who used the information to market time the BBHG Funds and to exercise hedging strategies through other financial and brokerage institutions. The Commission seeks permanent injunctive relief, disgorgement, prejudgment interest, and civil penalties, as well as a prohibition against Pilgrim and Baxter from acting in certain enumerated positions with a mutual fund.

4. **In the Matter of Putnam Investment Management, LLC**, Investment Company Act Release Nos. 26255 (Nov. 13, 2003) and 26232 (Oct. 28, 2003). In settled administrative proceedings, the Commission found that at least six employees of Putnam, a registered investment adviser, engaged in market timing of mutual funds in their personal accounts. Four of these employees engaged in trading in funds over which they had investment decision-making responsibility and had access to non-public information regarding, among other things, current portfolio holdings and valuations and transactions not readily available to all fund shareholders. The Commission found that Putnam became aware that several investment management employees were engaging in market timing the funds, but Putnam failed to disclose the practice to the boards of directors of the funds and to the shareholders; and Putnam also failed to take adequate steps to detect and deter such trading activity through its own internal controls and its supervision of investment professionals. Putnam was ordered to cease and desist from committing or causing future violations, ordered to pay restitution, and ordered to comply with a myriad of undertakings to ensure future compliance. The amount of penalty Putnam shall pay is to be determined at a later date.

5. **SEC v. Justin M. Scott and Omid Kamshad**, Litigation Release No. 18428 (Oct. 28, 2003). In a district court action related to Section A.4., above, the Commission alleged that two employees of Putnam engaged in trading in funds over which they had investment decision-making responsibility and had access to non-public information regarding, among other things, current portfolio holdings and valuations and transactions not readily available to all fund shareholders. Further, the defendants failed to disclose their trading and that, by their trading, they potentially harmed other fund.

6. **SEC v. Martin J. Druffner**, Litigation Release No. 18444 (Nov. 4, 2003). The Commission alleged that five brokers formerly employed by Prudential Securities, Inc. defrauded mutual funds and their shareholders by misrepresenting their identities or the identities of their customers in connection with market timing trades after the mutual funds had restricted or blocked the brokers or their customers from further trading. In addition, the Commission alleged that a former branch manager of Prudential assisted the brokers by, among other things, approving their market timing trades. The Commission is seeking injunctive relief, disgorgement, penalties, and other equitable relief as the court deems appropriate.

7. **In the Matter of James Patrick Connelly, Jr.**, Investment Company Act Release No. 26209 (Oct. 16, 2003). The respondent in this administrative proceeding was a former officer of a registered investment adviser that managed a complex of funds. He approved agreements permitting certain investors to market time in the funds despite language in the funds' filings with the Commission that such activity would be discouraged and limiting exchanges among the funds. The Commission ordered Connelly to: (a) cease and desist from committing or causing violations Investment Company Act; (b) pay a civil penalty of $400,000; and (c) be barred from the broker-dealer, investment adviser, and fund industries.

8. **In the Matter of Steven B. Markovitz,** Advisers Act Release No. 2180 (Oct. 2, 2003). The Commission found that the respondent was a hedge fund trader who engaged in late trading of mutual fund shares on behalf of certain hedge funds. Certain broker-dealers enabled and permitted the respondent to communicate orders to purchase and sell mutual fund shares

before 4:00 p.m. and then confirm, alter, or cancel the proposed orders after 4:00 p.m. In some cases, Markovitz would communicate orders to the broker-dealers in the first instance after 4:00 p.m. The Commission ordered Markovitz to cease and desist from future violations, and was barred from the investment adviser and mutual fund industries.

9. **<u>In the Matter of Charles Sihpol, III,</u>** Investment Company Act Release No. 26179 (Sept. 16, 2003). Enforcement alleged that Sihpol, a former employee of Banc of American Securities LLC ("BAS") played a key role in enabling Canary Capital Partners, LLC; Canary Capital Partners, Ltd.; Canary Investment Management, LLC; and Edward J. Stern (collectively, "Canary") to engage in late trading of mutual fund shares. In addition, Enforcement alleged that Sihpol falsified, altered, destroyed, or evaded the creation of books and records that BAS was required to create, maintain, and preserve. Specifically, beginning around May 2001, Canary began manually to late trade BAS mutual funds. Sihpol (or a member of his team) would prepare and time stamp order tickets for proposed trades prior to 4:00 p.m. ET (when the BAS mutual funds priced their shares). Canary would decide whether to carry out the trades after 4:00 p.m. and at that time, and Sihpol (or a member of his team) would either use the order tickets to effect Canary's trades or would discard the tickets if Canary decided not to execute the trades. In the summer of 2001, BAS technicians installed an electronic direct access system in Canary's offices. Through this system, Canary was able to enter its trades directly into BAS' clearing function until 6:30 p.m. ET, and was able to late trade the BAS mutual funds with which BAS had clearing agreements. Canary used the electronic system to late trade mutual funds until the summer of 2003 and continued to trade manually whenever there were technical problems with the electronic system.

10. **<u>In the Matter of Alliance Capital Management, L.P.</u>**, Investment Advisers Act Release No. 2205 (Dec. 18, 2003). The Commission found that Alliance Capital, a registered investment adviser to several mutual funds as well as a sponsor and manager of several hedge funds, provided "timing capacity" in its mutual funds to known timers in return for, or in connection with, the timers' investments of "sticky assets" in Alliance Capital hedge funds or other investment vehicles from which Alliance Capital earned management fees. The prospectuses for the mutual funds gave the misleading impression that Alliance Capital sought to prevent timing in these mutual funds. In addition, Alliance Capital provided material nonpublic information the portfolio holdings of certain mutual funds to at least one of the timers, thus enabling the timer to profit from market timing in declining markets. The Commission settled the matter by obtaining significant remedial undertakings and $250 million in disgorgement and penalties, which the Commission contemplates will be distributed to injured shareholders pursuant to a Fair Fund distribution.

11. **<u>In the Matter of Massachusetts Financial Services, Co.,</u>** Investment Advisers Act Release No. 2213 (Feb. 5, 2004). The Commission found that Massachusetts Financial Services ("MFS"), an investment adviser and sponsor of hundreds of mutual funds, permitted widespread market timing of certain mutual funds, internally referred to as "Unrestricted Funds," despite prospectus disclosure that MFS funds "do not permit market timing or other excessive trading practices." John Ballen, president and CEO of MFS, approved, and Kevin Parke, chief investment officer, implemented MFS's policy permitting market timing in its Unrestricted Funds during the same period that they signed registration statements for certain Unrestricted

Funds that purportedly prohibited market timing. The respondents also failed to disclose the conflict of interest created by MFS's acceptance of investments from timers contrary to the interests of long-term shareholders. The Commission settled the matter by obtaining significant remedial undertakings and over $225 million in disgorgement and penalties, which the Commission contemplates will be distributed to injured shareholders pursuant to a Fair Fund distribution.

12. **<u>SEC v. Security Brokerage, Inc. and Daniel Calugar</u>**, Litigation Release No. 18524 (Dec. 24, 2003). The Commission filed civil fraud charges against Security Brokerage and its president and majority owner Calugar, for their participation in a scheme to defraud mutual fund shareholders through improper late trading and market timing. The Commission alleges that from at least 2001 to 2003, Calugar, trading through Security Brokerage, reaped profits of approximately $175 million from improper late trading and market timing, principally through mutual funds managed by Alliance Capital Management and Massachusetts Financial Services. Based on the Commission's application, the court issued a temporary restraining order freezing the assets of the defendants, prohibiting the destruction of documents, and granting expedited discovery.

13. **<u>In the Matter of Paul A. Flynn</u>**, Investment Advisers Act Release No. 2212, (Feb. 3, 2004). In this administrative proceeding, Enforcement alleged that from 2001 to 2003, Flynn, while employed as a Managing Director of Equity Investments at Canadian Imperial Bank of Commerce ("CIBC"), substantially assisted Security Trust Company, N.A. and CIBC hedge fund clients, including Canary Capital Partners, LLC, in engaging in late trading and deceptive market timing of mutual fund shares. Enforcement alleges that Flynn knew or was reckless in not knowing that CIBC's hedge fund clients were engaging in late trading and deceptive market timing, and further that he arranged financing for the hedge fund clients.

14. **<u>SEC v. Columbia Management Advisors, Inc. and Columbia Funds Distributor, Inc.</u>**, Litigation Release No. 18590 (Feb. 24, 2004). The Commission filed a civil action alleging that, from 1998 through 2003, Columbia Management Advisors, Inc., a registered investment adviser that manages Columbia mutual funds, and Columbia Funds Distributor Inc., a registered broker-dealer that is the principal underwriter and entity responsible for selling the funds, made arrangements to allow preferred mutual fund customers to engage in short-term and excessive trading, while at the same time falsely representing publicly that it prohibited such trading. Columbia Management Advisors and Columbia Funds Distributor are subsidiaries of FleetBoston Financial Corporation. Columbia Management Advisors and Columbia Funds Distributor accepted "sticky assets" in connection with certain of the arrangements.

15. **<u>SEC v. Mutuals.com, Inc.,</u>** Litigation Release No. 18489 (Dec. 4, 2003). The Commission filed civil fraud charges against Mutuals.com, Inc., its CEO, its president, and its compliance officer, as well as two affiliated broker-dealer firms. The Commission alleged that the defendants deceived hundreds of mutual fund companies and their shareholders by improperly helping institutional brokerage customers and advisory clients carry out thousands of market timing trades and illegal late trades in shares of those mutual funds.

B. Misappropriation

1. **SEC v. John J. Lawbaugh**, Litigation Release No. 18377 (Sept. 30, 2003). The Commission alleged that Lawbaugh, a principal of two face-amount certificate companies (1st Atlantic Guaranty Corporation and SBM Certificate Company), overstated the value of assets and failed to disclose transfers in certain filings with the Commission made by the face-amount certificate companies. These misrepresentations and omissions hid the fact that Lawbaugh misappropriated approximately $2 million for his own use. Further, the Commission alleged that Lawbaugh misappropriated approximately $1 million from investors by promising to invest their money in certificates of one of the face-amount companies. The money was not invested as promised.

2. **In the Matter of Vector Index Advisors, Inc. and Steven H. Adler,** Investment Company Act Release Nos. 25269 (November 15, 2001) and 25268 (Nov. 15, 2001). Adler was a principal of a registered investment adviser, Vector, and a registered investment company, ASM, and was also associated with a registered broker-dealer. Adler promised investors that he would use their money to buy and sell shares of ASM. Adler also told investors that he would maintain "market timing" accounts through Vector and that he would maximize investor returns by correlating the purchase and sale transactions to fluctuations in the markets. However, Adler misappropriated investor money to pay for expenses of Vector and his own expenses. Adler also prepared and furnished to investors fictitious monthly statements purportedly reflecting gains in their accounts. The Commission ordered Adler to cease and desist from future violations, and barred him from the broker-dealer, investment adviser, and fund industries. In a related action, **U.S. v. Steven H. Adler**, Litigation Release No. 17833 (Nov. 8, 2002), the United States Attorney's Office for the Middle District of Florida indicted Adler. Adler was convicted of mail and wire fraud and sentenced to jail.

C. Misrepresentations and/or Omissions

1. **SEC v. Irving Paul David**, Litigation Release No. 18300 (Aug. 21, 2003). From January 2001 through January 2003, David, formerly an officer of two investment companies, engaged in two schemes to embezzle money from the Consulting Group Capital Markets Funds and Smith Barney World Funds. At the very time that he was embezzling from the funds, David signed a certification pursuant to the Sarbanes-Oxley Act in which he falsely stated that he had disclosed to the Consulting Group Fund's auditors and audit committee any fraud, whether material or not, involving management. In fact, he had made no such disclosure. The Commission seeks permanent injunctive relief, disgorgement of ill-gotten gains with prejudgment interest, and civil penalties.

2. **In the Matter of Vector Index Advisors, Inc. and Steven H. Adler**, Investment Company Act Release Nos. 25269 (Nov. 15, 2001) and 25268 (Nov. 15, 2001). *See* Section B.2, above.

3. **In the Matter of ND Money Management, Inc.; Ranson Capital Corporation; Robert E. Walstad; and Monte L. Avery**, Investment Company Act Release No. 25523 (Apr. 12, 2002. Two registered investment advisers (ND Money Management and Ranson Capital) managed several registered state municipal bond funds. The Commission found that the funds'

disclosure was misleading because they invested contrary to certain investment restrictions, and that there were reporting violations under the fund's code of ethics and certain books and records violations. A principal of the Funds, Robert Walstad, and a portfolio manager of the funds, Monte Avery, were responsible for these violations. The Commission ordered: (a) the respondents be censured and ordered them to cease and desist from committing or causing any future violations; (b) ND Money Management, Ranson Capital, Walstad and Avery to pay civil penalties of $10,000, $10,000, $15,000 and $5,000, respectively; and (c) ND Money Management and Ranson to hire a consultant to conduct a review and follow-up reviews for four years.

4. **In the Matter of Lawrence P. Grady**, Investment Company Act Release No. 25201 (Sept. 28, 2001). Grady was the president, director, and sole employee of Minn Shares, Inc., a fund. Enforcement alleged that Grady made management decisions for the fund and was personally responsible for ensuring the fund's compliance with the Investment Company Act. Enforcement alleged that for a period of time the fund operated without a written code of ethics, that Grady failed to report his and his wife's personal securities transactions to the fund, and that Grady caused the fund to operate without a fidelity bond. In addition the fund did not file a proxy with the Commission and failed to transmit to shareholders semi-annual reports. Further, Enforcement alleged that Grady caused an affiliated person of the fund to engage in a prohibited transaction with the fund and made untrue statements of material fact about the fund's compliance with the Investment Company Act to fund shareholders in two proxy statements. The Commission ordered Grady to cease and desist from committing or causing any future violations, barred him from the mutual fund industry for three years, and ordered him to pay a penalty $10,000.

5. **SEC v. Michael Carnicle, Michael Hansen, William Straughan, Randy Glad, Lionel Reifler, Howard Ray, and Arie From,** Litigation Release No. 16293 (Sept. 27, 1999). The Commission alleged that Carnicle secretly established and controlled two Los Angeles-based mutual funds and knowingly made misrepresentations and omissions of material fact, including falsely representing that only 10% of the funds' monies would be invested in "illiquid" securities and that "exchange" transactions would only be conducted under limited circumstances. The court found that the Commission had demonstrated that it is entitled to all of the relief it sought against Carnicle: a permanent injunction, full disgorgement of the $444,323 Carnicle received in margin loans plus prejudgment interest, and the maximum third-tier penalty equal to Carnicle's pecuniary gain of $444,323. Similarly, the court found that the Commission was entitled to the second-tier penalties of $20,000 each that it sought against defendants Howard Ray and Randy Glad, who had previously been enjoined by default.

6. **In the Matter of Michael P. Traba**, Investment Company Act Release Nos. 23952 (Aug. 19, 1999) and 23595 (Dec. 10, 1998). Enforcement alleged that Traba, the portfolio manager of two bank-advised money market funds, caused both funds to hold structured notes whose values decreased significantly in 1994 as interest rates rose. As a result of the declining value of the derivatives, both funds ultimately broke a dollar. To hide the funds' losses, Enforcement alleged that Traba (1) instructed the funds' administrator to use amortized cost to value these derivatives under the required shadow pricing procedures; and (2) sold the derivatives to certain of the bank's common trust accounts at par, and resold them to another

bank account at a loss. In connection with this matter, the Office of the Comptroller of the Currency prohibited him from participating in the conduct of the affairs of an insured depository institution and ordered him to pay a $15,000 civil money penalty. The Commission ordered Traba to cease and desist from committing or causing violations and any future violations of the securities laws and to pay a penalty in the amount of $15,000, and barred him from association with any broker, dealer, or investment company.

7. **In the Matter of The Rockies Fund, Inc.; Stephen G. Calandrella; Charles M. Powell; Clifford C. Thygesen; and John C. Power**, Investment Company Act Release No. 26202 (Oct. 2, 2003); Initial Decision Release No. 181 (March 9, 2001). The Rockies Fund was a business development corporation and its board of directors consisted of Calandrella and two independent directors, Powell and Thygesen. Enforcement alleged that the fund and the three directors defrauded investors by materially overstating the fund's net assets. The overstatement of assets stemmed from: (1) the fund's improper classification of portfolio securities of Premier Concepts, Inc. ("Premier") as unrestricted; (2) the fund's improper claim of ownership of certain restricted Premier stock; and (3) a manipulation, by Calandrella and Powell, of the market for Premier stock by engaging in matched order and wash sales or trading through nominee accounts. Enforcement also alleged that the fund filed false and misleading annual and quarterly reports and that Calandrella improperly accepted compensation for the fund's purchase of Premier stock in that he caused the fund to enter into an agreement to pay money to one of his business acquaintances in return for, among other things, the acquaintance's agreement to forego a potential legal claim against Calandrella. In an initial decision, which the Commission upheld, the administrative law judge ("ALJ") ordered, among other things, that the respondents cease and desist from committing or causing future violations, that Calandrella be barred from associating with an investment company, that Powell and Thygesen be prohibited from associating with an investment company for three years, and that Calandrella, Powell, and Thygesen pay a civil penalty of $500,000, $160,000, and $160,000, respectively.

8. **In the Matter of Piper Capital Management, Inc.; Worth V. Bruntjen; Marijo A. Goldstein; Robert H. Nelson; Amy K. Johnson; Molly Destro; and Edward J. Kohler,** Advisers Act Release No. 2163 (Aug. 26, 2003); Initial Decision Release No. 175 (Nov. 30, 2000); **In the Matter of Worth V. Bruntjen**, Investment Company Act Release No. 23664 (Jan. 26, 1999) and Advisers Act Release No. 1737 (July 28, 1998). Enforcement alleged that from approximately early 1992 through at least April 1994, Piper Capital Management, Inc. ("PCM"), the investment adviser to a government bond fund, and Bruntjen and Goldstein, the fund's portfolio managers, committed fraud by making false and misleading statements to investors regarding the risks associated with an investment in the fund and the leveraging of fund assets. The order alleges that, despite its conservative investment objective, the fund was in fact a high-risk investment as a result of PCM's, Bruntjen's, and Goldstein's investment of fund assets in interest rate-sensitive collateralized mortgage obligation derivatives. In addition, the order alleges that PCM, Bruntjen, and Goldstein caused the fund to change its investment objective without shareholder approval. PCM and Bruntjen committed fraud by making false statements to investors regarding Bruntjen's educational background in PCM's amendments to its Forms ADV. Kohler, president of PCM and supervisor of Bruntjen and Goldstein during the relevant time period, failed reasonably to supervise Bruntjen, and Goldstein with a view to preventing their violations of the federal securities laws.

The Commission settled with Bruntjen, and he was ordered to cease and desist from committing or causing future violations and to pay a penalty of $100,000. In addition, the Commission barred him from the securities industry. In the litigated aspect of the case, Commission upheld the ALJ's order that: (1) revoked PCM's registration; (2) ordered PCM to pay a penalty of $2,005,000; (3) censured the individual defendants (Goldstein, Nelson, Johnson, and Destro); and (4) ordered them to cease and desist from committing or causing any future violations.

9. **<u>In the Matter of Terence Michael Coxon, Alan Michael Sergy, World Money Managers and World Money Securities, Inc</u>.,** Advisers Act Release Nos. 2161 (Aug. 21, 2003) and 1857 (Mar. 2, 2002); Initial Decision No. 140 (Apr. 1, 1999); and Advisers Act Release No. 1604 (Jan. 13, 1997). Enforcement alleged that the certain fund affiliates had unlawfully engaged in practices concerning the fund's tax planning strategy, the allocation of fund operating expenses, the allocation of certain fund distribution expenses, the manufacture of tax equalization credits, the fund's investment policies; and had materially misrepresented those practices or the risks associated with those practices in the fund's advertising and promotional materials.
The Commission ordered: (1) the investment adviser and Coxon to cease and desist from committing or causing any future violations; (2) the investment adviser and Coxon to disgorge a total of $971,777.54 and pay prejudgment interest; and (c) the Division of Enforcement to submit a plan for the administration and distribution of the disgorgement funds. The Commission dismissed the proceedings against Sergy who was suffering from a serious, progressive disability and was no longer in the securities industry.

10. **<u>In the Matter of Fundamental Portfolio Advisors, Inc.; Lance M. Brofman; and Fundamental Service Corporation</u>**, Advisers Act Release No. (July 15, 2003); Initial Decision Release No. 180 (Jan. 29, 2001); and Exchange Act Release No. 39158 (Sept. 30, 1997). Enforcement alleged that Fundamental Portfolio Advisors, Inc. ("FPA"), a registered investment adviser; Malanga, FPA's president; Brofman, the former portfolio manager of the Fundamental U.S. Government Strategic Income Fund; and Fundamental Service Corporation ("FSC"), a registered broker-dealer affiliated with FPA, which distributes and markets the fund, violated certain antifraud provisions of the federal securities laws because they marketed the fund as a safe investment, offering relative stability of net asset value ("NAV"), when it was not. Enforcement also alleged that FPA, Brofman, and Malanga failed to disclose FPA's soft dollar arrangements to the board of the fund and other funds managed by FPA when questioned about such arrangements at three board meetings. The Commission upheld an ALJ order that: (1) Brofman, FPA, and FSC to cease and desist from committing or causing any violations certain provisions of the securities laws; (2) Brofman to pay a civil penalty of $250,000; (3) FPA and FSC to each pay a civil penalty of $500,000; (4) Brofman to be barred from association with any broker, dealer, investment adviser, or investment company; (5) the registration of FPA as an investment adviser to be revoked; and (6) the registration of FSC as a broker or dealer to be revoked.

11. **<u>In the Matter of Fundamental Portfolio Advisors, Inc.; Lance M. Brofman; Vincent J. Malanga; and Fundamental Service Corporation</u>**, Advisers Act Release No. 1729 (July 7, 1998). In a matter related to C.10., above, the Commission suspended Malanga from the industry in any capacity for 12 months; barred him from being a supervisor or owner for two years; ordered him to pay a $25,000 civil penalty; and ordered him to cease and desist from committing or causing any future violations.

12. **In the Matter of Javed Anver Latef and Larry Alan Stockett**, Advisers Act Release No. 2116 (Mar. 20, 2003); **and In the Matter of Hudson Investor Funds, Inc.; Hudson Advisers, Inc.; Javed Anver Latef; and Larry Alan Stockett**, Initial Decision No. 139 (Mar. 30, 1999). Enforcement alleged that Latef was the president and director of the Hudson Investor Funds, a registered investment company, and president and sole shareholder of Hudson Advisers, a registered investment adviser, and Hudson Management, Inc. Stockett (through a fictitious company) was given the option to purchase the common stock of Hudson Management and Hudson Advisers for $100 each, and in return the fictitious company would pay the costs of expenses of operating the fund to the extent that fees available from the fund were not sufficient to cover those fees and expenses. Enforcement alleged that, after signing the agreements, Latef discovered that the fictitious company had never been incorporated, but both men acted as though the agreements were valid. Hudson Adviser's ADV did not disclose the financing arrangement with Stockett. In addition, a special edition of the New Industrialist magazine contained an application to invest in the fund and inaccurate information about the fund. Latef took no steps to correct inaccuracies in the front-page article and accepted investment applications from the magazine. The ALJ: (1) ordered the respondents to cease and desist from committing or causing future violations; (2) suspended Latef from associating with an investment adviser or investment company for three months; (3) barred Stockett from associating with any broker, dealer, municipal securities dealer, investment adviser, and investment company; and (4) ordered that Stockett pay a $50,000 penalty. The Commission, however, found that the charges against Stockett were not supported and dismissed the charges with respect to him.

13. **In the Matter of Scudder Kemper Investments, Inc. and Gary Paul Johnson,** Advisers Act Release No. 1848 (Dec. 22, 1999); and **In the Matter of Michael T. Sullivan, III,** Advisers Act Release No. 1849 (Dec. 22, 1999). Enforcement alleged that Sullivan, a former trader at Scudder's Boston derivatives trading desk, initiated over 100 unauthorized derivatives transactions, including the accounts of several registered investment companies. Although Sullivan had been given limited discretion to execute a derivatives trading strategy in these accounts, he repeatedly ignored loss limits and other limits. Sullivan concealed his activities by miscoding order tickets, forging the signatures of the portfolio managers on order tickets, and in some instances by not submitting any order ticket at all. Sullivan's unauthorized trading caused the investment companies to be exposed to a higher level of risk than that regarded by the portfolio managers as appropriate. Enforcement alleged that Scudder, through supervisor Johnson, failed reasonably to supervise Sullivan.

The Commission found that Scudder and Johnson failed reasonably to supervise the trader, and that Scudder aided and abetted and caused Sullivan's violations. Sullivan was barred from association with any investment adviser or registered investment company for five years. (A civil penalty was not imposed because of Sullivan's inability to pay.) Johnson was suspended from association with any investment adviser for three months and was suspended from acting in any supervisory capacity with any investment adviser for nine months. In addition, Johnson was ordered to pay a civil fine of $10,000. Scudder was censured and ordered to cease and desist from committing or causing any future violations, ordered to pay a civil fine of $250,000, and ordered to comply with its undertaking to maintain enhanced supervisory and policies and procedures. Sullivan was ordered to cease and desist from committing or causing any violation or any future violation of the applicable securities laws.

14. **In the Matter of Stephen H. Brown**, Advisers Act Release No. 1751; Investment Company Act Release No. 23434 (Sept. 14, 1998). *See also* **In the Matter of Mitchell Hutchins Asset Management,** Advisers Act Release No. 1654; Investment Company Act Release No. 22805 (Sept. 2, 1997). Brown managed the PaineWebber Short-Term U.S. Government Income Fund, which Mitchell Hutchins (a registered investment adviser and broker-dealer) marketed as a higher-yield and somewhat higher- risk alternative to money market funds and bank certificates of deposit. Brown violated the antifraud provisions of the federal securities laws when he invested the fund's assets in securities that exposed investors to significantly higher levels of risk than had been disclosed in the fund's offering materials. The Commission ordered Brown to cease and desist from future violations, and was barred from association with an investment adviser, investment company, broker, dealer, or municipal securities dealer for three years.

D. Conflicts of Interest

1. **In the Matter of Deutsche Asset Management, Inc.,** Advisers Act Release No. 2160 (Aug. 19, 2003). Enforcement alleged that Deutsche Asset Management ("DeAM"), the investment advisory unit of Deutsche Bank, AG, failed to disclose a material conflict of interest in its voting of client proxies for the 2002 merger between Hewlett-Packard Company ("HP") and Compaq Computer Corporation. Unbeknownst to DeAM's advisory clients, Deutsche Bank's investment banking division was working for HP on the merger, and had intervened in DeAM's proxy voting process on behalf of HP. This created a material conflict of interest for DeAM, which had a fiduciary duty to act solely in the best interests of its advisory clients. The Commission found that DeAM violated the Investment Advisers Act by voting client proxies in connection with the merger without first disclosing the circumstances of its investment banking affiliate's work for HP on the proposed merger and its intervention in DeAM's voting process. The Commission censured DeAM, ordered it to cease and desist from committing or causing any violations or future violations, and ordered it to pay a $750,000 penalty.

2. **In the Matter of Zion Capital Management, LLC and Ricky A. Lang**, Investment Advisers Act Release Nos. 2003 (Dec. 20, 2001) and 2200 (Dec. 11, 2003). Enforcement alleged that Zion Capital Management ("Zion"), an investment adviser, and Lang, the president and sole owner of Zion, allocated more profitable trades to an entity in which Lang had a financial interest ("Lang entity") and more unprofitable trades to Zion's advisory client, a hedge fund. As a result, during a nine-month period, Zion's client lost more than 60% of its investment while the Lang entity made a substantial profit. Enforcement also alleged that Zion and Lang misrepresented their trading strategy and methods for resolving conflicts of interest to investors in offering and other materials.

Among other things, the Commission found that Zion and Lang misrepresented that they would employ a similar trading strategy for the client and the Lang entity, and in fact, Lang repeatedly assigned better trades to the Lang entity and worse trades to the advisory client. The Commission concluded that Lang's trading created an actual conflict of interest between the advisory client and the Lang entity. The Commission barred Lang from association with an investment adviser or investment company, and further ordered Lang and Zion to cease and desist committing future violations, to pay jointly and severally disgorgement of $210,000 plus prejudgment interest, and to pay a joint and several penalty of $220,000, which shall become part of a disgorgement fund for the victims pursuant to the Fair Fund provision of the Sarbanes-Oxley Act of 2002.

E. Compliance

1. SEC v. 1st Atlantic Guaranty Corporation, Litigation Release No. 18103A (Apr. 25, 2003). 1st Atlantic was registered with the Commission as a face-amount certificate company. The Commission alleged that, as a result of the transfer of certain assets previously held by it, 1st Atlantic operated with reserves below the legal minimum required by the Investment Company Act. The Commission also alleged that between 1998 and 2002, the former CEO and chairman of 1st Atlantic diverted approximately $1 million from 1st Atlantic and transferred assets with a value of more than $2.8 to a subsidiary without consideration. In an attempt to cover its reserve deficiency, 1st Atlantic began to improperly count the value of the common stock of its subsidiary (Subsidiary) as a "qualified investment." However, the stock of the Subsidiary was not a qualified investment as defined by the Investment Company Act and should not be counted by 1st Atlantic towards its reserve requirement. Without this asset, 1st Atlantic did not meet its reserve requirements. Although the matter is in litigation, the court has already granted a temporary restraining order and a freeze on payment to certificate holders, and scheduled a hearing on the Commission's motion for an appointment of a receiver.

2. In the Matter of Gintel Asset Management, Inc.; Gintel & Co. LLC; Robert M. Gintel; and Stephen G. Stavrides, Investment Company Act Release No. 25798 (Nov. 8, 2002). Enforcement alleged that Gintel, a portfolio manager of a registered investment adviser, Gintel Asset Management, effected at least 40 cross trades on a principal basis between an investment company and accounts in which he had an ownership interest. Gintel Asset Management also engaged in prohibited principal transactions by causing client portfolios not affiliated with Gintel to trade with accounts in which Gintel had a substantial ownership stake, including the fund. Gintel Asset Management's principal transactions also rendered false a number of statements to clients and prospective clients representing that Gintel Asset Management did not engage in any affiliated or principal transactions. Stavrides, Gintel Asset Management's president and compliance officer, prepared and signed the Commission filings containing the false statements. In addition, Gintel engaged in personal trading in securities, frequently within seven days of trades in the same securities by the fund and other clients, in violation of the fund and Gintel Asset Management's code of ethics. Stavrides failed to apply the code of ethics' blackout periods for personal trading to Gintel, Gintel Asset Management, and an affiliated broker-dealer (Gintel & Co.) and also failed to establish, maintain, and enforce procedures reasonably designed to ensure that material non-public information was not misused.

Among other things, the respondents were censured, ordered to cease and desist committing or causing future violations, and ordered to pay a total of disgorgement, interest and penalties of approximately $925,000. The Commission also prohibited Gintel Asset Management from soliciting or advertising for any new investment advisory clients for one year, required Gintel Asset Management and Gintel & Co. to mail a copy of the Commission order to all current clients, and required Gintel & Co. to provide a copy of the order to all prospective clients not less than 48 hours before executing any brokerage account opening documents.

3. **In the Matter of Back Bay Advisors, L.P**., Advisers Act Release No. 25787 (Oct. 25, 2002). Enforcement alleged that Back Bay, formerly a registered investment adviser, engaged in prohibited affiliated transactions (cross trades) involving registered investment companies, made false statements or omissions to clients, altered records, and failed to reasonably supervise employees. Back Bay effected cross trades between an affiliated client and its investment companies and between investment companies without complying with an Investment Company Act Rule. Enforcement also alleged that Back Bay's personnel were ignorant of the applicable statutory requirements and followed their own procedures for cross trades. The Commission ordered Back Bay to pay a $150,000 penalty.

4. **In the Matter of Edgar M. Reed,** Investment Company Act Release No. 25786 (Oct. 25, 2002). *See* Section E.3., above. Reed was Back Bay's chief investment officer and a financial analyst. He supervised Back Bay's portfolio managers and traders, was responsible for ensuring that the investment staff executed trades, and managed portfolios in compliance with the securities laws. Enforcement alleged that after being informed that the Commission's staff intended to conduct a routine exam, Reed directed a trader to add information to the firm's complete cross trade tickets. The Commission censured Reed, ordered him to cease and desist from committing or causing future violations, suspended him from association with any investment adviser or registered investment company for 12 months, and ordered him to pay a $25,000 penalty.

5. **In the Matter of ND Money Management, Inc.; Ranson Capital Corporation; Robert E. Walstad; and Monte L. Avery,** Investment Company Act Release No. 25523 (Apr. 12, 2002). *See* Section C.3., above.

6. **In the Matter of Lawrence P. Grady**, Investment Company Act Release No. 25201 (Sept. 28, 2001). *See* Section C.4., above.

7. **In the Matter of Charles G. Dyer, Hawthorne Investment Trust, and Hawthorne Associates, Inc.,** Investment Company Act Release No. 25107 (Aug. 9, 2001). Enforcement alleged that a registered investment company failed to comply with the books and records, reporting, and governance requirements of the Investment Company Act. Dyer was the fund's sole officer and trustee. The fund renewed an investment advisory contract without the approval of a majority of the directors who were not interested persons. Further, the Hawthorne Associates and another adviser committed numerous books and records violations. The Commission: (1) ordered the fund, Hawthorne Associates, and Dyer to cease and desist from committing or causing future violations; (2) prohibited Dyer from associating with an investment company or an investment adviser for 12 months; and (3) ordered Dyer and Hawthorne

Associates to jointly pay a $25,000 penalty.

8. **In the Matter of Nova Communications Ltd and Murray W. Goldenberg**, Investment Company Act Release No. 24384 (Apr. 10, 2000). In this settled administrative proceeding, the Commission found that Nova Communications Ltd., formerly known as First Colonial Ventures Ltd. ("FVCL"), and its president and CEO, Goldenberg, engaged in a variety of unlawful conduct. FCVL engaged in four transactions in which FCVL acquired certain assets, leases, and interests. At the time that FCVL made these acquisitions, FCVL was operating as a business development company ("BDC"). The Investment Company Act prohibited FCVL, as a BDC, from acquiring any assets other than "BDC Qualifying Assets," unless at least 70% of FCVL's total assets were BDC Qualifying Assets. At the time that FCVL made each of the four acquisitions, less than 70% of FCVL's total assets were BDC Qualifying Assets. FCVL also issued over three million FCVL shares to Colonial Funds for no consideration, causing them to be listed at below NAV in contravention of the Investment Company Act. In addition, FCVL failed to maintain certain books and records regarding securities transactions. After becoming a BDC, FCVL offered and sold securities without including certain information in its offering circulars as required by Regulation E and failed to file certain documents with the Commission, including a registration statement, reports of its sales, and certain 10-Qs and 10-Ks. The Commission ordered the respondents to cease and desist from future violations.

9. **In the Matter of Terence Michael Coxon, Alan Michael Sergy, World Money Managers and World Money Securities, Inc.,** Advisers Act Release Nos. 2161 (Aug. 21, 2003) and 1857 (Mar. 2, 2002); Initial Decision No. 140 (Apr. 1, 1999); and Advisers Act Release No. 1604 (Jan. 13, 1997). *See* Section C.9., above.

10. **In the Matter of Concord Growth Corporation**, Investment Company Act Release No. 23470 (Sept. 28, 1998). The Commission instituted proceedings against Concord and certain individuals: Rutherford, the chairman, CEO, and 20% owner of Concord (in a related proceeding); Borgardt, a fund director and the fund's portfolio manager and president of the fund's investment adviser; and Banhazl, secretary and treasurer of the fund and portfolio manager of the fund. The Commission alleged that Concord, a commercial finance company that makes asset-backed loans to businesses, acting as principal, sold loan participations to a fund while it was an affiliate of an affiliate of the fund. No prior approval to engage in these transactions was sought or received from the Commission. The fund's entire portfolio consisted of loan participations purchased from, and originated and serviced by, Concord.

11. **In the Matter of Reid Rutherford**, Investment Company Act Release No. 23469 (Sept. 28, 1998). *See* Section E.10., above. The Commission ordered Rutherford to cease and desist from committing future violations, and pay a $5,000 penalty.

12. **In the Matter of Byron G. Borgardt and Eric M. Banhazl**, Investment Company Act Release No. 26169 (Aug. 25, 2003). *See* Section E.10., above. The Commission ordered Borgardt and Banhazl to cease and desist from committing future violations.

13. **In the Matter of Nicholas P. Howard**, Initial Decision No. 138 (Mar. 24, 1999), Exchange Act Release No. 47357 (Feb. 12, 2003). Howard was a senior vice president in charge of marketing at James Capel, Inc. (JCI). JCI was an investment adviser to the European Warrant Fund (EWF), a registered closed-end investment company. Howard, who had participated in the development of the EWF, received an indication of interest for securities being offered by JCI from Julius Baer Securities, Inc. on behalf of EWF. Howard was unable to reach the individual who had sent the indication of interest on behalf of EWF before the close of the subscription period to confirm EWF's order. JCI's president told Howard that JCI would purchase the shares and that Howard should contact Baer later. JCI purchased the shares. Howard later confirmed the order with Baer, and the shares were sold by JCI to the EWF. The shares were counted towards a 2,000,000 share offering minimum that was part of the transaction. Neither JCI nor Howard disclosed these circumstances to investors. The Commission suspended Howard from associating with a broker or dealer for three months, ordered him to cease and desist from future violations, and ordered him to pay a civil penalty of $50,000.

F. IPO Related

1. <u>In the Matter of Nevis Capital Management, LLC; David. R. Wilmerding; III; and Jon C. Baker</u>, Investment Company Act Release No. 26144 (July 31, 2003) and Investment Advisers Act Release No. 2214 (Feb. 9, 2004). In this administrative proceeding, Enforcement alleged that Nevis Capital Management, LLC ("Nevis), a registered investment adviser, disproportionately allocated IPOs to a registered investment company it advised, which at the time was a small start-up fund, and a hedge fund that paid a performance fee. Nevis failed to disclose the large impact the IPOs had on the unusually superior performance of the fund. Nevis allocated a large portion of IPOs it received to the fund and hedge fund at the expense of other clients. Nevis' Form ADV and brochure claimed that all clients would be treated equally ("on a pro-rata basis") and that interests of clients not related to Nevis would be given priority. The staff alleges that preferential IPO allocations enabled the fund to achieve outstanding performance between December 1998 and December 1999. The exceptional performance of the fund was accompanied by a tremendous asset growth. Further, Enforcement *alleged* that Nevis, Wilmerding and Baker made false and misleading statements and omitted material information in the fund's prospectus, annual and semi-annual reports, and advertisements by failing to disclose that the fund's performance was primarily attributable to IPOs, stating instead that the fund had invested only in a couple IPOs. The respondents ultimately settled the matter by agreeing to undertake appropriate review of its procedures, provide a copy of the Commission's order to current and prospective clients, and pay $2 million in disgorgement and penalties, which the Commission contemplates will be returned to defrauded shareholders through a Fair Fund distribution.

2. <u>In the Matter of Davis Selected Advisers-NY, Inc</u>., Investment Company Act Release No. 25727 (Sept. 4, 2002). Enforcement alleged that Davis Selected Advisers-NY, Inc. (a sub-adviser to a registered investment company), violated the Investment Company Act by failing to disclose that the fund's performance was significantly impacted by IPO trading. Specifically, an Investment Company Act form requires that a fund describe factors that materially affected fund performance in its last fiscal year. In 1999, the fund's total return was 31.4% and IPO trading accounted for over 25% of that return. In 2000, IPO trading accounted for over one half of the fund's total return of 11.5%. Neither the prospectus nor the fund's annual reports mentioned IPO trading. The Commission ordered the respondent to cease and desist from committing or causing future violations and to pay a $10,000 penalty.

3. **In the Matter of the Dreyfus Corporation and Michael L. Schonberg**, Investment Company Act Release No. 24450 (May 10, 2000). The Dreyfus Corporation ("Dreyfus") served as the investment adviser for the Dreyfus Aggressive Growth Fund ("DAG") and other investment companies ("Dreyfus Funds"). Schonberg served as portfolio manager for five of the Dreyfus Funds, including DAG. Enforcement alleged that over the course of DAG's first fiscal year, Schonberg's allocations of securities purchased in IPOs favored DAG over three other funds Schonberg managed. Neither Dreyfus nor Schonberg disclosed this practice, notwithstanding DAG's prospectus disclosure that investment opportunities would be allocated equitably among Dreyfus Funds. Dreyfus also did not review Schonberg's IPO allocations. DAG achieved exceptional returns during its first fiscal year in large part because of the investments in IPOs. Dreyfus did not disclose the large impact of the IPO investments, though it was questionable whether DAG could replicate its prior performance through continuing to invest in IPOs as the fund grew larger. In addition, Enforcement alleged that although Dreyfus had a written code of ethics, it had not instituted adequate procedures reasonably necessary to prevent violations of its code of ethics relating to potential conflicts of interest. The Commission ordered the following: (1) a censure of Dreyfus and Schonberg; (2) Dreyfus and Schonberg to cease and desist from committing or causing any future violation; (3) Dreyfus and Schonberg to pay penalties of $950,000 and $50,000, respectively; (4) Schonberg to be suspended from association with any investment adviser or investment company for nine months; and (5) Dreyfus to hire an independent consultant.

4. **In the Matter of Van Kampen Advisory Corp. and Alan Sachtleben**, Advisers Act Release No. 1819 (Sept. 8, 1999). Enforcement alleged that Van Kampen Advisory, a registered investment adviser, made disclosures in its sales literature and public filings that touted the performance of its Van Kampen Growth Fund (now known as Van Kampen Equity Trust) without disclosing the large impact that hot IPOs had on the fund's return. It instead attributed the performance to investment in technology, financial services and health care sectors. Sachtleben was Van Kampen Advisory's chief investment officer and had control over the advertisements for the fund and the public filings. The Commission censured Van Kampen Advisory and Sachtleben, and ordered them to cease and desist from future violations. Van Kampen Advisory and Sachtleben were ordered to pay civil penalties of $100,000 and $25,000, respectively.

5. **In the Matter of Monetta Financial Services, Inc**., Advisers Act Release Nos. 2136 (June 9, 2003) and 1702 (Feb. 26, 1998); and Initial Decision Release No. 162 (Mar. 27, 2000). Enforcement alleged that the president of an investment adviser allocated hot IPOs to fund directors (two inside director, "Valiant" and "Henry," and one independent director, "Russo") where the funds also were eligible and able to invest in the IPOs. The president of the investment adviser ("Bacarella") did not disclose the allocation practice or the material conflict of interest raised by the practice. The directors accepted the trades without disclosing the arrangement to fund shareholders and without getting approval of a disinterested representative of the fund. Among other things, the Commission ordered: (a) Monetta Financial Services and Robert Bacarella to cease and desist from committing or causing any future violations; (b) Bacarella be suspended from associating with an investment adviser for a period of 90 days; (c)

MFS pay a penalty of $200,000; and (d) Bacarella pay a penalty of $100,000.

G. Misconduct with Respect to Non-Fund Clients

1. SEC v. Nathan Chapman, Jr., Litigation Release No. 18203 (June 26, 2003). The Commission filed a civil injunctive action against Chapman, three of his companies and three of his associates in connection with the June 2000 IPO of, and subsequent secondary market trading in, the common stock of eChapman.com, Inc. ("ECMN"). The complaint alleged that, in an effort to rescue a failing IPO, Chapman and others engaged in fraudulent conduct, including: backdating trades and placing close to one-third of the IPO shares into the account of an advisory client, unauthorized sales of ECMN stock to customers of a broker-dealer controlled by Chapman; manipulating the market for ECMN stock for months following the IPO, and filing false and misleading reports with the Commission. As a result of the fraudulent conduct, investors lost millions of dollars. Finally, the complaint alleged that Chapman and others manipulated the market for ECMN by using IPO proceeds to buy hundreds of thousands of ECMN shares in the months following the offering, and discouraged advisory clients and brokerage customers from selling their ECMN stock.

2. In the Matter of Frederick A. Wolf, Investment Advisers Act Release No. 1933 (Mar. 20, 2001). The Commission found that shortly after Valley Forge Capital Holdings ("VFCH") purchased Barrington, a registered investment adviser, Wolf, the President of Barrington, began promoting VFCH securities to its advisory clients. Between January 1994 and July 1996, Barrington clients purchased $2.2 million in VFCH securities. Wolf was responsible for all of these purchases, either by recommending VFCH to his clients or by using his discretionary trading authority in certain client accounts to effectuate the purchases. In at least two cases, Wolf used his discretionary authority to purchase VFCH securities even though such high-risk investments were contrary to his clients' stated investment objectives. In other cases, Wolf recommended that clients purchase VFCH securities without disclosing the high-risk nature of the securities. In addition, beginning in July 1994 Barrington and Wolf were aware of red flags concerning the integrity of VFCH management and the truthfulness of its representations as to how it would use the offering proceeds. The Commission's order provided that Wolf cease and desist from future violations and that he be suspended from association with any investment adviser for a period of 12 months.

H. Market Manipulation

In the Matter of Baron Capital, Inc.; Ronald S. Baron; David Schneider; and Susan Blenke, Exchange Act Release No. 47751 (Apr. 29, 2003). Enforcement alleged that the CEO ("Baron") of a registered investment adviser ("Baron Capital") instructed two Baron Capital traders ("Schneider" and "Blenke") to manipulate the closing prices of stock of Southern Union Company ("SUG"). In June 1999, SUG and another company announced the terms of a planned merger, which depended on the average closing price of SUG's stock during a two-week pricing period. During the two-week pricing period, Baron Capital made large purchases of SUG during the final hour of trading each trading day, constituting 78% of the trading volume. The Commission ordered: (a) Baron Capital, Baron, Schneider, and Blenke to cease and desist from committing or causing any future violations; (b) Baron Capital, Baron, Schneider, and Blenke to be censured; (c) Baron Capital to pay a $2 million penalty; (d) Baron to pay a $500,000 penalty; (e) Schneider to pay a $125,000 penalty; and (f) Blenke to pay a $75,000 penalty. Baron Capital agreed to implement new procedures and hire a new compliance officer.

I. Mispricing of Fund Shares

1. **SEC v. Rupay-Barrington Capital Management, Inc., Litigation Release No. 17345 (Jan. 29, 2002)**. The Commission alleged that an adviser ("Rupay Management") caused an advisory client (a registered investment company) to carry a worthless receivable from the holding company for Rupay Barrington ("Rupay Group") when the Rupay Group was deeply insolvent. The Commission alleged that even though the receivable was uncollectible, Rupay Management caused the fund's books to reflect the receivable at full face value. The shareholders were not told of the worthless receivable and that Rupay Management advised its private advisory clients to invest in the fund. The Commission also alleged that the fund's shareholder report misrepresented that Rupay Group was paying on the receivable, when it was not. The defendants consented to the entry of a preliminary injunction and an order appointing a Special Master to assume management of the fund and to liquidate the fund.

2. **In the Matter of Judy M. Rupay and Dixon R. Holman,** Advisers Act Release No. 2113 (Mar. 4, 2003). *See* Section I.1., above. Judy Rupay was an indirect shareholder and director of Rupay Management and the president and CEO of the Rupay Group. Holman was a director and president of Rupay Management, the vice president and chief operating officer of the Group, and a vice president of the fund. The Commission found that Judy Rupay and Holman willfully aided and abetted and caused Rupay Management's violations. The Commission: (a) ordered Judy Rupay and Holman to cease and desist from committing or causing future violations; (b) prohibited Judy Rupay and Holman from associating with a registered investment company for six months; and (c) ordered Judy Rupay and Holman each to pay a $10,000 penalty.

3. **SEC v. Heartland Group, Inc.,** Litigation Release No. 17247 (Nov. 27, 2001). The Commission alleged that Heartland Group, a registered investment company with multiple series, failed to send an annual report to shareholders of three funds and failed to timely file the report with the Commission. The Commission further alleged that this failure was due to the Heartland Group's inability to obtain audited financial results for the three funds for fiscal year 2000, due to Heartland Group's independent public accountant's concerns regarding the underlying valuations of the securities held in the funds. The Commission obtained a permanent injunction enjoining Heartland Group from further violations. The court order also froze the assets held in the three funds and provided for the appointment of a receiver to take control of the assets, manage the funds, suspend redemptions in the funds, and, if appropriate, liquidate the funds.

4. **In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser,** Investment Advisers Act Release No. 1980 (Sept. 28, 2001). The Commission found that a portfolio manager, Trudie D. Whitehead, had defrauded a mutual fund and an offshore fund from 1996 to 1998. Whitehead concealed from the funds and their investment advisers that issuers of securities held by the funds were suffering severe financial problems and inflated the

value of the troubled securities, which caused one of the funds materially to overstate its NAV. The Commission found that the funds' manager, Legg Mason Fund Adviser ("LM Fund Adviser") and its sub-adviser, Western Asset Management ("WAM") failed to have adequate policies and procedures to respond adequately to indications that the portfolio manager was overstating the value of one of the fund's securities. LMFA and WAM were each ordered to pay a civil penalty of $50,000 and to comply with undertakings to maintain enhanced supervisory policies and procedures previously implemented. Whitehead was ordered: (a) to cease and desist from committing future violations; (b) to pay a civil penalty of $25,000; and (c) to be barred from associating with an investment adviser or an investment company. Kyle R. Kirkland, a registered representative who assisted Whitehead in this scheme, was ordered (a) to cease and desist from future violations; (b) to pay a civil penalty of $30,000; and (c) to be barred from association with any broker-dealer or investment company with a right to reapply for association after three years.

5. **In the Matter of Trudie D. Whitehead**, Investment Company Act Release No. 25198 (Sept. 28, 2001). *See* Section I.4., above.

6. **In the Matter of Kyle R. Kirkland**, Investment Company Act Release No. 25199 (Sept. 28, 2001). *See* Section I.4., above.

7. **In the Matter of John Wellington Bagwell**, Investment Company Act Release No. 24934 (Apr. 10, 2001). The Commission found that Bagwell was registered with the Commission as an investment adviser and conducted his advisory business as a sole proprietor. Bagwell also managed a registered investment company, the JWB Aggressive Growth Fund. The fund's registration statements represented that Bagwell agreed to reimburse the fund for certain operating expenses above the fund's expense cap. Bagwell regularly paid or reimbursed the fund for expenses until the end of April 1997. By early November 1997, the receivable was about 9% of the fund's net assets. In November 1997, Bagwell reduced the receivable with funds borrowed from one of the fund's shareholders. Previously, he had represented to the fund's trustees that he would reduce the receivable with personal funds. The receivable, however, continued to increase and by the end of September 1998, it reached about 18% of the fund's net assets. The fund accountant informed Bagwell that if the receivable was not paid, the fund's NAV should be reduced. Bagwell instructed the accountant not to adjust the fund's NAV and assured the fund's trustees that he could and would pay off the receivable. Bagwell proposed to the trustees a schedule to pay off the receivable by making monthly payments and he also provided the trustees with a financial statement that misrepresented his financial condition. By the end of 1998, the receivable reached 25% of the fund's NAV. In April 1999, Bagwell liquidated the fund. The Commission (a) barred Bagwell from association with any investment adviser or investment company; (b) ordered Bagwell to cease and desist from committing or causing any future violations; and (c) ordered Bagwell pay to pay a civil penalty of $10,000.

8. **In the Matter of Harry Michael Schwartz,** Investment Company Act 24053 (Sept. 27, 1999). The Commission found that Schwartz was the president and chief financial officer of a registered investment adviser and a director and officer of a registered investment company. The trustees of the fund approved an expense reimbursement agreement, which provided that the adviser would reimburse the fund for certain expenses that exceeded a specified limitation. The agreement also provided for a one-time capital contribution in the amount of $228,000 by the adviser to the fund to reimburse the fund for past expenses that exceeded a specified limitation. The Commission found that the adviser failed to disclose its poor financial condition or the fact that it had no available funds or commitments to meet its financial obligations to the fund. The adviser delayed making the capital contribution for approximately five months and was made only after a third party loaned money to the adviser for the payment. The adviser had agreed to reimburse the fund by a specific date but defaulted on the payment for nearly six weeks. The payment was made to the fund after Schwartz and third parties raised the money for the payment. A semi-annual report filed with the Commission disclosed the reimbursement agreement but failed to the terms of the agreement. The Commission: (a) ordered Schwartz to cease and desist from committing or causing any future violations; (b) suspended Schwartz from associating with any investment adviser or investment company for 12 months; and (c) order Schwartz to pay a penalty of 10,000.

9. **In the Matter of Ellen Griggs**, Advisers Act Release Nos. 1836 (Sept. 27, 1999) and 1750 (Sept. 14, 1998). *See also* **In the Matter of Mitchell Hutchins Asset Management**, Advisers Act Release No. 1654; Investment Company Act Release No. 22805 (Sept. 2, 1997) *See* Section C.14., above. The Commission found that Griggs, Stephen H. Brown's supervisor, failed reasonably to supervise Brown with a view to preventing his violations of the federal securities laws. Brown had invested PaineWebber Short-Term U.S. Government Income Fund assets in securities that exposed investors to significantly higher levels of risk than had been disclosed in the fund's offering materials. His improper conduct remained undetected by Mitchell Hutchins until late April 1994 because Griggs failed to review his purchases of securities for the fund's portfolio. Griggs was suspended from association with any investment adviser for one month and from acting in any supervisory capacity with any investment adviser for a period of four months immediately following her suspension from association, and was ordered to pay a civil monetary penalty of $10,000.

10. **SEC v. Michael Carnicle, Michael Hansen, William Straughan, Randy Glad, Lionel Reifler, Howard Ray, and Arie From**, Litigation Release No. 16293 (Sept. 27, 1999). *See* Section C.5., above.

11. **In the Matter of James Thomas McCurdy**, Initial Decision Release No. 213 (Aug. 13, 2002); Accounting and Auditing Enforcement Release No. 1404 (June 14, 2001). *See* Section I.7., above. Enforcement alleged that McCurdy, an Ohio certified public accountant ("CPA"), failed to comply with professional auditing standards by failing to obtain sufficient competent evidence of a receivable from a related party in connection with the audit of JWB Aggressive Growth Fund. The ALJ dismissed the proceedings upon finding that McCurdy did not engage in improper conduct with the meaning of Rule 102 of the Commission's Rules of Practice.

12. **In the Matter of Parnassus Investments**, Initial Decision Release No. 131 (Sept. 3, 1998); and Advisers Act Release No. 1634 (May 28, 1997). The ALJ found that a mutual fund's directors and its investment adviser caused the fund to value a portfolio security at a value higher than its fair value. The ALJ found that for over two years, the directors valued the portfolio security at $0.344/share (the last available NASDAQ quote), despite the fact that the security was being traded at prices as low as $0.01/share during the period. The ALJ ordered respondents to cease and desist any such violation or future violation.

13. **<u>In the Matter of The Rockies Fund, Inc.; Stephen G. Calandrella; Charles M. Powell; Clifford C. Thygesen; and John C. Power</u>**, Investment Company Act Release No. 26202 (Oct. 2, 2003); Initial Decision Release No. 181 (Mar. 9, 2001); and Investment Company Act Release No. 23229 (June 2, 1998). *See* Section C.7., above.

14. **<u>In the Matter of Piper Capital Management, Inc.; Worth V. Bruntjen; Marijo A. Goldstein; Robert H. Nelson; Amy K. Johnson; Molly Destro; and Edward J. Kohler,</u>** Advisers Act Release No. 2163 (Aug. 26, 2003); Initial Decision Release No. 175 (Nov. 30, 2000**); <u>In the Matter of Worth V. Bruntjen</u>**, Investment Company Act Release No. 23664 (Jan. 26, 1999); and Advisers Act Release No. 1737 (July 28, 1998). Enforcement alleged that each of the respondents, except Kohler, committed fraud in connection with calculating the fund's NAV. According to the order, the fund's prospectus falsely stated that Piper Capital Management ("PCM") would calculate current NAV on a daily basis for purchases and redemptions of fund shares. Enforcement alleged that, in fact, a majority of the securities in the fund's portfolio were priced only on a weekly basis and that PCM and Bruntjen and Goldstein, the portfolio managers, knew or were reckless in not knowing of the weekly pricing. Enforcement further alleged that the respondents engaged in or were aware of a scheme to override dealer quotations and to gradually lower or "ratchet down" prices of securities in the fund's portfolio to limit declines in the fund's NAV. The Commission upheld the ALJ's findings and (a) revoked PCM's registration; (b) ordered PCM to pay a penalty of $2,005,000; (c) censured the individual defendants (Goldstein, Nelson, Johnson, and Destro); and (d) ordered them to cease and desist from committing or causing any future violations.

15. **<u>In the Matter of Carol A. Wallace</u>**, Exchange Act Release No. 48372 (Aug. 20, 2003); Initial Decision No. 178 (Dec. 18, 2000); and Exchange Act Release No. 41240 (Apr. 1, 1999). *See* Section C.7., above. Wallace was a CPA and auditor for the Rockies Fund.

16. **<u>In the Matter of John E. Backlund, John H. Hankins, Howard L. Peterson, and John G. Guffey</u>**, Investment Company Act Release No. 23639 (Jan. 11, 1999); and **<u>In the Matter of Craig S. Vanucci and Brian K. Andrew</u>**, Advisers Act Release No. 1782 (Jan. 11, 1999). In two related cases, the Commission instituted and simultaneously settled two proceedings involving a money market fund that "broke the dollar" (*i.e.*, failed to maintain a $1.00 per share NAV) and liquidated in September 1994 at $.96 per share. The Commission found that the fund's two portfolio managers invested 27% of the fund's assets in adjustable-rate derivatives, known as structured notes, an amount that the Commission found unsuitable for a money market fund. The Commission also found that the fund's directors knew at least by June 1994 that the fund had made a substantial investment in the derivatives and that the derivatives were plummeting in value in response to a sharp increase in short-term interest rates, which had a material, negative effect on the fund's NAV. They nonetheless continued to permit fund shares to be sold and redeemed at $1.00 per share and continued to permit the fund's portfolio securities to be valued using the amortized cost method without any reasonable expectation that the value of the derivatives would return to par or that they could be liquidated at their carrying value in the near future. The Commission ordered the directors to cease and desist from committing or causing future violations. In addition, John E. Backlund ("Backlund"), the president and a director of the fund, was ordered to pay a $10,000 civil penalty; and John H. Hankins, Howard L. Peterson, and John G. Guffey, also fund directors, were each ordered to pay a $5,000 civil penalty. Finally, Backlund was suspended from association with any investment company or investment adviser for 12 months. The Commission ordered the two portfolio managers to cease and desist from committing or causing future violations and to pay a $30,000 civil penalty.

17. SEC v. Heartland Advisors, Inc., Litigation Release No. 171 (Dec. 11 2003); **In the Matter of FT Interactive Data, f/k/a Interactive Data Corporation**, Investment Advisers Act Release No. 2201 (Dec. 11 2003); **In the Matter of Jon D. Hammes**, Investment Company Act Release No. 26290 (Dec. 11, 2003). See I.3., above. The Commission alleged that Heatland Advisors, an investment adviser to a complex of mutual funds, its CEO, two portfolio managers, four officers, and five directors mispriced the shares of the funds and/or committed insider trading. The value of the funds, and a smaller related fund, dropped by approximately $93 million during a two-week period in 2000 when Heartland Advisors sought to correct months of deliberate mispricing. Furthermore, certain of the insiders sold their shares, or tipped others to sell their shares, while aware that the funds had liquidity and pricing problems. The matter is litigating. In the first related administrative proceeding, the Commission found that FT Interactive Data, a securities pricing service, aided and abetted and caused certain of the violations. The pricing service settled the proceeding by being ordered to cease and desist from violations, pay a $125,000 fine, and undertake remedial action. In the second related administrative proceeding, the Commission found that four independent directors of the mutual funds negligently failed to adequately monitor the liquidity of the funds, and failed to take adequate steps to address the funds' pricing deficiencies. The Commission ordered the directors to cease and desist committing or causing future violations.

J. Advertising

1. In the Matter of The Thurlow Funds; Thurlow Capital Management, Inc.; and Thomas F. Thurlow, Investment Company Act Release No. 25761 (Oct. 2, 2002). The Commission instituted and settled proceedings that involved outdated performance returns on an Internet website advertising the Thurlow Growth Fund, a mutual fund offered by the Thurlow Funds, Inc., a registered investment company. As late as December 2000, the website prominently proclaimed returns for the Thurlow Growth Fund of 422% from inception through March 10, 2000. This information, while factually accurate, was rendered misleading by Thurlow's failure to disclose that the fund's total returns had declined by more than half between March 10, 2000 and September 30, 2000, the most recent quarter. The website emphasized the Thurlow Growth Fund's performance through March 10, 2000, essentially the time at which its performance had peaked, while failing to adequately disclose the decline over the subsequent two quarters. The Commission censured Thurlow Capital Management and Thomas F. Thurlow and ordered them to cease and desist from committing or causing any future violations. The Commission also ordered Thomas F. Thurlow to pay a civil money penalty of $20,000 and to comply with undertakings to confirm the information about stocks on Thurlow Capital Management's website.

2. **In the Matter of Merrimac Advisors Company**, Advisers Act Release Nos. 2009 (Jan. 4, 2002) and 1977 (Sept. 27, 2001). Enforcement alleged that, from 1997 through 1998, Fredric J. French, the principal of Merrimac Advisors Company, a registered investment adviser, provided clients and potential clients false information claiming that Merrimac had a five-year performance history of generating annual returns over 20%, and also overstating the number of Merrimac's clients and amount of client funds under management. The ALJ imposed a default judgment and the following sanctions: French and Merrimac were censured and ordered to cease and desist from committing or causing any future violations; the registration of Merrimac was revoked; French was ordered to be barred from association with any investment adviser and prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and ordered French and Merrimac each to pay a civil penalty of $50,000.

3. **In the Matter of Fundamental Portfolio Advisors, Inc.; Lance M. Brofman; Vincent J. Malanga; and Fundamental Service Corporation**, Advisers Act Release No. (July 15, 2003); Initial Decision Release No. 180 (Jan. 29, 2001); and Exchange Act Release No. 39158 (Sept. 30, 1997). *See* Section C.10., above.

4. **In the Matter of Javed Anver Latef and Larry Alan Stockett**, Advisers Act Release No. 2116 (Mar. 20, 2003); **and In the Matter of Hudson Investor Funds, Inc.; Hudson Advisers, Inc.; Javed Anver Latef; and Larry Alan Stockett**, Initial Decision No. 139 (Mar. 30, 1999). *See* Section C.12., above.

K. Soft Dollars

1. **In the Matter of Duff & Phelps Investment Management Co., Inc.,** Investment Company Act Release No. 25200 (Sept. 28, 2001). Enforcement alleged that Duff & Phelps Management Co., a registered investment adviser, obtained the pension fund of the International Brotherhood of Teamsters Union Local 710 ("Local 710") as a client after agreeing to direct brokerage trades to broker-dealer East West Institutional Services ("East West"). Enforcement alleged that East West had entered into an arrangement with two trustees of the Local 710 in which East West agreed to kick back to the two trustees a portion of the commissions directed to it by the Local 710's investment advisers. In addition to the East West arrangement, Duff negotiated a soft dollar agreement with the Pension Consultant. Under this agreement, Duff agreed to pay an annual fee with soft dollars to the Pension Consultant by directing commission business to the Pension Consultant's affiliated broker-dealer in exchange for a recommendation from the Pension Consultant that the Local 710 retain Duff as an investment adviser. Duff never disclosed any of the arrangements to disinterested representatives of the Local 710 or its other clients, including registered investment companies. The Commission (a) ordered Duff to cease and desist from committing or causing any future violations; (b) censured Duff; (c) ordered Duff to pay a civil penalty of $100,000; and (d) ordered Duff to pay disgorgement of $613,000 to the appropriate clients, as well as refunds of an additional $141,161 in commissions and pre-judgment interest to clients affected by soft-dollar arrangement between Duff and the Pension Consultant. The Commission found that Stevens, Duff's president and CEO, willfully aided and abetted Duff's violations and Commission ordered Stevens to (a) cease and desist from

committing or causing any violations or future violations and (b) pay a civil penalty of $20,000.

2. **In the Matter of Clarke T. Blizzard and Rudolph Abel**, Initial Decision No. 229 (June 12, 2003) and Advisers Act Release No. 2032 (Apr. 23, 2002); and **In the Matter of Clarke T. Blizzard,** Advisers Act Release No. 2030 (April 23, 2002); **In the Matter of Fleet Investment Advisors, Inc.,** Advisers Act Release No. 1821 (Sept. 9, 1999); **In the Matter of Karen Michalski and Christopher D. Sargent**, Advisers Act Release No. 1822 (Sept. 9, 1999); **In the Matter of Michael J. Rothmeier, Clarke T. Blizzard, Rudolph Abel, Donald C. Berry, Christopher P. Roach, Craig Janutol, and East West Institutional Services, Inc.,** Advisers Act Release No. 2016 (Feb. 28, 2002); Advisers Act Release No. 1823 (Sept. 9, 1999); and Advisers Act Release Nos. 1865, 1866, 1867 (Apr. 13, 2000). The Commission instituted administrative and cease and desist proceedings against Fleet Investment Advisors (successor to Shawmut Investment Advisers, Inc.). In related actions, the Commission instituted proceedings against certain of Fleet's employees and a broker-dealer for aiding and abetting various of Fleet's violations. The Commission found that Fleet had engaged in an undisclosed soft dollar arrangement by directing client brokerage to brokers in exchange for client referrals. The Commission also found that Fleet failed to seek best execution for clients and failed to maintain appropriate records. The Commission ordered Fleet to cease and desist from future violations and to disgorgement of more than $1.9 million. In a separate action, two traders were charged with aiding and abetting Fleet's violations and consented to a cease-and-desist order, a civil penalty of $5,000 each, and to be barred from association with an investment adviser with a right to reapply in 15 months.

Michael Rothmeier, Donald Berry, and Craig Janutol settled administrative proceedings in connection with Shawmut Advisers' fraudulent use of $1.8 million in equity and fixed income commission to pay broker-dealers for client referrals. Shawmut's ADV stated that it selected broker-dealers on the basis of research services. However, Shawmut directed brokerage to broker-dealers based on ability to refer clients. Rothmeier and Berry were ordered to cease and desist from certain violations of the Advisers Act. Rothmeier received a nine-month suspension from association with an investment adviser and was fined $15,000. Berry received a six-month suspension from association with an investment adviser and was fined $5,000. Janutol was suspended from association with any broker-dealer for six months and suspended from association in a supervisory and propriety capacity with any broker-dealer for 12 months. In addition, he was fined $5,000.

In a default order, the Commission (a) ordered Roach and East-West to cease and desist from committing or causing future violations; (b) barred Roach from association with any broker or dealer; (c) censured East-West; (d) revoked East-West's registration as a broker or dealer; (e) ordered Roach to disgorge $950,000 plus prejudgment interest; (f) ordered Roach to pay a civil penalty of $100,000; and (g) ordered East-West to pay a civil penalty of $500,000.

The ALJ dismissed the proceedings with respect to Abel and ordered Blizzard to: (a) be suspended from association with an investment adviser for 90 days; (b) pay a civil penalty of $100,000; (c) disgorge $548,233 plus prejudgment interest; and (d) cease and desist from committing or causing any violations or future violations.

L. Violation of Bar Orders

1. **In the Matter of Harry Michael Schwartz**, Investment Company Act 24053 (Sept. 27, 1999). *See* Section I.8., above.

2. **Securities and Exchange Commission v. Charles F. Parisi**, Litigation Release No. 16295 (Sept. 27, 1999). *See* Section L.1., above. Schwartz was Parisi's long-time employee.

M. Abusive Practices in the Sale of Investment Companies

1. **In the Matter of Morgan Stanley DW, Inc.,** Securities Act of 1933 (hereinafter cited as "Securities Act") Release No. 8339 (Nov. 17, 2003). The Commission found that Morgan Stanley, a registered broker-dealer, had a "Partners Program" in which select mutual funds paid Morgan Stanley substantial fees for preferred marketing of their funds. The Commission found that Morgan Stanley paid increased compensation to individual registered representatives and branch managers on sales of those funds' shares. The fund complexes paid the fees in cash or in the form of portfolio brokerage. In addition, Morgan Stanley failed to adequately disclose the point of sale the higher fees associated with large ($100,000 or greater) purchases of Class B shares of certain of its proprietary mutual funds could be reduced by purchase of Class A shares. The Commission also found that Morgan Stanley failed to disclose that the higher fees associated with the Class B shares could have a negative impact on customers' investment returns. The Commission censured Morgan Stanley and ordered it to (a) cease and desist from committing or causing an violations and any future violations; (b) to disgorgement plus prejudgment interest of $25 million and a civil penalty of $25 million; and (c) comply with certain undertakings including the hiring of a special consultant.

2. **SEC v. Gregory P. Waldon**, Exchange Act Release 48419 (Aug. 29, 2003); and Litigation Release No. 17591 (June 27, 2002); and **In the Matter of Donna N. Morehead,** Exchange Act Release No. 46121 (June 26, 2002). The Commission alleged that Waldon, a registered representative, engaged in switching transactions involving variable annuities. To induce customers to switch, Waldon made various misrepresentations and failed to disclose information concerning the costs and risks of switching. The Commission found that Waldon's supervisor, Morehead, failed to reasonably supervise Waldon. The Commission found that Morehead failed to reasonably supervise Waldon and ordered her to pay a $10,000 penalty and to be barred from association in a supervisory capacity with any broker or dealer for one year. Waldon was enjoined from future violations and, in a follow-on proceeding, the Commission barred Waldon from association with any broker-dealer with the right to reapply after three years.

3. **In the Matter of Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc.,** Advisers Act Release No. 2152 (July 30, 2003) and Initial Decision Release No. 160 (Jan. 31, 2000)**; In the Matter of FSC Securities Corporation**, Exchange Act Release No. 40765 (Dec. 9, 1998); **In the Matter of Michael Flanagan; Ronald Kindschi; and Spectrum Administration, Inc.,** Advisers Act Release No. 1776 (Dec. 9, 1998); **In the Matter of Richard Hoffman and Kirk Montgomery,** Exchange Act Release No. 40766 (Dec. 9, 1998);

and **In the Matter of Richard Hoffman and Kirk Montgomery,** Initial Decision Release No. 158 (Jan. 27, 2000). In related actions, the Commission instituted proceedings against registered representatives of FSC Securities Corporation ("FSC"), a registered broker dealer; Montgomery, FSC's chief compliance officer; Hoffman, a registered representative of FSC; Spectrum Administration, Inc. ("Spectrum"), a registered investment adviser; and Kindschi, Spectrum's associated person. Hoffman and Kindschi were independent contractors for two separate branch offices of FSC. In addition, Kindschi was associated with Spectrum. Flanagan was a registered representative employed by Kindschi. Enforcement alleged that Kindschi, Spectrum, and Flanagan engaged in breakpoint violations and that Flanagan engaged in breakpoint violations and mutual fund switching. Enforcement also alleged that Hoffman engaged in breakpoint violations and mutual fund switching. Enforcement further alleged that FSC and Montgomery failed reasonably to supervise a registered representative.

In a settled order, the Commission found that FSC had failed reasonably to supervise a registered representative, censured FSC, imposed a $50,000 fine, and accepted FSC's undertakings to retain an independent consultant to help FSC implement improved compliance procedures. An ALJ dismissed the charges against Hoffman and Montgomery. On appeal, the Commission found that the evidence did not support a finding of liability against Spectrum, Flanagan, and Kindschi on the charges and dismissed the proceeding.

4. **In the Matter of the Application of Wendell D. Belden**, Exchange Act Release No. 47859 (May 14, 2003). The NASD found that Belden, an investment company principal, had violated NASD rules by making unsuitable recommendations to a customer. Belden invested his customer's money (totaling more than one million dollars) in Class B mutual funds, which were subject to certain fees and charges. If Belton had invested the customer's money in Class A funds, the customer would not be charged a sales fee because his total investment was over one million dollars. Belden received a commission of $52,000; if he had invested his customer's money in Class A funds, Belden's commission would have been $16,000. In addition, the customer would not have incurred a contingent deferred sales charge when he exchanged his shares. The NASD suspended Belden for one year, fined him $40,000, ordered him to pay restitution of $55,567.03, and ordered that he requalify as a principal by examination. The Commission upheld the NASD's sanctions.

5. **In the Matter of Sandra Simpson and Daphne Pattee**, Exchange Act Release No. 45923 (May 14, 2002) and Initial Decision Release No. 148 (Sept. 21, 1999). Enforcement alleged that Simpson and Pattee, associated persons of Prudential Securities, Inc., defrauded customers by engaging in abusive mutual fund sales practices, including unauthorized transactions, unauthorized use of margins, unsuitable and excessive trading, and churning. Though Pattee was Simpson's sales assistant, the Commission found that they acted in concert to defraud their customers. Among other things, Simpson and Pattee identified "easy targets" by executing an unauthorized trade in account and waiting to see if the customer complained. If the customer failed to complain, they had identified an easy target. The Commission's order barred Simpson and Pattee from the broker-dealer industry; ordered that they cease and desist from committing or causing fraud violations; ordered them to pay, jointly and severally, $34,000 in disgorgement; and ordered Simpson and Pattee to pay penalties of $100,000 and $50,000, respectively.

6. **In the Matter of Norwest Investment Services, Inc. (now known as Wells Fargo Brokerage Services, LLC, successor by merger),** Exchange Act Release No. 45460 (Feb. 20, 2002). Enforcement alleged that a former registered representative of a bank-affiliated registered broker-dealer engaged in various sales practice violations, including fraudulent mutual fund switching in at least seven customer accounts (mostly elderly and unsophisticated customers). Enforcement also alleged that the respondent broker-dealer had inadequate mutual fund switching procedures to prevent or detect the registered representative's misconduct and did not have a system in place to communicate, implement, and enforce effectively the switching policies and procedures it did have. The Commission's order found that the respondent failed to supervise reasonably the registered representative, ordered the respondent to pay disgorgement and prejudgment interest in the amount of $3,245.19, and to pay a civil penalty of $150,000. The respondent also agreed to hire an independent consultant to conduct a review of its existing mutual fund switching procedures

7. **In the Matter of Russell C. Turek**, Exchange Act Release No. 45459 (Feb. 20, 2002). Russell Turek was a registered representative associated with a registered broker-dealer. The Commission accepted an offer of settlement from Turek, who had received commissions stemming from his unlawful conduct. The Commission found that on at least seven occasions Turek engaged in improper mutual fund switching. On least two occasions Turek induced the purchase of mutual fund shares resulting in the avoidance of breakpoints (the price level at which the sales charge paid by an investor decreases) in order to increase his commission. He also purchased shares of mutual funds for customers without the customers' authorization and forged customers' signatures. The Commission's order barred Turek from associating with any broker or dealer, ordered him to cease and desist from committing future violations, and ordered him to pay disgorgement and prejudgment interest in the total amount of $1,747.41 and pay a civil money penalty in the amount of $10,000.

8. **In the Matter of Raymond A. Parkins**, Advisers Act Release Nos. 2010 (Jan. 18, 2002) and 1898 (Sept. 25, 2000). Enforcement alleged that Parkins, the president of a registered investment adviser and a broker-dealer formerly registered with the Commission, induced his investment advisory clients to switch their variable annuity investments by providing them with unfounded, false, and misleading justifications for the switches, including false and misleading comparisons of the performances of certain variable annuities and false assurances that the switches would increase the diversification of his clients' portfolios. Parkins, in switch recommendation letters he sent to his clients, misrepresented or failed to inform his clients of the sales charges associated with the switches. As a result of the fraudulent conduct, Parkins' clients incurred unnecessary sales charges and, in some cases, lost a portion of their investment principal. Parkins was ordered to cease and desist from committing or causing any violation or future violations and barred for two years from association with any investment adviser or broker-dealer.

9. **In the Matter of Dale E. Frey**, Exchange Act Release No. 44982 (Oct. 25, 2001); **In the Matter of D.E. Frey and Company**, Exchange Act Release No. 43354 (Sept. 26, 2000). The Commission found that Frey, who was the CEO and a member of the hiring review committee of D.E. Frey, a registered broker-dealer, failed to reasonably supervise its employees. Between 1995 and 1999, three registered representatives at D.E. Frey, each of whom had a

disciplinary history or history of customer complaints, engaged in one or more sales practice abuses including unsuitable trading, unauthorized trading or churning in customer accounts. Frey failed reasonably to supervise those registered representatives and imposed sanctions, including a three-month suspension from the broker-dealer industry, and a 12-month suspension thereafter from serving in a supervisory or proprietary capacity within the broker-dealer industry.

10. In the Matter of J. Stephen Stout, Exchange Act Release No. 43410 (Oct. 4, 2000); Initial Decision No. 134 (Jan.7, 1999); and Securites Act Release No. 7309 (June 28, 1996). Enforcement alleged that Stout, a former salesperson of PaineWebber, Inc., engaged in unsuitable and unauthorized trading and made fraudulent statements and omitted material facts in connection with the offer and sale of securities. Among other things, the Commission found that Stout misled customers about the profitability of their accounts and repeatedly failed to take advantage of mutual fund break-points to minimize the cost of trading for his clients in order to increase the amount of commissions that he received. The Commission's order barred Stout from the broker-dealer industry; ordered him to cease and desist from committing or causing fraud violations; and ordered him to pay a $300,000 penalty.

11. In the Matter of Dean Witter Reynolds, Inc., Exchange Act Release No. 43215 (Aug. 28, 2000) and **In the Matter of Leslie E. Rossello**, Securities Act Release No. 7922 (Dec. 1, 2000). The Commission found that Rossello, a former registered representative of Dean Witter, engaged in at least 48 switch transactions in different accounts. The average time that Rossello's customers held the funds that she switched were eight months; some funds were held for two months before being switched. By switching, Rossello increased the commissions she and Dean Witter received. The switches occurred without the branch manager's prior approval. The Commission found that, while Dean Witter had written supervisory procedures in effect, it did not have a system in place to effectively implement the procedures. As a result, the Commission found that Dean Witter's systems were inadequate to prevent and detect mutual fund switching. The Commission's order provided that: Dean Witter was (a) censured; (b) ordered to remit to certain customers a total of $276,702; (c) ordered to pay a civil penalty of $200,000; and (d) ordered to hire an independent reviewer to review Dean Witter's mutual fund switching procedures and to submit a report to the Commission. Rossello was (a) ordered to cease and desist; (b) suspended from association with any broker-dealer for twelve months; and (c) ordered to pay a civil money penalty of $10,000.

12. In the Matter of the Application of Kenneth C. Krull, Exchange Act Release No. 40768 (Dec. 10, 1998), *aff'd sub nom.* **Krull v. SEC**, 248 F.3d 907 (9th Cir. 2001). The NASD found that Krull, a registered securities representative, switched a number of his customers in and out of a series of common stock mutual funds. Many of these transactions involved a transaction fee at the time of purchase and were subject to a seller's fee if sold within six years. Most of the customers held the mutual funds for less than a year based on petitioner's advice. Krull earned $ 171,000 in commissions and the customers earned $81,705 less than they would have if they had just held their investments long term. The NASD censured Krull, barred him in any principal or supervisory capacity, fined him $20,000, and suspended him for one year in any capacity with the requirement that he requalify as a general securities representative prior to acting again in that capacity. The NASD also ordered Krull to pay restitution of $171,140.93 to his customers with the proviso that such payment will be a condition for Krull's re-entry into the securities industry following his one-year suspension. The Commission sustained the NASD's sanctions but reduced the restitution amount to $81,705 to clients that had actually lost money.

13. **<u>In the Matter of American Express Financial Advisors Inc.,</u>** Securities Act Release No. 8365 (Feb. 12, 2004). The Commission, in an action announced jointly with the NASD, found that this brokerage firm, during 2001 and 2002, in selling mutual fund shares to customers, failed to provide certain customers with the reductions in front-end loans, or sales charges, also known as "breakpoint" discounts, that were described in the prospectuses of the funds. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 30 percent of eligible mutual fund transactions, resulting in at least $3.7 million additional costs to customers. The brokerage firm also did not disclose in confirmations the remuneration it received from the sales loads charged to these customers. In settling the matter, the brokerage firm agreed to pay a $3.7 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

14. **<u>In the Matter of Legg Mason Wood Walker, Incorporated</u>**, Securities Act Release No. 8368 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 35 percent of eligible mutual fund transactions, resulting in at least $2.3 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $2.3 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

15. **<u>In the Matter of Linsco/Private Ledger Corp.</u>**, Securities Act Release No. 8371 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 36 percent of eligible mutual fund transactions, resulting in at least $2.2 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $2.2 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

16. **<u>In the Matter of Raymond James Financial Services, Inc.</u>**, Securities Act Release No. 8374 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 32 percent of eligible mutual fund transactions, resulting in at least $2.6 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $2.6 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

17. **<u>In the Matter of UBS Financial Services, Inc.</u>**, Securities Act Release No. 8377 (Feb 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 30 percent of eligible mutual fund transactions, resulting in at least $4.6 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $4.6 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

18. **Wachovia Securities, LLC**, Securities Act Release No. 8380 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 29 percent of eligible mutual fund transactions, resulting in at least $4.8 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $4.8 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

19. **In the Matter of H.D. Vest Investment Securities, Inc.**, Securities Act Release No. 8383 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 33 percent of eligible mutual fund transactions, resulting in at least $725,000 additional costs to customers. In addition, the Commission found that this brokerage firm made unsuitable sales of class B mutual fund shares, and failed to tell these customers that an equivalent investment in class A shares could yield higher returns as a result of breakpoint discounts and reduced ongoing expenses. These unsuitable transactions earned the brokerage firm $691,000 in excess commissions. In settling the matter, the brokerage firm agreed to pay a $1.4 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts and recommendations of class B shares.