MEMO# 23939

November 9, 2009

SEC Sanctions Fund Adviser, its CEO and CCO, and Related Broker-Dealer for Defrauding Mutual Funds with Bogus Commissions

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TO: COMPLIANCE MEMBERS No. 48-09
SEC RULES MEMBERS No. 121-09
SMALL FUNDS MEMBERS No. 66-09
INVESTMENT ADVISER MEMBERS No. 21-09
EQUITY MARKETS ADVISORY COMMITTEE No. 49-09 RE: SEC SANCTIONS FUND ADVISER, ITS CEO AND CCO, AND RELATED BROKER-DEALER FOR DEFRAUDING MUTUAL FUNDS WITH BOGUS COMMISSIONS

The SEC has announced the settlement of a suit it recently filed charging a New York City-based investment adviser, its Chief Executive Officer (CEO), Chief Compliance Officer (who was also the funds' CCO), and affiliated broker-dealer with defrauding a family of mutual funds (the "funds"). [1] According to the SEC's Order, the fraud consisted of the Respondents charging over $24 million in bogus brokerage commissions on mutual fund trades funneled through the Respondent broker-dealer.

In settling this matter, while the Respondents neither admitted nor denied the SEC's findings, the SEC found that they violated the federal securities laws and, consequently, imposed the sanctions. In particular, the Respondents were each censured and ordered to cease and desist from further violations of the provisions they violated of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act, the Investment Advisers Act, and rules under these acts; the adviser was ordered to pay disgorgement in excess of $24 million plus a civil money penalty of $10 million; the CEO was ordered to pay a civil money penalty of $1 million; the CCO was ordered to pay a civil money penalty of $250,000; and the CEO and CCO were barred from association with any broker-dealer, investment adviser, or investment company and from acting as an officer or director of any issuer with registered securities.

The SEC's findings that led to these sanctions are briefly summarized below.

According to the SEC's Order, for approximately eighteen years, from 1986 to 2004, the Respondents were engaged in a fraudulent practice that misappropriated assets from the funds in the form of inflated broker commission payments made to the Respondent broker-dealer, which was affiliated with the Respondent investment adviser to the funds. The practice involved the Respondent investment adviser entering into arrangements with several unaffiliated brokerage firms (the "rebate brokers") to execute, clear, and settle securities trades on behalf of the funds at a discounted commission rate that varied from $.02 to $.01 per share. Instead of passing this discount directly to the funds, the Respondents arranged for the rebate brokers to charge the funds a commission rate of $.0488 per share and then to "rebate" to the Respondent broker dealer between $.0288 and $.0388 per share. The SEC Order notes that the Respondent broker-dealer did not provide any brokerage services to the funds for the commissions it received on these trades. In total, the Respondent investment adviser directed over $24 million of the funds' assets to the Respondent broker-dealer through this "commission recapture" program.

The SEC Order notes that the Respondents misled the independent directors of the funds' board of directors and the funds shareholders into believing that the Respondent broker-dealer provided bona fide brokerage services for the funds' securities trades. Moreover, the Respondents failed to disclose to the independent directors and the fund shareholders that they required a target percentage – as much as 70% of the funds' trades in NYSE-listed securities – to be allocated to this rebate program, thereby undermining the Respondent adviser's best execution duties.

The CEO and CCO were involved in structuring the commission recapture arrangements with the various rebate brokers and with signing written agreements memorializing the arrangements. The CEO supervised the head traders working in the Trading Department and, in turn, reported to the CEO on the profitability of the recapture program for the Respondent broker-dealer. The CEO and CCO were responsible for preparing and making presentations to the independent directors about why the Respondent broker-dealer, which they referred to as an "introducing broker," was receiving commission payments from the funds. Both the CEO and CCO also signed certain SEC filings that mischaracterized why the Respondent broker-dealer was receiving commission payments from the funds.

Based on this conduct the SEC Order found that the Respondents each violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act, and Rule 10b-5 under the Exchange Act. Additionally, the Order found that:

- The Respondent adviser willfully violated Sections 206(a), 206(2), and 207 of the Advisers Act and Sections 15(c), 17(e)(1), and 34(b) of the Investment Company Act;
- The Respondent broker-dealer willfully aided and abetted and caused the Respondent adviser's violation of Section 206(a) and 206(2) of the Advisers Act; and
- The CEO and CCO willfully aided and abetted and caused the Respondent adviser's violation of Section 206(a) and 206(2) of the Advisers Act and willfully violated Section 34(b) of the Investment Company Act.

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endnotes

[1] *See In the Matter of: Value Line, Inc., Value Line securities, Inc., Jean Bernhard Buttner, and Devid Henigson, Respondents,* SEC Release Nos. 33-9081, 34-60936, IA-2945, and IC-28989, dated Nov. 4, 2009 (the "SEC Order"), which is available at: http://www.sec.gov/litigation/admin/2009/33-9081.pdf.