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SEC Charges An Investment Adviser And Two Of Its Representatives With Misleading Pension Consulting Clients

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 6-09
CLOSED-END INVESTMENT COMPANY MEMBERS No. 8-09
PENSION MEMBERS No. 8-09
PENSION OPERATIONS ADVISORY COMMITTEE No. 4-09
SEC RULES MEMBERS No. 12-09
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TRANSFER AGENT ADVISORY COMMITTEE No. 11-09 RE: SEC CHARGES AN INVESTMENT ADVISER AND TWO OF ITS REPRESENTATIVES WITH MISLEADING PENSION CONSULTING CLIENTS

The Securities and Exchange Commission has announced that it has charged an investment adviser and two of its registered representatives with violations of the Investment Advisers Act relating to their misleading pension consulting clients and breaching their fiduciary duty to such clients. The actions against the adviser and one of its representatives (the "settling representative") have been settled; [1] the action against the second representative (the "contesting representative")is contested and will be scheduled for hearing. [2] While the adviser and the settling representative neither admitted on denied the Commission's findings, in settling the actions the Commission found them to have engaged in certain conduct in violation of the Adviser's Act. The basis for the Commission's actions, its settlement findings, and the sanctions imposed based on such findings are briefly summarized below.

I. OVERVIEW OF THE PROHIBITED CONDUCTS

Between 2002-2005, the investment adviser, through its pension consulting services

advisory program ("the Program") breached it fiduciary duty to the firm's pension clients and prospective clients by misrepresenting and omitting to disclose material information, including material conflicts of interests. In particular:

- The Adviser's and Settling Representative's Misrepresentations Regarding the List of Money Managers Generated by the Adviser – The Order finds that the investment adviser and its settling representative misrepresented the Program's process for identifying managers for its pension clients. According to the Order, the investment adviser represented to its clients that, as part of its Program, the adviser's New Jersey headquarters would analyze information provided by the client and determine, from over 1000 possible investment managers, which would be appropriate for the client. This list would then be narrowed to approximately five to eight managers, which would be presented to the client for consideration. In reality, according to the Order, the adviser's Florida branch office developed its own list of managers, which included approximately sixty managers – a far more limited universe than that represented to customers. In addition, some of the money managers on the branch office's list had not been vetted by the adviser's New Jersey office. In addition, the action filed against the contesting representative alleges that he failed to disclose his use of the vacation homes of principals of one of the money management firms that was on the branch office's short list of recommended managers and that such firm remained on the short list despite concerns about poor performance raised by some of the adviser's clients.
- The Adviser's Conflicts of Interests Relating to its Directed Brokerage Arrangements – The Order also finds that the adviser failed to disclose the conflicts of interests associated with its directed brokerage arrangements. According to the Order, clients paid for the Program on a fixed-fee basis. However, in lieu of making such payment in hard dollars, the adviser permitted clients to pay with directed brokerage, whereby the client directed their money manager to execute trades through the adviser's affiliated broker-dealer. The Order finds that, in entering into these arrangements the adviser failed to disclose that, even after the hard dollar fee had been satisfied, the adviser and its representatives would continue to receive a portion of the commissions generated through the directed brokerage arrangements. The Order cites two instances in which the fixed fee was $7500 but the directed brokerage arrangements generated $175,000 in fees from one client and $65,000 in fees from another client. The Order notes that, while in November 2005 the adviser began to disclose to its clients the brokerage commissions generated by such client, prior to this time there was no such disclosure, nor were clients informed that the adviser or its representatives might have a financial incentive to recommend that clients enter into directed brokerage arrangements.
- The Adviser's Conflicts of Interests Relating to its Transition Management Services – The Order also finds that the adviser failed to disclose to its pension clients its conflicts of interest relating to the adviser's transition management services. The transition management services were services offered by the adviser to facilitate the terminations of one money manager for a pension plan and the hiring of another. The adviser represented to clients that it could facilitate such transfer in a cost-effective and efficient process through cross trades and reduced commission costs. According to the Order, however, the adviser failed to disclose that the adviser generally received $0.01 per share in production credits for every transactional share. In one instance, these production credits total $150,000. The Order finds that, in failing to disclose the benefit to the adviser from the client utilizing the adviser's transitional management services, the adviser failed to disclose all actual or potential conflicts of

interests.

- The Adviser's Failure to Supervise its Florida Branch Office – All of the conduct described above occurred out of a Florida branch office of the adviser. The Order finds that the Commission did not reasonably supervise certain of the representatives in the Florida branch office with a view to violating the Federal securities laws. According to the Order, the supervisory structure of the adviser's representatives in this office was not well-delineated. For example, while branch-level supervisors believed that the adviser's New Jersey headquarters was responsible for supervising most aspects of the Florida representatives' conducts, the New Jersey office believed this responsibility rested with the local managers. The Order notes that, as a result of this "vacuum" in supervision, the Florida branch office maintained its own computer services, which the New Jersey office was not aware of and which the local managers never reviewed. The Order also finds that the adviser "did little" to train its representatives about their duties to advisory clients.
- The Adviser's Failure to Maintain Adequate Records – The Order also finds that, until December 2005, the adviser failed to maintain records evidencing its compliance with Rule 204-2(a)(14) of the Advisers Act, which requires advisers to maintain evidence of statements and amendments they have given or sent to any clients or prospective clients, together with a record of the dates that such information was provided to such clients.
- Allegations Involving the Contesting Representative – The Commission's Order against the contesting representative alleges that he: made material misrepresentations concerning the manager's identification process; failed to ensure that the conflicts of interest inherent in recommending the adviser's directed brokerage services were disclosed to clients; and failed to disclose conflicts of interests and made materially misleading statements concerning the adviser's transition management services. While each of these alleged violations largely track those described above by the adviser and the settling representative, the Commission's order against the contesting representative contains more details regarding his specific involvement with each of such violations.

II. VIOLATIONS OF LAW; PENALTIES IMPOSED

Based upon the above conduct, the Order against the adviser and the settling representative finds that the adviser violated: (1) 206(2) of the Advisers Act, which makes it unlawful for any adviser to engage in any transaction, practice, or course of conduct that operates as a fraud or deceit upon any client or prospective client; and Section 204 of the Act and Rule 204-2(a)(14), thereunder, for failing to maintain records of the offer or delivery of disclosure statements. It also finds that the settling representative aided and abetted the adviser's violation of Section 206(2) of the Advisers Act.

As a result, the adviser and the settling representative were censured and ordered to cease and desist from their respective violations of law. The adviser was additionally ordered to pay a civil monetary penalty of $1 million.

As noted above, the Order against the contesting representative will be scheduled for an administrative hearing.

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endnotes

[1] See In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Administrative Proceeding File No. 3-13357 (January 30, 2009)(the "Order") and In the Matter of Jeffrey Swanson, SEC Administrative Proceeding File No. 3-13358 (January 30, 2009) (the "Order against the settling representative"). These orders are available on the SEC's website at, respectively: http://www.sec.gov/litigation/admin/2009/ia-2834.pdf and http://www.sec.gov/litigation/admin/2009/ia-2835.pdf.

[2] See In the Matter of Michael A. Callaway, SEC Administrative Proceeding File No. 3-13356 (January 30, 2009) (the "Order against the contesting representative"), which is available at: http://www.sec.gov/litigation/admin/2009/ia-2833-o.pdf.