

MEMO# 22161

January 29, 2008

SEC Settles Case Against Adviser, Officers and a Director Over Alleged Mispricing of High Yield Bonds

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TO: ACCOUNTING/TREASURERS MEMBERS No. 2-08
COMPLIANCE MEMBERS No. 3-08
FIXED-INCOME ADVISORY COMMITTEE No. 1-08
INVESTMENT COMPANY DIRECTORS No. 1-08
SEC RULES MEMBERS No. 8-08
SMALL FUNDS MEMBERS No. 5-08 RE: SEC SETTLES CASE AGAINST ADVISER, OFFICERS
AND A DIRECTOR OVER ALLEGED MISPRICING OF HIGH YIELD BONDS

On January 25th, the Securities and Exchange Commission settled an action against an investment adviser and several of its current and former employees for securities law violations relating to the alleged mispricing of certain bonds owned by two high-yield municipal bond funds. [\[1\]](#) The respondents consented to the Order without admitting or denying the Commission's findings, except as to jurisdiction, which was admitted.

Commission Findings

This action arose from the sudden devaluation of two high-yield municipal bond funds between September 28 and October 13, 2000 and the facts leading up to that devaluation. The Commission's findings, which were for purposes of the settlement only and not binding, are summarized below.

During late 1999 and early 2000, portfolio managers for the two funds involved learned

that projects underlying several bonds held by the funds had gone into default or were failing. During this period, the funds relied upon values for these bonds provided by a single independent pricing vendor. The vendor did not reduce its valuations of the affected bonds based upon the information, and instead gradually lowered the value of the bonds in daily increments of 0.5 percentage points until the valuations reached 80 percent of par value. The adviser did not “fair value” the bonds, but rather continued to use the vendor’s valuations.

Later in 2000, the funds began to experience liquidity problems and had difficulty selling the bonds at or near the funds’ valuations, despite a board direction to do so. In September 2000, the funds sold some of the most illiquid bonds in a transaction that involved the adviser’s parent corporation and a personal guarantee by the adviser’s CEO.

On September 28, 2000, the funds had substantial one-day reductions in their net asset values. One fund’s NAV declined by 8.2% and the other fund’s NAV declined by 2.1%.

The next day, one of the fund’s portfolio managers and his relatives redeemed a number of shares of the funds. Two weeks later, the adviser’s treasurer also redeemed shares of the funds for accounts that he managed.

On October 13, the funds’ pricing committees further substantially reduced the values of the bonds. As a result, the funds had a second large decline in their net asset values. This time, one fund’s NAV declined by 50% and the other fund’s NAV declined by 33%.

Violations and Sanctions

The Commission found that the adviser did not properly fair value the bonds held by the funds, resulting in the material overstatement of the funds’ NAVs and the processing of purchases and redemptions at materially incorrect prices. The Commission also found that the board’s review of the October 13th devaluation of the bonds was inadequate because the board failed to identify the deficiencies in the adviser’s pricing of the bonds. As a result, the Commission found violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Section 206(2) of the Investment Advisers Act, and Section 34(b) of the Investment Company Act and Rule 22c-1(a) thereunder.

The Order imposes civil penalties, disgorgement, and prejudgment interest totaling \$3,907,095, censures the adviser and six of its officers or former officers, and imposes twelve-month suspensions against the two former employees who redeemed their fund shares prior to the October 13, 2000 devaluation. The Order also directs the adviser, the six officers, and a non-independent director to cease and desist from committing or causing future violations of some or all of the relevant provisions of the federal securities laws.

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Securities Regulation Investment Companies

endnotes

[1] In the Matter of Heartland Advisors, Inc., et al., Release No. 33-8884 (January 25, 2008) (the “Order”) (available at <http://www.sec.gov/litigation/admin/2008/33-8884.pdf>). This action follows an earlier proceeding based on the same facts where, in 2003, the Commission accepted settlements from and instituted cease-and-desist proceedings against four independent directors and an independent pricing service. See Memorandum No. 16878, dated December 16, 2003 (summarizing the earlier settlement and the filing of the civil complaint in this action).

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