

**MEMO# 11780**

April 4, 2000

# **ALJ ORDERS SANCTIONS IN CONNECTION WITH ALLOCATIONS OF HOT IPO SHARES TO FUND DIRECTORS**

1 In the Matter of Monetta Financial Services, Inc., SEC Admin. Proc. File No. 3-9546, Initial Decision Rel. No. 162 (March 27, 2000). A petition for review of the initial decision may be filed within 21 days of service of the decision. 1 [11780] April 4, 2000 TO: COMPLIANCE ADVISORY COMMITTEE No. 16-00 DIRECTOR SERVICES COMMITTEE No. 7-00 SEC RULES MEMBERS No. 23-00 RE: ALJ ORDERS SANCTIONS IN CONNECTION WITH ALLOCATIONS OF HOT IPO SHARES TO FUND DIRECTORS

A Securities and Exchange Commission administrative law judge (ALJ) recently ordered sanctions against a registered investment adviser, the president and director of the adviser, and two mutual fund directors (one of whom was an independent director) in connection with the adviser's allocation of "hot" IPO shares to the directors. The initial decision,<sup>1</sup> a copy of which is attached, is summarized below. The ALJ found that the adviser received allocations of hot IPO shares from broker-dealers underwriting these offerings, based on the adviser's clients' generation of commissions to the broker-dealers. The adviser's mutual fund clients generated the vast majority of these commissions. The adviser, in turn, allocated the IPO shares among its clients, including three directors of mutual funds advised by the adviser. The ALJ noted that the adviser's president distributed a portfolio of IPOs to the fund directors that was superior, in terms of mean return and standard deviation, to the IPO portfolio that he distributed to the funds. The ALJ concluded that the directors' oversight of the performance of the portfolio and its adviser could be "impaired or unduly influenced where the directors/trustees receive gifts from the adviser." Accordingly, the ALJ found that the adviser's distribution of IPOs to these directors "without disclosure to the other directors, trustees, or shareholders of the funds was a conflict of interest and a breach of fiduciary duty" that violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The ALJ also found that the adviser violated Sections 206(1) and 206(2) of the Investment Advisers Act, and that the adviser's president caused and willfully aided and abetted the adviser's primary violations. In addition, the ALJ found that the directors violated their fiduciary duties, including the duty of loyalty owed to the funds on whose boards they served, by knowingly accepting the IPO allocations without disclosing this fact to the funds and their shareholders and prospective shareholders. According to the ALJ, two of the directors acted with scienter because they established bank accounts for discretionary trades, received confirmations and account statements showing the IPO 2 Although the proceeding included allegations against all three directors who had received IPO allocations, the ALJ concluded that one of the three directors did not act with scienter or negligence in violating his fiduciary duties,

and thus did not violate the antifraud provisions of the securities laws. 2 trades, and did not disclose the transactions.<sup>2</sup> The interested director was also found to have violated Section 17(j) of the Investment Company Act and Rule 17j-1 thereunder by failing to report IPO transactions on a quarterly transactions report. The ALJ ordered the adviser, its president and the two fund directors to cease and desist from committing or causing any violations or any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The ALJ also ordered the adviser to cease and desist from committing or causing any violations or any future violations of Sections 206(1) and 206(2) of the Investment Advisers Act, and ordered the adviser's president to cease and desist from causing and/or aiding and abetting those violations or any future violations. The director who did not report his IPO transactions was ordered to cease and desist from committing or causing any violations or any future violations of Section 17(j) of the Investment Company Act and Rule 17j-1 thereunder. In addition, the ALJ censured the adviser and assessed a civil penalty of \$200,000. The adviser's president was suspended from associating with any investment adviser or registered investment company for ninety days, and assessed a civil penalty of \$100,000. The two directors were each suspended from associating with any registered investment company for thirty days, and ordered to disgorge the profits they realized on the sale of the IPO shares, plus prejudgment interest. The independent director was assessed a civil penalty of \$25,000, and the interested director was assessed a civil penalty of \$10,000. Kathy D. Ireland Associate Counsel

Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11780. ICI Members may retrieve this Memo and its attachment from ICINet (<http://members.ici.org>).