

MEMO# 10303

September 21, 1998

SEC SANCTIONS PORTFOLIO MANAGER IN CONNECTION WITH FUND INVESTMENTS IN CERTAIN STRIPPED MORTGAGE-BACKED SECURITIES

* In the Matter of Stephen H. Brown, Admin. Proc. File No. 3-9704 (September 14, 1998). The fund's investment adviser was sanctioned in a prior proceeding. See Memorandum to SEC Rules Members No. 69-97 and Compliance Advisory Committee No. 25-97, dated September 12, 1997. The SEC has also instituted administrative proceedings against the investment adviser's former chief investment officer and former co-portfolio manager of the short-term government bond fund, alleging a failure to reasonably supervise Brown. In the Matter of Ellen Griggs, Release No. IA-1750, Admin. Proc. File No. 3-9703 (September 14, 1998). [10303] September 21, 1998 TO: COMPLIANCE ADVISORY COMMITTEE No. 28-98 SEC RULES MEMBERS No. 73-98 RE: SEC SANCTIONS PORTFOLIO MANAGER IN CONNECTION WITH FUND INVESTMENTS IN CERTAIN STRIPPED MORTGAGE-BACKED SECURITIES

The Securities and Exchange Commission recently settled administrative proceedings and imposed sanctions against a portfolio manager in connection with a short-term government bond fund's investments in certain stripped mortgage-backed securities.* The portfolio manager consented to the entry of the order, without admitting or denying its findings. A copy of the order is attached and is summarized below. The order states that the fund's stated investment objective was to achieve the highest level of income consistent with the preservation of capital and low volatility of net asset value. In addition, an appendix to the prospectus disclosed that the fund had "no present intention" of investing in interest-only ("IO") and principal-only ("PO") stripped mortgage-backed securities that were not planned amortization class ("PAC") bonds. Notwithstanding these disclosures, the portfolio manager invested in certain non-PAC IOs and POs, as well as in PAC inverse IOs that were more volatile than permitted by the fund's low volatility investment objective. The fund suffered significant losses when interest rates rose sharply. According to the order, the portfolio manager frequently overrode prices provided by the fund custodian for the non-PAC IOs and POs and PAC inverse IOs that he purchased. The portfolio manager generated his own prices that, in most cases, were higher than the custodian-provided prices, but kept no documentation to support his calculations. The Commission found that the portfolio manager willfully 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 in purchasing the securities and rendering the fund's prospectus disclosures materially false and misleading. In addition, the portfolio manager was found to have willfully aided and abetted and caused the investment adviser to violate Section 34(b) of the Investment Company Act when he

purchased the securities that rendered the prospectus disclosures materially false and misleading. By causing the fund to deviate from a fundamental policy, the Commission found, the portfolio manager willfully aided and abetted and caused a violation of Section 13(a)(3) of the Investment Company Act. The order also states that the portfolio manager willfully violated Sections 206(1) and 206(2) of the Investment Advisers Act in purchasing the securities and overriding custodian-provided prices, and willfully aided and abetted and caused violations of the recordkeeping requirements set forth in Section 31(a) of the Investment Company Act and Rule 31a-1(a) thereunder in failing to document the basis for overriding custodian- provided prices or the methodology and calculations used to derive override prices. The SEC ordered the portfolio manager to cease and desist from committing or causing any violation and any future violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1) and 206(2) of the Advisers Act, and Section 34(b) of the Investment Company Act, and to cease and desist from causing any violation and any future violation of Sections 13(a)(3) and 31(a) of the Investment Company Act and Rule 31a-1(a) thereunder. In addition, the SEC barred the portfolio manager from association with any investment adviser, investment company, broker, dealer, or municipal securities dealer for at least three years. No civil penalties were assessed in light of the portfolio manager's financial inability to pay such a penalty. Frances M. Stadler Deputy Senior Counsel Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's Library Services Division at (202)326- 8304, and ask for this memo's attachment number: 10303.

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