

**MEMO# 9240**

September 12, 1997

# **SEC SANCTIONS FUND ADVISER IN CONNECTION WITH FUND INVESTMENTS IN CERTAIN STRIPPED MORTGAGE-BACKED SECURITIES**

\* In the Matter of Mitchell Hutchins Asset Management Inc., Admin. Proc. File No. 3-9383 (September 2, 1997). [9240] September 12, 1997 TO: SEC RULES MEMBERS No. 69-97 COMPLIANCE ADVISORY COMMITTEE No. 25-97 RE: SEC SANCTIONS FUND ADVISER IN CONNECTION WITH FUND INVESTMENTS IN CERTAIN STRIPPED MORTGAGE-BACKED SECURITIES

The Securities and Exchange Commission recently issued an order charging a mutual fund investment adviser and principal underwriter (the "firm") with violating several provisions of the federal securities laws in connection with a short-term government bond funds investments in certain stripped mortgage-backed securities.\* The firm consented to the entry of the order, without admitting or denying its findings. A copy of the order is attached and it is summarized below. The order states that the fund was marketed "as a higher yield and somewhat higher risk alternative to money market funds and bank certificates of deposit." It indicates that the funds stated investment objective was to achieve the highest level of income consistent with preservation of capital and low volatility of net asset value. In addition, an appendix to the prospectus stated 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, in late 1993 and early 1994, the funds portfolio manager invested in certain non-PAC IOs and POs, as well as in inverse IOs and "structured floaters" that were very sensitive to interest rate fluctuations. The fund suffered significant losses when interest rates rose sharply in the first half of 1994. 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 then generated prices based on his own method that, in most cases, were higher than the custodian-provided prices. The order describes certain steps taken by the firm after it discovered the presence of securities in the funds portfolio that, according to the order, were inconsistent with the funds "no present intention" statement and low volatility investment objective. These steps included recalculating the funds NAV and amending its prospectus, contacting the SEC staff concerning "the problems with" the fund, purchasing certain IO and PO securities and structured floater securities from the fund for \$145 million, paying investors \$33 million (the estimated losses associated with the securities), replacing the firms president and all persons with direct involvement for the funds management and supervision, and revising certain policies and procedures. The SEC found that the firm willfully violated the anti-fraud

provisions of the Securities Act of 1933 (Section 17(a)), the Securities Exchange Act of 1934 (Section 10(b) and Rule 10b-5 thereunder) and the Investment Advisers Act of 1940 (Sections 206(1) and 206(2)), noting that the portfolio managers purchases of non-PAC IOs and POs rendered the "no present intention" statement in the funds prospectus materially false and misleading and that these and other securities purchased by the portfolio manager also made the characterization of the fund as a low-volatility investment materially false and misleading. The order states that the firm acted recklessly with respect to its public disclosures concerning the funds performance, investment objective and permissible investments citing, among other things, the lack of supervisory review of the portfolio managers purchases until late April 1994 and the failure to "undertake any other reasonable effort" to ensure that the portfolio managers investments were consistent with the funds prospectus disclosure. The order states that the firm willfully violated Section 34(b) of the Investment Company Act of 1940 by rendering materially false and misleading the prospectus disclosures described above. In addition, the SEC found that the firm willfully aided and abetted and caused a violation of Section 13(a)(3) of the Investment Company Act by deviating from its low- volatility investment objective (which was a fundamental policy) without seeking shareholder approval. According to the order, the firm also aided and abetted and caused a violation of Section 31(a) of the Investment Company Act and Rule 31a-1 thereunder because from October 1993 through April 1994, the portfolio manager did not document the basis for overriding the prices of certain fund portfolio securities or the methodology and calculations used to derive override prices. As a result, the order states, the fund did not maintain records necessary to show the basis for the funds NAV and securities valuations reported in its balance sheets. The SEC further found that the firm failed reasonably to supervise the funds portfolio manager. In this regard, the order states that the firm did not have adequate procedures to implement or monitor the funds low-volatility investment objective, the "no present intention" statement in the prospectus, or the funds stated valuation method. It indicates that the firms supervisory practices concerning these matters were insufficient because, among other things, "they gave the portfolio manager too much control over the purchase and valuation of the Funds portfolio securities with inadequate oversight." The SEC censured the firm and ordered it to cease and desist from committing any violation and any future violation of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, Sections 206(1) and 206(2) of the Investment 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 thereunder. The SEC also assessed a civil money penalty of \$500,000. The order requires the firm to retain an independent consultant to, among other things, review and make appropriate recommendations regarding its policies and procedures with respect to: (1) preparation, review and approval of publicly-disseminated sales materials and broker-only sales and marketing materials concerning fund shares; (2) compliance with fundamental investment policies and restrictions as disclosed in fund prospectuses and SAs; (3) valuation of fund portfolio securities and supporting records; (4) NAV calculation; and (5) policies and procedures designed reasonably to prevent and detect, insofar as practicable, violations of the federal securities laws in connection with the matters described in (1) - (4) above. Frances M. Stadler Associate Counsel Attachment (in .pdf format) 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 Information Resource Center at (202)326-8304, and ask for this memo's attachment number: 9240.

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.