

MEMO# 3914

July 7, 1992

FEDERAL APPEALS COURT VACATES INJUNCTION AGAINST FUNDS THAT FAILED TO REGISTER WITH STATES

July 7, 1992 TO: SMALL FUNDS MEMBERS NO. 12-92 SEC RULES COMMITTEE NO. 45-92 STATE LIAISON COMMITTEE NO. 26-92 UNIT INVESTMENT TRUST COMMITTEE NO. 37-92 RE: FEDERAL APPEALS COURT VACATES INJUNCTION AGAINST FUNDS THAT FAILED TO REGISTER WITH STATES _____ As we previously informed you, the Securities and Exchange Commission filed a brief urging that the U.S. Court of Appeals for the District of Columbia affirm a district court decision that a family of mutual funds, the funds' adviser and an individual who was the principal officer of the adviser and the funds violated numerous provisions of the federal securities laws as a result of failing to register the funds' shares under state Blue sky laws. (See Memorandum to Small Funds Members No. 1-92, dated February 25, 1992; Memorandum to SEC Rules Committee No. 11-92, State Liaison Committee No. 8-92 and Unit Investment Trust Committee No. 12-92, dated March 5, 1992.) In an opinion issued on June 26, 1992, the appeals court reversed the district court's finding that appellants violated the antifraud provisions of the federal securities laws when they failed to book liabilities for non-registration under state Blue sky laws. In doing so, the appeals court concluded that the appellants did not act with the requisite scienter (i.e., intent to deceive, manipulate or defraud or extreme recklessness). With respect to the remaining fraud, pricing and reporting violations, the appeals court affirmed the district court's finding that the funds were negligently liable for omitting disclosure of the contingent liabilities. In so finding, the appeals court agreed with the district court's conclusion that the funds were obliged to include a footnote in their financial statements disclosing their liabilities since it would be material to investors even if the exact amount of the liabilities could not be calculated. However, the appeals court disagreed with the district court and the SEC with respect to the appropriate standard of materiality. According to the SEC (and the district court agreed) "a penny per share is material per se because mutual funds are priced and reported ... to a penny per share." The appeals court stated "[t]hat mutual funds are priced to a penny may afford convenience to investors - and provide an easy standard for the SEC to use as a benchmark for mutual fund pricing - but it does not conform in all cases to the Supreme Court's definition of materiality." The appeals court noted that according to testimony given by the SEC, the SEC would consider allowing a fund with high share prices to round its NAV to the nearest nickel or dime. In addition, the appeals court upheld the district court's findings of violation pertaining to the maintenance of valid investment advisory agreements and the maintenance and surprise auditing of certain bank accounts for client funds and securities. Finally, the appeals court vacated the permanent injunction against the

appellants on the basis that none of the violations were "flagrant or deliberate" and most were "technical in nature." A copy of the U.S. District Court of Appeals opinion is attached.
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