MEMO# 13125

March 6, 2001

ALJ ORDERS SANCTIONS IN CONNECTION WITH MUTUAL FUND INVESTMENTS AND SOFT DOLLAR ARRANGEMENTS

[13125] March 6, 2001 TO: ACCOUNTING/TREASURERS COMMITTEE No. 5-01 COMPLIANCE ADVISORY COMMITTEE No. 11-01 INVESTMENT ADVISERS COMMITTEE No. 3-01 SEC RULES MEMBERS No. 18-01 RE: ALJ ORDERS SANCTIONS IN CONNECTION WITH MUTUAL FUND INVESTMENTS AND SOFT DOLLAR ARRANGEMENTS A Securities and Exchange Commission administrative law judge (ALJ) recently ordered sanctions against a registered investment adviser to a mutual fund, an affiliated broker-dealer and an individual who was an owner of each entity as well as the portfolio manager for the fund, in connection with the fund's investments and the adviser's undisclosed soft dollar arrangements. The initial decision,1 a copy of which is attached, is summarized below. The ALJ found that the U.S. Government Strategic Income Fund at issue was marketed to conservative investors, and that its sales materials and prospectus emphasized safety and stability and de-emphasized risk. In May 1993, the Fund began purchasing inverse floaters, which were very sensitive to changes in interest rates, in an attempt to emulate similar funds with superior performance. The investment in inverse floaters was successful during 1993, but following a Federal Reserve Board increase in term interest rates, the Fund's net asset value decreased approximately 32 percent in one year. The ALJ concluded that the Fund's sales materials and prospectus contained misrepresentations and misleading representations as to its safety and stability, that the misrepresented and misleading information was clearly material, and that the portfolio manager acted with scienter. Accordingly, the ALJ found that the Fund's adviser violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 34(b) of the Investment Company Act in connection with selling shares, and that the broker-dealer violated Sections 10(b) and 15(c) of the Exchange Act and 1 In the Matter of Fundamental Portfolio Advisors, Inc., Lance Brofman, and Fundamental Service Corp., SEC Admin. Proc. File No. 3-9461, Initial Decision Rel. No. 180 (January 29, 2001). A petition for review of the initial decision has been filed. The broker-dealer previously was fined by NASD Regulation for misleading advertising in connection with the marketing of this fund. See Institute Memorandum to SEC Rules Members No. 17-98 and Advertising Subcommittee No. 10-98, dated March 4, 1998. 2Rules 10b-3 and 15c1-2 thereunder. The ALJ further held that the portfolio manager aided and abetted and caused these violations. In addition, the ALJ found that, from 1990 through 1995, the adviser made soft dollar payments through a processor of soft dollar arrangements, based on credits generated from transactions for funds managed by the adviser. Some of these payments went to a company owned by the wife of a business partner of one of the adviser's owners. The ALJ concluded that the adviser violated Sections 206(1) and (2) of the Investment Advisers Act by failing to disclose to the Fund's board of

directors the existence of this or any other soft dollar arrangement. The ALJ ordered the portfolio manager and the adviser to cease and desist from committing or causing any violations or future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 34(b) of the Investment Company Act, and Sections 206(1) and (2) of the Advisers Act. The ALJ also ordered the broker-dealer to cease and desist from committing or causing any violations or future violations of Section 17(a) of the Securities Act, and Sections 10(b) and 15(c) of the Exchange Act and Rules 10b-3, 10b-5 and 15c1-2 thereunder. In addition, the ALJ assessed a civil penalty of $250,000 against the portfolio manager and barred him from association with any broker, dealer, investment adviser, or investment company. The adviser and the broker-dealer were each assessed civil penalties of $500,000, and their SEC registrations were revoked. Kathy D. Ireland Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 13125. ICI Members may retrieve this memo and its attachment from ICINet (http://members.ici.org).
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