

MEMO# 14064

October 18, 2001

SEC SANCTIONS INVESTMENT ADVISERS FOR SECURITIES LAW VIOLATIONS

[14064] October 18, 2001 TO: COMPLIANCE ADVISORY COMMITTEE No. 50-01 INVESTMENT ADVISER MEMBERS No. 26-01 SEC RULES MEMBERS No. 69-01 RE: SEC SANCTIONS INVESTMENT ADVISERS FOR SECURITIES LAW VIOLATIONS The Securities and Exchange Commission, in a recent administrative proceeding, sanctioned an investment adviser and its subadviser for failing to reasonably supervise the subadviser's portfolio manager who, over a two-year period, defrauded a mutual fund and an offshore fund.¹ The Commission's order sanctioned both advisers for failing to have in place adequate policies and procedures designed to prevent the portfolio manager's securities violations. A copy of the order is attached, and it is summarized below.

Inflated Pricing Scheme According to the Commission's order, the portfolio manager engaged in a fraudulent scheme where, without proper authority, she caused the mutual fund and the offshore fund to purchase notes through private placements. She then defrauded the funds by inflating the prices for the notes, despite the issuers' financial problems, and then rolling up the distressed notes into shell companies and inflating the prices of the shell companies' notes. The Commission found that in calculating the funds' net asset values, the portfolio manager failed to abide by the funds' pricing procedures with respect to securities for which market quotations were not readily available. Rather than obtaining bid and ask quotes from two brokers as required, the manager set the bid and ask quotes for the notes herself through discussions with the broker-dealer from whom she purchased the notes. The Commission also found that the portfolio manager overstated the value of the notes by failing to take into account the notes' performance and the issuers' financial condition. The Commission determined that this inflated pricing resulted in the material overstatement of the net asset value of one of the funds. ¹ In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Release No. IA-1980; Administrative Proceeding File No. 3-10600, (September 28, 2001). ² Failure to Supervise The Commission found that both the subadviser and the adviser failed to reasonably supervise the portfolio manager. With respect to the subadviser, the Commission found that it failed to establish and implement adequate procedures regarding the purchase, monitoring and pricing of private placement securities. In particular, the portfolio manager (1) did not have the proper authority to enter into the private placement transactions, (2) was able to conceal from the funds and the advisers that the notes' issuers were suffering severe financial problems, and (3) was able, without detection, to inflate the value of the troubled notes, which caused one of the funds to materially overstate its net asset value. With respect to the adviser, the Commission found that it failed to have adequate policies and procedures in place to respond adequately to readily apparent "red flags" that indicated that the portfolio manager was overstating the value of one of the fund's securities. For example, the Commission noted that when the adviser learned that stale pricing was occurring for several of the notes it failed to

adequately follow-up and determine the cause of the problem. Also, when presented with an earlier proposed roll up transaction involving one of the funds, the adviser failed to reasonably investigate the reason for the transaction, other than to deny the request. According to the Commission, such an investigation would have detected the underlying irregularities. Without admitting or denying the Commission's findings, the subadviser and the adviser each agreed to pay a civil money penalty of \$50,000 and to comply with an undertaking to maintain the enhanced supervisory policies and procedures they each previously had adopted. Barry E. Simmons Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 14064, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14064. Attachment (in .pdf format)

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