

**MEMO# 12935**

December 15, 2000

# **SEC ADMINISTRATIVE LAW JUDGE ISSUES DECISION FINDING VIOLATIONS OF SECURITIES LAWS BY INVESTMENT ADVISER AND FUND OFFICIALS**

[12935] December 15, 2000 TO: ACCOUNTING/TREASURERS COMMITTEE No. 45-00 COMPLIANCE ADVISORY COMMITTEE No. 41-00 INVESTMENT ADVISERS COMMITTEE No. 24-00 SEC RULES MEMBERS No. 81-00 RE: SEC ADMINISTRATIVE LAW JUDGE ISSUES DECISION FINDING VIOLATIONS OF SECURITIES LAWS BY INVESTMENT ADVISER AND FUND OFFICIALS A Securities and Exchange Commission administrative law judge has issued an initial decision<sup>1</sup> that found numerous violations of the federal securities laws in a case involving an investment adviser and several individual respondents<sup>2</sup> of a now defunct mutual fund ("Fund"). In particular, the ALJ found that the investment adviser recklessly violated several sections of the federal securities laws by materially deviating from the Fund's stated investment objective and failing to disclose or obtain shareholder authorization for the deviation. The ALJ also found that the Fund's portfolio co-manager negligently violated several sections of the federal securities laws by failing to attempt to prevent the Fund from making misleading disclosures or representations. Finally, the ALJ found that the investment adviser and several of the individual respondents in the case recklessly violated several sections of the federal securities laws insofar as they participated in an effort to incorporate current values for stale- priced securities into the Fund's NAV over a period of days. The ALJ decision is attached and the most significant aspects of it are summarized below. Background The Fund was a diversified mutual fund whose portfolio initially was comprised almost exclusively of simple pass-through mortgage-backed securities.<sup>3</sup> The Fund, however, began to shift its portfolio composition from simple pass-through securities to collateralized mortgage 1 In the Matter of Piper Capital Management, Inc., et al., Initial Decision Release No. 175 (November 30, 2000). 2 The respondents in the case were (1) the Fund's investment adviser; (2) the Fund portfolio manager; (3) the Fund portfolio "co-manager"; and (4) several officials from the Fund's accounting department. 3 The ALJ found that the Fund's prospectuses systematically and uniformly emphasized the relatively conservative composition of the Fund portfolio and a strategy of seeking high current income while preserving principal investment by maintaining a portfolio security average weighted life of approximately three to five years. The ALJ also found that the Fund's semi-annual and annual reports to shareholders systematically and uniformly emphasized the same strategy, as well as both the quality of the Fund portfolio and its superior performance. 2 obligations ("CMO") derivative securities late in 1991. By March 1993, it had between 93.1% and 97.5% of the Fund's net assets invested in CMO derivative securities with the Fund's total CMO derivative investments

leveraged to as much as 149% of net assets. Between late 1991 and early 1994, interest rates affecting the CMO market declined significantly. Because CMO values generally vary inversely in relation to underlying interest rates, these securities generally increased in value during this time period. However, early in 1994, the Federal Reserve Board initiated a series of interest rate increases that had a severe negative impact on CMO values. This led to significant losses to funds holding these securities. As funds began to sell-off these securities, CMO values began to depress even further. The reduction in values of CMOs finally came to a head when, beginning on March 30, 1994, a large hedge fund manager was unable to satisfy broker-dealer margin calls and effectively caused the crash of the CMO market. Broker-dealers began liquidating several hundred million dollars in CMOs from these hedge funds, causing extreme price volatility and significant losses for the Fund. The Fund's valuation difficulties at this time were compounded by the discovery on March 31, 1994 that numerous individual security prices being provided by the Fund's pricing vendor on a daily basis had not been adjusted for an indeterminate period of time, rendering them stale and inaccurate. All these events made it extremely difficult for the Fund to establish an accurate daily NAV for the Fund from March 31, 1994 to April 8, 1994.

**Inadequate Risk Disclosure** The SEC's Division of Enforcement alleged, based on the facts discussed above, that the Fund's investment adviser and portfolio co-manager failed to state or misstated material facts to investors from January 1991 through April 1994 and that the investment adviser misrepresented the risks associated with an investment in the Fund through inaccurate or misleading filings, prospectuses, marketing materials, and other communications. Specifically, the Division alleged that the Fund's prospectuses, annual and semi-annual reports, and marketing materials and presentations should have specifically disclosed that: (1) the Fund was predominantly invested in CMO derivative securities; (2) the Fund's superior performance was primarily attributable to those securities; and (3) the proportion of CMO derivative securities contained in the Fund's portfolio significantly increased its volatility. The Division also alleged that the investment adviser and the portfolio co-manager marketed the Fund as a conservative investment when, in fact, the Fund exposed investors to significant risks by disproportionately investing in the interest rate-sensitive CMO securities. The ALJ determined that the investment adviser recklessly violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 13(a)(3) of the Investment Company Act by materially deviating from the Fund's stated investment objective<sup>4</sup> and failing to disclose or obtain shareholder authorization for the deviation. The ALJ also determined that the Fund portfolio co-manager negligently violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, as well as Section 10(b) of the Exchange Act and Rule 10b-5, by failing to attempt to prevent the Fund from making misleading disclosures.

<sup>4</sup> The Fund's stated investment objective was "a high level of current income consistent with preservation of capital." 3or representations concerning one of the Fund's risk/volatility indicators as well as one of the Fund's risk/volatility hedges.

**4Manipulation of the Fund's NAV** The Division also alleged, based on the facts discussed above, that the investment adviser: (1) misrepresented the Fund's NAV to shareholders and to the public; (2) improperly calculated the Fund's NAV on a weekly basis from October 1993 to March 31, 1994; and (3) purposefully manipulated the Fund's NAV from March 31, 1994 through April 8, 1994. The Division also alleged that the Fund portfolio co-manager, misrepresented the Fund's NAV to shareholders and to the public and purposefully manipulated the Fund's NAV from March 31, 1994 through April 8, 1994. Finally, the Division alleged that several of the individual respondents purposefully conspired to misrepresent the Fund's NAV to shareholders and to the public and purposefully conspired to manipulate the Fund's NAV from March 31, 1994 through April 8, 1994. The ALJ found that the respondents' failure to discover the stale-priced security problem prior to March 31, 1994 did not violate Section 17(a) as the Fund employed a

pricing service on whose quotes it was prima facie reasonable for the Fund to rely. In addition, the ALJ found the record did not establish that any of the respondents either knew or reasonably should have known that the pricing service was providing stale prices prior to March 31, 1994. The ALJ, however, found that the Investment Company Act and the Fund's prospectus required the respondents to use the current market values of all portfolio securities to determine the Fund NAV on March 31, 1994 and from April 4, 1994 through April 8, 1994 and any intentional or reckless deviation from the use of current market values for all portfolio securities to determine the Fund NAV constitutes NAV manipulation in violation of Section 17(a). Regarding pricing on March 31, 1994, the ALJ found that no price manipulation occurred. In particular, the ALJ stated that it is difficult to conceive how the respondents could have better handled the circumstances that confronted them on that day. The ALJ found that although the stale-priced security problem alone would have severely impaired the respondents' ability to determine an accurate NAV for the Fund, the other events taking place on that day, such as the hedge fund CMO liquidation and the fact that markets were closed the following day for Good Friday, severely impeded the Fund's ability to secure current market quotes from broker-dealers. The ALJ, however, found that beginning April 4, 1994, the respondents participated in an effort to incorporate current values for the stale-priced securities into the Fund NAV over a period of days and that their actions on April 4, 1994 through April 6, 1994 constituted extreme departures from standards of ordinary care. The ALJ also found that those departures presented a danger of misleading Fund buyers or sellers and this danger was so obvious that each of the respondents must have been aware of it. The ALJ therefore found that each of the respondents recklessly violated Section 17(a) and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by participating in a process that was intended gradually to lower specific Fund portfolio security prices and the Fund's NAV over this period of days. Other Securities Law Violations The ALJ also found that the respondents recklessly violated, insofar as they participated in an effort to incorporate current values for stale-priced securities into the Fund NAV over a 5period of days from April 4, 1994 through April 6, 1994: (1) Rule 22c-1 of the Investment Company Act, by causing the Fund to sell, purchase and redeem shares at prices that were not based on the Fund's current NAV; (2) Section 31(a) of the Investment Company Act and Rule 31a-1 thereunder by failing to maintain appropriate books and records in support of the Fund's financial statements; and (3) Section 34(b) of the Investment Company Act in that they made untrue statements of material facts, or omitted to state material facts, in the Fund's registration statements, reports, accounts, records or other documents that are required to be kept pursuant to Section 31(a) of the Investment Company Act and made false statements concerning the source of prices used in the calculation of the Fund's NAV contained in registration statements, applications and other required records. Sanctions The ALJ ordered that the Fund's investment adviser cease and desist from violating, or causing violations of, the federal securities laws. The ALJ also formally censured the investment adviser for the securities laws violations, revoked the investment adviser's registration to operate as an investment advisor, and assessed monetary penalties totaling \$2,005,000. The ALJ also ordered that, based upon the findings of the securities law violations discussed above, the individual respondents, including the portfolio co-manager, cease and desist from violating, or causing violations of, the federal securities laws and be formally censured for the violations attributed to them. Ari Burstein Associate Counsel 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 12935. ICI Members may retrieve this memo and its attachment from ICINet (<http://members.ici.org>). Attachment (in .pdf format)

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