MEMO# 15232

October 4, 2002

SEC ADMINISTRATIVE PROCEEDING REGARDING BEST EXECUTION BY INVESTMENT ADVISER

[15232] October 4, 2002 TO: COMPLIANCE ADVISORY COMMITTEE No. 82-02 INVESTMENT ADVISER MEMBERS No. 42-02 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 25-02 SEC RULES MEMBERS No. 87-02 RE: SEC ADMINISTRATIVE PROCEEDING REGARDING BEST EXECUTION BY INVESTMENT ADVISER The Securities and Exchange Commission recently accepted an offer of settlement and imposed sanctions in an administrative proceeding involving an investment adviser and its president for failing to obtain best-execution in client cross trades.1 The adviser and the president (who is also its sole shareholder and senior portfolio manager) consented to the entry of an order, without admitting or denying the Commission's findings. The order is summarized below. The order states that, from 1997 through 1999, the adviser failed to seek best execution in securities transactions for certain advisory clients because of an undisclosed trading practice involving cross trades between client accounts.2 The order further states that the cross trades occurred in connection with a portfolio management technique called "repositioning," which was developed by the president, who was involved as portfolio manager in all cross trades at issue. According to the order, the adviser engaged in repositioning when it identified a stock already held by clients that it believed remained a good long-term investment but had declined in price. The adviser viewed the price decline as a buying opportunity and determined that certain clients should purchase additional shares. The adviser would buy the amount of additional shares of the stock required for the clients in the open market and allocate all of these shares to only one group of clients. This allocation resulted in this first group of clients temporarily holding two positions in the shares: the just purchased lower cost shares and the previously owned higher cost shares. Shortly after creating these two positions, the adviser would sell the previously owned higher cost shares from the first group to the second group of clients in a cross trade. 1 In the Matter of Renberg Capital Management, Inc. and Daniel H. Renberg, Admin. Proc. File No. 3-10906 (October 1, 2002). A copy of the order is available on the Commission's website at www.sec.gov/litigation/admin/ia-2064.htm. 2 Best execution generally refers to an investment adviser's obligation to seek to execute securities transactions for clients on terms that are the most favorable to the client under the circumstances. 2 The adviser determined the price that the second group of clients paid to the first group in the cross trades, and the commissions paid by both accounts to effect the cross trades. The adviser always chose a crossing price that was within the prevailing bid-ask spread at the time of the cross trade, but was higher than the initial purchase price paid by the first group of clients. As a result of this cross trade practice, the second group of clients that purchased in the cross trades paid higher execution costs for their shares than the first group. From 1997

through 1999, the cross trade practice caused the second group of clients that purchased in the cross trades to pay approximately $310,000 in higher prices and commissions than if such clients had acquired the shares at the same per share cost as the first group. According to the order, by engaging in the repositioning described above, the adviser violated its duty to seek best execution and, therefore, willfully violated Section 206(2) of the Investment Advisers Act, which prohibits an adviser from engaging in any transaction, practice or course of business that operates as a fraud or deceit upon any client. The order further states that the adviser's president willfully aided and abetted and caused the adviser's violation. The adviser and the president were each censured and ordered to cease and desist from committing or causing any violation and any future violation of Section 206(2) of the Advisers Act. They were also ordered to pay a civil penalty of $40,000 and they agreed to make restitution to the second group of clients in the amount of $310,000. In settlement of this proceeding, the adviser also agreed to retain an independent consultant at its expense to conduct a review of the adviser's existing policies, practices and procedures designed to prevent and detect federal securities laws violations. In connection with its retention of the consultant, the adviser agreed to: (1) provide the Commission staff with the engagement letter detailing the consultant's responsibilities; (2) enter into an agreement with the consultant that prohibits the consultant from entering into certain relationships with the adviser for the period of the engagement and two years thereafter; (3) cooperate fully with the consultant including providing access to all documents and personnel reasonably requested; (4) require the consultant to report to the Commission staff on its activities as the staff requests; (5) arrange for the consultant to issue certain written reports that would be submitted to the Commission staff; (6) take all necessary and appropriate steps to adopt and implement all recommendations of the consultant; and (7) arrange for certain follow- up reviews by the consultant. Anu Dubey Assistant Counsel

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