

**MEMO# 15340**

November 7, 2002

## **SEC SANCTIONS INVESTMENT ADVISER AND CHIEF INVESTMENT OFFICER FOR VIOLATIONS RELATING TO PROHIBITED AFFILIATED TRANSACTIONS**

[15340] November 7, 2002 TO: COMPLIANCE ADVISORY COMMITTEE No. 98-02 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 29-02 INVESTMENT ADVISER MEMBERS No. 47-02 SEC RULES MEMBERS No. 98-02 RE: SEC SANCTIONS INVESTMENT ADVISER AND CHIEF INVESTMENT OFFICER FOR VIOLATIONS RELATING TO PROHIBITED AFFILIATED TRANSACTIONS The Securities and Exchange Commission recently accepted offers of settlement and imposed sanctions in administrative proceedings against an investment adviser and its chief investment officer for engaging in violations relating to prohibited affiliated transactions.<sup>1</sup> The investment adviser and the investment officer consented to the entry of the orders, without admitting or denying the Commission's findings. The orders are summarized below. The orders state that, between 1994 and 1999, the adviser, through its investment officer, effected cross trades between the accounts of the adviser's indirect parent company and various of the adviser's investment company clients and between investment companies advised by the adviser in violation of Sections 17(a)(1) and 17(a)(2) of the Investment Company Act. According to the orders, the first type of cross trade was altogether prohibited by the Act, while the second type of cross trade could have been exempted from Section 17(a) pursuant to Rule 17a-7, if the adviser and the investment officer had followed the provisions of the rule. The orders indicate that the violations from the second type of cross trades caused over \$200,000 in gross improper costs and expenses to clients.<sup>2</sup> The orders state that the adviser's personnel, including the investment officer, were ignorant of the applicable statutory requirements and followed their own practices in conducting the cross trades. Consequently, the adviser, largely through its investment officer, failed to disclose to its investment company clients its practice of cross trading between affiliates as required by Rule 17a-7. Also, however, after the SEC's staff had notified the adviser that it intended to conduct a routine examination of the adviser, the investment officer

<sup>1</sup> In the Matter of Back Bay Advisors, L.P., SEC Release No. IA-2070 (October 25, 2002); In the Matter of Edgar M. Reed, SEC Release No. IA-2069 (October 25, 2002). Copies of the orders are available on the Commission's website at [www.sec.gov/litigation/admin/ia-2070.htm](http://www.sec.gov/litigation/admin/ia-2070.htm) and [www.sec.gov/litigation/admin/ia-2069.htm](http://www.sec.gov/litigation/admin/ia-2069.htm), respectively.

<sup>2</sup> The adviser compensated its clients for these costs and expenses. It also compensated clients in the amount of approximately \$200,000 in connection with the first type of cross trades. 2 instructed a trader to alter the adviser's completed cross trade tickets to add information required by the rule. Based upon this conduct, the Commission found that the adviser and/or its investment officer:

- Willfully aided and abetted violations

of Sections 17(a)(1) and 17(a)(2) of the Investment Company Act by engaging in the two types of cross trades described above; • Willfully violated Sections 206(1) and 206(2) of the Advisers Act by failing to inform its mutual fund clients about the affiliated transactions that it had caused those clients to engage in; • Willfully aided and abetted violations of Section 34(b) of the Investment Company Act because its failure to inform its mutual fund clients about the affiliated transactions caused the funds to file false Forms N-SAR that incorrectly stated that the funds did not engage in affiliated transactions; • Willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder by the alteration of trade tickets, thereby rendering the tickets materially inaccurate. The Commission also found that the alteration of trade tickets caused the adviser to willfully violate Section 34(a) of the Investment Company Act; and • Failed reasonably to supervise its investment staff by: not having adequate procedures and policies in place to detect and prevent violations of the securities laws such as improper affiliated transactions; relying heavily on self-reporting and self-monitoring by portfolio managers to determine whether the adviser was in compliance with the federal securities laws; and not ensuring that its employees actually read or understood the adviser's procedures manuals. Based upon these findings, the adviser was censured and ordered to pay a civil penalty of \$150,000. The investment officer was censured and ordered to cease and desist from committing or causing any violations or future violations of the Investment Company Act and the Advisers Act and was suspended from association with an investment adviser for 12 months, suspended from serving in certain capacities for a registered investment company or certain service providers to registered investment companies for 12 months, and ordered to pay a civil penalty of \$25,000. Anu Dubey Assistant Counsel