

MEMO# 11517

January 6, 2000

SEC SANCTIONS TRADER, INVESTMENT ADVISER AND SUPERVISOR IN CONNECTION WITH CERTAIN DERIVATIVES TRADING

* In the Matter of Michael T. Sullivan, III, Admin. Proc. File No. 3-10122 (December 22, 1999); In the Matter of Scudder Kemper Investments, Inc. and Gary Paul Johnson, Admin. Proc. File No. 3-10121 (December 22, 1999). [11517] January 6, 2000 TO: COMPLIANCE ADVISORY COMMITTEE No. 2-00 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 1-00 INVESTMENT ADVISER MEMBERS No. 1-00 SEC RULES MEMBERS No. 3-00 RE: SEC SANCTIONS TRADER, INVESTMENT ADVISER AND SUPERVISOR IN CONNECTION WITH CERTAIN DERIVATIVES TRADING

The Securities and Exchange Commission recently accepted offers of settlement and imposed sanctions in administrative proceedings against a former derivatives trader with respect to trading activities for certain institutional accounts and against the advisory firm where he was employed and his supervisor for failure to supervise the trader.* The trader, the investment adviser and the supervisor consented to the entry of their respective orders, without admitting or denying their findings. Copies of the orders are attached and are summarized below. The order relating to the derivatives trader states that the trader had been given limited discretion to execute a derivatives trading strategy in 20 institutional accounts, including some registered investment companies. From July 1997 through October 1998, he executed over 100 transactions in 12 of those accounts that repeatedly exceeded internal loss limits and other limits on his discretion. According to the order, the trader avoided detection by miscoding order tickets, forging the signatures of the portfolio managers on order tickets and, in many cases, not submitting order tickets. His trading activities resulted in losses of more than \$16 million, and was inconsistent with portfolio managers' presentations to several participating investment companies regarding risk levels associated with the adviser's derivatives trading. The Commission found that the trader willfully violated Section 34(b) of the Investment Company Act by forging the signatures of the portfolio managers on the order tickets and therefore causing records required to be kept under Rule 31a-1(b)(6) to be materially misleading. In addition, the Commission concluded that the trader willfully aided and abetted and caused violations of Sections 206(1) and 206(2) of the Investment Advisers Act by causing the portfolio managers' presentations to be false and misleading as to a material fact. The Commission also found violations of the books and records provisions of the Investment Company Act and the Advisers Act. Specifically, in failing to submit hundreds of order tickets for the

investment companies affected by his trading, and forging and miscoding tickets, the trader willfully aided and abetted and caused violations of Section 31(a) of the Investment Company Act and Rule 31a-1(b)(6) thereunder. Furthermore, the Commission concluded that the trader's failure to submit many order tickets and his forgery and miscoding of others caused the investment adviser to fail to maintain an accurate memorandum of each brokerage order, and thus aided and abetted and caused the adviser's violations of Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder. The SEC ordered the trader to cease and desist from committing or causing any violation or any future violation of Section 34(b) of the Investment Company Act, and from causing any violation or future violation of Sections 204, 206(1) and 206(2) of the Advisers Act and Rule 204-2(a)(3) thereunder, and Section 31(a) of the Investment Company Act and Rule 31a-1(b)(6) thereunder. The Commission also barred the trader from association with any investment adviser or registered investment company for at least five years. The order relating to the investment adviser and the trader's supervisor states that the adviser failed to have in place procedures reasonably designed to prevent and detect the trader's violations. The order notes that the adviser's procedures relied on the trader to self-report without adequate independent verification, thereby allowing the trader to circumvent the restrictions on the derivatives trading strategy and the supervision of and controls on his activities. Accordingly, the Commission concluded that the adviser failed reasonably to supervise the trader with a view to preventing his violations of the cited provisions. The Commission also found that, by virtue of the trader's conduct, the adviser willfully aided and abetted and caused violations of Section 31(a) of the Investment Company Act and Rule 31a-1(b)(6) thereunder, and willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder. The SEC censured the adviser, ordered it to cease and desist from committing or causing any violation or future violation of Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder and from causing any violation or future violation of Section 31(a) of the Investment Company Act and Rule 31a-1(b)(6) thereunder, and ordered it to pay a civil penalty of \$250,000. With respect to the trader's supervisor, the order states that the supervisor failed adequately to fulfill his responsibilities for reviewing order tickets and summary reports, thereby failing to detect significant trading irregularities that would have been discovered through such reviews. Furthermore, according to the order, he failed on a consistent basis to reconcile order tickets to the summary reports, and thus was unable to determine whether the trades had been in compliance with internal limits or whether the trader had submitted order tickets. The Commission concluded that the supervisor had failed reasonably to supervise the trader with a view to preventing the violations described above. The SEC suspended the supervisor from association with any investment adviser for three months and from acting in any supervisory capacity with any investment adviser for nine months following the period of his suspension from association, and ordered him to pay a civil penalty of \$10,000. Kathy D. Ireland Associate Counsel Attachments Note: Not all recipients receive the attachments. To obtain a copy of the attachments referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11517. ICI Members may retrieve this Memo and its attachments from ICINet (<http://members.ici.org>).

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