



# SEC VALUATION AND LIQUIDITY GUIDANCE FOR REGISTERED INVESTMENT COMPANIES

## COMPENDIUM

VOLUME 1

**SEC VALUATION AND LIQUIDITY GUIDANCE FOR REGISTERED  
INVESTMENT COMPANIES**



# SEC VALUATION AND LIQUIDITY GUIDANCE FOR REGISTERED INVESTMENT COMPANIES

Compendium

Volume 1





The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding of, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

This publication is intended to provide a compendium of U.S. Securities and Exchange Commission (SEC) releases, staff letters, and enforcement actions related to the mutual fund valuation process. ICI published this document for use by legal and compliance professionals, service providers, and others involved in fund valuation practices. This publication is being distributed with the understanding that ICI does not render any legal, accounting, or other professional advice. Although ICI has made reasonable efforts to compile the SEC's guidance regarding fund valuation for the convenience and information of its members and others, ICI does not guarantee and is not responsible for the accuracy or completeness of this publication.

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## PREFACE

One of the hallmarks of mutual funds and many other registered investment companies is that they assign a value to each of their portfolio holdings every business day. The mandate to do so is among the core principles of the Investment Company Act of 1940, and the implementation and oversight of valuation policies and procedures are key compliance obligations.

The Investment Company Act's legal framework for the valuation of fund securities has been in place since the statute's enactment in 1940. It succinctly establishes a two-pronged approach: securities for which market quotations are readily available must be priced at market value, and all other securities must be assigned a fair value as determined in good faith by the fund's board.

Since 1940, the Securities and Exchange Commission and its staff have issued extensive guidance to assist funds in valuing their securities. Much of that guidance has centered on fair valuing securities, which is a good faith determination of the amount which the owner might reasonably expect to receive upon a current sale. This assessment has been widely recognized to be more art than science. As the Commission has stated, "no single standard for determining 'fair value in good faith' may be laid down since fair value depends upon the circumstances of each particular case."

Because of the inherent importance of the valuation process for funds, and the wide-ranging nature of the guidance that exists in a multitude of Commission releases, staff letters, and enforcement actions, as well as accounting publications, we have created this indexed and easily searchable compendium. We will update the compendium as appropriate to reflect new developments. We hope that legal and compliance professionals, service providers, and others involved in fund valuation practices will find it useful.

Karrie McMillan, General Counsel  
Investment Company Institute

July 2009



# PROVISIONS OF THE INVESTMENT COMPANY ACT

## SECTION 2(A)(41)

### Section 2. General definitions.

(a) When used in this title, unless the context otherwise requires—

(41) “Value”, with respect to assets of registered investment companies, except as provided in subsection (b) of section 28 means—

(A) as used in sections 3, 5, and 12, (i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, the market value at the end of such quarter; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value at the end of such quarter, as determined in good faith by the board of directors; and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, the cost thereof; and

(B) as used elsewhere in this title, (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors;

In each case as of such time or times as determined pursuant to this title, and the rules and regulations issued by the Commission hereunder. Notwithstanding the fact that market quotations for securities issued by controlled companies are available, the board of directors may in good faith determine the value of such securities: Provided, that the value so determined is not in excess of the higher of market value or asset value of such securities in the case of majority-owned subsidiaries, and is not in excess of market value in the case of other controlled companies.

For purposes of the valuation of those assets of a registered diversified company which are not subject to the limitations provided for in section 5(b)(1), the Commission may, by rules and regulations or orders, permit any security to be carried at cost, if it shall determine that such procedure is consistent with the general intent and purposes of this title. For purposes of sections 5 and 12 in lieu of values determined as provided in clause (A) above, the Commission shall by rules and regulations permit valuation of securities at cost or other basis in cases where it may be more convenient for such company to make its computations on such basis by reason of the necessity or desirability of complying with the provisions of any United States revenue laws or rules and regulations issued thereunder, or the laws or the rules and regulations issued thereunder of any State in which the securities of such company may be qualified for sale.

The foregoing definition shall not derogate from the authority of the Commission with respect to the reports, information, and documents to be filed with the Commission by any registered company, or with respect to the accounting policies and principles to be followed by any such company, as provided in sections 8, 30, and 31.

## SECTION 22(c)

### **Section 22. Distribution, redemption, and repurchase of securities; regulations by securities associations.**

(c) The Commission may make rules and regulations applicable to registered investment companies and to principal underwriters of, and dealers in, the redeemable securities of any registered investment company, whether or not members of any securities association, to the same extent, covering the same subject matter, and for the accomplishment of the same ends as are prescribed in subsection (a) of this section in respect of the rules which may be made by a registered securities association governing its members. Any rules and regulations so made by the Commission, to the extent that they may be inconsistent with the rules of any such association, shall so long as they remain in force supersede the rules of the association and be binding upon its members as well as all other underwriters and dealers to whom they may be applicable.

## SECTION 22(e)

### **Section 22. Distribution, redemption, and repurchase of securities; regulations by securities associations.**

(e) No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption, except—

(1) for any period (A) during which the New York Stock Exchange is closed other than customary weekend and holiday closings or (B) during which trading on the New York Stock Exchange is restricted;

(2) for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or

(3) for such other periods as the Commission may by order permit for the protection of security holders of the company.

The Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection.



# RULES AND FORMS UNDER THE INVESTMENT COMPANY ACT

## RULE 2A-4

### **Rule 2A-4. Definition of “current net asset value” for use in computing periodically the current price of redeemable security.**

(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:

- (1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.
  - (2) Changes in holdings of portfolio securities shall be reflected no later than in the first calculation on the first business day following the trade date.
  - (3) Changes in the number of outstanding shares of the registered company resulting from distributions, redemptions, and repurchases shall be reflected no later than in the first calculation on the first business day following such change.
  - (4) Expenses, including any investment advisory fees, shall be included to date of calculation. Appropriate provision shall be made for Federal income taxes if required. Investment companies which retain realized capital gains designated as a distribution to shareholders shall comply with paragraph (h) of rule 6-03 of Regulation S-X.
  - (5) Dividends receivable shall be included to date of calculation either at ex-dividend dates or record dates, as appropriate.
  - (6) Interest income and other income shall be included to date of calculation.
- (b) The items which would otherwise be required to be reflected by subparagraphs (4) and (6) above need not be so reflected if cumulatively, when netted, they do not amount to as much as one cent per outstanding share.
- (c) Notwithstanding the requirements of paragraph (a) above, any interim determination of current net asset value between calculations made as of the close of the New York Stock Exchange on the preceding business day and the current business day may be estimated so as to reflect any change in current net asset value since the closing calculation on the preceding business day.



## **RULE 22c-1**

### **Rule 22c-1. Pricing of redeemable securities for distribution, redemption, and repurchase.**

(a) No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security; Provided, that:

(1) This paragraph shall not prevent a sponsor of a unit investment trust (hereinafter referred to as the "Trust") engaged exclusively in the business of investing in eligible trust securities (as defined in Rule 14a-3(b)) from selling or repurchasing Trust units in a secondary market at a price based on the offering side evaluation of the eligible trust securities in the Trust's portfolio, determined at any time on the last business day of each week, effective for all sales made during the following week, if on the days that such sales or repurchases are made the sponsor receives a letter from a qualified evaluator stating, in its opinion, that:

(i) In the case of repurchases, the current bid price is not higher than the offering side evaluation, computed on the last business day of the previous week; and

(ii) In the case of resales, the offering side evaluation, computed as of the last business day of the previous week, is not more than one-half of one percent (\$5.00 on a unit representing \$1,000 principal amount of eligible trust securities) greater than the current offering price.

(2) This paragraph shall not prevent any registered investment company from adjusting the price of its redeemable securities sold pursuant to a merger, consolidation, or purchase of substantially all of the assets of a company which meets the conditions specified in Rule 17a-8.

(b) For the purposes of this section,

(1) The current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the investment company sets, in accordance with paragraph (d) of this Rule, except on:

(i) Days on which changes in the value of the investment company's portfolio securities will not materially affect the current net asset value of the investment company's redeemable securities;

(ii) Days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company; or

(iii) Customary national business holidays described or listed in the prospectus and local and regional business holidays listed in the prospectus; and

(2) A "qualified evaluator" shall mean any evaluator which represents it is in a position to determine, on the basis of an informal evaluation of the eligible trust securities held in the Trust's portfolio, whether—

(i) The current bid price is higher than the offering side evaluation, computed on the last business day of the previous week, and

(ii) The offering side evaluation, computed as of the last business day of the previous week, is more than one-half of one percent (\$5.00 on a unit representing \$1,000 principal amount of eligible trust securities) greater than the current offering price.

(c) Notwithstanding the provisions above, any registered separate account offering variable annuity contracts, any person designated in such account's prospectus as authorized to consummate transactions in such contracts, and any principal

underwriter of or dealer in such contracts shall be permitted to apply the initial purchase payment for any such contract at a price based on the current net asset value of such contract which is next computed:

- (1) Not later than two business days after receipt of the order to purchase by the insurance company sponsoring the separate account (“insurer”), if the contract application and other information necessary for processing the order to purchase (collectively, “application”) are complete upon receipt; or
- (2) Not later than two business days after an application which is incomplete upon receipt by the insurer is made complete, Provided, that, if an incomplete application is not made complete within five business days after receipt,
  - (i) The prospective purchaser shall be informed of the reasons for the delay, and
  - (ii) The initial purchase payment shall be returned immediately and in full, unless the prospective purchaser specifically consents to the insurer retaining the purchase payment until the application is made complete.
- (3) As used in this section:
  - (i) “Prospective purchaser” shall mean either an individual contract owner or an individual participant in a group contract.
  - (ii) “Initial purchase payment” shall refer to the first purchase payment submitted to the insurer by, or on behalf of, a prospective purchaser.
- (d) The board of directors shall initially set the time or times during the day that the current net asset value shall be computed, and shall make and approve such changes as the board may deem necessary.

## **RULE 22e-2**

### **Rule 22e-2. Pricing of redemption requests in accordance with Rule 22c-1.**

An investment company shall not be deemed to have suspended the right of redemption if it prices a redemption request by computing the net asset value of the investment company’s redeemable securities in accordance with the provisions of Rule 22c-1.

## **RULE 38a-1**

### **Rule 38a-1. Compliance procedures and practices of certain investment companies.**

- (a) Each registered investment company and business development company (“fund”) must:
  - (1) *Policies and procedures.* Adopt and implement written policies and procedures reasonably designed to prevent violation of the Federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund.

## EXCERPT FROM FORM N-1A

### Part A: Information Required in a Prospectus

#### Item 6. Shareholder Information

(a) Pricing of Fund Shares. Describe the procedures for pricing the Fund's shares, including:

(1) An explanation that the price of Fund shares is based on the Fund's net asset value and the method used to value Fund shares (market price, fair value, or amortized cost).

Instruction. A Fund (other than a Money Market Fund) must provide a brief explanation of the circumstances under which it will use fair value pricing and the effects of using fair value pricing. With respect to any portion of a Fund's assets that are invested in one or more open-end management investment companies that are registered under the Investment Company Act, the Fund may briefly explain that the Fund's net asset value is calculated based upon the net asset values of the registered open-end management investment companies in which the Fund invests, and that the prospectuses for these companies explain the circumstances under which those companies will use fair value pricing and the effects of using fair value pricing.

(2) A statement as to when calculations of net asset value are made and that the price at which a purchase or redemption is effected is based on the next calculation of net asset value after the order is placed.

(3) A statement identifying in a general manner any national holidays when shares will not be priced and specifying any additional local or regional holidays when the Fund shares will not be priced.

#### Instructions.

1. In responding to this Item, a Fund may use a list of specific days or any other means that effectively communicates the information (*e.g.*, explaining that shares will not be priced on the days on which the New York Stock Exchange is closed for trading).

2. If the Fund has portfolio securities that are primarily listed on foreign exchanges that trade on weekends or other days when the Fund does not price its shares, disclose that the net asset value of the Fund's shares may change on days when shareholders will not be able to purchase or redeem the Fund's shares.

### Part B: Information Required in Statement of Additional Information

#### Item 18. Purchase, Redemption, and Pricing of Shares

(c) Offering Price. Describe the method followed or to be followed by the Fund in determining the total offering price at which its shares may be offered to the public and the method(s) used to value the Fund's assets.

#### Instructions.

1. Describe the valuation procedure(s) that the Fund uses in determining the net asset value and public offering price of its shares.

2. Explain how the excess of the offering price over the net amount invested is distributed among the Fund's principal underwriters or others and the basis for determining the total offering price.

3. Explain the reasons for any difference in the price at which securities are offered generally to the public, and the prices at which securities are offered for any class of transactions or to any class of individuals.

4. Unless provided as a continuation of the balance sheet in response to Item 22, include a specimen price-make-up sheet showing how the Fund calculates the total offering price per unit. Base the calculation on the value of the Fund's portfolio securities and other assets and its outstanding securities as of the date of the balance sheet filed by the Fund.

# RELEASES RELATED TO RULE 2a-4

## NOTICE OF PROPOSAL TO ADOPT RULE 2a-4 RELATING TO PERIODIC CALCULATION OF NET ASSET VALUE OF REDEEMABLE SECURITY

Release No. IC-4006

July 2, 1964

NOTICE IS HEREBY GIVEN that the Securities and Exchange Commission has under consideration adoption of a proposed Rule 2a-4 under the Investment Company Act of 1940 ("Act"). The proposed rule relates to the manner in which the net asset value of a redeemable security issued by a registered investment company is to be computed for purposes of the distribution, redemption, and repurchase of the security. The rule would be promulgated pursuant to authority conferred by Section 38(a) of the Act.

Section 38(a) authorizes the Commission to make rules and regulations, inter alia, defining "accounting, technical, and trade terms" used in the Act. "Net asset value" is a term used in, among other sections, Section 22 of the Act relating to "distribution, redemption, and repurchase of redeemable securities," and the concept is employed in the definition of the term "redeemable security" in Section 2(a)(31) of the Act.

The Commission's experience in the administration of the Act and its analysis of data provided by the periodic inspection of books and records maintained by registered investment companies pursuant to Section 31 of the Act indicate that the adoption of uniform procedures with respect to the calculation of net asset value of redeemable securities issued by registered investment companies would be in the public interest and in the interest of investors.

The text of the proposed Rule 2a-4 is as follows:

Rule 2a-4. Periodic Calculation of Net Asset Value of Redeemable Security.

(a) The periodic calculation of the net asset value of any redeemable security issued by a registered investment company for purposes of distribution, redemption, and repurchase shall include calculations made substantially in accordance with the following, with estimates used where necessary or appropriate:

- (1) Portfolio securities with respect to which market quotations are readily available shall be valued at market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.
- (2) Changes in holdings of portfolio securities shall be reflected no later than in the first calculation on the first business day following the trade date.
- (3) Changes in the number of outstanding shares of the registered company resulting from distributions, redemptions, and repurchases shall be reflected no later than in the first calculation on the first business day following such change.
- (4) Expenses, including any investment advisory fees, shall be reflected daily.
- (5) Dividends receivable shall be reflected daily either at exdividend dates or record dates, as appropriate.
- (6) Interest income and other income shall be reflected daily.

(b) Notwithstanding the requirements of paragraph (a) above, interim determinations of net asset value between calculations made as of the close of the New York Stock Exchange on the preceding business day and the current business day may be estimated so as to reflect any change in net asset value since the closing calculation on the preceding business day.

All interested persons are invited to submit their views and comments on the above proposal in writing to the Securities and Exchange Commission, Washington, D.C. 20549, on or before July 31, 1964. All such communications will be available for public inspection.

By the Commission.

## ADOPTION OF RULE 2a-4 DEFINING THE TERM “CURRENT NET ASSET VALUE” IN REFERENCE TO REDEEMABLE SECURITIES ISSUED BY A REGISTERED INVESTMENT COMPANY

Release No. IC-4105

December 22, 1964

On July 2, 1964, the Securities and Exchange Commission published notice (Investment Company Act Release No. 4006) that it had under consideration the adoption of a proposed Rule 2a-4 under the Investment Company Act of 1940 (“Act”) and invited the comments of interested persons. Upon consideration of the comments received, the Commission has determined pursuant to the authority conferred by Sections 38(a) and 22 of the Act to adopt Rule 2a-4 in the form set forth below.

Section 38(a) authorizes the Commission to make rules and regulations, inter alia, defining “accounting, technical, and trade terms” used in the Act. “Current net asset value” is a term used in Section 22 of the Act relating to “distribution, redemption, and repurchase of redeemable securities,” and the concept is employed in the definition of the term “redeemable security” in Section 2(a)(31) of the Act.

The Commission’s experience in the administration of the Act and its analysis of data provided by the periodic inspection of books and records maintained by registered investment companies pursuant to Section 31 of the Act indicate that uniformity with respect to the calculation of net asset value of redeemable securities issued by registered investment companies would be in the public interest and in the interest of investors. Accordingly, pursuant to the authority conferred by Sections 38(a) and 22 of the Act, the Commission has promulgated Rule 2a-4 defining the term “current net asset value” as it is used in the Act with reference to redeemable securities issued by a registered investment company.

The Commission has considered that the public interest and the interest of investors require that the rule be effective as promptly as is reasonably practicable in order that the current net asset value of redeemable securities currently being distributed, redeemed, and repurchased by registered investment companies be appropriately calculated. Consideration has also been given to the obligations of registered investment companies to file reports under the provisions of the Act and the rules thereunder relating to the fiscal periods of said companies, and to the substantial number of registered investment companies which will begin new fiscal periods on January 1, 1965. The Commission therefore finds that there is good cause for the rule to become effective on January 1, 1965. Accordingly, the effective date of the rule shall be January 1, 1965.

The text of Rule 2a-4 is as follows:

Rule 2a-4. Definition of “Current Net Asset Value” for Use in Computing Periodically the Current Price of Redeemable Security.

(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:

- (1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.
- (2) Changes in holdings of portfolio securities shall be reflected no later than in the first calculation on the first business day following the trade date.
- (3) Changes in the number of outstanding shares of the registered company resulting from distributions, redemptions, and repurchases shall be reflected no later than in the first calculation on the first business day following such change.
- (4) Expenses, including any investment advisory fees, shall be included to date of calculation.

(5) Dividends receivable shall be included to date of calculation either at ex-dividend dates or record dates, as appropriate.

(6) Interest income and other income shall be included to date of calculation.

(b) The items which would otherwise be required to be reflected by subparagraphs (4) and (6) above need not be so reflected if cumulatively, when netted, they do not amount to as much as one cent per outstanding share.

(c) Notwithstanding the requirements of paragraph (a) above, any interim determination of current net asset value between calculations made as of the close of the New York Stock Exchange on the preceding business day and the current business day may be estimated so as to reflect any change in current net asset value since the closing calculation on the preceding business day.

By the Commission.

## NOTICE OF PROPOSAL TO AMEND RULES 6-02-9 OF ARTICLE 6 OF REGULATION S-X AND RULE 2a-4 UNDER THE INVESTMENT COMPANY ACT OF 1940 WITH RESPECT TO PROVISION BY REGISTERED INVESTMENT COMPANIES FOR FEDERAL INCOME TAXES

Release Nos. 33-4995; 34-8671; IC-5780

August 20, 1969

NOTICE IS HEREBY GIVEN that the Securities and Exchange Commission has under consideration the amendment of Rule 6-02-9 of Article 6 of Regulation S-X and a related amendment of Rule 2a-4 under the Investment Company Act of 1940 ("Act").

Article 6 of Regulation S-X governs the form and content of financial statements filed by management investment companies (other than those which are issuers of periodic payment plan certificates) under the Act, the Securities Act of 1933 and the Securities Exchange Act of 1934. Rule 6-02-9 of Article 6 requires that appropriate provision shall be made in the financial statements of such companies for Federal income taxes.

Rule 2a-4 under the Act defines the term "current net asset value" of redeemable securities issued by registered investment companies used in computing periodically the current price of such securities for the purpose of distribution, redemption, and repurchase. Subparagraph (a)(4) of Rule 2a-4 provides that in computing such current net asset value expenses shall be included to the date of calculation.

The proposed amendment of Rule 6-02-9 of Regulation S-X would specifically provide that a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Internal Revenue Code ("Code") shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains realized during such year. The amendment would also revise the reference in Rule 6-02-9 to the section of the Code defining a company's status as a "regulated investment company" to its present designation of Subtitle A, Chapter 1, Subchapter M. The proposed amendment of Rule 2a-4 under the Act would add a sentence to subparagraph (a)(4) to require that appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

The primary purpose of the proposed amendment is to assure that regulated investment companies excepted by provisions of the Code from the payment of Federal income taxes on net income and realized capital gains distributed to shareholders will make appropriate provision for taxes on any realized undistributed capital gains designated as distributions to shareholders under provisions of the Code. Most regulated investment companies follow the practice of distributing realized capital gains to shareholders, thereby relieving such companies of the payment of Federal income taxes on such gains. However, under the provisions of Section 852(b)(3)(D) of the Code, a regulated investment company which elects to do so may retain realized long-term capital gains and, in effect, pay the tax on those gains on behalf of the shareholders. Every such shareholder at the close of the company's taxable year may include in his tax return his pro rata portion of the company's realized capital gains as if it had been distributed to him, accrue his capital gains tax thereon, and elsewhere in his tax return is allowed credit or refund for his pro rata share of the capital gains tax which has been paid for his benefit by the company but which is deemed to have been paid by him. At the same time, such shareholder may increase the tax basis of his shares by 75% of his pro rata portion of the realized gains.

The question of the appropriate method of tax accrual or adjustment of net asset value by investment companies which retain realized capital gains under Section 852(b)(3)(D) of the Code was considered by the National Association of Investment Companies (the predecessor to the present Investment Company Institute) and the Committee on Relations with the S.E.C. of the American Institute of Accountants in 1956 following the enactment of the provision of the Code in its present form. On November 2, 1956, the Association sent a memorandum to its members stating in part that the question had been considered by the Committee which was of the opinion that, since for a company intending to proceed under Section 852(b)(3)(D) the tax on realized undistributed capital gains would be on the shareholder and not the company, no allowance need be made, either for possible Federal income tax on unrealized appreciation or for Federal income tax on capital gains realized during the year. The memorandum stated that at the end of a company's taxable year the Federal income tax to be paid on realized but undistributed capital gains would be carried in an accrual account until paid.



The above procedure is followed as the generally accepted accounting practice by regulated investment companies which elect to retain realized capital gains and pay the tax on behalf of shareholders. Most of such companies are capital exchange funds which issued their shares for securities in tax-free exchanges and which are not making public offerings of shares. Of a total of 34 active exchange funds, 30 elected for their fiscal years ended in 1968 to retain realized capital gains, in whole or in part, and pay the tax on behalf of the shareholders. All except four of these exchange funds followed the practice of making provision for such taxes commencing on the last day of the taxable year. The four funds which did not follow the general practice, made provision for taxes on realized undistributed capital gains throughout the year as the gains were realized.

The proposed amendments to the rules would codify the generally accepted practice of making provision, commencing on the last day of the taxable year of the investment company, for taxes on realized undistributed capital gains designated as distributions to shareholders. The amended rules would not affect the rights of any person who may have redeemed shares prior to the adoption of the amendments.

Under the provisions of the Code, the taxes on realized capital gains retained by the company are payable by the company only on behalf of those persons who are shareholders on the last day of the taxable year in which the gains were realized. It is only those persons who are shareholders on the last day of the taxable year who are deemed under the provisions of the Code to have paid the tax imposed on the designated capital gains retained by the company and who, accordingly, are allowed credit or refund for the tax so deemed to have been paid by them and are entitled to increase the tax basis of their shares by 75% of their pro rata portion of the realized gains. Accrual of the tax by the company at any time prior to the last day of its taxable year therefore reduces the net asset value of the shares of holders who redeem during the year and who consequently receive no credit for the tax so accrued.

The proposed amendment of Rule 6-02-9 of Article 6 of Regulation S-X would be adopted pursuant to Sections 8, 30, 31(c) and 38(a) of the Investment Company Act of 1940; Sections 7 and 19(a) of the Securities Act of 1933; and Sections 12, 13, 15(d), and 23(a) of the Securities Exchange Act of 1934. The proposed amendment of Rule 2a-4 under the Investment Company Act of 1940 would be adopted pursuant to Sections 22 and 38(a) of that Act.

The rules as they are proposed to be amended are set forth below. The language to be added to the present rules is underlined, and the language to be deleted is in brackets.

Rule 6-02-9 of Article 6 of Regulation S-X would be amended to read as follows:

9. Federal income taxes. Appropriate provision shall be made, on the basis of the applicable tax laws, for Federal income taxes that it is reasonably believed are, or will become, payable in respect of (a) current net income, (b) realized gain on investments and (c) unrealized appreciation on investments. The company's status as a "regulated investment company" as defined in Subtitle A, Chapter 1, Subchapter M of the Internal Revenue Code as amended shall be stated in a note referred to in the appropriate statements. Such note shall also indicate briefly the principal present assumptions on which the company has relied in making or not making provisions for such taxes. However, a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Code shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains realized during such year.

As amended, paragraph (a) and subparagraph (a)(4) of Rule 2a-4 under the Investment Company Act of 1940 would read as follows:

(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded on the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:

(4) Expenses, including any investment advisory fees, shall be included to date of calculation. Appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

All interested persons are invited to submit views and comments on the proposed amendments to the rules. They should be submitted in writing to the Securities and Exchange Commission, Washington, D.C. 20549, on or before September 22, 1969. All such communications should refer to Investment Company Act Release No. 5780, and they will be available for public inspection.

By the Commission.

## **ADOPTION OF AMENDMENTS TO RULE 6-02-9 OF ARTICLE 6 OF REGULATION S-X AND RULE 2a-4 UNDER THE INVESTMENT COMPANY ACT OF 1940 WITH RESPECT TO PROVISION BY REGISTERED INVESTMENT COMPANIES FOR FEDERAL INCOME TAXES**

Release Nos. 33-5035; 34-8788; IC-5943

December 31, 1969

On August 20, 1969, the Securities and Exchange Commission published notice (Investment Company Act Release No. 5780) that it had under consideration the amendment of Rule 6-02-9 of Article 6 of Regulation S-X and a related amendment of Rule 2a-4 under the Investment Company Act of 1940 ("Act").

Article 6 of Regulation S-X governs the form and content of financial statements filed by management investment companies (other than those which are issuers of periodic payment plan certificates) under the Act, the Securities Act of 1933 and the Securities Exchange Act of 1934. Rule 6-02-9 of Article 6 requires that appropriate provision shall be made in the financial statements of such companies for Federal income taxes.

Rule 2a-4 under the Act defines the term "current net asset value" of redeemable securities issued by registered investment companies used in computing periodically the current price of such securities for the purpose of distribution, redemption, and repurchase. Subparagraph (a)(4) of Rule 2a-4 provides that in computing such current net asset value expenses shall be included to the date of calculation.

The proposed amendment of Rule 6-02-9 of Regulation S-X would specifically provide that a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Internal Revenue Code ("Code") shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains realized during such year. The amendment would also revise the reference in Rule 6-02-9 to the section of the Code defining a company's status as a "regulated investment company" to its present designation of Subtitle A, Chapter 1, Subchapter M. The proposed amendment of Rule 2a-4 under the Act would add a sentence to subparagraph (a)(4) to require that appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

The primary purpose of the proposed amendment is to assure that regulated investment companies excepted by provisions of the Code from payment of Federal income taxes on net income and realized gains distributed to shareholders will make appropriate provision for taxes on any realized undistributed capital gains designated as distributions to shareholders under the provisions of the Code. Most regulated investment companies follow the practice of distributing realized capital gains to shareholders, thereby relieving such companies of the payment of Federal income taxes on such gains. However, under the provisions of Section 852(b)(3)(D) of the Code, a regulated investment company which elects to do so may retain realized long-term capital gains and, in effect, pay the tax on those gains on behalf of the shareholders. Every such shareholder at the close of the company's taxable year shall include in his tax return his pro rata portion of the company's realized capital gains as if it had been distributed to him, accrue his capital gains tax thereon, and elsewhere in his tax return is allowed credit or refund for his pro rata share of the capital gains tax which has been paid for his benefit by the company but which is deemed to have been paid by him. At the same time, such shareholder shall increase the tax basis of his shares by the excess of his pro rata portion of the realized gains over the tax credit or refund allowed to him.

The question of the appropriate method of tax accrual or adjustment of net asset value by investment companies which retain realized capital gains under Section 852(b)(3)(D) of the Code was Considered by the National Association of Investment Companies (the predecessor to the present Investment Company Institute) and the Committee on Relations with the S.E.C. of the American Institute of Accountants in 1956 following the enactment of the provisions of the Code in its present form. On November 2, 1956, the Association send a memorandum to its members stating in part that the question had been considered by the Committee which was of the opinion that, since for a company intending to proceed under Section 852(b)(3)(D) the tax on realized undistributed capital gains would be on the shareholder and not the company, no allowance need be made, either for possible Federal income tax on unrealized appreciation or for Federal income tax on capital gains realized during the year. The memorandum stated that at the end of a company's taxable year

the Federal income tax to be paid on realized but undistributed capital gains would be carried in an accrual account until paid.

The above procedure is followed as the generally accepted accounting practice by regulated investment companies which elect to retain realized capital gains and pay the tax on behalf of shareholders. Most of such companies are capital exchange funds which issued their shares for securities in tax-free exchanges and which are not making public offerings of shares. Of a total 34 active exchange funds, 30 elected for their fiscal years ended in 1968 to retain realized capital gains, in whole or in part, and pay the tax on behalf of the shareholders. All except four of these exchange funds followed the practice of making provision for such taxes on the last day of the taxable year. The four funds which did not follow the general practice, made provision for taxes on realized undistributed capital gains throughout the year as the gains were realized.

The proposed amendments to the rules would codify the generally accepted practice of making provision, on the last day of the taxable year of the investment company, for taxes on realized undistributed capital gains designated as distributions to shareholders. The amended rules would not affect the rights of any person who may have redeemed shares prior to the adoption of the amendments.

Under the provisions of the Code, the taxes on realized capital gains retained by the company are payable by the company only on behalf of those persons who are shareholders on the last day of the taxable year in which the gains were realized. It is only those persons who are shareholders on the last day of the taxable year who are deemed under the provisions of the Code to have paid the tax imposed on the designated capital gains retained by the company and who, accordingly, are allowed credit or refund for the tax so deemed to have been paid by them and are entitled to increase the tax basis of their shares by the excess of their pro rata portion of the realized gains over the tax credit or refund allowed to them. Accrual of the tax by the company at any time prior to the last day of its taxable year therefore reduces the net asset value of the shares of holders who redeem or sell their shares during the year and who consequently receive no credit for the tax so accrued.

After consideration of the comments and suggestions received from interested persons, the Commission has determined to adopt the amendments to the rules.

The amendment of Rule 6-02-9 of Article 6 of Regulation S-X is adopted pursuant to Sections 8, 30, 31(c) and 38(a) of the Investment Company Act of 1940; Sections 7 and 19(a) of the Securities Act of 1933; and Sections 12, 13, 15(d), and 23(a) of the Securities Exchange Act of 1934. The proposed amendment of Rule 2a-4 under the Investment Company Act of 1940 is adopted pursuant to Sections 22 and 38(a) of that Act.

The rules as amended are set forth below.

Rule 6-02-9 of Article 6 of Regulation S-X is amended to read as follows:

9. Federal income taxes. Appropriate provision shall be made, on the basis of the applicable tax laws, for Federal income taxes that it is reasonably believed are, or will become, payable in respect of (a) current net income, (b) realized gain on investments and (c) unrealized appreciation on investments. The company's status as a "regulated investment company" as defined in Subtitle A, Chapter 1, Subchapter M of the Internal Revenue Code as amended shall be stated in a note referred to in the appropriate statements. Such note shall also indicate briefly the principal present assumptions on which the company has relied in making or not making provisions for such taxes. However, a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Code shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains during such year.

Subparagraph (a)(4) of Rule 2a-4 under the Investment Company Act of 1940 is amended so that paragraph (a) and subparagraph (a)(4) read as follows:

(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which

reflects calculations, whether or not recorded on the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:

(4) Expenses, including any investment advisory fees, shall be included to date of calculation. Appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

The amendments to Rule 6-02-9 of Article 6 of Regulation S-X and Rule 2a-4 under the Act shall be effective so that after the date of adoption of the amendments (December 31, 1969) no further provision shall be made for taxes in the circumstances stated in the amendment to Rule 6-02-9 except on the last day of the taxable year.

By the Commission.

## PROPOSED REVISION OF FINANCIAL STATEMENT REQUIREMENTS FOR REGISTERED INVESTMENT COMPANIES

Release Nos. 33-6374; 34-18402; IC-12153

January 11, 1982

**ACTION:** Proposed rules.

**SUMMARY:** The Commission is proposing a revision of Article 6 of Regulation S-X which is applicable to financial statements filed by registered investment companies. The revisions to Article 6 are being proposed to (1) eliminate rules which are duplicative of generally accepted accounting principles ("GAAP"), (2) effect changes which recognize current industry practices, and (3) integrate and simplify the rules to improve financial reporting. In addition, financial statement requirements for employee stock purchase, savings and similar plans would be similarly amended and transferred to a separate Article 6A. These proposed changes are part of the Commission's comprehensive reexamination of its requirements for financial statements in connection with its efforts to simplify and improve the current disclosure system.

**DATE:** Comments should be received by the Commission on or before April 30, 1982.

**ADDRESSES:** Comments should be submitted in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, Washington, D.C. 20549. Comment letters should refer to File No. S7-918. All comments will be available for public inspection at the Commission's Public Reference Room, 1100 L Street, N.W., Washington, D.C. 20549.

**FOR FURTHER INFORMATION CONTACT:** Clarence M. Staubs, or John W. Albert, office of the Chief Accountant, Securities and Exchange Commission, Washington, D.C. 20549 (202-272-2133).

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission is proposing a revision of Article 6 of Regulation S-X (17 CFR Part 210) which prescribes the form and content of financial statements filed for registered investment companies and employee stock purchase, savings and similar plans. The revisions to Article 6 are being proposed to (1) eliminate rules which are duplicative of GAAP, (2) effect changes which recognize current industry practices, and (3) integrate and simplify the rules to improve financial reporting. The proposed rules would integrate certain common reporting requirements of management investment companies, unit investment trusts, and face-amount certificate companies (collectively referred to as registered investment companies) in a revised Article 6. Financial statement requirements for employee stock purchase, savings and similar plans would be amended to change valuation requirements for certain assets and transferred to a separate Article 6A.

Under the proposed rules, management investment companies would be required to present a statement of operations rather than the separate statements of income and expense, realized gain or loss on investments, and unrealized appreciation or depreciation of investments currently furnished. In addition, the proposed rules would prescribe a reporting format for the presentation of a statement of net assets and establish criteria for its use. Finally, the proposed rules would amend the requirements regarding the basis used to value certain assets in the balance sheets of closed-end management investment companies.

### Background

In January 1980, the Commission issued four separate but related rule proposals<sup>1</sup> which, among other things, initiated a broad project to reexamine its registration and reporting requirements. The project was designed to make major changes in the Commission's disclosure system, and to effect integration of the registration and reporting requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934. A general revision of Articles 3 and 5 of Regulation S-X, included in the January rule proposals, has been accomplished and new uniform requirements governing the periods to be covered by financial statements, including special provisions for management investment companies, have been

<sup>1</sup> Proposed under Securities Act Release Nos. 6176 (45 FR 5972), 6177 (45 FR 5934), 6178 (45 FR 5943), and 6179 (45 FR 5963), respectively.

adopted. In addition, the industry-specific requirements related to property and liability insurance and life insurance companies were recently integrated within a revised Article 7.

In connection with its comprehensive review of Regulation S-X, the Commission has undertaken a review of the requirements for financial statements filed by registered investment companies contained in Article 6 of Regulation S-X. The existing requirements of Article 6 are comprised of a series of special rules applicable to: (1) management investment companies (§§ 210.6-01 to 210.6-10); (2) unit investment trusts (§§ 210.6-10a to 210.6-13); (3) face-amount certificate companies (§§ 210.6-20 to 210.6-24); and (4) employee stock purchase, savings and similar plans (§§ 210.6-30 to 210.6-34), respectively. This segregation of special rules for each type of registered investment company provides preparers of financial statements with a convenient reference; however, it also results in the repetition of many requirements applicable to more than one type of registered investment company. The proposed rules would simplify the requirements under Article 6 by integrating those rules which apply to more than one type of investment company and segregating others which are unique to a specific type of registered investment company.

In this connection, the Commission believes that the operations of unit investment trusts are not sufficiently different from those of management investment companies that separate requirements are necessary. Consequently, requirements for statements of condition and income and distributable funds of unit investment trusts have been integrated within the requirements for balance sheets and statements of operations applicable generally to registered investment companies. Where additional information is relevant to an understanding of the operations of a unit investment trust, it would be provided within the schedules specifically applicable to this type of investment company.

The existing requirements for face-amount certificate companies are set forth in a separate section of Article 6 which includes the special provisions unique to face-amount certificate companies and repeats the general provisions applicable to other types of investment companies. The proposed rules would integrate the requirements applicable to all investment companies, thereby eliminating many repetitious rules. Separate reporting formats for balance sheets and statements of operations would be retained for these companies due to the unique nature of this type of investment company.

In addition to simplifying the rules by integrating common provisions, the proposed rules would revise the existing requirements of Article 6 to eliminate or modify those rules which are duplicative of GAAP, no longer pertinent due to changes in current industry practices, or are made unnecessary by these proposals. A discussion of the more significant of these proposed revisions follows.

## Statement of Operations

Under the proposed rules, management investment companies would be required to present a statement of operations rather than the separate statements of income and expense, realized gain or loss on investments, and unrealized appreciation or depreciation of investments furnished pursuant to the existing rules. Since an open-end management investment company continuously trades its shares on the basis of its underlying net assets stated at value<sup>2</sup>, the Commission believes that it would be consistent for such investment companies to report changes in net assets resulting from all investment activities in the determination of operating results. Although a closed-end management investment company does not stand ready to redeem its shares on a continuous basis, the market price at which such shares are traded correlates with the company's net asset value. Furthermore, the proposal to report all changes in net assets resulting from investment activities in a basic statement of operations is consistent with the notion of comprehensive income set forth in Statement of Financial Accounting Concepts ("Concepts Statement") No. 3.<sup>3</sup> Under Concepts Statement No. 3, comprehensive income is defined as the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

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<sup>2</sup> Management investment companies are classified as either "open-end" or "closed-end" companies. An open-end management investment company stands ready to redeem its outstanding shares at current net asset value, and generally offers its shares to the public on a continuous basis. A closed-end management investment company, however, does not stand ready to redeem its outstanding shares; its shares are traded in a manner similar to those of other public companies.

<sup>3</sup> Concepts statements, such as Statement No. 3, "Elements of Financial Statements of Business Enterprise," issued in December 1980, do not establish accounting procedures or disclosure practices. Rather, these statements describe concepts and relationships that will underlie future financial accounting standards and practices and in due course serve as a basis for evaluating existing standards and practices.



While the proposed rules would require that the results of all investment activities be combined and reported within a statement of operations, the format prescribed by these rules would clearly distinguish amounts attributable to each of the basic investment activities for which separate statements are currently presented. This reporting format would provide financial statement users with the information necessary to assess the contribution of each element of investment activity. Commentators are requested to specifically address the appropriateness of substituting a statement of operations for the separate statements currently required, as well as the propriety of including both realized and unrealized gains and losses in the determination of net income.

### Statement of Net Assets

Because of the significance of the investment portfolio and the amount of net assets, both in total and on a per-share basis, to investors and shareholders, management investment companies often substitute a statement of net assets for the conventional balance sheet. The proposed rules would prescribe a reporting format for the presentation of a statement of net assets and establish criteria for its use. Since the major asset of any management investment company is its investment portfolio, the statement of net assets is comprised basically of a detailed listing of its securities portfolio similar to the schedule requirements for investment companies prescribed in Regulation S-X (§ 210.12-12). All other assets and total liabilities are netted for presentation in the statement, and a balance captioned as net assets is presented, together with the number of outstanding shares and value per share.

Since the statement of net assets is fully informative only in situations in which an investment company's securities portfolio represents virtually all of its net assets, the proposed rules would establish conditions to restrict the use of this statement to these circumstances. These proposed conditions are (1) that the amount of investment in securities (excluding investments in affiliated issuers) represent at least 95 percent of total assets, (2) that liabilities not be significant (defined as not exceeding 5 percent of total assets), and (3) that only one class of equity securities be outstanding. In addition, investment companies would not be permitted to use a statement of net assets if at the balance sheet date there are outstanding balances with related parties representing other than amounts arising from the conduct of regular investment advisory or management services or they have balances in respect to securities transactions involving short sales, open option contracts, or deposits on securities loaned. Where an investment company has unsettled balances of such nature, the Commission believes that the statement of net assets does not provide adequate disclosure, and that, in such circumstances, disclosure provided by a more conventional balance sheet and related footnotes is appropriate. Commentators are encouraged to specifically address the appropriateness of the criteria proposed by the Commission for the use of the statement of net assets.

### Valuation of Assets

Under the existing rules, closed-end management investment companies are permitted to state all assets at either cost or market. In recognition of the significance of asset value to management investment companies, virtually all closed-end companies currently reflect their investment securities at value. The proposed rules would eliminate the option of cost or value and require that closed-end companies state investments in securities at value consistent with current industry practice.

Section 28(b) of the Investment Company Act of 1940 requires investment companies which issue face-amount certificates to value their "qualified assets" in accordance with certain provisions of the Code of the District of Columbia. Unlike management investment companies whose assets are largely comprised of investments in marketable securities, issuers of face-amount certificates often hold more diverse investments, such as real estate. Issuers of face-amount certificates will continue to value all investment pursuant to the statutory requirements.

### Other Proposed Changes

The Commission has often been urged to reexamine its existing requirements for the content of the statement of changes in net assets presented by management investment companies. In the view of some, the statement is overly detailed and results in confusion to its users. The proposed rules are intended to simplify the content of this statement by eliminating the presentation of certain information already reported in other statements and by restricting the presentation of other information to supplemental, or footnote, status. For example, net gain or loss on investments as reflected in



the statement of operations would be presented in the statement of changes in net assets rather than showing separate captions for the net realized and unrealized components. In addition, changes in net assets resulting from capital share transactions would be presented net on the face of the statement, with details as to sales and redemptions shown in a footnote.

The proposed rules would also eliminate existing requirements for statements of surplus and sources of net assets. Requirements for a statement of surplus would be eliminated since general requirements for its content are already provided in Article 11 of Regulation S-X.<sup>4</sup> The statement of sources of net assets would also be deleted since this statement is not generally presented in practice and much of the information is already provided under other provisions of Article 6.

Under the proposed rules, the nature of the items to be presented as cash on the balance sheets (or statements of assets and liabilities) of registered investment companies would be restricted to cash on hand and demand deposits. This proposed treatment would differ from the reporting practices in other industries in which time and similar deposits may be included as cash items. The Commission believes that a different presentation is appropriate due to the unique nature of an investment company's operations, in which the investment of discretionary funds in time and similar deposits is considered to be an element of investment activity. Specific comments are encouraged on the distinction afforded to the balance sheet presentation of cash for registered investment companies.

The existing rules include specific instructions as to the appropriate method of accounting for certain transactions, such as those involving dividends and interest on investments. For example, the existing rules specify the conditions under which dividends in arrears on preferred stock or interest received on bonds in default may be recognized as income. Since the method of accounting for these transactions is set forth under GAAP, these specific instructions have been deleted from the proposed rules.

## Schedules

In a July 1981 release the Commission eliminated the requirements to disclose cost of individual securities in prospectuses and annual reports of management investment companies.<sup>5</sup> In order to conform to this action, the proposed rules would amend certain schedule requirements to eliminate disclosure of the cost of individual securities. However, much of the schedule information required under the existing rules has been carried forward under the proposed rules for purposes of evoking commentator response. Since a major objective of the Commission's reexamination of its requirements for financial statements is to ease reporting burdens in general while providing for meaningful information where necessary, the Commission solicits the views of both preparers and users of schedule information as to the usefulness of the proposed schedule requirements. Commentators are specifically encouraged to address the appropriateness of any of the existing and proposed schedule requirements, evaluating the cost burden of preparing the detailed information in relation to the usefulness of the information presented.

Detailed schedules required to be filed for registered investment companies and for which specific comment is encouraged include the following:

For Management Investment Companies

210.12-12 Investment in Securities of Unaffiliated Issuers

210.12-13 Investment—Other Than Securities

210.12-14 Investments in Affiliates for Unit Investment Trusts, and for Those Unincorporated Management Investment Companies Which Are Issuers of Periodic Payment Plan Certificates

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<sup>4</sup> Under Securities Act Release No. 6350, "Instructions for the Presentation and Preparation of Pro Forma Financial Information and Financial Statements of Companies Acquired or to be Acquired," the content of existing Article 11 was proposed to be relocated, with certain minor modifications, to a new Rule 3-04 ( § 210.3-04).

<sup>5</sup> Accounting Series Release No. 294, "Standardization of Financial Statement Requirements in Management Investment Company Registration Statements and Reports to Shareholders", (46 FR 36120).

210.12-19 Investments in Securities

210.12-20 Trust Shares

For Face-Amount Certificate Investment Companies

210.12-21 Investments in Securities of Unaffiliated Issuers

210.12-22 Investments in and Advances to Affiliates and Income Thereon

210.12-23 Mortgage Loans on Real Estate and Interest Earned on Mortgages

210.12-24 Real Estate Owned and Rental Income

210.12-25 Supplementary Profit and Loss Information

210.12-26 Certificate Reserves

210.12-27 Qualified Assets on Deposit

### **FASB Extraction Project**

Much of the authoritative literature concerning investment companies is provided in the industry audit guide, “Audits of Investment Companies,” issued by the American Institute of Certified Public Accountants (“AICPA”). This audit guide was issued in 1973 and generally has been adhered to in practice. In order to recognize subsequent changes in the industry, however, the investment company guide is scheduled for revision by the AICPA during the early part of 1982.

In 1979, the Financial Accounting Standards Board (“FASB”) announced its project to extract the specialized accounting and reporting principles and practices from the AICPA Guides and Statements of Position.<sup>6</sup> The audit guide for investment companies will be included as part of this project. Presently, the principles and practices embodied in the AICPA guides are considered preferable accounting, but are not enforceable standards to be adhered to under Rule 2-03 of the AICPA’s Code of Professional Ethics.<sup>7</sup> Should the extraction project be completed prior to the adoption of final Commission rules, duplicative Commission rules will be deleted.

### **Stock Purchase, Savings and Similar Plans**

#### **Plans Affected**

A portion of Article 6 of Regulation S-X ( § 210.6-30 through § 210.6-34) applies to employee stock purchase savings and similar plans, interests in which constitute securities which are required to be registered with this Commission.<sup>8</sup> Such plans may include, among others, those referred to as stock purchase, savings, option, bonus, appreciation, profit-sharing, thrift, incentive and certain pension plans.

#### **Valuation of Assets**

Under the existing rules, these employee plans are permitted to reflect assets in statements of financial condition at either cost or market. It appears inappropriate to permit assets which are held by these plans to be reported on a basis different from that used to derive amounts which may be realized by the participating employees at a given point in time. The proposed rules would require that these plans reflect their investment assets at a value which (1) with respect to securities for which market quotations are readily available is market value and (ii) with respect to other securities

<sup>6</sup> Statement of Financial Accounting Standards No. 32, “Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters” (September, 1979).

<sup>7</sup> As a result, accountants are not presently required to justify departure from financial accounting and reporting practices sanctioned by an AICPA guide or Statement of Position.

<sup>8</sup> Releases 33-6188 and 33-6281 dated February 1, 1980 and January 15, 1981 discuss application of the Securities Act of 1933 to employee benefit plans.

and assets is fair value as determined in good faith by the trustee(s) (or the person or persons who exercise similar responsibilities) for the plan.

Rule 6-31.4 (§ 210.6-31.4) already requires plans which value investments at cost to disclose the market value of each type of investment. Therefore, it appears that there should be little or no incremental cost involved in reporting such investments at market. Since the Commission is concerned with the cost burden associated with its rules, specific comments are invited as to the circumstances, if any, under which the incremental costs of reporting these assets at market or fair value would be other than insubstantial.

## Other Matters

Adoption of the amended rules proposed in this release would impact the references to specific provisions of Article 6, including provisions for financial statements, contained in other Articles of Regulation S-X. Appropriate changes to these references will be made in any final rules resulting from this proposal.

## Text of Proposed Rules

Part 210 of 17 CFR Chapter II is proposed to be amended as follows:

### **Part 210—Form and Content of and Requirements for Financial Statements, Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Investment Company Act of 1940, and Energy Policy and Conservation Act of 1975.**

1. By removing §§ 210.6-01 to 210.6-24 and adding new §§ 210.6-01 to 210.6-10 as follows:

#### **Registered Investment Companies**

§ 210.6-01 Application to §§ 210.6-01 to 210.6-10.

(a) Sections 210.6-01 to 210.6-10 shall be applicable to financial statements filed for registered investment companies.

§ 210.6-02 Definition of certain terms.

The following terms shall have the meaning indicated in this rule unless the context otherwise requires. (Also see §210.1-02 of this part.)

(a) Affiliate. The term “affiliate” means an “affiliated person” as defined in section 2(a)(3) of the Investment Company Act of 1940 unless otherwise indicated. The term “control” has the meaning in section 2(a)(9) of that Act.

(b) Value. As used in § 210.6-01 to 210.6-10, the term “value” shall have the meaning given in section 2(a)(41)(B) of the Investment Company Act of 1940.

(c) Balance Sheets; statements of net assets. As used in §§ 210.6-01 to 210.6-10, the term “balance sheets” shall include statements of assets and liabilities as well as statements of net assets unless the context clearly indicates the contrary.

(d) Qualified assets. (1) For companies issuing face-amount certificates subsequent to December 31, 1940 under the provisions of Section 28 of the Investment Company Act of 1940, the term “qualified assets” means qualified investments as that term is defined in Section 28(b) of the Act. A statement to that effect shall be made in the balance sheet.

(2) For other companies, the term “qualified assets” means cash and investments which such companies do maintain or are required, by applicable governing legal instruments, to maintain in respect of outstanding face-amount certificates.

(3) Loans to security holders may be included as qualified assets in an amount not in excess of certificate reserves carried on the books of account in respect of each individual certificate upon which the loans were made.

§ 210.6-03 Special rules of general application to registered investment companies.

The financial statements filed for persons to which §§ 210.6-01 to 210.6-10 are applicable shall be prepared in accordance with the following special rules in addition to the general rules in §§ 210.1-01 to 210.4-10 (Articles 1, 2, 3, and 4). Where the requirements of a special rule differ from those prescribed in a general rule, the requirements of the special rule shall be met.

(a) Content of financial statements. The financial statements shall be prepared in accordance with the requirements of this part (Regulation S-X) notwithstanding any provision of the articles of incorporation, trust indenture or other governing legal instruments specifying certain accounting procedures inconsistent with those required in §§ 210.6-01 to 210.6-10.

(b) Audited financial statements. Where, under Article 3 of this part, financial statements are required to be certified, the independent accountant shall have been selected and ratified in accordance with section 32 of the Investment Company Act of 1940, *54 Stat. 838 15 U.S.C. 1140*, and the applicable rules thereunder.

(c) Consolidated and combined statements.

(1) Consolidated and combined statements filed for registered investment companies shall be prepared in accordance with §§ 210.3A-01 to 210.3A-05 (Article 3A) except that (i) statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies; (ii) a consolidated statement of the registrant and any of its investment company subsidiaries shall not be filed unless accompanied by a consolidating statement which sets forth the individual statements of each significant subsidiary included in the consolidated statement: Provided, however, That a consolidating statement need not be filed if all included subsidiaries are totally held; and (iii) consolidated or combined statements filed for subsidiaries not consolidated with the registrant shall not include any investment companies unless accompanied by consolidating or combining statements which set forth the individual statements of each included investment company which is a significant subsidiary.

(2) If consolidating or combining statements are filed, the amounts included under each caption in which financial data pertaining to affiliates is required to be furnished shall be subdivided to show separately the amounts (i) eliminated in consolidation and (ii) not eliminated in consolidation.

(d) Valuation of assets. The balance sheets of registered investment companies, other than issuers of face-amount certificates, shall reflect all investments at value, with the aggregate cost of each class of investment reported under §§ 210.6-04.1, 6-04.2 and 6-04.3 and of the total investments reported under § 210.6-04.4 or § 210.6-05(b)(1) shown parenthetically. As required by Section 28(b) of the Investment Company Act of 1940, “qualified” assets of face-amount certificate companies shall be valued in accordance with certain provisions of the Code of the District of Columbia. For guidance as to valuation of securities, see Accounting Series Release Nos. 113, 116, 118 and 219.

(e) Qualified assets. State in a note the nature of any investments and other assets maintained or required to be maintained, by applicable legal instruments, in respect of outstanding face-amount certificates. If the nature of the qualifying assets and amount thereof are not subject to the provisions of section 28 of the Investment Company Act of 1940, a statement to that effect shall be made.

(f) Restricted securities. State in a note the following information as to investment securities which cannot be offered for public sale without first being registered under the Securities Act of 1933 (restricted securities):

(1) The policy of the person with regard to acquisition of restricted securities.

(2) The policy of the person with regard to valuation of restricted securities. Specific comments shall be given as to the valuation of an investment in one or more issues of securities of a company or group of affiliated companies if any part of such investment is restricted and the aggregate value of the investment in all issues of such company or affiliated group exceeds five percent of the value of total assets. (As used in this paragraph, the term “affiliated” shall have the meaning given in § 210.6-02(a) of this part.)

(3) A description of the person’s rights with regard to demanding registration of any restricted securities held at the date of the latest balance sheet.

(g) Income recognition. Dividends shall be included in income on the ex-dividend date; interest shall be accrued on a daily basis. Neither dividends nor interest shall be included unless payment is reasonably assured by past experience, guaranty or otherwise. Dividends declared on short positions existing on the record date shall be recorded on the ex-dividend date and included as an expense of the period.

(h) Federal income taxes. Appropriate provision shall be made on the basis of the applicable tax laws, for Federal income taxes that it is reasonably believed are, or will become, payable in respect of (1) investment income, (2) realized gain on investments and (3) unrealized appreciation on investments. The company's status as a "regulated investment company" as defined in Subtitle A, Chapter 1, Subchapter M of the Internal Revenue Code, as amended, shall be stated in a note referred to in the appropriate statements. Such note shall also indicate briefly the principal assumptions on which the company relied in making or not making provisions for income taxes. However, a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with section 852(b)(3)(D) of the Internal Revenue Code shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains realized during such year.

(i) Issuance and repurchase by a registered investment company of its own securities. In a footnote or separate statement referred to in the balance sheet, show for each class of the company's securities:

(1) The number of shares, units, or principal amount of bonds sold during the period of report, the amount received therefor, and, in the case of shares sold by closed-end management investment companies, the difference, if any, between the amount received and the net asset value or preference in involuntary liquidation (whichever is appropriate) of securities of the same class prior to such sale; and

(2) The number of shares, units, or principal amount of bonds repurchased during the period of report and the total or average cost thereof. Closed-end management investment companies shall furnish the following additional information as to securities repurchased during the period of report:

(i) As to bonds and preferred shares, the aggregate difference between cost and the face amount or preference in involuntary liquidation and, if applicable net assets taken at value as of the date of repurchase were less than such face amount or preference, the aggregate difference between cost and such net asset value;

(ii) As to common shares, the weighted average discount per share, expressed as a percentage, between cost of repurchase and the net asset value applicable to such shares at the date of repurchases. The information required by paragraph (i)(2)

(i) and (ii) may be based on reasonable estimates if it is impracticable to determine the exact amounts involved.

(j) Series companies. A person which in essence is comprised of more than one separate investment company shall include the information required by this part (Regulation S-X) on a comparative basis, except as to footnotes which need not be comparative.

(k) Certificate reserves. (1) For companies issuing face-amount certificates subsequent to December 31, 1940 under the provisions of Section 28 of the Investment Company Act of 1940, balance sheets shall reflect reserves for outstanding certificates computed in accordance with the provisions of Section 28(a) of the Act.

(2) For other companies, balance sheets shall reflect reserves for outstanding certificates determined as follows:

(i) For certificates of the installment type, such amount which, together with the lesser of future payments by certificate holders as and when accumulated at a rate not to exceed  $3\frac{1}{2}$  per centum per annum (or such other rate as may be appropriate under the circumstances of a particular case) compounded annually, shall provide the minimum maturity or face amount of the certificate when due.

(ii) For certificates of the fully-paid type, such amount which, as and when accumulated at a rate not to exceed  $3\frac{1}{2}$  per centum per annum (or such other rate as may be appropriate under the circumstances of a particular case) compounded annually, shall provide the amount or amounts payable when due.

(iii) Such amount or accrual therefor, as shall have been credited to the account of any certificate holder in the form of any credit, or any dividend, or any interest in addition to the minimum maturity or face amount specified in the

certificate, plus any accumulations on any amount so credited or accrued at rates required under the terms of the certificate.

(iv) An amount equal to all advance payments made by certificate holders, plus any accumulations thereon at rates required under the terms of the certificate.

(v) Amounts for other appropriate contingency reserves, for death and disability benefits or for reinstatement rights on any certificate providing for such benefits or rights.

(1) Inapplicable captions. Attention is directed to the provisions of § 210.4-03 which permit the omission of separate captions in financial statements as to which the items and conditions are not present, or the amounts involved not significant. However, amounts involving directors, officers, and affiliates shall nevertheless be separately set forth except as otherwise specifically permitted under a particular caption.

#### § 210.6-04 Balance Sheets.

This rule is applicable to balance sheets filed by registered investment companies except for persons who substitute a statement of net assets in accordance with the requirements specified in § 210.6-05(a), and issuers of face-amount certificates which are subject to the special provisions of § 210.6-06 of this part. Balance sheets filed under this rule shall comply with the following provisions:

#### **Assets**

1. Investments in securities of unaffiliated issuers. State in a note to the financial statements the amount of the aggregate gross unrealized appreciation for all securities in which there is an excess of value over cost and the aggregate gross unrealized depreciation for all securities in which there is an excess of cost over value.
2. Investments in and advances to affiliates. State separately investments in and advances to (a) controlled companies and (b) other affiliates.
3. Investments—other than securities. State separately each major class.
4. Total investments.
5. Cash. Include under this caption cash on hand and demand deposits. Provide in a note to the financial statements the information required under § 210.5-02.1 regarding restrictions and compensating balances.
6. Accounts and notes receivable. State separately amounts receivable from (a) sales of investments; (b) subscriptions to capital shares; (c) dividends and interest; (d) directors and officers; and (e) others, showing any other category of receivables which is in excess of five percent of total assets.
7. Deposits for securities sold short and open option contracts. State separately amounts held by brokers and custodians in connection with (a) short sales and (b) open option contracts.
8. Other assets. State separately (a) prepaid and deferred expenses; (b) pension and other special funds; (c) organization expenses; and (d) any other item not properly classified in another asset caption the amount of which is in excess of five percent of total assets.
9. Total assets.

#### **Liabilities**

10. Accounts payable and accrued liabilities. State separately amounts payable for (a) securities sold short; (b) open option contracts written; (c) other purchases of securities; (d) capital shares redeemed; (e) dividends or other distributions on capital shares; and (f) others. State separately the amount of any other liabilities which is in excess of five percent of total liabilities. Securities sold short and open option contracts written shall be stated at the market value of the related security.



11. Deposits for securities loaned. State the market value of securities loaned and indicate the nature of the collateral held as security for the loan.

12. Other liabilities. State separately (a) amounts payable for investment advisory, management and service fees; and (b) the total amount payable to (1) officers and directors; (2) controlled companies; and (3) other affiliates, excluding any amounts owing to non controlled affiliates which arose in the ordinary course of business and which are subject to usual trade terms.

13. Notes payable, bonds and similar debt. (a) State separately amounts payable to (1) banks or other financial institutions for borrowings; (2) controlled companies; (3) other affiliates; and (4) others, showing for each category amounts payable within one year and amounts payable after one year.

(b) Provide in a note the information required under § 210.5-02.19(b) regarding unused lines of credit for short-term financing and §§ 210.5-02.22(a) and (b) regarding unused commitments for long-term financing arrangements.

14. Total liabilities.

15. Commitments and contingent liabilities.

### **Net Assets**

16. Units of capital. (a) State on the face of the balance sheet, or if voluminous in a note, the title of each class of capital shares or other capital units, the number authorized, the number outstanding, and the dollar amount thereof.

(b) Unit investment trusts, including those which are issuers of periodic payment plan certificates, also shall state in a note to the financial statements (a) the total cost to the investors of each class of units or shares; (b) the adjustment for market depreciation or appreciation; (c) other deductions from the total cost to the investors for fees, loads and other charges, including an explanation of such deductions; and (d) the net amount applicable to the investors.

17. Accumulated undistributed income (loss). State on the face of the balance sheet (a) the accumulated undistributed investment income-net, (b) accumulated undistributed net realized gains (losses) on investment transactions, and (c) net unrealized appreciation (depreciation) in value of investments at the balance sheet date.

18. Other elements of capital. State separately any other elements of capital or residual interests appropriate to the capital structure of the reporting entity.

19. Net assets applicable to outstanding units of capital.

§ 210.6-05 Statements of net assets.

(a) Persons having only one class of equity securities outstanding may substitute a statement of net assets, as prescribed in § 210.6-05(b) below, for the balance sheet otherwise required by § 210.6-04 of this part: Provided, that

(1) There are no amounts due from or to officers, directors, controlled persons, or affiliates other than for regular investment advisory, management, and service fees covering a period of less than 60 days prior to the end of the latest period.

(2) At the close of the latest period, there were no amounts, conditions, or transactions related to (i) securities sold short, (ii) open option contracts written, (iii) deposits for securities loaned, or (iv) agreements to repurchase portfolio securities.

(3) Neither the total of all assets other than investments in securities of unaffiliated issuers nor the total of all liabilities exceeds five percent of the amount of total assets.

(b) Statements of net assets filed for persons meeting the requirements under § 210.6-05(a) shall consist of the following:

(1) A schedule of investments in securities of unaffiliated issuers as prescribed in §§ 210.12-12 or 210.12-19, as appropriate.

- (2) The excess (or deficiency) of other assets over (under) total liabilities stated in one amount.
- (3) The balance of the amounts captioned as net assets. The number of outstanding shares and net asset value per share shall be shown parenthetically.
- (4) The information required by (i) § 210.6-04.16, (ii) § 210.6-04.17 and (iii) § 210.6-04.18 shall be furnished in a note to the financial statements.

§ 210.6-06 Special provisions applicable to the balance sheets of issuers of face-amount certificates.

Balance sheets filed by issuers of face-amount certificates shall comply with the following provisions:

#### **Assets**

1. Investments. State separately each major class: such as, real estate owned, first mortgage loans on real estate, other mortgage loans on real estate, investments in securities of unaffiliated issuers, and investments in and advances to affiliates.
2. Cash. Include under this caption cash on hand and demand deposits. Provide in a note to the financial statements the information required under § 210.5-02.1 regarding restrictions and compensating balances.
3. Accounts and notes receivable. State separately amounts receivable from (a) sales of investments; (b) dividends and interest; (c) directors and officers; and (d) others, showing any other category of receivables which is in excess of five percent of total assets.
4. Total qualified assets. State in a note to the financial statements the amount of qualified assets on deposit classified as to general classes of assets and as to general types of depositories, such as banks and states, together with a statement as to the purpose of the deposits.
5. Other assets. State separately (a) investments in securities of unaffiliated issuers not included in qualifying assets in item 1 above; (b) investments in and advances to affiliates not included in qualifying assets in item 1 above; and (c) any other item not properly classified in another asset caption the amount of which is in excess of five percent of total assets.
6. Total assets.

#### **Liabilities**

7. Certificate reserves. Issuers of face-amount certificates shall state separately reserves for (a) certificates of the installment type; (b) certificates of the fully-paid type; (c) advance payments; (d) additional amounts accrued for or credited to the account of certificate holders in the form of any credit, dividend, or interest in addition to the minimum amount specified in the certificate; and (e) other certificate reserves. State in an appropriate manner the basis used in determining the reserves, including the rates of interest of accumulation.
8. Notes payable, bonds and similar debt. (a) State separately amounts payable to (1) banks or other financial institutions for borrowings; (2) controlled companies; (3) other affiliates; and (4) others, showing for each category amounts payable within one year and amounts payable after one year.  
  
(b) Provide in a note the information required under § 210.5-02.19(b) regarding unused lines of credit for short-term financing and §§ 210.5-02.22(a) and (b) regarding unused commitments for long-term financing arrangements.
9. Accounts payable and accrued liabilities. State separately (a) amounts payable for investment advisory, management and service fees; and (b) the total amount payable to (1) officers and directors; (2) controlled companies; and (3) other affiliates, excluding any amounts owing to non controlled affiliates which arose in the ordinary course of business and which are subject to usual trade terms. State separately the amount of any other liabilities which is in excess of five percent of total liabilities.
10. Total liabilities.



11. Commitments and contingent liabilities.

**Stockholders' Equity**

12. Capital shares. State on the face of the balance sheet, or if voluminous in note, the title of each class of capital shares or other capital units, the number authorized, the number outstanding and the dollar amount thereof. Show also the dollar amount of any capital shares subscribed but unissued, and show the deduction for subscriptions receivable therefrom.

13. Other elements of capital. (a) State separately any other elements of capital or residual interests appropriate to the capital structure of the reporting entity.

(b) A summary of each account under this caption setting forth the information prescribed in § 210.11-02 shall be given in a note or separate statement for each period in which a statement of operations is presented.

14. Total liabilities and stockholders' equity.

§ 210.6-07 Statements of operations.

Statements of operations filed by registered investment companies, other than issuers of face-amount certificates subject to the special provisions of § 210.6-08 of this part, shall comply with the following provisions:

1. Investment income. State separately income from (a) dividends; (b) interest on securities; and (c) other income. If income from investments in or indebtedness of affiliates is included hereunder, such income shall be segregated under an appropriate caption subdivided to show separately income from (1) controlled companies; and (2) other affiliates. If non-cash dividends are included in income, the bases of recognition and measurement used in respect to such amounts shall be disclosed. Any other category of income which exceeds five percent of the total shown under this caption shall be stated separately.

2. Expenses. (a) State separately the total amount of investment advisory, management and service fees, and expenses in connection with research, selection, supervision, and custody of investments. Amounts of expenses incurred from transactions with affiliated persons shall be disclosed together with the identity of and related amount applicable to each such person accounting for five percent or more of the total expenses shown under this caption together with a description of the nature of the affiliation. Expenses incurred within the person's own organization in connection with research, selection and supervision of investments shall be stated separately. Reductions or reimbursements of management or service fees shall be shown as a negative amount or as a reduction of total expenses shown under this caption.

(b) State separately any other expense item the amount of which exceeds five percent of the total expenses shown under this caption.

(c) A note to the financial statements shall include information concerning management and service fees, the rate of fee, and the base and method of computation. State separately the amount and a description of any fee reductions or reimbursements representing (1) expense limitation agreements or commitments; and (2) offsets received from broker-dealers showing separately for each amount received or due from (i) unaffiliated persons; and (ii) affiliated persons. If no management or service fees were incurred for a period, state the reason therefor.

(d) A note to the financial statements shall describe the basis and method of compensating directors and other persons included in the definition in section 2(a)(12) of the Investment Company Act of 1940.

(e) If any expenses were paid otherwise than in cash, state the details in a note.

(f) State in a note to the financial statements the amount of brokerage commissions (including dealer markups) paid to affiliated broker-dealers in connection with purchase and sale of investment securities. Open-end management companies shall state in a note the gross amount of sales charges deducted from the proceeds of sale of capital shares by the principal underwriter and the net amounts retained by any affiliated principal underwriter or other affiliated broker-dealer.

3. Interest and amortization of debt discount and expense.
4. Investment income before income tax expense.
5. Income tax expense. State separately (a) Federal income taxes and (b) other taxes on income applicable to investment income, distinguishing taxes payable currently from deferred income taxes.
6. Investment income-net.
7. Realized and unrealized gain (loss) on investments.
  - (a) State separately the net realized gain or loss on transactions in (1) investment securities of unaffiliated issuers, (2) investment securities of affiliated issuers, and (3) investments other than securities.
  - (b) Distributions of realized gains by other investment companies shall be shown separately under this caption.
  - (c) State separately (1) the gain or loss from expiration or closing of option contracts written, (2) the gain or loss on closed short positions in securities, and (3) other realized gain or loss. Disclose in a note to the financial statements the number and associated dollar amounts as to option contracts written: (a) at the beginning of the period; (b) during the period; (c) expired during the period; (d) closed during the period; (e) exercised during the period; (f) balance at end of the period.
  - (d) State separately the amount of the net increase or decrease during the period in the unrealized appreciation or depreciation in the value of investment securities and other investments held at the end of the period.
  - (e) State separately and (1) Federal income taxes and (2) other income taxes applicable to realized and unrealized gain (loss) on investments, distinguishing taxes payable currently from deferred income taxes.
8. Net gain (loss) on investments.
9. Net income (loss).

§ 210.6-08 Special provisions applicable to the statements of operations of issuers of face-amount certificates.

Statements of operations filed by issuers of face-amount certificates shall comply with the following provisions:

1. Investment income. State separately income from (a) interest on mortgages; (b) interest on securities; (c) dividends; (d) rental income; and (e) other investment income. If income from investments in or indebtedness of affiliates is included hereunder, such income shall be segregated under an appropriate caption subdivided to show separately income from (1) controlled companies; and (2) other affiliates. If non-cash dividends are included in income, the bases of recognition and measurement used in respect to such amounts shall be disclosed. Any other category of income which exceeds five percent of the total shown under this caption shall be stated separately.
2. Investment expenses. (a) State separately the total amount of investment advisory, management and service fees, and expenses in connection with research, selection, supervision, and custody of investments. Amounts of expenses incurred from transactions with affiliated persons shall be disclosed together with the identity of and related amount applicable to each such person accounting for five percent or more of the total expenses shown under this caption together with a description of the nature of the affiliation. Expenses incurred within the person's own organization in connection with research, selection and supervision of investments shall be stated separately. Reductions or reimbursements of management or service fees shall be shown as a negative amount or as a reduction of total expenses shown under this caption.
  - (b) State separately any other expense item the amount of which exceeds five percent of the total expenses shown under this caption.
  - (c) A note to the financial statements shall include information concerning management and service fees, the rate of fee, and the base and method of computation. State separately the amount and a description of any fee reductions or

reimbursements representing (1) expense limitation agreements or commitments; and (2) offsets received from broker-dealers showing separately for each amount received or due from (i) unaffiliated persons; and (ii) affiliated persons. If no management or service fees were incurred for a period, state the reason therefor.

(d) A note to the financial statements shall describe the basis and method of compensating directors and other persons included in the definition in section 2(a)(12) of the Investment Company Act of 1940.

(e) If any expenses were paid otherwise than in cash, state the details in a note.

(f) State in a note to the financial statements the amount of brokerage commissions (including dealer markups) paid to affiliated broker-dealers in connection with purchase and sale of investment securities.

3. Interest and amortization of debt discount and expense.

4. Investment income before income tax expense.

5. Income tax expense. State separately (a) Federal income taxes and (b) other taxes on income applicable to investment income, distinguishing taxes payable currently from deferred income taxes.

6. Provision for certificate reserves. State separately any provision for additional credits, or dividends, or interests, in addition to the minimum maturity or face amount specified in the certificates. State also in an appropriate manner reserve recoveries from surrenders or other causes.

7. Net investment income or loss.

8. Realized gain or loss on investments.

(a) State separately the net realized gain or loss on transactions in (1) investment securities of unaffiliated issuers, (2) investment securities of affiliated issuers, and (3) other investments.

(b) Distributions of capital gains by other investment companies shall be shown separately under this caption.

(c) State separately any (1) Federal income taxes and (2) other income taxes applicable to realized gain (loss) on investments, distinguishing taxes payable currently from deferred income taxes.

9. Net income or loss.

#### § 210.6-09 Statements of changes in net assets.

Statements of changes in net assets filed for persons to whom this article is applicable shall comply with the following provisions:

1. From investment activities. State separately (a) investment income-net as shown by § 210.6-07.6; (b) distributions from investment income-net; (c) balance; (d) net gain (loss) on investments as shown by § 210.6-07.8; (e) distributions from net gain on investments; and (f) balance.

2. Net equalization charges and credits. State the net amount of accrued undivided earnings separately identified in the price of capital shares issued and repurchased.

3. Increase or decrease in accumulated net income.

4. From capital share transactions. (a) State the increase or decrease in net assets derived from the net change in the number of outstanding shares or units. The number of shares or units representing the net change shall be disclosed.

(b) Disclose in a note to the financial statements for each class of the person's shares the value of shares issued in reinvestment of dividends and distributions of net gains on investments.

5. Net assets at the beginning of the period.

6. Net assets at the end of the period.

§ 210.6-10 What schedules are to be filed.

(a) When information is required in schedules for both the person and the person and its subsidiaries consolidated, it may be presented in the form of a single schedule, provided that items pertaining to the registrant are separately shown and that such single schedule affords a properly summarized presentation of the facts. If the information required by any schedule (including the notes thereto) is shown in the related financial statement or in a note thereto without making such statement unclear or confusing, that procedure may be followed and the schedule omitted.

(b) The schedules shall be examined by an independent accountant if the related financial statements are so examined.

(c) Management investment companies. Except as otherwise provided in the applicable form:

(1) The schedules specified below in this rule shall be filed for management investment companies as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

Schedule I—Investments in securities of unaffiliated issuers. The schedule prescribed by § 210.12-12 shall be filed in support of caption 1 of each balance sheet.

Schedule II—Investments—other than securities. The schedule prescribed by § 210.12-13 shall be filed in support of caption 3 of each balance sheet. This schedule may be omitted if the investments, other than securities, at both the beginning and end of the period amount to less than one percent of the value of total investments ( § 210.6-04.4).

Schedule III—Investments in and advances to affiliates. The schedule prescribed by § 210.12-14 shall be filed in support of caption 2 of each balance sheet.

Schedule IV—Amounts due from directors and officers. The schedule prescribed by § 210.12-03 shall be filed with respect to each person among the directors and officers from whom any amount was owed at any time during the period for which related statements of changes in net assets are required to be filed.

Schedule V—Investments—securities sold short. The schedule prescribed by § 210.12-12A shall be filed in support of caption 10(a) of each balance sheet.

Schedule VI—Open option contracts written. The schedule prescribed by § 210.12-12B shall be filed in support of caption 10(b) of each balance sheet.

Schedule VII—Short-term borrowings. The schedule prescribed by § 210.12-10 shall be filed in support of any amounts included in caption 13 of each balance sheet, which are payable within one year to banks for borrowings; factors and other financial institutions for borrowings; and holders of any short-term notes.

(d) Unit investment trusts. Except as otherwise provided in the applicable form:

(1) Schedules I, II, and IV, specified below in this section, shall be filed for unit investment trusts as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

(2) Schedules III and V, specified below in this section, shall be filed for unit investment trusts for each period for which a statement of operations is required to be filed for each person or group.

Schedule I—Investment in securities. The schedule prescribed by § 210.12-19 shall be filed in support of caption 1 of each balance sheet ( § 210.6-04) or caption (b)(1) of each statement of net assets ( § 210.6-05), as appropriate, and of captions 1(a), and 1(b), and 7(b) of each statement of operations.

Schedule II—Trust shares. The schedule prescribed by § 210.12-20 shall be filed in support of caption 16 of each balance sheet ( § 210.6-04) or caption 4(i) of each statement of net assets (210.6-05).

Schedule III—Gain or loss from transactions in trust property. A schedule shall be filed showing for each investment set forth in Schedule I in which there were any sales or redemptions during the period: (a) the aggregate amount received from sale; (b) the aggregate cost of the investment sold; and (c) the realized gain or loss thereon.

Schedule IV—Allocation of trust assets to series of trust shares. If the trust assets are specifically allocated to different series of trust shares, and if such allocation is not shown in the balance sheet in columnar form or by the filing of separate statements for each series of trust shares, a schedule shall be filed showing the amount of trust assets, indicated by each balance sheet condition filed, which is applicable to each series of trust shares.

Schedule V—Allocation of trust income and distributable funds to series of trust shares. If the trust income and distributable funds are specifically allocated to different series of trust shares and if such allocation is not shown in the statement of income and distributable funds in columnar form or by the filing of separate statements for each series of trust shares, a schedule shall be submitted showing the amount of income and distributable funds, indicated by each statement of operations filed, which is applicable to each series of trust shares.

(e) Face-amount certificate investment companies.

Except as otherwise provided in the applicable form:

(1) Schedules I, V and X, specified below, shall be filed for face-amount certificate investment companies as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

(2) All other schedules specified below in this section shall be filed for face-amount certificate investment companies for each period for which a statement of operations is filed, except as indicated for Schedules III and IV.

Schedule I—Investment in securities of unaffiliated issuers. The schedule prescribed by § 210.12-21 shall be filed in support of caption 1 and, if applicable, caption 5(a) of each balance sheet. Separate schedules shall be furnished in support of each caption, if applicable.

Schedule II—Investments in and advances to affiliates and income thereon. The schedule prescribed by § 210.12-22 shall be filed in support of captions 1 and 5(b) of each balance sheet and caption 1 of each statement of operations. Separate schedules shall be furnished in support of each caption, if applicable.

Schedule III—Mortgage loans on real estate and interest earned on mortgages. The schedule prescribed by § 210.12-23 shall be filed in support of captions 1 and 5(c) of each balance sheet and caption 1 of each statement of operations, except that only the information required by column G and note 8 of the schedule need be furnished in support of statements of operations for years for which related balance sheets are not required.

Schedule IV—Real estate owned and rental income. The schedule prescribed by § 210.12-24 shall be filed in support of captions 1 and 5(a) of each balance sheet and caption 1 of each statement of operations for rental income included therein, except that only the information required by columns H, I and J, and item “Rent from properties sold during the period” and note 4 of the schedule need be furnished in support of statements of operations for years for which related balance sheets are not required.

Schedule V—Qualified assets on deposit. The schedule prescribed by § 210.12-27 shall be filed in support of the information required by caption 4 of § 210.6-06 as to total amount of qualified assets on deposit.

Schedule VI—Amounts due from officers and directors. The schedule prescribed by § 210.12-03 shall be filed with respect to each director, officer, or employee from whom any amount was owed at any time during the period for which related statements of operation are filed. State if an exemption has been granted by the Commission with respect to amounts included in this schedule.

Schedule VII—Short-term borrowings. The schedule prescribed by § 210.12-10 shall be filed in support of any amounts included in caption 8 of each balance sheet which are payable within one year to banks for borrowings; factors and other financial institutions for borrowings; and holders of any short-term notes.

Schedule VIII—Indebtedness to affiliates—not current. The schedule prescribed by § 210.12-05 shall be filed in support of any amounts included in caption 9 of each balance sheet. This schedule and Schedule II may be combined if desired.

Schedule IX—Supplementary profit and loss information. The schedule prescribed by § 210.12-25 shall be filed in support of each statement of operations.

Schedule X—Guarantees of securities of other issuers. The schedule prescribed by § 210.12-08 shall be filed with respect to any guarantees of securities of other issuers by the person for which the statement is filed.

Schedule XI—Certificate reserves. The schedule prescribed by § 210.12-26 shall be filed in support of caption 7 of each balance sheet.

Schedule XII—Valuation and qualifying accounts. The schedule prescribed by § 210.12-09 shall be filed in support of all other reserves including in the balance sheet.

2. By removing § 210.6-30 and adding a new § 210.6A-01 as follows:

**Employee Stock Purchase, Savings and Similar Plans**

§§ 210.6A-01 Application of §§ 210.6A-01 to 210.6A-05.

(a) §§ 210.6A-01 to 210.6A-05 shall be applicable to financial statements filed for employee stock purchase, savings and similar plans.

3. By removing § 210.6-31 and adding a new § 210.6A-02 as follows:

§ 210.6A-02 Special rules applicable to employee stock purchase, savings and similar plans.

The financial statements filed for persons to which this article is applicable shall be prepared in accordance with the following special rules in addition to the general rules in §§ 210.1-01 to 210.4-10. Where the requirements of a special rule differ from those prescribed in a general rule, the requirements of the special rule shall be met.

(a) Investment programs. If the participating employees have an option as to the manner in which their deposits and contributions may be invested, a description of each investment program shall be given in a footnote or otherwise. The number of employees under each investment program shall be stated.

(b) Net asset value per unit. Where appropriate, the number of units and the net asset value per unit shall be given by footnote or otherwise.

(c) Federal income taxes. (1) Appropriate provision shall be made, on the basis of the applicable tax laws, for Federal income taxes that it is reasonably believed are, or will become, payable in respect of (i) current net income, (ii) realized net gain on investments, and (iii) unrealized appreciation on investments. If the plan is not subject to Federal income taxes, a note shall so state indicating briefly the principal assumptions on which the plan relied in not making provision for such taxes. [2] State the Federal income tax status of the employee with respect to the plan.

(d) Valuation of assets. The statement of financial condition shall reflect all investments at value, showing cost parenthetically. For purposes of this rule, the term “value” shall mean (1) market value for those securities having readily available market quotations and (2) fair value as determined in good faith by the trustee(s) for the plan (or by the person or persons who exercise similar responsibilities) with respect to other securities and assets.

4. By redesignating §§ 210.6-32, 210.6-33, and 210.6-34 as §§ 210.6A-03, 210.6A-04, and 210.6A-05, respectively.

5. By revising § 210.12-12 and adding new §§ 210.12-12A and 210.12-12B to read as follows:

§ 210.12-12 Investments in Securities of Unaffiliated Issuers.

[For management investment companies only]

Column A	Column B	Column C
Name of issuer and title of issue <sup>1,2</sup>	Balance held at close of period. Number of shares principal amount of bonds and notes <sup>5</sup>	Value of each item at close of period <sup>3,4,6,7,8</sup>

<sup>1</sup> Each issue shall be listed separately: *Provided*, however, that an amount not exceeding five percent of the total of Column C may be listed in one amount as "Miscellaneous securities," provided the securities so listed are not restricted, have been held for not more than one year prior to the date of the related balance sheet, and have not previously been reported by name to the shareholders of the person for which the statement is filed or to any exchange, or set forth in any registration statement, application, or annual report or otherwise made available to the public.

<sup>2</sup> List separately (a) common shares; (b) preferred shares; (c) bonds and notes; (d) time deposits; and (e) put and call options purchased. Within each of these subdivisions, classify in an appropriate manner according to type of business; e.g., aerospace, banking, chemicals, machinery and machine tools, petroleum, utilities, etc.; or according to type of instrument; e.g., commercial paper, bankers' acceptances, certificates of deposit. Restricted securities shall not be combined with unrestricted securities of the same issuer. Repurchase agreements shall be stated separately showing for each the name of bank or broker-dealer from whom purchased, stipulated interest rate, repurchase date and description of collateral securities. The totals for each class of investments, subdivided by business grouping or instrument type, shall be shown together with their percentage value compared to net assets ( §§ 210.6-04(19) or 210.6-05(b)(3)).

<sup>3</sup> Column C shall be totaled. The total of column C shall agree with the correlative amounts shown on the related balance sheet.

<sup>4</sup> Indicate by an appropriate symbol each issue of securities which is non-income producing. Evidences of indebtedness and preferred shares may be deemed to be income producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no cash or in kind dividends declared, the issue shall not be deemed to be income producing. Common shares shall not be deemed to be income producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares.

<sup>5</sup> Indicate by an appropriate symbol each issue of restricted securities. State the following in a footnote: (a) as to each such issue (1) acquisition date, (2) carrying value per unit of investment at date of related balance sheet, e.g., a percentage of current market value of unrestricted securities of the same issuer, etc., and (3) the cost of such securities; (b) as to each issue acquired during the year preceding the date of the related balance sheet, the carrying value per unit of investment of unrestricted securities of the same issuer at (1) the day the purchase price was agreed to and (2) the day on which an enforceable right to acquire such securities was obtained; and (c) the aggregate value of all restricted securities and the percentage which the aggregate value bears to net assets.

<sup>6</sup> Indicate by an appropriate symbol each issue of securities subject to option.

<sup>7</sup> Where value is determined on any basis other than closing prices reported on a national securities exchange, explain such other basis in a footnote.

<sup>8</sup> State in a footnote the aggregate cost for Federal tax purposes.



## § 210.12-12A Investments—Securities Sold Short.

[For management investment companies only]

Column A	Column B	Column C
Name of issuer and title of issue <sup>1</sup>	Balance short position at close of period. (Number of shares)	Value of each open short position <sup>2,3</sup>

<sup>1</sup> Each issue shall be listed separately.<sup>2</sup> Column C shall be totaled. The total of column C shall agree with the correlative amounts shown on the related balance sheet.<sup>3</sup> Where value is determined on any basis other than closing prices reported on a national securities exchange, explain such other basis in a footnote.

## § 210.12-12B Open Option Contracts Written.

[For management investment companies only]

Column A	Column B	Column C	Column D	Column E
Name of issuer <sup>1,2</sup>	Number of contracts <sup>3</sup>	Exercise price	Expiration date	Value <sup>4</sup>

<sup>1</sup> Information as to put options shall be shown separately from information as to call options.<sup>2</sup> Options of an issuer where exercise prices or expiration dates differ shall be listed separately.<sup>3</sup> If the number of shares subject to option is substituted for number of contracts, the column name shall reflect that change.<sup>4</sup> Column E shall be totaled and shall agree with the correlative amount shown on the related balance sheet.

6. By revising § 210.12-13 as follows:

## § 210.12-13 Investments Other Than Securities.

[For management investment companies only]

Column A	Column B	Column C	Column D
Description <sup>1</sup>	Value of each item at beginning of period—quantity <sup>2</sup>	Value of gross purchases and additions made during period—quantity <sup>2</sup>	Gross sales and reductions during period—quantity <sup>2</sup>
<b>Column E</b>		<b>Column F</b>	
Balance held at close of period—quantity <sup>2,3,4,5</sup>		Value of each item at close of period <sup>6,7,8</sup>	

<sup>1</sup> The required information is to be given as to all investments which were held at any time during the period. List each major class of investments by descriptive title.<sup>2</sup> If practicable, indicate the quantity or measure in appropriate units.<sup>3</sup> Indicate by an appropriate symbol each investment which is non-income producing.<sup>4</sup> Indicate by an appropriate symbol each investment not readily marketable. The term "investment not readily marketable" shall include investments for which there is no independent publicly quoted market and investments which cannot be sold because of restrictions or conditions applicable to the investment or the company.<sup>5</sup> Indicate by an appropriate symbol each investment subject to option. State in a footnote (a) the quantity subject to option, (b) nature of option contract, (c) option price, and (d) dates within which options may be exercised.<sup>6</sup> Column F shall be totaled and shall agree with the correlative amount shown on the related balance sheet.<sup>7</sup> State the basis of determining value.<sup>8</sup> State in a footnote the aggregate cost for Federal income tax purposes.



7. By revising § 210.12-14 as follows:

§ 210.12-14 Investments in and Advances to Affiliates.

[For management investment companies only]

<b>Column A</b>	<b>Column B</b>
Name of issuer and title of issue or nature of indebtedness <sup>1</sup>	Number of shares—principal amount of bonds, notes and other indebtedness held at close of period

  

<b>Column C</b>	<b>Column D</b>	<b>Column E</b>
Amount of equity in net profit and loss for the period <sup>2,6</sup>	Amount of dividends or interest <sup>2,5</sup> (1) Credited to income (2) Other	Value of each item at close of period <sup>2,3,4,5</sup>

<sup>1</sup> (a) List each issue separately and group (1) investments in majority-owned subsidiaries, segregating subsidiaries consolidated; (2) other controlled companies; and (3) other affiliates. Give totals for each group. If operations of any controlled companies are different in character from those of the company, group such affiliates (1) within divisions and (2) by type of activities. (b) If during the period there has been any increase or decrease in the amount of investment in and advance to any affiliate, state in a footnote (or if there have been changes to numerous affiliates, in a supplementary schedule) (1) name of each issuer and title of issue or nature of indebtedness; (2) balance at beginning of period; (3) gross additions; (4) gross reductions; (5) balance at close of period as shown in Column E. Include in the footnote or schedule comparable information as to affiliates in which there was an investment at any time during the period even though there was no investment at the close of the period of report.

<sup>2</sup> Columns C, D and E shall be totaled. The totals of Column E shall agree with the correlative amount shown on the related balance sheet.

<sup>3</sup> State the basis of determining the value of each item in Column E.

<sup>4</sup> (a) Indicate by an appropriate symbol each issue of restricted securities. The information required by instruction 5 of § 210.12-12 shall be given in a footnote. (b) Indicate by an appropriate symbol each issue of securities subject to option. The information required by instruction 5 of § 210.12-13 shall be given in a footnote.

<sup>5</sup> (a) Include in Column D (1) as to each issue held at the close of the period, the dividends or interest included in caption 1 of the statement of operations. In addition, show as the final item in Column D (1) the aggregate of dividends and interest included in the statement of operations in respect of investments in affiliates not held at the close of the period. The total of this column shall agree with the correlative amount shown on the related statement of operations. (b) Include in Column D (2) all other dividends and interest. Explain in an appropriate footnote the treatment accorded each item. (c) Indicate by an appropriate symbol all non-cash dividends and explain the circumstances in a footnote. (d) Indicate by an appropriate symbol each issue of securities which is non-income producing.

<sup>6</sup> The information required by Column C shall be furnished only as to controlled companies.

8. By revising § 210.12-19 as follows:

§ 210.12-19 Investments in Securities.<sup>9</sup>

[For issuers of periodic payment plan certificates and unit investment trusts]

<b>Part 1</b>				
<b>Column A</b>	<b>Column B</b>	<b>Column C</b>	<b>Column D</b>	<b>Column E</b>
Name of issuer and title of issue <sup>1</sup>	Market value at beginning of period. Number of shares—principal amount of bonds and notes	Gross purchases and additions as to each issue during period. Number of shares—principal amount of bonds and notes <sup>2</sup>	Gross sales and reductions as to each issue during period. Number of shares—principal amount of bonds and notes	Balance held at close of period. Number of shares—principal amount of bonds and notes

  

<b>Part 2</b>			
<b>Column F</b>	<b>Column G</b>	<b>Column H</b>	<b>Column I</b>
Market value of each issue at close of period <sup>3,4,6</sup>	Distribution received shares on trust shares	Dividends on other <sup>5</sup>	Interest

<sup>1</sup> Group separately (a) shares of investment companies, and (b) other securities. As to securities set forth in group (a), list separately (1) trust shares in trusts created or serviced by the depositor or sponsor of this trust; (2) trust shares in other trusts; and (3) securities of other investment companies. As to securities set forth in group (b), list (1) evidences of indebtedness; (2) preferred shares; (3) common shares; and (4) other securities. Within each of these subdivisions classify according to type of business insofar as possible, e.g., railroads, utilities, banks, insurance companies, industrials. Give totals of each group, subdivision, and class.

<sup>2</sup> Describe briefly the nature of any additions otherwise than through cash purchases.

<sup>3</sup> Column F shall be totaled. The total of Column F at the close of the most recent period shall agree with the related caption in the balance sheet.

<sup>4</sup> If market value is determined on any basis other than closing prices reported on any national securities exchange, explain such other basis in a note.

<sup>5</sup> Identify all dividends other than cash taken up in income, and state the basis on which so taken up.

<sup>6</sup> State in a footnote the aggregate cost for purposes of the Federal income tax.

<sup>9</sup> The required information is to be given as to each issue of securities held at any time during the period.

9. By revising § 210.12-20 as follows:

§ 210.12-20 Trust Shares.

(For all Issuers of Periodic Payment Plan Certificates and Unit Investment Trusts)

1. Amount at which trust shares were carried at beginning of period <sup>1,2</sup>	\$
2. Additions during period resulting from: (a) Creation of trust shares <sup>1</sup> (b) Allocations of investment income-net and realized gains (c) Unrealized appreciation (depreciation) in underlying trust property <sup>2</sup> (d) Other additions <sup>3</sup>	\$
3. Total additions	\$
4. Deductions during period resulting from: (a) Surrender and cancellation of trust shares <sup>1</sup> (b) Other distributions (or transfers to distributable funds) of amounts credited to trust shares (c) Other deductions <sup>4</sup>	\$
5. Total deductions	\$
6. Amount at which trust shares were carried at end of period <sup>1,5</sup>	\$

<sup>1</sup> Insert the applicable number of trust shares.

<sup>2</sup> State the basis of determining the amount.

<sup>3</sup> State separately each significant item.

<sup>4</sup> State separately all significant items. If market depreciation of underlying trust property is included, the amount thereof shall be shown separately. Expenses required to be set forth in the statement of operations shall not be set forth here.

<sup>5</sup> The balance at the close of the most recent period shall agree with caption 16 of the related balance sheet.

These amendments are proposed to be effective for fiscal periods ending after June 30, 1982.

### Authority

These amendments are being proposed pursuant to the authority in sections 7, 8, and 19(a) of the Securities Act of 1933 [15 U.S.C. 77g, 77h, and 77s(a)]; Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934 [15 U.S.C. 78l, 78m, 78o(d), 78w]; and sections 8, 30(d), 31(c), and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-8, 80a-29(d), 80a-30(c), and 80a-37(a)].

In addition, the Commission is mindful of the cost to registrants and others of its proposals and recognizes its responsibilities to weigh with care the costs and benefits which result from its rules. Accordingly, the Commission specifically invites comments on the costs to registrants and others of the adoption of the proposals published herein.

By the Commission.

## ADOPTION OF REVISIONS TO FINANCIAL STATEMENT REQUIREMENTS FOR REGISTERED INVESTMENT COMPANIES

Release Nos. 33-6442; 34-19300; IC-12871

December 6, 1982

**ACTION:** Final rules.

**SUMMARY:** The Commission announces the adoption of final rules which amend Article 6 of Regulation S-X regarding financial statements filed by registered investment companies. The amendments to Article 6 are being adopted to (1) eliminate rules which are duplicative of generally accepted accounting principles ("GAAP"), (2) effect changes which recognize current industry practices, and (3) integrate and simplify the rules to improve financial reporting. In addition, financial statement requirements for employee stock purchase, savings and similar plans are also being amended and transferred to a separate Article 6A. These amendments are part of the Commission's comprehensive reexamination of its requirements for financial statements in connection with its efforts to simplify and improve the current disclosure system.

**EFFECTIVE DATE:** Effective for companies and plans with fiscal years ended after June 15, 1983, with earlier implementation encouraged. Where comparative financial statements are presented, all reported periods shall conform with the rules being adopted.

**FOR FURTHER INFORMATION CONTACT:** Clarence M. Staubs, John W. Albert or Lawrence S. Jones, office of the Chief Accountant, Securities and Exchange Commission, Washington, D.C. 20549 (202-272-2130).

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission is adopting final rules which amend Article 6 of Regulation S-X (17 CFR Part 210) regarding financial statements filed for registered investment companies and employee stock purchase, savings and similar plans. The amendments to Article 6 are being adopted to (1) eliminate rules which are duplicative of GAAP, (2) effect changes which recognize current industry practices, and (3) integrate and simplify the rules to improve financial reporting. The rules integrate certain common reporting requirements of management investment companies, unit investment trusts, and face-amount certificate companies (referred to collectively as registered investment companies) in a revised Article 6. Financial statement requirements for employee stock purchase, savings and similar plans are also amended to change requirements for valuation of investments and to transfer the rules to a separate Article 6A.

The final rules require management investment companies to present an all-inclusive statement of operations rather than the separate statements of income and expense, realized gain or loss on investments, and unrealized appreciation or depreciation of investments currently being furnished. The results of these operations will be captioned "net increase (decrease) in net assets resulting from operations." In addition, a reporting format is being prescribed for the presentation of a statement of net assets and a revised format adopted for the statement of changes in net assets. Finally, the requirements regarding the basis used to value certain assets in the balance sheets of closed-end management investment companies are being amended.

In connection with an ongoing review of Regulation S-X, the Commission established a project to review the requirements for financial statements filed by registered investment companies set forth in Article 6 of Regulation S-X. In a release issued on January 11, 1982,<sup>1</sup> the Commission invited public comment on proposed rules which would revise the financial statement requirements for these companies. A total of 19 letters were received during the comment period ended May 30, 1982.<sup>2</sup> Although the number of commentators was relatively few, the letters were generally very substantive. Accordingly, the comments included in these letters have been considered and appropriate changes made in the final rules adopted by the Commission.

<sup>1</sup> Securities Act Release 6374 (47 FR 2776).

<sup>2</sup> Representation among the commentators was virtually evenly divided between accounting firms or groups (9) and industry and related groups (8). Comments were also received from 2 law firms or groups. The comment period was extended 30 days from its original deadline of April 30, 1982.

## Statement of Operations

The introduction of an all-inclusive statement of operations to replace the separate statements of income and expense, realized gain or loss on investments, and unrealized appreciation or depreciation of investments currently required represented the most significant proposed change and accordingly was addressed by many commentators. Views of the commentators were virtually evenly divided on this issue. Supportive commentators indicated that the adoption of an income statement results in a more meaningful presentation, and is consistent with the “total return” concept utilized by many investment companies. In addition, commentators supported the all-inclusive income statement as consistent with the concept of comprehensive income cited in the proposing release. Opposing views generally focused on the inclusion of unrealized appreciation or depreciation in determining net income, arguing that income recognition is premature since the earnings process has not been completed. Other commentators argued that the all-inclusive income statement ignores the varying objectives of different investment companies.

The Commission believes that it is appropriate to report all changes in net assets resulting from investment activities in a basic statement and accordingly is adopting the requirement for an all-inclusive statement of operations. Since an open-end management investment company continuously trades its shares on the basis of its underlying net assets stated at value,<sup>3</sup> the Commission believes that it is consistent for such investment companies to report changes in net assets resulting from all investment activities in the determination of operating results. Although a closed-end management investment company does not stand ready to redeem its shares on a continuous basis, the market price at which such shares are traded correlates with the company’s net asset value.

In adopting the requirements for a statement of operations, the Commission has considered the views of commentators who, while supportive of the income statement concept, opposed labeling the net result as “net income.” These commentators cautioned that readers could confuse net income with the subcaption “investment income-net” also presented in the statement of operations or infer that net income represents amounts totally available for distribution. The Commission finds merit in these views and accordingly has adopted a reporting format under which the results of the income statement are captioned, “net increase (decrease) in net assets resulting from operations.”

## Statement of Net Assets

Rather than present a conventional balance sheet, management investment companies often substitute a statement of net assets. Since the major asset of any management investment company is its investment portfolio, the statement of net assets is comprised basically of a detailed listing of its securities portfolio similar to the schedule requirements for investment companies prescribed in Regulation S-X (§ 210.12-12). All other assets and total liabilities are often netted for presentation in the statement, and a balance captioned as net assets is presented, together with the number of outstanding shares and value per share.

Since the statement of net assets is fully informative only in situations in which an investment company’s securities portfolio represents virtually all of its net assets, the Commission proposed rules which would establish conditions to restrict the use of this statement to such a situation. These proposed conditions were that (1) the amount of investment in securities (excluding investments in affiliated issuers) represent at least 95 percent of total assets, (2) liabilities not be significant (defined as not exceeding 5 percent of total assets), and (3) only one class of equity securities be outstanding. In addition, investment companies would not be permitted to use a statement of net assets if, as of the balance sheet date, there were outstanding balances with related parties representing amounts other than those arising from the conduct of regular investment advisory or management services or there were balances with respect to securities transactions involving short sales, open option contracts, or deposits on securities loaned.

Most commentators opposed the proposal to establish criteria for the use of the statement of net assets. In their view, failure to meet all of the proposed conditions should not result in forfeiture of the right to use the statement. These commentators suggested that additional disclosure requirements be imposed instead.

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<sup>3</sup> Management investment companies are classified as either “open-end” or “closed-end” companies. An open-end management investment company stands ready to redeem its outstanding shares at current net asset value, and generally offers its shares to the public on a continuous basis. A closed-end management investment company, however, does not stand ready to redeem its outstanding shares; its shares are traded in a manner similar to those of other public companies.

The Commission finds merit in this argument. As a consequence, the rules being adopted prohibit the presentation of a statement of net assets only in circumstances where the amount of investments in securities (other than investments in affiliated issuers) represents less than 95 percent of total assets. A reporting format for the statement of net assets is also being adopted to require that balances resulting from transactions with related parties, with certain limited exceptions, be presented on the face of the statement and that balances of other specified liabilities, including amounts related to short sales and open option contracts, be disclosed in the footnotes. Where the related party transaction occurs in the ordinary course of business, is subject to the usual trade terms, and involves non controlled affiliates, presentation on the face of the statement would not be required.

### Valuation of Assets

Although the existing rules permit an option to state all assets at either cost or value, virtually all closed-end management investment companies currently reflect their investment securities at value. The final rules recognize current industry practice and require that closed-end companies state investments in securities at value.

Section 28(b) of the Investment Company Act of 1940 requires investment companies which issue face-amount certificates to value their “qualified assets” in accordance with certain provisions of the Code of the District of Columbia. Unlike management investment companies whose assets are largely comprised of investments in marketable securities, issuers of face-amount certificates often hold more diverse investments, such as real estate. Issuers of face-amount certificates will continue to value all investments pursuant to the statutory requirements.

### Statement of Changes in Net Assets

In its January release, the Commission proposed certain revisions to its existing requirements for the content of the statement of changes in net assets presented by management investment companies. The revisions were intended to simplify the content of this statement by eliminating the presentation of certain information already reported in other statements and by restricting the presentation of other information to supplemental or footnote status. Commentators generally disagreed with the reporting format proposed by the Commission and offered specific suggestions for its improvement. The Commission finds merit in many of the suggestions and accordingly has adopted the following revised format for reporting changes in net assets:

Increase (decrease) in net assets

Operations:

Investment income-net

Realized gain (loss) on investments-net

Increase (decrease) in unrealized appreciation or depreciation-net

Net increase (decrease) in net assets resulting from operations

Net equalization credits

Dividends to shareholders from:

Investment income-net

Realized gain from investment transactions-net

Capital share transactions (net increase or decrease)

Total increase (decrease)

Net assets

Beginning of year

End of year (including parenthetical disclosure of amounts of undistributed net investment income as of end of each year presented)

## Materiality Thresholds

Many commentators opposed the proposed requirement to separately present the amount of any liability which exceeds five percent of total liabilities, suggesting that since total liabilities are often insignificant to investment companies, separate presentation of amounts representing five percent of this caption would not be meaningful. These commentators suggested that the reporting of separate liability accounts be triggered by a more significant benchmark, such as their relationship to total assets. In adopting final rules on this issue, the Commission has deleted any reference to numerical tests in determining when separate presentation of a particular asset or liability account is appropriate. Persons are referred instead to the general standards of significance set forth in Rule 6-03(1) of Regulation S-X which permits the omission of separate captions where the items and conditions are not present, or the amounts involved not significant. The only exception to this general standard applies to amounts involving related parties which are required to be set forth regardless of amount.

## Series Companies

A few commentators questioned the proposed requirement that financial information for series companies be provided on a comparative basis. This view is premised on the fact that a shareholder of one series company generally has no direct financial interest in the other series, and that comparative information on the other series is not meaningful. Commentators pointed out that assets, liabilities and results of operations are accounted for separately for each series, and that it is only for Federal income tax purposes that the series are ever combined and treated as a separate entity. For example, in the event that a series has a capital loss, the net capital loss may be used to offset any net capital gain from another series. The Commission finds merit in this argument and accordingly has deleted the requirement for comparative data of other series companies from the final rules and will require instead footnote disclosure of the income tax consequences and any contingencies arising from the relationship between related series issuers where appropriate.

## Schedules

Although much of the proposed schedule information was carried forward from existing rules, the proposing release solicited public comment as to the usefulness of the proposed schedule requirements. As a result of the input provided by these commentators, the Commission is adopting certain significant revisions to its schedule requirements. These revisions include the elimination of schedules furnished pursuant to Rules 12-19 and 12-20 titled, "Investments in Securities," and "Trust Shares," respectively and which are applicable to unit investment trusts only. Instead of presenting the information on investments in securities called for in Rule 12-19, unit investment trusts would provide the information currently required for management investment companies under Rule 12-12 titled, "Investments in Securities of Unaffiliated Issuers." This change responds to the views expressed by commentators that the operations of unit investment trusts are not significantly different from those of management investment companies and that detailed information on investment activity during the period required under Rule 12-19 but not under Rule 12-12 is unnecessary. Finally, Rule 12-20 has been deleted because the information is generally duplicative of that provided in the statement of changes in net assets.

In addition to the changes affecting unit investment trusts, the requirements to provide detailed information as to investment activity have been deleted from the schedule furnished pursuant to Rule 12-13, "Investments other than Securities." In response to comments opposing the proposed requirements to provide detailed information on each separate securities issue, instructions to Rule 12-12 have been revised to permit grouping of short-term debt securities. In order to provide information to enable investors to assess the possible income tax consequences of unrealized gains or losses, the schedule requirements under Rules 12-12 and 12-13 have been expanded to require disclosure of the amounts of the aggregate unrealized appreciation or depreciation of securities based on the relationship between value and cost as determined for Federal income tax purposes. In addition, the requirement to disclose the basis for determining value where stock exchange prices are not used has been deleted from Rule 12-12 since such disclosure is already required in footnotes.

## Other Changes

The final rules reflect certain other changes which eliminate additional rules identified by commentators as being duplicative of GAAP. Examples of these deletions from the proposed rules include, but are not limited to, portions of



the general guidance on income recognition under Rule 6-03(g) and provisions for Federal income taxes under Rule 6-03(h). In addition, other proposed requirements, such as disclosure of the gross amounts of unrealized appreciation and depreciation of investment securities on the basis of historical cost, have been deleted based on commentators' concerns that they are contrary to GAAP.

In other instances, the final rules reflect changes to conform the requirements of Article 6 with other sections of Regulation S-X. For example, the requirements to present receivable balances under Rules 6-04.6 and 6-06.3 have been expanded to provide for separate disclosure of notes receivable balances to conform with similar provisions under Article 5 of Regulation S-X. In addition, the requirement to present net asset amounts in balance sheets of registered investment companies has been expanded to include per share data conforming to the requirements under Rule 6-05.4 for statements of net assets. Further, since the requirements for a statement of changes in net assets permit disclosure of the number of authorized and outstanding capital shares to be provided in a footnote, the requirements of Rule 6-04.16 relating to balance sheet presentation have been revised to permit presentation of this information either on the face of the balance sheet or in footnotes.

A few commentators suggested that certain of the proposed requirements, such as disclosures of restricted securities and the basis and method of compensating directors, called for information which is not generally appropriate for footnote presentation. Although the Commission finds merit in these arguments, it regards the information as meaningful. Accordingly, these disclosure requirements are included in the final rules being adopted. The Commission will reconsider these requirements at the time of any future project to transfer these type disclosure requirements from the financial statements to other sections of the prospectus and annual report.

Finally, technical amendments are being adopted to conform the references to specific provisions of Article 6 contained in other rules and regulations of the Commission with the amended rules.

### **FASB Extraction Project**

As discussed in an earlier section of this release, the revisions to Article 6 are being adopted to, among other things, eliminate rules which are duplicative of GAAP. In this connection, the Commission recognizes that the Financial Accounting Standards Board ("FASB") has begun a project to extract the specialized accounting and reporting principles and practices from the industry audit guide, "Audits of Investment Companies," issued by the American Institute of Certified Public Accountants.<sup>4</sup> Upon completion of this project, the Commission will reexamine the rules being adopted in this release with the intent of eliminating any rules which become duplicative.

### **Text of Amended Rules**

**Accounting, Reporting Requirements, Securities Chapter II Title 17 of the Code of Federal Regulations Is Amended as Follows:**

**Part 210—Form and Content of and Requirements for Financial Statements, Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Investment Company Act of 1940, and Energy Policy and Conservation Act of 1975**

1. By revising paragraph (a) of § 210.3-18 to read as follows:

§ 210.3-18 Special provisions as to registered management investment companies and companies required to be registered as management investment companies.

(a) For filings by registered management investment companies, the following financial statements shall be filed:

(2) An audited statement of operations for the most recent fiscal year conforming to the requirements of § 210.6-07.

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<sup>4</sup> At present, the principles and practices embodied in industry audit guides are considered preferable accounting but are not enforceable standards to be adhered to under Rule 3-02 of the AICPA's of Professional Ethics. In Statement of Financial Accounting Standards No. 32, the FASB announced a project to extract the specialized accounting and reporting principles and practices from the AICPA Guides and Statements of Position.



(3) Audited statements of changes in net assets conforming to the requirements of § 210.6-09 for the two most recent fiscal years.

2. By revising paragraph (a) of § 210.5-01 to read as follows:

§ 210.5-01 Application of §§ 210.5-01 to 210.5-04.

(a) Sections 210.5-01 to 210.5-04 shall be applicable to financial statements filed by all persons except —

(1) Registered investment companies (see §§ 210.6-01 to 210.6-10).

(2) Employee stock purchase, savings and similar plans (see §§ 210.6A-01 to 210.6A-05).

(3) Insurance companies (see §§ 210.7-01 to 210.7-05).

(4) Committees issuing certificates of deposit (see §§ 210.8-01 to 210.8-03).

(5) Bank holding companies and banks (see §§ 210.9-01 to 210.9-05).

(6) Brokers and dealers when filing Form X-17A-5 [§ 249.617] (see §§ 240.17a-5 and 240.17a-10 under the Securities Exchange Act of 1934).

3. By removing §§ 210.6-01 to 210.6-24 and adding new §§ 210.6-01 to 210.6-10 as follows:

#### **Registered Investment Companies**

§ 210.6-01 Application of §§ 210.6-01 to 210.6-10.

Sections 210.6-01 to 210.6-10 shall be applicable to financial statements filed for registered investment companies.

§ 210.6-02 Definition of certain terms.

The following terms shall have the meaning indicated in this rule unless the context otherwise requires. (Also see § 210.1-02 of this part.)

(a) Affiliate. The term “affiliate” means an “affiliated person” as defined in section 2(a)(3) of the Investment Company Act of 1940 unless otherwise indicated. The term “control” has the meaning in section 2(a)(9) of that Act.

(b) Value. As used in §§ 210.6-01 to 210.6-10, the term “value” shall have the meaning given in section 2(a)(41)(B) of the Investment Company Act of 1940.

(c) Balance sheets; statements of net assets. As used in §§ 210.6-01 to 210.6-10, the term “balance sheets” shall include statements of assets and liabilities as well as statements of net assets unless the context clearly indicates the contrary.

(d) Qualified assets. (1) For companies issuing face-amount certificates subsequent to December 31, 1940 under the provisions of section 28 of the Investment Company Act of 1940, the term “qualified assets” means qualified investments as that term is defined in section 28(b) of the Act. A statement to that effect shall be made in the balance sheet.

(2) For other companies, the term “qualified assets” means cash and investments which such companies do maintain or are required, by applicable governing legal instruments, to maintain in respect of outstanding face-amount certificates.

(3) Loans to certificate holders may be included as qualified assets in an amount not in excess of certificate reserves carried on the books of account in respect of each individual certificate upon which the loans were made.

§ 210.6-03 Special rules of general application to registered investment companies.

The financial statements filed for persons to which §§ 210.6-01 to 210.6-10 are applicable shall be prepared in accordance with the following special rules in addition to the general rules in §§ 210.1-01 to 210.4-10 (Articles 1, 2, 3, and 4). Where

the requirements of a special rule differ from those prescribed in a general rule, the requirements of the special rule shall be met.

(a) Content of financial statements. The financial statements shall be prepared in accordance with the requirements of this part (Regulation S-X) notwithstanding any provision of the articles of incorporation, trust indenture or other governing legal instruments specifying certain accounting procedures inconsistent with those required in §§ 210.6-01 to 210.6-10.

(b) Audited financial statements. Where, under Article 3 of this part, financial statements are required to be audited, the independent accountant shall have been selected and ratified in accordance with section 32 of the Investment Company Act of 1940.

(c) Consolidated and combined statements.

(1) Consolidated and combined statements filed for registered investment companies shall be prepared in accordance with §§ 210.3A-01 to 210.3A-05 (Article 3A) except that (i) statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies; (ii) a consolidated statement of the registrant and any of its investment company subsidiaries shall not be filed unless accompanied by a consolidating statement which sets forth the individual statements of each significant subsidiary included in the consolidated statement: Provided, however, That a consolidating statement need not be filed if all included subsidiaries are totally held; and (iii) consolidated or combined statements filed for subsidiaries not consolidated with the registrant shall not include any investment companies unless accompanied by consolidating or combining statements which set forth the individual statements of each included investment company which is a significant subsidiary.

(2) If consolidating or combining statements are filed, the amounts included under each caption in which financial data pertaining to affiliates is required to be furnished shall be subdivided to show separately the amounts (i) eliminated in consolidation and (ii) not eliminated in consolidation.

(d) Valuation of assets. The balance sheets of registered investment companies, other than issuers of face-amount certificates, shall reflect all investments at value, with the aggregate cost of each category of investment reported under §§ 210.6-04.1, 6-04.2 and 6-04.3 and of the total investments reported under § 210.6-04.4 or § 210.6-05.1 shown parenthetically. State in a note the methods used in determining value of investments. As required by section 28(b) of the Investment Company Act of 1940, "qualified" assets of face-amount certificate companies shall be valued in accordance with certain provisions of the Code of the District of Columbia. For guidance as to valuation of securities, see §§ 404.03 to 404.05 of the Codification of Financial Reporting Policies.

(e) Qualified assets. State in a note the nature of any investments and other assets maintained or required to be maintained, by applicable legal instruments, in respect of outstanding face-amount certificates. If the nature of the qualifying assets and amount thereof are not subject to the provisions of section 28 of the Investment Company Act of 1940, a statement to that effect shall be made.

(f) Restricted securities. State in a note unless disclosed elsewhere the following information as to investment securities which cannot be offered for public sale without first being registered under the Securities Act of 1933 (restricted securities):

(1) The policy of the person with regard to acquisition of restricted securities.

(2) The policy of the person with regard to valuation of restricted securities. Specific comments shall be given as to the valuation of an investment in one or more issues of securities of a company or group of affiliated companies if any part of such investment is restricted and the aggregate value of the investment in all issues of such company or affiliated group exceeds five percent of the value of total assets. (As used in this paragraph, the term "affiliated" shall have the meaning given in § 210.6-02(a) of this part.)

(3) A description of the person's rights with regard to demanding registration of any restricted securities held at the date of the latest balance sheet.

(g) Income recognition. Dividends shall be included in income on the ex-dividend date; interest shall be accrued on a daily basis. Dividends declared on short positions existing on the record date shall be recorded on the ex-dividend date and included as an expense of the period.

(h) Federal income taxes. The company's status as a "regulated investment company" as defined in Subtitle A, Chapter 1, Subchapter M of the Internal Revenue Code, as amended, shall be stated in a note referred to in the appropriate statements. Such note shall also indicate briefly the principal assumptions on which the company relied in making or not making provisions for income taxes. However, a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with section 852(b)(3)(D) of the Internal Revenue Code shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains realized during such year.

(i) Issuance and repurchase by a registered investment company of its own securities. Disclose for each class of the company's securities:

(1) The number of shares, units, or principal amount of bonds sold during the period of report, the amount received therefor, and, in the case of shares sold by closed-end management investment companies, the difference, if any, between the amount received and the net asset value or preference in involuntary liquidation (whichever is appropriate) of securities of the same class prior to such sale; and

(2) The number of shares, units, or principal amount of bonds repurchased during the period of report and the cost thereof. Closed-end management investment companies shall furnish the following additional information as to securities repurchased during the period of report:

(i) As to bonds and preferred shares, the aggregate difference between cost and the face amount or preference in involuntary liquidation and, if applicable net assets taken at value as of the date of repurchase were less than such face amount or preference, the aggregate difference between cost and such net asset value;

(ii) As to common shares, the weighted average discount per share, expressed as a percentage, between cost of repurchase and the net asset value applicable to such shares at the date of repurchases.

The information required by paragraphs (i)(2)(i) and (ii) may be based on reasonable estimates if it is impracticable to determine the exact amounts involved.

(j) Series companies. The information required by this part shall, in the case of a person which in essence is comprised of more than one separate investment company, be given as if each class or series of such investment company were a separate investment company; this shall not prevent the inclusion, at the option of such person, of information applicable to other classes or series of such person on a comparative basis, except as to footnotes which need not be comparative.

If the particular class or series for which information is provided may be affected by other classes or series of such investment company, such as by the offset of realized gains in one series with realized losses in another, or through contingent liabilities, such situation shall be disclosed.

(k) Certificate reserves. (1) For companies issuing face-amount certificates subsequent to December 31, 1940 under the provisions of section 28 of the Investment Company Act of 1940, balance sheets shall reflect reserves for outstanding certificates computed in accordance with the provisions of section 28(a) of the Act.

(2) For other companies, balance sheets shall reflect reserves for outstanding certificates determined as follows:

(i) For certificates of the installment type, such amount which, together with the lesser of future payments by certificate holders as and when accumulated at a rate not to exceed 3½ per centum per annum (or such other rate as may be appropriate under the circumstances of a particular case) compounded annually, shall provide the minimum maturity or face amount of the certificate when due.

(ii) For certificates of the fully-paid type, such amount which, as and when accumulated at a rate not to exceed 3½ per centum per annum (or such other rate as may be appropriate under the circumstances of a particular case) compounded annually, shall provide the amount or amounts payable when due.

(iii) Such amount or accrual therefor, as shall have been credited to the account of any certificate holder in the form of any credit, or any dividend, or any interest in addition to the minimum maturity or face amount specified in the certificate, plus any accumulations on any amount so credited or accrued at rates required under the terms of the certificate.

(iv) An amount equal to all advance payments made by certificate holders, plus any accumulations thereon at rates required under the terms of the certificate.

(v) Amounts for other appropriate contingency reserves, for death and disability benefits or for reinstatement rights on any certificate providing for such benefits or rights.

(1) Inapplicable captions. Attention is directed to the provisions of §§ 210.4-02 and 210.4-03 which permit the omission of separate captions in financial statements as to which the items and conditions are not present, or the amounts involved not significant. However, amounts involving directors, officers, and affiliates shall nevertheless be separately set forth except as otherwise specifically permitted under a particular caption.

#### § 210.6-04 Balance sheets.

This rule is applicable to balance sheets filed by registered investment companies except for persons who substitute a statement of net assets in accordance with the requirements specified in § 210.6-05, and issuers of face-amount certificates which are subject to the special provisions of § 210.6-06 of this part. Balance sheets filed under this rule shall comply with the following provisions:

#### **Assets**

1. Investments in securities of unaffiliated issuers.
2. Investments in and advances to affiliates. State separately investments in and advances to (a) controlled companies and (b) other affiliates.
3. Investments—other than securities. State separately each major category.
4. Total Investments.
5. Cash. Include under this caption cash on hand and demand deposits. Provide in a note to the financial statements the information required under § 210.5-02.1 regarding restrictions and compensating balances.
6. Receivables. (a) State separately amounts receivable from (1) sales of investments; (2) subscriptions to capital shares; (3) dividends and interest; (4) directors and officers; and (5) others.  
  
(b) If the aggregate amount of notes receivable exceeds 10 percent of the aggregate amount of receivables, the above information shall be set forth separately, in the balance sheet or in a note thereto, for accounts receivable and notes receivable.
7. Deposits for securities sold short and open option contracts. State separately amounts held by others in connection with (a) short sales and (b) open option contracts.
8. Other assets. State separately (a) prepaid and deferred expenses; (b) pension and other special funds; (c) organization expenses; and (d) any other significant item not properly classified in another asset caption.
9. Total assets.

### Liabilities

10. Accounts payable and accrued liabilities. State separately amounts payable for (a) securities sold short; (b) open option contracts written; (c) other purchases of securities; (d) capital shares redeemed; (e) dividends or other distributions on capital shares; and (f) others. State separately the amount of any other liabilities which are material. Securities sold short and open option contracts written shall be stated at value.

11. Deposits for securities loaned. State the value of securities loaned and indicate the nature of the collateral received as security for the loan, including the amount of any cash received.

12. Other liabilities. State separately (a) amounts payable for investment advisory, management and service fees; and (b) the total amount payable to (1) officers and directors; (2) controlled companies; and (3) other affiliates, excluding any amounts owing to non controlled affiliates which arose in the ordinary course of business and which are subject to usual trade terms.

13. Notes payable, bonds and similar debt. (a) State separately amounts payable to (1) banks or other financial institutions for borrowings; (2) controlled companies; (3) other affiliates; and (4) others, showing for each category amounts payable within one year and amounts payable after one year.

(b) Provide in a note the information required under § 210.5-02.19(b) regarding unused lines of credit for short-term financing and § 210.5-02.22(b) regarding unused commitments for long-term financing arrangements.

14. Total liabilities.

15. Commitments and contingent liabilities.

### Net Assets

16. Units of capital. (a) Disclose the title of each class of capital shares or other capital units, the number authorized, the number outstanding, and the dollar amount thereof.

(b) Unit investment trusts, including those which are issuers of periodic payment plan certificates, also shall state in a note to the financial statements (a) the total cost to the investors of each class of units or shares; (b) the adjustment for market depreciation or appreciation; (c) other deductions from the total cost to the investors for fees, loads and other charges, including an explanation of such deductions; and (d) the net amount applicable to the investors.

17. Accumulated undistributed income (loss). Disclose (a) the accumulated undistributed investment income-net, (b) accumulated undistributed net realized gains (losses) on investment transactions, and (c) net unrealized appreciation (depreciation) in value of investments at the balance sheet date.

18. Other elements of capital. Disclose any other elements of capital or residual interests appropriate to the capital structure of the reporting entity.

19. Net assets applicable to outstanding units of capital. State the net asset value per share.

§ 210.6-05 Statements of net assets.

In lieu of the balance sheet otherwise required by § 210.6-04 of this part, persons may substitute a statement of net assets if at least 95 percent of the amount of the person's total assets are represented by investments in securities of unaffiliated issuers. If presented in such instances, a statement of net assets shall consist of the following:

1. A schedule of investments in securities of unaffiliated issuers as prescribed in § 210.12-12.

2. The excess (or deficiency) of other assets over (under) total liabilities stated in one amount, except that any amounts due from or to officers, directors, controlled persons, or other affiliates, excluding any amounts owing to non controlled affiliates which arose in the ordinary course of business and which are subject to usual trade terms, shall be stated separately.

3. Disclosure shall be provided in the notes to the financial statements for any item required under §§ 210.6-04.10 to 210.6-04.13.
4. The balance of the amounts captioned as net assets. The number of outstanding shares and net asset value per share shall be shown parenthetically.
5. The information required by (i) § 210.6-04.16, (ii) § 210.6-04.17 and (iii) § 210.6-04.18 shall be furnished in a note to the financial statements.

§ 210.6-06 Special provisions applicable to the balance sheets of issuers of face-amount certificates.

Balance sheets filed by issuers of face-amount certificates shall comply with the following provisions:

#### **Assets**

1. Investments. State separately each major category: such as, real estate owned, first mortgage loans on real estate, other mortgage loans on real estate, investments in securities of unaffiliated issuers, and investments in and advances to affiliates.
2. Cash. Include under this caption cash on hand and demand deposits. Provide in a note to the financial statements the information required under § 210.5-02.1 regarding restrictions and compensating balances.
3. Receivables. (a) State separately amounts receivable from (1) sales of investments; (2) dividends and interest; (3) directors and officers; and (4) others.  
  
(b) If the aggregate amount of notes receivable exceeds 10 percent of the aggregate amount of receivables, the above information shall be set forth separately, in the balance sheet or in a note thereto, for accounts receivable and notes receivable.
4. Total qualified assets. State in a note to the financial statements the amount of qualified assets on deposit classified as to general categories of assets and as to general types of depositories, such as banks and states, together with a statement as to the purpose of the deposits.
5. Other assets. State separately (a) investments in securities of unaffiliated issuers not included in qualifying assets in item 1 above; (b) investments in and advances to affiliates not included in qualifying assets in item 1 above; and (c) any other significant item not properly classified in another asset caption.
6. Total assets.

#### **Liabilities**

7. Certificate reserves. Issuers of face-amount certificates shall state separately reserves for (a) certificates of the installment type; (b) certificates of the fully-paid type; (c) advance payments; (d) additional amounts accrued for or credited to the account of certificate holders in the form of any credit, dividend, or interest in addition to the minimum amount specified in the certificate; and (e) other certificate reserves. State in an appropriate manner the basis used in determining the reserves, including the rates of interest of accumulation.
8. Notes payable, bonds and similar debt. (a) State separately amounts payable to (1) banks or other financial institutions for borrowings; (2) controlled companies; (3) other affiliates; and (4) others, showing for each category amounts payable within one year and amounts payable after one year.  
  
(b) Provide in a note the information required under § 210.5-02.19(b) regarding unused lines of credit for short-term financing and § 210.5-02.22(b) regarding unused commitments for long-term financing arrangements.
9. Accounts payable and accrued liabilities. State separately (a) amounts payable for investment advisory, management and service fees; and (b) the total amount payable to (1) officers and directors; (2) controlled companies; and (3) other affiliates, excluding any amounts owing to non controlled affiliates which arose in the ordinary course of business and which are subject to usual trade terms. State separately the amount of any other liabilities which are material.

10. Total liabilities.

11. Commitments and contingent liabilities.

### **Stockholders' Equity**

12. Capital shares. Disclose the title of each class of capital shares or other capital units, the number authorized, the number outstanding and the dollar amount thereof. Show also the dollar amount of any capital shares subscribed but unissued, and show the deduction for subscriptions receivable therefrom.

13. Other elements of capital. (a) Disclose any other elements of capital or residual interests appropriate to the capital structure of the reporting entity.

(b) A summary of each account under this caption setting forth the information prescribed in § 210.3-04 shall be given in a note or separate statement for each period in which a statement of operations is presented.

14. Total liabilities and stockholders' equity.

### **§ 210.6-07 Statements of operations.**

Statements of operations filed by registered investment companies, other than issuers of face-amount certificates subject to the special provisions of § 210.6-08 of this part, shall comply with the following provisions:

1. Investment income. State separately income from (a) dividends; (b) interest on securities; and (c) other income. If income from investments in or indebtedness of affiliates is included hereunder, such income shall be segregated under an appropriate caption subdivided to show separately income from (1) controlled companies; and (2) other affiliates. If non-cash dividends are included in income, the bases of recognition and measurement used in respect to such amounts shall be disclosed. Any other category of income which exceeds five percent of the total shown under this caption shall be stated separately.

2. Expenses. (a) State separately the total amount of investment advisory, management and service fees, and expenses in connection with research, selection, supervision, and custody of investments. Amounts of expenses incurred from transactions with affiliated persons shall be disclosed together with the identity of and related amount applicable to each such person accounting for five percent or more of the total expenses shown under this caption together with a description of the nature of the affiliation. Expenses incurred within the person's own organization in connection with research, selection and supervision of investments shall be stated separately. Reductions or reimbursements of management or service fees shall be shown as a negative amount or as a reduction of total expenses shown under this caption.

(b) State separately any other expense item the amount of which exceeds five percent of the total expenses shown under this caption.

(c) A note to the financial statements shall include information concerning management and service fees, the rate of fee, and the base and method of computation. State separately the amount and a description of any fee reductions or reimbursements representing (1) expense limitation agreements or commitments; and (2) offsets received from broker-dealers showing separately for each amount received or due from (i) unaffiliated persons; and (ii) affiliated persons. If no management or service fees were incurred for a period, state the reason therefor.

(d) If any expenses were paid otherwise than in cash, state the details in a note.

(e) State in a note to the financial statements the amount of brokerage commissions (including dealer markups) paid to affiliated broker-dealers in connection with purchase and sale of investment securities. Open-end management companies shall state in a note the net amounts of sales charges deducted from the proceeds of sale of capital shares which were retained by any affiliated principal underwriter or other affiliated broker-dealer.

3. Interest and amortization of debt discount and expense.



4. Investment income before income tax expense.
5. Income tax expense. Include under this caption only taxes based on income.
6. Investment income-net.
7. Realized and unrealized gain (loss) on investment-net. (a) State separately the net realized gain or loss on transactions in (1) investment securities or unaffiliated issuers, (2) investment securities of affiliated issuers, and (3) investments other than securities.
  - (b) Distributions of realized gains by other investment companies shall be shown separately under this caption.
  - (c) State separately (1) the gain or loss from expiration or closing of option contracts written, (2) the gain or loss on closed short positions in securities, and (3) other realized gain or loss. Disclose in a note to the financial statements the number and associated dollar amounts as to option contracts written: (a) at the beginning of the period; (b) during the period; (c) expired during the period; (d) closed during the period; (e) exercised during the period; (f) balance at end of the period.
  - (d) State separately the amount of the net increase or decrease during the period in the unrealized appreciation or depreciation in the value of investment securities and other investments held at the end of the period.
  - (e) State separately any (1) Federal income taxes and (2) other income taxes applicable to realized and unrealized gain (loss) on investments, distinguishing taxes payable currently from deferred income taxes.
8. Net gain (loss) on investments.
9. Net increase (decrease) in net assets resulting from operations.

§ 210.6-08 Special provisions applicable to the statements of operations of issuers of face-amount certificates.

Statements of operations filed by issuers of face-amount certificates shall comply with the following provisions:

1. Investment income. State separately income from (a) interest on mortgages; (b) interest on securities; (c) dividends; (d) rental income; and (e) other investment income. If income from investments in or indebtedness of affiliates is included hereunder, such income shall be segregated under an appropriate caption subdivided to show separately income from (1) controlled companies; and (2) other affiliates. If non-cash dividends are included in income, the bases of recognition and measurement used in respect to such amounts shall be disclosed. Any other category of income which exceeds five percent of the total shown under this caption shall be stated separately.
2. Investment expenses. (a) State separately the total amount of investment advisory, management and service fees, and expenses in connection with research, selection, supervision, and custody of investments. Amounts of expenses incurred from transactions with affiliated persons shall be disclosed together with the identity of and related amount applicable to each such person accounting for five percent or more of the total expenses shown under this caption together with a description of the nature of the affiliation. Expenses incurred within the person's own organization in connection with research, selection and supervision of investments shall be stated separately. Reductions or reimbursements of management or service fees shall be shown as a negative amount or as a reduction of total expenses shown under this caption.
  - (b) State separately any other expense item the amount of which exceeds five percent of the total expenses shown under this caption.
  - (c) A note to the financial statements shall include information concerning management and service fees, the rate of fee, and the base and method of computation. State separately the amount and a description of any fee reductions or reimbursements representing (1) expense limitation agreements or commitments; and (2) offsets received from broker-dealers showing separately for each amount received or due from (i) unaffiliated persons; and (ii) affiliated persons. If no management or service fees were incurred for a period, state the reason therefor.
  - (d) If any expenses were paid otherwise than in cash, state the details in a note.



(e) State in a note to the financial statements the amount of brokerage commissions (including dealer markups) paid to affiliated broker-dealers in connection with purchase and sale of investment securities.

3. Interest and amortization of debt discount and expense.

4. Provision for certificate reserves. State separately any provision for additional credits, or dividends, or interests, in addition to the minimum maturity or face amount specified in the certificates. State also in an appropriate manner reserve recoveries from surrenders or other causes.

5. Investment income before income tax expense.

6. Income tax expense. Include under this caption only taxes based on income.

7. Investment income-net.

8. Realized gain (loss) on investments-net.

(a) State separately the net realized gain or loss on transactions in (i) investment securities of unaffiliated issuers, (2) investment securities of affiliated issuers, and (3) other investments.

(b) Distributions of capital gains by other investment companies shall be shown separately under this caption.

(c) State separately any (1) Federal income taxes and (2) other income taxes applicable to realized gain (loss) on investments, distinguishing taxes payable currently from deferred income taxes.

9. Net income or loss.

§ 210.6-09 Statements of changes in net assets.

Statements of changes in net assets filed for persons to whom this article is applicable shall comply with the following provisions:

1. Operations. State separately (a) investment income-net as shown by § 210.6-07.6; (b) realized gain (loss) on investments-net of any Federal or other (loss) on investments-net of any Federal or other income taxes applicable to such amounts; (c) increase (decrease) in unrealized appreciation or depreciation-net of any Federal or other income taxes applicable to such amounts; and (d) net increase (decrease) in net assets resulting from operations as shown by § 210.6-07.9.

2. Net equalization charges and credits. State the net amount of accrued undivided earnings separately identified in the price of capital shares issued and repurchased.

3. Distributions to shareholders. State separately distributions to shareholders from (a) investment income-net; (b) realized gain from investment transactions-net; and (c) other sources.

4. Capital share transactions. (a) State the increase or decrease in net assets derived from the net change in the number of outstanding shares or units.

(b) Disclose in the body of the statements or in the notes, for each class of the person's shares, the number and value of shares issued in reinvestment of dividends as well as the number and dollar amounts received for shares sold and paid for shares redeemed.

5. Total increase (decrease).

6. Net assets at the beginning of the period.

7. Net assets at the end of the period. Disclose parenthetically the balance of undistributed net investment income included in net assets at the end of the period.

§ 210.6-10 What schedules are to be filed.

(a) When information is required in schedules for both the person and the person and its subsidiaries consolidated, it may be presented in the form of a single schedule, provided that items pertaining to the registrant are separately shown and that such single schedule affords a properly summarized presentation of the facts. If the information required by any schedule (including the notes thereto) is shown in the related financial statement or in a note thereto without making such statement unclear or confusing, that procedure may be followed and the schedule omitted.

(b) The schedules shall be examined by an independent accountant if the related financial statements are so examined.

(c) Management investment companies. Except as otherwise provided in the applicable form:

(1) The schedules specified below in this rule shall be filed for management investment companies as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

Schedule I—Investments in securities of unaffiliated issuers. The schedule prescribed by § 210.12-12 shall be filed in support of caption 1 of each balance sheet.

Schedule II—Investments—other than securities. The schedule prescribed by § 210.12-13 shall be filed in support of caption 3 of each balance sheet. This schedule may be omitted if the investments, other than securities, at both the beginning and end of the period amount to less than one percent of the value of total investments (§ 210.6-04.4).

Schedule III—Investments in and advances to affiliates. The schedule prescribed by § 210.12-14 shall be filed in support of caption 2 of each balance sheet.

Schedule IV—Amounts due from directors and officers. The schedule prescribed by § 210.12-03 shall be filed with respect to each person among the directors and officers from whom any amount was owed at any time during the period for which related statements of changes in net assets are required to be filed.

Schedule V—Investments—securities sold short. The schedule prescribed by § 210.12-12A shall be filed in support of caption 10(a) of each balance sheet.

Schedule VI—Open option contracts written. The schedule prescribed by § 210.12-12B shall be filed in support of caption 10(b) of each balance sheet.

Schedule VII—Short-term borrowings. The schedule prescribed by § 210.12-10 shall be filed in support of any amounts included in caption 13 of each balance sheet which are payable within one year to banks for borrowings; factors and other financial institutions for borrowings; and holders of any short-term notes.

(d) Unit investment trusts. Except as otherwise provided in the applicable form:

(1) Schedules I and II, specified below in this section, shall be filed for unit investment trusts as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

(2) Schedule III, specified below in this section, shall be filed for unit investment trusts for each period for which a statement of operations is required to be filed for each person or group.

Schedule I—Investment in securities. The in support of caption 1 of each balance sheet (§ 210.6-04).

Schedule II—Allocation of trust assets to series of trust shares. If the trust assets are specifically allocated to different series of trust shares, and if such allocation is not shown in the balance sheet in columnar form or by the filing of separate statements for each series of trust shares, a schedule shall be filed showing the amounts of trust assets, indicated by each balance sheet filed, which is applicable to each series of trust shares.

Schedule III—Allocation of trust income and distributable funds to series of trust shares. If the trust income and distributable funds are specifically allocated to different series of trust shares and if such allocation is not shown in the statement of operations in columnar form or by the filing of separate statements for each series of trust shares, a schedule

shall be submitted showing the amount of income and distributable funds, indicated by each statement of operations filed, which is applicable to each series of trust shares.

(c) Face-amount certificate investment companies. Except as otherwise provided in the applicable form:

(1) Schedules I, V and X, specified below, shall be filed for face-amount certificate investment companies as of the dates of the most recent audited balance sheet and any subsequent unaudited statement being filed for each person or group.

(2) All other schedules specified below in this section shall be filed for face-amount certificate investment companies for each period for which a statement of operations is filed, except as indicated for Schedules III and IV.

Schedule I—Investment in securities of unaffiliated issuers. The schedule prescribed by § 210.12-21 shall be filed in support of caption 1 and, if applicable, caption 5(a) of each balance sheet. Separate schedules shall be furnished in support of each caption, if applicable.

Schedule II—Investments in and advances to affiliates and income thereon. The schedule prescribed by § 210.12-22 shall be filed in support of captions 1 and 5(b) of each balance sheet and caption 1 of each statement of operations. Separate schedules shall be furnished in support of each caption, if applicable.

Schedule III—Mortgage loans on real estate and interest earned on mortgages. The schedule prescribed by § 210.12-23 shall be filed in support of captions 1 and 5(c) of each balance sheet and caption 1 of each statement of operations, except that only the information required by column G and note 8 of the schedule need be furnished in support of statements of operations for years for which related balance sheets are not required.

Schedule IV—Real estate owned and rental income. The schedule prescribed by § 210.12-24 shall be filed in support of captions 1 and 5(a) of each balance sheet and caption 1 of each statement of operations for rental income included therein, except that only the information required by columns H, I and J, and item “Rent from properties sold during the period” and note 4 of the schedule need be furnished in support of statements of operations for years for which related balance sheets are not required.

Schedule V—Qualified assets on deposit. The schedule prescribed by § 210.12-27 shall be filed in support of the information required by caption 4 of § 210.6-06 as to total amount of qualified assets on deposit.

Schedule VI—Amounts due from officers and directors. The schedule prescribed by § 210.12-03 shall be filed with respect to each director, officer, or employee from whom any amount was owed at any time during the period for which related statements of operation are filed. State if an exemption has been granted by the Commission with respect to amounts included in this schedule.

Schedule VII—Short-term borrowings. The schedule prescribed by § 210.12-10 shall be filed in support of any amounts included in caption 8 of each balance sheet which are payable within one year to banks for borrowings; factors and other financial institutions for borrowings; and holders of any short-term notes.

Schedule VIII—Indebtedness to affiliates—not current. The schedule prescribed by § 210.12-05 shall be filed in support of any amounts included in caption 9 of each balance sheet. This schedule and Schedule II may be combined.

Schedule IX—Supplementary profit and loss information. The schedule prescribed by § 210.12-25 shall be filed in support of each statement of operations.

Schedule X—Guarantees of securities of other issuers. The schedule prescribed by § 210.12-08 shall be filed with respect to any guarantees of securities of other issuers by the person for which the statement is filed.

Schedule XI—Certificate reserves. The schedule prescribed by § 210.12-26 shall be filed in support of caption 7 of each balance sheet.

Schedule XII—Valuation and qualifying accounts. The schedule prescribed by § 210.12-09 shall be filed in support of all other reserves included in the balance sheet.

4. By removing § 210.6-30 and adding a new § 210.6A-01 as follows:

**Employee Stock Purchase, Savings and Similar Plans**

§ 210.6A-01 Application of §§ 210.6A-01 to 210.6A-05

(a) Sections 210.6A-01 to 210.6A-05 shall be applicable to financial statements filed for employee stock purchase, savings and similar plans.

5. By removing § 210.6-31 and adding a new § 210.6A-02 as follows:

§ 210.6A-02 Special rules applicable to employee stock purchase, savings and similar plans.

The financial statements filed for persons to which this article is applicable shall be prepared in accordance with the following special rules in addition to the general rules in §§ 210.1-01 to 210.4-10. Where the requirements of a special rule differ from those prescribed in a general rule, the requirements of the special rule shall be met.

(a) Investment programs. If the participating employees have an option as to the manner in which their deposits and contributions may be invested, a description of each investment program shall be given in a footnote or otherwise. The number of employees under each investment program shall be stated.

(b) Net asset value per unit. Where appropriate, the number of units and the net asset value per unit shall be given by footnote or otherwise.

(c) Federal income taxes. (1) If the plan is not subject to Federal income taxes, a note shall so state indicating briefly the principal assumptions on which the plan relied in not making provision for such taxes.

(2) State the Federal income tax status of the employee with respect to the plan.

(d) Valuation of assets. The statement of financial condition shall reflect all investments at value, showing cost parenthetically. For purposes of this rule, the term “value” shall mean (1) market value for those securities having readily available in good faith by the trustee(s) for the plan (or by the person or persons who exercise similar responsibilities) with respect to other securities and assets.

6. By redesignating §§ 210.6-32, 210.6-33, and 210.6-34 as §§ 210.6A-03, 210.6A-04, and 210.6A-05, respectively.

7. By revising § 210.12-01 to read as follows:

§ 210.12-01 Application of §§ 210.12-01 to 210.12-27.

These sections prescribe the form and content of the schedules required by §§ 210.5-04, 210.6-10, 210.6A-05, 210.7-05 and 210.9-05.

8. By revising § 210.12-12 and adding new §§ 210.12-12A and 210.12-12B to read as follows:

## § 210.12-12 Investments in Securities of Unaffiliated Issuers.

Column A	Column B	Column C
Name of issuer and title of issue <sup>1,2</sup>	Balance held at close of period. Number of shares—principal amount of bonds and notes <sup>5</sup>	Value of each item at close of period <sup>3,4,6,7,8</sup>

<sup>1</sup> Each issue shall be listed separately: Provided, however, than an amount not exceeding five percent of the total of Column C may be listed in one amount as "Miscellaneous securities," provided the securities so listed are not restricted, have been held for not more than one year prior to the date of the related balance sheet, and have not previously been reported by name to the shareholders of the person for which the schedule is filed or to any exchange, or set forth in any registration statement, application, or annual report or otherwise made available to the public.

<sup>2</sup> List separately (a) common shares; (b) preferred shares; (c) bonds and notes; (d) time deposits; and (e) put and call options purchased. Within each of these subdivisions, classify in an appropriate manner according to type of business; e.g., aerospace, banking, chemicals, machinery and machine tools, petroleum, utilities, etc.; or according to type of instrument; e.g., commercial paper, bankers' acceptances, certificates of deposit. Short-term debt instruments of the same issuer may be aggregated, in which case the range of interest rates and maturity dates shall be indicated. For issuers of periodic payment plan certificates and unit investment trusts, list separately (a) trust shares in trusts created or serviced by the depositor or sponsor of this trust; (b) trust shares in other trusts; and (c) securities of other investment companies. Restricted securities shall not be combined with unrestricted securities of the same issuer. Repurchase agreements shall be stated separately showing for each the name of the party or parties to the agreement, the date of the agreement, the total amount to be received upon repurchase, the repurchase date and description of securities subject to the repurchase agreements.

<sup>3</sup> The subtotals for each category of investments, subdivided by business grouping or instrument type, shall be shown together with their percentage value compared to net assets (§§ 210.6-04.19 or 210.6-05.4).

<sup>4</sup> Column C shall be totaled. The total of column C shall agree with the correlative amounts shown on the related balance sheet.

<sup>5</sup> Indicate by an appropriate symbol each issue of securities which is non-income producing. Evidences of indebtedness and preferred shares may be deemed to be income producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no cash or in kind dividends declared, the issue shall not be deemed to be income producing. Common shares shall not be deemed to be income producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares.

<sup>6</sup> Indicate by an appropriate symbol each issue of restricted securities. State the following in a footnote: (a) as to each such issue (1) acquisition date, (2) carrying value per unit of investment at date of related balance sheet, e.g., a percentage of current market value of unrestricted securities of the same issuer, etc., and (3) the cost of such securities; (b) as to each issue acquired during the year preceding the date of the related balance sheet, the carrying value per unit of investment of unrestricted securities of the same issuer at (1) the day the purchase price was agreed to and (2) the day on which an enforceable right to acquire such securities was obtained; and (c) the aggregate value of all restricted securities and the percentage which the aggregate value bears to net assets.

<sup>7</sup> Indicate by an appropriate symbol each issue of securities held in connection with open put or call option contracts or loans for short sales.

<sup>8</sup> State in a footnote the following amounts based on cost for Federal income tax purposes: (a) aggregate gross unrealized appreciation for all securities in which there is an excess of value over tax cost, (b) the aggregate gross unrealized depreciation for all securities in which there is an excess of tax cost over value, (c) the net unrealized appreciation or depreciation, and (d) the aggregate cost of securities for Federal income tax purposes.

## § 210.12-12A Investments—Securities Sold Short.

[For management investment companies only]

Column A	Column B	Column C
Name of issuer and title of issue <sup>1</sup>	Balance of short position at close of period. (Number of shares)	Value of each open short position <sup>2</sup>

<sup>1</sup> Each issue shall be listed separately.<sup>2</sup> Column C shall be totaled. The total of column C shall agree with the correlative amounts shown on the related balance sheet.

## § 210.12-12B Open Option Contracts Written.

[For management investment companies only]

Column A	Column B	Column C	Column D	Column E
Name of issuer <sup>1,2</sup>	Number of contracts <sup>3</sup>	Exercise price	Expiration date	Value <sup>4</sup>

<sup>1</sup> Information as to put options shall be shown separately from information as to call options.<sup>2</sup> Options of an issuer where exercise prices or expiration dates differ shall be listed separately.<sup>3</sup> If the number of shares subject to option is substituted for number of contracts, the column name shall reflect that change.<sup>4</sup> Column E shall be totaled and shall agree with the correlative amount shown on the related balance sheet.

9. By revising § 210.12-13 as follows:

## § 210.12-13 Investments Other Than Securities.

[For management investment companies only]

Column A	Column B	Column C
Description <sup>1</sup>	Balance held at close of period—quantity <sup>2,3,5</sup>	Value of each item at close <sup>4,6,7</sup>

<sup>1</sup> List each major category of investments by descriptive title.<sup>2</sup> If practicable, indicate the quantity or measure in appropriate units.<sup>3</sup> Indicate by an appropriate symbol each investment which is non-income producing.<sup>4</sup> Indicate by an appropriate symbol each investment not readily marketable. The term “investment not readily marketable” shall include investments for which there is no independent publicly quoted market and investments which cannot be sold because of restrictions or conditions applicable to the investment or the company.<sup>5</sup> Indicate by an appropriate symbol each investment subject to option. State in a footnote (a) the quantity subject to option, (b) nature of option contract, (c) option price, and (d) dates within which options may be exercised.<sup>6</sup> Column C shall be totaled and shall agree with the correlative amount shown on the related balance sheet.<sup>7</sup> State in a footnote the following amounts based on cost for Federal income tax purposes: (a) aggregate gross unrealized appreciation for all investments in which there is an excess of value over tax cost, (b) the aggregate gross unrealized depreciation for all investments in which there is an excess of tax cost over value, (c) the net unrealized appreciation or depreciation, and (d) the aggregate cost of investments for Federal income tax purposes.

10. By revising § 210.12-14 as follows:

§ 210.12-14 Investments in and Advances to Affiliates.

[For management investment companies only]

Column A	Column B	Column C
Name of issuer and title of issue of nature of indebtedness <sup>1</sup>	Number of shares—principal amount of bonds, notes and other indebtedness held at close of period	Amount of equity in net profit and loss for the period <sup>2,6</sup>
Column D	Column E	
Amount of dividends of interest <sup>2,5</sup> (1) Credited to income (2) Other	Value of each item at close of period <sup>2,3,4,5</sup>	

<sup>1</sup> (a) List each issue separately and group (1) investments in majority-owned subsidiaries, segregating subsidiaries consolidated; (2) other controlled companies; and (3) other affiliates. (b) If during the period there has been any increase or decrease in the amount of investment in and advance to any affiliate, state in a footnote (or if there have been changes to numerous affiliates, in a supplementary schedule) (1) name of each issuer and title of issue or nature of indebtedness; (2) balance at beginning of period; (3) gross additions; (4) gross reductions; (5) balance at close of period as shown in Column E. Include in the footnote or schedule comparable information as to affiliates in which there was an investment at any time during the period even though there was no investment at the close of the period of report.

<sup>2</sup> Give totals for each group. If operations of any controlled companies are different in character from those of the company, group such affiliates (1) within divisions and (2) by type of activities.

<sup>3</sup> Columns C, D and E shall be totaled. The totals of Column E shall agree with the correlative amount shown on the related balance sheet.

<sup>4</sup> (a) Indicate by an appropriate symbol each issue of restricted securities. The information required by instruction 5 of § 210.12-12 shall be given in a footnote. (b) Indicate by an appropriate symbol each issue of securities subject to option. The information required by instruction 5 of § 210.12-13 shall be given in a footnote.

<sup>5</sup> (a) Include in Column D (1) as to each issue held at the close of the period, the dividends or interest included in caption 1 of the statement of operations. In addition, show as the final item in Column D (1) the aggregate of dividends and interest included in the statement of operations in respect of investments in affiliates not held at the close of the period. The total of this column shall agree with the correlative amount shown on the related statement of operations. (b) Include in Column D (2) all other dividends and interest. Explain in an appropriate footnote the treatment accorded each item. (c) Indicate by an appropriate symbol all non-cash dividends and explain the circumstances in a footnote. (d) Indicate by an appropriate symbol each issue of securities which is non-income producing.

<sup>6</sup> The information required by Column C shall be furnished only as to controlled companies.

11. By deleting §§ 210.12-19 and 210.12-20.

**Part 270—General Rules and Regulations, Investment Company Act of 1940**

12. By revising section (4) of paragraph (a) of § 270.2a-4 to read as follows:

Definition of “Current Net Asset Value” for Use in Computing Periodically the Current Price of Redeemable Security

§ 270.2a-4 (a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate.

(4) Expenses, including any investment advisory fees, shall be included to date of calculation. Appropriate provision shall be made for Federal income taxes if required. Investment companies which retain realized capital gains designated as a distribution to shareholders shall comply with paragraph (h) of § 210.6-03 of Regulation S-X.

## Authority

These amendments are adopted pursuant to the authority in sections 7, 8, and 19(a) of the Securities Act of 1933 [*15 U.S.C. 77g, 77h, and 77s(a)*]; sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934 [*15 U.S.C. 78l, 78m, 78o(d), 78w*]; and sections 8, 30(d), 31(c), and 38(a) of the Investment Company Act of 1940 [*15 U.S.C. 80a-8, 80a-29(d), 80a-30(c), and 80a-37(a)*].

By the Commission.





## RELEASES RELATED TO RULE 22c-1

### **NOTICE OF PROPOSAL TO ADOPT RULE 22c-1 UNDER THE INVESTMENT COMPANY ACT OF 1940 PRESCRIBING THE TIME OF PRICING REDEEMABLE SECURITIES FOR DISTRIBUTION, REDEMPTION, AND REPURCHASE, AND TO AMEND RULE 17a-3(a)(7) UNDER THE SECURITIES EXCHANGE ACT OF 1934 REQUIRING DEALERS TO TIME-STAMP ORDERS**

Release Nos. 34-8340; IC-5413

June 25, 1968

NOTICE IS HEREBY GIVEN that the Securities and Exchange Commission has under consideration the adoption of Rule 22c-1 under the Investment Company Act of 1940 ("Investment Company Act") prescribing the time for pricing redeemable securities of registered investment companies for distribution, redemption, and repurchase. The proposed rule would be adopted pursuant to the authority granted to the Commission in Sections 22(c) and 38(a) of that Act. Notice is also given that the Commission has under consideration a companion measure in the form of a proposed amendment to Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 ("Securities Exchange Act") which would require dealers to time-stamp the receipt of orders from customers. The amendment would be adopted pursuant to the authority granted to the Commission in Sections 17(a) and 23(a) of that Act.

Section 22(c) of the Investment Company Act, by reference to Section 22(a), authorizes the Commission to make rules and regulations applicable to principal underwriters of, and dealers in, the redeemable securities of registered investment companies "for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities." Such rules and regulations are authorized with respect to, among other things, the time for computing the minimum price at which any redeemable security issued by an investment company may be purchased from such company and the maximum price at which such security may be sold to such company or at which such security may be surrendered to such company for redemption. Section 38(a) of the Investment Company Act authorizes the Commission to issue such rules as are necessary or appropriate to the exercise of the powers conferred upon the Commission in that Act.

One purpose of proposed Rule 22c-1 is to eliminate or reduce so far as reasonably practicable any dilution of the value of outstanding redeemable securities of registered investment companies through (i) the sale of such securities at a price below their net asset value or (ii) the redemption or repurchase of such securities at a price above their net asset value. Dilution through the sale of redeemable securities at a price below their net asset value may occur, for example, through the practice of selling securities for a certain period of time at a price based upon a previously established net asset value. This practice permits a potential investor to take advantage of an upswing in the market and an accompanying increase in the net asset value of investment company shares by purchasing such shares at a price which does not reflect the increase. An investor may be encouraged to purchase securities in this manner by the practice of announcing the next sale price in advance of the time at which it becomes effective, thereby enabling the investor to time his purchase so as to obtain investment company securities at the lower of two known prices. Based upon its experience in the administration of the Investment Company Act, the Commission believes that such practices have the effect of diluting the value of outstanding redeemable securities of registered investment companies.

Another purpose of proposed Rule 22c-1 is to eliminate or reduce so far as reasonably practicable other results, aside from dilution, which arise from the sale, redemption, or repurchase of securities of registered investment companies and which are unfair to the holders of such outstanding securities. The Commission believes that the practice of selling securities for a certain period of time, at a price based upon a previously established net asset value, encourages speculative trading practices which so compromise registered investment companies as to be unfair to the holders of their outstanding securities. This pricing practice allows speculators to buy large blocks of such securities under circumstances where the net asset value of the securities has increased but where the increase in value is not reflected in the price. The speculators hold such securities until the next net asset value is determined and then redeem them at large profits. These speculative trading practices can seriously interfere with the management of registered investment companies to the extent that (i) management may hesitate to invest what it believes to be speculators' money and (ii) management may have to effect untimely liquidations when speculators redeem their securities. Based upon its experience in the administration of the Investment Company Act, the Commission believes that such practices cause unfair results to the holders of outstanding securities of registered investment companies.

Proposed Rule 22c-1 would prohibit any registered investment company issuing any redeemable security; any person designated in such issuer's prospectus as authorized to consummate transactions in any such security; and any principal underwriter of, or dealer in, any such security from selling, redeeming, or repurchasing any such security except at a price determined in accordance with the provisions of the rule. The proposed rule would require that the price be based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security. Current net asset value is defined by the proposed rule to be that computed on each day during which the New York Stock Exchange is open for trading, not less frequently than twice daily as of three hours after the commencement of trading and as of the time of the close of trading on such Exchange. The effect of the proposed rule would be to prohibit the practice of selling securities for a certain period of time at a price based on a previously established net asset value.

It should be noted that Rule 2a-4 under the Act defines the term "current net asset value" for use in computing the current price of redeemable securities issued by registered investment companies for the purpose of distribution, redemption, and repurchase.

It also should be noted that Rule 31a-1(b)(1) under the Investment Company Act provides, in pertinent part, that every registered investment company shall maintain and keep current journals or other records of original entry containing an itemized daily record in detail of all sales and redemptions of its own securities. It is expected that registered investment companies will time-stamp, upon receipt, all orders with respect to sales, repurchases, and redemptions of their own securities.

In order to implement proposed Rule 22c-1 under the Investment Company Act, the Commission proposes, as a companion measure, to amend Rule 17a-3(a)(7) under the Securities Exchange Act to require dealers, when selling securities to, or buying securities from, a customer, other than a broker or dealer, to stamp on the memorandum of order the time of receipt. Brokers are already subject to such requirement under subparagraph (a)(6) of Rule 17a-3.

The text of proposed Rule 22c-1 under the Investment Company Act reads as follows:

"Rule 22c-1. Pricing of Redeemable Securities for Distribution, Redemption and Repurchase.

(a) No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security.

(b) For the purposes of this Rule, the current net asset value of any such security shall be that computed on each day during which the New York Stock Exchange is open for trading, not less frequently than twice daily as of three hours after the commencement of trading and as of the time of the close of trading on such Exchange."

The text of the proposed Commission action under the Securities Exchange Act is as follows:

“Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 is amended by deleting the period at the end of the sentence and adding; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum for each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered.’ As so amended, the subparagraph reads:

A memorandum of each purchase and sale for the account of such member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered.”

All interested persons are invited to submit views and comments on proposed Rule 22c-1 under the Investment Company Act and the proposed amendment to Rule 17a-3(a)(7) under the Securities Exchange Act. Written statements of views and comments in respect of the proposed Rule and the proposed amendment should be submitted to the Securities and Exchange Commission, Washington, D.C. 20549 on or before August 1, 1968. All such communications will be available for public inspection.

By the Commission.

## **ADOPTION OF RULE 22c-1 UNDER THE INVESTMENT COMPANY ACT OF 1940 PRESCRIBING THE TIME OF PRICING REDEEMABLE SECURITIES FOR DISTRIBUTION, REDEMPTION, AND REPURCHASE, AND AMENDMENT OF RULE 17a-3(A)(7) UNDER THE SECURITIES EXCHANGE ACT OF 1934 REQUIRING DEALERS TO TIME-STAMP ORDERS**

Release No. 34-8429; IC-551

October 16, 1968

On June 25, 1968, the Securities and Exchange Commission published notice (Investment Company Act Release No. 5413; Securities Exchange Release No. 8340) that it had under consideration the adoption of Rule 22c-1 under the Investment Company Act of 1940 ("Investment Company Act") and the amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 ("Securities Exchange Act") and invited all interested persons to submit their views and comments upon the proposal. The Commission has considered all the comments and suggestions received and has determined to adopt Rule 22c-1 under the Act in the form set forth below and to adopt the amendment of Rule 17a-3(a)(7) under the Securities Exchange Act as originally proposed.

Section 22(c) of the Investment Company Act, by reference to Section 22(a), authorizes the Commission to make rules and regulations applicable to principal underwriters of, and dealers in, the redeemable securities of registered investment companies "for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities." Such rules and regulations are authorized with respect to, among other things, the time for computing the minimum price at which any redeemable security issued by an investment company may be purchased from such company and the maximum price at which such security may be sold to such company or at which such security may be surrendered to such company for redemption. Section 38(a) of the Investment Company Act authorizes the Commission to issue such rules as are necessary or appropriate to the exercise of the powers conferred upon the Commission in that Act.

One purpose of Rule 22c-1 is to eliminate or reduce so far as reasonably practicable any dilution of the value of outstanding redeemable securities of registered investment companies through (i) the sale of such securities at a price below their net asset value or (ii) the redemption or repurchase of such securities at a price above their net asset value. Dilution through the sale of redeemable securities at a price below their net asset value may occur, for example, through the practice of selling securities for a certain period of time at a price based upon a previously established net asset value. This practice permits a potential investor to take advantage of an upswing in the market and an accompanying increase in the net asset value of investment company shares by purchasing such shares at a price which does not reflect the increase. An investor may be encouraged to purchase securities in this manner by the practice of announcing the next sale price in advance of the time at which it becomes effective, thereby enabling the investor to time his purchase so as to obtain investment company securities at the lower of two known prices. Based upon its experience in the administration of the Investment Company Act, the Commission believes that such practices have the effect of diluting the value of outstanding redeemable securities of registered investment companies.

Another purpose of Rule 22c-1 is to eliminate or reduce so far as reasonably practicable other results, aside from dilution, which arise from the sale, redemption, or repurchase of securities of registered investment companies and which are unfair to the holders of such outstanding securities. The Commission believes that the practice of selling securities for a certain period of time, at a price based upon a previously established net asset value, encourages speculative trading practices which so compromise registered investment companies as to be unfair to the holders of their outstanding securities. This pricing practice allows speculators to buy large blocks of such securities under circumstances where the net asset value of the securities has increased but where the increase in value is not reflected in the price. The speculators hold such securities until the next net asset value is determined and then redeem them at large profits. These speculative trading practices can seriously interfere with the management of registered investment companies to the extent that (i) management may hesitate to invest what it believes to be speculators' money and (ii) management may have to effect untimely liquidations when speculators redeem their securities. Based upon its experience in the administration of the Investment Company Act, the Commission believes that such practices cause unfair results to the holders of outstanding securities of registered investment companies.

Rule 22c-1 prohibits any registered investment company issuing any redeemable security; any person designated in such issuer's prospectus as authorized to consummate transactions in any such security; and any principal underwriter of, or dealer in, any such security from selling, redeeming, or repurchasing any such security except at a price determined in accordance with the provisions of the rule. The rule requires that the price be based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security. Current net asset value is defined by the rule to be that computed on each day during which the New York Stock Exchange is open for trading, not less frequently than once daily as of the time of the close of trading on such Exchange. The effect of the rule is to prohibit the practice of selling securities for a certain period of time at a price based on a previously established net asset value.

After consideration of the comments and suggestions received from interested persons, the Commission has determined to substitute a once daily pricing requirement for the twice daily pricing requirement originally proposed. However, the once daily pricing requirement is not intended to prohibit an investment company from pricing its redeemable securities more frequently if it so wishes. Furthermore, where an investment company believes that the once daily pricing requirement will be unduly burdensome, it can apply to the Commission for an appropriate exemption.

It should be noted that Rule 2a-4 under the Act defines the term "current net asset value" for use in computing the current price of redeemable securities issued by registered investment companies for the purpose of distribution, redemption, and repurchase.

It also should be noted that Rule 31a-1(b)(1) under the Investment Company Act provides, in pertinent part, that every registered investment company shall maintain and keep current journals or other records of original entry containing an itemized daily record in detail of all sales and redemptions of its own securities. It is expected that registered investment companies will time-stamp, upon receipt, all orders with respect to sales, redemptions, and repurchases of their own securities.

Any person desiring a Commission order under Section 6(c) of the Investment Company Act granting an exemption from the once daily pricing requirement of Rule 22c-1 before its effective date may file an application under that Section. Such application should of course be supported with factual data and legal arguments to enable the Commission to make the required finding that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

In order to implement Rule 22c-1 under the Investment Company Act, the Commission, as a companion measure, has determined to adopt an amendment of Rule 17a-3(a)(7) under the Securities Exchange Act to require dealers, when selling securities to, or buying securities from, a customer, other than a broker or dealer, to stamp on the memorandum of order the time of receipt. Brokers are already subject to such requirement under subparagraph (a)(6) of Rule 17a-3.

The text of Rule 22c-1, adopted by the Commission pursuant to the authority granted to it in Sections 22(c) and 38(a) of the Investment Company Act, is as follows:

**Rule 22c-1. Pricing of Redeemable Securities for Distribution, Redemption and Repurchase**

(a) No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security.

(b) For the purposes of this rule, the current net asset value of any such security shall be that computed on each day during which the New York Stock Exchange is open for trading, not less frequently than once daily as of the time of the close of trading on such Exchange.

The text of the Commission action, pursuant to the authority granted to the Commission in Sections 17(a) and 23(a) of the Securities Exchange Act, is as follows:

Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 is amended by deleting the period at the end of the sentence and adding<sup>6</sup>; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum for each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered.” As so amended, the subparagraph reads:

A memorandum of each purchase and sale for the account of such member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered.

In order that investment companies and broker-dealers may have a reasonable period of time to conform their present pricing practices and current prospectuses to the new requirements, Rule 22c-1 under the Investment Company Act and the amendment of Rule 17a-3(a)(7) under the Securities Exchange Act are declared effective at the commencement of business on January 13, 1969.

By the Commission.

## NOTICE OF PROPOSAL TO AMEND RULE 22c-1: PRICING OF INVESTMENT COMPANY SHARES GENERALLY

Release No. IC-10691

May 15, 1979

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rulemaking.

SUMMARY: On January 8, 1979, the Commission proposed for public comment a rulemaking which, among other things, proposed an amendment of the rule under the Investment Company Act of 1940 which ties to the New York Stock Exchange the days and time for pricing an investment company's redeemable securities even though its portfolio securities may not be listed for trading on that exchange. The Commission has considered the comments received and has decided to republish for public comment a revision of part of the rulemaking, which would (1) unlink that rule from the business days of the New York Stock Exchange and (2) allow directors of an investment company to determine the time for it to compute the current net asset value of its redeemable securities.

DATE: Comments must be received by June 29, 1979.

ADDRESSES: Send comments in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 N. Capitol Street, Washington, D.C. 20549. (Refer to File No. S7-782.) All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 1100 L Street, N.W., Washington, D.C.

FOR FURTHER INFORMATION CONTACT: Mark J. Mackey, Esq., Investment Company Act Study Group, Division of Investment Management, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549, (202) 755-1547.

SUPPLEMENTARY INFORMATION: The Commission proposes for public comment an amendment to Rule 22c-1 of the Investment Company Act of 1940 ("Act"), regarding the pricing of investment company shares generally. This rulemaking, if adopted, would (1) unlink the rule from the business days of the New York Stock Exchange, and (2) allow directors of an investment company to determine the time for the investment company to compute the current net asset value of its redeemable securities.

In response to its request for comments regarding Investment Company Act Release No. 10545 (Jan. 8, 1979, *44 FR* 3376, Jan. 16, 1979), proposing rules to provide start-up exemptions for certain unit investment trusts and to regulate the pricing of all investment companies' redeemable securities, the Commission received and considered 14 letters. All comments received appeared to favor the Commission's rulemaking; but, with a single exception, each commentator suggested modifications to the proposals. As a result of considering these comments, the Commission has decided to republish for public comment a revision of that part of the rulemaking which relates to the pricing of investment company shares generally, and to adopt, in a separate release, that part of the rulemaking which relates solely to unit investment trusts.<sup>1</sup>

### Pricing of Investment Company Shares Generally

After considering the comments received, the Commission has determined to republish in modified form a proposed amendment to paragraph (b) of Rule 22c-1 under the Act. That paragraph presently ties to the New York Stock Exchange the days and time for the pricing of an investment company's redeemable securities even though the investment company's portfolio securities may not be listed for trading on that exchange. The Commission had proposed to amend that paragraph to require forward pricing for all investment company redeemable securities as of the close of the relevant primary trading market in which each portfolio security is traded.<sup>2</sup>

<sup>1</sup> See Investment Company Act Release No. 10690, May 15, 1979.

<sup>2</sup> The proposed rulemaking represented a codification of existing orders in the area. See, e.g., *G.T. Pacific Fund, Inc.*, Investment Company Act Release No. 9748 (May 3, 1977).



Commentators favored divorcing the pricing of securities from the New York Stock Exchange's trading hours, but generally expressed a variety of reservations regarding the manner for determining any particular portfolio security's relevant primary trading market. Concern was also expressed as to the procedures to be followed when an investment company's portfolio consists of securities with differing relevant primary markets.

Accordingly, the Commission proposes to give each investment company's board of directors enhanced responsibility in establishing the time for which the investment company will forward price its redeemable securities.<sup>3</sup> Their determination would allow each investment company to compute its current net asset value at a time most appropriate to its particular investment portfolio. However, the directors would have to review at least annually the continuing appropriateness of their determination as to the time the company should compute the net asset value of its redeemable shares.<sup>4</sup>

Moreover, commentators noted that the trading days of the New York Stock Exchange may not coincide with the trading days of other securities marketplaces. To address the concerns expressed by such commentators while ensuring that redemptions, repurchases and sales of the securities issued by an investment company are transacted by it with the investing public at an accurate price, the Commission proposes to amend Rule 22c-1(b) to provide for the pricing of redeemable securities on all days when there is a sufficient degree of trading in the investment company's portfolio securities that the current net asset value of the investment company's redeemable securities might be materially affected by changes in the value of these portfolio securities.<sup>5</sup>

An investment company is, of course, always obligated to provide a price for its shareholders which is not materially misleading in the context for which it is used.<sup>6</sup>

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<sup>3</sup> Investment Company Act Release No. 5519, in which Rule 22c-1 was adopted, cites two purposes for Rule 22c-1: (1) to eliminate any dilution in the value of investment company shares; and (2) to eliminate certain speculative trading purchase:

Dilution through the sale of redeemable securities at a price below their net asset value may occur, for example, through the practice of selling securities for a certain period of time at a price based upon a previously established net asset value. This practice permits a potential investor to take advantage of an upswing in the market and an accompanying increase in the net asset value of investment company shares by purchasing such shares at a price which does not reflect the increase.

This rulemaking would not, of course, affect the requirement in paragraph (a) of Rule 22c-1 that such price be based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security, except regarding certain unit investment trusts; nor would the rulemaking affect any of the special considerations applicable to the valuation of securities discussed in Accounting Series Release No. 118 (Dec. 23, 1970).

<sup>4</sup> Of course, the directors could not, in accordance with their fiduciary obligations, contemporaneously determine to accelerate or defer pricing the securities in response to highly beneficial or adverse market conditions.

<sup>5</sup> If, for example, an investment company had a substantial portion of its portfolio securities listed on a securities exchange, it would be expected to price its redeemable securities on days when that exchange is open for trading since on those days the value of the investment company's redeemable securities might be materially affected. In the event that sufficient portfolio securities are traded on a foreign securities exchange, this obligation may require the investment company to price its shares on each day when that exchange is open for trading, whether or not the principal national securities exchanges in the United States are open for business. The Commission does not expect this element of directorial consideration, in establishing the time and dates for determining the price of its redeemable securities, generally to cause an investment company to incur significant increased operational costs. Rather, the Commission believes that a management investment company, in fulfilling its overriding investment management responsibilities, typically would be open for business to monitor such market's activity where the amount of exchange trading was significant. In other instances—for example, a company whose portfolio management is entirely overseas—the investment company would be expected to provide alternative procedures to segregate orders received for purchase, sale, or redemption of its securities during non-business days according to the time received in order to provide investors with the benefits of accurate pricing of the investment company's redeemable shares.

But, the Division of Investment Management has provided "no-action" assurances with respect to Rule 22c-1 where an investment company has proposed not to compute the current net asset value of its redeemable securities on days when no such security was tendered for redemption and no order to purchase or sell such security was received. *See* letters to Investment Company Institute, Professional Investment Co., Inc., and Prudential Fund of Boston, Inc., dated Oct. 26, 1978, June 3, 1975 and July 1, 1971, respectively. The letter to Investment Company Institute additionally addressed a number of other issues concerning the pricing of investment company securities.

<sup>6</sup> For example, in the case of an investment company which invests exclusively in New York Stock Exchange listed securities, a price computed during the mid-morning should not be represented as a price determined at that exchange's close. However, the Commission recognizes that, in order to publicly disseminate information regarding the net asset value of its shares through communications media, an investment company may be required to compute the price of its redeemable securities prior to the cessation of all significant market activity in its portfolio securities. The Commission would not object to such a price, provided that such price is not represented to be the current net asset value computed at the close of all such markets.

## Text of Rulemaking

It is proposed to amend Part 270 of Chapter II of Title 17 of the Code of Federal Regulations by amending paragraph (b) of § 270.22c-1 as follows:

§ 270.22c-1 Pricing of redeemable securities for distribution, redemption and repurchase.

\* \* \*

(b) For the purposes of this section, (1) the current net asset value of any such security shall be computed (i) on each day in which there is a sufficient degree of trading in the investment company's portfolio securities that the current net asset value of the investment company's redeemable securities might be materially affected by changes in the value of the portfolio securities, and (ii) at such specific time during the day as determined by the board of directors, including a majority of the directors who are not interested persons of the investment company, no less frequently than annually; and (2) a "qualified evaluator" shall mean any evaluator which represents it is in a position to determine, on the basis of an informal evaluation of the eligible trust securities held in the Trust's portfolio, whether —

(i) the current bid price is higher than the offering side evaluation, computed on the last business day of the previous week, and

(ii) the offering side evaluation, computed as of the last business day of the previous week, is more than one-half of one percent (\$5.00 on a unit representing \$1,000 principal amount of eligible trust securities) greater than the current offering price.

Statutory Basis: Amended Rule 22c-1 is proposed pursuant to the provisions of Section 22(c) [*15 U.S.C. 80a-22(c)*] and Section 38(a) [*15 U.S.C. 37(a)*] of the Act.

By the Commission.

## ADOPTION OF AMENDMENTS TO RULE 22C-1: PRICING OF INVESTMENT COMPANY SHARES GENERALLY

Release Nos. IC-10827

August 13, 1979

**SUMMARY:** The Commission today is adopting an amendment to the rule under the Investment Company Act of 1940 which requires, in part, that an investment company's redeemable securities be priced on each day the New York Stock Exchange is open for trading, not less frequently than once daily at that exchange's close, even though the investment company's portfolio securities might not be listed on that exchange. The amended rule unlinks the pricing of investment company shares from the New York Stock Exchange by requiring that the net asset value of such shares be computed (i) not less frequently than once daily on each day (other than days when no order to purchase or sell or tender for redemption is received) in which there is a sufficient degree of trading in the investment company's portfolio securities that the current net asset value of the investment company's redeemable securities might be materially affected by changes in the value of these portfolio securities, and (ii) at such specific time during the day as determined by a majority of the board of directors of the investment company no less frequently than annually.

**EFFECTIVE DATE:** December 1, 1979.

**FOR FURTHER INFORMATION CONTACT:** Mark B. Goldfus, Special Counsel, (202) 755-0230 or Mark J. Mackey, Esq., (202) 755-1547, Investment Company Act Study Group, Division of Investment Management, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549.

**SUPPLEMENTARY INFORMATION:** The Commission today amended paragraph (b) of Rule 22c-1 [*17 CFR 270.22c-1*] under the Investment Company Act of 1940 ("Act") [*15 U.S.C. 80-1 et seq.*], which pertains to the computation of the current net asset value at which an investment company must sell, purchase or redeem its securities. The rule, as amended, generally provides that, for purposes of Section 22c-1, the current net asset value of such a security shall be computed (1) not less frequently than once daily on each day (other than a day during which no tender for redemption or order to purchase or sell such security was received by the investment company) in which there is a sufficient degree of trading in the investment company's portfolio securities that the current net asset value of the investment company's redeemable securities might be materially affected by changes in the value of these portfolio securities, and (ii) at such specific time during the day as determined by a majority of the board of directors of the investment company no less frequently than annually. The reasons for the Commission's proposing to amend Rule 22c-1 were discussed thoroughly in Investment Company Act Release No. 10691 (May 15, 1979), *44 FR 29678* (May 22, 1979). Persons interested in a more detailed discussion of the amendment should refer to that release.

In response to its request for comments regarding the proposed amendment to Rule 22c-1, the Commission received and considered 10 letters. The commentators, with a single exception, generally approved the intent of the amendment to unlink the requirement of computing current net asset value from the business days and hours of the New York Stock Exchange ("NYSE"). In response to recommendations included in these comments the Commission has made certain modifications to the amended rule.

Among the comments, several commentators addressed whether the amendment precludes an investment company's determining the current net asset value of its redeemable securities more frequently than once during a particular day. The Commission emphasizes that the amendment is not intended to limit the frequency of such determinations. Accordingly, to resolve any potential ambiguity, the text of the amended rule has been modified specifically to address this concern.

A number of commentators also questioned the Commission's position that, if an investment company has a substantial portion of its portfolio securities listed on a foreign securities exchange, such company may be required to price its shares on each day when that exchange is open, whether or not the principal national securities exchanges in the United States are open. These commentators believed, generally, that this position would involve significant and unwarranted costs. In this regard, the Commission notes that in most instances an investment company—by segregating orders received, although not necessarily making the appropriate calculations prior to the next business day—may satisfy its obligations

to provide its investors with accurate pricing on days which are not business days in the United States in a manner which should not incur unreasonable costs.<sup>1</sup> Moreover, to ensure that an investment company will not be subject to unjustifiable expenses in computing the net asset value of its redeemable securities, the Commission has determined to incorporate into the text of the rule the “no-action” position of the Division of Investment Management that an investment company need not compute the net asset value on days when no such security was tendered for redemption and no order to purchase or sell such security was received.<sup>2</sup> The Commission believes that its action represents an appropriate balance between a concern that an investment company’s shareholders should not bear unreasonable operating costs and the need to provide investors with the benefits of accurate valuation during periods of significant trading activity in that investment company’s portfolio securities.

Several commentators believed that the amendment’s requirement that a majority of the directors who are not interested persons<sup>3</sup> of the investment company determine, in addition to the determination of the entire board of directors, the specific time for computing the current net asset value could be construed to reflect a general, unwarranted distrust of management. These commentators asserted that such a determination is not a decision in which any directors have a personal interest and, therefore, it should not require independent consideration by the disinterested directors. The Commission had included this requirement in the amended rule in recognition of the responsibility of disinterested directors as “independent watchdogs” over an investment company’s operations.<sup>4</sup> In this regard, it also should be noted that this requirement accords with statutorily assigned special duties of disinterested directors regarding certain other decisions in which management apparently has no direct financial interest.<sup>5</sup> However, the Commission is persuaded on balance that there are sufficient investor protections in the rule, such that any practical benefit from a separate polling of the disinterested directors would be slight. Thus, it has withdrawn that condition from the rule.

### Authority, Effective Date

The Commission amends Rule 22c-1 pursuant to the provisions of Section 22(c) [15 U.S.C. 80a-22(c)] and Section 38(a) [15 U.S.C. 37(a)] of the Act. The amendments to Rule 22c-1 will be effective in 90 days.

### Text of Adopted Rule

Part 270 of Chapter II of Title 17 of the Code of Federal Regulations is amended by amending paragraph (b) of § 270.22c-1 as follows:

§ 270.22c-1 Pricing of redeemable securities for distribution, redemption and repurchase.

\* \* \*

(b) For the purposes of this section, (1) the current net asset value of any such security shall be computed (i) no less frequently than once daily on each day (other than a day during which no such security was tendered for redemption and no order to purchase or sell such security was received by the investment company) in which there is a sufficient degree of trading in the investment company’s portfolio securities that the current net asset value of the investment company’s redeemable securities might be materially affected by changes in the value of the portfolio securities, and (ii) at such specific time during the day as determined by a majority of the board of directors of the investment company no less frequently than annually; and (2) a “qualified evaluator” shall mean any evaluator which represents it is in a position to determine, on the basis of an informal evaluation of the eligible trust securities held in the Trust’s portfolio, whether —

<sup>1</sup> For example, in an application for exemption from the provisions of then-existing Rule 22c-1, an investment company which invested primarily in foreign issuers undertook to the Commission to segregate orders received on Saturdays and certain holidays when the U.S. mail is delivered. G.T. Pacific, Investment Company Act Release Nos. 9680 (Mar. 17, 1977), 11 SEC Docket 2034, and 9748 (May 3, 1977), 12 SEC Docket 328.

<sup>2</sup> See Release No. 10691, proposing the amendments to Rule 22c-1.

<sup>3</sup> The term “interested person” is defined in Section 2(a)(19) of the Act [15 U.S.C. 80a-2(a)(19)].

<sup>4</sup> See *Burks v. Lasker*, 99 S. Ct. 1831, 1849 (May 14, 1979), quoting, *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (CA 2 1977).

<sup>5</sup> See, e.g., Section 16(c) [15 U.S.C. 80a-16(c)] [filling certain vacancies on board of directors] and Section 32(a) [15 U.S.C. 80a-31(a)] [selection of accountants].

(i) the current bid price is higher than the offering side evaluation, computed on the last business day of the previous week, and

(ii) the offering side evaluation, computed as of the last business day of the previous week, is more than one-half of one percent (\$5.00 on a unit representing \$1,000 principal amount of eligible trust securities) greater than the current offering price.

By the Commission.

## PROPOSAL TO AMEND RULE 22c-1 AND ADOPT NEW RULE 22e-2: PRICING OF REDEEMABLE SECURITIES FOR DISTRIBUTION, REDEMPTION, AND REPURCHASE

Release No. IC-14244

November 21, 1984

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rulemaking.

SUMMARY: The Commission is proposing for comment a rule and rule amendment under the Investment Company Act of 1940 relating to the pricing of redeemable securities by investment companies. Specifically, the proposals would limit the days on which pricing might be required to customary United States business days, and would provide that an investment company will not have suspended the right of redemption if it prices a redemption request by computing net asset value pursuant to the amended rule. The proposals, if adopted, would simplify and clarify pricing requirements primarily for funds with portfolio securities trading on foreign markets.

DATE: Comments must be received by January 28, 1985.

ADDRESS: Three copies of all comments should be submitted to Shirley E. Hollis, Acting Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549. Comment letters should refer to File No. S7-39-84. All comments received will be available for public inspection in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Jay Gould, Esq., Office of Disclosure Policy and Adviser Regulation, (202) 272-2107, 450 Fifth Street, NW., Room 5130, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission is publishing for comment a proposed amendment to Rule 22c-1(b) [*17 CFR 270.22c-1*] and a new Rule 22e-2 [*17 CFR 270.22e-2*] under the Investment Company Act of 1940 [*15 U.S.C. 80a-1 et seq.*]. The amendment to Rule 22c-1(b) would require investment companies subject to its provisions to compute the current net asset value of their redeemable securities at least every weekday (Monday through Friday) except for: (i) Days which are customary United States business holidays that are stated in the prospectus, (ii) days on which no security is tendered for redemption and no customer order is received, or (iii) days when the degree of trading in the investment company's portfolio securities is such that the current net asset value of the investment company's redeemable securities will not be affected by changes in the value of the portfolio securities. New Rule 22e-2 would simply apply the pricing provisions of amended Rule 22c-1 to the Section 22(e) requirement regarding the honoring of redemption requests. Proposed Rule 22e-2 would make it clear that an investment company would not be required to price redemption requests on days on which pricing would not be required under Rule 22c-1.

### Background

Rule 22c-1(b), as amended in 1979, requires investment companies issuing redeemable securities to compute the net asset value of shares (i) not less frequently than once daily on each day (other than days when no order to purchase or sell is received and no tender for redemption is made) in which there is a sufficient degree of trading in the investment company's portfolio securities that the current net asset value of the fund's redeemable securities might be materially affected by changes in the value of the portfolio securities, and (ii) at such specific time during the day as determined by a majority of the board of directors of the investment company no less frequently than annually.<sup>1</sup>

Rule 22c-1 was originally adopted in 1968 to require forward pricing of investment company redeemable securities.<sup>2</sup> The rule requires that an open-end investment company, for purposes of sales, redemptions and repurchases of its redeemable securities, give investor orders the next computed price of the net asset value after receipt of the order. Prior to adoption

<sup>1</sup> *17 CFR 270.22c-1(b)*.

<sup>2</sup> ICA Release No. 5519 (October 16, 1968); *33 FR 16331* (November 7, 1968).

of Rule 22c-1, investor orders to purchase and redeem could be executed at a price computed before receipt of the order, allowing investors to lock-in a low price in a rising market and a higher price in a falling market. The forward pricing provision of Rule 22c-1 was designed to eliminate these trading practices and the dilution to fund shareholders which occurred as a result of backward pricing.

Under the rule as originally adopted, current net asset value was to be computed at least once every day at the close of the New York Stock Exchange. In 1979, the rule was amended to unlink the pricing of investment company shares from New York Stock Exchange trading days and eliminate the requirement that pricing be done at a specific time.<sup>3</sup> As amended the rule gave the boards of directors of investment companies responsibility for establishing the time for pricing, and permitted an investment company to compute current net asset value at a time which is most appropriate for its particular investment portfolio.<sup>4</sup>

In amending the rule in 1979, the Commission intended that investors receive a fair and accurate valuation of their securities so that they could take appropriate trading action on every day in which there is a “significant degree of trading” in the portfolio securities. As the Commission has interpreted the amended rule, an investment company is not required to keep its administrative offices open on Saturdays, Sundays, and holidays but it must accept investor orders every day mail is delivered and price its redeemable securities as of the day such orders are received.

### **Proposed Amendment to Rule 22c-1(b)**

The proposed amendment to 22c-1(b) would establish customary United States business days as the days on which an investment company, at a minimum, must price its redeemable securities provided customer orders are received<sup>5</sup> and there is significant trading in the fund’s portfolio securities. Specifically, the amendment would permit a fund to limit its business days to Monday through Friday, exclusive of customary United States business holidays that are disclosed in the prospectus.

As discussed above, currently, an investment company whose portfolio securities trade on Saturday, for example, must segregate mail received on Saturday from other mail and determine whether the trading in the fund’s portfolio securities on Saturday might have materially affected the fund’s net asset value. If so, Saturday net asset value must be computed and Saturday orders must be processed at that price. The same procedures must be followed where trading in the fund’s portfolio securities occurs on a business holiday in the United States on which mail is delivered.

Members of the investment company industry have argued that this requirement imposes an administrative and financial burden on investment companies and their transfer agents or pricing services which is not justified by the limited benefits derived by investors. The rule permits investment companies to keep their administrative offices closed on Saturday and, accordingly, does not require that investment companies receive wire or telephone transactions on Saturday. Even if funds were open on Saturday, the Federal Reserve wire transfer system is closed on Saturday as are transfer agents, pricing services and other investment company support organizations. In addition, investor orders received in Saturday’s mail generally do not reflect an attempt to act on Saturday’s trading activity.

Because the arguments made by investment companies appear to have merit, the Commission has decided to propose an amendment to Rule 22c-1. The proposed amendment would permit an investment company to give investor orders received in Saturday’s mail the next computed price on Monday. This arrangement would give all investors equal

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<sup>3</sup> ICA Release No. 10827 (August 13, 1979), *44 FR 48659* (August 20, 1979).

<sup>4</sup> For example, because substantially all money market trading occurs in the morning, most money market funds compute net asset value at noon.

<sup>5</sup> Investment companies will be expected to comply with the long-standing staff position with regard to when an order to purchase or redeem is “received.” Arguments have sometimes been made that where the fund itself is closed for business, an order has not been “received” even though the postal service has delivered the order to the fund’s place of business or transfer agent. The staff has historically not accepted that argument, but has taken the position that if a fund is unable, due to emergency conditions such as snowstorms or power failures, to complete the mechanical process of pricing on a day on which it would normally be required to do so under Rule 22c-1, the price for that day may be calculated subsequently and applied to sales, redemptions and repurchases that were in fact received in the mail or otherwise on that same day. Similarly, if a fund decided to close its business operations for a local holiday or for other comparable reasons, the fund would be expected to later calculate net asset value for that day and apply that price to orders that were received that day.



opportunity to place orders with the fund, while permitting funds to limit pricing to customary business days. The amendment also would eliminate the need to price on holidays on which mail is delivered.

An investment company's pricing practices must be disclosed in its prospectus. Because the United States business holidays observed by funds may vary somewhat, the rule would require specific disclosure in the prospectus of the holidays on which the fund will not price its redeemable securities.<sup>6</sup> Also, to the extent that a fund's pricing practices may limit investor access to the fund on days when significant trading in the fund's portfolio securities may occur, the Commission would expect the fund to explain the consequences of its pricing practices in its prospectus.

It should be noted that, although the rule amendment would permit funds to eliminate segregated pricing of orders received on Saturdays and holidays, it would not require them to do so. Also, if the rule amendment is adopted, the Commission will re-examine it from time to time if the increasingly international character of the securities markets results in longer trading days, additional trading days in United States markets, or other changes that may affect the operation of the rule.

### Proposed Rule 22e-2

Section 22(e) of the Investment Company Act provides that an investment company may not suspend the right of redemption, or postpone payment upon redemption for more than seven calendar days after tender of redemption, except in limited circumstances. These circumstances are when the New York Stock Exchange is closed other than on normal closing days or when trading is restricted, in emergencies where it is not reasonably practicable to calculate net asset value, and where ordered by the Commission for the protection of shareholders. The staff has interpreted Section 22(e) generally to require investment companies to honor a redemption request received on any day the New York Stock Exchange is open.

To clarify the application of the general pricing requirements of Rule 22c-1 to the pricing of redemption requests pursuant to Section 22(e), proposed Rule 22e-2 states that a fund does not violate Section 22(e) if it honors redemption requests by pricing them in accordance with the pricing requirements of Rule 22c-1.<sup>7</sup> Thus, an investment company can postpone calculating a price for redemption purposes on any day on which pricing is not required under Rule 22c-1. This means, for example, that an investment company would not violate Section 22(e) of the Act if it did not calculate a price for redemption purposes on a day where the primary trading market for the investment company's portfolio securities was closed, and the degree of trading in the investment company's other portfolio securities was not significant enough to trigger the pricing requirement of Rule 22c-1. It should be noted, however, that an investment company would violate Section 22(e) (and Section 22(c)) and Rule 22c-1 of the Act if it failed to price a redemption request with respect to a day where the degree of trading in its portfolio securities was such that pricing under Rule 22c-1 would be required even though there was no trading in a substantial portion of the investment company's portfolio securities because the foreign exchange on which those securities trade was closed. New Rule 22e-2 codifies a staff position maintaining the principle of forward pricing established by Rule 22c-1.<sup>8</sup>

### List of Subjects in 17 CFR Part 270

Investment Companies, Reporting and Recordkeeping Requirements, Securities.

<sup>6</sup> Open-end management companies would disclose their pricing practices and holiday closings in Part A of Form N1-A.

<sup>7</sup> A fund whose portfolio securities trade on several foreign exchanges or on one or more foreign exchanges in addition to a domestic market may continue to rely on the Division's no-action position in Putnam Growth Fund and Putnam International Equities Fund, Inc., (pub. avail. February 23, 1981) with regard to the limited circumstances under which a fund may use a previous closing price to calculate current net asset value. Under Putnam, if the foreign exchange on which a portfolio security is principally traded is closed at the time a fund computes its current net asset value, then the fund may use the previous closing price on the foreign exchange to calculate the value of the security, except when an event has occurred since the time the value was established that is likely to have resulted in a change in such value. If an event does occur which will affect the value of portfolio securities after the market has closed, the fund must, to the best of its ability, determine the fair value of the securities, as of the time pricing is done under Rule 22c-1, by using appropriate indicia of value which, in certain cases, may include the opening price at which trading in the securities next begins.

<sup>8</sup> *Nomura Capital Fund of Japan, Inc., Nomura Index Fund of Japan, Inc.* (pub. avail. January 20, 1980).



## Text of Proposals

Accordingly, Part 270 of Chapter II, Title 17 of the Code of Federal Regulations is proposed to be amended as follows:

### Part 270—Rules and Regulations, Investment Company Act of 1940

1. Paragraph (b)(1) of § 270.22c-1 is revised to read as follows:

§ 270.22c-1 Pricing of Redeemable Securities for Distribution, Redemption and Repurchase.

\* \* \*

(b) For the purposes of this section: (1) The current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at such specific time during the day that a majority of the board of directors of the investment company determines no less frequently than annually. However, the current net asset value of such securities need not be determined on (i) days in which the degree of trading in the investment company's portfolio securities is such that the current net asset value of the investment company's redeemable securities will not be materially affected by changes in the value of the portfolio securities, (ii) days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company, or (iii) customary United States business holiday as specifically disclosed in the prospectus; \* \* \*

2. By adding § 270.22e-2 to read as follows:

§ 270.2e-2 Pricing of Redemption Requests When Foreign Exchange on Which Investment Company Trades Is Closed but the New York Stock Exchange Is Open.

An investment company shall not be deemed to have suspended the right of redemption if it honors a redemption request by computing the net asset value of the investment company's redeemable securities in accordance with the provisions of Rule 22c-1. (§ 270.22c-1)

## Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding the proposed amendment to Rule 22c-1 and proposed Rule 22e-2. The analysis notes that the proposed amendment and proposed rule would have the principle effect of allowing investment companies whose portfolio securities trade primarily on foreign exchanges to maintain customary United States business days while preserving forward pricing of investor orders. The objective of the proposed amendment and proposed rule is to reduce operating costs to investment companies while still providing investors with access to the fund and forward pricing for all transactions.

A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Jay Gould, Esq., Office of Disclosure Policy and Adviser Regulation, Securities and Exchange Commission (202) 272-2107, 450 Fifth Street, NW., Washington, D.C. 20549.

## Statutory Authority

The Commission is proposing the amendments to Rule 22c-1 pursuant to Sections 22(c) (15 U.S.C. 80a-22(c)) and Section 38(a) (15 U.S.C. 80a-37(a)) of the Investment Company Act of 1940.

The Commission is proposing Rule 22e-2 pursuant to Sections 6(c) (15 U.S.C. 80a-6(c)), 22(e) (15 U.S.C. 80a-22(e)) and 38(a) (15 U.S.C. 80a-37(a)) of the Investment Company Act of 1940.

By the Commission.

## ADOPTION OF REVISIONS TO RULE 22c-1 AND NEW RULE 22e-2: AMENDMENT TO PRICING RULE AND ADOPTION OF RULE ON PRICING OF REDEMPTIONS

Release No. IC-14559

June 6, 1985

AGENCY: Securities and Exchange Commission.

ACTION: Adoption of rule and rule amendment.

SUMMARY: The Commission is adopting a rule and rule amendment under the Investment Company Act of 1940. These actions limit the days on which a registered investment company is required to price its redeemable securities to customary United States business days and provide that an investment company will not have suspended the right of redemption if it prices a redemption request by computing net asset value under the amended rule. The rule and rule amendment will simplify and clarify pricing and redemption requirements for all funds especially those with portfolio securities trading in foreign markets. The Commission also is amending staff Guidelines to Form N-1A to reflect these actions.

EFFECTIVE DATE: June 13, 1985.

FOR FURTHER INFORMATION CONTACT: Forrest Foss, Special Counsel or Jay Gould, Attorney, (202) 272-2107, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission is adopting an amendment to Rule 22c-1 and a new Rule 22e-2 under the Investment Company Act of 1940 (*15 U.S.C. 80a-1 et seq.*) (the “1940 Act”), relating to the computation by an investment company of the value of its redeemable securities for purposes of sales and redemptions (commonly called “pricing”).

The changes were proposed in Investment Company Act Release No. 14244 (November 21, 1984).<sup>1</sup> The amendment to Rule 22c-1 will require investment companies to price their redeemable securities at least once every week day (Monday through Friday) except on: (i) Customary national, local, or regional business holidays disclosed in the prospectus; (ii) days when no security is tendered for redemption and no customer order is received; or (iii) days when changes in the value of the investment company’s portfolio securities do not affect the current net asset value of the investment company’s redeemable securities. New Rule 22e-2 will make clear that an investment company is not required to price redemption requests on days when pricing is not required under Rule 22c-1.

Five commentators submitted views on the proposal and unanimously supported limiting the days on which pricing is required to customary United States business days. The commentators contended, however, that the Commission should also permit funds to forego pricing on local and regional holidays and days when emergency weather conditions cause a fund to halt operations. Commentators also argued, that the disclosure conditions of the proposal were unnecessarily burdensome. As discussed below, the Commission has made several changes in the rule amendment in response to the comments. Also, in response to a technical comment, the caption of new Rule 22e-2 has been revised.

### Local and Regional Holidays

Commentators unanimously supported the proposal to require pricing on weekdays only, that is, Monday through Friday. They were also supportive of the proposal to permit an investment company to forego pricing on customary United States business holidays. However, they argued that the specific term—“United States business holidays”—used in the proposal was ambiguous, and recommended that the Commission expand Rule 22c-1 to permit a fund to forego pricing on customary local and regional holidays.

Commentators cited the same administrative and financial burdens described in the proposing release with respect to Saturday and holiday pricing as justification for eliminating required pricing on local and regional holidays. It was also

<sup>1</sup> *49 FR 46558* (November 27, 1984).

pointed out that local Federal Reserve wire transfer systems, banks, transfer agents, pricing services, and other support organizations may be closed or unavailable on local holidays, making pricing on these days difficult. In addition, it was argued that investor orders which a fund receives on a local or regional holiday would be limited, in many cases (even if the fund were to remain open) to mail orders because banks are generally closed and, as a result, wire transfers cannot be received. As stated in the proposing release with regard to Saturday pricing, orders received through the mail generally do not reflect an attempt to trade on market events which occur on the day the mail order is received.

The Commission has decided to expand the amendment to include local and regional holidays among the days on which pricing will not be required. Nonetheless, an investment company which closes its facilities and decides not to price on local or regional holidays must list these holidays in its prospectus. It should also be pointed out that the amended rule prescribes minimum requirements and will not preclude an investment company from pricing its redeemable securities on local holidays or weekends.<sup>2</sup> A fund which chooses to calculate its net asset value on days not required by the amended rule, however, must do so consistently and for both the purchase and sale of its redeemable securities.

## Disclosure

The proposal would have required investment companies to specifically state in the prospectus the holidays on which pricing would not occur. Commentators criticized this approach as burdening the prospectus with unnecessary disclosure. Instead, commentators recommended that a fund be permitted to use a more general description of its closing days in the prospectus and to place any required specific disclosure in the Statement of Additional Information. Suggestions for appropriate general descriptions of holiday policies included statements to the effect that pricing will take place “everyday the New York Stock Exchange is open” for trading, or that pricing will not be done on “days the New York Stock Exchange is closed,” or on “any federal holiday.” One commentator indicated that specific prospectus disclosure of holiday closings would be appropriate where the holidays went beyond those observed by the New York Stock Exchange.

The rule as adopted incorporates many of these suggestions. Although the rule requires a description in the prospectus of the customary national business holidays observed by the fund, it eliminates the requirement that all holidays be specifically listed in the prospectus. A fund could use the types of descriptions referred to above or others which convey the necessary meaning about the customary national business holidays on which orders will not be priced. Where the fund is closed on local or regional holidays, the rule requires that the prospectus contain a listing of these additional holiday closings. In the Commission’s view, this specific disclosure is required because investors in areas of the country distant from a fund may not be aware of the local and regional holidays. Where the customary national business holidays on which the fund is closed are only described generally in the prospectus, they must be specifically listed in the Statement of Additional Information. If all holiday closings are specifically listed in the prospectus, the list need not be repeated in the Statement of Additional Information.

Three commentators addressed the statement in the proposing release that “to the extent that a fund’s pricing practices may limit investor access to the fund on days when significant trading in the fund’s portfolio securities may occur, the Commission would expect the fund to explain the consequences of its pricing practices in its prospectus.” One commentator suggested that due to the technical nature of the information and its applicability to funds whose portfolios trade primarily on foreign markets, the disclosure should be placed in the Statement of Additional Information. Two other commentators argued that this disclosure be deleted altogether.

The Commission has considered these comments and decided that, where disclosure of the consequences of a fund’s holiday closing policy on fund pricing practices is necessary, it may be in the Statement of Additional Information. Appropriate disclosure about the impact of a fund’s closing policies on investors depends, of course, on the nature of the fund. For example, funds with portfolio securities primarily listed on foreign exchanges which trade on Saturdays or other customary United States business holidays would be expected to disclose to their investors, if the fund does not price on these days, that the portfolio will trade and the net asset value of the fund’s redeemable securities may be significantly affected on days when the investor has no access to the fund. In other cases, where for example the fund’s

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<sup>2</sup> This could be done by the investment company remaining open on weekends or on any holiday(s) or by segregating orders received on such days for separate pricing.

portfolio trades only on the New York Stock Exchange and the fund is closed only on days when that exchange is closed, the fund could forego discussion of the consequences of its closing policy on investors.

The Commission is amending guideline 28 of the Guidelines to Form N-1A to reflect the amendment to Rule 22c-1 and the foregoing disclosure requirements.<sup>3</sup>

## Emergency Closings

In response to criticism by commentators, the Commission is clarifying the staff's position on pricing requirements when funds are closed due to emergencies such as snow storms. As indicated in the proposing release, where a fund is unable, due to emergency conditions, to complete the mechanical process of pricing on a day when it would normally be required to do so under Rule 22c-1, the price for that day may be calculated subsequently and applied to sales, redemptions, and repurchases that were in fact received in the mail or otherwise on that same day. A number of commentators recommended that Rule 22c-1 be expanded to include "emergency days" as days on which pricing need not occur. As justification, commentators cited the same administrative and financial burdens associated with weekend pricing, and also suggested that it may be difficult or impossible to discern on which day mail orders are actually received during emergency conditions.

The Commission believes that clarification of the existing staff interpretation will address the practical problem raised by commentators. Under that interpretation, a mail order is considered received by the fund if the postal service has delivered it to the fund's place of business or transfer agent on a given day even if, because of an emergency closing, neither the fund nor its transfer agent is able to perform the mechanical processing of pricing on that day. The fund is expected to make every effort to price investor orders for purchase and redemption on the day the order is actually received,<sup>4</sup> and to establish procedures so as to reasonably be able, following an emergency closing, to insure that investor orders can be given the price that, but for the emergency, would have been computed on the day of actual receipt.<sup>5</sup> Nonetheless, if the fund is unable to segregate orders received on the emergency closed day from those received on the next day the fund is open for business, the fund may give all these orders the next price calculated after operations resume. This approach may be used where, for example, as a result of a snowstorm, local authorities declare a state of emergency, businesses are required to close, and only emergency travel is permitted. A fund relying on this exception, of course, must process purchase orders on the same basis as requests for redemption.

## Effective Date

The rule and rule amendment are effective upon publication in the Federal Register. An investment company which determines to change its pricing practices to take advantage of the rule changes (for example, a fund with securities trading on Saturday which now will forego Saturday pricing), must amend its disclosure in accordance with applicable requirements. The staff anticipates that generally funds could make the appropriate changes by use of a "sticker" under Rule 497(d). A fund which does not change its pricing practices in response to the rule changes may make any necessary changes in its disclosure at the time it files its annual update by post-effective amendment.

## List of Subjects in 17 CFR Part 270

Investment Companies, Reporting and Recordkeeping Requirements, Securities.

<sup>3</sup> The Guidelines to Form N-1A are a compilation of Commission releases and staff interpretations intended to assist registrants in preparing registration statements and complying with applicable requirements.

<sup>4</sup> When orders are not processed on the day of receipt, but nonetheless use that day's price, there is a potential for dilution of the interests of the fund's other shareholders.

<sup>5</sup> These emergency closings are to be distinguished from situations where a fund or its transfer agent experience computer failures or other operational problems. Where operational problems unrelated to an emergency closing result in transactions being processed on an "as of" basis, the adviser, transfer agent or another responsible party may be liable to the fund for any resulting dilution.

## Text of Amendment

Part 270 of Chapter II, Title 17 of the Code of Federal Regulations is amended as follows.

### Part 270—Rules and Regulations, Investment Company Act of 1940

1. The authority citation for Part 270 continues to read in part as follows:

#### Authority

Secs. 38, 40, 54; Stat. 841, 842; *15 U.S.C. 80a-37, 80c-89, 80a-22(c), 80a-22(e), 80a-6(c), 80a-37(a)*.

2. Paragraph (b)(1) of § 270-22c-1 is revised to read as follows:

§ 270.22c-1 Pricing of Redeemable Securities for Distribution, Redemption and Repurchase.

\* \* \*

(b) For the purposes of this section, (1) the current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the investment company sets at least annually, except on (i) days on which changes in the value of the investment company's portfolio securities will not materially affect the current net asset value of the investment company's redeemable securities, (ii) days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company, or (iii) customary national business holidays described or listed in the prospectus and local and regional business holidays listed in the prospectus;

\* \* \*

3. By adding § 270.22e-2 to read as follows:

§ 270.22e-2 Pricing of Redemption Requests in accordance with Rule 22c-1.

An investment company shall not be deemed to have suspended the right of redemption if it prices a redemption request by computing the net asset value of the investment company's redeemable securities in accordance with the provisions of Rule 22c-1.

4. Guideline 28, of Guidelines for Form N-1A, beginning at paragraph 9, is amended to read as follows:

\* \* \*

Item 7 requires a statement in the prospectus as to when calculations of net asset value are generally made. The current net asset value of redeemable securities should be computed at least once each day whenever there is enough trading in the investment company's portfolio securities to materially affect the current net asset value of the investment company's redeemable securities and on which an order for purchase, redemption, or repurchase of its securities is received. Calculations of net asset values should be made at such specific time or times during the day as set by the directors of the investment company, at least once a year. An investment company need not compute net asset value on (i) a day when no order to purchase or sell such security was received or was on hand, having been received since the last previous computation of net asset value or (ii) customary national business holidays described or listed in the prospectus and local and regional business holidays listed in the prospectus.<sup>6</sup>

Under Item 7, a fund must identify in a general manner or list the customary national business holidays on which it will (or will not) price. For this purpose, a fund could indicate, for example, that pricing will take place "every day the New York Stock Exchange is open for trading" or "Monday through Friday exclusive of federal holidays" or the fund may use some other general description which conveys the necessary meaning about the customary national business holidays

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<sup>6</sup> Investment Company Act Release No. 10827 (August 13, 1979) [*44 FR 48660* (August 20, 1979)]; Investment Company Act Release No. 14559 (June 6, 1985).

on which orders will (or will not) be priced. A fund which will be closed on local or regional holidays must specifically list these holidays under Item 7 of the prospectus. Where national holidays on which the fund will be closed are only generally described in the prospectus, they must be specifically listed in the Statement of Additional Information. If all holiday closings are specifically listed in the prospectus, the list need not be repeated in the Statement of Additional Information.

Where a fund's closing policy may have a significant impact on investor access to the fund, this should be explained in the Statement of Additional Information under Item 19. The necessity for and appropriate level of disclosure under Item 19 depends on the nature of the fund. For example, funds with portfolio securities primarily listed on foreign exchanges which trade on Saturdays or other customary United States national business holidays would be expected to disclose to their investors, if the fund does not price on these days, that the portfolio will trade and the net asset value of the fund's redeemable securities may be significantly affected on days when the investor has no access to the fund. On the other hand, a fund need not discuss the consequences of its pricing policies if the fund's portfolio securities trade only on the New York Stock Exchange and the fund is closed only on days when that exchange is closed.

The prospectus disclosure regarding sales charges should make clear that the term "offering price" as used throughout the prospectus includes the sales charge, if any.

By the Commission.

## EXCERPT FROM REVISION OF CERTAIN ANNUAL REVIEW REQUIREMENTS OF INVESTMENT COMPANY BOARDS OF DIRECTORS

Release Nos. 33-7013; IC-19719

September 17, 1993

### C. Rule 22-1

Rule 22c-1 generally requires the purchase and redemption of a redeemable security to be effected at the current net asset value next computed after receipt of a purchase or redemption request.<sup>1</sup> Subject to limited exceptions, current net asset value must be computed at least once daily.<sup>2</sup> Rule 22c-1 seeks to address the problem of “dilution” and to curb certain speculative trading practices.<sup>3</sup>

As amended, Rule 22c-1 no longer requires directors to establish annually the time (or times) each day that the company will calculate current net asset value. Annual approval of pricing time does not materially advance the purpose of Rule 22c-1, which is accomplished by the fundamental requirement of forward pricing. Amended paragraph (b)(1) and new paragraph (e) of Rule 22c-1 require instead that the board initially establish the pricing time, and thereafter make and approve changes as it deems necessary.<sup>4</sup> In connection with these amendments, the Division is adopting conforming amendments to the Guidelines to Forms N-1A [17 CFR 239.15A, 274.11A] and N-3 [17 CFR 239.17a, 274.11b].<sup>5</sup>

All commenters supported the proposed amendments. One commenter also suggested that fund management—and not the board—should be responsible for setting the time at which net asset value is determined.<sup>6</sup> The Commission is taking no action on the commenter’s recommendation at this time. The board’s role in setting the pricing time may provide some investor protections. In addition, because the time at which net asset value is determined rarely changes, the requirement under the amended rule that the board initially approve the calculation time and any subsequent changes should not be burdensome.

### Part 270—Rules and Regulations, Investment Company Act of 1940

6. Section 270.22c-1 is amended by revising paragraph (b)(1) and adding paragraph (e) to read as follows:

§ 270.22c-1 Pricing of Redeemable Securities for Distribution, Redemption and Repurchase.

(b) \* \* \*

(1) the current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the investment company sets, in accordance with paragraph (e) of this section, except on:

(i) days on which changes in the value of the investment company’s portfolio securities will not materially affect the current net asset value of the investment company’s redeemable securities;

(ii) days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company; or

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<sup>1</sup> Rule 22c-1(a).

<sup>2</sup> Rule 22c-1(b)(1).

<sup>3</sup> See Pricing of Redeemable Securities for Distribution, Redemption and Repurchase and Time-Stamping of Orders by Dealers, Investment Company Act Release No. 5519 (Nov. 7, 1968), 33 FR 16331.

<sup>4</sup> The board, for example, may decide to change pricing time in response to new developments, such as altered trading hours or changes in the nature of the fund’s investments.

<sup>5</sup> These amendments delete references to the annual approval requirements.

<sup>6</sup> ABA Subcommittee Letter, *supra* note 6, at 5.

- (iii) customary national business holidays described or listed in the prospectus and local and regional business holidays listed in the prospectus; and
- (e) The board of directors shall initially set the time or times during the day that the current net asset value shall be computed, and shall make and approve such changes as the board deems necessary.





# ACCOUNTING SERIES RELEASES

## ACCOUNTING SERIES RELEASE NO. 113

Release Nos. IC-5847; ASR-113  
October 21, 1969

The Securities and Exchange Commission today made public the following statement.

### “Restricted Securities”

The Commission is aware that many investment companies have been acquiring substantial quantities of securities that cannot be offered to the public for sale without first being registered under the Securities Act of 1933 (“restricted securities”). For the year 1968, annual reports filed by registered investment companies indicate that open-end and closed-end companies together held in excess of \$4.2 billion of restricted equity securities. Open-end companies—excluding exchange funds—accounted for about \$3.2 billion of these restricted securities which represented 4.4 per cent of their total net assets. The acquisition by investment companies of such securities raises certain problems under the securities laws of which shareholders, distributors, managements and directors of these companies should be aware. This statement discusses these problems. No inference should be drawn from publication of this statement, however, as to the desirability or merits of the acquisition of restricted securities by a registered investment company.

### Problems for the Seller

Section 4(2) of the Securities Act of 1933 exempts from the registration requirements of that Act “transactions by an issuer not involving any public offering.” This is the so-called “private offering” provision in the Securities Act. The securities involved in transactions effected pursuant to this exemption are referred to as restricted securities because they cannot be resold to the public without prior registration. They are also sometimes referred to as “investment letter securities” because of the practice frequently followed by the seller in such a transaction, in order to substantiate the claim that the transaction does not involve a public offering, of requiring that the buyer furnish a so-called “investment letter” representing that the purchase is for investment and not for resale to the general public.

The private offering exemption of Section 4(2) of the Securities Act is available only where the offerees do not need the protections afforded by the registration procedure. As the Court of Appeals for the Second Circuit recently stated in *Katz v. Amos Treat & Co.*, CCH Fed'l. Sec. Law Rep. P92,409 (1969):

“The Supreme Court has instructed that the applicability of the exemption should turn on whether the particular class of persons affected need the protection of the Act. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).”

The test of the availability of the Section 4(2) exemption is whether the offerees are in such a position with respect to the issuer as to have access to the kind of information that would be made available in a registration statement filed pursuant to the Securities Act. This test is no different when the offeree is an investment company.

## Problems for the Buyer

### 1. The Problems of Valuation

It is critically important that an investment company properly value its portfolio securities. It is obvious, for example, that any distortion in the valuation of a restricted security held by an investment company will distort the price at which the shares of the investment company are sold or redeemed. It is also clear that investment managers who are compensated on the basis of net asset value or performance may be unduly compensated if a restricted security, purchased at a discount from the market quotation for unrestricted securities of the same class, is overvalued. In such a case, investors may also be misled by the reported performance of the investment company.

The acquisition of restricted securities by both open-end and closed-end investment companies creates serious problems of valuation. Section 2(a)(39) of the Investment Company Act of 1940 and Rule 2a-4 thereunder requires that in determining net asset value, “securities for which market quotations are readily available” must be valued at current market value while other securities and assets must be valued at “fair value as determined in good faith by the board of directors.”

Readily available market quotations refers to reports of current public quotations for securities similar in all respects to the securities in question. No such current public quotations can exist in the case of restricted securities. For valuation purposes, therefore, restricted securities constitute securities for which market quotations are not readily available. Accordingly, their fair values must be determined in good faith by the board of directors and this obligation necessarily continues throughout the period these securities are retained in the company’s portfolio.

Restricted securities should be included in the portfolio of a company and valued to determine current net asset value on the date that the investment company has an enforceable right to demand the securities from the seller.

Where the investment company negotiates the acquisition of the restricted securities directly with the owner of the securities, there are three significant dates. The first occurs when the investment company and the seller orally agree upon the price and the amount of the securities (the “handshake date”). At this point, there would not seem to be any enforceable right of the investment company to demand the securities from the seller since, in most states, particularly those which have adopted the Uniform Commercial Code, there is no enforceable right unless there exists some writing “sufficient to indicate that a contract has been made for sale of a stated quantity of described securities at a defined or stated price” (Section 8-319(a) of the Uniform Commercial Code). If the terms of the oral understanding do not contemplate compliance with any condition by the seller, it is suggested that the investment company procure, from the seller, a signed memorandum setting forth the price and quantity of securities to be sold. Upon receipt of that memorandum, an enforceable right would be obtained. The securities should be valued as of that date.

In those situations where the oral understanding contemplates the execution of a formal contract of purchase and sale, no enforceable right exists until the time the formal contract is signed (the “contract date”). If the formal contract does not require compliance with any conditions by the seller, an enforceable right is then obtained, and the securities should be valued as of that date.

Where the formal contract requires compliance with stated conditions which the investment company believes should not be waived, no enforceable right is obtained until the stated conditions are satisfied. In that situation, the valuation date should be the date upon which the conditions are satisfied (the “closing date”).

Restricted securities are often purchased at a discount, frequently substantial, from the market price of outstanding unrestricted securities of the same class. This reflects the fact that securities which cannot be readily sold in the public market place are less valuable than securities which can be sold, and also the fact that, by the direct sale of restricted securities, sellers avoid the expense, time and public disclosure which registration entails.

As a general principle, the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. This depends upon their inherent worth, without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature. Consequently, the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except

for most unusual situations, be improper.<sup>1</sup> Further, the continued valuation of such securities at cost would be improper if, as a result of the operations of the issuer, change in general market conditions or otherwise, cost has ceased to represent fair value. In such circumstances, maintaining the value of the restricted securities at cost would mislead investors as to the value of the portfolio of the investment company which holds restricted securities.

Instead of valuing restricted securities at cost or at the market value of unrestricted securities of the same class, some investment companies value restricted securities held in their portfolio by applying either a constant percentage or an absolute dollar discount to the market quotation for unrestricted securities of the same class. The automatic valuation of restricted securities by such a method, however, would also not appear to satisfy the requirement of the Act that each security, for which a market quotation is not readily available, be valued at fair value as determined in good faith by the board of directors.

Thus, it would be improper in valuing restricted securities automatically to maintain the same percentage discount (from the market quotation for unrestricted securities of the same class) that was received when the restricted securities were purchased, without regard to other relevant factors such as, for example, the extent to which the inherent value of the securities may have changed.

Furthermore, the valuation of restricted securities by reference to the market price for unrestricted securities of the same class assumes that the market price for unrestricted securities of the same class is representative of the fair value of the securities. This may not be the case when the market for the unrestricted securities is very thin, i.e., only a limited volume of shares are available for trading. With a thin market, the news of the investment company's purchase of the restricted securities may, by itself, have the effect of stimulating a public demand for the unrestricted securities, the supply of which has not been increased, and thus lead to a spiralling increase in the valuation of both the restricted and unrestricted securities.

Moreover, if in valuing restricted securities, the diminution in value attributable to the restrictive feature is itself affected by factors subject to change, such as the length of time which must elapse before the investment company may require the issuer to cause the securities to be registered for public sale, the valuation should reflect any such changes.

Some companies value restricted securities, acquired at prices below the market quotations for unrestricted securities of the same class, by automatically amortizing the difference over some chosen period on the assumption that it will be possible to sell them at the market price for unrestricted securities at the expiration of the time period. Under prevailing conditions, however, it cannot always be determined either that the securities will, in fact, be effectively registered at the expiration of that period or that their public sale will otherwise be possible. For example, the issuer may be unable or unwilling to register at the expiration of the estimated period, and public sale at the end of that period without registration may not be lawful. Consequently, the practice of automatically amortizing the discount over an arbitrarily chosen period creates the appearance of an appreciation in the value of the securities which has not, in fact, occurred, and, accordingly, is improper.

An undertaking by the issuer to register the securities within a specified time period would not dictate a different result. In view of the many factors that may alter the date of the proposed public offering, it is at best speculative to use such an undertaking alone as the basis for amortizing the discount.

Similarly, the possible adoption by the Commission of the more definite holding periods contained in proposed Rules 101, 160, 161, 162, 163, 164, and 180, Securities Act Release No. 4997, (dated September 15, 1969) would also not alter the conclusion that amortization of the discount may be improper. The more definite holding periods there proposed are available only if certain specified conditions are met.

In summary, there can be no automatic formula by which an investment company can value restricted securities in its portfolio to comply with Section 2(a)(39) and Rule 2a-4. It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith; and the data and information considered and the analysis thereof should be retained for inspection by the company's independent auditors. While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted security in the company's portfolio, it must

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<sup>1</sup> See *Proposed Guidelines for the Preparation of Form N-8B-1*, Investment Company Act Release No. 5633, p. 21 (March 11, 1969).

continuously review the appropriateness of any method so determined. The actual calculations may be made by persons acting pursuant to the direction of the board.

## 2. The Problems of Portfolio Management

In addition to valuation, restricted securities present special problems of portfolio management.

The concept of the Securities Act exemption of a private placement of securities is premised on the belief that in such a situation the investor has such information concerning the issuer that he is able to fend for himself without need for the disclosures that would be provided by an effective registration statement. Correlatively, where the investor is a registered investment company, it would seem to be the fiduciary duty of the persons responsible for the investment decisions of the investment company to obtain, prior to purchase, the necessary information to make an independent analysis of the investment merits of the particular restricted securities.<sup>2</sup> Also, in order to enable the continuing valuation of such securities, the investment company should require the seller to undertake to provide, to the extent known to the seller, information on a continuing basis as to any subsequent private sales of the issuer's securities. The investment company should also assure itself that it is in the position to obtain the appropriate financial information at appropriate times. It is assumed that any public disclosures, such as that made in periodic reports filed pursuant to the Securities Exchange Act, are carefully considered by the investment company portfolio manager.

There is also the paradox of too much success to consider. For example, if restricted securities rapidly appreciate in value, perhaps because of an improvement in the business of the issuer, an investment company may find instead of having, for example, 5 percent of its assets invested in a particular company, it has instead, 25 per cent of its assets in that company. The investment company to which this happens suffers a loss in diversification and may find that it has become overly sensitive to any adverse developments in the affairs of that particular portfolio company.

The foregoing factors in portfolio management relate to both open-end and closed-end management companies. There are additional special factors that relate only to open-end companies.

Section 2(a)(31), when read together with Section 5(a), of the Investment Company Act requires that the holders of redeemable shares issued by an open-end investment company be entitled to receive approximately their proportionate share of the issuer's current net assets, or the cash equivalent thereof, upon presentation of the security to the issuer or to a person designated by the issuer. Section 22(e) of the Act provides that, absent specified unusual conditions, payment of the redemption price must be made within seven days after the tender of a redeemable security to an investment company or its agent designated for that purpose.

It is desirable that an open-end company retain maximum flexibility in the choice of portfolio securities which, on the basis of their relative investment merits, could best be sold where necessary to meet redemptions. To the extent that the portfolio consists of restricted securities, this flexibility is reduced.

Restricted securities may not be publicly sold—nor can they be distributed to redeeming shareholders as an in-kind redemption. While they may be sold privately, there may not be sufficient time to obtain the best price since the date of payment or satisfaction may not be postponed more than seven days after the tender of the company's redeemable securities for redemption. A private sale within that period may result in the investment company receiving less than its carrying value of the restricted securities. This would result in a preference in favor of the redeeming shareholders and a diminution of the net asset value per share of shareholders who have not redeemed. Therefore, instead of arranging a private sale of restricted securities, an open-end company that is faced with redemptions may decide to sell unrestricted securities which it would otherwise have retained on the basis of comparative investment merit.

Significant holdings of restricted securities not only magnify the valuation difficulties but may also present serious liquidity questions. Because open-end companies hold themselves out at all times as being prepared to meet redemptions within seven days, it is essential that such companies maintain a portfolio of investments that enable them to fulfill that obligation. This requires a high degree of liquidity in the assets of open-end companies because the extent of redemption demands or other exigencies are not always predictable. It has been with this in mind that the staff of the

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<sup>2</sup> See *The Value Line Fund v. Marcus* ('64-'66 Transfer Binder) CCH Fed'l. Sec. Law Rep. P91,523 at p. 94,970 (S.D.N.Y. 1965).

Commission has for several years taken the position that an open-end company should not acquire restricted securities when the securities to be acquired, together with other such assets already in the portfolio, would exceed 15 per cent of the company's net assets at the time of acquisition. The Commission, however, is of the view that a prudent limit on any open-end company's acquisition of restricted securities, or other assets not having readily available market quotations, would be 10 per cent.<sup>3</sup> When as a result of either the increase in the value of some or all of the restricted securities held, or the diminution in the value of unrestricted securities in the portfolios, the restricted securities come to represent a larger percentage of the value of the company's net assets, the same valuation and liquidity questions occur. Accordingly, if the fair value of restricted holdings increases beyond 10 per cent, it would be desirable for the open-end company to consider appropriate steps to protect maximum flexibility. The Commission will re-examine appropriate limitations in this area in light of all the policy objectives of the Investment Company Act.

### 3. The Problem of Disclosure

Section 8(b)(1)(D) of the Investment Company Act requires that an investment company include, in its registration statement filed with the Commission under the Act, information as to its policy with respect to "engaging in the business of underwriting securities issued by other persons." Item 4(c) of Form N-8B-1 requires that a registrant under the Act describe its policy or proposed policy with respect to "the underwriting of securities of other issuers." In response to this item, registrant's policy with respect to the acquisition of restricted securities should be disclosed.<sup>4</sup> In view of the fact that policies listed under Item 4 are fundamental policies which cannot be changed without prior shareholder approval, the importance of adopting a clear policy with regard to such investments is apparent.

The prospectus of a registered investment company should also fully disclose the company's policy with respect to restricted securities.<sup>5</sup> It is also clear that an investment company which has a policy of acquiring restricted securities is responsible for full and adequate disclosure with respect to all matters relating to the valuation of such securities. Specifically, there should be included, in a note to the financial statements, (1) identification of any restricted securities and the date of acquisition, (2) disclosure of the methods used in valuing such securities both at the date of acquisition and the date of the financial statements, (3) disclosure of the cost of such securities and the market quotation for unrestricted securities of the same class both on the day the purchase price was agreed to (the so-called "handshake date"), and on the day the investment company first obtained an enforceable right to acquire such securities, and (4) a statement as to whether the issuer or the registrant will bear costs, including those involved in registration under the Securities Act, in connection with the disposition of such securities.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder makes it unlawful, among other things, for any person, in connection with the purchase or sale of securities, to employ any device, scheme, or artifice to defraud or to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading, or engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any persons.

The offering price of securities issued by a management investment company is premised upon the net asset value of such shares as determined pursuant to Section 2(a)(39) of the Act and Rule 2a-4 thereunder and is so represented in its prospectus. The improper valuation of restricted securities held by such a company would distort the net asset value of the shares being offered or, in the case of an open-end company, redeemed, and would therefore constitute a fraud and deceit within the meaning of Section 10(b) and Rule 10b-5.

An open-end company, of course, represents to investors, in its prospectus, that it will, as required by Section 22(e) of the Act, redeem its securities at approximate net asset value within seven days after tender. To the extent a material percentage of the assets of an open-end company consist of restricted securities which cannot publicly be sold without registration under the Securities Act, the ability of the company to comply with the provisions of the Investment

<sup>3</sup> The Commission is aware that certain open-end companies may have acquired restricted securities in excess of 10 per cent of net assets. It is assumed that such companies will not undertake commitments, beyond any obligation existing on this date, to acquire restricted securities until, in the normal course of business, such holdings are not in excess of 10 per cent of current net asset value.

<sup>4</sup> See *Proposed Guidelines for the Preparation of Form N-8B-1*, Investment Company Act Release No. 5633, p. 7 (March 11, 1969).

<sup>5</sup> See *Proposed Guidelines for the Preparation of Forms S-4 and S-5*, Investment Company Act Release No. 5634, pp. 11, 13 (March 11, 1969).

Company Act relating to redemption, and to fulfill the implicit representations made in its prospectus with respect thereto, may be adversely affected.<sup>6</sup> In any such situation, the investment company concerned and the persons responsible for the sale of its securities should give careful consideration to the possible application of the provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

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<sup>6</sup> See *Proposed Guidelines for the Preparation of Form N-8B-1*, Investment Company Act Release No. 5633, p. 7 (March 11, 1969).



## ACCOUNTING SERIES RELEASE NO. 118

### ACCOUNTING FOR INVESTMENT SECURITIES BY REGISTERED INVESTMENT COMPANIES

Release Nos. 33-5120; 34-904; IC-6295; ASR-118

December 23, 1970

The Securities and Exchange Commission today announced the publication of its views relating to some of the more important questions concerning the accounting by registered investment companies for investment securities in their financial statements and in the periodic computations of net asset value for the purpose of pricing their shares. The questions relate both to the amounts at which investment securities should be carried and to the circumstances under which individual securities may be included among the assets. This release discusses certain accounting matters in order to give additional guidance to the management of investment companies, as well as certain related auditing procedures which are considered appropriate for the guidance of independent accountants. A release was issued by the Commission on October 21, 1969<sup>1</sup> on the specific subject of the problems relating to so-called “restricted securities,” i.e., those which must be registered under Section 5 of the Securities Act of 1933 prior to public sales, and the discussion of valuation herein does not alter any of the special considerations applicable to such securities as discussed in that release.

The financial statements of registered investment companies appearing in registration statements, proxy statements, and annual reports filed with the Commission are governed by various provisions of the Investment Company Act of 1940 (the “Act”), the rules thereunder, and by Regulation S-X, Article 6 of which sets forth accounting rules applicable to such companies. While Regulation S-X does not by its terms apply to periodic reports to stockholders, Section 30(d) of the Act provides that such reports “shall not be misleading in any material respect in the light of the reports” (including annual reports) required to be filed under Section 30(a) and (b). To the extent that any provisions in an investment company’s articles of incorporation, trust indenture or other governing legal instruments specify accounting procedures inconsistent with those required by Regulation S-X, the latter must be followed in accordance with Rule 6-02-1 thereof.

#### Inclusion of Securities in the Portfolio

The statement of assets and liabilities of a registered investment company comprises, for the most part, not only investments in securities which are held by a custodian or are on hand, but also frequently includes securities as to which contracts to purchase have been entered into but which have not been received. Securities held by a custodian or on hand that have been contracted to be sold are excluded from the investments in such statement. In the ordinary transaction through a broker, recording the transaction on the date the broker advises the investment company that the securities have been purchased or sold (the “trade date”), rather than when delivery is made or due (the “settlement date”), is the established and acceptable practice in investment company accounting.

In the case of purchases or sales of securities other than in the usual brokerage transactions, the date on which the investment company obtains an enforceable right to demand the securities or the payment therefor—the date the transaction should be recorded—is sometimes difficult to determine. The considerations involved in determining such transaction date are similar to those discussed at page 3 of the aforementioned release on restricted securities. When a question arises as to the date an enforceable right is obtained by the investment company, an opinion of legal counsel as to when the right occurred should normally be obtained by the company’s management and made available to the independent accountant. Such an opinion should be in writing, and a copy should be included in the accountant’s working papers.

Where the propriety or validity of an investment in a security by an investment company is questionable because of particular provisions of the Act, or state law, or the company’s investment policy or other representations as stated in its filings with the Commission, or legal obligations in respect of a contract or transaction, a written opinion of legal counsel should also be obtained by the company’s management, made available to the independent accountant, and a copy

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<sup>1</sup> Investment Company Act Release No. 5847; Accounting Series Release No. 113. *See also* a supplementary release issued on April 13, 1970, Investment Company Act Release No. 6026; Accounting Series Release No. 116. Note. *See* letter to the American Institute of Certified Public Accountants, p. 8.



included in the working papers. If the questions of propriety or validity are not satisfactorily resolved, the circumstances of the investment should be disclosed in the financial statements or notes thereto.

Securities held by the company or its custodian should be substantiated by the company's independent accountant in the course of an audit by inspection of such securities or by obtaining confirmation from a custodian which maintains the securities in custody pursuant to clause (1) of Section 17(f) of the Act. When securities contracted to be purchased but not yet received are included in the statement of assets and liabilities, confirmation of the contract to purchase should be obtained from the bank, broker, or other person responsible for the delivery of such securities. Where satisfactory confirmation has been received, audit procedures normally need not be extended to obtain evidence of subsequent receipt of the securities by the company or its custodian unless additional substantiation is considered necessary by the independent accountant under the circumstances. Where satisfactory confirmation has not been received, subsequent receipt of such securities should be substantiated by other appropriate procedures.

In accordance with Section 30(e) of the Act, the certificate of the company's independent accountant should include a brief statement concerning the substantiation of securities owned. Except for securities contracted to be purchased but not received, the certificate should state that the securities were either inspected by the independent accountant or, where the company's securities were maintained in custody pursuant to clause (1) of Section 17(f) of the Act, were confirmed to him by the custodian. In the case of securities contracted to be purchased but not received by the company or its custodian, reference should be made to confirmation by banks, brokers, or others or to alternative procedures, as appropriate in the circumstances.

## **Valuation of Securities**

Under Rule 6-02-6 of Regulation S-X, the statements of assets and liabilities of open-end investment companies must reflect all assets at value, showing cost parenthetically, while closed-end companies may elect to use either this basis or to reflect all assets at cost, showing value parenthetically.

"Value" is defined in Section 2(a)(39) of the Act. For purposes of determining the amounts at which securities and other assets are carried in the statements of assets and liabilities included in annual and other reports and in registration statements filed by investment companies, "value" is defined in pertinent part as: "(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors. . ." This definition is also used in Rule 2a-4 under the Act as the required basis for computing periodically the current net asset value of redeemable securities of investment companies for the purpose of pricing their shares.

In some circumstances value can be determined fairly in more than one way. Hence, the standards set forth below should be considered as guidelines, one or more of which may be appropriate in the circumstances of a particular case. These standards should be followed, and a company's stated valuation policies should be consistent with them. Any variation from the standards should be disclosed in the financial statements or notes thereto even though the variation is in accordance with the company's stated valuation policy. In addition, any deviation from a stated valuation policy, whether or not in conformity with the standards, should be disclosed in the financial statements or notes thereto.

## **Securities Listed or Traded on a National Securities Exchange**

Ordinarily, little difficulty should be experienced in valuing securities listed or traded on one or more national securities exchanges, since quotations of completed transactions are published daily. If a security was traded on the valuation date, the last quoted sale price generally is used. In the case of securities listed on more than one national securities exchange the last quoted sale, up to the time of valuation, on the exchange on which the security is principally traded should be used or, if there were no sales on that exchange on the valuation date, the last quoted sale, up to the time of valuation, on the other exchanges should be used. With respect to the time of valuation Rule 22c-1 under the Act requires that current net asset value shall be computed not less frequently than once daily as of the time of the close of trading on the New York Stock Exchange.

If there was no sale on the valuation date but published closing bid and asked prices are available, the valuation in such circumstances should be within the range of these quoted prices. Some companies as a matter of general policy use the

bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range considered best to represent value in the circumstances; each of these policies is acceptable if consistently applied. Normally, it is not acceptable to use the asked price alone. Where, on the valuation date, only a bid price or an asked price is quoted or the spread between bid and asked prices is substantial, quotations for several days should be reviewed. If sales have been infrequent or there is a thin market in the security, further consideration should be given to whether “market quotations are readily available.” If it is decided that they are not readily available, the alternative method of valuation prescribed by Section 2(a)(39)—“fair value as determined in good faith by the board of directors”—should be used.

### **Over-the-Counter Securities**

Quotations are available from various sources for most unlisted securities traded regularly in the over-the-counter market. These sources include tabulations in the financial press, publications of the National Quotation Bureau and the “Blue List” of municipal bond offerings, several financial reporting services, and individual broker-dealers. These quotations generally are in the form of inter-dealer bid and asked prices. Because of the availability of multiple sources, a company frequently has a greater number of options open to it in valuing securities traded in the over-the-counter market than it does in valuing listed securities. A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any of these policies is acceptable if consistently applied. Normally, the use of asked prices alone is not acceptable.

Ordinarily, quotations for a security should be obtained from more than one broker-dealer, particularly if quotations are available only from broker-dealers not known to be established market-makers for that security, and quotations for several days should be reviewed. If the validity of the quotations appears to be questionable, or if the number of quotations is such as to indicate that there is a thin market in the security, further consideration should be given to whether “market quotations are readily available.” If it is decided that they are not readily available, the security should be considered one required to be valued at “fair value as determined in good faith by the board of directors.”

### **Securities Valued “in Good Faith”**

To comply with Section 2(a)(39) of the Act and Rule 2a-4 under the Act, it is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, the board may appoint persons to assist them in the determination of such value, and to make the actual calculations pursuant to the board’s direction. The board must also, consistent with this responsibility, continuously review the appropriateness of the method used in valuing each issue of security in the company’s portfolio. The directors must recognize their responsibilities in this matter and whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair.

No single standard for determining “fair value . . . in good faith” can be laid down, since fair value depends upon the circumstances of each individual case. As a general principle, the current “fair value” of an issue of securities being valued by the Board of Directors would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. Methods which are in accord with this principle may, for example, be based on a multiple of earnings, or a discount from market of a similar freely traded security, or yield to maturity with respect to debt issues, or a combination of these and other methods. Some of the general factors which the directors should consider in determining a valuation method for an individual issue of securities include: 1) the fundamental analytical data relating to the investment, 2) the nature and duration of restrictions on disposition of the securities, and 3) an evaluation of the forces which influence the market in which these securities are purchased and sold. Among the more specific factors which are to be considered are: type of security, financial statements, cost at date of purchase, size of holding, discount from market value of unrestricted securities of the same class at time of purchase, special reports prepared by analysts, information as to any transactions or offers with respect to the security, existence of merger proposals or tender offers affecting the securities, price and extent of public trading in similar securities of the issuer or comparable companies, and other relevant matters.

This release does not purport to delineate all factors which may be considered. The directors should take into consideration all indications of value available to them in determining the “fair value” assigned to a particular security.<sup>2</sup> The information so considered together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decisions should be documented in the minutes of the directors’ meeting and the supporting data retained for the inspection of the company’s independent accountant.

### **Auditing Security Valuations**

In the case of securities for which market quotations are readily available, the independent accountant should independently verify all the quotations used by the company at the balance sheet date and satisfy himself that such quotations may properly be used under the standards stated above.

In the case of securities carried at “fair value” as determined by the Board of Directors in “good faith,” the accountant does not function as an appraiser and is not expected to substitute his judgment for that of the company’s directors; rather, he should review all information considered by the board or by analysts reporting to it, read relevant minutes of directors’ meetings, and ascertain the procedures followed by the directors. If the accountant is unable to express an unqualified opinion because of the uncertainty inherent in the valuations of the securities based on the directors’ subjective judgment, he should nevertheless make appropriate mention in his certificate whether in the circumstances the procedures appear to be reasonable and the underlying documentation appropriate.

When considering values assigned to securities by the company, the independent accountant should consider any investment limitations or conditions on the acquisition or holding of such securities which may be imposed on the company by the Act, by its certificate or by-laws, by contract, or by its filings with the Commission. If such restrictions are met by a narrow margin, the independent accountant may need to exercise extra care in satisfying himself that the evidence indicates that the security valuation determinations were not biased to meet those restrictions.

### **Investments in Affiliates or Affiliated Persons**

Various rules of Regulation S-X require that the financial statements of an investment company state separately investments in, investment income from, gain or loss on sales of securities of, and management or other service fees payable to, (a) controlled companies and (b) other “affiliates.” As stated in Rule 6-02-4 of Regulation S-X, the term “affiliate” means an affiliated person as defined in Section 2(a)(3) of the Act, and the term “control” has the meaning given in Section 2(a)(9) of the Act. The term “affiliated person” is defined in Section 2(a)(3) of the Act in such a manner as to encompass such control relationships and also the direct or indirect ownership of five percent or more of the outstanding voting securities of any issuer. An affiliated person as there defined also includes any officer, director, partner, co-partner, or employee or, with respect to an investment company, any investment adviser or member of an advisory board thereof.

In ascertaining the existence of any such affiliations, the independent accountant should consider the facts obtained during the course of an audit and also make inquiries of the company’s management; and his working papers should include written representations from the management as evidence of such inquiries. The representations should be in the form of a statement that the company, except to the extent indicated, (i) does not own any securities either of persons who are directly affiliated, or, to the best information and belief of management, of persons who are indirectly affiliated, (ii) has not received income from or realized gain or loss on sales of investments in or indebtedness of such persons, (iii) has not incurred expenses for management or other service fees payable to such persons, and (iv) has not otherwise engaged in transactions with such persons. Where there is a question as to the existence of an affiliation, a written opinion of legal counsel should be obtained by the company’s management, made available to the independent accountant, and a copy included in the working papers. Regulation S-X requires disclosure in the financial statements or notes thereto of details of such investments and transactions.

By the Commission.

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<sup>2</sup> With regard to restricted securities, consideration should be given to the discussion on pages 2 through 5 of the release on this subject (see Note 1 *supra*).

**Exhibit**

December 16, 1970

Mr. Robert M. Maynard, Chairman, Committee on Investment Companies, American Institute of Certified Public Accountants, 666 Fifth Avenue, New York, NY 10019

Dear Mr. Maynard:

I want to thank you and your committee for the assistance you have given us in developing a much needed Accounting Series Release on Accounting for Investment Securities by Registered Investment Companies which the Commission has approved for publication.

The Commission has considered your committee's suggestions with particular reference to the circumstances in which a "subject to" opinion would be appropriate. I am authorized to advise you that the "subject to" form of qualified opinion may be used when an investment company's portfolio includes a significant amount represented by securities for which market quotations are not readily available and when the auditor is satisfied that the procedures followed and the information obtained are adequate to enable the board of directors to value the securities but is unable to form an opinion as to the fairness of the specific values determined in good faith by the board of directors. As developed in our conversations, an opinion in the following form, introduced by the standard scope paragraph, in the interests of uniformity of language should be used:

As discussed more fully in Note 1 to the financial statements, securities amounting to \$ ( % of net assets) have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and have inspected underlying documentation; while in the circumstances the procedures appear to be reasonable and the documentation appropriate, determination of fair values involves subjective judgment which is not susceptible to substantiation by auditing procedures.

In our opinion, subject to the effect on the financial statements of the valuation of securities determined by the Board of Directors as described in the preceding paragraph, the (financial statements) present fairly.

Sincerely,

Andrew Barr, Chief Accountant

## ACCOUNTING SERIES RELEASE NO. 219 VALUATION OF DEBT INSTRUMENTS BY MONEY MARKET FUNDS AND CERTAIN OTHER OPEN- END INVESTMENT COMPANIES

Release Nos. IC-9786; ASR-219

May 31, 1977

AGENCY: Securities and Exchange Commission.

ACTION: Rule Interpretation.

SUMMARY: The Commission has issued an interpretation of a rule adopted under the Investment Company Act of 1940 (the "Act") indicating, generally, that it shall be considered inappropriate under the provisions of the rule for "money market" funds and certain other open-end investment companies to determine the fair value of debt portfolio securities on an amortized cost basis, except in the case of securities with remaining maturities of 60 days or less. There has been considerable confusion and uncertainty as to the appropriate methods to be utilized by "money market" funds in valuing their portfolio securities. This interpretation should help insure that shares of such companies are sold and redeemed at prices reflecting the fair value of the underlying portfolio securities.

EFFECTIVE DATE: Immediately.

FOR FURTHER INFORMATION CONTACT: Kenneth S. Gerstein, Esq., Division of Investment Management, Securities and Exchange Commission, Washington, D.C. 20549 (202-755-0233).

SUPPLEMENTARY INFORMATION: On April 28, 1975, there was published for public comment notice of a position the Commission proposed to take regarding the standardization of procedures utilized by registered investment companies, including "money market" funds, for the valuation of short-term debt instruments in their portfolios.<sup>1</sup> The proposed valuation position would have suggested "marking to market" as the most appropriate method for valuing any short-term debt securities held by registered investment companies and would have expressed the belief that it would be desirable for such companies to discontinue the "amortized cost" method of valuation.<sup>2</sup>

Among the public comments with respect to the proposed position on valuation of short-term debt instruments were those suggesting that: (1) the benefits of "marking to market" valuation were small compared to the attendant costs of such valuation method; (2) many "money market" fund shareholders desire a valuation method that would achieve a constant asset value; and (3) the Commission lacks the authority to preclude the use of amortized cost valuation. Other commentators suggested that only "money market" funds be required to "mark to market."

Nevertheless, after consideration and analysis of the comments received with respect to the proposal, the Commission, for the reasons discussed below, has issued this interpretation setting forth its views as to the appropriateness of certain methods utilized by "money market" funds and certain other registered open-end management investment companies to determine the fair value of debt securities in their portfolios. The interpretation that the Commission has issued differs in some respects from the proposed position and is discussed in detail below. The Commission expects companies to comply with this interpretation at the earliest possible date consistent with their obligations to avoid disruption of their operations, but in any event not later than November 30, 1977.

The Commission recognizes that, in the absence of the interpretation it has determined today to issue, there has been considerable confusion and uncertainty as to the appropriate methods to be utilized by "money market" funds in valuing their portfolio securities. This interpretation should help remove the uncertainty and further the objectives of enabling investors in such funds to: (1) purchase and redeem their shares at prices appropriately reflecting the current value of fund

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<sup>1</sup> Investment Company Act of 1940 Release No. 8757, April 15, 1975.

<sup>2</sup> *Id.* The release also indicated the Commission's tentative view that money market funds might be permitted to portray return by means of a quotation such as "yield to average life." In Investment Company Act Release No. 8816 (June 12, 1975) notice was given of proposed guidelines with respect to standardizing money market fund yield quotations. Such guidelines would have permitted the use of "yield to average life" quotations. The Commission is still considering these matters.

portfolio securities; (2) be properly credited for any unrealized appreciation or depreciation in such portfolio securities; and (3) be provided with meaningful and comparable information with which to appraise investment returns and the current earning ability of “money market” funds.

*Interpretation with Respect to Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies.*

The Commission is aware that many investment companies, including some “money market” funds, value short-term debt instruments in their portfolios on an amortized cost basis. Under this method of valuation, investment companies initially value such instruments at their cost on the date of purchase and, if the instrument was purchased at a discount, thereafter assume a constant proportional increase in value until maturity.<sup>3</sup> However, during the period a debt security is held, changes in the market rate of interest and other factors may affect the price at which that security could be sold. As a general principle, the longer the remaining maturity of an outstanding debt security, the more that price will be affected by such interest rate changes.

The Commission is concerned that the use of the amortized cost method in valuing portfolio securities of registered investment companies may result in over-valuation or undervaluation of the portfolios of such companies, relative to the value of the portfolios determined with reference to current market factors.

In the case of registered open-end management investment companies (“mutual funds” or “funds”), this would mean investors purchasing or redeeming shares could pay or receive more or less than the actual value of their proportionate shares of the funds’ current net assets. The effect of such sales or redemptions may therefore result in inappropriate dilution of the assets and returns of existing shareholders.<sup>4</sup>

Although inappropriate valuation of securities could cause these effects in various types of funds, the position taken herein is addressed specifically to the case of: (1) “money market” funds, and (2) other open-end investment companies that hold a significant amount of debt securities, such that the use of the amortized cost method in valuing any portion or type of these debt securities could have a material impact on such funds, net asset values per share. Generally, the Commission would consider the use of a particular valuation method to have a material impact if the use of that method, as opposed to another method, might cause a change of at least one cent in a net asset value per share of \$10.00.<sup>5</sup> The interpretation explained below will be applicable to both “money market” funds and these other open-end investment companies.<sup>6</sup>

Generally, “money market” funds are open-end investment companies which invest primarily in short-term debt instruments. They provide a vehicle to permit investors to take advantage of what at times may be the higher short-term interest rates earned on large investments. Through a pooling of money these funds enable the purchase of larger denomination instruments than could normally be bought by the individual small investor. These funds have also attracted investments from corporation, bank trust departments, and other institutional investors. Another characteristic of money market funds is the short-term investment perspective of many shareholders. Although the portfolio

<sup>3</sup> In simplified terms, for instruments purchased at a discount, the difference between the cost of such an instrument at purchase and its maturity value is divided by the number of days to maturity and that amount is accrued daily as an increase in the value of the instrument each day. More precisely, amortized cost valuation may be described as cost, adjusted for amortization of premium, or for accretion of discount.

<sup>4</sup> For example, redemptions of shares in a fund which has overvalued its portfolio or sales of shares in a fund which has undervalued its portfolio could result in the dilution of the assets and returns of other investors in the fund. The extent of such dilutive effects would be dependent upon several factors, including the extent of the overvaluation or undervaluation, and the proportion of fund shares sold or redeemed at such times.

<sup>5</sup> Although one cent differences in net asset values per share of \$10.00 might appear to be insignificant, the effects of such differences can be material to the decisions of investors when translated into differences in rates of return. Moreover, the inequitable effects of amortized cost valuation can occur in the case of any open-end investment company where a significant proportion of a company’s portfolio consists of debt securities valued at amortized cost. The extent of such inequitable effects will, of course, depend upon changes in interest rates and the level of a company’s sales and redemptions of shares.

<sup>6</sup> See, generally, Accounting Series Release No. 118 (December 23, 1970) [35 FR 19986], “Accounting for Investment Securities by Registered Investment Companies,” and Investment Company Act of 1940 Release No. 7221 (June 29, 1972) [37 FR 12790], “Guidelines for the Preparation of Form N-8B-1”, as they relate to the valuation of portfolio securities by open-end investment companies.



composition of “money market” funds is variable both in terms of the types of securities purchased and their maturities, the portfolios of such funds typically include U.S. government and government agency issues, certificates of deposit, banker’s acceptances, and commercial paper.

Section 22(c) [15 U.S.C. 80a-22(c)] of the Act [15 U.S.C. 80a-1 *et seq.*], by reference to Section 22(a) [15 U.S.C. 80a-22(a)] of the Act, authorizes the Commission to adopt rules prescribing, inter alia, methods for computing the minimum purchase price and maximum redemption price of redeemable securities issued by a registered investment company:

\*\*\* for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of . . . purchase, redemption, or sale which is unfair to holders of such other outstanding securities. . . .

Section 2(a) (41) [15 U.S.C. 80a-2(a) (41)] of the Act defines “value”, as here relevant, to mean:

(B) . . . (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the [registered investment company’s] board of directors. . . .

Rule 2a-4 [17 CFR 270.2a-4] promulgated under the Act provides, in part, that the “current net asset value” of a redeemable security issued by a registered investment company used in computing its price, for the purposes of distribution and redemption, means:

\*\*\* an amount which reflects calculations . . . made substantially in accordance with the following, with estimates used where necessary or appropriate:

(1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities . . . shall be valued at fair value and determined in good faith by the board of directors. . . .

Now that both the Commission and the money market fund industry have had the benefit of experience with this relatively new investment product, and to help insure that shares of such funds are sold and redeemed at prices reflecting the current market or fair value of such funds’ portfolio securities, the Commission has concluded that it shall prospectively consider it inconsistent with the provisions of Rule 2a-4 for a money market fund to determine the fair value of debt securities which mature at a date more than 60 days subsequent to the valuation date on an amortized cost basis.

Although debt securities with remaining maturities in excess of 60 days should not be valued at amortized cost, the Commission will not object if the board of directors of a money market fund, in good faith, determines that the fair value of debt securities originally purchased with remaining maturities of 60 days or less shall be their amortized cost value, unless the particular circumstances dictate otherwise.<sup>7</sup> Nor will the Commission object if, under similar circumstances, the fair value of debt securities originally purchased with maturities of in excess of 60 days, but which currently have maturities of 60 days or less, is determined by using amortized cost valuation for the 60 days prior to maturity, such amortization being based upon the market or fair value of the securities on the 61st day prior to maturity.<sup>8</sup>

The Commission believes that money market funds and those other companies to which this interpretation is applicable should value debt securities with greater than 60 days remaining to maturity based upon current market quotations if readily available or, if such quotations are not readily available, in such a manner as to take into account any unrealized appreciation or depreciation due to changes in interest rates and other factors which would influence the current fair

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<sup>7</sup> The fair value of securities with remaining maturities of 60 days or less may not always be accurately reflected through the use of amortized cost valuation, due to an impairment of the creditworthiness of an issuer, or other factors. In such situations, it would appear to be incumbent upon the directors of a fund to recognize such factors and take them into account in determining “fair value.”

<sup>8</sup> A fund also may use amortized cost valuation for a period less than 60 days prior to maturity, in which case the principles indicated above would also be applicable.

values of such securities.<sup>9</sup> These methods are sometimes referred to as “marking to market.” In determining “fair value” by reference to current interest rates and other factors, the board of directors of a money market fund may, of course, utilize whatever method it determines in good faith to be most appropriate.<sup>10</sup> The method utilized could be based in part, for example, upon quotations by dealers or issuers for securities of similar type, quality and maturity.

Except in the circumstances delineated above, the Commission believes that, in view of the experience which has now been gained with respect to the characteristics of money market funds, the use of the amortized cost method of valuation by a money market fund cannot in the future represent a “good faith” effort to determine the “fair value” of portfolio securities for purposes of Rule 2a-4; such valuation fails to consider the impact of market factors subsequent to the date a debt security is purchased on the value of such security. Moreover, the probability that amortized cost valuation will not approximate “fair value” is progressively greater for securities of increasingly longer maturities. The Commission believes that the use of amortized cost valuation by money market funds in valuing securities with remaining maturities in excess of 60 days is not an appropriate estimate of market value or “fair value” and further that, because alternative valuation procedures which consider market factors are available, use of amortized cost valuation under such circumstances as an estimate is not necessary. This standard should help insure that fund shares are sold and redeemed at prices reflecting the appropriate proportionate share of funds’ current net assets, and minimize the potential for dilution of the assets and returns of existing shareholders.

The Commission is also of the view that money market fund shareholders should be accurately credited with the effects of any unrealized appreciation or depreciation that may occur when the value of a fund’s portfolio fluctuates. If such effects are not reflected in either a fund’s net asset value or its distributions to shareholders, as a practical matter the result would be a situation analogous to that which would exist if amortized cost valuation were used, and similar dilutive effects could occur. Such may be the case, for example, where a money market fund “marks to market,” but declares a daily dividend of accrued interest income and reflects any remaining unrealized appreciation or depreciation in a “floating” net asset value of \$1.00 nominal value per share, rounded to the nearest cent. Under these circumstances, unrealized capital changes, which could materially affect the value of such fund’s portfolio, would ordinarily not be of sufficient magnitude to cause the net asset value to change by one cent. The effects of unrealized appreciation and depreciation, in the case of a fund with a “floating” \$1.00 net asset value per share, would generally appear in the third and fourth decimal places, and when rounded to the third decimal place (i.e., tenths of one cent) would still not have a one cent impact on the net asset value. Moreover, if such a one cent change should occur, dilution may also result, since a relatively small change in net asset value would cause a larger change in the computed net asset value per share due to rounding. For example, if in the type of fund described above the net asset value was calculated accurately to three decimal places, were a change in net asset value from \$1.004 to \$1.006 to occur, such change of \$ .002 would cause the net asset value, when rounded to the nearest cent, to change by one full cent.

To alleviate these results and insure that shareholders are more properly credited for capital appreciation or depreciation, the Commission believes that any money market fund which reflects capital changes in its net asset value per share should calculate, and utilize for purposes of sales and redemptions, a current net asset value per share with an accuracy of one-tenth of one percent (equivalent to the nearest one cent on a net asset value of \$10.00).<sup>11</sup> Any less precise calculation

<sup>9</sup> In Accounting Series Release No. 118, note 6, *supra*, the Commission stated that:

As a general principle, the current ‘fair value’ of an issue of securities being valued by the Board of Directors would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale.

In that release, the Commission notes various factors that might be considered in arriving at “fair value”, which factors included: yield to maturity with respect to debt issues . . . an evaluation of the forces which influence the market in which these securities are purchased and sold . . . [and the] price and extent of public trading in similar securities of the issuer or comparable companies, and other relevant matters.

<sup>10</sup> See note 6 *supra*.

<sup>11</sup> Such calculation is applicable only with respect to those money market funds which do not include in their distributions to shareholders all capital changes. If such a fund had a net asset value of \$10.00 per share, it would be appropriate to calculate its current net asset value accurately to one tenth of a cent, rounded to the nearest one cent. If such a fund had a net asset value per share of \$1.00 it would be appropriate to calculate its current net asset value accurately to the nearest one hundredth of one cent, rounded to the nearest one tenth of one cent.



by such a fund might have the effect of masking the impact of changing values of portfolio securities and therefore might not “reflect” the fund’s calculations pertaining to its portfolio valuation as required by Rule 2a-4.<sup>12</sup>

Boards of directors of money market funds and those other funds referred to above should consider and re-evaluate current fund pricing practices in light of the positions expressed herein. In this regard, the Commission recognizes that such consideration may result in decisions by some funds to make various modification of their valuation and distribution practices. To avoid any sudden changes in net asset values some funds might wish to effect a gradual transition to new valuation methods. Moreover, some time may be necessary to take the action necessary to adopt new dividend policies or other measures designed to implement the views expressed herein. Therefore, to allow adequate time for planning and effecting orderly transitions, the Commission, as noted above, expects companies to comply with this interpretation by no later than November 30, 1977.

By the Commission.

George A. Fitzsimmons  
Secretary  
May 31, 1977

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<sup>12</sup> See note 5, *supra*.

## OTHER RELEASES RELATED TO VALUATION AND PRICING

### IN THE MATTER OF CHRISTIANA SECURITIES COMPANY; E.I. DU PONT DE NEMOURS AND COMPANY

Administrative Proceeding File No. 3-3928

Release No. IC-8615

December 13, 1974

#### Findings and Opinion of the Commission

Merger of a Registered Investment Company into Its Affiliate

Mergers Generally – Applicable Standards – Disparity in Benefits – Historical Factors

Where registered closed-end investment company and affiliated operating company made joint application under Investment Company Act for exemption from statutory prohibition so as to permit proposed merger of investment company into affiliated company, held, the terms of the proposed merger, including exchange ratio based on underlying net asset value of investment company rather than aggregate market price of its own shares, are reasonable and fair and do not involve overreaching, and are consistent with the Act's general purposes. Exemption granted.

Where registered closed-end investment company formed in 1915, a quarter of a century prior to the enactment of the Investment Company Act, for the sole purpose of controlling an industrial company, whose securities were its only asset of any consequence, wished to merge into such industrial company and where, because of tax factors and other reasons, benefits to investment company were greater than those to industrial company, held, imbalance of benefit does not render transaction inherently unfair; some transactions are more important to one side than to the other.

Where functionless investment company sought to merge into its affiliated portfolio company, held, public policy against the perpetuation of unnecessary entities makes it inappropriate for the Commission to insist on terms likely to result in investment company's continued existence.

#### Intrinsic Investment Values versus Market Prices

Intrinsic investment values, held, controlling in assessing fairness of proposed merger of closed-end investment company into portfolio company. Contention that hypothetical adverse market impact of merger of closed-end investment company into its affiliated portfolio company should be given great weight in assessing fairness of merger proposal, rejected, just result could be attained on basis of investment company's net asset value without conjectural assessment of market impact.

#### Restraints on the Power of Alienation

Proposal by objecting stockholders for restraints on the alienability of marketable securities to be issued pursuant to proposed merger on ground that unrestricted sales of such securities would lower the market price of the objectors' shares, rejected, as unnecessary under the circumstances.

#### Taxation

Where registered investment company's managers' decision to merge it into its affiliated portfolio company was motivated by tax factors which led them to prefer a merger that would require the Commission's approval under the Act to a liquidation that would give investment company's shareholders the net asset value of their holdings but impose

substantial and uncertain tax liabilities on them, held, Act's "reasonable and fair" standard does not entitle portfolio company's shareholders to the benefit of the taxes that the United States would otherwise have collected.

#### **Dissolution of Registered Investment Company**

Merger of registered investment company into its affiliated portfolio company that would eliminate duplicative operating expenses and taxation, held, consistent with Investment Company Act's purposes: Finding of consistency with investment company's purposes under Section 17(b)(2) of the Act, not required, where company's existence is to be terminated.

#### **Practice and Procedure**

Asserted Inadequacy of the Record

Request for Remand

Pre-Trial Discovery

Depositions

Due Process

Rules of Practice

Objecting security holders' request for remand to supplement assertedly inadequate record, denied, because matters into which they wished to inquire irrelevant under governing legal principles.

Hearing officer's denial of requests for depositions, affirmed, where Commission's rules made no provision for such depositions.

Due process does not require depositions.

#### **COUNSEL: APPEARANCES:**

Kenneth W. Gemmill, Matthew J. Broderick, Stephen R. Miller and Richard S. Seltzer, of Dechert, Price & Rhoads, for Christiana Securities Company.

Daniel M. Gribbon, Cyril V. Smith, Jr. and Peter B. Archie, of Covington & Burling, for E.I. du Pont de Nemours and Company.

Gerald Osherooff, for the Division of Investment Management Regulation of the Commission.

Lewis C. Murtaugh, of Murtaugh, King, Neiman & Graiss, pro se.

Richard J. Collins, Jr., of Rassieur, Long, Yawitz & Schneider, pro se.

Ernest N. May, pro se.

Daniel W. Maher, pro se.

## Findings and Opinion of the Commission

### I

This case involves one of the world's great industrial complexes. It is here under the Investment Company Act of 1940. Its origins, however, go back to 1915.

At that time T. Coleman du Pont<sup>1</sup> was the largest single stockholder of E.I. du Pont de Nemours and Company ("Du Pont").<sup>2</sup> He wished to dispose of that interest. To keep Coleman's large block of stock within the family thus assuring its continued control of the enterprise, Coleman's cousin Pierre joined with others to form a holding company.<sup>3</sup> That was Christiana Securities Company.<sup>4</sup> It began life with the substantial amount of du Pont stock acquired from Coleman plus other blocks of that security contributed by Pierre and by other family members in exchange for Christiana shares.<sup>5</sup> Thus Christiana was organized by members of the du Pont family for the service of their own interests. Through Christiana, the family's dominant faction made sure that its massive holdings in du Pont would be voted as a block.<sup>6</sup> Christiana was a control device. Historians friendly to Pierre and to the family point out that:

"[I]t was as chairman of the Christiana Securities Company that his power was most explicitly defined. His immediate family held over 60% of Christiana common stock, and Christiana in turn held over 30% of the Du Pont common stock outstanding (through Delaware Realty<sup>7</sup> and personal holdings the share held by Pierre's family in Du Pont was even higher). Since the Du Pont Company still owned close to 35% of the voting stock of General Motors, the family had practical control of that corporation."<sup>8</sup>

### II

The du Pont family is large. And since the family rewarded outstanding managerial performance with Christiana stock, there were some non-du Pont stockholders in Christiana from the very beginning.<sup>9</sup> So by 1940, when the Investment Company Act went into effect, Christiana had far more than a handful of stockholders.

Christiana registered under the Act. It had to do so for two reasons:

(A) Christiana had more than the 100 security holders whose presence, with other facts, brings the Act into play.<sup>10</sup>

(B) Christiana maintained, and still maintains, that it did not and does not run Du Pont. It insists that it is not Du Pont's parent. It concedes that it "has the potential to exercise a controlling influence over Du Pont," but it has consistently contended that this potential lies dormant and unexercised and that there is no actual control relationship. This, its own version of the facts, made, and makes, Christiana an investment company of the closed-end, non-diversified type rather than an industrial holding company.<sup>11</sup>

<sup>1</sup> The du Pont family spells its name with a lowercase "d."

<sup>2</sup> In this opinion the company's name is hereinafter spelled with an uppercase "D."

<sup>3</sup> With one exception, all of the people involved were members of the du Pont family. And the outsider was a man closely linked to the family.

<sup>4</sup> Christiana was at first called Du Pont Securities Company. It took its present name in 1918.

<sup>5</sup> The historical treatment is based on Chandler & Salsbury, *Pierre S. Du Pont and the Making of the Modern Corporation*, 322-358 (1971). For other accounts see James, Alfred I. *Du Pont: The Family Rebel* (1941) (critical of Pierre and his associates and castigating them as "the secret six"); Donaldson, *Caveat Venditor* (Privately printed 1964) presenting the situation from Coleman's viewpoint.

<sup>6</sup> The historical writings cited in the preceding footnote show that a family feud between Pierre and his cousin Alfred had much to do with Christiana's origins.

<sup>7</sup> See Delaware Realty and Investment Company, 40 S.E.C. 469 (1961)

<sup>8</sup> Chandler & Salsbury, *Pierre S. Du Pont and the Making of the Modern Corporation*, 564-565 (1971). On page 565 the authors note that "During the 1920s Pierre and his brothers were obsessively concerned about assuring control."

<sup>9</sup> Chandler & Salsbury, *Pierre S. Du Pont and the Making of the Modern Corporation*, 581 (1971).

<sup>10</sup> Section 3(c)(1).

<sup>11</sup> For fuller discussion see this Commission's 1966 report on the Public Policy Implications of Investment Company Growth, House Report No. 2337, 89th Cong., 2d Sess. 40, n. 54.

### III

Today Christiana is still what it was at its birth in 1915, a receptacle for a huge block of Du Pont common stock. It holds 28.3% of the issue. This massive commitment accounts for something like 98% of Christiana's total assets.<sup>12</sup>

Christiana's stock is still highly concentrated. While it has over 11 million common shares outstanding, 95.5% of them are held by a mere 338 people. Christiana remains in overwhelming measure a du Pont family affair, 75% of its outstanding shares being held by family members.

This does not mean that Christiana is just a collective name for the descendants of the original stockholders. It is a publicly held company with about 8,000 stockholders. There is an over-the-counter market in the issue, and for reasons hereinafter explained, Christiana shares have over the years had a certain appeal to a few of the many people who wanted to invest in Du Pont. It was – and for that matter, still is – cheaper to buy into Du Pont indirectly by buying Christiana than it was to acquire the underlying Du Pont shares themselves. Someone with \$10,000 that he wanted to invest in Du Pont common could do so in one of two ways. The first was to buy \$10,000 worth of Du Pont on the New York Stock Exchange. The second was to buy \$10,000 worth of Christiana in the over-the-counter market. Since Christiana, like most other closed-end investment company issues, has long tended to sell at a substantial discount from net asset or liquidation value, the Christiana buyer got what could be regarded as a real bargain. His \$10,000 purchased an interest in Du Pont that might have cost him \$12,000, \$13,000 or \$14,000 had he acquired it in the direct Du Pont form rather than in the indirect Christiana form. One did not have to be a du Pont in order to see the point. The record suggests that some of the 338 large holders previously referred to may be wholly unconnected with the founding family. Although members of the du Pont family still hold about 75% of Christiana, the other 25% belongs to public investors.

### IV

Those who control Christiana (and who presumptively at least are for present purposes deemed to control Du Pont as well<sup>13</sup> think that Christiana has outlived its usefulness. Du Pont, they say, is no longer a family firm. Hence the family no longer needs Christiana. It has no contemporary function.

And Christiana is expensive. It costs something to run. Much more important than administrative costs are the taxes that have to be paid because of Christiana's existence. For practical purposes, Christiana's income consists entirely of the dividends it collects from Du Pont. Yet Federal income tax has to be paid on those dividends before they can be distributed to Christiana's stockholders. Were there no Christiana and were the present Christiana stockholders to own their Du Pont shares directly, there would be no such tax.

Accordingly, Christiana's management urges that Christiana merge into its portfolio company, Du Pont. Du Pont's management agrees.<sup>14</sup> The salient features of the joint Christiana-Du Pont proposal are these:<sup>15</sup>

(1) Christiana's assets and liabilities will become those of Du Pont.<sup>16</sup>

(2) Accordingly, Du Pont will reacquire the 13,417,120 shares of its own common now in Christiana's portfolio.<sup>17</sup> Those shares will be retired.

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<sup>12</sup> It also holds a small block of Du Pont preferred. The non-Du Pont assets consist of the two daily newspapers in Wilmington, Delaware, and 3.5% of the stock of the Wilmington Trust Company. Qua trustee for various du Ponts and du Pont relatives, the Trust Company holds more than half of Christiana's common stock.

<sup>13</sup> Under Section 2(a)(9) of the Act an interest of more than 25% in voting securities is presumed to constitute control. We also note that Christiana and Du Pont have five common directors.

<sup>14</sup> In addition to the five common directors referred to in the preceding footnote, another seven of Du Pont's 26 directors own Christiana common stock.

<sup>15</sup> The application before us states that the 12 Du Pont directors who are also directors or stockholders of Christiana did not participate in the consideration of the merger proposal.

<sup>16</sup> Du Pont intends to dispose of the newspaper interests and the bank stock (*see* n. 12 on p. 5, *supra*) to be acquired from Christiana.

<sup>17</sup> Christiana's 16,256 shares of Du Pont's \$4.50 preferred (0.96% of the outstanding shares of that class) will also be reacquired by Du Pont.

(3) Each Christiana common share will become 1.123 shares of Du Pont.<sup>18</sup>

The merger is designed to be tax-free to Christiana and its stockholders. Accordingly, it is conditioned on a ruling to that effect by the Internal Revenue Service.

## V

Like other corporate mergers, this one cannot be consummated unless the law of the state of incorporation (in this case Delaware for both companies) is followed. Hence the stockholders of both companies must approve. Were this an ordinary amalgamation between industrial or mercantile firms, the merits of the matter would be none of our concern. Our responsibility would be solely that of seeing to it that the two companies' stockholders were told enough about the proposal to enable them to reach an informed judgment. The decision would be theirs, not ours.

But Christiana is an investment company, and the Congress that passed the Investment Company Act deemed transactions of this character to be fraught with potential for overreaching and unfairness.<sup>19</sup> Accordingly, it prohibited them,<sup>20</sup> subject to our power to lift the prohibition<sup>21</sup> "if evidence establishes that . . . the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of *any* person<sup>22</sup> concerned."<sup>23</sup>

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<sup>18</sup> In time the present Christiana holders may also receive some additional Du Pont stock. This would stem from a contingent, unliquidated tax refund claim that Christiana now has against the United States. Du Pont will acquire that claim. If it collects on it within five years from the effective date of the merger, it will distribute additional shares of its common whose then current market value will equal the proceeds of the claim. Should the tax refund claim remain unsettled and adjudicated within the aforementioned five-year period the number of additional shares issued will be based on the then fair value of the claim.

The plan makes provision for the holders of Christiana's 106,500 7% callable preferred. Those shares are callable at \$120. Accordingly, the plan calls for their conversion into shares of Du Pont with a then market value of \$120, based on the average closing price of Du Pont common stock in the New York Stock Exchange for the ten trading days immediately preceding the effective date of the merger, plus cash equal to the accrued dividend. Du Pont states that its present intention is to offer dissenting Christiana preferred holders who follow Delaware's statutory appraisal procedures \$120 in cash (plus the accrued dividend) for each share.

<sup>19</sup> Section 1(b)(2) of the Act states that "the national public interest and the interest of investors are adversely affected – when investment companies are . . . managed . . . in the interest of directors, officers, . . . or other affiliated persons thereof . . . in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders." Of special significance here is Section 1(b)(2)'s reference to investment companies' affiliated persons. Christiana and Du Pont are "affiliated persons" of each other. That is so because Christiana owns more (far more) than 5% of Du Pont's voting securities. See Sections 2(a)(3)(A) and 2(a)(3)(B).

<sup>20</sup> Section 17(a)(1) of the Act makes it "unlawful for any affiliated person [of] . . . a registered investment company . . . knowingly to sell any security or other property to such registered company." The proposed combination would take the form of a statutory merger. But this would constitute a "sale" by Christiana of its assets to Du Pont within the meaning of Section 17(a)(1). *E.I. du Pont de Nemours & Company*, 34 S.E.C. 531 (1953), overruling *Phoenix Securities Corporation*, 9 S.E.C. 241 (1941).

<sup>21</sup> Section 17(b) provides that "notwithstanding subsection (a), any person may file with the Commission an application for an order exempting a proposed transaction . . . The Commission *shall* [emphasis added] grant such application and issue such order of exemption if . . ."

<sup>22</sup> Because of its special impact here the word "any" has been italicized. Its presence means that we must find this transaction fair to the stockholders of both companies. See *Bowser, Inc.*, 43 S.E.C. 277 (1967).

As we said in *Fifth Avenue Coach Lines, Inc.*, 43 S.E.C., 635, 639 (1967): "[T]hat Section 17(a) by its terms makes it unlawful for the affiliate, rather than the investment company, to engage in specified types of transactions, does not . . . indicate a Congressional concern for the shareholders of the investment company to the exclusion of the other stockholders affected. While it is true that the protection of fund shareholders was a primary consideration which led to the passage of the Act, we find nothing in the legislative history which persuades us that Congress intended the broad language of Section 17(b) to be read in the restrictive manner which applicants suggest, nor have we ever done so. We cannot believe the Congress intended, after requiring an agency of the Government to examine a transaction such as this, to put that agency in the position of effectively authorizing the transaction when there are circumstances raising questions as to possible overreaching of a person concerned which has public investors."

<sup>23</sup> Section 17(b)(1).

Does this transaction meet that test? That is the central question before us.<sup>24</sup> A negative answer will end the matter. Should our answer be in the affirmative, the managers of both companies will be at liberty to proceed to seek the approval of their stockholders.

## VI

At first blush it is hard to see a real problem here. In economic reality Christiana stock already is Du Pont stock—under another name. Substantially, all that we are dealing with is an exchange of equivalents.

Christiana owns 13,417,120 shares of Du Pont common. But there are only 11,710,103 Christiana common shares outstanding. It follows that a Christiana common share is in economic substance 1.15 shares of Du Pont common. Make a few simple adjustments for the relatively inconsequential preferred stocks of the two companies and for the newspaper interests and the bank stock that Du Pont will get from Christiana,<sup>25</sup> and the whole thing is over.

That in essence is the view of the two companies involved. Our Division of Investment Management Regulation agrees. But three Du Pont stockholders disagree.<sup>26</sup>

## VII

The objecting Du Pont stockholders consider the view just outlined misleadingly simplistic. They contend that this transaction will:

- (A) Confer great benefits on Christiana's stockholders;
- (B) Give Du Pont's stockholders nothing worth mentioning but actually injure them; and
- (C) Serve no real business purpose for Du Pont.

## VIII

The objectors are clearly right when they say that the merger will be a very good thing indeed for Christiana's stockholders. Their benefits will stem from:

- (A) The Federal tax structure; and
- (B) Stock market phenomena.

We begin with the tax factors. There are two of them. One is the Federal corporate income tax that Christiana now pays.<sup>27</sup> The United States Treasury takes 7.2 cents out of every dollar of dividend income that Christiana gets before such

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<sup>24</sup> But it is not the only question presented. Under Section 17(b)(2) we must also find the proposed transaction consistent with Christiana's policy. And Section 17(b)(3) precludes approval unless we find the merger consistent with the Act's general purposes. Its primary general purpose, of course, is the protection of investors. Finally, the parties invoke Section 17(d) and our Rule 17d-1 thereunder, which taken together prohibit joint enterprises and joint arrangements between investment companies and persons affiliated with them, unless we approve the specific transaction involved.

<sup>25</sup> See n. 12 on p. 5, *supra*.

<sup>26</sup> These stockholders, Lewis C. Murtaugh, Richard J. Collins, Jr., and Daniel W. Maher, participated in the hearings before the administrative law judge. An initial decision having been waived, the case came to us after the record was closed. Briefs were filed, and we heard oral argument. Our findings are based on an independent review of the record.

<sup>27</sup> Many closed-end investment companies do not pay federal corporate income taxes. They, like most of the open-end companies, avail themselves of the special treatment that Subchapter M of the Internal Revenue Code gives to so-called regulated investment companies, i.e., companies regulated by this Commission under the Investment Company Act. Such companies are free from all corporate income taxes so long as they distribute all of their income to their stockholders. But this special tax benefit is available only to "diversified" investment companies. Christiana, of course, is as undiversified as an investment company can possibly be. Hence its federal income tax status is no different from that of any other corporation. Sections 851-855 of the Internal Revenue Code.



dividend income is disbursed to the Christiana stockholders.<sup>28</sup> So the merger will increase each Christiana stockholder's individual pre-tax income by 7.2% over what he would receive if Du Pont dividends continued to be passed through Christiana.<sup>29</sup> Of course, this 7.2% accretion will be taxable income in the individual stockholder's hands. A particular Christiana stockholder's net tax benefit will therefore depend on the tax bracket in which he happens to find himself. To the extent that Christiana stock is held by people in high tax brackets, the actual increment to the Christiana stockholders' net after taxes will be significantly less than 7.2%.<sup>30</sup> The second tax factor relates to the tax cost of alternative methods of achieving the end that the applicants wish to reach. Christiana could be killed off without any need for our prior (or for that matter subsequent) approval. Nothing in the Act or anywhere else in the law inhibits a registered investment company from liquidating. But a liquidation might be much more expensive for Christiana's stockholders than this tax-free plan.<sup>31</sup> Liquidation would certainly be a great deal more conjectural.<sup>32</sup>

In view of what has just been said about the special 7.2% tax burden on Christiana's stockholders, it would be unsurprising to find Christiana's shares selling at a discount of about that magnitude from net asset value.<sup>33</sup> Actually, however, the discount has been much higher than that. When the merger negotiations were first announced it was 23%. During the preceding two years it had been as high as 25% and was never below 20%.

The mere announcement of the planned merger led to an appreciable narrowing of the discount. Its consummation will, of course, extinguish the discount forever. Thus the merger will substantially enhance the market value of the Christiana stockholders' property.

What is the offsetting benefit to Du Pont's stockholders? Applicants point to the fact that Christiana's stockholders will get only 97.5% of its adjusted net asset value. This looks like a 2.5% discount from net asset value. But the actual dilution to be suffered by the Christiana stockholders will be only 1.8%. That is so because Christiana is so substantial a Du Pont stockholder. Since Christiana has a 28.3% interest in Du Pont, 28.3% of the 2.5% discount will go right back into the Christiana holders' pockets. Accordingly, objectors dismiss the discount as derisory, a mere "pacifier."

The objectors' claim of positive harm to themselves and the other similarly situated Du Pont stockholders rests entirely on market factors.<sup>34</sup> They point out that from a stock market point of view Christiana's massive block of Du Pont is sterilized. Christiana has never sold any of its Du Pont. Nor, so long as it remains in being, is Christiana ever likely to do so.

The enormous capital gains taxes that would have to be paid are enough in themselves to inhibit Christiana from selling any of its Du Pont holdings. Those taxes would arise at two levels. First, at the corporate level there would be a very heavy tax on Christiana itself. The basis of its Du Pont shares is but a tiny fraction of those shares' present value. And should

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<sup>28</sup> The applicable normal corporate income tax is 48%. Section 11 of the Internal Revenue Code. But all corporations (whether investment companies or not) are entitled to deduct from their income 85% of any dividends that they receive. Section 243 of the Code. Thus the maximum effective federal corporate income tax on dividend income is 48% of 15% or 7.2%.

<sup>29</sup> Christiana pays out substantially all of its after-tax income in dividends.

<sup>30</sup> Additional savings will stem from the elimination of Christiana's operating expenses. The application states, however, that those expenses are "relatively minor."

<sup>31</sup> Christiana's tax picture is said to be clouded by reason of the distributions of General Motors common stock resulting from the anti-trust divestiture decree entered against Du Pont. *United States v. E.I. du Pont de Nemours & Co.*, 366 U.S. 816 (1961). We are told that this is so because:

"(a) the fair market value of the General Motors stock received by Christiana pursuant to the anti-trust divestiture decree . . . is the subject of a tax refund suit by Christiana against the United States Government and is thus presently indeterminable; (b) the effect of pro rata distributions by Christiana of General Motors stock to its own stockholders is uncertain under the tax laws; and (c) the effect of distributions by Christiana of General Motors and Hercules Powder Company stock . . . is uncertain."

<sup>32</sup> Christiana's brief states that its "stockholders would in effect be voting tax litigation for themselves were they to sanction a liquidation."

<sup>33</sup> Implicit in this statement is the somewhat unrealistic assumption of a market for Du Pont common that is entirely income-oriented.

<sup>34</sup> Some Du Pont stockholders are also Christiana stockholders. Objectors do not weep for them. Their concern is with the people whose interest in Du Pont stems entirely from their ownership of its stock. Since there are over 225,000 Du Pont holders as against a mere 8,000 Christiana holders, it is obvious that most Du Pont stockholders belong to the class whose interests the objectors champion.



Christiana follow its past practice of distributing all of its income to its stockholders, a second onerous tax would fall on the individuals who own Christiana.

Most of Christiana's stock has a very low basis in the hands of those who now hold it. That is so because:

(A) The holders either paid much less for it than it is now worth or acquired it from donors who bought it for far less than present value; and

(B) The basis of their Christiana shares has already been materially reduced by reason of their receipt of substantial quantities of General Motors stock, pursuant to the Du Pont divestiture distribution.<sup>35</sup>

The objectors say that the merger will work a radical change in this state of affairs. They note that the corporate capital gains tax inhibition will vanish. After Christiana is dead and gone, no one will worry about the capital gains taxes that it would have had to pay had it remained alive. True, the holders of about 70% of Christiana's stock state that they have no present intention of selling the Du Pont shares to be received in exchange for their Christiana holdings. But the objectors point out that:

(A) No binding commitments to refrain from selling have been given.<sup>36</sup>

(B) The plan's carefully crafted provisions for Securities Act registration statements at the selling stockholders' expense (twice a year on a non-firm commitment basis and once a year on the basis of a firm commitment underwriting for at least \$25 million) show that some important holders have given some thought to some selling at some time.

(C) Public investors unrelated to Christiana's control group own about 25% of the company's stock. Hence the merger will give them about 3 1/4 million shares of Du Pont common. They will be as free as other non-controlling Du Pont stockholders to sell those shares whenever and wherever they choose without registering them under the Securities Act.

Objectors argue that the merger will have an adverse impact on them even if nobody actually sells. They ask us to focus on potential available supply. Such supply will, they say, be increased by over 13 million shares. The market's knowledge of this is bound to depress the price. Ergo, Christiana should be required to compensate the Du Pont stockholders for the "vast and virtually uncontrolled increase in the supply of marketable stock" flowing from the merger.

As for Du Pont, objectors argue that it has been doing well all these years and will continue to do well with or without Christiana; that applicants have failed to show that Christiana is an incubus to Du Pont; and that though the proposal does a great deal for the du Pont family, it does nothing of consequence for Du Pont. True, after the merger's consummation Du Pont will have about 188,500 fewer common shares outstanding than it now does. But presently outstanding shares of that issue number 47,445,810. So the number of shares outstanding will be diminished by a mere four-tenths of one percent.

One objector argues for a substantial increase in the contemplated 2.5% or 1.8% (depending on whether one looks at gross or at net impact) discount from Christiana's net asset value.<sup>37</sup> The other two also urge an increase in the discount. But they go on to attack the whole affair root and branch. They consider it an outrageous assault on the rights of the Du Pont stockholders and on the law of supply and demand. What they deem essential are conditions to "Protect the price of Du Pont shares." They therefore implore us to impose restraints on the alienability of the new Du Pont common shares to be issued pursuant to the merger.

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<sup>35</sup> See n. 31 on pp. 10-11, *supra*. Some 3 million Christiana shares (roughly 25% of the issue) have a zero basis.

<sup>36</sup> Indeed, the Wilmington Trust Company, record owner of more than half of Christiana's outstanding shares (*see* n. 12 on p. 5, *supra*) states that its fiduciary responsibilities may require it to do some selling from time to time.

<sup>37</sup> See p. 11, *supra*.

## IX

Applicants consider the objectors' contentions frivolous and absurd. So does our Division of Investment Management Regulation.<sup>38</sup> We take a different view. To us the questions presented are substantial and troublesome. This is not an easy case. But after careful consideration of the issues raised, we find ourselves constrained to resolve them against the objectors and to grant the application before us.

That there is an imbalance of benefit is plain. This merger cannot possibly do as much for Du Pont as it will for Christiana. The very slight reduction in the amount of Du Pont's outstanding common and the resulting increase in earnings per Du Pont common share is incommensurate with the tax and the market value benefits inuring to the Christiana stockholders.

Applicants ask us to look at other benefits that will, they say, be reaped by Du Pont and its stockholders. We have done that. And we find their magnitude far from striking.

Apart from the small reduction in the number of Du Pont shares outstanding and the resulting small increases in book value and in earnings per Du Pont common share, it is said that Du Pont will benefit from:

- (A) The "dispersal" of Christiana's large block of Du Pont common; and
- (B) Its escape from the Investment Company Act, which precludes it from entering into transactions with Christiana without our approval.

The "dispersal" argument is somewhat puzzling. Applicants insist over and over again that it is most unlikely that any substantial number of Du Pont shares will come to market by reason of the proposed transaction. In that regard applicants point quite cogently to the large individual capital gains taxes that selling Christiana holders will have to pay and to the long-run character of the du Pont family's investment commitment to the company that bears its name. What then is likely to be dispersed?

It would seem that the dispersal will be formal, not substantive. Today some people own a great deal of Du Pont indirectly through Christiana. Tomorrow those very same people will still own a great deal of Du Pont. But they will own it directly rather than indirectly. What will that change do for Du Pont?

Du Pont's answers to these questions look to the long run. Its brief concedes that its "management was aware of no immediate prospect of any adverse consequences from the Christiana holdings." The brief goes on to argue, however, "that over the long term such a possibility might arise."

The precise nature of these possible long-term adverse consequences is obscure. The argument rests on the possibility of a future clash between the people then in control of Christiana and the people then managing Du Pont. It assumes that in this hypothetical situation the Du Pont managers will be the "good guys" and the Christiana control group the "bad guys." The argument seems far-fetched and rests on premises we consider unacceptable. Christiana's extinction may well

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<sup>38</sup> Though in accord with the applicants on every substantive point presented, the Division has certain qualms about the performance of the financial experts who testified on their behalf with respect to the value of Christiana's Du Pont holdings. It asks us to say some harsh words about those experts and to make a pronouncement about the role of an independent expert in a proceeding of this character. We agree with the Division that financial experts should be diligent, conscientious, and painstaking. On the record before us, we think it inappropriate to go beyond that truism. The importance of expert testimony varies from case to case. In some situations such testimony is crucial. When a closely held firm or a business of an esoteric character must be appraised, much turns on what the experts say. La Salle Street Capital Corporation, Investment Company Act Release No. 6693 (August 23, 1971) is illustrative. That case presented a question about the value of a major league baseball franchise. Such questions are, as was said at page 7 of the La Salle Street opinion, "not susceptible to precise determination." The instant case, on the other hand, involves marketable securities. The questions presented are in our view essentially legal. Hence they cannot be resolved by reference to the opinions of financial experts, however conscientious and however eminent. We do not go so far as to say that expert testimony is of no weight here. Some of it we have found interesting and even instructive. But in view of the nature of the issues raised, we think its weight limited. We note, for example, that some of the experts seem to have spent a great deal of time studying our decisions under Section 17 of the Act and pondering the implications of the opinions in those cases. That sort of thing is normally the function of a lawyer, not of an expert witness. The Division has, we think, failed to give due heed to the special nature of this concrete case. Observations about experts in our past opinions have been mechanically transposed to contexts quite different from those in which they were uttered.

make it somewhat easier for Du Pont's managers to maintain themselves in office. We, however, cannot presume that this will necessarily be in the Du Pont stockholders' interest.<sup>39</sup> And in any event the Investment Company Act was not designed to foster the retention of control by managerial groups. Nothing in it warrants a holding that such control is to be preferred to control by important stockholders.<sup>40</sup>

No showing has been made that the Investment Company Act imposes any really onerous burdens on Du Pont. No doubt the applications that the company is required to file by reason of its affiliation with Christiana are something of a nuisance.<sup>41</sup> But no contention has been made that the Act has interfered or is likely to interfere with the company's business. Hence we find it is difficult to view Du Pont's exit from the Act's net as a significant benefit.

But the Act's requirement that the transaction be reasonable, fair, and free from overreaching, does not mean that the benefits to the parties must be nicely balanced. Such a reading would be wholly impractical and would frustrate legitimate arrangements. Some transactions are more important to one side than to the other. This one is of that type. And that does not make it inherently unfair under Section 17(b). Nor does the fact that Christiana has much more at stake than Du Pont mean that the consideration moving from Christiana to Du Pont must be large enough to inflict really substantial detriment on the former.

The benefit to Du Pont is far from awesome. But it is sufficient to meet the statutory standard. Christiana is a legal device. Those who invented it did so to serve their own purposes.<sup>42</sup> And they had every right to do that. Now the inventors' heirs and successors in interest conclude that the device is obsolete. That is their privilege. Nothing in the Act

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<sup>39</sup> As a former Chairman of this Commission recently observed: "The raider may . . . be a better manager than the raidee." Cary, A Proposed Federal Corporate Minimum Standards Act, 29 Bus. Law, 1101, 1105 (1974).

<sup>40</sup> Certain Delaware decisions seem to hold otherwise. They are beside the point. Our concern here is not with the niceties of local corporation law, but with broad Federal investor-protection standards formulated in large measure because of the inadequacies of local corporation law. *See* Cary, Federalism and Corporate Law; Reflections upon Delaware, 83 Yale L.J. 663 (1974).

<sup>41</sup> Our files show that there have been approximately 50 applications since the Investment Company Act went into effect back in 1940.

<sup>42</sup> The parties did not go into Christiana's history on the record. But we thought it appropriate to take administrative notice of some fairly well-known facts of economic history. And we did so at the outset of this opinion. We cannot forget that Christiana as an investment company is of a very special kind and that the situation with which we are confronted was created long, long before anyone dreamed of any such statute as the Investment Company Act. Compare Hawaiian Electric Company, Inc., Holding Company Act Release No. 16592 (January 26, 1970), p. 5 where our view of the Public Utility Holding Company Act's impact on the matters there before us was much influenced by Hawaii's unique history.

The Public Utility Holding Company Act to which we have just referred has a certain bearing here. As applicants note, Section 11(b) (2) of that statute mandates the elimination of unnecessary holding companies in the industries affected. Were that Act applicable to Christiana, it would have vanished long ago. Nobody suggests that it serves any real purpose in the world of today. Of course, Du Pont is neither an electric company nor a gas company. So we have no power to destroy Christiana on our own motion. But we think the policy against the multiplication of superfluous corporate entities articulated in the Holding Company Act sound and salutary. When as here questions about wholly unnecessary entities come before us in non-utility contexts, it is quite inappropriate for us to insist on their perpetuation or to impose terms likely to lead the parties to conclude that it would be cheaper and better to keep them alive.

compels them to pay a high price for exercising it.<sup>43</sup> Only if their decision to dismantle Christiana inflicts cognizable harm on Du Pont and on its stockholders unrecompensed by the proposed discount, can we insist on terms harsher for them than those now before us.<sup>44</sup>

Another aspect of this case illustrates that principle. The Christiana stockholders could have caused Christiana to be liquidated. They would then have become the direct owners of the Du Pont shares now held by Christiana. Had they done so, the situation would have been essentially the same as that contemplated by this merger.

But a liquidation, unlike this merger, would have adverse tax consequences for Christiana's stockholders. And in view of the problems attributable to the General Motors divestiture, the extent of their potential tax liability is shrouded in uncertainty.<sup>45</sup> The proposed merger is thus designed to avoid the serious tax problems that Christiana's liquidation would engender for its stockholders. Aside from those tax problems, however, the economic impact of this merger on Du Pont and its stockholders is no more onerous than the impact that would be produced were the Christiana stockholders to exercise their prerogative to liquidate Christiana. More specifically, the possible market effects resulting from the

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<sup>43</sup> But they must pay a fair price. And in assessing the fairness of the proposed price one is struck by the fact that the Securities Act restricts the marketability of Christiana's massive block of Du Pont. Objectors do not demur to the proposal on this ground. Nor does our staff. We, however, have considered the question *sua sponte*. We have done so because (1) as the Commission pointed out some years ago, "the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper." ("Restricted Securities," Investment Company Act Release No. 5847, Accounting Series Release No. 113 (October 21, 1969)); and (2) in the normal case a discount of only 2.5% from net asset value would be much too small to reflect the diminution in value resulting from the restrictive feature. After such consideration, we find this one of those "most unusual situations" referred to in the above-cited release in which it is proper to value restricted securities at the price assigned by the market to unrestricted securities of the same class.

The typical investment company-restricted security situation involves the acquisition of a block of restricted securities for investment at a price below that at which unrestricted securities of the same class are selling, with the discount (usually a substantial one) being attributable to the restrictions imposed by the Securities Act on persons who take securities in so-called private placements. None of these factors is present here. Christiana's 13,417,120 shares of Du Pont were not acquired for investment in the ordinary sense of that term. Those shares are a historic control block assembled almost two decades before anyone thought of any such statute as the Securities Act. And although the price Christiana paid for its Du Pont holdings was nominal when viewed in relation to their present value, it received no discounts at the time of purchase. What has just been said is more than historical digression. It has contemporary relevance. A block of securities restricted under the Securities Act because it is large enough to confer control cannot be equated mechanically for all purposes with smaller non-controlling blocks restricted only because they were acquired in transactions claimed to have been exempt from the Securities Act's registration and prospectus-delivery requirements by reason of the special provision in Section 4(2) of that statute for "transactions . . . not involving any public offering." Our policy with respect to the valuation of restricted stock by investment companies rests on two principal considerations. First, the impropriety of an investment company recording essentially fictitious profits by buying restricted stock at a discount and then marking it up to the market; and secondly, the fact that stock which cannot be publicly sold without registration normally is worth less than stock which is free for trading. Neither consideration is applicable here. Christiana did not acquire Du Pont stock as a discount by reason of the status of that stock under the Securities Act, and Christiana never intended to, and never has, traded in and out of Du Pont stock. If Christiana has ever made the clearly momentous decision to attempt to sell its Du Pont stock, registration under the Securities Act would have been the least of its problems.

Also pertinent in this regard is the fact that much (probably most) of the Du Pont stock to be received by the Christiana stockholders will itself be restricted under the Securities Act. To discount the value of those persons' present indirect holdings in Du Pont on the ground that those holdings are restricted under the Securities Act and then to give them new direct Du Pont shares that would be similarly restricted, would involve a double subtraction that we deem impermissible.

<sup>44</sup> It might seem that the discount should at the very least equal the 7.2% income tax benefit to be realized by the Christiana stockholders. However, their actual benefit will in most cases be less than 7.2%. See p. 10, *supra*. This consideration, however, we put to one side. The heart of the matter is that the tax benefits to be reaped by the Christiana people will inflict no corresponding detriment on Du Pont or on its stockholders. The burden will fall wholly on the United States. And neither the du Pont family nor the other Christiana holders are under any duty to maximize their tax liabilities. As the Court of Appeals for the Second Circuit said when it spoke through Judge Learned Hand in *Helvering v. Gregory*, 69 F.2d 809, 810 (1934): "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Also in point are Judge Hand's subsequent observations when he dissented in *Commissioner v. Newman*, 159 F.2d 848 (C.A. 2, 1947), cert. denied 331 U.S. 859 (1947): "[T]here is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." 159 F.2d at 850-851. Nor do we see how Section 17(b)'s "reasonable and fair" standard can be deemed to require Christiana's stockholders to turn every nickel of their tax savings over to Du Pont. The tax savings are of some weight. But it does not follow that the Du Pont stockholders are to be subrogated to the rights that the United States now enjoys under the status quo.

<sup>45</sup> See n. 31 on pp. 10-11, *supra*.

Christiana stockholders acquiring direct ownership of the Du Pont shares would be the same. It may be that in the course of bargaining between wholly unrelated parties, Du Pont could have exacted a handsome price for permitting consummation of the transaction in a form that relieves the Christiana stockholders of their tax problems. But Du Pont's failure to do that does not render the transaction unreasonable or unfair. The Du Pont stockholders, including the objectors, have no property interest in the Christiana stockholders' tax problems. A principal reason why Section 17 of the Investment Company Act requires us to pass upon the fairness of transactions such as this, is to prevent persons in a strategic position from using that position to effect transactions for other than fair value. And fair value does not change simply because a strategic position arises from something other than affiliation.

## X

That brings us to what we think the crux of the case: the objectors' claim of detriment by reason of market impact.

Here we find a hot dispute about the probable facts. Objectors envision endless torrents of Du Pont shares descending on the market. Although never too clear about exactly what they expect to happen, they profess great alarm about the low prices to which Du Pont common will fall.<sup>46</sup> Applicants laugh at that. They say that nobody is going to sell anything. Christiana's brief tells us that:

"In the present situation, there is no reason to suppose that the distribution of Du Pont shares to Christiana stockholders will add even one share to the market for Du Pont stock. The consummation of the merger will simply leave the Christiana stockholder with Du Pont shares in place of the Christiana shares he has formerly held—in most cases—for many years. There is no reason to suppose that the Christiana stockholder will sell those shares . . . [A]dverse tax consequences will be visited on a former Christiana stockholder if he does sell Du Pont stock. Those consequences are a strong deterrent to sale since receipt of the Du Pont stock in the merger will be tax-free."

We think the objectors' prophecies much too gloomy.<sup>47</sup> Hence it looks to us as though the applicants have the better of the argument. But we refrain from enmeshing ourselves in this thicket of conjectures about what people are likely to do in the future with their own property.

We assume that the merger may engender some selling that would otherwise not take place. We assume further that such selling may at certain points in time be substantial. Proceeding on those assumptions, we are nevertheless after considerable thought unable to detect any uncompensated detriment to the Du Pont stockholders of a type that we can properly take into account.

The stock market has its peculiarities. In essentials, however, it is much like other more basic markets in goods, services, and the factors of production. Here as elsewhere increased supply will (all other factors being equal—which in practice they may or may not be) lower prices. Should the Wilmington Trust Company decide to sell a substantial amount of Du Pont common, the price of the issue will be affected to some extent.

We agree with the objectors about that. But we disagree with their contention that this short-run view of the pricing process is the one that governs here. What we have before us in these proceedings is a proposal for a fundamental

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<sup>46</sup> But they never explain why Christiana's holders would be eager to sell at such depressed levels. Objectors have no doubts about Du Pont's investment merit. Indeed, they think Du Pont a pearl of great price. Nor do they suggest that those who guide Christiana's destinies have any real doubts about Du Pont. The objectors' position is self-contradictory. On the one hand, they stress the great wealth of the du Ponts. On the other, they are (or claim to be) obsessed by the virtual certainty of massive sales at distress prices. But why should people whose remoteness from the brink of destitution is constantly stressed by the objectors themselves rush off madly to dispose of valuable property for less than its intrinsic worth? Objectors never answer that question. Instead they shift their ground by moving from the Christiana control group to the non-controlling public investors who own about 25% of Christiana. These people, they note, will be free from the Securities Act's registration and prospectus-delivery inhibitions. They proceed to postulate devastating waves of helter-skelter selling by the public holders. These horrors seem fanciful to us. We see no reason to assume that there will be a psychosis epidemic among either the controlling or the non-controlling Christiana stockholders. We think that in financial matters at least both groups are at least as rational as the general run of Humanity.

<sup>47</sup> Our reasons have been stated in the preceding footnote.



corporate readjustment. In that context transitory market phenomena are of secondary significance. We look at the case not from the objectors' tape-watcher perspective,<sup>48</sup> but as a problem in economic realities and business fundamentals.<sup>49</sup>

Hence we find ourselves compelled to discount objectors' market impact worries even more heavily than they would have us discount Christiana's net asset value. A share of Du Pont common is a fractional proprietary interest in a large business. In no way will the Christiana merger detract from either the assets or the earning power of that business. The fundamentals of the situation will remain as they are. Thus the merger cannot affect—and no contention has been made that it would or could affect—Du Pont's intrinsic investment value. That the merger might possibly engender selling of a volume that could on occasion cause Du Pont's market price to dip below the level at which it would otherwise stand is of little moment. Such undervaluation would undoubtedly attract the attention of investors and speculators interested in chemical issues. They could scarcely escape noticing it. And why would they spurn the resulting bargain? Nothing brought to our attention suggests that the marketplace might be slow to notice Du Pont's cheapness relative to comparable stocks. And we see no reason to assume that it would. We therefore conclude that such depressing effects on the price of Du Pont common as may occasionally manifest themselves by reason of the proposed transaction will be of relatively brief duration. We proceed on the premise that over time the securities markets are rational.<sup>50</sup> And if that premise be sound, an issue as well-known and as conspicuous as Du Pont common cannot remain on the bargain counter for long.<sup>51</sup>

<sup>48</sup> We cast no aspersions on tape watchers. They have every right to speculate. And while pursuing their own self-interest, they sometimes perform a useful social function. Hence they are often the objects of our solicitude. But that is so in matters arising under the Securities Exchange Act. When we work under this Act, under Chapter X of the Bankruptcy Act, and under the Public Utility Holding Company Act, their interests yield to those of the long-term investor.

<sup>49</sup> We may draw attention to what we consider the striking parallel between Section 17(b)(1)'s reasonable, fair, and free from overreaching test and the "fair and equitable" standard that Congress laid down in the Bankruptcy Act (Sections 174, 221(2)), and in the Public Utility Holding Company Act (Section 11(e)). True it is that the words "fair and equitable" have a precise technical meaning in insolvency law. Nor are we unmindful of the distinctions that may well be drawn between a legally mandated reorganization under the Holding Company Act and a consensual arrangement such as the one now before us. But the ancient reorganization concept of "fair and equitable" also has a broader meaning that we think indistinguishable from the Investment Company Act test that governs here. See *Protective Committee v. Anderson*, 390 U.S. 414, 424-441 (1968).

Hence we find the many reorganization cases that emphasize intrinsic value and deprecate market factors persuasive here. See, e.g., *S.E.C. v. Central-Illinois Securities Corp.*, 338 U.S. 96, 152 (1949) ("Congress, perhaps believing that the application of such an amorphous standard as that of 'colloquial equity' was beyond the competence of courts and commissions, has instead prescribed the requirement that investment values be preserved."); *Niagara Hudson Power Corp. v. Leventritt*, 340 U.S. 336, 346-348 (1951) ("The informed judgment of the Commission, rather than that of the market, has been designated by the Act as the appropriate guide to fairness and equity within the meaning of the Act. Under the standards approved by this Court, that informed judgment looks for investment values. . . . [T]he Central-Illinois case . . . expressly rejected the 'colloquial equity' approach of the District Court, which placed special emphasis upon market history. . . . Moreover, we find no lack of authority . . . [for] the general principle that a class of securities may go unrecognized in a reorganization when . . . they have no investment value.") Pertinent here are the District Court's observations at the close of its opinion in *In re Imperial '400' National, Inc.*, 374 F. Supp. 949, 978, (D.N.J., 1974): "Concern has been expressed . . . with respect to the market value of new . . . stock as opposed to its investment value. No matter how carefully I may calculate 'value,' I have no control over what may happen to price in the public market. But my concern under the Bankruptcy Act is value and not price."

<sup>50</sup> The premise may or may not be empirically demonstrable. Some academicians who speculate about the nature of speculation question it. But see the observations on "central value" and "intrinsic value" in Graham, Dodd & Cottle, *Security Analysis* 26, et seq. (4th ed., 1962). We, however, are not at liberty to question it. The statutes we have been directed to administer start from the axiom that markets are or can be made economically rational. We are no freer to question that axiom than we are to question the desirability of registration statements and prospectuses under the Securities Act. If prices and values are as unrelated to each other over time as the objectors contend, the Investment Company Act is nonsensical and this Commission's labors under it farcical. For obvious reasons we take a different view.

<sup>51</sup> The closed-end discount that pervades this case may raise doubts about this. The closed-end discount phenomenon, which is neither peculiar to Christiana nor of recent vintage (see our previously cited 1966 report on the Public Policy Implications of Investment Company Growth at pp. 42-44; see also Metz, *Unkindly Year in Closed Ends*, *N.Y. Times*, January 11, 1974 at 42, col. 3; *Where Stocks Can Be Bought at a Discount*, *U.S. News & World Report*, May 27, 1974, p. 61) has its intriguing and to some extent disquieting aspects. But we see nothing in it that serves as an augury about the probable market action of a stock like Du Pont. Closed-end companies are seldom liquidated. Investors attracted to them by the discount assume the risk that the discount may widen against them. And in Christiana's case special factors come into play. Du Pont is an active, well-known listed stock. Christiana, on the other hand, is a thinly traded over-the-counter issue. The relative illiquidity of an investment in Christiana would seem to have had some influence on the discount.

Suppose that we were inclined to see more abstract merit than we do in the objectors' market impact argument. Even then we would be unable to give it much weight in deciding the concrete case before us. How can we possibly tell how much Du Pont common is likely to come to market by reason of this merger in 1976? 1980? 1985? And even if we could form some educated guesses about that, how would we measure the impact of the additional supply on the market price? The objectors are unable to supply us with supply and demand schedules for Du Pont common for the ensuing decade.<sup>52</sup> And we decline to construct our own.<sup>53</sup> Speculations about the probable behavior patterns of speculators are much too slender a reed on which to predicate findings of fairness under the Investment Company Act.<sup>54</sup>

Even if we had the light of hindsight available to us, we could not properly focus on the factors that the objectors consider central.

Suppose that we were able to take another look at this case some years after the merger. Du Pont's actual post-merger market history would then be available to us. But it would be of little help. Stock prices are volatile and the factors that influence them multifarious.<sup>55</sup> We know of nothing that would permit an accurate post-merger assessment. A pre-merger one would obviously be an even wilder guess.

## XI

At times the law undertakes explorations almost as speculative as those on which the objectors ask us to embark. Thus in the law of tort judges and juries place price tags on pain and suffering – and indeed on human life itself. And to come closer to home, in reorganizations under the Bankruptcy and Public Utility Holding Company Acts we and the courts try to estimate the probable future earnings of business enterprises and the multiples at which it is appropriate to capitalize those earnings.<sup>56</sup> Those inquiries are undertaken because justice requires that the effort be made.

That differentiates those situations from this one. Here justice requires no ventures into the unknown and unknowable. An investment company, whose assets consist entirely or almost entirely of securities the prices of which are determined in active and continuous markets, can normally be presumed to be worth its net asset value. What better guide to its value could there be? The simple, readily usable tool of net asset value does the job much better than an accurate gauge of market impact (were there one) could. The record indicates that most of Christiana's stock is held by long-term investors. Hence there is no pressing need to depart from the net asset value test.<sup>57</sup>

That understates matters. In these circumstances, any significant departure from the net asset value criterion would work positive injustice. Objectors' proposals would strip the long-term Christiana investor of some of the intrinsic value

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<sup>52</sup> Were there any such schedules, their very existence would alter the situation. If investors and speculators had the benefit of perfect foresight, they would alter their plans.

<sup>53</sup> Having denounced investment advisers who "vie with each other in making unsupportable claims to prophetic insight" (Spear & Staff, Incorporated, 42 S.E.C. 549, 556 (1965)), we refrain from similar transgressions of our own.

<sup>54</sup> Compare Jade Oil & Gas Co., Corporate Reorganization Release No. 289, p. 14 (September 15, 1969).

<sup>55</sup> Du Pont is generally regarded as an issue of prime investment quality. Applicants and objectors agree on that. Yet during 1974 its price has ranged from 179 to 84 1/2. Lest 1974 be tossed off as an especially disturbed year, we look for comparative purposes to 1970-1972. And we find that during those years the price ranged from 184 to 92. Du Pont is now selling at 8 times earnings. Not too long ago it was selling at 24 times earnings. Some years ago it was at 27 times earnings. These numbers show the inherent futility of any effort to measure the impact of incremental supply. Yet objectors ask us to assess the psychological effects of purely potential supply.

<sup>56</sup> See Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510, 526 (1941) quoted with approval in Protective Committee v. Anderson, 390 U.S. 414, 441-442 (1968): "The criterion of earning capacity is the essential one . . . Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made."

<sup>57</sup> Investment companies are as a general rule media for long-term investment. That makes net asset value the touchstone. And the Act is based on that premise. Section 2(a)(41)(B) states that "'Value' with respect to assets of registered investment companies . . . means . . . with respect to securities for which market quotations are readily available, the market value of such securities." And although the closed-end discount phenomenon was well-known in 1940, the Congress that passed the Act chose to protect closed-end stockholders against dilution of intrinsic values rather than to facilitate the sale of new closed-end shares. Section 23(b) of the Act shows that. It provides that "No registered closed-end company shall sell any common stock of which it is the issuer at a price below the current net asset value of such stock." And we have viewed net asset value as the controlling factor in Section 17 proceedings. See, e.g., Harbor Plywood Corporation, 40 S.E.C. 1002, 1010 (1962); Delaware Realty and Investment Company, 40 S.E.C. 469, 473 (1961). Compare Central States Electric Corporation, 30 S.E.C. 680, 700 (1949) (advisory report on plans for the reorganization of a closed-end investment company under Chapter X of the Bankruptcy Act urging "net asset value as the primary measure of value of an investment company.")

of his holdings. Such expropriation would be wholly unjustifiable. It would also be most inappropriate to frustrate the reasonable expectations of those who bought into Christiana in the belief that it was a legitimate way of buying Du Pont at a lower price.<sup>58</sup>

## XII

Having concluded that pecuniary assessment of hypothetical future market impact would be unnecessary and inappropriate,<sup>59</sup> we turn to the objectors' suggestions for restraints on the alienation of the Du Pont shares to be issued under the merger.<sup>60</sup>

The Securities Act is now 41 years old. Hence there is nothing novel about the idea that it is in the public interest and appropriate for the protection of investors to inhibit certain strategically situated persons from selling securities whenever they choose. But neither the Securities Act nor the Securities Exchange Act prohibits such people from selling. What those statutes prohibit are offers and sales without appropriate disclosure. It is a long, long jump from that to an unconditional ban on any sales at all. And quantitative limits on a holder's freedom of sale that rest not on the buyers' need for disclosure, but on the assumed desirability of protecting other holders from the market effects of large-scale selling would entail almost as broad a leap. We see no need for such a leap in this case.<sup>61</sup>

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<sup>58</sup> Objectors talk to windfalls. We cannot detect them. True, people bought Christiana on the theory that it was a cheap way of buying Du Pont. But those who did that took the risk that the closed-end discount might widen against them. Those who reasoned that long-run value would win out in the end and that Christiana could not last forever will do well. But such rewards for astuteness and lucky guesses are inherent in the nature of markets.

<sup>59</sup> Objectors make much of certain assertedly contrary positions said to have been taken by the applicants, their controlling persons and their counsel and financial advisers in the Du Pont-General Motors divestiture proceedings. *See* *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586 (1957); 177 F. Supp. 1 (N.D. Ill., 1959); 366 U.S. 316 (1961). But the views that the applicants found it convenient to take in another case under another statute before another forum are not controlling here. Moreover, the General Motors situation had nothing in common with this one. There Du Pont was to distribute its millions of General Motors shares to Du Pont's stockholders. Under the Internal Revenue Code, as it then was, the recipients of those shares would have been deemed to have realized taxable income. So they would have had to pay taxes.

To raise the money with which to pay those taxes, they would or might have had to sell at least some of the General Motors shares that they received by reason of the divestiture. (This problem was solved for the most part by the addition of Section 1111 to the Internal Revenue Code.) Here no taxes need be paid except by those Christiana holders who may voluntarily decide to sell. Nor are the governing legal standards the same. The Internal Revenue Code's standard is "fair market value." The word "market" is conspicuously absent from Section 17(b).

<sup>60</sup> No specific suggestions are made.

<sup>61</sup> Objectors seek to protect their property rights. But the Christiana stockholders also have property rights. It is not for us to prefer one group's property rights over the other's. The Du Pont stockholders are far more numerous than the Christiana stockholders. *See* n. 34 on p. 11, *supra*. But that is of no consequence. These matters are not resolved by plebiscite. Section 17(b)(1) seeks to prevent "overreaching on the part of any person concerned." Compare *Protective Committee v. Anderson*, 390 U.S. 414, 435 (1968): "[A] plan of reorganization which is unfair to some persons may not be approved by the court even though the vast majority of creditors have approved it."



### XIII

We said earlier that this is not an easy case. But its difficulties do not stem from the hypothetical market impact on which objectors focus. They flow rather from the striking disparity between the substantial benefits to be received by Christiana and the far more modest ones inuring to Du Pont. This disparity justifies the proposed 2.5% or 1.8% discount from Christiana's net asset value. That is not to say that applicants have come up with the one right figure. There is no such figure. Fairness is a range, not a point. Something less than the discount arrived at by the applicants might well pass muster.<sup>62</sup> And a slightly higher discount would also be within the permissible range. But one appreciably higher than the discount now before us would divest Christiana's stockholders of a significant portion of the intrinsic investment values to which they are legally and equitably entitled. It would therefore run afoul of Section 17(b)(1) of the Act.<sup>63</sup>

### XIV

We find the proposed merger:

- (A) Reasonable and fair;
- (B) Free from overreaching on the part of any person concerned;<sup>64</sup> and
- (C) Consistent with the general purposes of the Act.<sup>65</sup>

The standard of Section 17(b) being met, there is no need to invoke Section 6(c).<sup>66</sup>

An appropriate order will issue.

By the Commission (Chairman Garrett and Commissioners Loomis, Evans, Sommer and Pollack).

### ORDER GRANTING APPLICATION

Christiana Securities Company, a registered closed-end non-diversified investment company, and E. I. du Pont de Nemours and Company, its affiliate, made joint application under Sections 17(b) and 6(c) of the Investment Company Act for an exemption from Section 17(a) of certain transactions incident to a merger of Christiana into Du Pont. The application also sought permission to effect such transactions under Section 17(d) and Rule 17d-1.

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<sup>62</sup> Objectors say that the applicants' negotiations were not at arm's-length. And in view of the links between Christiana and Du Pont they may well be right about that. It matters not. In assessing fairness we look not to the nature of the negotiations but to their results. It is precisely because transactions of this character are replete with inherent conflicts of interest that the Act requires that they be submitted to us. As we said in *Atlas Corporation*, 37 S.E.C. 72, 85-86 (1956): "It is evident that Section 17 of the Act was not designed to prohibit transactions solely for the reason that they are not negotiated at arm's-length. On the contrary, Section 17(b) of the Act directs us to exempt transactions between controlling or affiliated persons where the evidence establishes that the terms thereof are reasonable and fair and do not involve overreaching on the part of any person concerned. Clearly, Section 17 contemplates that transactions meeting these standards will be permitted although arm's-length bargaining may not have been present or, indeed, may have been impossible in view of the relationship of the parties."

<sup>63</sup> That being our view of the law of the case, we see no merit to the objectors' contention that the record is so inadequate on the market impact aspect of the matter as to require a remand. Nor do we see any basis for the claim that adequate discovery about the Christiana control group's present intent to sell or refrain from selling in the future was improperly denied. To have delved into the matters into which objectors sought to inquire would have swelled the record pointlessly. Moreover, our Rules of Practice make no provision for the taking of depositions in situations other than those covered by Rule 15(a) of those rules. There may be a trend toward liberality in pre-trial discovery. But that did not empower the administrative law judge to disregard the plain meaning of our rules. Due process does not require depositions. *See Miner v. Atlass*, 363 U.S. 641 (1960); *N.L.R.B. v. Interboro Contractors, Inc.*, 432 F. 2d 854, 857-858 (C.A. 2, 1970), cert. denied, 402 U.S. 915 (1971).

<sup>64</sup> We make no findings under Section 17(b)(2), which requires that the proposed transaction be consistent with the investment company's policy. That section has no bearing on cases in which investment companies propose to go out of existence. *See Aviation and Transportation Corporation*, 8 S.E.C. 527, 538-539 (1941).

<sup>65</sup> That is so because it will eliminate pyramiding duplicative operating expenses, and unnecessary taxation. *See the Aviation and Transportation case cited in the preceding footnote, at page 539 of 8 S.E.C.*

<sup>66</sup> Applicants also pray for exemptive relief from Section 17(d) of the Act and our Rule 17d-1 thereunder. No issue has been raised as to the applicability of those provisions. Hence we assume without so deciding that they may have some bearing here. To the extent if any, that this is so, we find the standards of that section and that rule satisfied.

Hearings were held after appropriate notice. An initial decision by the administrative law judge was waived. Proposed findings and briefs were filed. And the Commission heard oral argument.

The Commission has this day issued its Findings and Opinion. On the basis of such Findings and Opinion, it is

ORDERED that the proposed transactions be, and they hereby are, exempted from Section 17(a) of the Investment Company Act; and it is further

ORDERED that said transactions be, and they hereby are, exempted from Section 17(d) of that Act and from Rule 17d-1 thereunder.

## EXCERPT FROM PROPOSED FORM N-7 FOR REGISTRATION OF UNIT INVESTMENT TRUSTS

Release Nos. 33-6580; IC-14513

May 14, 1985

### IV. Guidelines

Over the years, numerous releases and no-action positions have described the views of the staff on matters affecting investment company disclosures. In addition, the staff has developed a number of policies relating to unit investment trusts that have not been formally announced. When it adopted Form N-1A, the Commission published staff guidelines for Form N-1A<sup>1</sup> that bring together and update many of these positions for mutual funds. Guidelines have not been available to registrants for Form N-8B-2 and Form S-6. In order to assist registrants in preparing Form N-7, the Commission is publishing staff guidelines for this form, included as Appendix B to this release. These guidelines represent a compilation of staff positions with respect to appropriate disclosure for unit investment trusts.<sup>2</sup> Comments are invited on the guidelines and other subjects not covered by them in order to assist the staff in developing appropriate final guidelines for Form N-7.

### Restricted Securities

Guide 3 would permit a unit investment trust to hold in its portfolio restricted securities with a value of up to 25% of the face amount of the portfolio securities in the trust at the time of deposit (and up to 40% where the increase is a result of the sale or change in value of unrestricted securities) if a number of conditions are met. For purposes of this guideline, "restricted securities" mean those securities that cannot be sold publicly by the trustee without registration under the Securities Act. The conditions, in general, are designed to ensure the liquidity of the trust securities as a whole.

The 25% limitation set forth in proposed Guide 3 represents a change in the position of the staff. Current policy allows a unit investment trust to invest up to 40% of face amount of portfolio securities in restricted securities (and up to 50% where the increase is a result of the sale or change in value of unrestricted securities). The 40% figure is considerably more liberal than the 10% investment which the Commission has stated would be a prudent limit on any open-end investment company's acquisition of restricted securities, or other assets not having a readily available market quotation.<sup>3</sup>

These limitations on holdings of restricted securities are premised on Commission concerns over the valuation and liquidity of restricted securities that were discussed in Securities Act Release No. 5847 (October 21, 1969). Because open-end management investment companies and unit investment trusts must be prepared to satisfy redemptions within seven days under Section 22(e) of the 1940 Act,<sup>4</sup> they must maintain a portfolio of investments that enables them to fulfill that obligation. This requires a high degree of liquidity because redemption demands or other exigencies are not always predictable. Further, the seven-day period for payment or satisfaction upon redemption required under Section 22(e) may necessitate that an investment company sell restricted securities in a hastily arranged private placement and therefore receive less than the market value of the restricted securities reflected in the trust series net asset value. Thus, instead of arranging a private sale of restricted securities, an investment company that is faced with redemptions may decide to sell unrestricted securities that it would otherwise have retained on the basis of comparative investment merit. Although the longer-term nature of investments in trusts compared generally to mutual funds, the fixed portfolio of most unit investment trusts, and the maintenance of a secondary market for securities by unit investment trust sponsors support a more liberal policy for investment in restricted securities by unit investment trusts than by mutual funds, the Commission believes, in view of the potential problems raised by the statutorily mandated seven-day redemption period under Section 22(e) of the 1940 Act, that a 25% limitation is more appropriate than a 40% one.

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<sup>1</sup> Investment Company Act Release No. 13436 (August 12, 1963) [48 FR 37920 (August 22, 1963)].

<sup>2</sup> As such, unless the guidelines incorporate rules of the Commission, they do not have the force of rules promulgated by the Commission. To the extent the guidelines may reflect a change in staff policy, the staff would expect to apply them on a prospective basis only.

<sup>3</sup> Securities Act Release No. 5847 (October 21, 1969) [35 FR 19969 (December 31, 1969)].

<sup>4</sup> Although most unit trust sponsors maintain a secondary market for units of the various trust series, the sponsors may stop maintaining a secondary market at any time or may otherwise redeem units purchased from unit holders in the secondary market, bringing into play the redemption requirements of Section 22(e).

## Guide 2—Valuation of Securities Being Offered

Item 16 requires a registrant to identify in the prospectus the method used to value the assets. In some circumstances, value can be determined fairly in more than one way. For securities traded on a national securities exchange, valuation normally should be based on market value when readily available.<sup>5</sup> If a security was traded on the valuation date, the last reported sale price generally is used. In the case of securities listed on more than one national securities exchange, the last reported sale, up to the time of valuation, on the exchange on which the security is principally traded should be used or, if there were no sales on that exchange on the valuation date, the last reported sale, up to the time of valuation, on the other exchanges should be used.

If there was no sale on the valuation date but published closing bid and asked prices are available, the valuation in such circumstances should be within the range of these quoted prices. Some companies as a matter of general policy use the bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range of bid and asked prices considered best to represent value in that circumstance; each of these policies is acceptable if consistently applied. Normally, the use of the asking price alone is not appropriate. Where, on the valuation date, only a bid price or an asking price is quoted or the spread between bid and asked prices is substantial, quotations for several days should be reviewed. If sales have been infrequent or there is a thin market in the security, or the size of the reported trades is considered not representative of the fund's holding (as in the case of certain debt securities), further consideration should be given as to whether "market quotations are readily available." If it is decided that they are not readily available, the alternative method of valuation prescribed by Section 2(a)(41), that is, "fair value," as determined in good faith by the trustee or its appointed person, should be used.

For debt or equity securities traded over-the-counter where closing prices are not readily available, quotations for a security should be obtained from more than one broker-dealer, particularly if quotations are available only from broker-dealers not known to be established market-makers for that security. A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoted on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in that circumstance. The staff will consider any of these policies appropriate if consistently applied.

If the validity of the quotations appears to be questionable, or if the number of quotations is such as to indicate that there is a thin market in the security, further consideration should be given to whether "market quotations are readily available." If it is decided that they are not readily available, the security should be considered one required to be valued at "fair value" as determined in good faith by the trustee or its appointed person.

To comply with Section 2(a)(41) of the Act and Rule 2a-4 under the Act, the trustee or its appointed person must satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and determine the method of arriving at the fair value of each such security. No single standard for determining "fair value in good faith" can be established, since fair value depends upon the circumstances of each individual case. As a general principle, the current "fair value" of an issue of securities being valued would be the amount which the owner might reasonably expect to receive for the securities upon their current sale.<sup>6</sup>

Securities held under circumstances where the sale of such securities to the public would not be permissible without an effective registration statement under the Securities Act are considered securities for which market quotations are not readily available. They must, therefore, be valued in good faith by the trustee or its appointed person.<sup>7</sup> It would be improper for the trustee or its appointed person to value these securities at the market quotation for unrestricted securities of the same class without considering other relevant factors, although this may be a factor considered in structuring the

<sup>5</sup> Investment Company Act Release No. 7221 (June 9, 1972) [37 FR 12790 (June 24, 1972)]. Registrants often value their debt securities by reference to other securities which are considered comparable in rating, interest rate, due date, etc. (often called "matrix pricing") or rely on pricing services which use matrix pricing for valuation of these securities. Responsibility for making sure that a pricing method is proper rests with the registrant.

<sup>6</sup> For a general discussion of the factors to be considered in this determination, see Investment Company Act Release No. 6295 (December 23, 1970) [35 FR 19986 (December 31, 1970)].

<sup>7</sup> Investment Company Act Release No. 7221, *supra*.

final valuation.<sup>1</sup> The existence of a shelf registration for the restricted securities may be properly considered as another factor in the determination of the value of such securities, but there may not be an automatic valuation at market price based on this factor alone.<sup>2</sup>

### Guide 3—Restricted Securities

Subject to the three conditions described below, up to 25% in face amount of the securities in any series of a unit investment trust may consist of restricted securities. For purposes of this guideline, the term “restricted securities” shall mean those securities that cannot be sold publicly by the trustee without registration under the Securities Act of 1933, as amended. If the conditions are not met, the trust may hold up to 10% of the face amount of the portfolio securities in restricted securities or other illiquid securities. The first condition is that sales of unrestricted securities from the portfolio will not result in (i) restricted securities constituting more than 40% in face amount of the securities remaining in the trust after the completion of the sale, and (ii) the trust holding less than \$250,000 in face amount of any obligation which is a restricted security or less than 1,000 shares of any preferred stock which is a restricted security.

The second condition is that the sponsor intends to maintain a secondary market in the units of the trust after the units are originally issued. Alternatively, if for any reason the sponsor discontinues its maintenance of a secondary market, the sponsor intends to purchase units of the trust tendered for redemption, at prices not less than the current redemption prices for units of the trust, in the event that (i) it would be necessary for the trust to sell restricted securities to meet redemptions or (ii) it is not feasible to dispose of the restricted securities within the period during which tendering unit holders are required to be paid.

Under the third condition, any trust containing restricted securities with a value equal to more than 10% of the face amount of the portfolio securities must be reasonably diversified and liquid. The following must be met to fulfill the third condition:

- (a) The sponsor limits its deposit of the securities of any single issuer, or of any two or more affiliated issuers, to less than 10% of the value of that trust.
- (b) The restricted securities are either rated, or, if not rated, are issued by issuers that have outstanding obligations that are rated investment grade—one of the four highest rating grades assigned by a nationally recognized statistical rating organization.
- (c) The securities (including the restricted securities) are valued by an independent evaluator at the time the securities are deposited in the trust and during the time they remain in the trust.

If restricted securities are to be included in the portfolio of a trust, the percentage in face amount of the securities in the portfolio which are restricted securities must be disclosed in the prospectus. The policy of investing in restricted securities, and the risks related thereto, should be briefly discussed in the prospectus pursuant to Items 3 and 5, with a fuller discussion in the Statement of Additional Information. The Statement of Additional Information must also disclose the conditions stated above and must briefly discuss any other material impact the inclusion of restricted securities may have on the trust.

The percentages set forth in this guideline will not apply in situations where the portfolio contains restricted securities for which the principal market is outside of the United States. The maximum percentage in these cases must be determined on a case-by-case basis, taking into consideration, among other things, the liquidity of these restricted securities in their overseas markets.

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<sup>1</sup> Investment Company Act Release No. 5847 (October 21, 1969) [35 FR 253 (December 31, 1970)].

<sup>2</sup> Investment Company Act Release No. 6121 (July 20, 1970).

## EXCERPT FROM REPROPOSED FORM N-7 FOR REGISTRATION OF UNIT INVESTMENT TRUSTS

Release Nos. 33-6693; IC-15612

March 9, 1987

### Guide 2. Valuation of Securities Being Offered

Item 11 requires a registrant to identify in the prospectus the method used to value trust assets. In some circumstances, value can be determined fairly in more than one way. For securities traded on a national securities exchange, valuation normally should be based on market value when readily available.<sup>1</sup> If a security was traded on the valuation date, the last reported sale price generally is used. In the case of securities listed on more than one national securities exchange, the last reported sale, on the date of valuation, on either a composite transactions reporting system or the exchange on which the security is principally traded should be used or, if there were no sales on that exchange on the valuation date, the last reported sale, up to the time of valuation on the other exchanges should be used.

If there was no sale on the valuation date but published closing bid and asked prices are available, the valuation should be within the range of these quoted prices. Some companies as a matter of general policy use the bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range of bid and asked prices considered to best represent value in that circumstance; each of these policies is acceptable if consistently applied. Normally, the use of the asked price alone is not appropriate. Where, on the valuation date, only a bid price or an asked price is quoted or the spread between bid and asked prices is substantial, quotations for several days should be reviewed. If sales have been infrequent or there is a thin market in the security, or the size of the reported trades is not representative of the fund's holding (as in the case of certain debt securities), further consideration should be given as to whether "market quotations are readily available." If it is decided that they are not readily available, the alternative method of valuation prescribed by Section 2(a)(41), that is, "fair value," as determined in good faith by the trustee or its appointed person, should be used.

For debt or equity securities traded over-the-counter where closing prices are not readily available, quotations should be obtained from more than one broker-dealer, particularly if quotations are available only from broker-dealers not known to be established market-makers for that security. A registrant may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoted on a particular security; or it may use a valuation within the range of bid and asked prices considered to best represent value in that circumstance. The staff will consider any of these policies appropriate if consistently applied. If the validity of the quotations for securities traded over-the-counter appears to be questionable, or if the number of quotations indicates that there is a thin market in the security, further consideration should be given to whether "market quotations are readily available." If it is decided that they are not readily available, the security should be valued at "fair value" as determined in good faith by the trustee or its appointed person.

To comply with Section 2(a)(41) of the Act and Rule 2a-4, the trustee or its appointed person must satisfy itself that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and determine the method of arriving at the fair value of each such security. No single standard for determining "fair value in good faith" can be established, since fair value depends upon the circumstances of each individual case. As a general principle, the current "fair value" of an issue of securities being valued would be the amount which the owner might reasonably expect to receive for the securities upon their current sale.<sup>2</sup>

Restricted securities are securities which cannot be sold to the public without an effective registration statement under the Securities Act. These securities generally do not have readily available market quotations. They must, therefore, be valued

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<sup>1</sup> Investment Company Act Release No. 7221 (June 9, 1972) [37 FR 12790 (June 24, 1972)]. Registrants often value their debt securities by reference to other securities which are considered comparable in rating, interest rate, due date, etc. (often called "matrix pricing") or rely on pricing services which use matrix pricing for valuation of these securities. Responsibility for using a proper pricing method rests with the registrant.

<sup>2</sup> See Investment Company Act Release No. 6295 (December 23, 1970) [35 FR 19986 (December 31, 1970)], for a general discussion of the factors to be considered in this determination.

in good faith by the trustee or its appointed person.<sup>3</sup> It would be improper for the trustee or its appointed person to value these securities at the market quotation for unrestricted securities of the same class without considering other relevant factors, although the market quotation may be a factor considered in structuring the final valuation.<sup>4</sup> The existence of a shelf registration for the restricted securities may be properly considered as another factor in the determination of the value of such securities, but there may not be an automatic valuation at market price based on this factor alone.<sup>5</sup>

### Guide 3. Restricted Securities

Up to 40% in face amount of the securities in any series of a unit investment trust may consist of restricted securities, if the series meets the three conditions described below. For any series which contains restricted securities, all securities in the portfolio must be valued by an independent evaluator at the time the securities are deposited in the trust and during the time the series continues to hold restricted securities. (*See* Guide 2.) For purposes of this guideline, the term “restricted securities” shall mean those securities that cannot be sold publicly by the trustee without registration under the Securities Act of 1933, as amended.

The first condition is that sales of any securities from the portfolio will not result in (i) restricted securities constituting more than 50% in face amount of the securities remaining in the series after the completion of the sale, and (ii) the series holding less than \$250,000 in face amount of any obligation which is a restricted security or less than 1,000 shares of any preferred stock which is a restricted security.

The second condition is that the sponsor maintains a secondary market in the units of the series after the units are originally issued. Alternatively, if for any reason the sponsor discontinues its maintenance of a secondary market, the sponsor must purchase units of the series tendered for redemption at a price not less than the current redemption price for units of the series if (i) it would be necessary for the series to sell restricted securities to meet redemptions and (ii) it is not feasible to dispose of the restricted securities within the period during which tendering unit holders are required to be paid.

Under the third condition, any series containing restricted securities with a value equal to more than 10% of the face amount of the portfolio securities must be reasonably diversified. The sponsor must limit its deposit of the securities of any single issuer, or of any two or more affiliated issuers, to less than 10% of the value of that series.

If all three conditions are not met, the series may hold up to 10% of the face amount of the portfolio securities in restricted securities or other illiquid securities.

If restricted securities are to be included in the portfolio of a trust, the percentage of restricted securities in the portfolio must be disclosed in the prospectus. The policy of investing in restricted securities, and the risks related to the specific restricted securities, should be briefly discussed in response to Items 5 and 9. Registrant must also briefly discuss any other material impact the inclusion of restricted securities may have on the series.

The percentages set forth in this guideline will not apply in situations where the portfolio contains restricted securities for which the principal market is outside the United States. The maximum percentage in these cases must be determined on a case-by-case basis, taking into consideration, among other things, the liquidity of these restricted securities in their overseas markets. For purposes of Form N-7, securities which are actively traded and have a principal market outside the United States are not considered restricted securities.

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<sup>3</sup> Investment Company Act Release No. 7221, *supra*.

<sup>4</sup> Investment Company Act Release No. 5847 (October 21, 1969) [*35 FR 253* (December 31, 1970)].

<sup>5</sup> Investment Company Act Release No. 6121 (July 20, 1970).



## EXCERPT FROM AMENDMENTS TO FORM N-1A: REGISTRATION FORM USED BY OPEN-END MANAGEMENT INVESTMENT COMPANIES

Release Nos. 33-7512; 34-39748; IC-23064

March 13, 1998

### II. Discussion

#### A. Part A: Information in the Prospectus

##### 6. Item 7. Shareholder Information

##### b. Valuation of Fund Shares and Net Asset Value

*Valuation.* The Commission proposed to eliminate an existing requirement of Form N-1A that a fund disclose in its prospectus that the price at which investors' purchase and redemption requests are effected is calculated on the basis of the fund's current net asset value and that the fund identify the methods used to value its portfolio securities (e.g., market price or fair value).<sup>6</sup> The Commission proposed to take this action principally because, in meeting the requirement, funds typically go beyond the required identification of the methods used and repeat the substance of rules under the Investment Company Act specifying the way in which the net asset value of a fund must be calculated. In addition, the information presented by a fund usually repeats information required to be included in the SAI. This disclosure has tended to be lengthy and technical and, as discussed below, appears not to have been very informative for investors.

The Commission has re-evaluated the disclosure of information in fund prospectuses about the calculation of net asset value in light of numerous complaints from investors that the Commission received recently regarding the manner in which some funds determined their net asset value. In response to volatility in various markets, some funds recently valued certain of their securities on the basis of fair value rather than on the basis of the last market quotations for the securities.<sup>7</sup> In taking this action, the funds appear to have relied on a long-standing position of the Commission's staff that a fund may (but is not required to) value portfolio securities traded on a foreign exchange using fair value, rather than the closing price of the securities on the exchange, when an event occurs after the close of the exchange that is likely to have changed the value of the securities.<sup>8</sup> Many investors complained that they were unaware that their funds could use fair value pricing in such a situation. In response to these complaints, the Division undertook a review of the disclosure documents of funds using such fair value pricing and found that, although the funds disclosed the practice in their prospectuses, the funds' discussions of their pricing procedures would have been enhanced if they had followed the principles of plain English.<sup>9</sup> Investors' recent questions about fund pricing procedures confirm the general importance of this information to at least some investors. Thus, the Commission has determined to continue to require that funds

<sup>6</sup> Under the Investment Company Act and its rules, funds generally are required to use market quotations to value portfolio securities. If market quotations are not readily available, the fund must value the securities at "fair value as determined in good faith by the board of directors." Section 2(a)(41) (15 U.S.C. 80a-2(a)(41)); Rule 2a-4 (17 CFR 270.2a-4).

<sup>7</sup> These funds took this action under circumstances in which stock markets in Asia had closed 13 to 14 hours before the pricing of fund shares in the United States. In that time, several funds identified events that indicated a significant change in the price of securities traded on these markets since the last market quotations. On the basis of this assessment, the funds valued their securities using fair value rather than the market price of the securities. See Barnhart, *Asia Aficionados Found Profit in Times of Turmoil*, Chicago Tribune, Nov. 23, 1997 at C3; Smith, *Funds: A Hidden Trick Investors Should Know About*, Business Week, Nov. 17, 1997 at 41; Authers, *Now the Funds Are Coming Under Fire*, Financial Times, Nov. 8, 1997 at 2; Wyatt, *The Market Turmoil: Funds; Fidelity Invokes Fine Print and Angers Some Customers*, The New York Times, Oct. 31, 1997 at D6; Gasparino, *Pricing System Trips Fidelity, Angers Clients*, Wall Street Journal, Oct. 30, 1997 at C1.

<sup>8</sup> See *Putnam Growth Fund* (pub. avail. Feb. 23, 1981). Fair value pricing in this context is designed to protect the long-term value of fund shares from the actions of short-term investors who might buy or redeem fund shares in an attempt to profit from short-term market movements.

<sup>9</sup> See "Remembering the Past: Mutual Funds and the Lessons of the Wonder Years," Barry P. Barbash, Director, Division of Investment Management, SEC, at the 1997 ICI Securities Law Procedures Conference, Washington, D.C. (Dec. 4, 1997).



identify the methods used to value their assets in their prospectuses.<sup>1</sup> The Commission is, however, adding an instruction in Form N-1A that will encourage funds to discontinue the use of boilerplate disclosure of the technical aspects of valuation and require them to include a statement about the effect of the fund's use of fair value net asset calculation.

## Text of Rule and Form Amendments

### Part A: Information Required in a Prospectus

#### Item 7. Shareholder Information

(a) Pricing of Fund Shares. Describe the procedures for pricing the Fund's shares, including:

(1) An explanation that the price of Fund shares is based on the Fund's net asset value and the method used to value Fund shares (market price, fair value, or amortized cost).

Instruction. If a Fund has a policy that contemplates using fair value pricing under special circumstances (e.g., when an event occurs after the close of the exchange on which the Fund's portfolio securities are principally traded that is likely to have changed the value of the securities), provide a brief explanation of the circumstances and the effects of this policy. If the Fund's policy is to use fair value pricing only when market prices are unavailable, it need not explain the circumstances and the effects of the policy.

(2) A statement as to when calculation of net asset value are made and that the price at which a purchase or redemption is effected is based on the next calculation of net asset value after the order is placed.

(3) A statement identifying in a general manner any national holidays when shares will not be priced and specifying any additional local or regional holidays when the Fund shares will not be priced.

Instructions.

1. In responding to this Item, a Fund may use a list of specific days or any other means that effectively communicates the information (e.g., explaining that shares will not be priced on the days on which the New York Stock Exchange is closed for trading).

2. If the Fund has portfolio securities that are primarily listed on foreign exchanges that trade on weekends or other days when the Fund does not price its shares, disclose that the net asset value of the Fund's shares may change on days when shareholders will not be able to purchase or redeem the Fund's shares.

### Part B: Information Required in a Statement of Additional Information

#### Item 18. Purchase, Redemption, and Pricing of Shares

(c) Offering Price. Describe the method followed or to be followed by the Fund in determining the total offering price at which its shares may be offered to the public and the method(s) used to value the Fund's assets.

Instructions.

1. Describe the valuation procedure(s) that the Fund uses in determining the net asset value and public offering price of its shares.

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<sup>1</sup> Item 7(a). An instruction to this Item, as adopted, requires a fund to provide a brief explanation of specific policies of the fund concerning use of the fair value method of pricing fund shares. Form N-1A, as amended, requires a fuller explanation of fair value pricing policies in the SAI. Item 18(c).

## EXCERPT FROM ADOPTION OF RULE 38a-1: COMPLIANCE PROGRAMS OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Release Nos. IA-2204; IC-26299

December 17, 2003

### II. Discussion

#### 2. Investment Companies

c. *Policies and Procedures.* Funds' or their advisers' policies and procedures should address the issues we identified for investment advisers above.<sup>2</sup> In addition, we expect policies and procedures of funds (or fund service providers) to cover certain other critical areas. In light of our recent enforcement actions against a number of fund managers and service providers,<sup>3</sup> we are taking this opportunity to review the application of these policies and procedures to several important areas of compliance with the Federal securities laws by funds and their service providers.

*Pricing of portfolio securities and fund shares.* The Investment Company Act requires funds to sell and redeem their shares at prices based on their current net asset value, and to pay redemption proceeds promptly.<sup>4</sup> The Investment Company Act requires funds to calculate their net asset values using the market value of their portfolio securities when market quotations for those securities are "readily available," and, when a market quotation for a portfolio security is not readily available, by using the fair value of that security, as determined in good faith by the fund's board.<sup>5</sup> These pricing requirements are critical to ensuring fund shares are purchased and redeemed at fair prices and that shareholder interests are not diluted. When fund shares are mispriced, short-term traders have an arbitrage opportunity they can use to exploit a fund and disadvantage the fund's long-term investors by extracting value from the fund without assuming any significant investment risk. Mispricing may occur with respect to portfolio securities traded on a foreign market that closes before the time at which the fund prices its shares.<sup>6</sup> If an event affecting the value of the portfolio securities occurs *after* the foreign market closes but *before* the fund prices its shares, the foreign market closing price for the portfolio security will not reflect the correct current value of those securities when the fund prices its shares. In 1984, we stated that, in these circumstances, a fund "*must, to the best of its ability, determine the fair value of the securities, as of the*

<sup>2</sup> See *supra* text accompanying notes 17 through 22. Funds are also subject to requirements to maintain written compliance policies and procedures in certain of our rules. The new rules do not supplant these requirements. See, e.g., Investment Company Act Rules 2a-7(c)(7) (17 CFR 270.2a-7(c)(7)) (requiring boards of money market funds to establish written procedures "reasonably designed \* \* \* to stabilize the money market fund's net asset value per share") and 17j-1(c)(1) (17 CFR 270.17j-1(c)(1)) (requiring funds to "adopt a written code of ethics containing provisions reasonably necessary to prevent" certain persons affiliated with the fund, its investment adviser or its principal underwriter from engaging in certain fraudulent, manipulative, and deceptive actions with respect to the fund); Form N-1A, Item 13(f) (17 CFR 239.15A; 274.11A) (requiring funds to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities); 31 CFR 103.130(c) (requiring funds to develop an anti-money laundering program, which includes the establishment and implementation of "policies, procedures, and internal controls reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable provisions of the Bank Secrecy Act and the implementing regulations thereunder"); Regulation S-P ("Privacy of Consumer Financial Information") (17 CFR 248.30) (requiring funds to "adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information").

<sup>3</sup> See *supra* notes 6 and 7 and accompanying text.

<sup>4</sup> Section 22(e) of the Investment Company Act generally prohibits mutual funds from suspending the right of redemption and prohibits funds from postponing the payment of redemption proceeds for more than seven days. 15 U.S.C. 80a-22(e). Rule 22c-1(b) under the Act generally requires that a fund's net asset value be computed at least once daily, Monday through Friday, at a time or times specified by the fund's board of directors. 17 CFR 270.22c-1(b).

<sup>5</sup> Section 2(a)(41) of the Investment Company Act and Rule 2a41-1 (17 CFR 270.2a41-1).

<sup>6</sup> Mispricing may also occur when a domestic trading market in a security closes before the time the fund prices its shares, or when market quotations for a security are not reliable because, e.g., sales have been infrequent or there is a thin market in the security. See Accounting Series Release No. 118 (Dec. 23, 1970) (35 FR 19986 (Dec. 31, 1970)). Thus, in addition to monitoring for events that may necessitate fair value pricing, funds must pay attention to circumstances that would suggest the need for using fair value pricing.

time” that the fund prices its shares.<sup>1</sup> We believe that funds that fail to fair value their portfolio securities under such circumstances may violate Rule 22c–1 under the Investment Company Act.<sup>2</sup> Fund directors who countenance such practices fail to comply with their statutory valuation obligations<sup>3</sup> and fail to fulfill their fiduciary obligation to protect fund shareholders. Accordingly, Rule 38a–1 requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security;<sup>4</sup> provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security;<sup>5</sup> and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments.<sup>6</sup>

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<sup>1</sup> *Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase*, Investment Company Act Release No. 14244 (Nov. 21, 1984) (49 FR 46558 (Nov. 21, 1984)), at n. 7 (emphasis added) (proposing amendments to Rule 22c–1). Subsequent to the issuance of this release, our staff has reminded funds of their fair valuation obligations. In 1999 and 2001, the Division of Investment Management issued interpretive letters elaborating on funds’ obligations under Sections 2(a)(41) of the Investment Company Act and Rule 22c–1 (17 CFR 270.22c–1) thereunder. Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 8, 1999) (<http://www.sec.gov/divisions/investment/guidance/tyle120899.htm>); letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Apr. 30, 2001) (<http://www.sec.gov/divisions/investment/guidance/tyle043001.htm>).

<sup>2</sup> 17 CFR 270.22c–1.

<sup>3</sup> Section 2(a)(41) (15 U.S.C. 80a–2(a)(41)) of the Investment Company Act.

<sup>4</sup> In some cases, funds have adopted policies and procedures requiring the use of fair value pricing in circumstances when prices may be affected by events subsequent to the close of trading, but have established criteria that result in infrequent use of fair value pricing, which provides an opportunity for price arbitrage. *See, e.g.,* Susan Lee, *The Dismal Science: The Feeling’s Not Mutual*, Wall St. J., Nov. 24, 2003, at A15. As we have stated previously, funds must fair value their portfolio securities whenever market quotations become unreliable. *See supra* note 42. The failure of a fund to establish sufficiently sensitive criteria for using fair value pricing should be recognizable in subsequent reviews of the accuracy of the prices used to compute the net asset value of the fund.

<sup>5</sup> In determining fair value, some funds use correlations between the exchange prices of foreign securities and other appropriate instruments or indicators, such as relevant indices, American Depositary Receipts, and futures contracts. Software developed by vendors is today available to assist funds to determine the fair value of portfolio securities.

<sup>6</sup> In a companion release, we are proposing to amend funds’ disclosure requirements with respect to the use and the effects of fair value pricing. *See* Section II.B of Companion Disclosure Release, *supra* note 8.

## EXCERPT FROM PROPOSED RULE 22C-2 RELATING TO MUTUAL FUND REDEMPTION FEES

Release No. IC-26375A

March 5, 2004

### F. Request for Further Comment on Rule 22c-2

The proposed mandatory redemption fee is designed to work together with our other regulatory initiatives and with tools fund managers already have at their disposal to curb harmful market timing transactions.<sup>7</sup> Fund managers can use information they receive about transactions in omnibus accounts to take steps to better enforce market timing policies, including barring market timers from the fund. Tighter controls on information about portfolio holdings will make successful market timing transactions more difficult.<sup>8</sup> While a mandatory redemption fee would reduce the profitability of abusive market timing trades, standing alone it would be unlikely to deter abusive market timing transactions in which the profits are expected to exceed the fee, or that do not involve short-term transactions.<sup>9</sup>

A significant proportion of abusive market timing has been designed to exploit systematic pricing discrepancies between the value assigned to a fund's portfolio securities for purposes of calculating the fund's net asset value and the "fair value" of those portfolio securities. We believe that the use of fair value pricing, as required by the Act,<sup>10</sup> can reduce or eliminate the arbitrage opportunities that these market timers seek, and that the primary response of funds and fund managers must, therefore, be to more accurately calculate the daily net asset value of the fund by using fair value pricing methods when closing prices are unreliable.<sup>11</sup>

Recent experience has shown, however, that the requirement to implement fair value pricing has not always been sufficient to eliminate these arbitrage opportunities. One possible reason is that fair value pricing involves subjective judgments that leave open the possibility of market timing, albeit at reduced profits.<sup>12</sup> Another possibility is that some funds have applied fair value pricing inconsistently, or only to the most egregious pricing discrepancies. While a mandatory redemption fee may reduce, or eliminate, arbitrage profit opportunities, we are also actively considering ways in which the implementation of fair value pricing could be improved.

Our examination staff is in the process of gathering information about funds' current fair value pricing practices, and we have directed the staff of the Division of Investment Management to examine the fair value pricing methodologies

<sup>7</sup> See *supra* note 7 and accompanying text.

<sup>8</sup> See Compliance Programs of Investment Companies and Investment Advisers, *supra* note 6, at nn. 54-56 and accompanying text (a fund's compliance policies and procedures should address potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio); see also Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, *supra* note 7, at nn. 52-67 and accompanying text (proposal to require open-end management investment companies and insurance company managed separate accounts that offer variable annuities to disclose their policies and procedures with respect to the disclosure of their portfolio securities, and any ongoing arrangements to make available information about their portfolio securities).

<sup>9</sup> See Conrad S. Ciccotello, Roger M. Edelen, Jason T. Greene and Charles W. Hodges, Trading at Stale Prices and Modern Technology: Policy Options for Mutual Funds in the Internet Age, 7 VA J.L. & Tech. 6, at nn. 141-144 and accompanying text ("Redemption fees can be quite effective in reducing stale price trading." However, "redemption fees cannot address the problems caused by large market moves. For example, in the 1997 Asian Crisis, a fourteen-percent overnight return was available based on the Hong Kong market. At that point, even a two-percent redemption fee would not deter stale price traders.").

<sup>10</sup> The Investment Company Act requires funds to calculate their net asset values using the market value of portfolio securities when market quotations are readily available. Section 2(a)(41) [15 U.S.C. 80a-2(a)(41)] of the Investment Company Act and Rule 2a-4 [17 CFR 270.2a-4]. If a market quotation for a portfolio security is not readily available (or is unreliable), the fund must establish a "fair value" for that security, as determined in good faith by the fund's board. See Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase, Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR 46558 (Nov. 27, 1984)] at n. 7 (proposing amendments to Rule 22c-1).

<sup>11</sup> Fair value pricing takes after-market-close events into account in determining the fund's daily net asset value. In a release recently adopting Rule 38a-1, we reiterated the obligation of funds to fair value their securities under certain circumstances to reduce market timing arbitrage opportunities and to have procedures to meet these obligations. See Compliance Programs of Investment Companies and Investment Advisers, *supra* note 6.

<sup>12</sup> See Frederick C. Dunbar and Chudozie Okongwu, (Market) Timing is (Not) Everything, Wallstreetlawyer.com, Oct. 2003, ("There are many possible ways to adjust pricing. The goal is to adjust the stale prices of the securities held by a fund by the predicted effect of the information that becomes known between each security's last trade and the pricing of the fund. However, such adjustments are costly to produce and inexact at best.").

used by the funds and the quality of pricing those methodologies' yield, for purposes of evaluating whether there are additional measures that we could take to improve funds' fair value pricing. In connection with our consideration of these issues, we will be seeking additional comment on specific issues related to fair value pricing.<sup>1</sup> However, at this time we ask commenters to address generally fair value pricing as it relates to abusive market timing. What areas of uncertainty do funds face when trying to fair value their portfolio securities? Are there areas of uncertainty that could be resolved with further guidance from us? If funds implement fair value pricing effectively, is a mandatory redemption fee unnecessary to address abusive market timing?<sup>2</sup>

After reviewing all information, we will consider whether to issue additional interpretive guidance or undertake further rulemaking with respect to fair value pricing. Those additional comments and information will be relevant to our decision whether a mandatory redemption fee is necessary or appropriate to deter abusive market timing.

We request comment on whether there are additional tools that the Commission should consider to combat harmful market timing transactions.

Should the Commission require that funds determine the value of purchase and redemption orders at the net asset value calculated the next day after it receives those orders, rather than at the time that the fund next calculates its NAV? Under such an approach, market timers would not be able to predict whether the next day's NAV would be higher or lower and, therefore, would not be able to trade profitably. On the other hand, such an approach would diminish ordinary investors' ability to promptly effect their mutual fund investment decisions.

Are there other means to discourage abusive market timing that we should consider?

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<sup>1</sup> Such a request for comment could include, for example, whether we should adopt a rule requiring funds to regularly review the appropriateness and accuracy of methods used in valuing securities. Currently such a practice must be a part of a fund's compliance policies and procedures. *See* Compliance Policies and Programs of Investment Companies and Investment Advisers, *supra* note 14 at Section II.A. In addition, we could request comment on whether we should adopt a rule clarifying when a fund must recalculate its net asset value when it has repriced portfolio securities.

<sup>2</sup> We recognize, however, that a redemption fee may nonetheless be necessary to address the costs of short-term trading discussed previously.

## EXCERPT FROM FORM N-1A: DISCLOSURE REGARDING MARKET TIMING AND SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS

Release Nos. 33-8408; IC-26418

April 16, 2004

### II. Discussion

#### B. Disclosure of Circumstances Under Which Funds Will Use Fair Value Pricing and the Effects of Such Use

The Commission is adopting, with one modification to address commenters' concerns, proposed amendments to the Instruction to Item 6(a)(1) of Form N-1A, and adding a corresponding Instruction to Form N-3, to clarify that all mutual funds and managed separate accounts that offer variable annuities, other than money market funds, are required to explain briefly in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing.<sup>3</sup> We are adopting these amendments to clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable).<sup>4</sup> Money market funds will not be subject to the requirement to disclose the circumstances under which they will use fair value pricing and the effects of such use, because such funds are subject to Rule 2a-7 under the Investment Company Act, which contains its own detailed pricing requirements.<sup>5</sup> Commenters generally supported this proposed amendment.

The required disclosure regarding the circumstances under which a fund will use fair value pricing should be specific to the fund. For example, if a fund invests exclusively in frequently traded exchange listed securities of large capitalization domestic issuers and calculates its NAV as of the time the exchange typically closes, there may be very limited circumstances in which it will use fair value pricing (e.g., if the exchange on which a portfolio security is principally traded closes early or if trading in a particular portfolio security was halted during the day and did not resume prior to the fund's NAV calculation). By contrast, if a fund invests primarily in securities that are traded on overseas markets, we would expect a fuller discussion of the circumstances under which the fund will use fair value pricing, such as specific events occurring after the close of the overseas exchange that would cause the fund to use fair value pricing.<sup>6</sup> The instruction we are adopting will also require a fund to explain the effects of using fair value pricing, similar to the current instruction.<sup>7</sup>

A number of commenters expressed concern that requiring specific disclosure of the circumstances under which a fund will use fair value pricing might help arbitrageurs to identify circumstances in which they could take unfair advantage of a fund's pricing policies. In addition, one such commenter argued that limiting funds to specific formulas that can be changed only by registration statement amendments or supplements may prove unworkable in volatile markets or

<sup>3</sup> Instruction to Item 6(a)(1) of Form N-1A; Instruction to Item 11(c) of Form N-3. We are not amending Forms N-4 and N-6 because these forms are used by insurance company separate accounts that are organized as unit investment trusts and typically hold only securities issued by underlying mutual funds. These underlying mutual funds are responsible for valuing their own portfolio securities, including, as required, through fair valuation.

<sup>4</sup> See Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR 46558, 46559-46660 n. 7 (Nov. 27, 1984)] (proposing amendments to Rule 22c-1).

<sup>5</sup> Rule 2a-7(c) under the Investment Company Act [17 CFR 270.2a-7(c)] (describing the requirements for calculating the share price of money market funds using the amortized cost and penny-rounding methods).

<sup>6</sup> We note that Rule 38a-1 under the Investment Company Act [17 CFR 270.38a-1] requires funds to adopt policies and procedures that require a fund to monitor for circumstances that may necessitate the use of fair value prices, establish criteria for determining when market quotations are no longer reliable for a particular portfolio security, provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security, and regularly review the appropriateness and accuracy of the method used in valuing securities and make any necessary adjustments. See Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74713, 74718 (Dec. 24, 2003)].

<sup>7</sup> See Investment Company Act Release No. 23064 (Mar. 13, 1998) [63 FR 13916 (Mar. 23, 1998)] (adopting Instruction to Item 7(a)(1) of Form N-1A requiring a brief explanation of the circumstances and the effects of using fair value pricing). In the Proposing Release, we stated that we would expect that the description of the effects of using fair value pricing would be fund specific, e.g., minimizing the possibilities for time-zone arbitrage, in the case of a fund investing in overseas markets. See Proposing Release, *supra* note 5, 68 FR at 70408. As one commenter noted, minimizing the possibilities for time-zone arbitrage may be more appropriately characterized as an objective of fair value pricing than a guaranteed result or effect.



business emergencies. These commenters recommended that the Commission require only general disclosure of the circumstances under which a fund will use fair value pricing. We wish to clarify that neither the requirement we are adopting, nor the current requirement, requires disclosure of the specific methodologies and formulas that a fund uses to determine fair value prices. For example, if a fund has a policy to fair value price securities traded on overseas markets in the event that there is a specific percentage change in the value of one or more domestic securities indices following the close of the overseas markets, the fund will not be required to disclose the specific percentage change that would trigger fair valuation. In addition, a fund's disclosure need not be so specific that the fund may not adjust the triggering events from time to time in response to market events or other causes.

Our amendments will require the fair value pricing disclosure to be included in a fund's prospectus, as proposed. Some commenters suggested that the required information about fair value pricing may be more appropriately included in a fund's SAI. In addition, some commenters suggested that the location of the disclosure should depend on the significance of market timing as a potential problem for the fund; thus, in cases where market timing is a more important concern, such as foreign stock funds that are subject to time-zone arbitrage, the information should be included in the prospectus itself. We continue to believe, however, that information about the circumstances under which a fund will use fair value pricing and the effects of using fair value pricing should be included in the prospectus together with other key information about a fund. We also believe that it is preferable for investors if the information is uniformly located in one document, rather than located in the prospectus for some funds and the SAI for others. In addition, the instruction requires the disclosure regarding fair value pricing to be brief, and, as noted above, funds will not be required to provide detailed information about their fair value pricing methodologies and formulas.

One commenter also requested clarification regarding how the instruction would apply in the case of a mutual fund that invests in other mutual funds, such as a fund of funds. The commenter noted that each mutual fund in which a fund is invested will have to include in its own prospectus a brief explanation of the circumstances under which it will use fair value pricing and the effects of such use. We are adding language to the instruction to clarify that, with respect to any portion of a fund's assets that are invested in one or more mutual funds, the fund may briefly explain that the fund's NAV is calculated based upon the NAVs of the mutual funds in which the fund invests, and that the prospectuses for those funds explain the circumstances under which they will use fair value pricing and the effects of using fair value pricing.<sup>1</sup>

## Part 274—Forms Prescribed Under the Investment Company Act of 1940

### Form N-1A

#### Item 6. Shareholder Information

(a) \*\*\*

(1) \*\*\*

Instruction. A Fund (other than a Money Market Fund) must provide a brief explanation of the circumstances under which it will use fair value pricing and the effects of using fair value pricing. With respect to any portion of a Fund's assets that are invested in one or more open-end management investment companies that are registered under the Investment Company Act, the Fund may briefly explain that the Fund's net asset value is calculated based upon the net asset values of the registered open-end management investment companies in which the Fund invests, and that the prospectuses for these companies explain the circumstances under which those companies will use fair value pricing and the effects of using fair value pricing.

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<sup>1</sup> Instruction to Item 6(a)(1) of Form N-1A; Instruction to Item 11(c) of Form N-3.

## EXCERPT FROM ADOPTION OF RULE 22c-2 RELATING TO MUTUAL FUND REDEMPTION FEES

Release No. IC-26782

March 11, 2005

### II. Discussion

We continue to believe, and the weight of evidence submitted by commenters suggests, that redemption fees, together with effective valuation procedures,<sup>2</sup> can be an effective means to protect funds and fund shareholders by requiring that short-term traders compensate funds for the costs that may result from frequent trading.<sup>3</sup> Commenters persuaded us, however, that a mandatory fixed redemption fee imposed by Commission rule is not the best way to achieve our goals. Some funds may not have costs that warrant imposing any redemption fee; others may have lower costs and could protect their shareholders by imposing a redemption fee of less than two percent.<sup>4</sup> Boards of directors, as several commenters suggested, are better positioned to determine whether the fund needs a redemption fee and, if so, the amount of the fee.<sup>5</sup> We agree and have decided not to adopt a mandatory redemption fee.

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<sup>2</sup> The Investment Company Act requires funds to calculate their net asset values using the market value of the portfolio securities when market quotations for those securities are readily available, and, when a market quotation for a portfolio security is not readily available, by using the fair value of that security, as determined in good faith by the fund's board. *15 U.S.C. 80a-2(a)(41); 17 CFR 270.2a41-1*. These valuation requirements are critical to ensuring that fund shares are purchased and redeemed at fair prices, shareholder interests are not diluted, and opportunities for arbitrage through short-term trading are diminished. We are working to address issues that arise under the valuation requirements and anticipate issuing a release in the near future.

<sup>3</sup> See Comment Letter of the Vanguard Group (May 10, 2004) ("In our experience, redemption fees, together with fair value pricing and active transaction monitoring, are very effective in curtailing short-term trading that may harm funds and their shareholders."); Comment Letter of Consumer Federation of America and Fund Democracy, Inc. (May 11, 2004) (recommending that mandatory redemption fees supplement fair value pricing); Comment Letter of Fidelity Investments (June 4, 2004) ("Even for international funds it should be recognized that fair-value pricing cannot eliminate potential short-term trading. In our experience fair-value pricing of foreign markets can curtail potential arbitrage profits on days when markets move significantly, but is less reliable in preventing short-term trading profits on less active days: a price move of 25 or 50 basis points, for example. Redemption fees assure that traders are not tempted to try to capture these small potential profits at the expense of other investors."). See also, e.g., Gregory B. Kadlec, On Solutions to the Mutual Fund Timing Problem (Aug. 30, 2004) [http://www.ici.org/issues/timing/wh04\\_mkt\\_time\\_solutions.pdf](http://www.ici.org/issues/timing/wh04_mkt_time_solutions.pdf), appended to Comment Letter of the Investment Company Institute (Sept. 2, 2004) (study commissioned and submitted by the Investment Company Institute, ("In principle, the timing problem could be fully resolved by either removing predictability from NAVs (i.e., fair value pricing) or imposing barriers to its exploitation (i.e., redemption fees). Because of the practical limitations of removing predictability and the cost of imposing barriers, the most effective and efficient solution involves a balanced and modest attack on each front.")).

<sup>4</sup> See Comment Letter of Fidelity Investments (June 4, 2004) ("We do not believe that lower-volatility funds that invest in more liquid markets—government bond funds, for example or balanced funds—should be required to adopt redemption fees in order to protect shareholders in international funds and a few other fund types from short-term trading."); Comment Letter of Merrill Lynch, Pierce, Fenner & Smith Inc. (May 10, 2004) ("The short-term trading issue is actually a number of different, although related, issues, which affect different types of investment companies and products in different ways."); Comment Letter of the Vanguard Group (May 10, 2004) (recommending that short-term bond funds be excepted from mandatory redemption fee rule).

<sup>5</sup> See Comment Letter of Charles Schwab & Co., Inc. (May 10, 2004) (arguing that fund boards should decide whether redemption fees are appropriate in order to avoid a "one-size fits all" approach); Comment Letter of Fidelity Investments (June 4, 2004) (recommending that the rule require a fund board to consider whether redemption fees are appropriate, because a mandatory fee would, in many cases, penalize shareholders who are not engaging in excessive trading); Comment Letter of Merrill Lynch, Pierce, Fenner & Smith Inc. (May 10, 2004) (recommending that fund boards address the different issues resulting from short-term or frequent trading, as applicable, to different types of funds because a mandatory redemption fee would be unfair to many shareholders who are not frequent traders); Comment Letter of Rydex Investments (Apr. 20, 2004) (opposing "one-size fits all" mandatory redemption fee because fund boards should decide whether redemption fees are appropriate).





# LIQUIDITY

## EXCERPT FROM RESALE OF RESTRICTED SECURITIES; CHANGES TO METHOD OF DETERMINING HOLDING PERIOD OF RESTRICTED SECURITIES UNDER RULES 144 AND 145

Release Nos. 33-6862; 34-27928; IC-17452

April 23, 1990

### F. Investment Company Act Issues

Several commenters on the initial proposal stated that adoption of Rule 144A would necessitate a reevaluation of the limits currently placed on investments in restricted securities by investment companies that issue redeemable securities (“open-end funds”),<sup>1</sup> and are required by Section 22(e) of the Investment Company Act to make payment to shareholders for securities tendered for redemption within seven days of their tender.<sup>2</sup> These investment companies must maintain a high degree of liquidity to assure that portfolio securities can be sold and the proceeds used to meet redemptions in a timely manner. Under a long-standing Commission interpretive position, a restricted security would generally be regarded as illiquid.<sup>3</sup> The Commission is modifying this position with respect to securities eligible for resale under Rule 144A. The determination of the liquidity of Rule 144A securities in the portfolio of an investment company issuing redeemable securities is a question of fact for the board of directors to determine, based upon the trading markets for the specific security. The board should consider the unregistered nature of a Rule 144A security as one of the factors it evaluates in determining whether or not a security is illiquid.<sup>4</sup> Generally, an “illiquid security” is any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the company has valued the instrument.<sup>5</sup>

The Commission is not, at this time, requiring that any particular factors be considered by investment companies in making liquidity determinations for Rule 144A securities. After having an opportunity to evaluate the experience of investment companies with the Rule, the staff may publish guidelines discussing factors that should be considered

<sup>1</sup> See Sections 5(a)(1) and 4(2) of the Investment Company Act of 1940 [15 U.S.C. §§ 80a-5(a)(1) and 80a-4(2)].

<sup>2</sup> 15 U.S.C. § 80a-22(e).

<sup>3</sup> Investment Company Act Release No. 5847 (Oct. 21, 1969) [35 FR 19989] (“Release 5847”). The Commission stated in Release 5847 that the prudent limit on any open-end fund’s holdings of restricted securities or securities not having readily available market quotations would be ten percent. See Guide 13 to Form N-1A [17 CFR 274.11A]. A commenter raised a question as to how foreign securities are treated for purposes of this limitation. The Commission recognizes that foreign securities would not necessarily be illiquid for purposes of the ten percent test, despite their restricted nature, if the foreign security can be freely traded in a foreign securities market and all the facts and circumstances support a finding of liquidity.

<sup>4</sup> The Commission believes that the ultimate responsibility for liquidity determinations is that of the board of directors. However, the board may delegate the day-to-day function of determining the liquidity of securities to the fund’s investment adviser, provided that the board retains sufficient oversight. See, e.g., Investment Company Act Release No. 13005 (Feb. 2, 1983) [48 FR 5894]; Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555] (discussing delegation by the board of directors of its duty to evaluate the creditworthiness of broker-dealers with which the company proposes to enter into repurchase agreements under Rule 2a-7 [17 CFR 270.2a-7] under the Investment Company Act). The Board (or its delegatee) should also continue to monitor the liquidity of Rule 144A securities. If as a result of changed conditions, it is determined that a Rule 144A security is no longer liquid, the fund’s holdings of illiquid securities should be reviewed and the board should determine if any steps are required to assure that the ten percent test continues to be satisfied. In the case of a UIT, which has no board of directors or adviser, the responsibility for liquidity determinations is that of the depositor who also acts as sponsor for the trust (the “sponsor”). Where the sponsor has delegated the function of supervising the portfolio after the date of deposit to a provider of portfolio supervisory services, it may delegate the day-to-day function of determining the liquidity of portfolio securities to such provider, provided that the sponsor retains sufficient oversight.

<sup>5</sup> Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773] (adopting amendments to Rule 2a-7).

in making such liquidity decisions. The Commission understands that a number of factors are currently considered by investment companies in reaching liquidity decisions. Examples of factors that would be reasonable for a board of directors to take into account with respect to a Rule 144A security (but which would not necessarily be determinative) would include, among others: (1) the frequency of trades and quotes for the security; (2) the number of dealers willing to purchase or sell the security and the number of other potential purchasers; (3) dealer undertakings to make a market in the security; and (4) the nature of the security and the nature of the marketplace trades (e.g., the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer).

A commenter requested that the Commission make clear that Rule 144A resales of securities of investment companies do not constitute a “public offering” within the meaning of Sections 3(c)(1)<sup>6</sup> or 7(d)<sup>7</sup> of the Investment Company Act. Section 3(c)(1) exempts “private” investment companies from registration under the Investment Company Act if the company’s outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and the company is not making and does not presently propose to make a public offering of its securities. Section 7(d) prohibits foreign investment companies from using jurisdictional means to publicly offer their securities for sale in the United States unless the company receives an order permitting it to register under the Investment Company Act. In *Touche Remnant* (pub. avail. August 27, 1984), the staff of the Division of Investment Management took the position that a foreign investment company could engage in a private offering to U.S. persons coincident with a public offering outside the U.S. without traditional concepts of integration applying [See Securities Act Release No. 4708 (July 9, 1964)] as long as the offering using jurisdictional means in the U.S. did not cause shares of the fund to be beneficially owned by more than 100 U.S. residents. Thus, the term “public offering” in Section 7(d) of the Act was interpreted to include an offer by jurisdictional means that causes the shares of a foreign investment company to be beneficially owned by more than 100 U.S. residents.

The Commission believes that resales of privately placed investment company securities pursuant to the safe harbor provisions of Rule 144A would not cause the issuing investment company to lose the exemption provided by Section 3(c)(1) or cause a violation of Section 7(d) of the Investment Company Act as long as after the resale the securities are held, for purposes of Section 3(c)(1), by no more than 100 beneficial owners or, for purposes of Section 7(d), by no more than 100 beneficial owners who are U.S. residents. Moreover, the Commission believes that a resale in reliance on Rule 144A, even if anticipated by the issuing investment company, would not, in and of itself, result in the company “having reason to believe that such security . . . will be made the subject of a public offering” within the meaning of Section 7(a) of the Investment Company Act.<sup>8</sup> However, Rule 144A will not obviate the obligation of a company to register or, in the case of a foreign investment company, to apply for an exemptive order permitting it to register, under the Investment Company Act if, with regard to a domestic company, there are more than 100 beneficial owners of its securities, or, with regard to a foreign company, there will be more than 100 U.S. residents who are beneficial owners of its securities.

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<sup>6</sup> 15 U.S.C. § 80a-3(c)(1).

<sup>7</sup> 15 U.S.C. § 80a-7(d).

<sup>8</sup> 15 U.S.C. § 80a-7(a).

## REVISIONS OF GUIDELINES TO FORM N-1A

Release Nos. 33-6927; IC-18612

March 12, 1992

AGENCY: Securities and Exchange Commission.

ACTION: Revisions to Guidelines.

SUMMARY: The Commission is publishing revisions to the Guidelines to Form N-1A to permit open-end management investment companies to increase from 10% to 15% the amount of illiquid assets they may hold. Revising the Guidelines will permit investment companies more flexibility to make investments in the illiquid securities of small businesses. This could provide small businesses with better access to the capital markets in a manner consistent with the public interest and the protection of investment company shareholders.

EFFECTIVE DATE: March 20, 1992.

FOR FURTHER INFORMATION CONTACT: Jeremiah de Michaelis, Branch Chief (202) 272-2096, or Richard Pfordte, Attorney (202) 272-2103, Division of Investment Management, Securities and Exchange Commission, 450 5th Street NW., Washington DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is publishing revisions of the Guidelines to Form N-1A (17 CFR 239.15A, 274.11A), the registration form used by open-end management investment companies (“mutual funds”) to register under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) (“1940 Act”) and to register their securities under the Securities Act of 1933 (15 U.S.C. 77a-1 et seq.). The revised Guidelines will permit a mutual fund to invest up to 15% of its net assets in illiquid securities. Currently, the Guidelines recommend a 10% limit on mutual fund investments in illiquid assets. In addition, the revisions make other minor changes to the Guidelines and place the discussion of liquidity requirements in one place. The Guidelines, which consist of a compilation and adaptation of applicable Commission releases and staff positions, are prepared by the Division of Investment Management for use in the preparation and filing of registration statements on Form N-1A.

### I. Background

The Guidelines are being revised in connection with the Commission’s efforts to remove unnecessary barriers to capital formation and to facilitate access to the capital markets by small businesses.<sup>1</sup> Historically, small local enterprises have satisfied a large portion of their capital needs by using the financial resources of local banks and similar institutions. In recent years, concern has been expressed about the ability of U.S. small businesses to obtain financing from traditional sources.<sup>2</sup> The health and existence of small business is critical to local economies and to the national economy.

Mutual funds represent a significant potential source of capital for small business.<sup>3</sup> Currently there are 1,787 funds which have aggregate total assets of \$474.2 billion that could be a source of capital for small businesses.<sup>4</sup> Allowing mutual funds to invest an additional 5% of their net assets in illiquid securities, including illiquid securities of U.S. small businesses, could make a significant amount of capital available to small business without significantly increasing the risk to any fund.

<sup>1</sup> See Securities Act Rel. No. 6924 (Mar. 11, 1992) (“Small Business Initiatives” proposing, among other things, amendments to regulation A and Rule 504) and Securities Act Rel. No. 6926 (Mar. 12, 1992) (proposing amendments to regulation E).

<sup>2</sup> See *The Small Business Credit Crunch, Hearings Before the House of Representatives Comm. on Small Business*, 101st Cong., 2nd Sess. (1990).

<sup>3</sup> See section 1(a)(4) of the 1940 Act (15 U.S.C. 80a-1(a)(4)) (mutual funds are “media for investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of savings into the capital markets”).

<sup>4</sup> This estimate was derived by subtracting from the total assets of mutual funds the assets of funds that ordinarily would not invest in the securities of small businesses—money market funds, funds investing primarily in securities of the U.S. government and its agencies and instrumentalities, and funds investing primarily in securities of state and local governments. See Investment Company Institute *Trends in Mutual Fund Activity* (Nov. 1991), table 6A.

However, the securities of small businesses are generally illiquid and mutual funds are constrained in the amount of illiquid assets they may hold. Under the 1940 Act, mutual funds must stand ready to redeem shares daily and pay redeeming shareholders within seven days of receiving a redemption request.<sup>5</sup> In addition, a mutual fund must compute its net asset value each business day and give purchase and redemption orders the price next computed after receipt of an order.<sup>6</sup> Moreover, most mutual funds allow shareholders easily to exchange their fund shares for shares of another mutual fund managed by the same investment adviser, in transactions which generally can include only nominal costs. Shareholders thus easily may move their money among equity, income, and money market funds as they choose, increasing the need for liquidity of mutual fund assets.

To compute an accurate net asset value per share, a mutual fund must be able to value each portfolio security accurately. Mutual funds must use market price to value securities for which market quotations are readily available; the board of directors must make a good faith determination of the fair value of securities for which market prices are not readily available.<sup>7</sup> If the net asset value of a mutual fund is not accurate, purchasing or redeeming shareholders may pay or receive too little or too much for their shares, and the interests of remaining shareholders may be overvalued or diluted.

To meet these requirements, a mutual fund must maintain a high degree of portfolio liquidity. In 1969, the Commission stated that a prudent limit on mutual fund holdings of illiquid securities would be 10 percent.<sup>8</sup> This conservative standard was designed to ensure that mutual funds will be ready at all times to meet even remote contingencies. The 10% standard has been reflected in the Guidelines to Form N-1A, the mutual fund registration form. The Commission has determined it is consistent with investor protection to increase the limit in the Guidelines to 15%. The Commission believes that a 15% standard should satisfactorily assure that mutual funds will be able to make timely payment for redeemed shares. Experience has shown that mutual funds generally have not had difficulty in meeting redemption requests from available cash reserves, even during times of abnormally high selling activities in the securities markets.<sup>9</sup> Even if a fund were forced to sell securities to meet redemption requests, substantially all of its remaining assets would be required to be liquid securities which it could sell consistent with appropriate portfolio management.

## II. Revision of Liquidity Test in Guidelines to Form N-1A

As revised, Guide 4 will permit a mutual fund to invest up to 15% of its assets in illiquid assets. An illiquid asset is defined as an asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment on its books.<sup>10</sup>

While the changes to the Guidelines will permit mutual funds to increase their holdings of illiquid assets, it will not require them to do so.<sup>11</sup> Nor will it relieve a fund from the requirements concerning valuation and the general responsibility to maintain a level of portfolio liquidity that is appropriate under the circumstances. If no market quotations for an illiquid security are available, the board of directors of the fund will be required to determine the fair value of the security. In addition, the Commission expects funds to monitor portfolio liquidity on an ongoing basis to determine whether, in light of current circumstances, an adequate level of liquidity is being maintained. For example, an equity fund that begins to experience a net outflow of assets because investors increasingly shift their money from equity to income funds should consider reducing its holdings of illiquid securities in an orderly fashion in order to

<sup>5</sup> Section 22(e) of the 1940 Act (*15 U.S.C. 80a-22(e)*) prohibits a mutual fund from suspending the right of redemption or postponing the date of payment or satisfaction upon redemption for more than seven days after the tender of such security to the mutual fund.

<sup>6</sup> Rule 22c-1(a) (*17 CFR 270.22c-1(a)*).

<sup>7</sup> Rule 2a-4 (*17 CFR 270.2a-4*).

<sup>8</sup> Investment Company Act Rel. No. 5847 (Oct. 21, 1969).

<sup>9</sup> During the 1987 market break, approximately 2% of all equity mutual fund shares were redeemed on October 16 and 19, 1987, and most funds were able to meet these redemptions from available cash reserves. See Securities and Exchange Commission, Division of Market Regulation. The October 1987 Market Break 2-17 to -18 (1988).

<sup>10</sup> Investment Company Act Rel. No. 14983 (Mar. 12, 1986) (*51 FR 9773* (Mar. 21, 1986)) (adopting amendments to rule 2a-7 under the 1940 Act) (*17 CFR 270.2a-7*).

<sup>11</sup> Funds that have fundamental investment policies restricting their ability to invest in illiquid securities would be required by section 13(a) of the 1940 Act (*15 U.S.C. 80a-13(a)*) to obtain shareholder approval to change those policies. In addition, funds that choose to make additional investments in illiquid assets, as permitted by the Guideline revision, should consider whether to amend or “sticker” their disclosure documents to reflect these changes.

maintain adequate liquidity. Finally, the Commission intends to review the operation of the Guideline revision through its investment company inspection program to determine whether the revision is achieving its intended purposes in a manner consistent with investor protection.

### III. Text of Revisions to the Guidelines

List of Subjects in 17 CFR Parts 239 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is amended as follows:

#### **Part 239—Forms Prescribed Under the Securities Act of 1933**

#### **Part 274—Forms Prescribed Under the Investment Company Act of 1940**

1. The authority citation for part 239 continues to read as follows:

Authority: *15 U.S.C. 77a, et seq.*, unless otherwise noted.

2. The authority citation for part 274 continues to read as follows:

Authority: The Investment Company Act of 1940, *15 U.S.C. 80-1 et seq.*, unless otherwise noted;

3. Amending Guide 4 to Form N-1A (239.15A and 274.11A) by adding at the end a paragraph to read as follows:

#### **Guide 4. Types of Securities**

\* \* \*

If an open-end company holds a material percentage of its assets in securities or other assets for which there is no established market, there may be a question concerning the ability of the fund to make payment within seven days of the date its shares are tendered for redemption. The usual limit on aggregate holdings by an open-end investment company of illiquid assets is 15 percent of its net assets. An illiquid asset is any asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment. See Investment Company Act Release No. 14983 (Mar. 12, 1986).

4. Amending Guide 12 to Form N-1A (239.15A and 274.11A) by removing the last sentence and adding a new last sentence to read as follows:

#### **Guide 12. Purchase and Sale of Real Estate**

\* \* \*

For the limits on the aggregate holdings by open-end companies of illiquid assets, see Guide 4.

5. Amending Guide 13 to Form N-1A (239.15A and 274.11A) by removing the fourth and fifth sentences and adding a new last sentence to read as follows:

#### **Guide 13. The Making of Loans to Other Persons**

\* \* \*

For the limits on the aggregate holdings by open-end companies of illiquid assets, see Guide 4.

March 12, 1992.

By the Commission.





## STAFF GUIDANCE

### STAFF INTERPRETIVE POSITION RELATING TO WHETHER IT WOULD BE IMPROPER FOR A BOARD OF DIRECTORS OF A REGISTERED INVESTMENT COMPANY TO VALUE CERTAIN SECURITIES AT MARKET VALUE

Release No. IC-6121  
July 20, 1970

The Securities and Exchange Commission today called attention to an interpretive position its Division of Corporate Regulation has taken relating to the proposed valuation at market price of restricted shares that are acquired by a registered investment company. The Staff interpretive position summarized in this release was taken in response to an inquiry directed to the Staff. While the views expressed by the Staff as set forth in this release are those of persons who are continually working with the provisions of the statute and rule involved and can be relied upon as representing the views of the division in which they originate, the public is cautioned that the opinions expressed in the release are not, and do not purport to be an official expression of, the Commission's views.

A summary of the inquiry together with the response of the Division of Corporate Regulation follows:

A law firm requested the comments of the Staff with respect to the proposed valuation of certain shares proposed to be acquired from an industrial company by one or more registered investment companies. Under the proposal, the issuer would register the offering under the Securities Act of 1933 on Form S-1, and the registration statement would contain an undertaking that, in the event of resale by the offeree registered investment companies, the issuer would provide the required statutory prospectus. To meet this obligation the issuer would agree to maintain an effective registration statement for a stated period of time; and, at the time of a proposed resale, the investment company would give notice to the issuer, which would file a post-effective amendment identifying the seller and the number of shares proposed to be issued. The law firm believed that, as a result of the previous filing, the post-effective amendment would promptly be permitted to become effective; and it expressed the view that these arrangements greatly increased the marketability of the shares and justified the proposed valuation at the market price of fully tradeable shares of the same issuer.

Without reaching the question of whether in this particular situation the Division of Corporation Finance would accept a registration statement of this type for filing under the Securities Act of 1933, the Staff of the Division of Corporate Regulation stated:

“Under Section 2(a)(39) of the Investment Company Act of 1940, and Rule 2a-4 thereunder, a registered investment company is required to determine continuously the net asset value of securities which it acquires. As the Commission stated in Investment Company Act Release No. 5847 (1969), the fair value of securities which cannot be sold to the public without an effective registration statement under the Securities Act of 1933 must be determined in good faith by the company's board of directors.

“Whether or not it would be appropriate for the board of directors of a registered investment company to value the securities of the issuer at the market price of fully tradeable shares of the same class depends upon all of the circumstances affecting the issuer and its shares at the time of the valuation. The maintenance of a ‘shelf’ registration for the securities in question is a factor which a registered investment company's board of directors could properly take into consideration in valuing these securities. However, it is impossible to predict in advance how long it will take between the filing of a post-effective amendment and its becoming effective. For example, substantial changes in the business and finances of

the industrial company may require the same degree of review as a new registration statement. Further, because of new, but incompleting ventures, the industrial company may desire not to make public such ventures for some period of time. Therefore, while the existence of a 'shelf' registration statement is a factor that should be considered in the determination of the value of such securities, automatic valuation at market price on this basis alone, without taking other factors into account, would be improper."

Orval L. DuBois  
Secretary

**Paul Revere Investors, Inc.****Staff Response**

February 21, 1973

(publicly available March 22, 1973)

Based upon the foregoing and the attachments thereto, we will not recommend that the Commission take any action against the Company under Section 2(a)(41) of the Act, if it establishes the proposed Securities Valuation Committee and procedures for the purpose of valuation of the Company's restricted securities between meetings of the Board of Directors; provided however that the "Guidelines for use by the Securities Valuation Committee" make it clear that, in addition to the duties and procedures specified by the second paragraph of the Guidelines, the Committee has the duty and responsibility to advise the Board of Directors at any time it believes that the methods established for valuing any restricted security or securities are erroneous so that the Board may determine whether such methods should be modified.

We note that the proposed Guidelines and Committee apply specifically to the valuation of restricted securities. However, Section 2(a)(41) also requires that unrestricted securities for which there are not market quotations readily available must also be valued by the Board of Directors (*see* Investment Company Act Release No. 6295). In this regard, we assume that the proposed valuation procedure for restricted securities would also be used for unrestricted securities for which no market quotations are readily available.

Alan Rosenblat, Chief Counsel

Division of Investment Management Regulation

By

Peter M. Sullivan, Attorney

Karl Smeltzer

**Incoming Letter**

August 18, 1972

**Allan S. Mostoff, Director****Division of Investment Company Regulation****Securities and Exchange Commission****500 North Capitol Street, N.W.****Washington, D.C. 20549**

Dear Mr. Mostoff:

Re: Paul Revere Investors Inc. File No. 811-2197

Paul Revere Investors Inc. (the "Company") is a closed-end, non-diversified management investment company which was organized in May 1971 and went public through a public offering of its shares on September 30, 1971. Under its investment policy it invests principally in long-term, fixed-income debt obligations which have equity features and which are acquired in direct placements. When fully invested in accordance with this policy, which is expected to take approximately two years from the date of the public offering, the Company must have at least 85% of its assets invested in direct placements and in equity securities acquired as a result of the exercise of warrants, options or conversion rights acquired in direct placements.

The Company also has an automatic dividend investment plan (the “plan”) under which participating shareholders may automatically re-invest all dividends in shares of the Company’s stock. Such reinvestment is at net asset value or at market price, whichever is lower. Depending upon which is lower, the Company issues additional shares or the agent for the participants purchases shares in the market. Current policy is to pay dividends monthly.

Section 2(a)(41) of The Investment Company Act of 1940 (the “Act”) provides in pertinent part as follows:

“Value, with respect to assets of registered investment companies – means – (B) – (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.”

Section 23(b) of the Act provides in pertinent part as follows:

“No registered closed-end company shall sell any common stock of which it is the issuer at a price below the current net asset value of such stock—which net asset value shall be determined as of a time within forty-eight hours, excluding Sundays and holidays, next preceding the time of such determination), except—under such other circumstances as the Commission may permit by rules and regulations or orders for the protection of investors.”

Owners of the Company’s shares, as well as potential investors, like to know the current net asset value per share. Since securities acquired in direct placements fall within the category of “other securities and assets” in Subsection 2(a) (41) (B) (ii) of the Act, their fair value is that “determined in good faith by the board of directors.” Thus, the longer the period that has elapsed since the most recent determination by the board of directors (“Board”), the more out of date is the most recent value that can be given.

Further, participants in the Plan are entitled to shares at the lower of net asset value per share or market value. It is therefore necessary to determine net asset value to establish which cost basis is applicable, and, if this is net asset value, the actual issue price of the shares payable as a dividend. Under the provisions of Section 23(b) of the Act the net asset value for issue purposes must be determined as of a time within forty-eight hours of the time of issue. This has caused the Board to meet within forty-eight hours prior to each monthly dividend payment to value the restricted securities.

Need for frequent meetings on a restrictive time schedule to value restricted securities has proved burdensome to the members of the Board, particularly to those who are not interested parties of the Company or its investment adviser. This was one of the principal considerations in the recent resignation of one director, and management fears that it will lose the services of others and will not be able to replace them with new directors of comparable stature, ability and value to the Company unless an alternative is devised. It would appear that some reasonable alternative might be agreed upon which would provide necessary safeguards to protect the public and yet permit more frequent determinations of net asset value.

The Company proposes that the Board create a Securities Valuation Committee (“Committee”) delegating to it certain powers and responsibilities to value restricted securities between meetings of the Board under guidelines established by the Board. The exact composition of the Committee could be left to the Board but it is contemplated that both the Board and management be represented.

The foregoing procedure would appear to be within the contemplation of the terms of Investment Company Act Release No. 5847 dated October 21, 1969, where it is stated:

“While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted security in the company’s portfolio, it must continually review the appropriateness of any method so determined. The actual calculations may be made by persons acting pursuant to the directions of the board.”

The Board would meet no less often than quarterly to review, and if necessary amend, the guidelines. Further, a provision designed to provide some flexibility and adjustment of the method of valuation between meetings of the Board, to protect against unusual and unexpected fluctuations in value of any restricted securities in the portfolio would be included.

It should be noted that a substantial majority of the value of the Company’s direct placements is, and for an indefinite period of time will be, in debt securities rather than in equity securities. Though many of the same considerations apply

in valuation of restricted debt securities as in the valuation of restricted equity securities, a difference exists which was recognized in the opening paragraph of Release No. 5847 mentioned above. This directed the application of the release toward the problems created by the acquisition of restricted equity securities. Their fair value is related to considerations such as public acceptance and earnings which tend to make values volatile. The fair value of restricted debt securities on the other hand, particularly under the Company's investment policy where restricted debt securities will ordinarily be held to maturity, depends basically upon the solvency of the issuer and is relatively stable.

Attached hereto as Exhibit A is a copy of guidelines proposed for initial adoption by the Company's Board to implement the proposed procedures. It is felt that the application of these guidelines between meetings of the Board will permit determination of net asset value within acceptable limits. If experience indicates that this is not accomplished, the Board on its own, or at the request of management, can amend them at any time to increase accuracy. The key to Schedule I to the guidelines is a mechanical aid rather than a rigid framework and can also be modified as needed. Special instructions under Footnote E would be expected to be used frequently.

Attached hereto as Exhibit B are copies of valuation sheets showing the value of restricted securities owned by the Company as determined by the Board at each valuation from the date of acquisition of such restricted securities to the date of this letter. It will be noted that with one exception the only change in valuation of any debt security from cost has been to amortize original issue discount. The only changes in valuation of equity securities relate to situations where there is a market in the same class of security.

The Company requests approval of the procedures proposed in paragraph D hereof. If it is felt that further limitations or restrictions are needed for the protection of stockholders or others, representatives of the Company would be pleased to discuss these with the staff, as well as answer any further questions the staff may have. Your favorable consideration is respectfully requested.

Very truly yours,

A. Warren McDougal

Clerk

#### EXHIBIT A

##### **Paul Revere Investors Inc. Guidelines for Use by Securities Valuation Committee in Valuing Restricted Securities**

The value to be given restricted securities is "fair value" which shall mean their inherent worth without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature. The method of valuing each restricted security in the Company's portfolio will be established by the directors not less often than quarterly. The Committee will follow the method established in valuing each restricted security until a new method is established by the directors or in accordance with the following paragraph.

The Committee shall have the duty and responsibility to keep current on all factors which may have an effect on fair value of restricted securities in the Company's portfolio. If the Committee determines that there has been a change in such factors causing the net asset value of the Company determined under the methods established by the directors to vary more than 1% from what the Committee deems net asset value to be, no net asset value will be published or otherwise used until the methods which the Committee deems erroneous have been reviewed by a majority of the Board and either affirmed or modified by them. Such review and affirmation or modification may be accomplished by telephone, letter or other means of communication and shall be noted in the official records of the Committee, giving the names of those directors approving and disapproving. If agreement is not obtained from a majority of the Board, determination shall be deferred until agreement is obtained or until the next regular or special meeting of the Board.

The initial method established for valuing each restricted security in the Company's portfolio is set forth in Schedule I attached. Restricted securities purchased subsequent to any meeting of the Board shall, until the next following meeting of the Board, be valued as follows:

Debt securities—Cost plus accrued amortization of original issue discount, if any.

Preferred Stock—Cost plus accrued amortization of original issue discount, if any.

Common Stock—Cost or, if there is a market in unrestricted securities of the same class, a value discounted from market value in the same proportion as cost was discounted from market on the date of the firm agreement to purchase.

Warrants or Options—Cost, or if there is a market in unrestricted securities of the same class or of the same class as the underlying securities, (i) a value discounted from market value in the same proportion as cost was discounted from market on the date of the firm agreement to purchase or (ii) a value equal to cost plus or minus one-fourth of the difference between the market value of securities of the same class as the underlying security on the date of the firm agreement to purchase and on the valuation date (but never less than zero), whichever is applicable.

The Board of Directors of Paul Revere Investors Inc.

## PUTNAM GROWTH FUND AND PUTNAM INTERNATIONAL EQUITIES FUND, INC.

### Staff Response

January 23, 1981

(publicly available February 23, 1981)

Based on the representations contained in your letter, we would not recommend any action to the Commission under Section 22(d) of the Investment Company Act of 1940 (the "1940 Act") or Rules 22e-1 and 2a-4 under the 1940 Act if The Putnam Growth Fund and Putnam International Equities Fund, Inc. ("the Funds") value their assets at 4:00 p.m. New York time and use as the values of their portfolio securities which are principally traded on foreign securities exchanges the next preceding closing values of such securities on their respective exchanges except when an event has occurred since the time a value was so established that is likely to have resulted in a change in such value, in which case the fair value of the securities as of 4:00 p.m. New York time will be determined by the consideration of other factors. In addition, based on the representations contained in your letter, we would not recommend any action under the aforementioned provisions if each of the Funds, a substantial majority of whose portfolio securities are not principally traded on Japanese exchanges, does not price its shares for sale or redemption as of those Saturdays that the Japanese exchanges are open for business.

Stanley B. Judd

### Incoming Letter

October 22, 1980

Securities and Exchange Commission  
Division of Investment Management  
500 North Capitol Street  
Washington, D.C. 20549

Attention: Joel H. Goldberg, Associate Director  
Stanley B. Judd, Assistant Chief Counsel  
Re: The Putnam Growth Fund  
Putnam International Equities Fund, Inc.

Gentlemen:

The purpose of this letter is to request confirmation by the staff of the Securities and Exchange Commission that it will not recommend action by the Commission under Section 22(d) of the Investment Company Act of 1940 (the "1940 Act") and Rules 22(c)(1) and 2a-4 under the 1940 Act if The Putnam Growth Fund and Putnam International Equities Fund, Inc. value their assets invested in securities of companies principally traded in foreign companies in accordance with the procedure outlined below.

### Facts:

The Putnam Growth Fund ("Putnam Growth") is a Massachusetts business trust which is registered under the 1940 Act as an open-end management company which had assets as of September 30, 1980 of approximately \$690 million. The investment objective of Putnam Growth is to seek long-term growth of capital with current income as a secondary consideration. Under most conditions, common stocks have constituted a substantial majority of the Fund's investments. As of September 30, 1980, Putnam Growth had approximately \$48 million, or 7%, invested in securities of issuers whose securities are primarily traded in foreign countries. As of that date, approximately 3% of the Fund's total assets were



invested in securities of companies whose securities are principally traded on the Tokyo Stock Exchange. The Fund may invest up to 20% of its assets in securities of foreign issuers although to date the Fund has never invested in the aggregate more than 10% of its assets in such securities. Putnam Growth is owned by approximately 85,000 shareholders.

Putnam International Equities Fund, Inc. (“Putnam Equities”) is a Massachusetts corporation which is registered under the Act as an open-end management company with assets as of September 30, 1980 of approximately \$42 million. The investment objective of Putnam Equities is to seek capital appreciation by investing its assets primarily in common stocks. Up to 70% of Putnam Equities’ assets may be invested from time to time in securities principally traded in foreign markets. As of September 30, 1980, investments of the Fund could be geographically divided as follows:

Australia	6.4%
England	2.4%
Germany	9.2%
Hong Kong	4.2%
Japan	26.4%
South Africa	6.9%
Switzerland	2.9%
Netherlands	4.6%
United States	37.0%

Putnam Equities is owned by approximately 13,000 shareholders.

Both Putnam Growth and Putnam Equities currently value their assets at 4:00 p.m. each day on which the New York Stock Exchange is open for trading. Securities which are principally traded in foreign countries are valued as of 4:00 p.m. New York time using as a basis for this valuation the next preceding closing values for such securities on the stock exchanges where such securities are principally traded. For many foreign securities there are American Depository Receipts (“ADRs”) which reflect ownership in the underlying foreign security. Such ADRs are traded in the U.S. in the over-the-counter market and are valued daily as of approximately 4:00 p.m. New York time. Where such ADRs exist and are actively traded, the Funds use such ADRs to value the underlying foreign security whether or not they in fact own the ADRs.<sup>1</sup>

Both Putnam Growth and Putnam Equities are sold only in the United States. In the case of orders for purchases and sales through dealers, the applicable public offering price will be the net asset value determined as of the close of the New York Stock Exchange on the date the order was placed plus the applicable sales charge but only if the order is received by the dealer prior to the close of the Exchange and transmitted to the Funds’ distributor prior to its close of business that date, normally 5:00 p.m. Boston time.

Both Putnam Growth and Putnam Equities are managed pursuant to contracts with The Putnam Management Company, Inc. which also acts as investment adviser to eleven other open-end and one closed end investment companies. The pricing of the Funds’ portfolios is done by Putnam Administrative Services Company, Inc. acting as agent for The Putnam Management Company, Inc.

The offices of Putnam Growth, Putnam Equities, The Putnam Management Company, Inc. and Putnam Administrative Services Company are not open for business on Saturday. No fund business is transacted on that day and there are no personnel regularly present to process orders to purchase shares or to determine prices of portfolio securities and make other calculations necessary to determine net asset value. To the extent necessary, investment matters on such days relating to foreign securities are generally followed by portfolio managers from their own homes. Mail addressed to the Funds or their shareholder servicing agent or principal underwriter at the street address is picked up Monday through

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<sup>1</sup> As of September 30, 1980, approximately one-third of Putnam Growth’s foreign investments and one-quarter of Putnam Equities’ foreign investments reflect ownership by the Funds of ADRs.

Friday at a central post office in Boston and processed on those days. A clerical person picks up box mail each Saturday but the letters are not opened until Monday nor is there personnel present to open such mail on Saturday.

### Discussion:

In response to comments of the Commission's staff in connection with certain registration statements of open-end investment companies which have recently or will soon become effective and in light of the response of the Commission's staff to the "no action letter" of Nomura Capital Fund of Japan and Nomura Index Fund of Japan of November 6, 1979 (the "Nomura Letter"), Putnam Growth and Putnam Equities have reviewed their pricing policies with respect to foreign securities. Such review has been made not only with respect to the practice of not pricing securities which are traded in the Japanese market on those Saturdays on which the Japanese Stock Exchange is open for trading but also generally with respect to the manner in which each Fund normally values its foreign securities on a regular business day. While each Fund believes that its procedures are appropriate and fair to all investors, we believe it is appropriate in light of the Nomura Letter to seek the views of the Commission's staff as to the current procedures followed by these two Funds.

Rule 22c-1(a) and (b) provides in part:

"(a) No registered investment company issuing any redeemable security . . . shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security; . . ."

"(b) For the purposes of this rule, (1) the current net asset value of any such security shall be computed (i) no less frequently than once daily on each day (other than a day during which no such security was tendered for redemption and no order to purchase or sell such security was received by the investment company) in which there is a sufficient degree of trading in the investment company's portfolio securities that the current net asset value of the investment company's redeemable securities might be materially affected by changes in the value of the portfolio securities, and (ii) at such specific time during the day as determined by a majority of the board of directors of the investment company no less frequently than annually; . . ."

Rule 2a-4 under the Act provides in part:

"(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:

(1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company. . . ."

As described above, Putnam Growth and Putnam Equities, at the time of their daily computation of net asset value at 4:00 p.m. New York time, utilize for purposes of determining the proper security value of portfolio investments traded principally in foreign countries the market values for such securities as of the close of trading on the principal exchanges where such securities are traded as of a time earlier in the day. For example, with respect to securities traded on the London Stock Exchange, trading has ceased as of 10:00 a.m. New York time and there are no current market quotations as of 4:00 p.m. New York time except those market quotations which are available from earlier in the day at the close of business of the London Stock Exchange. For this reason, Putnam Growth and Putnam Equities have used such earlier values for purposes of estimating the value of such securities as of 4:00 p.m. New York time.

We believe that the above procedure for valuing such foreign securities is consistent with the requirements of Rule 2a-4(a) under the Act for either of two reasons. First, if one determines that portfolio securities traded in London and for which trading ceased approximately six hours earlier in the day are "portfolio securities with respect to which market quotations are readily available" then one is required to use "current market values" for such securities in computing current net asset value. Since no securities have generally traded in London since 10:00 a.m. New York time, the only current market values available for determining the value of such securities as of 4:00 p.m. New York time are the closing prices on

the London Stock Exchange earlier in the day. Pursuant to the provisions of Rule 2a-4, Putnam Growth and Putnam Equities estimate the prices as of 4:00 p.m. New York time utilizing the earlier day London closing values as the basis for such estimates. Second, if one determines that as of 4:00 p.m. New York time the London securities are not “portfolio securities with respect to which market quotations are readily available” one is then required to value such securities “at fair value as determined in good faith by the board of directors of the registered company.” In this case, the Fund would in almost all instances use, for purposes of fair valuation, the closing prices of such London securities of approximately six hours earlier and estimate that as of 4:00 p.m. New York time such values reflect fair value of such securities as of that time. In either case, the valuation made at 4:00 p.m. New York time is being estimated based on market values which reflected closing values as of earlier in the day. Such method would clearly seem to be permissible under Rule 2a-4.

If, however, some extraordinary event were to occur after the close of business on the London Stock Exchange but prior to the close of business on the New York Stock Exchange on the same day and the Funds’ officers, to whom authority for pricing the respective Funds has been delegated, determine that such closing prices are no longer a reasonable estimate of such securities values as of 4:00 p.m. New York time, then there would be made a fair value determination of the value of such securities as of 4:00 p.m. using other appropriate indicia of value or valuation of the Funds’ overall portfolio would be suspended until early the next morning at which time current portfolio quotations for such London securities could be obtained with the previous U.S. closing prices used for U.S. securities.

The above valuation procedures of Putnam Growth and Putnam Equities avoid the abuses which forward pricing, as set forth in Rule 22c-1, was intended to limit. For example, an investor who enters an order to purchase shares of either Putnam Growth or Putnam Equities at 3:00 p.m. New York time will not be circumventing the requirement of Rule 22c-1 that such shares be purchased at a price which is next computed after the order is received. This is true even with respect to foreign securities, values for which will be established as of 4:00 p.m. New York time. This is not any less true because the Fund utilizes prices reflecting closing stock exchange values earlier in the day since the determination that such prices continue to be valid is made in fact after the order has been received. In those rare circumstances when the earlier London or other foreign markets’ closing values are no longer deemed by the Funds to be accurate as of 4:00 p.m. New York time the Funds procedures for valuation as required by the Act would require that the Funds utilize fair value procedures for arriving at a 4:00 p.m. New York valuation and thus the valuation would continue to be made after the order has been received.

Further, the utilization of 4:00 p.m. New York time as the valuation time not only for Putnam Growth but also for Putnam Equities which may have a majority of its securities traded in countries outside of the United States is appropriate and consistent with the Act and the rules thereunder. As stated in Rule 22c-1, it is required that directors/trustees of each Fund determine the specific time during the day when a fund must value its assets. The utilization by Putnam Equities of 4:00 p.m. New York time is not only consistent with the provisions of Rule 2a-4 for the reasons stated above but also permits the Fund’s shareholders to have a net asset value fixed at a time consistent with other mutual funds and which permits the maximum public distribution of such prices. To pick another time, for example 10:00 a.m. New York time (i.e., the close of business on the European markets) would mean that a shareholder who purchased his or her shares at 11:00 a.m. New York time would not be given a value for such purchase until 10:00 a.m. the next day and would not be able to read the price per share received in a newspaper until the following day or two full days after the order was entered. This approach would not seem to be beneficial for shareholders and would tend to underscore the reasonableness of the director’s decision that a 4:00 p.m. New York time on the day the order to purchase or sell shares is received is the proper time for valuing Putnam Equities’ securities.

With respect to the specific practice of Putnam Equities not to value its securities on Saturday even on those days on which the Japanese Stock Exchange may be open for trading, we believe that the above discussion supports the Fund’s practice on this point as well.<sup>2</sup> While it may be quite appropriate for funds which have substantially all of their securities traded on the Tokyo Stock Exchange to value their securities as of those Saturdays on which that exchange is open for trading, such a practice would present highly unusual problems for a fund such as Putnam Equities.

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<sup>2</sup> As a practical matter, it would be highly unlikely as regards Putnam Growth that the Directors would determine that the amount of trading occurring in Tokyo with respect to securities owned by the Fund would have a material effect on that Fund’s net asset value. *See* Rule 22c-1.

So long as a majority of Putnam Equities' portfolio is not traded on the Tokyo Stock Exchange, an attempt to arrive at a Saturday valuation with respect to orders which are deemed to have been received on Saturday would present distortions that far outweigh any possible benefit to be gained. In the first place, since the Tokyo Stock Exchange is generally 14 hours ahead of the New York Stock Exchange, it has, on those Saturdays when it is open for trading, already closed for the day as of 2:00 a.m. New York time. Therefore, as of Saturday morning New York time when conceivably an order could be received by mail, the Tokyo Exchange has already been closed for a substantial period of time. Even if one assumes that it would be appropriate to attempt (utilizing the method of estimating values under Rule 2a-4 described above) to estimate the Japanese portfolio as of 4:00 p.m. New York time on Saturday, the overriding problem is presented by the fact that as described above, a substantial majority of the Funds' portfolio securities have not traded at all on that day. To estimate the value as of Saturday night of a substantial majority of securities based on closing prices on Friday (and with respect to European securities based on substantially earlier prices on Friday) would seem to present serious problems not only with respect to mechanics for such valuation but the very accuracy thereof. On the other hand, since no Saturday trading on the Japanese market can possibly occur after an order has been received on Saturday by the collection of mail on that day, it does not seem inappropriate that such order be treated as an order received on Monday morning. Even if one wished to give a Saturday price to such order to reflect the Japanese portion of the portfolio, it would be necessary to wait until Monday morning to value the remaining portion of the portfolio and thus, with respect to U.S. securities, one would be combining portfolio values determined at least 56 hours apart! Moreover, for a U.S. fund sold only in the U.S., which does not invest a substantial majority or even a majority of its securities in the Japanese market and which has stated in its prospectus that valuations occur only at the close of business on days on which the New York Stock Exchange is open for trading and where orders on Saturday could only be received by mail, it is difficult to perceive that an investor would normally have any expectation of receiving a special Saturday valuation. This is especially true since one would assume that most shareholders who are interested in receiving a particular valuation as of a particular day would rarely trust such timing to the vagaries of the mail service but would rather utilize their dealer or call the Fund's distributor directly. In short, we believe that so long as a substantial majority of portfolio holdings of Putnam Equities are invested in securities which are not traded on Saturday, it is highly appropriate that the Fund continue to follow its practice of computing net asset value only on those days on which the New York Stock Exchange is open for trading.

If you need any additional information in connection with the foregoing, please do not hesitate to contact the undersigned. Also, in the event that you have any difficulty taking the position requested in this letter, I would appreciate the opportunity to discuss this matter with you further at your convenience.

Sincerely yours,

Edward P. Lawrence

cc: Mr. Richard M. Cutler  
Vice Chairman  
The Putnam Funds

## EXCERPT FROM 1990 LETTER TO INVESTMENT COMPANY REGISTRANTS

January 11, 1990

Dear Registrant:

The Division of Investment Management has prepared this letter to assist investment company registrants in preparing filings in 1990. This letter provides general guidance to investment companies filing registration statements and post-effective amendments in connection with the public offering of securities. These comments represent the views of the staff of the office of Disclosure Review and not necessarily those of the Securities and Exchange Commission (the "Commission").

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### II. Disclosure Comments

#### C. Valuation and Liquidity

Registrants often value debt securities by reference to other securities which are considered by the board of directors to be comparable in rating, interest rate, due date, etc. (often called matrix pricing) or use pricing services for valuation of these securities. Registrants are reminded that matrix pricing should not ignore a reliable market quotation for an actively traded security. An open-end investment company should limit its investments in securities which are not readily marketable to no more than ten percent of the company's net assets. The staff considers municipal lease securities to be illiquid because of the inefficiency and thinness of the market in which they are traded. Registration statement disclosure should clearly and completely discuss the company's policy of investing in illiquid securities (see Guides 11, 12, and 13 to Form N-1A) and its valuation practices including an indication of the degree of reliance on a pricing service. (See Guide 28 to Form N-1A.)

\* \* \*

We trust that this letter will assist you in preparing your forthcoming filings. Of course, it is not intended to replace the comment process. Any questions about specific investment company filings should be directed to the staff member(s) responsible for reviewing the documents.

Sincerely,

Carolyn B. Lewis  
Assistant Director

## EXCERPT FROM 1992 LETTER TO INVESTMENT COMPANY REGISTRANTS

January 17, 1992

Dear Registrant:

The Division of Investment Management has prepared this letter to assist investment company registrants in preparing disclosure filings in 1992. It covers disclosure developments since January 3, 1991 when the last “generic comment letter” was issued. These comments represent the views of the staff of the Division of Investment Management and are not necessarily those of the Securities and Exchange Commission (the “Commission”). They are intended to assist registrants in preparing disclosure documents and are not considered to be of precedential value in any court or other official forum.

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### II. Disclosure Comments

#### E. Investment Policies and Rule 144A

In adopting Rule 144A under the 1933 Act, the Commission stated that the determination by an open-end investment company of the liquidity of securities eligible for resale under Rule 144A is a question of fact for the board of directors to determine, based upon the trading markets for the specific security. See Securities Act Release No. 6862 (April 23, 1990).

Some funds have fundamental policies prohibiting them from investing in restricted securities or securities subject to legal or contractual restrictions on resale. A security eligible for resale under Rule 144A falls within one of these categories. Therefore, a fund or series having such a policy must change the policy before investing in Rule 144A securities. If the policy is a fundamental policy, the change must be submitted to shareholders for approval. If the policy is non-fundamental, the board of directors may approve the change in policy. Once the policy is changed, the prospectus should be revised to disclose the fund’s policy of investing in Rule 144A securities and the board of directors’ duty to determine the liquidity of securities.

The board of directors is not required specifically to approve and review each Rule 144A security selected by the investment adviser for the fund’s portfolio. The board is responsible for developing and establishing guidelines and procedures for determining the liquidity of Rule 144A securities and monitoring the investment adviser’s implementation of the guidelines and procedures.

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### III. Recent Revisions of Staff Positions

#### B. Municipal Lease Obligations

In a letter to the Investment Company Institute dated June 21, 1991, the staff modified its position on whether municipal lease securities are illiquid. The letter states that an open-end investment company may determine to treat municipal lease obligations as liquid under guidelines established by the board of directors. Determinations concerning the liquidity and appropriate valuation of a municipal lease obligation should be made based upon all relevant factors, such as the frequency of trades and quotes for the obligation, the number of dealers willing to purchase or sell the security and the number of potential buyers, the willingness of dealers to undertake to make a market in the securities, and the nature of the marketplace trades. The letter sets forth additional factors unique to municipal lease obligations that should be considered.

#### C. Liquidity of IOs and POs

Recently, the staff modified its position on the liquidity of interest-only and principal-only fixed mortgage-backed securities (“IOs” and “POs”) issued by the United States Government or its agencies and instrumentalities. Previously the staff took the position that open-end investment companies should count these securities in the ten percent limit on illiquid securities.

In light of the evolution of the relevant markets, the staff now takes the position that the determination of whether a particular government-issued IO or PO backed by fixed-rate mortgages is liquid may be made under guidelines and standards established by the board of directors. Such a security may be deemed liquid if it can be disposed of promptly in the ordinary course of business at a value reasonably close to that used in the calculation of the net asset value per share.

We trust that this letter will assist you in preparing filings in 1992. Of course, it is not intended to replace the disclosure comment process. Any questions about specific company filings should be directed to the staff member responsible for reviewing that company's documents.

Sincerely,

Carolyn B. Lewis  
Assistant Director



## UNITED MUNICIPAL BOND FUND

### Staff Response

Publicly available July 30, 1992

Your letter of October 29, 1991, requests assurance that we would not recommend that the Commission take any enforcement action if United Municipal Bond Fund and United Municipal High Income Fund, Inc. (collectively, the “Funds”) purchase and sell certain municipal bonds between themselves in reliance on Rule 17a-7 under the Investment Company Act of 1940 (“1940 Act”) in the manner described in your letter.

The Funds are registered open-end investment companies managed by Waddell & Reed, Inc. Most of the municipal bonds in which the Funds invest are not actively traded and are frequently held by a relatively few investors. As a result, the Funds value their securities on a daily basis using Muller Data Corporation, an independent matrix pricing service (“Pricing Service”). The Funds propose to purchase and sell municipal bonds between themselves, using the Pricing Service to value the securities.

Section 17(a) of the 1940 Act prohibits a registered investment company from selling securities to, or purchasing securities from, affiliated persons or affiliated persons of affiliated persons. Rule 17a-7 conditionally exempts certain purchases and sales of securities between registered investment companies that share a common investment adviser from the prohibitions of Section 17(a). Rule 17a-7(a) requires, among other things, that the transaction involve securities for which market quotations are readily available. In addition, Rule 17a-7(b) requires that the transaction be effected at the independent current market price. Rule 17a-7(b)(4) provides that the current market price for securities, such as the municipal bonds in which the Funds invest, be calculated by averaging the highest and lowest current independent bid and offer prices determined on the basis of reasonable inquiry. The municipal bonds which the Funds propose to trade between themselves do not have readily available market quotations. In addition, you state that the proposed transactions cannot be effected at the “current market price” because the Funds cannot obtain independent bid or offer prices for the municipal bonds and, therefore, cannot comply with Rule 17a-7(b)(4). Rather, the Funds propose to purchase and sell the bonds at values supplied by the Pricing Service.

In adopting amendments to Rule 17a-7,<sup>1</sup> the Commission noted that reliance on market quotations provides an independent basis for determining that a transaction is fair and reasonable and does not involve overreaching. The Commission further noted that “if the rule were expanded to include securities for which market quotations are not readily available, the independent basis for determining the value of securities would be eliminated.” You state that although the proposed pricing methodology does not comply with the letter of Rule 17a-7, it is consistent with the rule’s fundamental principle that the subject securities be priced on an independent basis. Further, you state that the prices provided by the Pricing Service would take into consideration any market activity in the municipal bonds and be determined on the basis of “reasonable inquiry” for purposes of Rule 17a-7.<sup>2</sup>

We would not recommend that the Commission take any enforcement action under Section 17(a) of the 1940 Act if the Funds buy and sell municipal bonds for which market quotations are not readily available between themselves, provided they comply with the following conditions: (1) the municipal bonds are valued by averaging prices obtained from at least three independent matrix pricing services, or by averaging three independent bid prices, or by averaging three prices obtained from some combination of independent pricing services and independent bid prices;<sup>3</sup> (2) the independent matrix

<sup>1</sup> Investment Company Act Rel. No. 11676 (March 10, 1981).

<sup>2</sup> *But see Principal Preservation Tax-Exempt Fund and Tax-Exempt Portfolios, Inc.* (pub. avail. Dec. 12, 1986) (where the staff stated that the term “reasonable inquiry” contemplates that the fund will solicit a sufficient number of bid and offer prices from disinterested third parties, as determined in accordance with Rule 17a-7(b)(4), to approximate the actual value of the security on the secondary market.) The Funds cannot comply with this standard.

<sup>3</sup> The staff has issued several exemptive orders permitting unit investment trusts to sell portfolio securities to the highest bidder, including their sponsors, provided a minimum of three bids were obtained from persons other than the sponsors or their affiliated persons. *See Dean Witter Reynolds, Inc.*, Investment Company Act Rel. Nos. 15311 (Sept. 16, 1986) (notice) and 15356 (Oct. 10, 1986) (order) *PaineWebber, Inc.*, Investment Company Act Rel. Nos. 15399 (Nov. 5, 1986) (notice) and 15451 (Dec. 3, 1986) (order).



pricing services are not affiliated persons of the Funds or affiliated persons of affiliated persons of the Funds as defined in Section 2(a)(3) of the 1940 Act; (3) the independent matrix pricing services are not engaged directly or through affiliated persons in underwriting or distributing the municipal bonds; (4) no brokerage commission, fee (except for customary transfer fees and matrix pricing servicing fees) or other remuneration is paid in connection with the transactions; and (5) the Funds comply with paragraphs (c), (e), and (f) of Rule 17a-7.

Because this response is based on the unique facts and representations in your letter, you should note that any different facts or representations might require a different conclusion. Moreover, this response only expresses the Division's position on enforcement action and does not purport to express any legal conclusions on the questions presented.

Jana M. Cayne  
Attorney

## Incoming Letter

October 29, 1991

Office of Chief Counsel  
Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Judiciary Plaza  
Washington, D.C. 20549

Re: Request for No-Action Position  
Section 17(a) and Rule 17a-7 under the Investment Company Act of 1940  
United Municipal Bond Fund, Inc.  
United Municipal High Income Fund, Inc.

Ladies and Gentlemen:

United Municipal Bond Fund, Inc. and United Municipal High Income Fund, Inc. ("Funds") respectfully request that the Staff of the Division of Investment Management ("Staff") of the Securities and Exchange Commission ("Commission") advise us that it will not recommend any enforcement action to the Commission if the Funds enter into the transactions described herein in reliance on Rule 17a-7 under the Investment Company Act of 1940 ("1940 Act"). As required by the Commission, enclosed are seven additional copies of this letter.

In response to a comment received from the Staff of the Chicago Regional office of the Commission in April 1991, the Funds advised the Staff of the Chicago Regional office that interfund transactions of the type described herein would no longer be made except and until such transactions are permitted by release or no action letter. They also advised such Staff that they intended to consult with independent counsel concerning the desirability of seeking a no action letter from the Commission. This request is being made after such consultation with independent counsel.

## Background

The Funds are both registered under the 1940 Act as open-end management investment companies, are organized under Maryland law as Maryland corporations and have the same investment adviser, Waddell & Reed, Inc. The adviser does not have an affiliate engaged in the municipal bond business.

Both Funds invest primarily in municipal debt securities, such as general obligation, revenue and industrial development bonds, the interest income from which is generally free from federal income taxation. The goal of United Municipal Bond Fund, Inc. is to provide income to shareholders which is not subject to federal income taxation. The goal of United Municipal High Income Fund, Inc. is to provide a high level of income which is not subject to federal income taxation

by investing primarily in medium and lower quality municipal bonds which provide higher yields than bonds of higher quality.

An issue of municipal bonds is typically purchased and held by a small number of institutional investors which purchase the securities for long term investment, thereby precluding development of a conventional secondary market. The absence of an active secondary market requires that daily valuation of the securities in both Funds' portfolios be based upon an approximation of actual market value such as the methodology described herein.

The municipal bonds held in both of the Funds' portfolios are, and have been since the Funds' respective inception dates,<sup>1</sup> valued daily for purposes of Rule 2a-4 of the 1940 Act on the basis of prices provided by an independent pricing service ("Pricing Service"). Prices are supplied by the Pricing Service at the close of the regular session of the New York Stock Exchange. The Pricing Service determines its municipal bond prices pursuant to a pricing methodology, sometimes referred to as a matrix methodology, which is the same for each Fund. If the same securities are held by both Funds, the securities are valued at the same price for both Funds by the Pricing Service. The Pricing Service takes into account a variety of factors, including without limitation the most recent market activity with respect to a subject security, liquidity, yield, rating, type of industry, coupon rate, maturity and economic conditions. This type of methodology is intended to approximate what the actual market values of municipal securities would be if an active secondary market for these securities existed.

Both Funds currently use the Pricing Service offered by Muller Data Corporation ("Muller"). Muller is and has been paid fees for providing pricing information to the Funds, which information may be used for any purposes the Funds and their adviser desire. Additional consideration is not required for any specific additional or special use of the information.

The Boards of Directors of both Funds, including the Directors who are not interested persons of the Funds, have reviewed the use of the Pricing service and the type of methodology used by the Funds as described herein and determined it to be an appropriate and reasonable method for determining fair value of portfolio securities in accordance with the requirements of Rule 2a-4. In addition, the Boards of Directors have approved the submission to the Staff of this request for no action advice.

### **Proposed Transactions**

From time to time, one Fund may desire to sell its holdings or a portion of its holdings of a particular security which the other Fund is interested in purchasing. In order to avoid forcing one Fund to attempt to sell the securities on the open market while the other Fund attempts to simultaneously purchase the securities on the open market, it is proposed that the Funds be allowed to periodically effect purchase and sale transactions directly between the Funds in reliance on Rule 17a-7 of the 1940 Act as described herein.

For purposes of these transactions, the securities would be valued and the transactions would be effected at values supplied by a Pricing Service. The Pricing Service used would be the same Pricing Service used to value municipal bonds in the Funds' respective portfolios for purposes of Rule 2a-4. The values would be determined at the end of the business day on which the decision to effect the transaction is made. The end of the business day is selected to attempt to avoid any arbitrariness which might unknowingly benefit one of the Funds and because this is the time of day at which prices are supplied by the Pricing Service. The values to be provided in connection with the proposed transactions would be supplied on the same basis as those values upon which municipal bonds in both Funds' portfolios are valued on a daily basis for purposes of Rule 2a-4. No additional or special consideration or compensation would be paid in connection with the valuation of securities in the proposed transactions.

The proposed transactions would only be effected with respect to those securities which the Funds' investment adviser determines are appropriate investments for the purchasing Fund and which are consistent with that Fund's investment objective and policies.

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<sup>1</sup> United Municipal Bond Fund, Inc. commenced operations in 1976. United Municipal High Income Fund, Inc. commenced operations in 1985.

The Boards of Directors of both Funds, including the Directors who are not interested persons of the Funds, have adopted procedures reasonably designed to provide for compliance with the conditions of Rule 17a-7 with respect to transactions other than the proposed transactions. These procedures would be amended to be applicable to all proposed transactions and the amended procedures also would be reasonably designed to provide for compliance with the conditions of Rule 17a-7 for all transactions, including the proposed transactions.

## Discussion

Because the Funds have the same investment adviser, each might be deemed to be an affiliated person of an affiliated person of the other within the meaning of Section 2(a)(3) of the 1940 Act. Section 17(a) of the 1940 Act generally prohibits a registered investment company from selling securities to, or purchasing securities from, an affiliated person of an affiliated person, unless the transaction qualifies for an exemption from Section 17(a). Rule 17a-7 of the 1940 Act offers an exemption from the prohibitions of Section 17(a) for transactions that meet certain terms and conditions. The Rule reflects the Commission's judgment that transactions between parties with the same investment adviser should be exempt in certain circumstances.

It appears Rule 17a-7 was designed to address transactions involving equity securities which are regularly traded on an exchange or in the over-the-counter market, rather than transactions involving municipal debt securities, such as those involved in the proposed transactions, which have significantly different market characteristics. Therefore, an inherent difficulty exists in applying Rule 17a-7 to transactions involving municipal bonds, for which it is common practice to use an independent Pricing Service.

Nevertheless, the proposed transactions are intended to comply with the purposes underlying Rule 17a-7. Rule 17a-7(b) requires that the subject securities be valued at the "current market price." As discussed above, the securities subject to the proposed transactions will not be reported securities, securities whose principal market is an exchange, or securities quoted in the NASDAQ System, as specified in Rule 17a-7(b)(1)-(3). In addition, most municipal bonds in which the two Funds invest are frequently held by a relatively few investors and the bonds are not actively traded. There are normally no current independent bids or offers for such bonds that would satisfy the requirements of Rule 17a-7(b)(4). Consequently, the Funds propose to use a Pricing Service to determine the "current market price" of securities involved in the proposed transactions. Although the Funds currently use Muller, it is believed that any pricing methodology such as that described herein used by a Pricing Service should be acceptable for purposes of Rule 17a-7.

While the proposed pricing methodology is not within the letter of Rule 17a-7, it is consistent with the fundamental principle of Rule 17a-7 that the subject securities be priced on an independent basis. The values determined pursuant to a Pricing Service such as that described herein are based upon information obtained on an independent basis. The structure of the municipal bond market does not allow for any other alternatives which would meet the fundamental objective of Rule 17a-7 regarding independence of prices. In addition, the rationale of Rule 17a-7 applies to the proposed transactions in that each could be legally effected on the open market through a dealer. If the Funds were forced to sell and purchase the securities on the open market, practical problems would result with no compensating benefits. First, transaction costs (such as mark-ups or mark-downs, as the case may be) would be incurred by the Funds in the open market transactions. The proposed transactions would benefit the shareholders of both Funds by avoiding such transaction costs. Second, there can be no assurance that the securities, once sold on the open market, would be available to the Fund desiring to purchase the securities. The Commission has noted that the interpositioning of a dealer in transactions such as the proposed transactions does not remove them from the prohibitions of Section 17(a).<sup>2</sup> The proposed transactions would ensure that each Fund is able to effect the purchase or sale transaction which it determines to be in the Fund's best interests.

The prices provided by the Pricing Service that would be used in the proposed transactions take into consideration any market activity in the subject securities and reflect prior quotes even if no current quotes exist. Accordingly, use of the Pricing Service would constitute a reasonable inquiry under Rule 17a-7(b)(4). The prices derived by the Pricing Service based upon the pricing methodology described herein are used on a daily basis to determine net asset value under Rule 2a-4 and are the only prices available for the determination of value of securities which would be involved in the

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<sup>2</sup> See Investment Company Act of 1940 Release 11136 (April 21, 1980) at note 10 and accompanying text.

proposed transactions. The potential for abuse is virtually eliminated as the use of such Pricing Service provides an independent basis for determining that the proposed transactions are effected at a price which is fair and reasonable and does not involve overreaching.

To the best of the Funds' knowledge, the Staff has not considered the issues involved in connection with the proposed transactions under Rule 17a-7 in other no-action positions or requests for exemptive relief.

### **Conclusion**

The Funds hereby request that the Staff of the Commission advise us that it will not recommend enforcement action to the Commission if the Funds were to effect at the end of the business day purchase and sale transactions involving municipal bonds between the Funds, and value the securities based upon prices supplied at the end of the business day by a Pricing Service which is used by the Funds to value municipal bonds in the Funds' respective portfolios for purposes of Rule 2a-4, which prices would be based upon a pricing methodology such as that described herein, in order to meet the requirements of Rule 17a-7 that the securities in the transactions be valued at their "current market price." The Funds represent that all proposed transactions under Rule 17a-7 will be consistent with the investment objective and policies of each Fund and with the other provisions of Rule 17a-7.

If you require further information with respect to this request, please contact the undersigned at 913-236-1923. If the Staff intends to issue a response that is adverse to this request, we respectfully further request the opportunity of a telephone conference prior to issuance of a response.

Very truly yours,

United Municipal Bond Fund, Inc.

United Municipal High Income Fund, Inc.

## INVESTMENT COMPANY INSTITUTE

December 9, 1992

Mr. Matthew P. Fink  
President  
Investment Company Institute  
1600 M Street, N.W., Suite 600  
Washington, D.C. 20036

Re: Investments in Illiquid Securities by Money Market Funds

Dear Mr. Fink:

In March of this year, the Commission revised the Guidelines to Form N-1A to increase the amount of illiquid securities an open-end investment company may hold from ten percent to fifteen percent of its net assets.<sup>1</sup> Recently, several money market funds relying on Rule 2a-7 have sought to rely upon the Guidelines Release to adopt or amend their investment policies to permit investment of up to fifteen percent of their net assets in illiquid securities.

In its release, the Commission did not discuss specifically whether the higher limit would be appropriate for money market funds. The Division does not believe, however, that the Commission intended to change its long-standing position with respect to the acquisition of illiquid securities by money market funds.

The releases proposing, adopting and amending Rule 2a-7 repeatedly emphasize the special duty of the board of directors of a money market fund to monitor purchases of illiquid securities.<sup>2</sup> In 1986, the Commission summarized this position:

[M]oney market funds often have a greater and perhaps less predictable volume of redemptions than other open-end investment companies. Further, the portfolio management of a money market fund might be impaired if a fund were forced to meet redemption requests by selling marketable securities that it would otherwise wish to retain in order to avoid attempting to dispose of illiquid portfolio instruments. Finally, the valuation of illiquid securities may potentially overstate or understate the fund's net asset value to the detriment of shareholders. In light of these potential problems, the board of directors of a money market fund relying on the rule must take steps to limit the acquisition of illiquid portfolio instruments to a level lower than the ten percent limit set for other types of open-end investment companies.<sup>3</sup>

As recently as 1990, the Commission reaffirmed its views regarding the need for money market funds to maintain a liquid portfolio.<sup>4</sup>

The Commission revised the Guidelines to Form N-1A in March 1992 only after determining that, even during periods of abnormally high selling activity, mutual funds have had no difficulty meeting redemption requests from available cash reserves. The Commission thus concluded that the ten percent standard was overly conservative and that increasing it to fifteen percent was consistent with the protection of investors. In reaching this conclusion, however, the Commission did not consider the unique liquidity and valuation requirements of money market funds.

Furthermore, it does not appear that the Commission intended to include money market funds in the Guidelines Release. The Commission revised the Guidelines in connection with its efforts to make the capital markets more accessible to small businesses. While the revision does not require that any additional investments in illiquid securities be securities of

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<sup>1</sup> Investment Company Act Release No. 18612 (Mar. 12, 1992) ("Guidelines Release").

<sup>2</sup> See Investment Company Act Releases No. 12206 (Feb. 1, 1982) (proposing Rule 2a-7); No. 13380 (July 11, 1983) (adopting Rule 2a-7); No. 14983 (Mar. 12, 1986) (amending Rule 2a-7); and No. 17589 (July 17, 1990) (proposing amendments to Rule 2a-7).

<sup>3</sup> Investment Company Act Release No. 14983 (citing Investment Company Act Release No. 13380, *supra* note 2).

<sup>4</sup> See Investment Company Act Release No. 17589 (July 17, 1990).

small businesses, clearly small businesses were the intended beneficiaries. Money market funds generally cannot invest in the securities of small businesses by virtue of the rating requirements for eligible securities under Rule 2a-7.<sup>5</sup>

In summary, the staff does not believe the Commission intended to include money market funds among those funds that may invest up to fifteen percent of net assets in illiquid securities. In the absence of any other Commission statements on this topic, we assume the Commission continues to believe that money market funds should limit their acquisition of illiquid securities to less than ten percent. If you have any questions regarding the Division's position on this issue, please do not hesitate to contact me at (202) 272-2750, or Max Berueffy at (202) 272-2079.

Sincerely,

Marianne K. Smythe

Director

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<sup>5</sup> Thus, in estimating the significance of mutual funds as a potential source of capital for small business, the Commission "subtract[ed] from the total assets of mutual funds the assets of funds that ordinarily would not invest in the securities of small businesses [such as] money market funds." Guidelines Release, *supra* note 1, at n. 4.

## MERRILL LYNCH MONEY MARKETS INC.

### Staff Response

January 14, 1994

Your letters of July 8, and October 19, 1992, and June 17, and October 6, 1993, request that the staff concur with your view that the board of directors of a registered, open-end investment company may determine that certain commercial paper issued in reliance on the exemption from registration in Section 4(2) of the Securities Act of 1933 (“1933 Act”) (“4(2) Paper”) is a liquid security. You also request that the staff concur with your view that the board of directors of a registered, open-end investment company may delegate to the fund’s investment adviser the responsibility for determining and monitoring the liquidity of 4(2) Paper in the fund’s portfolio.

An open-end investment company generally may not invest more than 15% of its net assets in illiquid securities and other illiquid assets.<sup>1</sup> The Commission has taken the position that restricted securities, that is, securities that cannot be offered to the public without first being registered under the 1933 Act, generally are regarded as illiquid.<sup>2</sup> The Commission has, however, permitted an open-end investment company’s board of directors to determine that Rule 144A and foreign securities are liquid, despite their restricted nature.<sup>3</sup> Similarly, in reliance on the Commission’s position, the staff has stated that a fund’s board of directors may determine that certain mortgage-backed securities and municipal lease obligations are liquid using the same Rule 144A analysis.<sup>4</sup>

You state that most commercial paper is issued in reliance on the exemption in Section 3(a)(3) of the 1933 Act (“3(a)(3) Paper”).<sup>5</sup> Because 3(a)(3) Paper may be sold and resold to the public without 1933 Act registration, it is presumptively liquid and therefore is not subject to the 15% limitation. Commercial paper that does not meet the requirements of Section 3(a)(3) typically is issued in reliance on Section 4(2), which exempts from registration “transactions by an issuer not involving a public offering.” Unlike 3(a)(3) Paper, 4(2) Paper is considered a restricted security because it may be resold only if the offering is registered under the 1933 Act or the sale is effected in a private transaction exempt from registration under the 1933 Act.<sup>6</sup> Therefore, 4(2) Paper generally is regarded as illiquid for purposes of the 15% illiquidity limit.<sup>7</sup>

You believe that 4(2) Paper is as liquid as 3(a)(3) Paper and therefore that 4(2) Paper need not automatically be considered illiquid for purposes of the 15% illiquidity limitation. You state that 4(2) Paper represents about \$84 billion, or 23% of the total market of \$364 billion for dealer-placed commercial paper, and in the period January 1989-July 1992, accounted for between 29% and 35% of all new commercial paper programs. You state that Moody’s Investor Services, Inc. (“Moody’s”) and/or Standard & Poor’s (“S&P”) currently rate about three hundred 4(2) Paper programs, and

<sup>1</sup> See SEC, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation* 178 (1992), citing Investment Company Act Rel. No. 18612 (Mar. 12, 1992).

<sup>2</sup> See Investment Company Act Rel. No. 5847 (Oct. 21, 1969); Securities Act Rel. No. 6862 (Apr. 23, 1990) (“Release 6862”) (adopting Rule 144A under the 1933 Act). An illiquid security is one that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the company has valued the instrument. Investment Company Act Rel. No. 14983 (Mar. 12, 1986) (adopting amendments to Rule 2a-7 under the Investment Company Act of 1940).

<sup>3</sup> Release 6862. With respect to Rule 144A securities, the Commission did not require a board to consider any particular factors in making a liquidity determination, but set out a non-exclusive list of factors that a board reasonably could consider: 1) the frequency of trades and quotes; 2) the number of dealers willing to purchase or sell the security and the number of potential purchasers; 3) dealer undertakings to make a market in the security; and 4) the nature of the security and the market place trades. *Id.* The Commission also recognized that foreign securities would not necessarily be illiquid for purposes of the 15% limitation, despite their restricted nature, if the foreign security can be freely traded in a foreign securities market and all the facts and circumstances support a finding of liquidity. *Id.* at n.60.

<sup>4</sup> See Letter to Registrants (Jan. 17, 1992) (certain mortgage-backed securities); Letter to Catherine L. Heron, Vice President - Tax and Pension, Investment Company Institute, from Carolyn B. Lewis, Assistant Director, Division of Investment Management (June 21, 1991) (municipal lease obligations).

<sup>5</sup> Section 3(a)(3) exempts any note “which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months.

<sup>6</sup> See, e.g., Rule 144A.

<sup>7</sup> You state that the maximum term of 4(2) Paper is one year, although, like 3(a)(3) Paper, 4(2) Paper generally has a maturity of nine months or less. Telephone conversation between William Goodwin and Lawrence Stoller (December 7, 1993).



Moody's and S&P list twenty-two firms as dealers in those programs.<sup>8</sup> More than 85% of those programs are rated in the highest rating category by at least one nationally recognized statistical rating organization ("NRSRO").<sup>9</sup> You represent that Merrill Lynch Money Markets Inc. ("Merrill Lynch") has between 7,000 and 10,000 accounts that purchase commercial paper; 27% of Merrill Lynch's 4(2) Paper customers (by dollar amount of transactions) are investment companies, including money market funds.<sup>10</sup>

You state that, in Merrill Lynch's experience, participants in the commercial paper market do not distinguish between 4(2) Paper and 3(a)(3) Paper. Merrill Lynch has observed that 4(2) Paper and 3(a)(3) Paper trade in the market in parity with one another, and it believes that buyers would not pay the same amount for 4(2) Paper as 3(a)(3) Paper if they perceived a difference in liquidity.<sup>11</sup> Bids occur for the two types of paper with the same frequency, and bid-ask spreads in the secondary market, in Merrill Lynch's experience, are the same for contemporaneous transactions in both types of paper of comparable quality. You also state that Merrill Lynch's average turnover rate, that is, the ratio of the amount of commercial paper Merrill Lynch buys compared to the amount it sells, is substantially identical for 3(a)(3) and 4(2) Paper.<sup>12</sup> Merrill Lynch believes that this demonstrates that, on average, 3(a)(3) and 4(2) Paper take the same amount of time to be sold and, therefore, are equally liquid.

Although Rule 144A securities are not subject to the illiquidity presumption, you state that many 4(2) Paper programs do not qualify for the Rule 144A safe harbor, primarily because the programs were established before the adoption of Rule 144A and may not require non-reporting issuers to provide financial information.<sup>13</sup> Because these programs are outside the safe harbor, you state that open-end investment companies that purchase nonqualifying 4(2) Paper treat it as illiquid.

We concur in your view that a fund's board of directors may conditionally determine for purposes of the 85% liquidity requirement that an issue of 4(2) Paper is liquid, whether or not it may be resold under Rule 144A. To make that determination, the following conditions must be met: 1) the 4(2) Paper must not be traded flat or in default as to principal or interest; 2) the 4(2) Paper must be rated in one of the two highest rating categories by at least two NRSROs, or if only one NRSRO rates the security, by that NRSRO; if the security is unrated, the board must determine that the security is of equivalent quality;<sup>14</sup> and 3) the board must consider the trading market for the specific security, taking into account all relevant factors.<sup>15</sup>

Further, we concur in your view that the board of directors may delegate to the fund's investment adviser the responsibility for determining and monitoring the liquidity of 4(2) Paper in the fund's portfolio, provided the board retains sufficient oversight. The board or adviser must continue to monitor the liquidity of any 4(2) Paper purchased. If the board or adviser determines that an issue of 4(2) Paper no longer is liquid, it must review the fund's portfolio to

<sup>8</sup> You state that the same dealers in the 4(2) Paper market are also in the 3(a)(3) Paper market. Telephone conversation between William Goodwin and Monica Parry (November 10, 1992).

<sup>9</sup> You state that the NRSROs base their ratings on the structure of the program as well as the financial condition of the issuer. Telephone conversation between William Goodwin and Monica Parry (January 12, 1993).

<sup>10</sup> Exhibit B to your October 6, 1993 letter. Thirty-eight percent of Merrill Lynch's 3(a)(3) Paper customers are investment companies. You state that a majority of Merrill Lynch's commercial paper customers purchase both 3(a)(3) and 4(2) Paper. Telephone conversation between William Goodwin and Monica Parry (November 10, 1992).

<sup>11</sup> See, e.g., Exhibit A to your October 6, 1993 letter.

<sup>12</sup> Exhibit A to your October 6, 1993 letter.

<sup>13</sup> Telephone conversation between William Goodwin and Monica Parry (January 15, 1993). Rule 144A(d)(4) requires nonreporting issuers to provide upon request reasonably current financial information to holders and prospective purchasers.

<sup>14</sup> It may be imprudent to treat an unrated issue of 4(2) Paper as liquid unless the fund can perform an analysis of factors similar to those performed by the rating agencies and reasonably conclude that the issue of 4(2) Paper is liquid. This analysis must also support the conclusion that an unrated issue of 4(2) Paper meets the fund's credit quality standards.

<sup>15</sup> The Division of Market Regulation has taken the position that a broker-dealer can treat 4(2) Paper in the same manner as 3(a)(3) Paper for purposes of Rule 15c3-1 under the Securities Exchange Act of 1934 (the net capital rule) provided that: 1) the paper is not traded flat or in default as to principal or interest; 2) the paper is not issued by a parent or affiliated company of the broker-dealer; 3) the paper is rated in one of the two highest categories by at least two of the NRSROs, and if any of the two ratings is reduced below the two highest rating categories, the broker-dealer will deduct a portion of the carrying value of the paper from its net worth; and 4) the paper is the subject of a commercial paper program that is administered by an issuing and paying agent bank and for which there exists a dealer willing to make a market in that paper, or the paper is administered by a direct issuer pursuant to a direct placement program. Securities Industry Association (pub. avail. Mar. 10, 1992).



determine whether the fund must take any action to ensure that its portfolio complies with the 15% illiquidity limitation. Even if it delegates determinations to the investment adviser, the board remains ultimately responsible for liquidity decisions.<sup>16</sup>

These positions are based on the facts and representations in your letters and telephone conversations; any different facts or representations may require a different conclusion.

Monica L. Parry  
Senior Counsel

## Incoming Letter

October 6, 1993

Ms. Monica Parry  
Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: Merrill Lynch Money Markets Inc.

Dear Ms. Parry:

Enclosed is the additional information the staff requested in support of our request, on behalf of Merrill Lynch Money Markets Inc. ("MMI" or "Merrill Lynch"), for a no-action letter with respect to the liquidity of commercial paper issued in reliance on the exemption from registration contained in Section 4(2) of the Securities Act of 1933 ("4(2) Paper"). I am enclosing one original and four copies of such information.

The information enclosed is as follows:

1. Exhibit A is a comparison of the dollar weighted average rate paid to each significant group of investors for 3(a)(3) versus 4(2) Paper for A-2/P-2 rated issues, presented with, and in the same format as, the data previously presented for A-1+/P-1 and A-1/P-1 rated issues. As we understand it, the staff had requested the data for A-2/P-2 rated issues in order to determine whether the differential between rates for 3(a)(3) and 4(2) paper follows a trend as ratings decline that could be attributed to the special liquidity requirements of open-end registered investment companies as a group. One could infer from the data that money funds and other registered investment companies do demand an increasing premium for 4(2) Paper as the ratings of the 4(2) Paper decline. However, MMI does not believe liquidity is the issue affecting any of the noted rate differentials and point to the rate differential between 4(2) and 3(a)(3) Paper in the A-1+/P-1 category as proof: We can find no rational basis for concluding that money funds and other registered investment companies will accept, as the data also imply, a lower rate for 4(2) Paper in this rating category because it is more liquid than similarly rated 3(a)(3) Paper. We would therefore argue that the rate differential is random across the investor groups listed and that if any rate premium at all is demanded by money funds and investment companies, it is more likely for A-2/P-2 rated 4(2) Paper as a result of the double penalty imposed by regulations restricting holdings of both lower rated as well as 4(2) Paper under Rule 2a-7 under the Investment Company Act of 1940, rather than decreased liquidity.

2. Exhibit B is a chart showing the percentage of Merrill Lynch's 3(a)(3) and 4(2) commercial paper that is purchased by registered investment companies, as well as the percentage of commercial paper purchased by other investors. In MMI's experience, the Merrill Lynch data is representative of the customer base for the entire commercial paper market. MMI believes that the smaller proportion of 4(2) Paper purchased by registered investment companies is, again, the result of regulatory bias against holdings of 4(2) Paper, rather than liquidity concerns.

3. Exhibit C is a daily summary of Merrill Lynch's commercial paper buy and sell volume for each of 3(a)(3) and 4(2) Paper for the July/August 1993 60-Day period as well as the most recent 60-days ending September 10, 1993. Daily

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<sup>16</sup> Release 6862 at n.61.

average turnover is computed as the amount of each of 3(a)(3) and 4(2) Paper sold on that day divided by the amount of 3(a)(3) and 4(2) Paper purchased on that day. A turnover ratio of less than 1.0 indicates that Merrill Lynch sold less 3(a)(3) or 4(2) Paper, as applicable, than it purchased. A turnover ratio in excess of 1.0 indicates that Merrill Lynch sold more 3(a)(3) or 4(2) Paper, as applicable, than it purchased. Please note that turnover on individual days can differ markedly as a result of factors like the time of day certain issuers came into the market (paper positioned late in the day generally stays in inventory overnight because there are few buyers in the market after 1:00 p.m.), or trading strategies (the trading desk may hold more or less commercial paper in inventory depending on expectations about rates or supply). Over time, however, these daily differences should average out, and in fact do; the turnover averages reported for 3(a)(3) and 4(2) Paper for the two 60-day periods are statistically identical, indicating that, on average, 3(a)(3) and 4(2) paper take the same amount of time to be sold and are therefore equally liquid.

Please call me at (212) 326-3550 should the staff have any additional questions following its review of the enclosed information.

Very truly yours,

William Goodwin

### Incoming Letter

June 17, 1993

Ms. Monica Parry  
 Securities and Exchange Commission  
 450 Fifth Street, N.W.  
 Mail Stop 10-6  
 Washington, D.C. 20549

Re: Merrill Lynch Money Markets Inc.

Dear Ms. Parry:

We are grateful for the opportunity you gave us and representatives of Merrill Lynch Money Markets Inc. (“MMI”) on May 12 to present market information in support of our request for a no-action letter with respect to the liquidity of commercial paper issued in reliance on the exemption from registration contained in Section 4(2) of the Securities Act of 1933 (“4(2) Paper”). We found it helpful to gain insight into your concerns and to be able to address them as presented.

There were, however, a number of questions raised by you and your colleagues to which we were unable to fully respond at the time. We have set them forth below with information we believe provides the clarification you were seeking.

1. Does the average all-in rate data paid to investors as a group, presented on May 12, that shows that 4(2) Paper trades at the same rate as commercial paper issued in reliance on Section 3(a)(3) of the Securities Act of 1933 (“3(a)(3) Paper”) mask a difference in the rate paid to money funds and other investment companies that are regulated as to liquidity?

In Exhibit A, MMI has calculated the average rate paid to each significant investor group in the commercial paper market by issuers rated A-1+/P-1 and A-1/P-1 for 3(a)(3) Paper and 4(2) Paper and compared those rates for each group. As you can see, although the rates are not necessarily identical, they do not follow a consistent pattern. In MMI’s views, the variations are likely a result of noise in the data from changes in rating of the programs in the time period under consideration. What is most important is that the data does not indicate that money funds and investment companies are demanding a rate premium for investments in 4(2) Paper. We believe it is reasonable to conclude that where 4(2) Paper is purchased by money funds and investment managers, the fact that the paper is technically a restricted security under the 1933 Act drives its treatment, not the manner in which it is traded in the marketplace.

2. What proportion of 4(2) Paper programs are single-dealer versus multiple dealer and is it appropriate to include single-dealer programs in the scope of a no-action letter?

In Exhibit B, MMI has compiled data from Standard & Poor's corporation and Moody's Investors Service, as well as MMI's database, to determine the proportion of commercial paper programs that are single-dealer versus multiple dealer. As you may note, just over one-half of all 4(2) Paper programs in existence, and one-third of those for which MMI is a dealer, are single-dealer programs. MMI previously reported to you that 4(2) Paper comprised approximately 20% of new CP programs, 20% of all new CP issuance, 20% of all CP outstanding and 20% of CP secondary market activity. Exclusion of single-dealer 4(2) Paper programs from the scope of the no-action letter would therefore preclude approximately 50% of the 4(2) Paper market and 10% of the CP market as a whole from ready access by open-end investment companies. We believe that excluding 50% of the 4(2) Paper market and, given that the CP market exceeds \$525 billion in size, 10% of the CP market is still restrictive, particularly so because the CP market does not differentiate between single- and multiple-dealer programs

3. Does it take longer to sell 4(2) Paper than it does to sell 3(a)(3) Paper and is 4(2) Paper consequently less liquid in a way not shown in the rate comparison data?

MMI does not track and is therefore unable to present data regarding the amount of time it takes to sell either 4(2) or 3(a)(3) Paper. However, because MMI acts as principal for all of the primary issuance and secondary market commercial paper in which it deals, MMI believes that if 4(2) Paper took longer to sell than 3(a)(3) Paper, MMI would at any given point in time hold relatively more 4(2) Paper in inventory than it would 3(a)(3) Paper. MMI therefore undertook to examine MMI's average daily inventory of 4(2) and 3(a)(3) Paper as a proportion of the average daily volume of each type of commercial paper issued through MMI. No significant difference in these proportions was found: The average daily inventory of 4(2) Paper comprised 3.8% of the average daily volume of 4(2) Paper issued through Merrill Lynch compared with 3.6% for 3(a)(3) Paper. We therefore believe that the data confirms the statement we made in our meeting with you that 4(2) and 3(a)(3) paper sell in approximately the same amount of time.

We hope we have fully addressed the concerns you expressed to us on May 12. We continue to request your concurrence with our view that the liquidity of 4(2) Paper, where it is subject to the conditions described in the March 10, 1992 Division of Market Regulation no-action letter to the SIA as modified in our initial July 8, 1992 request to you on behalf of MMI, is such that a board of directors of a registered open-end investment company may delegate to the investment adviser the responsibility for determining and monitoring the liquidity of such paper to the same extent it has delegated such responsibility to the investment adviser with respect to 3(a)(3) Paper.

Please call me at (212) 326-3550 if you have any questions regarding the enclosed or would like additional information. For the convenience of the staff, four additional copies of this letter (with exhibits) are enclosed.

Very truly yours,

William Goodwin

## Incoming Letter

July 8, 1992

Thomas S. Harman, Esq.  
Associate Director and Chief Counsel  
Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: Commercial Paper Exempted from Registration by Section 4(2) of the Securities Act of 1933—Liquidity

Dear Mr. Harman:

We are writing on behalf of Merrill Lynch Money Markets Inc. (“MMI”) to seek your concurrence in our view that commercial paper not registered under the Securities Act of 1933 (the “1933 Act”) in reliance on the exemption contained in Section 4(2) of the 1933 Act (“4(2) Paper”) may be determined to be liquid by a registered open-end investment company (a “mutual fund”) for purposes of meeting its 85% liquidity requirement,<sup>1</sup> provided that the 4(2) Paper meets certain requirements as described below. MMI is the leading dealer in commercial paper, and many of its customers for such instruments are mutual funds, including money market funds.

### I. Background

Commercial paper, which ranges in various maturities up to nine months, is highly liquid. Commercial paper outstanding in the United States exceeds \$525 billion,<sup>2</sup> with more than \$25 billion transacted daily, and is approximately the same size as the U.S. Treasury Bill market.

Most commercial paper is issued in reliance on the exemption from registration contained in Section 3(a)(3) of the 1933 Act (“3(a)(3) Paper”). Section 3(a)(3) exempts any “note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months . . .” 3(a)(3) Paper, being an exempted security, may be freely issued and resold without 1933 Act registration. Commercial paper not meeting the requirements of Section 3(a)(3), for example, because the proceeds are not to be used for current transactions or because the issuer determines not to make a public offering of its securities,<sup>3</sup> is typically issued in reliance on Section 4(2) of the 1933 Act, which exempts “transactions by an issuer not involving any public offering.” 4(2) Paper, however, may be resold only if the sale is registered under the 1933 Act or if the sale is effected in a private transaction, utilizing Rule 144A under the 1933 Act or, less frequently, the so-called Section 4(1-½) exemption.<sup>4</sup>

As indicated, 4(2) Paper was created to serve the same function as 3(a)(3) Paper, which is to satisfy the short-term financing requirements of large industrial and financial issuers. 4(2) Paper was designed to trade in the same market and in the same manner as 3(a)(3) Paper. Participants in the primary and secondary markets for commercial paper are primarily institutions, and exclusively so in the case of 4(2) Paper.<sup>5</sup> Accordingly, there has in fact developed a secondary market for 4(2) Paper that, notwithstanding the restricted status of the securities under the 1933 Act, possesses the same degree of liquidity as the secondary market for 3(a)(3) Paper. In practice, most institutional purchasers do not draw a

<sup>1</sup> That requirement is that an open-end investment company have no more than 15% of its net assets in illiquid securities and other illiquid assets. Guide 4 to the Guides to Form N-1A as amended, Release No. IC-18612 (Mar. 12, 1992).

<sup>2</sup> Federal Reserve Bank of New York Release No. 1932, May 13, 1992. Moreover, as an indication of the liquidity of commercial paper financial statements prepared in accordance with generally accepted accounting principles often include commercial paper under the caption “cash and cash equivalents.”

<sup>3</sup> Such as an issuer relying on the exemption from registration as an investment company contained in Section 3(c)(1) of the Investment Company Act of 1940, which is not available to issuers making public offerings of their securities.

<sup>4</sup> See The Section “4(1-½)” Phenomenon: Private Resales of “Restricted” Securities 34 Bus. L. 1961, 1971, 1975-1977 (1979).

<sup>5</sup> Generally, such institutions would qualify as Qualified Institutional Buyers for purposes of Rule 144A. See III.A. below.

distinction between the two types of commercial paper in making their investment decisions.<sup>6</sup> In MMI's experience, holders of 4(2) Paper enjoy the same degree of liquidity as holders of 3(a)(3) Paper, a fact which is evidenced by the lack of any price differential between the two types of commercial paper (assuming equivalent credit quality). An institutional purchaser would not pay the same amount for 4(2) Paper as 3(a)(3) Paper if it believed the latter was more liquid than the former.

In 1990, the Commission publicly adopted an interpretive position to the effect that mutual funds could determine that restricted securities eligible to be resold in reliance on Rule 144A under the 1933 Act are liquid. In March 1992, the Division of Market Regulation issued an interpretive letter stating that 4(2) Paper meeting certain requirements held by broker-dealers could be considered liquid for purposes of regulatory net capital requirements. The Division of Market Regulation concluded, in effect, that 4(2) Paper meeting the specified requirements could be treated the same as 3(a)(3) Paper for net capital purposes. These two interpretations are analyzed in more detail below. Because in MMI's experience 4(2) Paper enjoys the same degree of liquidity as 3(a)(3) Paper, we and MMI believe that the logic behind both the Commission's interpretive position in the Rule 144A context and that of the Division of Market Regulation in the context of the net capital rule is equally applicable in the case of 4(2) Paper held by mutual funds. That logic—namely that a determination as to the liquidity of a particular instrument should focus on whether there in fact exists a ready market for the instrument rather than solely on the existence of restrictions on resale—makes it appropriate in our view for the Division to adopt the interpretive position requested herein.

## II. Nature of the Problem

In MMI's experience, most money market funds actively purchase 4(2) Paper but reluctantly book it as illiquid for purposes of the 85% liquidity requirement. In some cases, the investment policies or restrictions of a fund limit the purchase of restricted securities. In a significant number of other cases, however, where their investment policies or restrictions are not an issue, mutual funds treat 4(2) Paper as illiquid (or decline to purchase it) not because they believe the securities are in fact illiquid, but rather because they believe the staff of the Commission might consider 4(2) Paper, because of its restricted status, to be, in effect, per se illiquid. MMI believes that Commission staff members conducting inspections of fund complexes have expressed concerns as to the liquidity of 4(2) Paper, a practice which has contributed to the reluctance of some mutual funds to consider 4(2) Paper to be liquid.

Apparently, the source of the funds' concern is "the longstanding Commission interpretive position [that] a restricted security would generally be regarded as illiquid."<sup>7</sup> As discussed in more detail below, this position has been modified by the Commission to permit mutual funds under certain circumstances to consider securities eligible for resale pursuant to Rule 144A to be liquid. Notwithstanding the modified interpretive position, however, a significant number of mutual fund customers of MMI, including a number of money market funds, continue to express concerns as to the staff's position on the liquidity of 4(2) Paper. We believe their concerns relate to whether 4(2) Paper will meet the liquidity standards enunciated by the Commission in the course of modifying its interpretive position (discussed below). We believe their concerns also arise from the fact that many 4(2) Paper programs do not satisfy all of the requirements of the Rule 144A safe harbor, primarily because they were established prior to the adoption of Rule 144A.

We recognize that a determination as to whether a particular security is or is not liquid is ultimately a factual determination. Nevertheless, we believe it would be appropriate for the staff to acknowledge that where a particular issue of 4(2) Paper meets certain objective standards of liquidity, it lies within the discretion of the management of a mutual fund, in the reasonable exercise of its business judgment, to determine that the 4(2) Paper is liquid. The staff's concurrence in this view would, MMI believes, benefit both commercial paper issuers, by opening up significant new sources of financing, and mutual funds, by enhancing the supply of available high-quality short-term investments.

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<sup>6</sup> For example, as of April 1992, MMI acted as dealer with respect to 642 commercial paper programs representing more than \$90 billion in principal amount outstanding. Of these, 140 programs (22%) involved the issuance of 4(2) Paper (representing more than \$18 billion (20%) in outstanding principal amount). Moreover, in 1991, more than 29% of the new commercial paper programs established by MMI, which issued securities in excess of \$3 billion principal amount, involved 4(2) Paper.

<sup>7</sup> Release No. IC-17452 (Apr. 23, 1990).

### III. Detailed Analysis

#### A. Recent Commission Action - Rule 144A

Rule 144A provides a nonexclusive safe harbor exemption from the registration requirements of the 1933 Act for specified resales of restricted securities to any “Qualified Institutional Buyer” (“QIB”)<sup>8</sup> as defined in the Rule.<sup>9</sup> In Rule 144A’s adopting release (the “Rule 144A release”), the Commission concluded that restricted securities eligible to be resold in reliance on Rule 144A (“Rule 144A securities”) could be determined to be liquid by a mutual fund. The Commission stated that such a determination “is a question of fact for the board of directors to determine, based upon the trading markets for the specific security.”<sup>10</sup>

Accordingly, it seems clear that the board of directors of a mutual fund may exercise its reasonable judgment, taking into account all relevant factors, to determine that 4(2) Paper that may be resold in compliance with Rule 144A is not illiquid for purposes of meeting the fund’s liquidity requirement.

We submit that the Commission’s reasoning in the Rule 144A context is equally applicable in the case of the 4(2) Paper market where, as discussed above, not all secondary market transactions are effected in reliance on Rule 144A but where, in MMI’s experience, there is the same liquidity available to sellers regardless of whether or not the safe harbor of Rule 144A is available.

#### B. Recent Staff Action - The SIA Letter

Until recently, an analogous problem existed under Rule 15c3-1 under the 1934 Act (the “net capital rule”) and its application to commercial paper and other money market instruments for purposes of determining capital charges (“haircuts”) under subparagraph (c)(2)(vii) of the rule. In adopting Rule 144A, the Commission stated:

As to domestic securities, the Division of Market Regulation’s position is that those securities which may be resold through Rule 144A (and which otherwise would be subject to a 100% haircut), except for corporate debt securities that are traded flat or in default as to principal or interest or are not rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations, should be treated for net capital purposes in the same manner as those securities that can be publicly offered and sold without registration and that are deemed to have a ready market for purposes of the net capital rule.<sup>11</sup>

The status under the net capital rule of 4(2) Paper that cannot be resold in reliance on Rule 144A, however, remained problematical.

As set forth in detail below, on March 10, 1992, the Division of Market Regulation took the position, in effect, that 4(2) Paper meeting certain conditions is liquid for purposes of the net capital rule.<sup>12</sup>

Subparagraph (c)(2)(vii) of the net capital rule requires that a broker-dealer take a 100 percent haircut from net capital of the carrying value of securities or evidences of indebtedness in its proprietary or other accounts for which there is no “ready market” as defined in subparagraph (c)(11) of the net capital rule “or which cannot be publicly offered or

<sup>8</sup> Most registered investment companies would qualify as QIBs. In order to be a QIB, an investment company must own and invest or be part of a family of investment companies that owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with that QIB. Rule 144A(a)(1)(i)(B) and (iv).

<sup>9</sup> The availability of the safe harbor exemption in Rule 144A is subject to a number of conditions that 4(2) Paper programs established prior to the adoption of the Rule did not incorporate. Resales of commercial paper issued pursuant to these programs, therefore, are not effected in reliance on the Rule, as noted above. For example, if the issuer of the securities to be sold is neither a reporting company under the 1934 Act nor exempt from reporting pursuant to Rule 12g3-2(b) under the 1934 Act, nor a foreign government eligible to use Schedule B under the 1933 Act, the availability of the rule is conditioned on the holder of the security and a prospective purchaser from the holder having the right to obtain from the issuer specified limited information about the issuer upon request.

<sup>10</sup> Release No. IC-17452, note 7 *supra*.

<sup>11</sup> Rule 144A release, note 7, *supra*.

<sup>12</sup> The March 10, 1992 letter does not refer to Rule 144A, and thus apparently extends to securities transactions that are not covered by Rule 144A.



sold because of statutory restrictions . . . .” This would be equivalent to a determination for purposes of the Investment Company Act of 1940 (the “1940 Act”) that a security is illiquid.

Subsection (c)(11)(i) defines “ready market” to include

a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at a price within a relatively short time conforming to trade custom.

This is functionally equivalent to the definition of liquidity used by the Commission under the 1940 Act.<sup>13</sup>

In response to representations made by the Securities Industry Association (“SIA”) by letters dated July 6, 1989 and August 14, 1990, Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, by letter dated March 10, 1992, stated that the Division of Market Regulation would not recommend that the Commission take enforcement action if broker-dealers did not apply the 100 percent haircut to 4(2) Paper under certain conditions, set forth below. Mr. Macchiaroli’s response was based on the representations made by the SIA in its letter dated July 6, 1989, which are set forth in Appendix A hereto.

As a result of these representations and further correspondence, the Division of Market Regulation agreed that, for purposes of the net capital rule, it would not recommend to the Commission that enforcement action be taken if broker-dealers did not deduct 100% of the carrying value of 4(2) Paper in their proprietary accounts because there was “no ready market for such securities or the securities could not be publicly offered or sold because of statutory, regulatory or contractual arrangements or other restrictions.” This position was subject to the following conditions:

Commercial paper, whether or not exempted from the registration requirement under Section 3(a)(3) of the Securities Act, may be deemed to have a ready market under subparagraph (c)(7) of the Uniform Net Capital Rule and not subject to a deduction of 100% of its carrying value, if the following conditions are met:

1. The commercial paper is not traded flat or in default as to principal or interest.
2. The commercial paper is not issued by a parent or an affiliated company of the broker-dealer.
3. The commercial paper is rated in one of the two highest categories by at least two of the nationally recognized statistical rating organizations . . . .<sup>14</sup>

If, at any time, any of the two ratings is reduced below the two highest categories the broker-dealer will deduct from net worth, when computing net capital, 15% of the carrying value of the commercial paper. Any time after the thirtieth day subsequent to the date when any of the two ratings is reduced below the two highest categories, there shall be a deduction from net worth equal to 100% of the carrying value of the position.

4. The commercial paper is the subject of a commercial paper program which is (a) administered by an issuing and paying agent bank and there exists a dealer willing to make a market in said commercial paper, or (b) is administered by a direct issuer pursuant to a direct placement program.

We believe that the representations of the SIA (which are set forth in Appendix A) are equally applicable to demonstrate that 4(2) Paper meeting the conditions of the March 10, 1992 Division of Market Regulation letter is liquid for purposes of the 1940 Act. Moreover, the position of the Division of Market Regulation is strong support for the proposition that it is within the business judgment of management of registered open-end investment companies to determine that commercial paper acquired in transactions not complying with Rule 144A and meeting the foregoing conditions, with appropriate modifications to take into account regulation under the 1940 Act, is not illiquid for purposes of Guide 4 of the Guidelines to Form N-1A.

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<sup>13</sup> See p.11, *infra*.

<sup>14</sup> As indicated on pp.6-7 *supra*, the condition for no 100% haircut in the Rule 144A release for a domestic Rule 144A security is that it be rated in one of the four highest rating categories.



Specifically, condition 2 is not necessary (substituting “investment company” for “broker-dealer”) because Section 17(a) of the 1940 Act would prohibit such transactions.

The second paragraph of condition 3 is not necessary for money market funds because Rule 2a-7(c)(5) would require the board of directors, in the event of security downgrades, to reassess promptly whether [the] security presents minimal credit risks and . . . cause the money market fund to take such action as the board of directors determines is in the best interest of the money market fund and its shareholders, provided, however, that [such] reassessment . . . is not required if in accordance with the procedures adopted by the board of directors, the security is disposed of (or matures) within five business days of the adviser becoming aware of the new rating and the board is subsequently notified of the adviser’s actions.

We believe that it would be appropriate to impose the same conditions on a non-money market fund for purposes of this request although, as discussed in IV below, we believe the responsibility to reassess liquidity and credit risks in the event of ratings downgrades can properly be delegated to the fund’s investment adviser.

Regarding condition 4, in order to assure that a secondary market in fact exists for the 4(2) Paper, we believe that it would be appropriate to treat 4(2) Paper as liquid only in cases where clause (a) is applicable (i.e., the commercial paper program is administered by an issuing and paying agent bank and there exists a dealer willing to make a market in the 4(2) Paper).

In addition, a small minority of 4(2) Paper programs have required purchasers to agree to limit resales to a group of designated permissible offerees, generally consisting of a limited number of institutional investors. Because a specific analysis of each such program would be required to make a determination as to the liquidity of 4(2) Paper issued in the program, we are excluding these programs from the scope of this request for interpretive relief.

In sum, the Division of Market Regulation’s March 10, 1992 letter, in effect, acknowledges that 4(2) Paper meeting the conditions in its letter has a ready market within the meaning of the net capital rule. This is highly significant because the definition of “ready market” in the net capital rule (set forth on page 7, *supra*) is functionally equivalent to the 1940 Act definition of liquidity as most recently reiterated by the Commission in Release No. IC-18612: “an asset which may . . . be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment on its books.”<sup>15</sup>

Other provisions of the 1940 Act are consistent with this conclusion. For example, Section 2(a)(41) of the 1940 Act defines value with respect to securities for which market quotations are readily available [as] the market value of such securities . . . .<sup>16</sup>

#### IV. Procedural Parity with 3(a)(3) Paper

In the Rule 144A release, the Commission stated it believed that the ultimate responsibility for liquidity determinations is that of the board of directors. However, the board may delegate the day-to-day function of determining the liquidity of

<sup>15</sup> Release No. 18612, note 1, *supra*, citing Release No. IC-14983 (Mar. 12, 1986).

<sup>16</sup> This means that there are no “haircuts” under the 1940 Act. See Release IC-5847 (Oct. 21, 1969) cited in footnote 60 of the Rule 144A release. In this connection, we believe that it is irrelevant in determining liquidity for purposes of Guide 4 that the net capital rule requires haircuts on even readily marketable commercial paper having a maturity of 30 days or more of 1/8 of 1 percent to 1/2 of 1 percent, depending on the maturity. We do not believe that these haircuts are relevant to the question as to whether 4(2) Paper is liquid for purposes of the 1940 Act. The net capital requirements were adopted for the purpose of assuring that broker-dealers have sufficient liquidity to meet their current obligations in the context of allowing the debt obligations of a broker-dealer to be as much as 15 times its net capital. For example, a broker-dealer with balance sheet assets of \$20 million and liabilities of \$10 million—a net worth of \$10 million—might have insufficient net capital because its assets are subject to substantial haircuts. Due to the nature of mutual funds, and especially due to the restrictions on the issuance of senior securities in Section 18(f)(1) of the 1940 Act, the ratio of debt to net asset value could never even approach 15 times.

Indeed, the net capital rule in paragraph (c)(ii)(vi)(D) requires a haircut of 2 percent even for redeemable securities of a registered money market fund, and haircuts of up to 9 percent for other types of investment company securities. In short, the presence or absence of haircuts under the net capital rule is not determinative. The fact is that 4(2) Paper meeting the requirements set forth above has been treated by the Division of Market Regulation as “readily marketable,” and can, with the modifications to those requirements set forth above, be treated as liquid for purposes of the 1940 Act.

securities to the fund's investment adviser, provided that the board retains sufficient oversight. (Rule 144A Release, note 7 *supra*, fn. 61.)

In the release, the Commission also listed a number of factors that might be considered in evaluating the liquidity of Rule 144A securities (such as the frequency of trades and quotes, the number of dealers willing to purchase and sell, etc.), but did not require that any particular factors be taken into account in making liquidity determinations.

Generally, the function of monitoring liquidity is delegated to the investment adviser via broad provisions in the investment advisory contract. In the context of Rule 144A securities, however, principally as a result of the Commission's discussion in the Rule 144A release, we believe the boards of most mutual funds that actively purchase Rule 144A securities have adopted written procedures specifically delegating to the investment adviser responsibility for determining the liquidity of Rule 144A securities, establishing guidelines for making that determination, providing for the periodic monitoring by the board of positions in Rule 144A securities, etc. These special board procedures are deemed advisable presumably because the relatively new (since 1990) market for Rule 144A securities is still in its development stage.

The market for commercial paper, however, is a mature one. Participants in that market do not distinguish between 3(a)(3) Paper and 4(2) Paper and mutual funds purchasing 3(a)(3) Paper do not as a rule subject those purchases to the type of specialized liquidity procedures described in the preceding paragraph. Since the market for 3(a)(3) Paper and 4(2) Paper are one and the same, no regulatory purpose would be served by having mutual funds follow Rule 144A-type procedures with respect to their purchases of 4(2) Paper. In MMI's view, however, based on discussions with its customers, requiring such procedures would be a significant deterrent to the purchase of 4(2) Paper by many, if not most, mutual funds. Since this result, which we believe is an unnecessary one, would substantially deprive the industry of the benefits expected to accrue from your issuing the interpretive position requested herein, we additionally request that you affirm that the board of directors of a mutual fund may delegate to the investment adviser the responsibility for determining and monitoring the liquidity of 4(2) Paper meeting the foregoing conditions under the same terms that it has delegated such responsibility to the investment adviser with respect to 3(a)(3) Paper.

## V. Conclusion

Based on the foregoing, we request the staff's concurrence in our view that a registered open-end investment company could determine that 4(2) Paper (including 4(2) Paper that cannot be resold in reliance on Rule 144A) is not illiquid within the meaning of Guide 4, provided that (i) the board of directors of the company in the reasonable exercise of its business judgment has determined that the particular 4(2) Paper is not illiquid and (ii) the conditions in the March 10, 1992 Division of Market Regulation letter, as modified above, are satisfied with respect to such 4(2) Paper. We also request the staff's concurrence in our view that the company's board of directors may delegate to the investment adviser the responsibility for determining and monitoring the liquidity of 4(2) Paper meeting such conditions to the same extent that it has delegated such responsibility to the investment adviser with respect to 3(a)(3) Paper.

Please call me at (212) 326-3550 if you have any questions regarding the foregoing. If I am unavailable, please call Alan Rosenblat at (202) 626-3332.

Very truly yours,

William Goodwin

**EXCERPT FROM MEMORANDUM FROM THE DIVISION OF INVESTMENT MANAGEMENT TO SEC CHAIRMAN LEVITT RE: MUTUAL FUNDS AND DERIVATIVE INSTRUMENTS**

September 26, 1994

The Honorable Edward J. Markey  
Chairman  
Subcommittee on Telecommunications and Finance  
Committee on Energy and Commerce  
U.S. House of Representatives  
2125 Rayburn House Office Building  
Washington, D.C. 20515

The Honorable Jack Fields  
Ranking Republican Member  
Subcommittee on Telecommunications and Finance  
Committee on Energy and Commerce  
U.S. House of Representatives  
2125 Rayburn House Office Building  
Washington, D.C. 20515

Dear Chairman Markey and Representative Fields:

Thank you for your letter dated June 15, 1994 concerning mutual fund use of derivatives. Your letter raises a number of important questions concerning the framework for the regulation and oversight of these activities. I share your concern for these important investor protection issues, and am particularly committed to finding improved ways for funds to communicate to shareholders the risks of investment.

Your letter requested that the Commission undertake a comprehensive study of the use of derivatives by mutual funds. I am enclosing a memorandum prepared by the Division of Investment Management that comprises the requested study.

Mutual funds are the investment vehicle of choice for funding Americans' essential needs—for educating their children, for retiring with dignity. The Commission considers the protection of mutual fund investors absolutely essential. We have been, and will be, vigilant in addressing the issues raised by mutual fund use of derivatives, and we look forward to working with you in this endeavor.

Sincerely,

Arthur Levitt  
Chairman

Enclosure

Memorandum

September 26, 1994

TO: Chairman Levitt

FROM: Division of Investment Management

RE: Mutual Funds and Derivative Instruments

This memorandum responds to a letter dated June 15, 1994 (the "Letter"), from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce ("Subcommittee"), requesting that the Commission undertake a study of the use of derivatives by mutual funds and, more particularly, the adequacy of laws and regulations governing their disclosure and use. The Letter raises questions about (1) Commission knowledge of mutual fund use of derivatives, (2) disclosure of mutual fund use of derivatives, (3) the effect of mutual fund competition on derivatives use, (4) mutual fund pricing of derivatives, (5) liquidity of derivatives held by mutual funds, (6) leverage available to mutual funds through derivatives, (7) risks faced by investors in bank-advised mutual funds, and (8) derivative use by money market funds.

As you are aware, investor protections issues raised by mutual fund use of derivatives have received heightened attention by the Commission since you became Chairman. You have urged fund directors and trustees to exercise meaningful oversight of fund derivative investments and have encouraged the management of every fund using derivatives to manage their derivatives risks effectively. In addition, you have directed the Division to make mutual fund use of derivatives a priority – in the disclosure review process, in fund inspections, and in policy considerations. In responding to the Letter, this memorandum also reviews the steps taken to date by the Commission and the Division to address investor protection issues raised by mutual fund use of derivatives and describes the further actions that the Division recommends.

#### **4. Are Mutual Funds Experiencing Problems Pricing Exotic Derivatives?**

##### **a. Pricing requirements**

Mutual fund share pricing policies and practices are governed generally by Sections 2(a)(41) and 22(c) of the Investment Company Act and Rules 2a-4 and 22c-1 thereunder.<sup>1</sup> Section 22(c) provides the Commission with the authority to make rules governing the methods for computing the prices for mutual fund shares. Rule 22c-1 provides in part that a mutual fund may not sell or redeem its securities "except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."<sup>2</sup>

Rule 22c-1 generally provides that the current net asset value of a mutual fund's securities must be calculated every business day during which an order is received either to purchase or redeem a share of the fund.<sup>3</sup> Section 2(a)(41) and Rule 2a-4 require a fund to mark its assets to market in computing net asset value. In the marking to market process, market quotations are required to be used for those securities for which the quotations are readily available. For all other securities and assets, a fund is required to use fair values as determined in good faith in accordance with procedures approved by its board of directors or trustees.<sup>4</sup>

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<sup>1</sup> 5 U.S.C. § 80a-2(a)(41), -22(c); 17 C.F.R. §270.2a-4, .22c-1.

<sup>2</sup> 17 C.F.R. § 270.22c-1(a).

<sup>3</sup> 17 C.F.R. § 270.22c-1(b)(1).

<sup>4</sup> 15 U.S.C. § 80a-2(a)(41)(B); 17 C.F.R. § 270.2a-4(a)(1); Restricted Securities, Investment Company Act Release No. 5847 (Oct. 21, 1969) [hereinafter Release 5847].

## b. Pricing v. price reporting

Before addressing the issue of mutual fund pricing of derivative investments, we believe it would be useful to distinguish between pricing and price reporting.<sup>5</sup> Although the Investment Company Act, and thus the Commission, regulate the pricing of fund shares in the manner described above, neither the Investment Company Act nor the Commission regulates—or even requires—the reporting of share prices to the news media. The incident referred to in the Letter, the absence of a reported price in the morning paper for a fund with derivative investments, is not the subject of either federal law or Commission regulation and is a separate issue from the question of whether purchasing and redeeming shareholders receive the correct price for their shares. Although share prices may be unreported because they are not calculated in time to meet newspaper deadlines, and the presence of certain derivatives in a fund’s portfolio may make it more difficult to meet publication deadlines, this does not mean that investors receive an incorrect price upon redemption, or pay an incorrect price at purchase.<sup>6</sup>

## c. Pricing and derivatives

The obligation of a mutual fund to calculate daily net asset value accurately for purposes of share sales and redemptions is critical to investor confidence. If net asset value is incorrectly computed, purchasing or redeeming shareholders may pay or receive too little or too much, and the interests of shareholders may be overvalued or diluted. The accurate valuation of each portfolio asset, including derivative instruments, is the foundation for computing fund net asset value.

Funds normally obtain market quotations from one or more sources, such as last sale prices reported by service vendors or bid and asked quotations supplied by market makers. Many derivatives may be priced in this manner. Exchange-traded derivatives, such as futures and exchanged-traded options, for example, generally can be priced based on last sale prices or market quotations.

Prior to purchasing an instrument, derivative or otherwise, a mutual fund typically evaluates the availability of market prices for the instrument. If market quotations are not readily available for the instrument, the fund must be prepared to use fair value as determined in good faith in accordance with procedures approved by its board of directors or trustees. When a fund decides to purchase an instrument, it typically will have determined either that market quotations are readily available or that it can implement fair value procedures. This decision-making process acts as a brake on a fund’s acquisition of an instrument when it is evident, from the outset, that pricing will be problematic.

Market conditions change over time, and a fund may find that an instrument that had readily available market prices when it was acquired ceases to have such price availability. This appears to have been the situation during recent months in the mortgage-backed securities market, where decreased liquidity has resulted in the deterioration of accurate market pricing information for some derivative securities—such as certain collateralized mortgage obligations. In these circumstances, it may be more difficult to establish reliable prices.<sup>7</sup>

The changing nature of markets makes it difficult, if not impossible, to ensure that mutual funds will never purchase instruments that become illiquid and, consequently, difficult to price. Nevertheless, the statutory and regulatory pricing requirements discussed above, together with the liquidity requirements discussed in response to question 5, act as significant checks on mutual fund investments in instruments that are difficult to price. Indeed, fund sponsors face

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<sup>5</sup> A fuller discussion of this issue appears in our August 22, 1994 Memorandum on Mutual Fund Share Price Reporting, responding to a letter dated June 30, 1994, from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunication and Finance of the House Committee on Energy and Commerce.

<sup>6</sup> Chairman Levitt recently requested that the National Association of Securities Dealers, Inc. (“NASD”), and the Investment Company Institute (“ICI”) address issues relating to fund price reporting. Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink, President, ICI (June 28, 1994). The NASD and the mutual fund industry have taken some steps to alleviate the time pressures and technological problems that may result in reporting problems, including an extension of the NASD’s price reporting deadline, and are considering others. See Letters from Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink, President, ICI, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission (July 13, 1994). We are monitoring further developments in this area and working with the NASD and the mutual fund industry to ensure that the reporting system serves the interest of investors in obtaining accurate price information.

<sup>7</sup> See, e.g., Paine Webber Fund, *supra* note 5; Robert McGough, Baird Fund Spurs Worries About Pricing, Wall St. J., Aug. 15, 1994, at C1 [hereinafter Baird Fund].

substantial liabilities for pricing errors. In those instances when fund transactions occur at incorrect prices, it is the Division's policy that errors should be corrected when discovered, and fund sponsors should reimburse shareholders who have experienced a material economic loss due to the errors. Fund sponsors' own economic interests therefore militate against significant use of instruments that will cause pricing problems.

In order to provide assurances of price accuracy, funds typically employ extensive control procedures. For many funds, the control process begins with the use of independent pricing services to value fund holdings. Because pricing services compete for business, it is in their best interests to provide accurate prices. At the fund level, validation procedures, tolerance checks, and other reviews are often employed to test and control the validity of pricing.<sup>8</sup>

The Division does not believe that legislative changes are needed at this time to address pricing issues raised by derivatives. The Division intends, however, to continue to evaluate pricing issues in our inspections and will perform targeted examinations to obtain more information on these issues. If appropriate, we will consider issuing rules to address proper procedures for pricing determinations.

## 5. Are Mutual Funds Experiencing Liquidity Problems Because of Exotic Derivatives?

### a. Does the Commission believe that some of the more exotic and volatile derivatives should be considered "illiquid?" Has the Commission considered whether the 15% rule should be applied to any types of derivative products?

Section 22(e) of the Investment Company Act generally requires that a mutual fund make payment for redeemed shares within seven days after the tender of the shares.<sup>9</sup> Because mutual funds hold themselves out to investors as being prepared at all times to meet redemptions within seven days, it is essential that funds maintain investment portfolios that will enable them to fulfill this obligation. For this reason, and because the extent of redemption demands are not predictable, mutual funds must maintain highly liquid portfolios.<sup>10</sup>

The Commission has published a guideline requiring that mutual funds generally limit their investments in illiquid assets to 15% of net assets. The guideline limit is 10% in the case of money market funds.<sup>11</sup> An asset is considered "illiquid" if a fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the instrument.<sup>12</sup>

On occasion, the Commission and the Division have taken the position that certain classes of instruments are generally illiquid.<sup>13</sup> Generally, however, the determination of whether a particular mutual fund asset, including a derivative instrument, is illiquid should be made under guidelines and standards established by the fund's board of directors or

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<sup>8</sup> For example, many funds employ automated exception reports that compare the current day's price for each portfolio instrument to the previous day's closing price and note any instrument that has changed by more than a preset limit. A second typical procedure identifies any portfolio instrument price changes that cause the fund's share price to move more than a preset amount. A third common procedure compares portfolio transaction prices to price quotations obtained from pricing services and/or dealers. A fourth procedure involves portfolio manager review of the "price-make-up sheet," the detailed listing of each instrument held by the fund and the associated price. At the share price level, changes in share price are compared to changes in comparable indices to assure reasonableness. Price changes that exceed preset levels must be reverified and explained before they are entered into the accounting system for share price computation. Fund pricing staff may also look for corporate actions, news stories, or other developments to explain price changes.

<sup>9</sup> 15 U.S.C. § 80a-22(e). This requirement does not apply during any period that (1) the New York Stock Exchange ("NYSE") is closed other than customary weekend and holiday closings or trading on the NYSE is restricted; (2) an emergency exists as a result of which disposal by the fund of securities owned by it is not reasonably practicable or it is not reasonably practicable for the fund fairly to determine the value of its net assets; or (3) the Commission permits for the protection of shareholders of the fund. *Id.*

<sup>10</sup> See Release 5847, *supra* note 43.

<sup>11</sup> See Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992), 57 FR 9828 (raising guideline for non-money market funds from 10% to 15% to facilitate capital raising by small businesses) [hereinafter Release 18612]; Letter from Marianne K. Smythe, Director, Division of Investment Management, to Matthew P. Fink, President, Investment Company Institute (Dec. 9, 1992) (clarifying that change in limit from 10% to 15% does not apply to money market funds); Release 5847, *supra* note 43, at 7.

<sup>12</sup> Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986), 51 FR 9773, 9777; Guidelines for Form N-1A, Guide 4.

<sup>13</sup> Release 5847, *supra* note 43 (restricted securities generally illiquid).



trustees.<sup>14</sup> Examples of factors that may be taken into account in determining liquidity include (1) the frequency of trades and quotes for the instrument, (2) the number of dealers willing to purchase or sell the instrument and the number of other potential purchasers, (3) dealer undertakings to make a market in the instrument, and (4) the nature of the instrument and the nature of the marketplace in which the instrument trades, including the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer.<sup>15</sup> Ultimate responsibility for liquidity determinations rests with the fund's board, but the board may delegate the day-to-day function of determining liquidity to the fund's investment adviser, provided the board retains sufficient oversight.<sup>16</sup>

The Division believes that particular derivative instruments may be illiquid under all or most market conditions. This will more likely be the case if a derivative is designed to meet the needs of a particular investor. Such a derivative, almost by design, would not have the broad market required to support a finding that the instrument is liquid. The liquidity of other derivative instruments, however, may vary depending on market conditions. An instrument that is liquid in one market environment may become illiquid in another market environment. This has recently been the case, for example, for certain collateralized mortgage obligations. Recent interest rate increases and full dealer inventories apparently caused markets for these instruments virtually to disappear, leaving previously liquid instruments illiquid.<sup>17</sup>

Fund management's obligation to make liquidity determinations is a continuing one in the case of instruments, including derivatives, whose liquidity may vary under different market conditions. If changed market conditions result in previously liquid portfolio holdings becoming illiquid, fund management should determine whether any steps are required to assure that the fund continues to meet the 15% guideline.<sup>18</sup>

We note that, in general, there is a close relationship between the liquidity of an instrument, derivative or otherwise, and the ease with which the instrument may be priced, the subject of question 4. If a security trades in a liquid market, there is a strong likelihood that reliable market prices will be readily available. Conversely, reliable prices for securities traded in an illiquid market are often difficult to obtain.

#### **b. Has the Commission considered whether the 15% figure itself should be revisited?**

In 1992, the Commission raised the limit on illiquid assets from 10% to 15% for non-money market funds to facilitate capital raising by small businesses.<sup>19</sup> The limit for money market funds remains 10%. Recent illiquidity in the market for certain mortgage derivatives raises once again the question of what limit is appropriate.<sup>20</sup>

The Division has been focusing on the illiquid assets limit in its inspections of mutual funds to determine whether funds are complying with the limit on an ongoing basis, whether funds are holding illiquid investments to the maximum amount permitted, and whether there is a need to reduce the limit. We recommend that the Commission act promptly to consider reducing the ceiling.

<sup>14</sup> See Merrill Lynch Money Markets Inc. (pub. avail. Jan. 14, 1994) (commercial paper issued in reliance on registration exemption in section 4(2) of Securities Act of 1933); Letter from Carolyn B. Lewis Assistant Director of Investment Management, to Investment Company Registrants (Jan. 17, 1992) (government-issued interest-only and principal-only securities backed by fixed-rate mortgages, municipal lease obligations); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Catherine L. Heron, Investment Company Institute (June 21, 1991) (municipal lease obligations) [hereinafter ICI letter]; Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990), 55 FR 17933, 17940-41 (Rule 144A securities, foreign securities) [hereinafter Release 17452].

<sup>15</sup> See Release 17452, *supra* note 53, at 55 FR 17940-41; ICI Letter, *supra* note 53, at 1.

<sup>16</sup> Release 17452, *supra* note 53, at 55 FR 17940 n.61.

<sup>17</sup> See, e.g., Saul Hansell, Markets in Turmoil: Investors Undone: How \$600 Million Evaporated—A Special Report; Fund Manager Caught Short By Crude and Brutal Market, N.Y. Times, Apr. 5, 1994, at A1 [hereinafter Markets in Turmoil].

<sup>18</sup> Release 17452, *supra* note 53, at 55 FR 17940 n.61.

<sup>19</sup> Release 18612, *supra* note 50.

<sup>20</sup> See, e.g., Baird Fund, *supra* note 46; Robert McGough & Anita Raghavan, PaineWebber Again Props Up Bond Fund, Wall St. J., July 25, 1994, at C1 [hereinafter PaineWebber Again Props Up Bond Fund].



June 15, 1994

The Honorable Arthur Levitt, Jr.  
Chairman  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C.

Dear Chairman Levitt:

Pursuant to Rules X and XI of the United States House of Representatives, and this Subcommittee's continuing responsibility to oversee the nation's mutual fund industry, we write to request that the Commission undertake a comprehensive study of the growing use of derivatives by mutual funds, and more particularly, the adequacy of laws and regulations governing their disclosure and use. We believe that such a study is warranted in light of a small but growing number of reports of substantial losses apparently attributable to derivatives holdings at certain mutual funds. Some of these losses were apparently incurred rapidly, and, more importantly, occurred at funds, such as short-term government bond funds and money market funds, which many individuals believe to be cautious and conservative (though obviously not entirely risk-free) investments.

As you may recall, we have discussed the general subject of derivatives and mutual funds several times during your tenure at the Commission. The first time was during the Subcommittee's oversight hearing on the fund industry in August 1993, when Chairman Markey asked whether some risks associated with derivatives were so substantial as to justify the consideration of limits on a fund's ability to include them as part of its portfolio. We addressed related issues at the Subcommittee's hearing several weeks ago, when we reviewed the conclusions and recommendations of a two-year General Accounting Office study (the GAO study) of how best to manage and oversee the risks associated with derivatives.

In your written testimony submitted in connection with the Subcommittee's hearing on the GAO study, you observed that the Commission's inspections of investment companies (as well as a recently conducted survey) appeared to indicate that derivatives have a limited though apparently growing role in the operation of some mutual funds, particularly fixed income funds. This conclusion is neither surprising nor, in general terms, unwelcome. As you know, we share your belief that many derivative financial products play an essential role in hedging against risks created by fluctuating interest and currency exchange rates. Other derivatives often are useful in reducing exposure to potential price changes in various equities or commodities.

It is now abundantly clear, however, that derivatives can create risk as well as hedge against it. And for a variety of reasons, derivatives can sometimes create an extraordinary amount of risk virtually overnight. A recent story in *Time* magazine quoted a derivatives dealer and effectively illustrated the dichotomy between hedging and speculation. The dealer said that "[w]e are almost equally divided between two groups of customers—one that wants to protect everything it has and the other that wants to make a 200% killing overnight."<sup>1</sup> Obviously, to the extent that mutual funds engage in speculative derivatives activity involving volatile derivatives instruments, they pass the risk on to their shareholders around the country.

To respond to the concerns that have recently been raised, the Subcommittee requests that the Commission undertake a comprehensive study of the use of derivatives by open-end investment companies. The study should, of course, address every issue related to the use of derivatives by mutual funds that the SEC deems to be important to its mission of protecting investors and promoting the integrity and health of the industry. The study should also respond to the following specific Subcommittee concerns:

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<sup>1</sup> Similarly, a recent Institutional Investor survey of pensions fund officers revealed that 27% use derivatives primarily to enhance the fund's returns. An additional 37% viewed enhancing returns as equal in importance to hedging against risk.

#### **4. Are Mutual Funds Experiencing Problems Pricing Exotic Derivatives?**

As you know, the establishment of a daily net asset value is one of the core requirements of the Investment Company Act of 1940, a bedrock part of the fund industry, and no doubt one of the key reasons for its great success. But the esoteric derivatives held by one fund that recently reported dramatic losses were apparently so complex that on some days, the firm couldn't establish their value. If we understand that particular issue properly, when that fund's investors turned to their morning paper to see the value of their mutual fund shares, they saw a blank line. The Subcommittee believes serious analysis should be given to financial products that are so exotic, risky and illiquid that they might interfere with the absolutely essential function of establishing a daily price for fund shares.

#### **5. Are Mutual Funds Experiencing Liquidity Problems Because of Exotic Derivatives?**

Liquidity is obviously of enormous importance to mutual funds, because investors are entitled to redeem their shares at any time. That is one reason why the SEC expressly requires that a fund hold no more than 15% of its assets in illiquid instruments. Some have argued that the reason one fund complex agreed to inject ten million dollars of its own capital into their fund was to ease the liquidity problems that they had been encountering as they sought to unwind the fund's CMOs. While we don't know the details about these particular CMOs, we do know that some derivatives are custom designed for use by a single institution, which would seem to greatly reduce their liquidity. Does the Commission believe that some of the more exotic and volatile derivatives should be considered "illiquid"? Has the Commission considered whether the 15% rule should be applied to any types of derivative products, or whether the 15% figure itself should be revisited?

Sincerely,

Edward J. Markey  
Chairman

Jack Fields  
Ranking Republican Member

## UNITED MUNICIPAL BOND FUND

### Staff Response

January 27, 1995

Catherine S. Bardsley, Esq.  
Kirkpatrick & Lockhart  
1800 M Street, N.W.  
Washington, D.C. 20036-5891

Re: United Municipal Bond Fund (pub. avail. July 30, 1992)

Dear Ms. Bardsley:

By letter dated October 29, 1991,<sup>1</sup> United Municipal Bond Fund, Inc. and United High Income Fund, Inc. (the "Funds") requested the staff's assurance that it would not recommend enforcement action to the Commission under Section 17(a) of the Investment Company Act of 1940 ("1940 Act") if the Funds, in reliance on Rule 17a-7 under the 1940 Act, bought and sold between themselves municipal bonds for which market quotations are not readily available. The Funds proposed to value the bonds by using the price provided by the Funds' independent pricing service for purposes of calculating net asset value under Rule 2a-4 under the 1940 Act. The staff granted the Funds no-action relief in United Municipal Bond Fund (pub. avail. July 30, 1992), but not on the terms requested. Instead, the staff required that the Funds value the municipal bonds by averaging prices obtained from at least three independent matrix pricing services, or by averaging three independent bid prices, or by averaging three prices obtained from some combination of pricing services and bid prices.

By letter dated October 18, 1994, you requested that the staff reconsider its position, and permit the Funds to buy and sell certain municipal bonds between themselves using the price provided by their independent pricing service, as proposed in the Funds' initial no-action request. You state that taking the average of prices provided by pricing services, bid prices, or some combination thereof results in an artificial gain or loss for the purchasing or selling Fund because the average price is unlikely to be the same as the price that the Fund uses to compute net asset value. Moreover, completing the transaction using the average of two or three bid prices always will be disadvantageous to the seller of the security.

You believe that the use of the Funds' pricing service to price transactions between the Funds provides a reliable method of determining the value of the securities, particularly in view of the steps the Funds take to verify the accuracy of the prices quoted. The Funds' use the prices provided by an independent pricing service, Muller Data Corporation ("Muller"), to value their municipal bonds for purposes of Rule 2a-4. Muller's staff determines the price of a particular security by "hand pricing," which consists of gathering market information about that security (e.g., trade execution data and the latest bid and ask quotes for the security, as well as information about offerings of similar securities).<sup>2</sup> The Funds' adviser, Waddell & Reed (the "Adviser"), regularly tests the overall accuracy of Muller's pricing system. Each week, the Adviser obtains prices from another pricing service for those securities that represent 1% or more of the net assets of each of its funds that use Muller's pricing service. The Adviser compares the total of the alternate prices to the total of Muller's prices.<sup>3</sup> Further, each Fund's board annually reviews and approves the use of Muller and the Adviser's testing methodology. In addition, the Funds' independent auditor, Price Waterhouse, as part of its annual review of the Funds'

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<sup>1</sup> See Letter to Municipal Bond Fund (pub. avail. July 30, 1992).

<sup>2</sup> On November 9, 1994, the Commission approved a program by the Municipal Securities Rulemaking Board to make pricing information available to investors. Securities Exchange Act Release No. 34955 (November 9, 1994), *59 FR 59810* (order approving file No. SR-MSRB-94-09). Under the first phase of the program, reports of inter-dealer transactions and daily high-low and average price figures for the most frequently traded issues will be made public. Under phase two and phase three of the program, these requirements will be expanded to include institutional customer transactions and retail transactions. Finally, the program will implement more contemporaneous reporting of transaction information. We expect that such information will be utilized by pricing services and persons charged with evaluating the performance of pricing services as it becomes available.

<sup>3</sup> You state that the Adviser believes that its testing methodology is accurate and that it would promptly consider alternatives if, in the future, its methodology did not accurately test Muller's prices.

internal control structure, tests the reliability of Muller's pricing system. Specifically, Price Waterhouse compares the aggregate of Muller's prices with the aggregate of the alternate prices from its own pricing module.

The Funds are not requesting relief with respect to transactions involving municipal bonds with an embedded swap, cap or floor, or other derivative structure that would impair the liquidity of the bond because of the customized nature of the structure, the information (or lack thereof) available about the bond, or other factors. The Adviser will determine whether a bond should be excluded on the basis of this description, subject to the general review and oversight by each Fund's board of directors. You also state that the Funds will not rely on the staff's no-action position to engage in transactions in municipal bonds that the Adviser knows or has reason to know are in default, including those that are in technical default.<sup>4</sup>

The staff agrees to modify the pricing condition in the original no-action relief granted to the Funds, and, accordingly, would not recommend that the Commission take any enforcement action under Section 17(a) if the Funds buy and sell portfolio securities between themselves using a price provided by the pricing service that values the Funds' municipal bonds for Rule 2a-4 purposes, provided that the Funds comply with the conditions in your October 18, 1994 letter and above.<sup>5</sup>

Sincerely,

Jana M. Cayne  
Attorney  
Office of Chief Counsel

### **Incoming Letter**

October 18, 1994

#### **VIA MESSENGER**

Amy R. Doberman, Esq.  
Special Counsel  
Division of Investment Management  
Securities and Exchange Commission  
450 5th Street, N.W.  
Washington, D.C. 20549

Re: Your Ref. No. 91-536-CC

United Municipal Bond Fund, Inc.

United Municipal High Income Fund, Inc.

Dear Ms. Doberman:

This letter is to respond to the issues raised in the telephone conference call August 12, 1994, regarding the request of United Municipal Bond Fund, Inc., and United Municipal High Income Fund, Inc. ("Funds") for no-action assurance as to the application of Rule 17a-7 under the Investment Company Act of 1940 ("1940 Act") and the staff's above-referenced response. In that call, the staff requested that the Funds: (a) make certain changes in their proposed definition of an embedded derivative for purposes of determining which municipal bonds are to be excluded from the relief requested; (b) address further the testing of the prices from the pricing service used by the Funds; and (c) provide a consolidated statement of the facts and discussions contained in the prior letters submitted on behalf of the Funds since the issuance of the staff's initial response.

<sup>4</sup> Confirmed in a telephone conversation between Catherine Bardsley and Amy Doberman, November 3, 1994.

<sup>5</sup> The other conditions to no-action relief that were included in the original no-action letter remain unchanged.

As presented more fully below, the Funds agree to the staff's requested revisions to the definition of embedded derivatives and have provided further information as to the testing of the pricing service's prices. This letter also consolidates the substance of my prior letters of April 20, 1993 and January 4, 1994 to Thomas S. Harman and of June 22, 1994 to Jana M. Cayne (copies of which letters are attached for your reference). As in each of those prior letters, the Funds respectfully request that the staff re-evaluate its no-action response and modify that response to permit the Funds to use the price provided by an independent pricing service as the current market price for purposes of compliance with Rule 17a-7.

## Background

By letter dated October 29, 1991, the Funds requested that the staff provide assurance that it would not recommend enforcement action if the Funds between themselves buy and sell municipal bonds at the prices provided by the independent pricing service which is also used by each Fund to value the municipal bonds in its portfolio for purposes of Rule 2a-4 under the 1940 Act. The staff's response, which was sent to the Funds and made publicly available on July 30, 1992, stated that the staff would not recommend enforcement action under Rule 17a-7 if, as the first of five conditions set forth in the response:

(1) the municipal bonds are valued by averaging prices obtained from at least three independent matrix pricing services, or by averaging three independent bid prices, or by averaging three prices obtained from some combination of independent pricing services and independent bid prices; [footnote omitted] . . .

(Copies of the respective request and no-action letters are enclosed for your reference.) Shortly thereafter, at the Funds' request, I spoke with Ms. Cayne about whether in certain circumstances, the number of prices required to be averaged could be reduced from three to two.

This possibility was not pursued further by the Funds because, after the first transaction in accordance with the no-action letter, it became apparent that there was a more fundamental problem with the averaging approach itself. Specifically, in a sale made in reliance on the no-action letter and at a price determined by averaging two independent bid prices and one price from an independent pricing service, the selling Fund experienced a loss, because each of the bid prices, and therefore the average of the three prices, was lower than that provided by the pricing service (whose price, had there been no sale, would have been used for the Fund's valuation pursuant to Rule 2a-4).<sup>1</sup> Waddell & Reed Investment Management Company, the investment adviser to each Fund, thereafter informed the Directors of the Funds that it would investigate further the impact of the averaging approach and that until the issue was resolved to the satisfaction of the Funds, no further transactions would be made in reliance upon the no-action letter.

## Specific Issues

### Artificial Gain or Loss

As previously expressed in telephone conversations with the staff and in my letter of April 20, 1993, the Funds believe that implementation of the first condition set forth in that response disadvantages one, and possibly both, of the parties to the transaction in that the execution price prescribed by that condition results in an artificial element of gain or loss on the transaction. This gain (or loss) is artificial for two reasons. One is that the prescribed execution price rarely, if ever, will be the price at which the particular securities would otherwise be traded with an unaffiliated counter-party. In addition, the gain or loss is artificial because the execution price is calculated differently from the method used by the Funds in calculating net asset value per share. As a result, the purchaser (as opposed to the seller) will have an immediate and unintended, unrealized gain or loss. The use of a price based on the average of three prices, as required under the first condition of the no-action letter, creates an element of gain or loss that is economically artificial but nonetheless has real, adverse tax and accounting effects to the Funds and their respective shareholders.

For purposes of Rule 2a-4 under the 1940 Act each Fund typically values the municipal bonds held in its portfolio on the basis of prices provided by an independent pricing service. The problem with the first condition of the no-action letter is simply that, in virtually all cases, the price derived from the average of three numbers will be different from any one of

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<sup>1</sup> The Fund did not suffer any actual loss because an amount representing the difference between the sale price and the price provided by the pricing service was promptly paid to the Fund by the Fund's investment adviser.

the three. Certainly this differential does not represent a better or more accurate market-based valuation but does result in more or less gain or loss on a sale transaction. The problem is illustrated by the following example:

Fund A has a municipal bond in its portfolio that it purchased at par (100.00) and is currently priced at 105.00 by Fund A's independent pricing service. In order to sell the bond to Fund B under the no-action letter, Fund A obtains two independent bids, 105.00 and 104.00, which when averaged with the price from the pricing service, produce a price of 104.66.

Using a sale price of 104.66 results in a gain of 4.66; had the pricing service price been used as the sale price, the gain to Fund A would have been 5.00. Fund A's net asset value is also 0.34 less using the average than it would have been using the price provided by the pricing service (which would have been used to value the bond had it not been sold). There is a corresponding impact on Fund B. If 104.66 is the initial value of the bond in Fund B's portfolio, Fund B will have a built-in potential gain or loss of 0.34 simply by virtue of the differential between the averaged price and the pricing service valuation. Thus, when Fund B next determines its net asset value and values the bond at the price provided by the independent pricing service (assume 105.00 or higher), Fund B's net asset value will reflect an increase of 0.34 which is artificial in that it derives solely from the change in pricing methodology. Thus, the pricing methodology prescribed in the first condition of the no-action letter creates an artificial element of gain or loss to each party that distorts the economic reality of the transaction.

In condition one of the no-action letter, the staff may have sought to parallel the approach in section (b)(4) of the Rule 17a-7, i.e., using the average of the highest current independent bid and lowest current independent offer. Rule 17a-7(b)(4) may reflect the appropriate valuation for securities whose values under Rule 2a-4 are derived according to that methodology. It is not, however, an appropriate methodology for securities which regularly use a different valuation method such as an independent pricing service.

To apply the general methodology of Rule 17a-7(b)(4), as reflected in condition one, so as to require a Fund to use a different methodology for inter-fund transactions than the Fund does for Rule 2a-4 net asset value determinations serves no policy purpose and instead has unwarranted and adverse consequences to the Fund and its shareholders. Indeed, it seems contrary to the policy underlying Rule 17a-7 that two funds with the same pricing policy that enter into a cross-transaction could not use that pricing policy and instead must use a different pricing method that will almost always result in an immediate unrealized gain or loss to the purchaser together with a distortion of the seller's gain or loss. Accordingly, the Funds request that the staff permit the Funds to use the price provided by an independent pricing service which the Fund otherwise uses for Rule 2a-4 purposes as the current market price for purposes of compliance with Rule 17a-7.

### **Pricing Service**

Each Fund has, since its inception, used the prices provided by Muller Data Corporation ("Muller") to value the municipal obligations in the Fund's portfolio for purposes of Rule 2a-4 under the 1940 Act. In our discussions with Muller personnel, Muller has described its services to the Funds as "hand pricing" rather than "matrix pricing." Muller does not attempt to follow a general universe of municipal securities for its mutual fund clients, but rather, it has advised us, it follows only the securities in those clients' portfolios. Muller has a staff of evaluators to whom clients' securities are assigned, typically according to particular segments of the municipal market, such as pre-refunded bonds or general obligations. We understand that evaluators operate generally as follows: in the morning, an evaluator calls his or her contacts in the market (e.g., dealers and portfolio managers) to gather further information about recent trades, current bids, offerings of similar securities, general conditions or movements in the market or in particular market sectors, etc.; and in the afternoon, the evaluator makes an evaluation of each security for which he or she is responsible.

We have discussed with Muller personnel certain of the publicized concerns relating to municipal bonds with embedded derivatives and the attendant pricing issues. In this context, we note that Muller regards these issues as raised primarily by bonds with embedded swaps, caps or floors. This is in contrast to municipal bonds with common variable or floating rate features, which Muller characterizes as relatively easy to follow.

We understand, however, that dealers have responded to concerns regarding embedded derivatives by increasing the amount and frequency of information provided to services such as Muller and others in the secondary market. Muller



is one of the participants in the Task Force on Derivatives Information Standardization formed last fall by the Public Securities Association to study the standardization and dissemination of information on municipal bond derivatives.

### **Testing of Pricing Service Prices**

Waddell & Reed Investment Management Company (“Manager”), in its capacity as the investment adviser to each Fund, regularly tests the overall accuracy of Muller’s pricing system. Under its current procedures, each week the Manager obtains from another pricing service prices for those securities which represent 1% or more of the net assets of all funds advised by the Manager that use Muller’s pricing service. The total of these alternate prices is then compared to the total derived from Muller’s prices for the same securities. Under current procedures, on an annual basis each Fund’s Board of Directors reviews and considers the continuance of the use of the pricing service and the Manager’s testing methodology.

In addition, in connection with its annual review of the internal control structure for the Funds and the other funds for which it serves as independent accountants, Price Waterhouse tests the reliability of Muller’s pricing. Price Waterhouse uses its Automated Systems and Services for Investment Securities Transactions (“PW-ASSIST”) pricing module to evaluate the prices provided by Muller. Price Waterhouse compares the aggregate of the prices provided by Muller and the aggregate of the alternate PW-ASSIST prices. Where the difference is immaterial in relation to a fund’s net assets, Price Waterhouse is able to establish an independent basis for reliance that the prices provided by Muller are indicative of market value.

As reported in my letter of June 22, 1994, a then-recent, representative application of the 1% test performed by the Manager was as follows:

For United Municipal Bond Fund, Inc., 30 of a total of approximately 100 securities were tested, representing approximately \$400 million of a total \$1 billion in assets.

For United Municipal High Income Fund, Inc., 30 of a total of approximately 150 securities were tested, representing approximately \$90 million of a total \$350 million in assets.

In addition, please be advised that a recent representative application of the 1% test was follows:

For United Municipal Bond Fund, Inc., 31 of a total of approximately 205 securities were tested, representing approximately \$377 million of a total \$944 billion in assets.

For United Municipal High Income Fund, Inc., 28 of a total of approximately 191 securities were tested, representing approximately \$89 million of a total \$328 million in assets.

Further, the turnover rates, as stated in the annual reports for the respective Funds’ fiscal years ended September 30, 1989, through 1993, were as follows:

For United Municipal Bond Fund, Inc., the turnover rates were 226%, 181%, 144%, 125% and 94.5%, respectively.

For United Municipal High Income Fund, Inc., the turnover rates were 38%, 27%, 60%, 54% and 26%, respectively.

For the fiscal year ended September 30, 1994, the portfolio turnover rates were 62.6% (unaudited) for United Municipal Bond Fund, Inc., and 26.3% (unaudited) for United Municipal High Income Fund, Inc.

The Manager believes that its testing methodology provides a meaningful test of the overall accuracy of the prices provided by the pricing service used by the Funds. If the Manager were to determine this methodology did not meaningfully test that service’s prices, it would promptly consider the alternatives available and take such actions as it deemed necessary or appropriate, including notice to the Fund’s Board of Directors of the actions taken and or recommended.

### **Exclusion of Municipal Bonds with Embedded Derivatives**

In view of the concerns previously expressed by the staff regarding municipal bonds with embedded derivatives, the Funds had proposed limiting their original no-action request so as to exclude inter-Fund sales of municipal bonds with embedded derivatives from the scope of the relief requested. Based on our discussions with the staff with respect



to defining embedded derivatives for this purpose, the Funds agree that the municipal bonds to be excluded from the no-action relief requested by the Funds are those with an “embedded swap, cap or floor, or other derivative structure that would impair the liquidity of the bond because of the customized nature of the structure, the information (or lack thereof) available about the bond, or other factor(s).”

Each Fund anticipates that determinations as to a bond’s exclusion or eligibility would be made by its investment adviser, subject to the general review and oversight by the Board of Directors. It is the Funds’ understanding that certain types of municipal bonds with aspects which might technically be deemed “derivative,” such as those having a variable amount, adjustable rate or put feature, nevertheless do not necessarily present valuation concerns. Further, a determination that a bond had an embedded structure which “would impair liquidity” would not necessarily constitute a determination that the bond is illiquid for purposes of a Fund’s limitation on illiquid securities.

\* \* \* \*

We hope the foregoing is responsive to your requests and will enable the staff to permit the Funds, for purposes of Rule 17a-7, to treat the price provided by an independent pricing service, and which is the price otherwise used for Rule 2a-4 purposes, as the current market price of a municipal bond, other than a municipal bond with an embedded derivative.

If you have further questions or believe that there are further issues which remain to be resolved, please contact either the undersigned or Clifford J. Alexander at 202/778-9068.

Thank you for your consideration of this important matter for the Funds.

Very truly yours,

Catherine S. Bardsley

## EXCERPT FROM 1998 GUIDES TO FORM N-1A RELATED TO VALUATION

### Guide 4. Types of Securities

If an open-end company holds a material percentage of its assets in securities or other assets for which there is no established market, there may be a question concerning the ability of the fund to make payment within seven days of the date its shares are tendered for redemption. The usual limit on aggregate holdings by an open-end investment company of illiquid assets is 15 percent of its net assets, except money market fund investment in illiquid securities is limited to less than 10 percent of its net assets. An illiquid asset is any asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment.

### Guide 11. Underwriting Securities of Other Issuers

If an open-end company holds a material percentage of its assets in restricted securities, such holdings may raise questions concerning valuation and the ability of the company to make payment within seven days of the date its shares are tendered for redemption.

### Guide 28. Valuation of Securities Being Offered

Item 7 requires a registrant to identify in the prospectus the method used to value the assets. In some circumstances, value can be determined fairly in more than one way. For any asset traded on a national exchange, valuation normally should be based on market value when readily available.<sup>1</sup> If a security was traded on the valuation date, the last quoted sale price generally is used. In the case of securities listed on more than one national securities exchange, the last quoted sale, up to the time of valuation, on the exchange on which the security is principally traded should be used or, if there were no sales on that exchange on the valuation date, the last quoted sale, up to the time of valuation, on the other exchanges should be used.

If there was no sale on the valuation date but published closing bid and asked prices are available, the valuation in such circumstances should be within the range of these quoted prices. Some companies as a matter of general policy use the bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range of bid and asked prices considered best to represent value in that circumstance; each of these policies is acceptable if consistently applied. Normally, the use of the asked price alone is not appropriate. Where, on the valuation date, only a bid price or an asked price is quoted or the spread between bid and asked prices is substantial, quotations for several days should be reviewed. If sales have been infrequent or there is a thin market in the security, or the size of the reported trades is considered not representative of the fund's holding (as in the case of certain debt securities), further consideration should be given as to whether "market quotations are readily available." If it is decided that they are not readily available, the alternative method of valuation prescribed by Section 2(a)(41)—"fair value as determined in good faith by the board of directors"—should be used.

For debt or equity securities traded over-the-counter where closing prices are not readily available, quotations for a security should be obtained from more than one broker-dealer particularly if quotations are available only from broker-dealers not known to be established market-makers for that security. A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoted on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in that circumstance. The staff will consider any of these policies appropriate if consistently applied.

If the validity of the quotations appears to be questionable, or if the number of quotations is such as to indicate that there is a thin market in the security, further consideration should be given to whether "market quotations are readily

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<sup>1</sup> For debt securities, the staff is aware that registrants often value portfolio securities by reference to other securities which are considered comparable in rating, interest rate, due date, etc. (often called "matrix pricing") or rely on pricing services which use matrix pricing for valuation of these instruments. (Of course, a pricing service does not need to rely on a matrix to develop the prices it supplies to registrants.) Although the staff does not object to the use of matrix pricing or a pricing service by funds, registrants should be aware that it is their responsibility to ascertain that these methods are relying on the proper criteria in their valuation process.

available.” If it is decided that they are not readily available, the security should be considered one required to be valued at “fair value as determined in good faith by the board of directors.”

To comply with Section 2(a)(41) of the Act and Rule 2a-4 under the Act, the directors must satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and determine the method of arriving at the fair value of each such security. No single standard for determining “fair value in good faith” can be established, since fair value depends upon the circumstances of each individual case. As a general principle, the current “fair value” of an issue of securities being valued by the board of directors would be the amount which the owner might reasonably expect to receive for them upon their current sale.

Securities held under circumstances where the sale of such securities to the public would not be permissible without an effective registration statement under the Securities Act are considered securities for which market quotations are not readily available. They must, therefore, be valued in good faith by the board of directors. It would be improper for the board of directors to value these securities at the market quotation for unrestricted securities of the same class without considering other relevant factors, although this may be a factor considered in structuring the final valuation. The existence of a shelf registration for the restricted securities may be properly considered by the board of directors as another factor in the determination of the value of such securities, but there may not be an automatic valuation at market price on this factor alone.

The valuation of short sales of securities, which are not traded on a national exchange, can be at the asked price, that being the most conservative value, or the mean average of bid and asked prices. The use of bid price alone to value short position is not appropriate.

Certain securities trading practices such as reverse repurchase agreements, firm commitment agreements and standby commitment agreements require the consideration of special factors in connection with valuation. For example, changes in the value of a firm commitment agreement will affect the price at which shares of an investment company may be sold, redeemed or repurchased. Accordingly, directors, in determining fair value, must take care that no inaccuracies exist with regard to the valuation of such trading practices. In valuing standby commitments (puts), registrants using the amortized cost method of valuation should indicate that the acquisition of a standby commitment will not affect the valuation of the underlying security which will continue to be valued in accordance with the amortized cost method. The actual standby commitment will be valued at zero in determining net asset value. In such event, where the fund pays directly or indirectly for a standby commitment, its cost will be reflected as an unrealized loss for the period during which the commitment is held by the fund and will be reflected in realized gain or loss when the commitment is exercised or expires.<sup>2</sup>

The maturity of a municipal obligation purchased by the fund will not be considered shortened by any standby commitment to which such obligation is subject. Therefore, standby commitments will not affect the dollar weighted average maturity of the fund’s portfolio. [However, where a money market fund acquires a variable rate or floating rate municipal obligation having a demand feature which allows the fund unconditionally to obtain the amount due from the issuer upon notice of seven days or less, the maturity of the instrument will normally be the longer of the notice period for the commitment or the time remaining to the next rate adjustment.]

Money market funds with portfolio securities that mature in one year or less may use the amortized cost or penny rounding method to value their securities pursuant to the conditions of Rule 2a-7. If the portfolio of a money market fund is to be valued at amortized cost, there must be disclosure in the Statement of Additional Information in response to Item 19 concerning the effect of this method of valuation on the fund’s net asset value and yield as interest rates change and the corresponding dilution of shareholders’ interest.

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<sup>2</sup> There may be alternative methods of valuation of standby commitments, but in any event the value of the standby commitment together with the underlying security should not exceed the amount received by the fund upon disposal of the underlying security.

## INVESTMENT COMPANY INSTITUTE

December 8, 1999

Mr. Craig S. Tyle  
General Counsel  
Investment Company Institute  
1401 H Street, N.W.  
Washington, D.C. 20005

Dear Mr. Tyle:

As a result of recent events, we believe that it would be helpful to some open-end management investment companies (“mutual funds” or “funds”) to review their obligations to price and redeem fund shares during emergency or unusual situations. As you know, the ability to redeem fund shares is a primary consideration for mutual fund investors, especially during emergency or unusual situations. Because all funds may experience emergency or unusual situations at some point, we believe that it would be useful to review funds’ pricing obligations under the law, and to provide additional guidance to funds on their obligations to price and redeem their securities during these and other situations.

We discuss below three issues relating to funds’ responsibilities for pricing portfolio securities. First, we clarify that market quotations for portfolio securities are not readily available when the exchanges or markets on which those securities trade do not open for trading for the entire day, and that funds, accordingly, must price those securities based on their fair value (“fair value price”). Second, we provide additional guidance regarding the process of fair value pricing, and describe certain factors that funds should consider when fair value pricing portfolio securities. Finally, we discuss the obligations of fund boards of directors (“boards”) for fair value pricing securities, and discuss measures that boards may take when discharging those responsibilities.

### Section 22(e) and Rule 22c-1

The Investment Company Act of 1940 (“1940 Act”) requires mutual funds to price and redeem their shares at the net asset values (“NAV”) next computed after receipt of redemption requests, and to make prompt payment of redemption proceeds.<sup>1</sup> Generally, under the 1940 Act, funds may, but are not required to, suspend redemptions and postpone payment for redemptions already tendered for any period during which the New York Stock Exchange (“NYSE”) is closed. For purposes of Section 22(e) of the 1940 Act, the staff considers the NYSE to be closed on any day when it does not open for trading for the entire day. Whether the NYSE could otherwise be considered to be closed on any given day depends on the particular facts and circumstances of the situation. When funds encounter difficulties in selling or pricing their portfolio securities due to, among other things, market breaks, trading restrictions, internal fund failures, or natural disasters, Section 22(e) does not permit funds to suspend redemptions in the absence of certain determinations by the Commission.<sup>2</sup>

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<sup>1</sup> Section 22(e) of the 1940 Act generally prohibits mutual funds from suspending the right of redemption and prohibits funds from postponing the payment of redemption proceeds for more than seven days. Rule 22c-1(b) under the 1940 Act generally requires that a fund’s NAV be computed at least once daily, Monday through Friday, at a specific time or times as determined by the fund’s board.

<sup>2</sup> Section 22(e) also permits a fund to suspend redemptions in two other situations. First, a fund may suspend redemptions for any period during which trading on the NYSE is restricted, as determined by the Commission. Second, a fund may suspend redemptions for any period during which an emergency exists, as determined by the Commission, as a result of which it is not reasonably practicable for the fund to (1) liquidate its portfolio securities, or (2) fairly determine the value of its net assets. With respect to exigent circumstances that do not constitute an “emergency,” *see generally* Investment Company Act Rel. No. 14459 (June 6, 1985) (discussing instances in which funds are unable to complete the mechanical process of pricing on days when pricing would normally be required under Rule 22c-1, and methods that funds may employ to address those situations).

### Availability of Market Quotations

The 1940 Act requires mutual funds to value their portfolio securities by using the market value of the securities when market quotations for the securities are “readily available.”<sup>3</sup> When market quotations are not readily available, the 1940 Act requires fund boards to determine, in good faith, the fair value of the securities. These pricing requirements are critical to ensuring that the prices at which fund shares are purchased and redeemed are fair, and do not result in dilution of shareholder interests or other harm to shareholders.<sup>4</sup>

When the exchange or market on which a security is traded does not open for trading for an entire trading day, and no other market prices are available, we believe that market quotations for that security are no longer “readily available.” In such instances, funds holding securities traded on the closed exchange or market must fair value price those securities.<sup>5</sup> For example, following September’s earthquake in Taiwan, the Taiwan Stock Exchange (“TSE”) was closed for a number of days. We believe that under these circumstances, market prices for securities traded on the TSE were not “readily available” and that funds holding such securities were required to use fair value prices in determining NAV.<sup>6</sup> In anticipation of circumstances such as these, funds should consider adopting procedures that are designed to alert the board and fund management to conditions that may necessitate fair value pricing of portfolio securities.

### Fair Value Pricing

In recent years, commentators have suggested that we should provide additional or further guidance regarding pricing issues and the factors that fund boards should evaluate when fair value pricing a fund’s portfolio securities. These suggestions were primarily directed at ASR Nos. 113 and 118, which were issued by the Commission at a time when financial markets were less diverse and funds had fewer investment alternatives.<sup>7</sup> Although we recognize the limited scope of these ASRs, we also note that they were not intended to provide comprehensive guidance to funds on how to address all pricing issues, nor were they specifically addressed to emergency or unusual situations. ASR Nos. 113 and 118 were intended to provide general illustrative guidance on certain valuation issues, and we believe that they continue to represent the views of the Commission.<sup>8</sup>

The Commission has stated that, as a general principle, the fair value of a portfolio security is the price which the fund might reasonably expect to receive upon its current sale.<sup>9</sup> Ascertaining fair value requires a determination of the amount that an arm’s-length buyer, under the circumstances, would currently pay for the security. Fair value cannot be based on what a buyer might pay at some later time, such as when the market ultimately recognizes the security’s true value as

<sup>3</sup> Section 2(a)(41)(B) of the 1940 Act defines “value” as: (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board. This definition also is used in Rule 2a-4 under the 1940 Act as the required basis for computing periodically the current NAV of funds for the purpose of pricing their shares.

<sup>4</sup> For example, if fund shares are overpriced, redeeming shareholders will receive a windfall at the expense of shareholders that remain in the fund, and purchasing shareholders will pay too much for the shares. Similarly, sales of shares in a fund that has undervalued its portfolio would also have dilutive effects. See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. 136-38, 289 (1940); Accounting Series Release (“ASR”) No. 219 (May 31, 1977). Thus, pricing of fund portfolio securities based upon their current values is necessary to ensure fairness among all fund shareholders.

<sup>5</sup> We note that, in these circumstances, the determination that market quotations are no longer “readily available” does not preclude a fund’s board from concluding that the most recent closing market price represents fair value. We believe that the most recent closing market prices generally should be considered, along with other appropriate factors, when determining the fair value of securities for which current market quotations are not readily available.

<sup>6</sup> In situations such as the Taiwan earthquake, funds should pay particular attention to whether all issuers are affected by significant events similarly. For example, in the event of a natural disaster, funds that hold securities of affected issuers should, to the extent possible, make efforts to determine whether a particular issuer has been affected by that event differently from the damage inflicted generally.

<sup>7</sup> ASR No. 113, Financial Reporting Codification (CCH) § 404.04 (Oct. 21, 1969); ASR No. 118, Financial Reporting Codification (CCH) § 404.03 (Dec. 23, 1970).

<sup>8</sup> See, e.g., *Parnassus Investments*, Initial Dec. No. 131 (Sept. 3, 1998), initial dec. final (Oct. 8, 1998) (administrative law judge (“ALJ”) finding, among other things, that the fund’s directors failed to act in accordance with guidance provided in ASR Nos. 113 and 118 and failed to satisfy their good faith obligations when fair value pricing portfolio securities).

<sup>9</sup> See ASR Nos. 113 and 118, *supra* note 7; ASR No. 219, *supra* note 4.

currently perceived by the portfolio manager.<sup>10</sup> Funds also may not fair value price portfolio securities at prices which are not achievable on a current basis on the belief that the fund would not currently need to sell those securities.<sup>11</sup> Thus, bond or similar funds generally may not fair value price portfolio securities at par based on the expectation that the funds will hold those securities until maturity,<sup>12</sup> if the funds could not receive par value upon the current sale of those securities.<sup>13</sup>

This is not to say that fair value pricing is an inelastic concept. Indeed, ASR Nos. 113 and 118 recognize that no single standard exists for determining fair value in good faith. Instead, the Commission adopted a more flexible standard which requires fund directors to “satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security.” ASR No. 118 further states that “directors should take into account all indications of value *available to them* in determining the fair value assigned to a particular security” (emphasis added). Whether a factor is “appropriate,” and whether a particular indication of value is available, depends upon the particular facts and circumstances of the situation. Thus, during emergency situations, fund boards should evaluate as many relevant factors as they are able to under the circumstances.

ASR Nos. 113 and 118 suggest that fundamental analytical information is among the most important factors for fund boards to evaluate when fair value pricing portfolio securities. While we believe that an analysis of the value of the investment itself continues to be of primary importance in determining fair value, we also believe that in many situations fund boards may need to incorporate other, external sources of information in their fair value determinations. Information derived from world financial markets and various financial products, which can assist in establishing the value of portfolio securities or can provide indications as to the value of securities comparable to those in the portfolio, may be useful for fair value pricing in certain circumstances.

The following list of factors that fund boards may need to consider, if relevant, when fair value pricing portfolio securities is merely illustrative, and is not intended to preclude a board’s consideration of any other factors. The factors include: the value of other financial instruments, including derivative securities, traded on other markets or among dealers; trading volumes on markets, exchanges, or among dealers; values of baskets of securities traded on other markets, exchanges, or among dealers; changes in interest rates; observations from financial institutions; government (domestic or foreign) actions or pronouncements; and other news events. With respect to securities traded on foreign markets, the factors also might include the value of foreign securities traded on other foreign markets, ADR trading, closed-end fund trading, foreign currency exchange activity, and the trading prices of financial products that are tied to baskets of foreign securities, such as WEBS.<sup>14</sup>

We believe that a fund board, when fair value pricing portfolio securities in an emergency or other unusual situation, should evaluate the nature and duration of the event and the forces influencing the operation of the financial markets.

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<sup>10</sup> See *Parnassus*, *supra* note 8 (ALJ finding that a board’s valuation of a portfolio security based upon what the security would be worth upon the sale of the company as a going concern, when no such offers were forthcoming, was not determined in good faith).

<sup>11</sup> When investors redeem fund shares, they are entitled to obtain their proportionate amount of the value of the fund’s portfolio securities at the time that the transaction is effected. Similarly, when investors buy fund shares, they should not pay any more (or less) than the value of those shares at that time. See also note 4, *supra*.

<sup>12</sup> See ASR No. 219, *supra* note 4. In ASR No. 219, the Commission stated that it would not object if boards of certain funds determined, in good faith, that the fair value of their portfolio debt securities with remaining maturities of 60 days or less was equal to their amortized cost, unless an impairment to the creditworthiness of the issuers or other factors vitiated the accuracy of such amortized cost valuations.

<sup>13</sup> Unlike mutual funds, closed-end management investment companies (“closed-end funds”) are not obligated to redeem fund shares at NAV. Nonetheless, closed-end fund boards are required to fair value price portfolio securities in good faith and in accordance with the same principles that apply to mutual funds. Under Section 30(e) of the 1940 Act, closed-end funds must report their NAVs to fund shareholders semi-annually. They also typically report their NAVs in newspapers weekly. In addition, closed-end funds that periodically repurchase their shares in reliance on Rule 23c-3 under the 1940 Act are required to compute NAV in connection with each repurchase offer. The failure to report accurate NAVs may result in the market being misled and investors buying and selling fund shares at market prices that are based, in part, on inaccurate NAVs. In addition, an adviser’s receipt of advisory fees that are based on inflated NAVs may raise issues under, among other things, Sections 15(c) and 36(b) of the 1940 Act, and Section 206 of the Investment Advisers Act of 1940.

<sup>14</sup> We understand that in connection with the extreme volatility that occurred in world financial markets in October 1997, certain funds used a variety of indicators and benchmarks to fair value price their Asian portfolio securities, including news items, the bids on baskets of securities, ADR trading, closed-end fund trading, and futures on the securities indices of certain countries.



The board also should evaluate factors relating to the event that precipitated the problem, whether the event is likely to recur, whether the effects of the event are isolated or whether they affect entire markets, countries, or regions. We believe that, at a minimum, fund boards should consider how factors, such as those listed above, or other, similar factors, to the extent relevant, may assist in fair value pricing portfolio securities.

### The Board's "Good Faith" Responsibilities

The development of world financial markets and the proliferation of new financial products have both simplified and complicated a board's responsibilities when fair value pricing portfolio securities. Access to information regarding global financial markets, as well as instantaneous communications, are continually raising the amount of current and accurate information in the marketplace. New markets and products, such as those discussed above, provide alternative pricing indicators and benchmarks, which can ease the task of fair value pricing. Conversely, these new sources of information also have increased significantly the number of factors that a mutual fund board may need to evaluate when fair value pricing portfolio securities. This, in turn, provides additional challenges to fund directors, who may have to consider numerous alternatives when making complex decisions under tight time constraints.<sup>15</sup>

We also recognize that different fund boards, or funds in the same complex with different boards, when fair value pricing identical securities, could reasonably arrive at prices that were not the same, consistent with the boards' obligation to fair value price in good faith.<sup>16</sup> We believe that "good faith" is a flexible concept that can accommodate many different considerations, including the incorporation of a variety of sources of information. Finally, we believe that the specific actions that a mutual fund board must take in order to satisfy its good faith obligation under Section 2(a)(41) of the 1940 Act will vary, depending on the nature of the particular fund, the context in which the board must fair value price, and, importantly, the pricing procedures adopted by the board.

Some commentators have suggested that, in light of the changes in securities and markets, mutual fund boards are ill-equipped to fair value price portfolio securities and that the obligations placed on boards by the 1940 Act are unworkable. Mutual fund boards, however, typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities. Most boards fulfill their obligations by reviewing and approving pricing methodologies, which may be formulated by the board, but more typically are recommended and applied by fund management. In reviewing and approving pricing procedures, boards should determine whether those methodologies and procedures are reasonably likely to result in the valuation of securities at prices which the funds could expect to receive upon their current sale. Mutual funds also may use a number of other techniques to minimize the burdens of fair value pricing on their directors. For example, a number of funds delegate certain responsibilities for fair value pricing decisions to a valuation committee. Such committees generally assist the board in developing methodologies by which fair values are to be calculated, and implement the board-approved methodologies on a day-to-day basis or as frequently as necessary.

A mutual fund board can take significant steps toward satisfying its good faith obligations prior to an emergency or unusual situation. We believe that, in general, the degree of involvement required of a board during emergencies will depend heavily on the comprehensiveness of the pricing procedures adopted for the fund and the degree of discretion vested in fund management. If, for example, a board has approved comprehensive procedures which provide methodologies for how fund management should fair value price portfolio securities, including procedures which would be appropriate for that particular emergency situation, a board would need to have comparatively little involvement in the valuation process in order to satisfy its good faith obligation. This necessitates, of course, that the board periodically review the appropriateness of the methods used to fair value price portfolio securities and the quality of the prices obtained through these procedures, and that it make changes when appropriate.

When the board has vested a comparatively greater amount of discretion in fund management, or when pricing procedures are relatively vague, we believe that the board's involvement must be greater and more immediate. In

<sup>15</sup> One factor placing time pressure on funds to quickly determine NAV is the brief period between the time that most U.S. funds price their securities and the deadline for reporting NAV information to the NASDAQ in order to ensure that the NAVs are reported in the next day's newspapers. Although we recognize the importance of publishing this information in newspapers, this concern is secondary to ensuring that the fund's NAV is accurate. Moreover, the availability of other systems for delivering NAV information, including internet web sites and automated telephone operating systems, provides funds with alternative methods for disseminating current NAVs.

<sup>16</sup> We generally believe, however, that a board could not arrive at different fair valuations for identical securities held by two or more funds that the board oversees, consistent with its good faith obligation.



these instances, a fund board may be required to evaluate how emergency conditions are affecting the fund's pricing mechanisms, whether the pricing procedures are appropriate, what inquiries fund management is making, and what factors management is considering when making valuation recommendations. Depending on the particular circumstances, the board may need to evaluate how particular portfolio securities are being priced, or, when the fund has limited or no fair value pricing procedures, authorize the specific pricing methodology used.

In any event, given that the fund's board retains oversight responsibility for the valuation of the fund's assets, the board should receive periodic reports from fund management that discuss the functioning of the valuation process and that focus on issues and valuation problems that have arisen.

\* \* \* \* \*

This letter addresses certain selected pricing issues and is not intended to provide comprehensive guidance on this subject. Nothing in this letter is intended to alter the guidance in ASR Nos. 113 or 118, or the general requirement that funds must use market values to value their portfolio securities when market quotations are readily available.

We will consider whether to provide additional guidance on pricing issues in the future. We would appreciate your sharing this letter with your members. If you have any questions, please contact me, Mercer Bullard, or Evan Geldzahler, at (202) 942-0660.

Very truly yours,

Douglas Scheidt  
Associate Director and Chief Counsel

## 2001 ANNUAL INDUSTRY COMMENT LETTER TO CFOs

February 14, 2001

Dear Chief Financial Officer:

The accounting staff of the Division of Investment Management has prepared this letter to assist investment company registrants and their independent public accountants in addressing certain accounting-related matters. These comments represent the views of the staff of the Division and are not necessarily those of the Securities and Exchange Commission. The comments addressed in this letter apply to filings, including reports to shareholders, made by registered investment companies and investment advisers.

### Discounting Market Quotations for Large Holdings (Block Discounts)

We recently received a question about whether it is appropriate for a registered investment company to value an unrestricted security at a discount or premium from a readily available market quotation based solely on the size of the investment company's holding. The 1940 Act requires a registered investment company to value securities using market quotations when they are readily available.<sup>1</sup> Therefore, we do not believe it is appropriate to discount or mark-up a readily available market price for an unrestricted security solely because an investment company holds a large quantity of the outstanding shares of an issuer or holds an amount that is a significant portion of the security's average daily trading volume.

This letter contains information of importance to your company's independent public accountants; therefore, we encourage you to discuss these items with them. Address any questions about the contents of this letter or related matters to Brian D. Bullard, Kenneth B. Robins, Assistant Chief Accountants, or me, at (202) 942-0590.

Very truly yours,

John S. Capone  
Chief Accountant

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<sup>1</sup> See 15 U.S.C. § 80a-2(a)(41) (2000) (Section 2(a)(41) of the 1940 Act); 17 C.F.R. § 270.2a-4 (2000) (Rule 2a-4 under the 1940 Act).

## AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

April 11, 2001

Mr. Mark V. Sever  
Chair, Accounting Standards Executive Committee  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036-8775

Dear Mark:

Based on your letter dated March 13, 2001, I understand that the Accounting Standards Executive Committee (AcSEC) has decided to pursue a project addressing whether it is appropriate to use a blockage factor in estimating fair value, and what methodology should be used to measure a blockage factor. I want to reiterate that the SEC staff does not support the use of blockage factors, and, thus, this project being undertaken by AcSEC until such time as broader guidance on valuation models and methodologies used to measure fair value is completed.

The Investment Company Act of 1940 (the 1940 Act) requires a registered investment company to value securities using market quotations when they are readily available. Therefore, we do not believe it is appropriate to discount or mark-up a readily available market price for an unrestricted security solely because an investment company holds a large quantity of the outstanding shares of an issuer or holds an amount that is a significant portion of the security's average trading volume. FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, also prohibits the adjustment of quoted market prices in the determination of fair value. Similar guidance can be found in APB Opinion No. 25, Accounting for Stock Issued to Employees, which requires quoted market prices to be used to measure compensation cost.

The staff is concerned that a block of stock could create earnings management opportunities. For example, a block of stock may be acquired, and a discount from the market value may be recorded. In many cases, that stock will not be sold as a block, but instead in smaller amounts, creating gains, and increasing earnings reported to investors. This practice decreases the quality of earnings.

While not authoritative, we have noted that the Joint Working Group of Standard Setters' Recommendations on Accounting for Financial Instruments and Similar Items would not permit blockage adjustments. Moreover, we have noted that the FASB technical staff's comments on the International Accounting Standards Committee's Exposure Draft, Business Combinations, included "why should an enterprise be allowed to discount . . . market value?" The FASB staff also commented that any adjustments to market value may promote "undesirable accounting."

The SEC staff does not support AcSEC's pursuit of a valuation project focused solely on blockage. Even if AcSEC completes a project on blockage, SEC registrants will continue to be precluded from applying a blockage factor in estimating the fair value of unrestricted investments if a quoted price in an active market is available. Accounting Series Release (ASR) No. 118 states that the last quoted sale price should generally be used without adjustment. ASR 113 provides guidance with respect to restricted securities.

If you have any questions or would like to discuss these issues further, please contact Jackson Day or David Kane at (202) 942-4400.

Sincerely,

Lynn E. Turner  
Chief Accountant

## INVESTMENT COMPANY INSTITUTE

April 30, 2001

Mr. Craig S. Tyle  
 General Counsel  
 Investment Company Institute  
 1401 H Street, N.W.  
 Washington, D.C. 20005

Dear Mr. Tyle:

This letter follows up on our December 1999 letter<sup>1</sup> to you and addresses several topics for which further clarification and guidance appear to be necessary. We set forth our views on the obligations of funds and their directors under the Investment Company Act of 1940 (the “1940 Act”) to determine, in good faith, the fair value of the funds’ portfolio securities when market quotations are not readily available. We also provide our views on other topics, such as the valuation of securities traded on certain foreign exchanges and the inappropriate use of fair value pricing for securities for which market quotations are readily available.<sup>2</sup>

### I. Fair Value Pricing and Significant Events

#### A. Background

The 1940 Act requires funds to calculate their net asset values (“NAVs”) by using the market value of their portfolio securities when market quotations for those securities are “readily available.”<sup>3</sup> When market quotations for a portfolio security are not readily available, a fund must calculate its NAV by using the fair value of that security, as determined in good faith by the fund’s board.<sup>4</sup> The 1940 Act generally requires funds to compute their NAVs at least once daily, Monday through Friday, at a specific time or times as determined by their boards (“NAV calculation”).<sup>5</sup> Typically, funds calculate their NAVs once each day at or near the close of the major U.S. securities exchanges and markets (usually 4:00 p.m., Eastern Time (“ET”)).

Funds generally calculate their NAVs by using the closing prices of portfolio securities on the exchange or market (whether foreign or domestic) on which the securities principally trade. Many foreign markets, however, operate at times that do not coincide with those of the major U.S. markets. For example, Asian markets generally operate during the evening and nighttime in the United States and close before the opening of the major U.S. markets.<sup>6</sup> As a result, the closing prices of securities that principally trade on foreign exchanges or markets (“foreign securities”) may be as much as 12-15 hours old by the time of the funds’ NAV calculation, and may not reflect the current market values of those securities at that time. In particular, the closing prices of foreign securities may not reflect their market values at a fund’s NAV calculation if an event that will affect the value of those securities (“significant event”) has occurred since the closing prices were established on the foreign exchange or market, but before the fund’s NAV calculation.

<sup>1</sup> See Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (Dec. 8, 1999) (the “1999 Letter”).

<sup>2</sup> The guidance provided in this letter and the 1999 Letter applies to all investment companies regardless of their classification (*e.g.*, open-end, closed-end) or investment objectives or strategies (*e.g.*, investing in a particular sector or tracking an index).

<sup>3</sup> Section 2(a)(41)(B) of the 1940 Act defines “value” as: “(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.” This definition also is used in Rule 2a-4 under the 1940 Act as the required basis for computing a fund’s current NAV.

<sup>4</sup> *Id.* As the Commission previously has noted, funds that fair value price their portfolio securities should document their decision making and retain the supporting data for inspection by the funds’ independent accountants. See Accounting Series Release No. 118, Financial Reporting Codification (CCH) § 404.03 (Dec. 23, 1970) (“ASR No. 118”).

<sup>5</sup> Rule 22c-1(b) under the 1940 Act. Rule 22c-1(a) requires funds to sell and redeem their shares at the NAVs next computed after receipt of an order.

<sup>6</sup> From November through March, for example, the Tokyo Stock Exchange is generally open for trading between 7:00 p.m. and 1:00 a.m., ET, while the Hong Kong Stock Exchange is open between 9:00 p.m. and 3:00 a.m., ET.

## **B. The Failure to Determine the Fair Value of Portfolio Securities Following Significant Events May Result in Dilution**

Funds may dilute the value of their shareholders' interests if they calculate their NAVs using closing prices that were established before a significant event has occurred. Dilution generally may occur, for example, if fund shares are overpriced because redeeming shareholders will receive a windfall at the expense of the shareholders that remain in the fund. Similarly, dilution may occur when a fund sells its shares at a price lower than its NAV. The risk of dilution increases when significant events occur because such events attract investors who are drawn to the possibility of arbitrage opportunities.<sup>7</sup> In such situations, short-term investors may attempt to exploit the discrepancies between market prices that are no longer current, and the values of a fund's portfolio securities.<sup>8</sup>

Fair value pricing can protect long-term fund investors from short-term investors who seek to take advantage of funds as a result of significant events occurring after a foreign exchange or market closes, but before the funds' NAV calculation. Attached as Exhibit 1 is an example that demonstrates how certain short-term investors, in two days and at no risk to their investments, could profit by more than \$900,000, on a \$10 million investment, from a small fund that does not use fair value pricing. These profits would dilute the share value of long-term investors in the fund. Although the value of the securities held by both funds in the example would remain the same after the market recovers from the short period of volatility, the NAV of the fund that does not use fair value pricing would decline from \$10 to \$9.82—a drop of nearly 20 cents per share for every remaining shareholder in the fund, which is a direct result of the actions taken by the aggressive short-term investors.

## **C. Availability of Market Quotations**

The Commission previously has addressed the issue of whether market quotations are readily available under certain circumstances. In ASR No. 118, the Commission instructed funds to carefully consider various indications of the validity and reliability of market quotations. With regard to securities listed or traded on a national securities exchange, the Commission stated that:

[i]f sales have been infrequent or there is a thin market in the security, further consideration should be given to whether "market quotations are readily available." If it is decided that they are not readily available, the alternative method of valuation prescribed by Section [2(a)(41)]—"fair value as determined in good faith by the board of directors"—should be used.

The Commission reached the same conclusion with regard to over-the-counter securities, indicating that if the validity of quotations from broker-dealers appears to be questionable or if the number of quotations is such as to indicate that there is a thin market in the security, further consideration should be given to whether market quotations are readily available. With regard to foreign securities, a fund similarly must consider the reliability of market quotations. Low trading volume of securities in some foreign markets raises issues as to the reliability of the market quotations and can trigger the requirement to fair value price those securities.

Additionally, with regard to a foreign security, a fund must evaluate whether a significant event (i.e., an event that will affect the value of a portfolio security) has occurred after the foreign exchange or market has closed, but before the fund's NAV calculation. If the fund determines that a significant event has occurred since the closing of the foreign exchange or market, but before the fund's NAV calculation, then the closing price for that security would not be considered a "readily

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<sup>7</sup> Investors are drawn to market conditions that allow them to "take advantage of an upswing in the market and an accompanying increase in the net asset value of investment company shares by purchasing such shares at a price which does not reflect the increase." Investment Company Act Release No. 5519 (Oct. 16, 1968) (Rule 22c-1 adopting release).

<sup>8</sup> Arbitrage activity also may harm shareholders because it may cause funds to manage their portfolios in a disadvantageous manner. For example, a fund's investment adviser may maintain a larger percentage of its assets in cash or may be forced to prematurely liquidate certain portfolio securities to meet higher levels of redemptions due to arbitrage activity. This is particularly true for funds that invest primarily in foreign or emerging markets securities, which are often thinly traded. Funds also may incur increased brokerage and administrative costs related to the arbitrage activity.

available” market quotation, and the fund must value the security pursuant to a fair value pricing methodology.<sup>9</sup> This position is consistent with the views expressed by the Commission in Investment Company Act Release No. 14244 (Nov. 21, 1984).<sup>10</sup>

This position applies equally to domestic securities. If, for example, a U.S. market closes early on a given day, or if the market regularly closes before a fund’s NAV calculation, and an event occurs that affects the value of a fund’s portfolio security subsequent to that closing, but before the fund’s NAV calculation, then the market’s closing price for that security would no longer be considered a “readily available” market quotation. Likewise, if trading in a security is halted during the trading day, and trading in that security does not resume prior to the close of the exchange or market, the last quotations prior to the trading halt would not be considered “readily available.”

#### D. Monitoring for Significant Events and Assessing the Availability of Market Quotations

Consistent with their obligations under the 1940 Act, funds should continuously monitor for events that might necessitate the use of fair value prices. Funds also should establish criteria for determining whether market quotations are readily available.

Whether a particular event is a significant event depends on whether the event will affect the value of a fund’s portfolio securities. Such events may relate to a single issuer or to an entire market sector. Moreover, significant fluctuations in domestic or foreign markets may constitute a significant event. Significant events also may stem from occurrences not tied directly to the securities markets, such as natural disasters, armed conflicts, or significant governmental actions.<sup>11</sup>

Recent advances in communications technology have increased the availability of financial and other news sources that funds can use to monitor for significant events.<sup>12</sup> Some funds have established milestones or trigger points which also may signal that significant events have occurred since the close of the foreign exchange or market on which their portfolio securities trade, such as a certain percentage rise or fall in the value of a basket of foreign securities that trade on another market, or a certain percentage change in a foreign futures index.<sup>13</sup>

More generally, funds should assess the availability of market quotations for their portfolio securities each day by reviewing various factors, including whether the securities are thinly traded, sales have been infrequent, or other data exist that may call into question the reliability of the market quotations.<sup>14</sup> Funds that automatically use market quotations to calculate their NAVs, without first verifying that the market quotations are readily available, cannot be assured that the resulting NAVs are accurate.

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<sup>9</sup> A determination that market quotations are no longer “readily available” would not preclude a fund’s board from concluding that the most recent closing market prices represent fair value. The most recent closing market prices generally should be considered, along with other appropriate factors, when determining the fair value of securities for which current market quotations are not readily available. *See* the 1999 Letter, *supra* n. 1, at n. 5.

<sup>10</sup> In that release, the Commission affirmed that a fund whose portfolio contains foreign securities could continue to rely on the Division’s no-action position in *Putnam Growth Fund and Putnam International Equities Fund, Inc.*, Division of Investment Management no-action letter (Feb. 23, 1981), with respect to the use of immediately preceding closing prices on foreign exchanges or markets when no significant event has occurred. Discussing Putnam, the Commission also stated that:

[i]f an event does occur which will affect the value of portfolio securities after the market has closed, the fund must, to the best of its ability, determine the fair value of the securities, as of the time pricing is done under Rule 22c-1, by using appropriate indicia of value which, in certain cases, may include the opening price at which trading in the securities next begins.

Investment Company Act Release No. 14244, at n. 7 (proposing amendments to Rule 22c-1).

<sup>11</sup> *See* the 1999 Letter, *supra* n. 1 (providing guidance with respect to pricing portfolio securities in certain emergency or unusual situations).

<sup>12</sup> In our view, such monitoring generally should not be unduly burdensome because funds and their investment advisers typically monitor such data on a continuous basis in determining whether to buy, sell, or continue to hold portfolio securities.

<sup>13</sup> In the 1999 Letter, we identified certain factors that boards may wish to consider when determining the fair values of fund portfolio securities. We believe that these same factors can assist funds in determining whether a significant event has occurred. *See* the 1999 Letter, *supra* n. 1, at text accompanying n. 14.

<sup>14</sup> *See, e.g.*, ASR No. 118, *supra* n. 4.

## E. Disclosure of Pricing Policies

In 1997, some investors complained that they were unaware that funds could fair value price their portfolio securities. In response to these complaints, we reviewed the disclosure documents of a number of different funds and determined that the funds generally disclosed their valuation practices, including their ability to use fair value pricing. We further determined, however, that the disclosure would be enhanced if the funds followed the principles of plain English.<sup>15</sup>

In early 1998, the Commission adopted amendments to Form N-1A, the registration form for mutual funds.<sup>16</sup> In doing so, the Commission decided to retain the requirement that funds explain the method used to value their portfolio securities (i.e., market value, fair value, or amortized cost). In light of our review of certain funds' disclosure relating to fair value, however, the Commission added an instruction to Form N-1A clarifying that funds that contemplate using fair value pricing also must briefly explain the circumstances and effects of its use.

We believe that funds and their shareholders would benefit from enhanced plain English disclosure of the use of fair value pricing and its effects. We also believe that funds that are more likely to use fair value pricing should consider providing additional information to their shareholders (e.g., in shareholder reports) about the circumstances and effects of using fair value pricing.<sup>17</sup> Such disclosure may result in fewer shareholder complaints and also may discourage arbitrage activity.

## II. Additional Matters Relating to Valuation

We also believe that it is appropriate to address the following valuation-related issues:

### A. Ongoing Pricing Responsibilities

As the Commission previously has stated, boards must “continuously review the appropriateness of the method used in valuing” portfolio securities.<sup>18</sup> Funds should regularly evaluate whether their pricing methodologies continue to result in values that they might reasonably expect to receive upon a current sale. Funds should assess the availability and reliability of market quotations, and should regularly test the accuracy of their fair value prices by comparing them with values that are available from other sources, including actual trade prices, as well as quotations from pricing services and dealers. Funds also should make any appropriate adjustments to their fair valuation methodologies.<sup>19</sup> In addition, funds should evaluate the appropriateness of their fair value methodology for foreign securities by reviewing next-day opening prices or actual sales of the securities on the foreign exchange or market.<sup>20</sup>

### B. The Good Faith Requirement

In the 1999 Letter, we discussed the requirement that fund boards must determine, in “good faith,” the fair value of portfolio securities for which market quotations are not readily available.<sup>21</sup> We stated our view that the good faith requirement is a flexible concept that can accommodate many different considerations, and that the specific actions that a

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<sup>15</sup> See Investment Company Act Release No. 23064 (Mar. 13, 1998), at text accompanying n. 152 (adopting amendments to Form N-1A).

<sup>16</sup> *Id.*

<sup>17</sup> A fund, for example, could explain that it is required by law to use the fair values of its portfolio securities to calculate its NAV under certain circumstances, and could illustrate the effects of fair value pricing in a hypothetical situation. Such disclosure could help to educate shareholders about the effects of significant events on the fund's NAV, and explain why the fund's NAV may not correlate with the prevailing direction or magnitude of market movements on certain days.

<sup>18</sup> ASR No. 118, *supra* n. 4.

<sup>19</sup> Funds also should implement appropriate measures to ensure that when they use fair value prices provided by pricing services to calculate their NAVs, those prices reflect what the funds might reasonably expect to receive upon a current sale of the securities.

<sup>20</sup> We recognize that the fair value prices of securities determined in accordance with a fund's fair valuation methodology may be different from the next-day opening or actual sales prices of the securities. Such discrepancies do not necessarily indicate that the fund's fair value prices are inappropriate. Instead, the fund should reevaluate its fair value methodology to determine what, if any, adjustments should be made to that methodology.

<sup>21</sup> See *supra* n. 1.



board must take will vary, depending on the nature of the particular fund, the context in which the board must fair value price, and the pricing procedures adopted by the board.<sup>22</sup>

Since we issued the 1999 Letter, we have been requested to provide additional guidance concerning the good faith requirement of the amount that the fund might reasonably expect to receive for a security upon its current sale, based upon all of the appropriate factors that are available to the fund.<sup>23</sup> Furthermore, we believe that a board acts in good faith when it “continuously review[s] the appropriateness of the method used” in determining the fair value of the fund’s portfolio securities.<sup>24</sup> Compliance with the good faith standard generally reflects the directors’ faithfulness to the duties of care and loyalty that they owe to the fund.

We believe, however, that a fund board generally would not be acting in good faith if, for example, the board knows or has reason to believe that its fair value determination does not reflect the amount that the fund might reasonably expect to receive for the security upon its current sale. In addition, a fund board generally would not be acting in good faith if it acts with reckless disregard for whether its fair value determination reflects the amount that the fund might reasonably expect to receive for the security upon its current sale. The Commission has instituted several enforcement actions against fund directors under these circumstances.<sup>25</sup>

### C. Trading Limits on Individual Foreign Securities

We also have been asked to address the valuation of certain foreign securities that are subject to trading limits, or “collars,” on the exchanges or markets on which they primarily trade. Certain foreign securities exchanges have mechanisms in place that confine any one day’s price movement in an individual security to a pre-determined range, based on that day’s opening price. The mechanisms prevent the price for that security from moving outside of two, pre-determined prices (“limit down” and “limit up”) on any given day. These limitations may effectively end trading in a security on a given day because they restrict the price of the security from rising or falling beyond the limit up or limit down price.<sup>26</sup> The collars could prevent a security from trading for days or even weeks.

Under these circumstances, we believe that funds must determine the fair values of their portfolio securities if the limit up or limit down prices of those securities have been reached, and no trading has taken place at those prices. We believe that the fact that trading has not yet resumed and that no two-sided market exists demonstrates that market

<sup>22</sup> In providing this guidance, we also stated that “different fund boards, or funds in the same complex with different boards, when fair value pricing identical securities, could reasonably arrive at prices that were not the same, consistent with the boards’ obligations to fair value price in good faith”. See the 1999 Letter, *supra* n. 1.

<sup>23</sup> Consistent with the good faith requirement, boards may appoint persons to assist them in determining fair values and to make actual fair value calculations under the boards’ direction. See ASR No. 118, *supra* n. 4. See also the 1999 Letter, *supra* n. 1.

<sup>24</sup> See ASR No. 118, *supra* n. 4.

<sup>25</sup> In one action, for example, the fund’s directors continued to fair value a portfolio security at its last available NASDAQ market quotation for a significant period of time, notwithstanding that the directors knew, among other things, that the security had been de-listed from the NASDAQ, the issuer had experienced continuing losses and repeatedly failed to meet income projections, and actual sales prices during the period were lower than the fair value used by the directors to calculate NAV. *Parnassus Investments, et al.*, Initial Dec. No. 131 (Sept. 3, 1998), initial dec. final (Oct. 8, 1998). In another action, a fund’s directors, among other things, fair valued certain of the fund’s restricted portfolio securities as if they were not restricted. *In the Matter of the Rockies Fund, Inc., et al.*, Initial Dec. No. 181 (Mar. 9, 2001), Order Granting Petitions for Review (Apr. 10, 2001). See also *In the Matter of Lloyd Blonder*, Investment Company Act Release No. 19755 (Sept. 30, 1993) (director approved fair values of portfolio securities while knowing that they were insupportable, and without considering any of the factors that the board was required to consider); *In the Matter of Daniel D. Weston*, Investment Company Act Release No. 19754 (Sept. 30, 1993) (same); *In the Matter of Brewster B. Gallup*, Investment Company Act Release No. 20267 (May 3, 1994); and *In the Matter of William P. Hartl and Eric P. Lipman*, Investment Company Act Release No. 19840 (Nov. 8, 1993).

<sup>26</sup> For example, if the foreign issuer released a report announcing poor financial results, the price of the issuer’s securities might fall to the limit down price. If buyers believed that the limit down price did not reflect the security’s market value, i.e., that price was still too high, trading in that security would effectively end for the day. On the following day, trading in the security would open at the previous day’s limit down price. If that price was still too high to attract buyers, the price would then drop to that day’s limit down price. This scenario would be repeated until each day’s incremental change allowed the price to fall to a level at which buyers would return to the market and normal trading could resume.

quotations are not readily available. If trading has taken place at the limit down or limit up price, funds should consider whether market quotations are readily available for those securities by evaluating, among other things, the frequency of those trades and other factors that may call into question the validity and reliability of the prices at which those trades occurred.<sup>27</sup>

#### **D. The Inappropriate Use of Fair Values When Market Quotations Are Readily Available**

We also wish to set forth our views on the obligation of funds to value their portfolio securities for which market quotations are readily available. In such circumstances, funds are not permitted to ignore these quotations and fair value price the securities. This would not be consistent with a fund's obligation under the 1940 Act and could result in an incorrect NAV.

We believe that funds must exercise reasonable diligence to obtain market quotations for their portfolio securities before they may properly conclude that market quotations are not readily available. If, for example, a fund obtains market quotations for a portfolio security from one source and determines that they are unreliable, the fund should diligently seek to obtain market quotations from other sources, such as other dealers or other pricing services, before concluding that market quotations are not readily available.

\* \* \* \* \*

We hope that this letter will assist funds and their directors to fulfill their valuation-related responsibilities under the 1940 Act. We would appreciate your sharing this letter with your members. If you have any questions, please contact me, Elizabeth Osterman, Evan Geldzahler, or Lily Chiu, at (202) 942-0660.

Very truly yours,

Douglas Scheidt

Associate Director and Chief Counsel

#### **Example: Fair Value Pricing**

The following example illustrates how fair value pricing can safeguard long-term mutual fund investors. It is based entirely on hypothetical facts and does not take any fees into account. All numbers have been rounded off.

Assume that two different foreign-stock mutual funds—Fund A and Fund B—both own securities that are traded primarily on the same Asian foreign exchange. Both funds generally use closing market prices to value their portfolio securities, but Fund B determines the fair value of its portfolio securities if a significant event that would affect the value of those securities occurs after the close of the foreign exchange but before its NAV calculation. Each fund has total assets of \$50 million, with 5 million shares outstanding and an NAV of \$10 per share.

##### **Day 1: Foreign Market Declines and Investors Buy Fund Shares**

On Day 1, the Asian market closes (at 3:00 a.m. Eastern Time) significantly lower, causing the value of the securities held by both funds to decrease approximately 10 percent. During Day 1 in the United States, trading in other instruments (such as financial futures, depositary receipts, exchange-traded funds, and closed-end country funds) indicates a countervailing increase in value of approximately 10 percent, which strongly suggests that stock prices in the Asian market, when it opens, will increase to the same level as before the previous day's decrease. Knowing this, investors buy \$10 million worth of shares of each fund to try to take advantage of potentially undervalued fund shares. At the end of Day 1, Fund A, using the share prices at the close of the Asian market, calculates its NAV at \$9 per share. This is the price at which the investors buy shares of the fund. Fund B's NAV remains at \$10 per share because, using fair value pricing, Fund B took into account the likely increase in share prices in the Asian market by evaluating the trading in other instruments.

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<sup>27</sup> See ASR No. 118, *supra* n. 4.

## Day 2: Foreign Market Recovers and Investors Redeem Their Shares

On Day 2, the Asian market rebounds to equal its original level before Day 1. The market closes on Day 2 at this level. The valuation of the securities in Fund A, using closing market prices, increases and offsets the losses from the previous day. The valuation of the securities in Fund B remains the same as it was at the end of Day 1.

### Result: Investors Profit at Expense of Long-Term Investors in Fund A

If the investors who bought fund shares on Day 1 redeem their shares on Day 2, the investors who bought shares of Fund A (which used closing market prices) have a profit of \$911,110, which reflects their purchase of undervalued fund shares at \$9 per share on Day 1. This profit is at the expense of long-term investors in Fund A, whose share value is reduced by \$0.18 per share (even though the value of the fund's underlying assets is unchanged). This \$0.18 represents profits taken by the short-term, redeeming investors. By contrast, the investors who bought shares of Fund B (which used fair value pricing) break even, because the value at which they redeem their shares on Day 2, \$10 per share, is the same as the value at which they bought the shares on Day 1. The share value of long-term investors of Fund B also remains the same, and there is no loss to these investors.

The chart below illustrates this hypothetical example:

	Beginning	Day 1	Day 2	After Redemption by Investors
<b>Fund A</b>				
<b>Closing Market Prices</b>				
Total Assets	\$50 million	\$45 million <sup>1</sup>	\$60 million <sup>2</sup>	\$49.09 million <sup>3</sup>
Fund Shares	5 million	5 million	6.11 million <sup>4</sup>	5 million
Net Asset Value <sup>5</sup>	\$10/share	\$9/share	\$9.82/share	\$9.82/share
Profit Taken by Investors				\$911,110 <sup>6</sup>
Loss to Long-Term Investors				\$911,110

<b>Fund B</b>				
<b>Fair Value Pricing</b>				
Total Assets	\$50 million	\$50 million <sup>7</sup>	\$60 million <sup>8</sup>	\$50 million <sup>9</sup>
Fund Shares	5 million	5 million	6 million <sup>10</sup>	5 million
Net Asset Value <sup>5</sup>	\$10/share	\$10/share	\$10/share	\$10/share
Profit Taken by Investors				0
Loss to Long-Term Investors				0

<sup>1</sup> Total assets (\$50 million) minus decrease in value of approximately 10 percent of securities held by the fund (\$5 million).

<sup>2</sup> Day 1 total assets (\$45 million) plus increase in value of approximately 10 percent of securities held by the fund (\$5 million) plus amount invested by investors (\$10 million).

<sup>3</sup> Day 2 total assets (\$60 million) minus amount of assets redeemed by investors (\$10.91 million = 1.11 million shares invested at \$9.82 per share).

<sup>4</sup> Day 1 fund shares outstanding (5 million) plus shares issued to investors (1.11 million = \$10 million divided by \$9 per share).

<sup>5</sup> NAV = total assets divided by number of fund shares.

<sup>6</sup> Beginning total assets (\$50 million) minus total assets after redemption by investors (\$49.09 million).

<sup>7</sup> Total assets (\$50 million) minus decrease in value of approximately 10 percent of securities held by the fund (\$5 million) plus likely increase in value of approximately 10 percent of securities held by the fund under fair value pricing (\$5 million).

<sup>8</sup> Day 1 total assets (\$50 million) plus amount invested by investors (\$10 million).

<sup>9</sup> Day 2 total assets (\$60 million) minus amount of assets redeemed by investors (\$10 million = 1 million shares invested at \$10 per share).

<sup>10</sup> Day 1 fund shares outstanding (5 million) plus shares issued to investors (1 million = \$10 million divided by \$10 per share).

## FEDERATED MUNICIPAL FUNDS

### Staff Response

November 20, 2006

Your letter dated November 15, 2006 requests that we extend the no-action position that we took in United Municipal Bond Fund (pub. avail. Jan. 27, 1995) (the “1995 letter”) to address the use of Standard & Poor’s Securities Evaluations, Inc. (“SPSE”), an independent pricing service, in connection with certain 17a-7 transactions, as defined below. In the 1995 letter, we agreed not to recommend enforcement action to the Securities and Exchange Commission (the “Commission”) under Section 17(a) of the Investment Company Act of 1940 (the “1940 Act”) against certain affiliated funds if they use the prices provided by Muller Data Corporation, now operating as FT Interactive Data (“FTID”), an independent pricing service, when engaging in 17a-7 transactions involving certain municipal securities for which market quotations are not readily available.<sup>1</sup> We respond to your request below, and also provide general guidance concerning Rule 17a-7 and best execution and the duty of loyalty, and the Nasdaq Official Closing Price.

### Independent Pricing Services

Section 17(a) of the 1940 Act prohibits any affiliated person of a registered fund, or any affiliated person of such a person, from selling securities to, or purchasing securities from, the fund. Rule 17a-7 under the 1940 Act generally exempts from the prohibitions of Section 17(a) certain purchases and sales of securities between funds that are affiliated solely by reason of having a common investment adviser (“17a-7 transactions”). As relevant here, Rule 17a-7 requires that: the 17a-7 transactions involve securities for which market quotations are readily available; the 17a-7 transactions are effected at the independent current market prices of the securities; and the “current market price” for certain securities (such as municipal securities) is calculated by averaging the highest and lowest current independent bid and offer price determined on the basis of a reasonable inquiry.<sup>2</sup>

In the 1995 letter, we agreed not to recommend enforcement action to the Commission under Section 17(a) of the 1940 Act against certain affiliated funds if they engaged in 17a-7 transactions involving municipal securities for which market quotations were not readily available. In the 1995 letter, the prices of the municipal securities that were to be used in the 17a-7 transactions were the same as the prices that were to be used to determine the funds’ net asset values per share (“NAV”) consistent with Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder.<sup>3</sup> Your letter specifically requests that we extend the no-action position in the 1995 letter to permit certain affiliated funds advised by Federated Investment Management Company (and other commonly controlled investment advisers) that invest primarily in municipal bonds (the “Municipal Funds”) to use SPSE, rather than FTID, as their independent pricing service and engage in 17a-7 transactions under substantially similar circumstances.

In the 1995 letter, we did not intend that FTID would be the only independent pricing service that could be used by funds relying on the letter. It may be appropriate for a fund, subject to the approval of its board of directors, to use other independent pricing services for these purposes. Accordingly, we would not recommend enforcement action to the Commission under Section 17(a) of the 1940 Act against the Municipal Funds if they use SPSE (or any other independent pricing service) as their independent pricing service and engage in 17a-7 transactions involving municipal securities for which market quotations are not readily available, provided that the Municipal Funds comply with all of the representations contained in the Municipal Bond Fund letters, other than their use of SPSE (or any other independent

<sup>1</sup> The relief that we provided in the 1995 letter was based on the representations contained in that letter, as well as the representations contained in an earlier related letter, United Municipal Bond Fund (pub. avail. July 30, 1992) (the “1992 letter,” together with the 1995 letter, the “Municipal Bond Fund letters”).

<sup>2</sup> See Rule 17a-7(a); Rule 17a-7(b); and Rule 17a-7(b)(4).

<sup>3</sup> In the 1992 letter, we provided similar no-action relief for 17a-7 transactions involving municipal securities for which market quotations were not readily available, the prices for which were to be obtained through pricing methodologies that differed from those that the funds used when calculating their NAVs. That approach, however, had the unintended effect of causing artificial gains and losses for the funds. As a result, in the 1995 letter, we altered our position in the 1992 letter.

pricing service), rather than FTID, as their independent pricing service.<sup>4</sup> Please note that this position represents our view on enforcement action only and does not express any legal conclusions on the issues presented. Furthermore, this position is based on all of the facts and representations in your letter; any different facts or representations may require a different conclusion.

### Best Execution and the Duty of Loyalty

Before causing funds that it manages to enter into 17a-7 transactions, an investment adviser should carefully consider, among other things, its duty to seek best execution for each fund and its duty of loyalty to each fund. In particular, the investment adviser to the fund seeking to sell securities in a 17a-7 transaction should ensure that the selling fund's total proceeds are the most favorable under the circumstances.<sup>5</sup> The investment adviser also should ensure that the buying fund's total cost is the most favorable under the circumstances.<sup>6</sup> If the adviser to the selling fund can obtain greater proceeds for that fund by selling the security in the market, rather than by selling it to the other fund in a 17a-7 transaction, the adviser should sell the security in the market. The same principle applies to the buying fund's participation in a 17a-7 transaction.

In addition, consistent with an investment adviser's duty of loyalty, we believe that an investment adviser should not cause funds to enter into a 17a-7 transaction unless doing so would be in the best interests of each fund participating in the transaction. Thus, for instance, the buying fund should not participate in a 17a-7 transaction that benefits only the selling fund; if the buying fund were to participate in such a transaction, it may forgo an opportunity to make a better investment in a different security.

### Nasdaq Official Closing Price

We also wish to take this opportunity to note that, in our view, the use of another pricing methodology, the Nasdaq Official Closing Price ("NOCP"), is consistent with the policies of Section 17(a) and Rule 17a-7. Rule 17a-7(b)(1) provides that the current market price for an "NMS stock," as that term is defined in 17 CFR 242.600, is:

[T]he last sale price with respect to such security reported in the consolidated transaction reporting system ('consolidated system') or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to 17 CFR 242.602) if there are no reported transactions in the consolidated system that day.

The consolidated last sale price is comprised of the final last sale eligible trade report submitted to the Securities Information Processor during the regular trading session by any market center, including Nasdaq.

In April 2003, Nasdaq began calculating the NOCP, as an alternative to the consolidated last sale price, for a subset of NMS stock made up of all Nasdaq National Market securities (more than 3,900 companies that are the larger and generally more actively traded Nasdaq securities) and Nasdaq SmallCap securities (more than 1,300 securities of smaller, less-capitalized companies that do not qualify for inclusion in the Nasdaq National Market). The NOCP is based on the price of the last unmodified trade reported to Nasdaq's proprietary trade reporting system—Automated Confirmation Transaction System or "ACT"—at or before 4:00:02 pm. To determine the NOCP, Nasdaq systems then normalize that

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<sup>4</sup> For example, the 1995 letter included representations about the steps that the funds took to ensure the reliability of the prices supplied by the pricing service.

<sup>5</sup> Although paragraph (d) of the rule generally provides that no brokerage commissions or fees may be charged in connection with 17a-7 transactions, an investment adviser nevertheless has a fiduciary duty to seek to execute any 17a-7 transaction in a manner that ensures that each fund's total cost or proceeds is the most favorable under the circumstances. *See generally* Securities Exchange Act Release No. 23170 (Apr. 23, 1986) (defining best execution of client trades).

<sup>6</sup> *See* In the Matter of Michael L. Smirlock, Advisers Act Release No. 1393 (Nov. 29, 1993) (Advisory employee violated Section 206(2) of the Investment Advisers Act of 1940 when he executed cross trades between advisory clients without, among other things, obtaining independent price information on the security involved from any dealer in order to obtain an accurate and independent evaluation of the market prices. "Thus, [he] did not take the necessary and proper steps to ensure that he obtained the best price and execution on behalf of his advisory clients who purchased the securities in the cross trades.")

price by ensuring that it is at or within Nasdaq's best bid and ask quotations. The NOCP calculation does not affect, although it may differ from, the consolidated last sale price.<sup>7</sup>

We believe that funds' use of NOCP prices in 17a-7 transactions would be consistent with the policies underlying Section 17(a) and Rule 17a-7 because of the manner in which the NOCP prices are independently determined. We believe that NOCP prices provide "an independent basis for determining that the terms of the transaction are fair and reasonable to each participating investment company and do not involve overreaching."<sup>8</sup> We would not recommend enforcement action to the Commission under Section 17(a) of the 1940 Act against affiliated funds if, when engaging in 17a-7 transactions, the funds determine the current market price of a security that is NMS stock by using the NOCP price rather than by using one of the methodologies listed in Rule 17a-7(b)(1).<sup>9</sup> Of course, the funds must also comply with the other requirements of Rule 17a-7. Please note that this position represents our view on enforcement action only and does not express any legal conclusions on the issues presented.

Rule 17a-7(b)(1) has been part of the rule since it was adopted originally in 1966. *See* Investment Company Act Release No. 4697 (Sept. 8, 1966). The Commission has amended Rule 17a-7(b)(1) once since Nasdaq was permitted to establish a NOCP in 2003, but the Commission did not consider the use of NOCP prices in 17a-7 transactions in that amendment. *See* Securities Exchange Act Release No. 51808 (June 9, 2005) (adopting rules under Regulation NMS) ("the rules adopted today amend a number of rules [including Rule 17a-7(b)(1)] that cross-reference current NMS rules or that use terms that Regulation NMS amends or eliminates. These amendments are intended to be non-substantive."). We believe that the Commission's non-inclusion of NOCP in Rule 17a-7 does not signify its view that NOCP is inappropriate for purposes of the rule.

In general, Rule 17a-7 does not mandate a particular time at which 17a-7 transactions should take place. *See* Investment Company Act Release No. 8494 (Sept. 13, 1974) (adopting amendments to Rule 17a-7), where the Commission stated:

"Another comment suggested that an ambiguity may exist in the construction of the word 'last' in paragraph (b)..., i.e., whether 'last' refers to and means the sales price or bid and offer next preceding the transaction or whether 'last' means the closing sales or closing bid and offer on the day of the transaction. The word 'last' in paragraph (b) is intended to refer to sales prices which immediately precede the transaction being executed in accordance with the existing rule."

We note, however, that funds should use the NOCP price for 17a-7 transactions only when the NOCP price is the last sales price that immediately precedes the transaction. We also note that funds may agree, prior to the dissemination of an NOCP price, to engage in a 17a-7 transaction using that price. Thus, the 17a-7 transaction would take place as if it were simultaneous with the dissemination of the NOCP price.

Susan Gault-Brown  
Senior Counsel

<sup>7</sup> *See* Securities Exchange Act Release No. 47517 (Mar. 18, 2003) (order granting approval to proposed rule change by the National Association of Securities Dealers, Inc. relating to the establishment of a NOCP); and Securities Exchange Act Release No. 47022 (Dec. 18, 2002) (notice of filing of proposed rule change by the National Association of Securities Dealers, Inc. relating to the establishment of a NOCP).

<sup>8</sup> *See* Investment Company Act Release No. 11676 (Mar. 10, 1981) (adopting amendments to Rule 17a-7).

<sup>9</sup> Most funds calculate their NAVs as of 4:00 p.m. Eastern time each business day. Such funds that engage in 17a-7 transactions using NOCP prices should use the prices in calculating their NAVs as well.



## Incoming Letter

November 15, 2006

Douglas J. Scheidt, Esquire  
Chief Counsel and Associate Director  
Division of Investment Management  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: Federated Municipal Funds - Rule 17a-7

Dear Mr. Scheidt:

We are writing on behalf of certain investment companies advised by Federated Investment Management Company (together with other commonly controlled investment advisers, “Federated”) that invest, or one or more series of which invest, primarily in municipal securities, i.e., securities issued by state and local governments (the “Municipal Funds”).<sup>1</sup> The Municipal Funds hereby request that the staff (the “Staff”) of the Securities and Exchange Commission (the “Commission” or the “SEC”) extend the no-action position that it took in the 1995 United Municipal Bond Fund no-action letter to address the use of Standard & Poor’s Securities Evaluations, Inc., an independent pricing service (“SPSE”), in connection with certain transactions under Rule 17a-7 under the Investment Company Act of 1940, as amended (the “1940 Act”).

The Staff has provided similar relief in a no-action letter to United Municipal Bond Fund (pub. avail. Jan. 27, 1995), which modified the Staff’s position in an earlier no-action letter (pub. avail. July 30, 1992) (as modified, the “United Fund Letters”). In the United Fund Letters, the Staff agreed not to recommend that the Commission take any enforcement action under Section 17(a) of the 1940 Act if the mutual funds bought and sold municipal securities under Rule 17a-7 using a price provided by the pricing service that valued the mutual funds’ municipal securities for purposes of Rule 2a-4. The Municipal Funds propose to comply with all of the conditions established in the United Fund Letters, except that the Municipal Funds would use prices provided by SPSE rather than prices provided by Muller Data Corporation (now operating as FT Interactive Data, “FTID”). The Municipal Funds believe that SPSE’s methods of evaluating municipal securities are, in all material respects, comparable to the methods employed by FTID.

### A. BACKGROUND

Section 17(a)(1) of the 1940 Act states, in relevant part, that “it shall be unlawful for any affiliated person...of...a registered investment company...or any affiliated person of such a person...acting as principal...knowingly to sell any security or other property to such registered investment company. ...” Section 2(a)(3)(C) of the 1940 Act defines an “affiliated person” of an investment company to include “any person directly or indirectly controlling, controlled by, or under common control with, such other person. ...” The Municipal Funds may be deemed to be under common control because they share common directors, common executive officers and a common investment adviser. This would make a Municipal Fund an “affiliated person” of each other Municipal Fund and, therefore, subject to principal transactions among the Municipal Funds to the prohibition of Section 17(a)(1). In addition, under Section 2(a)(3)(E), Federated is an “affiliated person” of the Municipal Funds and, consequently, entities other than Municipal Funds controlled by Federated may be deemed “affiliated persons” of an “affiliated person” of the Municipal Funds. Principal transactions between the Municipal Funds and these other entities would also be subject to Section 17(a)(1).

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<sup>1</sup> The Municipal Funds currently include the following open and closed-end management investment companies registered with the Commission: Cash Trust Series IT, Cash Trust Series, Inc., Federated Fixed Income Securities, Inc., Federated Income Securities Trust, Federated Intermediate Premier Municipal Income Fund, Federated Municipal High Yield Advantage Fund, Inc., Federated Municipal Securities Fund, Inc., Federated Municipal Securities Income Trust, Federated Premier Municipal Income Fund, Federated Short-Term Municipal Trust, Intermediate Municipal Trust and Money Market Obligations Trust. Federated would also rely on the Staff’s interpretive opinion with respect to any additional investment companies that retain Federated as an investment adviser (as defined in Section 2(a)(20) of the 1940 Act) to manage a portfolio invested primarily in municipal securities.

The Commission has previously determined, however, that certain transactions which involve the purchase or sale of securities between a registered investment company and another investment company or other entity which is an affiliated person, or affiliated person of an affiliated person, of such an investment company, do not necessarily give rise to the concerns underlying Section 17(a) of the 1940 Act. The Commission has therefore adopted regulations that permit certain principal transactions between the investment company and such other affiliated persons without exemptive relief provided certain safeguards are in place to prevent the abuses designed to be prevented by Section 17(a). Thus, for example, Rule 17a-7 permits the purchase or sale of securities between an investment company and another affiliated investment company.

Rule 17a-7 states that a “purchase or sale transaction between registered investment companies or separate series of registered investment companies, which are affiliated persons, or affiliated persons of affiliated persons, of each other, between separate series of a registered investment company, or between a registered investment company or a separate series of a registered investment company and a person which is an affiliated person of such registered investment company (or affiliated person of such person) solely by reason of having a common investment adviser or investment advisers which are affiliated persons of each other, common directors, and/or common officers, is exempt from Section 17(a) of the Act” provided that certain enumerated conditions are met. One condition of Rule 17a-7 is that the “transaction [be] effected at the independent current market price of the security.” In the case of municipal securities, paragraph (b)(4) of Rule 17a-7 defines the independent current market price as “the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.” Another condition of Rule 17a-7 is that the transactions involve securities for which market quotations are readily available.

The Board of Directors or Board of Trustees of each Municipal Fund (the “Board”) has adopted procedures in accordance with Rule 17a-7. The current procedures require Federated to use bid and offered prices obtained from three independent dealers to determine the price at which municipal securities are traded. The price used in the Rule 17a-7 transaction is the average of the highest bid and lowest offer. This normally results in a sale price that is better than the best bid, and a purchase price that is better than the best offer, so that both the buying and selling funds benefit from trading in accordance with Rule 17a-7.

The Municipal Funds sometime encounter difficulty obtaining reliable offers from dealers for purposes of Rule 17a-7 trades. While dealers willingly bid for securities held in a Municipal Fund’s portfolio, the price at which they would offer to sell securities that they do not hold in inventory and cannot readily obtain is understandably more tentative. Typically, dealers indicate that their offer price would be in the range of a spread over their bid price. In circumstances where the difference between bids from different dealers is greater than their indicated spreads, this can create a misleading impression that one dealer is willing to sell the securities at a lower price than another dealer would bid for it.

One alternative to this would be to use the average of three bid prices. This was the methodology initially authorized by the SEC in the United Fund Letters. However, as the United Fund Letters explain, this alternative systematically favors the buyer in the Rule 17a-7 transaction, because the seller necessarily receives less than the best bid for the securities. The Municipal Funds are therefore not seeking relief for this method.

In addition, as further explained in the United Fund Letters, use of any price in a Rule 17a-7 trade other than the price used to calculate the Municipal Funds’ net asset value may lead to artificial wealth transfers between the trading funds. For example, suppose that two funds hold the same security and use the same pricing service to value the security for purposes of calculating their net asset values. Assume further that the pricing service values the security at \$100 at all relevant times. If the funds transfer the security in a transaction under Rule 17a-7 at a price other than \$100, then when the funds next calculate their net asset values (using the pricing service valuation of \$100), one fund will appear to incur a loss (the selling fund, if the Rule 17a-7 price is below \$100; the buying fund if the Rule 17a-7 price is above \$100) while the other fund appears to receive a corresponding gain. The loss and gain are artificial because, in the absence of a contemporaneous market transaction in the security, there is no basis for concluding that the price used for the 17a-7 transaction is more reliable than the price provided by the pricing service.

Therefore, Federated believes that the best alternative would be to use prices provided by SPSE for Rule 17a-7 transactions involving municipal securities for which market quotations are not readily available. This approach will result in the same prices being used in the Rule 17a-7 transactions as the affiliated funds used for purposes of valuing the securities under

Section 2(a)(41) and Rule 2a-4. Federated represents that the Municipal Funds will comply with all of the representations contained in the United Fund Letters, other than their use of SPSE, rather than FTID, as their independent pricing service.

## **B. The United Fund Letters**

The United Municipal Bond Fund, Inc. and the United Municipal High Income Fund, Inc. (collectively the “United Funds”) made their initial request to use the price provided by their pricing service to value municipal securities for purposes of Rule 17a-7 in a letter dated October 29, 1991. Initially, the Staff was unwilling to provide the requested relief. Instead, the Staff agreed to allow the United Funds to value municipal securities in Rule 17a-7 trades using any of the following methods:

by averaging prices obtained from at least three independent matrix pricing services, or by averaging three independent bid prices, or by averaging three prices obtained from some combination of independent pricing services and independent bid prices; [footnote omitted].

The United Funds renewed their request in a subsequent letter dated April 20, 1993, after:

it became apparent that there was a more fundamental problem with the averaging approach itself. Specifically, in a sale made in reliance on the no-action letter and at a price determined by averaging two independent bid prices and one price from an independent pricing service, the selling Fund experienced a loss, because each of the bid prices, and therefore the average of the three prices, was lower than that provided by the pricing service (whose price, had there been no sale, would have been used for the Fund’s valuation pursuant to Rule 2a-4). [Footnote omitted.]

The United Funds based their renewed request primarily on the fact that their pricing service used “hand pricing” rather than “matrix pricing” to value municipal securities. According to the representations made in the United Funds’ final request letter dated October 18, 1994:

[FTID] has a staff of evaluators to whom clients’ securities are assigned, typically according to particular segments of the municipal market, such as pre-refunded bonds or general obligations. We understand that evaluators operate generally as follows: in the morning, an evaluator calls his or her contacts in the market (e.g., dealers and portfolio managers) to gather further information about recent trades, current bids, offerings of similar securities, general conditions or movements in the market or in particular market sectors, etc.; and in the afternoon, the evaluator makes an evaluation of each security for which he or she is responsible.

The United Funds also emphasized their regular testing of FTID’s prices:

Under its current procedures, each week the Manager obtains from another pricing service prices for those securities which represent 1% or more of the net assets of all funds advised by the Manager that use [FTID]’s pricing service. The total of these alternate prices is then compared to the total derived from [FTID]’s prices for the same securities. Under current procedures, on an annual basis each Fund’s Board of Directors reviews and considers the continuance of the use of the pricing service and the Manager’s testing methodology.

In addition, in connection with its annual review of the internal control structure for the Funds and the other funds for which it serves as independent accountants, Price Waterhouse tests the reliability of [FTID]’s pricing.

Under these circumstances, the Staff agreed “to modify the pricing condition in the original no-action relief granted to the Funds, and, accordingly, [not to] recommend that the Commission take any enforcement action under Section 17(a) if the Funds buy and sell portfolio securities between themselves using a price provided by the pricing service that values the Funds’ municipal bonds for Rule 2a-4 purposes. ...” [Footnote omitted]

### C. SPSE's Valuation Methodology

We have reviewed the current evaluation methodologies of SPSE and FTID.<sup>1</sup> Like FTID, SPSE employs “evaluators” who are “responsible for determining the evaluated prices for securities in a specific market sector.” Generally, the evaluators use an Integrated Evaluation System (“IES”) “that collect[s] and categorize[s] information to assist evaluators in determining an evaluated price for each security priced by SPSE.” The IES incorporates pricing models “that are specific to industry sectors, sub-sectors, and security structure,” and that are based on the following types of market data:

Trades in the security;

- » Bid/asked quotes that represent executable trade levels for the security;
- » Bids from a market participant with authority and capacity to complete a transaction in the security;
- » Trades of securities that the evaluator determines to be of meaningful size and comparable to the security being priced; and
- » Opinions of market participants (often referred to as “dealer quotes” or “marks”).

We understand that SPSE updates this information daily.

Clearly, the SPSE process corresponds in every material respect with the process outlined in the United Fund Letter. In each case, a trained professional uses current market information (including trades in, and offers and bids for, the security) to evaluate each security on a daily basis. The IES uses pricing models to determine valuations based on this information in the same manner as FTID’s evaluators, “build internal yield curves” to “extrapolate [various] factors to evaluate related [securities].” In summary, the Municipal Funds believe that the prices provided by SPSE will be as reliable for purposes of inter-fund trading under Rule 17a-7 as are the prices provided by FTID to the United Funds.

### D. Conclusion

In view of the foregoing, we respectfully request that the Staff would not recommend enforcement action to the Commission under Section 17(a) of the Investment Company Act against the Municipal Funds if they use SPSE as their independent pricing service and engage in 17a-7 transactions involving municipal securities for which market quotations are not readily available, provided that the Municipal Funds comply with all of the representations contained in the United Fund Letters, other than their use of SPSE, rather than FTID, as their independent pricing service.

In compliance with the procedures set forth in 1933 Act Release Nos. 6269 (December 5, 1980) and 5127 (January 25, 1971), seven copies of this letter are submitted herewith, and the specific subsections of the particular statutes to which this letter relates are indicated in the upper right-hand corner of the first page of this letter and each copy. If, for any reason, the Staff does not concur with our conclusions, we respectfully request a conference with the Staff before any adverse written response to this letter is issued.

Please acknowledge receipt of this letter by date stamping the enclosed receipt copy and returning the same in the enclosed self-addressed stamped envelope.

Should you or any member of the Staff have any questions concerning the foregoing or need additional information or clarification, please contact the undersigned, at (412) 288-1567.

Very truly yours,

Stephen A. Keen

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<sup>1</sup> Copies of the Standard & Poor’s Securities Evaluation General Methodology and the FT Interactive Data U.S. Municipal Bonds Evaluation Methodology are enclosed with this letter.

## EXCERPT FROM COMPLIANCE ALERT

July 2008

Dear Chief Compliance Officer:

The SEC staff conducts compliance examinations of SEC-registered investment advisers, investment companies, broker-dealers, and transfer agents and other types of registered firms to determine whether these firms are in compliance with the federal securities laws and rules, and to identify deficiencies and weaknesses in compliance and supervisory controls. This “ComplianceAlert” letter summarizes select areas that SEC examiners have recently reviewed during examinations and describes the issues we found and some of the practices we observed. By periodically sharing this information with compliance personnel, our intent is to alert you to these issues, encourage you to review compliance in these areas at your firm, and encourage improvements in compliance and in compliance programs. Some of the practices we discuss are for informational purposes, are not legal requirements, and, depending on the characteristics of your firm, may not be practicable for your firm to implement given its business or operations. We note that this document was prepared by the SEC staff.<sup>1</sup>

\* \* \*

### Valuation and Liquidity Issues in High Yield Municipal Bond Funds

Many high yield municipal bond funds invest in securities that trade in the secondary market on an infrequent basis or never trade in the secondary market. Market quotations for such securities are often not considered to be readily available. Such limited market activity usually results in the funds’ boards determining the fair value of these instruments for net asset value purposes, often considering pricing services’ evaluated prices. Further, liquidity determinations for a high yield municipal bond fund are critical to ensure that the fund is able to redeem fund shares within seven days, as required under the Investment Company Act.

During these examinations of high yield municipal bond funds, examiners generally focused on portfolio composition, valuation, and transaction activity. Specifically, examiners: analyzed the credit quality of portfolio holdings; reviewed illiquidity levels as determined by fund management; compared sales prices to prior day valuations; compared bond valuations provided by pricing services to market transaction data; reviewed fund policies and procedures relevant to security valuation and determinations of liquidity including, where applicable, board oversight of those policies and procedures; reviewed portfolio credit and research files; and interviewed compliance and advisory personnel regarding policies and procedures and internal controls relevant to valuation and liquidity determinations.

During a series of targeted examinations focusing on high yield fund valuation, examiners noted the following:

*Portfolio composition.* High yield funds with higher average credit qualities, fewer unrated securities, and fewer distressed and defaulted securities were generally less likely to have issues regarding valuation and liquidity raised by examiners. The percentage of illiquid securities held among the funds examined ranged from less than 1% to 70% of the fund’s portfolio holdings. Examiners particularly focused on whether funds may have been overvaluing securities classified as illiquid.

*Disclosure.* High yield funds often did not disclose the increased risk with respect to liquidity and valuation, as required. For example, examiners commented in situations where the percentage of illiquid securities held by a fund dramatically increased and the fund did not disclose: that a dramatic increase in the percentage of the fund invested in illiquid securities occurred and the risks associated with such an increase; what effect, if any, the increase may have on the fund’s ability to redeem investor shares in a timely manner consistent with the federal

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<sup>1</sup> The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other SEC staff, including in the Divisions of Investment Management and Trading and Markets, and do not necessarily reflect the views of the Commission or the other staff members of the SEC. Examinations indicating deficiencies generally result in (non-public) deficiency letters requesting that the firm take corrective action. Serious deficiencies may be referred to the SEC’s enforcement staff.

securities laws; and what steps, if any, the fund may take to dispose of some of the illiquid securities to bring the percentage within a range appropriate to the circumstances.

*Third-party pricing services.* Pricing services often relied on fund management to provide information needed to value securities held by high yield funds. Examiners commented that the fund's disclosure may be misleading if, in such instances, the fund represented that its pricing source provided "independent" values. Examinations revealed that pricing services relied on fund management to provide information at times, which may have resulted in stale review periods and stale valuations for a number of Rule 15c2-12 exempt securities. In addition, some funds were unable to sell securities at approximately the evaluated prices provided by a pricing service. Examiners may comment if the fund's board does not consider this information when subsequently evaluating the accuracy of the evaluated prices provided by the pricing service.

*Cross trades.* An adviser's trading of securities among client accounts can create risks that securities will be "dumped" from one client account to another, that the securities may be mispriced because they are not traded in the open market, or that one client may otherwise be disadvantaged. The few funds examined that entered into cross trades of securities for which there was no secondary market information were unable to provide examiners with documentation supporting their determination that the evaluated prices provided by the pricing services and used to cross the trades sufficiently represented market values (i.e., trade execution data, the latest bid and ask quotes, and information about offerings of similar securities).

*Board oversight.* It appeared that some funds did not adequately assess the accuracy of prices provided by pricing services. Examiners noted that some high yield funds' with effective valuation procedures required documentation and review of communications between portfolio management personnel and pricing services. The review of such communications can serve to detect and prevent inappropriate influence by portfolio management personnel over the valuation process and would substantiate the independence of a third-party pricing service.

*Records retention.* The manner in which some high yield funds chose to maintain their pricing histories for portfolio securities created difficulties for the personnel responsible for the high yield funds' pricing, and for boards of directors, to determine trends in price movements. Specifically, while not required, examiners have noted that funds' compliance reviews using electronic records allow for more efficient analysis and review of fund records for valuation anomalies and patterns requiring further research.

\* \* \*

This "ComplianceAlert" letter summarizes select areas that SEC examiners have recently reviewed during examinations and describes the issues found. We encourage you to review compliance in these areas at your firm, address any compliance or supervisory weaknesses and implement improvements as appropriate to your firm's compliance and supervisory programs.



## SEC OFFICE OF THE CHIEF ACCOUNTANT AND FASB STAFF CLARIFICATIONS ON FAIR VALUE ACCOUNTING

**Press Release 2008-234  
September 30, 2008**

Washington, D.C., Sept. 30, 2008—The current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors, and users of financial information. The SEC's office of the Chief Accountant and the staff of the FASB have been engaged in extensive consultations with participants in the capital markets, including investors, preparers, and auditors, on the application of fair value measurements in the current market environment.

There are a number of practice issues where there is a need for immediate additional guidance. The SEC's office of the Chief Accountant recognizes and supports the productive efforts of the FASB and the IASB on these issues, including the IASB Expert Advisory Panel's Sept. 16, 2008 draft document, the work of the FASB's Valuation Resource Group, and the IASB's upcoming meeting on the credit crisis. To provide additional guidance on these and other issues surrounding fair value measurements, the FASB is preparing to propose additional interpretative guidance on fair value measurement under U.S. GAAP later this week.

While the FASB is preparing to provide additional interpretative guidance, SEC staff and FASB staff are seeking to assist preparers and auditors by providing immediate clarifications. The clarifications SEC staff and FASB staff are jointly providing today, based on the fair value measurement guidance in FASB Statement No. 157, Fair Value Measurements (Statement 157), are intended to help preparers, auditors, and investors address fair value measurement questions that have been cited as most urgent in the current environment.

\* \* \*

### **Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?**

Yes. When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable. Statement 157 discusses a range of information and valuation techniques that a reasonable preparer might use to estimate fair value when relevant market data may be unavailable, which may be the case during this period of market uncertainty. This can, in appropriate circumstances, include expected cash flows from an asset. Further, in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to available observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs. The determination of fair value often requires significant judgment. In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.

### **How should the use of "market" quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?**

Broker quotes may be an input when measuring fair value, but are not necessarily determinative if an active market does not exist for the security. In a liquid market, a broker quote should reflect market information from actual transactions. However, when markets are less active, brokers may rely more on models with inputs based on the information available only to the broker. In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (e.g., whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.



**Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?**

The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

**Can transactions in an inactive market affect fair value measurements?**

Yes. A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used (generally without adjustment). Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative. If they are orderly, transactions should be considered in management's estimate of fair value. However, if prices in an inactive market do not reflect current prices for the same or similar assets, adjustments may be necessary to arrive at fair value.

A significant increase in the spread between the amount sellers are "asking" and the price that buyers are "bidding," or the presence of a relatively small number of "bidding" parties, are indicators that should be considered in determining whether a market is inactive. The determination of whether a market is active or not requires judgment.

**What factors should be considered in determining whether an investment is other-than-temporarily impaired?**

In general, the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred.

Determining whether impairment is other-than-temporary is a matter that often requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment. This includes an assessment of the nature of the underlying investment (for example, whether the security is debt, equity or a hybrid) which may have an impact on a holder's ability to assess the probability of recovery.

Existing U.S. GAAP does not provide "bright lines" or "safe harbors" in making a judgment about other-than-temporary impairments. However, "rules of thumb" that consider the nature of the underlying investment can be useful tools for management and auditors in identifying securities that warrant a higher level of evaluation.

To assist in making this judgment, SAB Topic 5M<sup>1</sup> provides a number of factors that should be considered. These factors are not all inclusive of the potential factors that may be considered individually, or in combination with other factors, when considering whether an other-than-temporary impairment exists. Factors to consider include the following:

- » The length of the time and the extent to which the market value has been less than cost;
- » The financial condition and near-term prospects of the issuer, including any specific events, which may influence the operations of the issuer such as changes in technology that impair the earnings potential of the investment or the discontinuation of a segment of the business that may affect the future earnings potential; or
- » The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

All available information should be considered in estimating the anticipated recovery period.

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<sup>1</sup> AU 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities, of the PCAOB Interim Auditing Standards also provide factors to consider when evaluating whether an impairment is other-than-temporary.

Finally, because fair value measurements and the assessment of impairment may require significant judgments, clear and transparent disclosures are critical to providing investors with an understanding of the judgments made by management. In addition to the disclosures required under existing U.S. GAAP, including Statement 157, the SEC's Division of Corporation Finance recently issued letters in March and September that are available on the SEC's Web site to provide real-time guidance for issuers to consider in enhancing the transparency of fair value measurements to investors. Additionally, the SEC staff and the FASB staff will continue to consult with capital market participants on issues encountered in the application of fair value measurements.

# # #

# SEC ENFORCEMENT ACTIONS ON VALUATION

## IN THE MATTER OF FINANCIAL PROGRAMS, INC., ET AL.

Release Nos. 34-11312; IA-447; IC-8725  
Administrative Proceeding File No. 3-4610

March 24, 1975

### Findings and Order Imposing Remedial Sanctions

#### I.

Financial Programs, Inc. (“Programs”), a mutual fund manager registered with this Commission as both broker-dealer and investment adviser, was and is investment adviser to and principal underwriter for four mutual funds.<sup>1</sup> John R. Hurley and James R. Frankenthaler were formerly employed by Programs as portfolio managers. To determine whether certain allegations about Programs, Hurley and Frankenthaler are true and the remedial action, if any, that ought to be taken, these proceedings were instituted<sup>2</sup> under the Securities Exchange, Investment Company, and Investment Advisers Acts.<sup>3</sup> Solely for the purpose of disposing of this matter and without admitting or denying the allegations in the order for proceedings, Programs, Hurley, and Frankenthaler have made offers of settlement. The Commission’s staff recommends that those offers be accepted. And the Commission has decided to do so.<sup>4</sup>

#### II.

The prospectuses of Programs’s funds represented that they were professionally managed by competent persons. Actually, Programs permitted inexperienced and incompetent persons to make significant investment decisions for the funds. Hurley, Frankenthaler, and other persons committed over \$21 million of the funds’ assets to over-the-counter securities that were speculative, unseasoned and in limited supply. They did that on the basis of recommendations made to them by a single salesman. Their reliance on him was excessive. Neither Programs, nor Hurley, nor Frankenthaler made any adequate independent study of the companies in question.<sup>5</sup>

The issues were thinly traded. And Programs, Hurley, and Frankenthaler caused the funds to buy them repeatedly and heavily. As previously noted, the supply of these securities available for trading in the public market was quite limited. In some cases, the funds eventually acquired much of that limited supply.<sup>6</sup>

<sup>1</sup> Financial Industrial Fund, Inc., Financial Industrial Income Fund, Inc., Financial Dynamics Fund, Inc., Financial Venture Fund, Inc.

<sup>2</sup> Three other persons formerly associated with Programs are also named as respondents.

<sup>3</sup> Section 15(b) of the Securities Exchange Act, Section 9(b) of the Investment Company Act, and Section 203(f) of the Investment Advisers Act.

<sup>4</sup> No evidentiary hearing has been held. The findings made below rest entirely on the order for proceedings and the offers of settlement. Hence they do not bind the non-settling respondents.

<sup>5</sup> They were Richard Packing Company, Richard Franchise Investment, Inc., Status Marketing Corp., Frigitemp Corp., Acrite Industries, Inc., Combustion Equipment Associates, Inc., Michael Craig Personnel, Inc., Cassette Cartridge, Inc., Data Lease Financial Corp., Component Systems, Underwriters Bank and Trust Company, Neo Tec Corp., Dimension V. Ltd., Textone, Inc., Integrated Medical Services, Ltd., and Pan American Dynamics.

<sup>6</sup> In none of the instances enumerated in the preceding footnote did the funds acquire in the aggregate less than 22% of the total quantity of securities available for public trading. It was not uncommon to acquire more than half the floating supply. In one case over 85% of the securities available for trading were acquired, and in another the 70% mark was exceeded.

Because of those substantial purchases, the prices of the securities rose. The funds' prospectuses, proxy-soliciting materials, and periodic reports reflected these price rises and the resulting increases in the net asset values of the funds' own shares. And they did so without disclosing that the ascending market prices had been caused and were being maintained by the funds' own purchases or mentioning the funds' inability to dispose of their holdings at the prices that their own buying had created.<sup>7</sup>

The prospectuses said that the funds invested in "securities believed to be readily marketable." The aforementioned securities could not reasonably have been considered "readily marketable."<sup>8</sup> The prospectuses also stated: "We do not purchase securities if the purchase would cause us, at the time, to have more than 5% of the value of our total assets invested in the securities of any one company or to own more than 10% of the voting securities of any one company (except obligations issued by the United States Government)." In practice, these limitations were sometimes disregarded.<sup>9</sup>

The literature that Programs caused the funds to disseminate about themselves did not disclose that the funds had incurred and were incurring unreasonably high transaction costs in the purchase of the securities recommended by the salesman. These securities could have been and should have been purchased from the dealers who made markets in them. But this was not done. Instead they were acquired through the brokerage firm with which the recommending salesman was associated. Not being a market maker itself, that firm had to buy the securities from the market makers with whom the funds could have dealt directly. And since the salesman's firm charged commissions, the funds and their shareholders were saddled by excessive transaction costs.<sup>10</sup>

Moreover, Programs caused the funds to keep excessive cash balances on deposit with a certain bank.<sup>11</sup> That bank considered those balances when it lent money to persons affiliated with Programs. Finally, for more than two years Programs failed to make an adequate inquiry into the transactions chronicled herein.<sup>12</sup> And having made no adequate inquiry, it, of course, failed to take appropriate action to recover for the funds the losses that they had sustained by reason of the events just narrated.

It follows from the foregoing that Programs willfully violated and willfully aided and abetted willful violations by others of the antifraud provisions of the Securities, Securities Exchange, Investment Company, and Investment Advisers Acts.<sup>13</sup>

### III.

Programs failed to supervise its subordinate employees reasonably with a view to the prevention of the foregoing violations. This breached the duty to supervise imposed by Section 15(b)(5)(E) of the Exchange Act.<sup>14</sup>

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<sup>7</sup> The purchases were made in 1969 and in the first four months of 1970. In May of 1970 the buying stopped, and the selling began. And the funds were able to sell these securities. But the prices they had to accept were so low that most of the original investment was lost.

<sup>8</sup> Compare *Wolf Corporation*, 42 SEC 1042, 1048 (1966); *National Lithium Corporation*, 40 SEC 746, 752 (1961).

<sup>9</sup> Another disregarded limitation involved *Financial Industrial Income Fund, Inc.* Its prospectus represented that it would invest in dividend-paying stock and in debt securities yielding interest income. Nevertheless, it purchased the debentures of an unseasoned company with nominal assets that was financially incapable of paying interest.

<sup>10</sup> This type of interpositioning was a breach of fiduciary duty. As the Commission said in *Delaware Management Company, Inc.*, 43 SEC 392, 400 (1967): "[R]espondents did not have a legitimate basis for believing that their transactions in portfolio securities on behalf of the Funds were in accordance with industry practice and applicable law. Persons engaged in the securities business cannot be unaware of their obligation to serve the best interests of customers and that interpositioning is bound to result in increased prices or costs."

<sup>11</sup> The Commission has suggested that "The balance maintained in such accounts should not exceed that amount which is necessary to meet current recurring expenses and distributions declared and payable to shareholders." *Investment Company Act Release No. 6863, Guidelines Relating to Checking Accounts* (December 6, 1971).

<sup>12</sup> The period referred to ran from May of 1970 to September of 1972.

<sup>13</sup> Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, Section 206 of the Investment Advisers Act, and Section 34(b) of the Investment Company Act.

<sup>14</sup> No finding is made under Section 203(e)(5) of the Investment Advisers Act. That section was not in effect during the relevant period.

#### IV.

The funds' prospectuses said that their shares were available to the public through Programs at net asset value plus a disclosed sales charge. Actually, however, buyers paid more than that. They were made to do so because the "net asset value" that they were charged was inflated by appraising the funds' positions in the salesman-recommended issues solely by reference to market quotations that had been boosted to and were being maintained at unreasonable high levels by the funds' own massive purchases. Hence those quotations were unrealistic guides to fair value.<sup>15</sup>

It follows that Programs willfully violated and willfully aided and abetted violations by others of Section 22(d) of the Investment Company Act. That section provides in pertinent part:

"No registered investment company shall sell any redeemable security issued by it to any person except . . . at a current public offering price disclosed in the prospectus, and . . . no principal underwriter of such security . . . shall sell any such security . . . except at a current public offering price described in the prospectus."

The overstatements of net asset value that imposed unfair burdens on incoming shareholders conferred undue benefits on withdrawing shareholders. Those benefits stemmed from the fact that shareholders who tendered their shares to the funds for redemption were paid off at true net asset value plus hidden premiums stemming from the inflated figures at which the funds carried their positions in the salesman-recommended issues. Hence the remaining shareholders were taxed for the benefit of those who chose to redeem. That was in willful violation of Rule 22c-1(a) under the Investment Company Act, which requires that redemptions be made only at prices "based on the current net asset value."<sup>16</sup>

Programs stresses certain mitigating factors. It asserts that:

- (1) Its management and that of the funds was changed in May of 1970—three years before the Commission's staff began to investigate this matter.
- (2) None of the alleged wrongdoing relating to the purchase or valuation of securities occurred under the new management.
- (3) The funds' investment performance under their present management has been better than the average performance of comparable funds.
- (4) The securities salesman who instigated the improper portfolio activity has been convicted in the United States District Court for the Southern District of New York for fraudulently inducing the funds to buy one of the securities involved.
- (5) When Hurley and Frankenthaler bought and sold securities for their own accounts at or about the same time that they were causing the funds to buy such securities, they violated Programs's own Code of Conduct.<sup>17</sup>

<sup>15</sup> In these circumstances Section 2(a)(39) of the Investment Company Act and the Commission's Rule 2a-4 under the Act made it "incumbent upon the Board of Directors [of each fund, and Programs, of course, was represented on those boards] to satisfy themselves that all appropriate factors relevant to . . . value . . . have been considered and to determine the method of arriving at the fair value of each such security." Investment Company Act Release No. 6295, Securities Act Release No. 5120, Securities Exchange Act Release No. 9049, Accounting Series Release No. 118, Accounting for Investment Securities by Registered Investment Companies (December 23, 1970). That release goes on to stress the gravity and the nondelegable character of the directors' responsibilities in this regard and then points out that: "No single standard for determining 'fair value' . . . in good faith can be laid down, since fair value depends upon the circumstances of each individual case. As a general principle, the current 'fair value' of an issue of securities being valued by the Board of Directors would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale . . . [F]actors which the directors should consider . . . include . . . the fundamental analytical data relating to the investment . . . and an evaluation of the forces which influence the market in which these securities are bought and sold."

<sup>16</sup> That rule was adopted under Section 22(c) of the Act, which when taken together with Section 22(a) of the statute, authorizes the Commission to prescribe rules about redemptions "for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company [i.e., the redeeming investment company] or any other result of . . . redemption . . . which is unfair to holders of such other outstanding securities."

<sup>17</sup> See part VII, *infra*.

Programs also points out that at the time of these events the Commission had published nothing about the way in which investment companies should value thinly traded portfolio securities.<sup>18</sup>

But see Cady, Roberts & Co., 40 SEC 907, 911 (1961): “These antifraud provisions encompass the infinite variety of devices by which undue advantage may be taken. . . .” See also SEC v. Capital Gains Research Bureau, Inc. 375 U.S. 180, 193 n. 41 (1963); Foshay v. United States 68 F.2d 205, 211 (C.A. 8, 1933).

## VI.

Programs’s offer of settlement obligated it to:

- (A) Refrain for 180 days from performing any investment advisory function for any new client;<sup>19</sup>
- (B) Offer the funds \$2.5 million in settlement of claims against it based on the activities described herein and on other grounds;
- (C) Pay half of that \$2.5 million to the funds<sup>20</sup> even if their Boards of Directors decide to reject Programs’s settlement offer to them,<sup>21</sup>
- (D) Employ (within 120 days from the date hereof) a special compliance officer satisfactory to the Commission,<sup>22</sup> who will:
  - (i) Review Programs’s procedures in managing the funds, including those dealing with the supervision of employees responsible for the purchase and sale of portfolio securities and with the maximum utilization of the funds’ cash balances;
  - (ii) Prepare a report based on such review, which report may recommend changes in and/or additions to Programs’s present procedures; and
  - (iii) Regularly monitor Programs’s compliance with the manual described in the following paragraph until the compliance program set forth in that document has been implemented;
- (E) Prepare and adopt (within 180 days after receipt of the special compliance officer’s report) a comprehensive manual of procedures, which manual shall (i) include a compliance program, and (ii) be submitted to the funds and to the Commission;
- (F) Refrain in the future from causing more than two people associated with it to serve on any of the funds’ boards,<sup>23</sup> and
- (G) Subject itself to the Commission’s jurisdiction should questions arise about its compliance with its undertakings.<sup>24</sup>

To advance their shareholders’ interest, the funds have undertaken to reconstitute their boards by adding three new directors to them. These new directors, who are to be satisfactory to the Commission’s staff and independent of

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<sup>18</sup> Its offer of settlement says: “During the period referred to by the Commission’s Order, no rule, regulation or release had been published by the Commission with respect to, and there were no generally accepted procedures for, the valuation of portfolio securities at other than quoted market prices in cases where a single mutual fund or a group of mutual funds, having the same investment adviser, purchased a significant portion of the securities of an issuer available for trading in the over-the-counter market, or which otherwise purported to limit the aggregate amount of a single issuer which could be purchased by such funds.”

<sup>19</sup> This will not impair Programs’s ability to continue to act for the funds and for other existing clients.

<sup>20</sup> This \$1.25 million fund has already been deposited with an escrow agent.

<sup>21</sup> Rejection will lead to the division of this \$1.25 million among the funds in accordance with their respective losses.

<sup>22</sup> The Commission is not to withhold its approval of this person unreasonably.

<sup>23</sup> This commitment will take effect at the next annual meetings of the funds’ shareholders.

<sup>24</sup> Programs’s offer provides that if it “fails to comply with any order issued pursuant to this offer or any undertaking made in this offer, the Commission may, after notice and hearing, issue such further order, or impose such sanction, as it deems appropriate.” The issues in any hearings held pursuant to this proviso will relate solely to Programs’s compliance with its own undertakings and the appropriateness of further relief. All findings made herein shall be binding for the purposes of any such subsequent hearing.

Programs, will constitute three of the four members of a special committee of each Board to be created for the purpose of determining whether to accept or reject Programs's settlement proposals.

## VII.

From what has thus far been said, it follows that Hurley and Frankenthaler:

- (1) Willfully violated all of the statutory sections that Programs violated; and
- (2) Willfully aided and abetted Programs's violations.

Moreover, Hurley and Frankenthaler bought a salesman-recommended issue for their own accounts not long before that same stock was purchased by a Programs-managed fund. They then sold that stock at a profit. These transactions were arranged by the recommending salesman. Hence they must be deemed vehicles by which he compensated Hurley and Frankenthaler for channeling the funds' brokerage to him. Accordingly, Hurley and Frankenthaler willfully violated Sections 17(d) and 17 (e)(1) of the Investment Company Act as well as the Commission's Rule 17d-1 under the former section.

Section 17(d) prohibits people in positions such as those occupied by Hurley and Frankenthaler from entering into any transaction in which any registered investment company linked with them is a "joint or a joint and several participant . . . in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered . . . company on a basis different from or less advantageous than that of any other participant." And Rule 17d-1 requires that every such transaction be approved in advance by the Commission.

As the Commission said a decade ago in another case:

"In the instant case we do not have the mere happenstance of simultaneous ownership of the same securities by an investment company and affiliated persons. On the contrary. . . Imperial and affiliated persons of Imperial undertook at or about the same time to invest in the same companies at the inducement or arrangement of the same persons. Section 17(d) seeks to prevent affiliated persons of a registered investment company from taking undue advantage of the investment company in transactions in which such persons and company participate in a joint undertaking. The possibility that the investment company was not disadvantaged does not cure the unlawfulness of proceeding with the joint enterprises without obtaining the prior approval of this Commission as required by Rule 17d-1."<sup>25</sup>

Section 17(e)(1) of the Act makes it unlawful for any affiliated person of a registered investment company or any affiliated person of such person, "acting as agent, to accept from any source any compensation . . . for the purpose or sale of any property of or for such registered company . . . except in the course of such person's business as underwriter or broker." Its applicability to the instant case is clear. As the Commission has said: "Section 17(e)(1) . . . is designed to prevent the receipt, by any affiliated person acting for the investment company, of any compensation in connection with the purchase and sale of investment company assets other than his regular salary or underwriter's or broker's fees."<sup>26</sup>

Frankenthaler's prohibited transaction related to a single security.<sup>27</sup> Hurley's case involves not only that security, but two others as well. In addition, Hurley received merchandise and other benefits from the recommending salesman.

Hence it is appropriate in the public interest to:

- (A) Bar Hurley from both the general securities business and the investment company industry, and

<sup>25</sup> Imperial Financial Services, Inc., 42 SEC 717, 727 (1965).

<sup>26</sup> Imperial Financial Services, Inc., *supra* at 727 (1965). *See also* United States v. Deutsch, 451 F.2d 98, 113 (C.A. 2, 1971), cert. denied 404 U.S. 1019 (1972): "[T]he requisite intent under § 17(e)(1) is intent to give and accept a gratuity in appreciation for past or present conduct . . . ."

<sup>27</sup> His case also presents mitigating factors that are not present in Hurley's. Frankenthaler says that he reported all of his transactions in securities to his superiors and that they never advised him that he was doing anything improper. Moreover, Frankenthaler had no prior experience as a mutual fund investment manager. He asserts that the guidance and supervision given him by Programs were grossly inadequate.



(B) Suspend Frankenthaler from association with any broker-dealer, or investment adviser for six months, with the proviso that he may after three months from the date hereof become so associated as a non-supervisory security analyst, and also bar him from association with any investment company with the proviso that he may after 18 months from the date hereof apply to the Commission for permission to become so associated upon a showing of appropriate supervision acceptable to the Commission's staff.

#### **VIII.**

Accordingly, IT IS ORDERED that Financial Programs, Inc. be and it hereby is, required to do all that it has undertaken to do in its offer of settlement herein and in the undertaking annexed thereto; and it is further

ORDERED that if the said Financial Programs, Inc. should fail to comply with any of its aforementioned undertakings the Commission may, after notice and hearing, issue such further order with respect to Financial Programs, Inc. or impose such additional sanction on it as it deems appropriate; and it is further

ORDERED that John R. Hurley be, and he hereby is, barred from association with any broker, dealer, or investment adviser; and it is further

ORDERED that the said John R. Hurley be, and he hereby is, prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser, depositor of, or principal underwriter for any registered investment company or any affiliated person of such investment adviser, depositor, or principal underwriter; and it is further

ORDERED that James R. Frankenthaler be, and be hereby is, suspended for six months from the date hereof from association with any broker, dealer, or investment adviser, provided, however, that he may after the expiration of three of said six months become so associated in a non-supervisory position as a security analyst; and it is further

ORDERED that the said James R. Frankenthaler be, and he hereby is, barred from association with any investment company, provided, however, that he may after 18 months from the date hereof and upon a showing of appropriate supervision acceptable to the Commission's staff apply to the Commission for permission to become so associated.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

## REPORT OF INVESTIGATION IN THE MATTER OF GREATER WASHINGTON INVESTORS, INC.

Release No. 34-15673  
March 22, 1979

### I. Introduction

The Commission has conducted a private investigation of Greater Washington Investors, Inc. ("GWI") and its wholly-owned small business investment company subsidiary, Greater Washington Industrial Investments, Inc. ("SBIC"). In light of the high standard of care to which investment company boards of directors are held under the Investment Company Act of 1940 ("1940 Act"), the Commission deems it appropriate that a public report of this investigation be issued pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act").\*

\*Commissioner Karmel dissents from the publication of this Release.

### II. Background

Greater Washington Investors, Inc., a District of Columbia corporation organized on August 26, 1959, is registered under the 1940 Act as a closed-end, nondiversified investment company of the management type principally investing in unseasoned technology-oriented companies for which no active markets exist. GWI is internally managed and its net asset value has fluctuated from \$4.8 million when it commenced operation in 1960 to a high of \$21 million in 1969 and a low of \$731,000 in 1975.

Until July 1, 1968, GWI operated as a federal licensee under the Small Business Investment Act of 1958. At that time it transferred to a newly created wholly-owned subsidiary, Greater Washington Industrial Investments, Inc., certain of its assets and liabilities and its license as a small business investment company.

Simultaneous with entering a formal order of investigation, the Commission on November 7, 1974, suspended over-the-counter trading in the securities of GWI. The suspension was initiated primarily because of questions concerning the GWI Board's valuation of portfolio securities for the semi-annual period ending June 30, 1974. GWI's net asset value as set forth in its semi-annual report dated June 30, 1974, appeared to the Commission to raise significant questions as to the value of its portfolio of restricted securities. The trading ban was lifted on December 26, 1974, with an explanatory statement by the Commission outlining its concerns with the June 1974 financial statements.

### III. Issuance of an Option Agreement

In 1968, GWI invested \$500,000 in common stock and notes of a company which owned and intended to develop 2,000 acres of land on Mississippi's Gulf Coast. By 1971 GWI had increased its investment to \$2.6 million, secured by a second mortgage on the land. The company was unsuccessful in its development efforts and defaulted on its obligations to GWI. In contemplation of foreclosure, GWI formed a wholly-owned subsidiary, Singing River Properties, Inc. ("SRP") in June 1971. To capitalize SRP, GWI exchanged the second trust notes for SRP stock and debentures. Foreclosure occurred in August 1971, when SRP "bid in" the properties in cancellation of the indebtedness and took ownership of the property subject to the existing first trust notes.

In June 1972, SRP obtained a \$4.5 million loan commitment from Continental Mortgage Investors ("CMI"), secured by substantially all of SRP's assets. In addition, GWI issued CMI an option which provided that upon maturity of the loan (June 30, 1975), or prior thereto in the event of default by SRP, CMI could require GWI to repurchase SRP's note at its then current face value plus accrued interest upon 30 days' written notice.

SRP, however, was in poor financial condition at the time it received the loan commitment. It lost \$226,000 during its first six months of operation, during which period GWI and its SBIC subsidiary invested \$339,661 in demand notes and non-interest-bearing advances. A footnote to SRP's December 31, 1971 financial statements stated:

The Company's present sources of revenue are not considered sufficient to support current operations or to finance the further development of the property. In addition, the Company's resources are not sufficient to permit repayment of

the \$1,200,400 first trust note if demand were made by [Bank]. Thus, the Company is in need of substantial additional financing and is presently dependent upon its parent company, [GWI], to provide the necessary funds. [GWI] has indicated its intention to continue to provide additional funds until other financing is obtained. However, the extent to which funds will continue to be provided cannot be presently determined. Management of the Company and of [GWI] are currently attempting to secure additional financing to provide necessary working capital to permit further development of the property and to refinance the first trust note.

In their report letter, SRP's independent auditors further stated:

This situation raises a question as to whether or not the going concern basis is an appropriate basis for these financial statements. If substantial additional financing is not obtained, or if the parent company discontinues providing funds, the Company may be unable to continue its operations.

For these reasons, the auditors did not express an opinion on SRP's financial statements prepared as of December 31, 1971 for the six-month period from the date of incorporation (June 30, 1971) to December 31, 1971.

SRP continued to lose money in 1972 (\$165,897 for the first six months), and by June 30, 1972, GWI had advanced an additional \$276,396.

The CMI loan to SRP was approved by the Continental Advisers loan committee in May 1972, subject to several conditions, one of which was that

[a] complete financial analysis by [a vice-president and treasurer of Continental Advisers and assistant treasurer of CMI] be conducted of [GWI], the parent company and such analysis and recommendations be reviewed by the Loan Committee as a condition precedent to the documentation of this loan. This is important in that [GWI] will provide a repurchase agreement to CMI, which repurchase agreement shall provide for the purchase of CMI's note either upon default or upon maturity.

That report states:

The specific purpose of the review was to determine whether [GWI] appeared to have the financial strength necessary to honor an agreement to repurchase the subject loan at the end of three years if the loan is not paid by its terms. In addition, attention was directed to the fact that it would be necessary for [GWI] to provide [SRP] with funds to service debt and provide marketing support during the second and third years of the subject loan program since such costs were built into the loan for only the first year.

\* \* \*

[GWI's president] has assured me that SRP is [GWI's] principal investment at this time and that the entire resources of [GWI] will be managed with a view of providing all the support necessary to meet the cash obligations arising from this project. He indicated that while cash flow generated from operations over the next three years would not be kept idle in order to accumulate funds against this contingent liability, the reinvestment of such funds will be made with the view of providing reasonable liquidity on a fairly short-term basis if necessary.

The financial statements of SRP do not indicate any real potential for providing funds for debt service and marketing costs. [GWI's president] is aware of this and indicated that [GWI] has committed \$1.5 million to support SRP.

The GWI Board stated that its decision to take over the Mississippi properties through foreclosure was predicated upon its judgment, based on a November 1969 MAI appraiser of such properties of more than \$4 million and subsequent independent valuations of up to \$8 million, that they were worth substantially more than the amount invested. A \$3.6 million MAI appraisal, made immediately after foreclosure, confirmed the Board's judgment that significant values existed and established a net value of GWI's interest in excess of \$1.8 million. The GWI Board states that its decision to support SRP financially was based upon evaluation prepared by various independent consultants. In addition, the decision to take the CMI development loan commitment was predicated in part upon contemporaneous projections

prepared by another consultant<sup>1</sup> which concluded that SRP would have been able to fully service the development loan as well as all other operating costs, including marketing. Thus, it is the Board's position that SRP was in relatively strong condition in terms of the value of its assets, and that it had a reasonable basis to conclude that SRP would be a viable operation if properly financed. The Board believes that its judgment was confirmed when SRP's auditors issued an unqualified opinion on SRP's 1972 financial statements following consummation of the CMI loan.

It is the Commission's view that where a wholly-owned subsidiary, in weak financial condition, dependent upon cash infusions from its parent to continue operations, receives a loan, the interest payments on which it cannot service and which its parent is obligated to repurchase upon default, the repurchase agreement evidences an indebtedness of the parent and is therefore a senior security within the meaning of Section 18(g) of the 1940 Act.

Section 18(a)(1)(A) of the 1940 Act requires that senior securities representing indebtedness have a 300 percent asset coverage. In the case of GWI, by virtue of a Commission order dated July 1, 1968, a 300 percent asset coverage on a consolidated, as well as parent-only, basis was required.<sup>2</sup> On June 30, 1972, after \$1,625,640 had been advanced by CMI under the loan agreement, GWI itself had 671% asset coverage.<sup>3</sup> However, the following figures indicate that by virtue of SBIC's previously outstanding indebtedness to the Small Business Administration, GWI did not, on a consolidated basis, have 300% asset coverage:<sup>4</sup>

Total Assets	Total Senior Securities	Asset Coverage
\$15,081,038	\$5,789,204	261%

It is GWI's belief, based on what it considers to be controlling authority, that the CMI transaction did not involve the issuance of a senior security; GWI states that in entering into the transaction it relied upon the considered advice of counsel to such effect.

By entering into the option agreement, the Commission believes that GWI became overly leveraged, a situation Section 18(a)(1)(A) was designed to prevent. Furthermore, the existence of the option ultimately became one of the considerations leading GWI to liquidate portfolio assets to support SRP. Failure to do so would have permitted CMI to assert a default by SRP and to trigger the option, if it so elected.

#### IV. The GWI Board of Directors' Valuation of Portfolio Securities

GWI is required by Section 30(d) of the 1940 Act to transmit to shareholders, at least semi-annually, reports which set forth the amount and value of securities owned. Section 2(a)(41) of the 1940 Act defines "value" to mean, with respect to securities for which market quotations are not readily available and other assets, "fair value as determined in good faith by the board of directors."

<sup>1</sup> This consultant was a portfolio company in which GWI had invested \$150,000 in debentures and warrants. In addition, it had a consulting contract with SRP, under the terms of which it would receive a fee of 1.5% of the CMI loan.

<sup>2</sup> The Commission's July 1, 1968 order, which was issued pursuant to Section 6(c) of the 1940 Act exempting GWI and its newly formed SBIC subsidiary from certain provisions of the 1940 Act, provided in relevant part: Subject always to Greater Washington, individually, and Greater Washington and Newsub on a consolidated basis, having the asset coverage required by Section 18(a) of the Act immediately after the issuance or sale of any senior securities. . . . Newsub may borrow from the SBA on such basis as the SBA may from time to time lend to small business investment companies and as may be permitted under the Act and applicable rules thereunder, provided that Greater Washington will not guarantee any such borrowings by Newsub, except the borrowings by Greater Washington from the SBA initially assumed by Newsub, but no extensions or renewals thereof, and provided that Greater Washington will not issue or have outstanding any other class of senior security in the period during which such guaranty is outstanding. Greater Washington will not itself, and will not cause or permit Newsub to otherwise issue any class of senior security.

<sup>3</sup> On July 16, 1974, SRP requested its last draw on the CMI loan commitment. As of that date, the Commission believes that GWI, on a "parent only" basis, with a 287% asset coverage (using the asset value determined by the GWI Board for the semi-annual report for June 30, 1974) no longer had the coverage required by Section 18(a)(1)(A). The Commission notes that the GWI Board did not determine the June 30, 1974 asset value until July 19, 1974.

<sup>4</sup> Continuous borrowing pursuant to this line of credit and a decreasing asset base created greater and greater deficiencies in asset coverage during the years 1972, 1973 and 1974. Thereafter SRP failed to make the interest payments required by the loan. In December 1975 the loan was modified to eliminate a need for interest payments other than from the proceeds of property sales, and CMI agreed to cancel the option agreement upon the investment of GWI of an additional \$600,000 in SRP over a stipulated period.

Both Accounting Series Release (“ASR”) 113 (October 21, 1969) and 118 (December 23, 1970) state that as a general principle, the current “fair value . . . would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale.” The AICPA Audit Guide for Investment Companies defines “current sale” to mean “an orderly disposition over a reasonable period of time.”

In an effort to insure that its valuations met the statutory test of good faith, the GWI Board of Directors stated that it valued its restricted securities in good faith by using “benchmarks” such as cost, market price, the price of a third-party transaction, or estimated realizable value. GWI believed that its valuations met the AICPA test of “orderly disposition over a reasonable period of time”; moreover, as the Small Business Administration states in its Valuation Guide for SBIC’s, “the very nature of (venture) investments eliminates this method (valuation in terms of current sale) in many cases.”

The GWI board had, with the assistance of its counsel and auditors, formalized its valuation procedures in 1963. It developed a standardized format for written valuation summaries; it established a valuation committee to review detailed information concerning each investment with GWI management quarterly and to provide recommendations to the GWI Board, and it held full valuation deliberations at board meetings which were often attended by its general counsel and independent public accountants.

Realizing that the valuation of venture-type investments is difficult and that there is no precise valuation for each investment, the Commission nevertheless considers the following valuation practices by the GWI Board to be inconsistent with statutory and regulatory requirements.

#### **A. Valuation of Debt Instruments without Reflecting Current Interest Rates**

At June 30, 1974 GWI held 23 debt instruments consisting of notes and debentures, 19 of which were valued at cost. These debt instruments were valued at approximately \$3.2 million (cost \$3.7 million) or 33.7% of the consolidated portfolio. In addition, GWI had advanced \$972,671 to SRP, which it carried at cost and on which it accrued no interest. The interest rate on the debt instruments ranged from 6% to 15%. The rate on five of these instruments was geared to the prevailing prime rate (11.75% in June 1974). Eleven debt instruments provided a return below the prime rate and below the 12%—15% return GWI received on its 1974 investments. As interest rates rose and GWI’s need for interest income increased, interest rates charged on new investments increased: some were pegged to the rapidly increasing prime rate and others carried rates substantially in excess of prime. The GWI Board of Directors, however, did not adjust the value of those debt instruments carrying interest rates below GWI’s current lending rate.

GWI points out that it has consistently and publicly taken the position that the discounting of debt securities to reflect changes in market rates is an unnecessary and inappropriate refinement in the valuation of venture-type debt instruments, especially when they are part of “packages” of investments including debt and equity components. The GWI Board states that it allocated changes to the equity component first and maintained debt at cost unless equity had been reduced to zero. GWI’s 1973 Annual Report to Shareholders states: “many of the debt securities which were purchased at par and have been so valued in the portfolio are not necessarily competitively priced as an individual security. However, viewed in the context of the total financing package and the issuer’s ability to repay at maturity, such valuation is considered appropriate.” The same of similar statement had been made in each of GWI’s annual reports since 1969. Thus, while the GWI Board separately reported its valuations of the equity and debt components of its portfolio security “packages,” it states that it was effectively valuing the securities as packages, as permitted by the Audit Guide. Finally, GWI points out that if the debt instruments in GWI’s June 30, 1974 portfolio had been discounted to a 12% interest rate, portfolio value would have been reduced by less than \$50,000 or ½ of 1% of portfolio value.

The Commission does not believe that the discounting of debt securities to reflect changes in market rates is an unnecessary and inappropriate refinement in the valuation of venture-type debt instruments. Such adjustments should have been taken into account in the valuation of these securities to give stockholders an indication of their fair value.

## B. Valuation of Restricted Securities at Current Market Quotations for Unrestricted Securities of the Same Class

At June 30, 1974, GWI held securities of four companies (Solid State Scientific, Inc., Western Microwave Laboratories, Inc., Radiation Systems, Inc., and Comtel Corporation), which in the view of the Commission were restricted securities, and which also had markets for unrestricted securities of the same class. Radiation Systems and part of the Solid State stock were acquired pursuant to Section 4(2) of the Securities Act. The Western Microwave stock was acquired pursuant to Section 4(1). The Comtel stock was acquired pursuant to Section 3(a)(10) of the Securities Act when the Company emerged from bankruptcy. The remaining Solid State shares were acquired pursuant to Section 3(a)(9) of the Securities Act when GWI converted debentures which it had previously received in a private placement. The GWI Board of Directors valued these securities at the “market price”<sup>1</sup> for unrestricted securities of the same class, and they constituted approximately 15% of GWI’s total investment portfolio. No discount from such market price was taken to adjust for any diminution in value resulting from the restrictive feature.

ASR 113 states that “valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper.”

While the portfolio securities in question were valued by the GWI Board as restricted securities at June 30, 1974, the GWI Board contends that they in fact were not “restricted” securities within the meaning of ASR 113, that even if ASR 113 were applicable, the portfolio securities were valued at their fair value in accordance with the “inherent worth” standard of that release and otherwise were valued in accordance with the requirements of ASR 113; and that there is a court-approved Commission precedent for valuing these securities at market. In addition, GWI contends that the valuation at market “bid” rather than the mean of “bid” and “asked” effectively represented a discount from “market price.” Finally, even if all the stock deemed “restricted” by the Commission had been discounted by 25% from market “mean” or 20% from market “bid,” the diminution of portfolio value would have been less than 3%.

In the Commission’s opinion the restricted securities valued as such by the GWI Board at June 30, 1974, were “restricted” securities within the meaning of ASR 113 because they “[could] not be offered to the public for sale without first being registered under the Securities Act of 1933.”<sup>2</sup> Valuing restricted securities, for which there is a market for unrestricted securities of the same class, at “inherent worth” is not the appropriate standard for valuing such securities and is not consistent with ASR 113, unless the securities in fact are discounted from “market price.” Nor does the Commission believe that a “most unusual situation” exists which would justify a departure from the general rule requiring a discount for the restrictive feature.

## C. Failure to Adjust the Valuation of Securities of Companies Which Experienced Serious Financial Problems

### 1. Singing River Properties, Inc.

At June 30, 1974, the GWI Board of Directors valued its investment in SRP at \$1,429,150, which represented approximately 15% of the value of GWI’s consolidated portfolio. A \$396,700 debenture and \$972,671 of non-interest-bearing advances were valued at cost. Three million dollars of equity was valued at SRP’s net book value of \$59,779, or 2% of cost. SRP operating losses were directly reflected in write-downs of the equity. The Board of Directors stated that it believed that in spite of SRP’s mounting losses (\$226,000 in its first six months of operations; \$346,733 in fiscal 1972; \$1,008,793 in fiscal 1973; and approximately \$564,528 the first six months of 1974), SRP’s real estate assets had substantial value and justified their June 30, 1974 valuation since the earlier appraised values were directly reduced by the amount of these losses.

<sup>1</sup> The Board determined the “market price” of GWI’s restricted equity securities having an over-the-counter market for unrestricted securities of the same class on the basis of the average “bid” price for such securities without diminution for their restrictive feature. ASR 118 would have permitted GWI to use valuations within the range of bid and asked prices considered best to represent value in the circumstances, including the mean of bid and asked prices.

<sup>2</sup> These securities in due course could properly be, and in part were, sold without registration pursuant to Rule 144.



SRP had its best year in 1972, with progress being made in developing the Mississippi property. The Evaluation Committee of the GWI Board of Directors asked that an appraisal be made of SRP's assets as of December 31, 1972. The \$6 million appraisal confirmed the progress that had been made and formed the basis for the December 31, 1972 valuation. However, this progress was abruptly halted the following year as was described in GWI's 1973 Annual Report to Shareholders:

At this time a year ago we were very encouraged by having sold 58 St. Andrews lots during 1972 (more than twice the number sold during the project's entire previous history), by the preliminary interest shown in the rental townhouses, and by the agreement we had reached with the local builder for joint development of Pinehurst. However, today we are almost equally discouraged by 1973's lack of continuing sales and rental momentum (with significant overbuilding in the Gulf Coast area, only 8 St. Andrews lots were sold during the year and Golfing Green is still over 60 percent unrented), by having to introduce the Pinehurst development without the assistance of a joint-venture partner and under depressed local housing conditions, and by the unreasonably high interest cost we have experienced as a result of the prime rate's 67 percent increase during the year.

GWI's ultimate recovery on its SRP investment depends on many complex factors, but sales rates and interest costs are two of the most significant. In 1971, shortly after foreclosure, a professional market study projected a local sales potential sufficient to enable GWI to recover its investment over about an eight-year period. A similar study completed in 1973 has significantly reduced the earlier market projection, while actual experience during the year fell far short of even this reduced level. Unfortunately, at the same time as the forecast of sales rates had been reduced, the prime interest rate has climbed to an unprecedented level resulting in a rapid escalation of SRP's interest costs during 1973. While the resurgence in housing demand which has been experienced on the Gulf Coast in recent weeks and the current indications of lower prime rate offer encouragement, we must assume that SRP will continue to require the major portion of GWI's resources for the foreseeable future.

A new appraisal was not obtained. Instead the GWI Board valued the investment at its net book value, which was derived from the foreclosure appraisal and reduced by subsequent operating losses. This represented a write-down on the investment of \$1,661,756 during 1973. In October 1973, the Internal Revenue Service disallowed SRP's claimed losses on the foreclosure and appraised the properties at a valuation of \$524,000 greater than the \$3.6 million MAI appraisal previously relied upon by GWI as the basis from which all subsequent SRP valuations were derived. The GWI Board was aware of and considered the impact of such appraisal on the earlier appraisals.

That the market value of SRP's assets at December 31, 1973 and June 30, 1974 may have been considerably less than that at which they were carried on the books of SRP is suggested by GWI's failure to attract a purchaser for the property. Beginning in January 1974, GWI actively sought to find a purchaser or joint venturer for SRP. Only one company was found which expressed interest in the project; however, the president of that company told the Commission staff that he was not seriously interested in the project at all. He recalls having gone to Mississippi to see the property, but said it had major problems and discussions never became serious. Nonetheless, the GWI Board states that it had been advised and believed at the time of the June 30, 1974 valuation that there was serious interest in a joint venture whereby the subject company would take over management and marketing at SRP and arrange any needed financing. Subsequent to the June 30, 1974 valuation, GWI was informed by letter dated July 22, 1974 that although the company's management "truly had an interest in pursuing" an involvement in SRP when GWI's management had visited them in June, a subsequent resignation by the company's vice president of marketing had precluded that possibility. In short, GMI could find no one interested in purchasing the property at the \$1.4 million at which it was valued by the GWI directors at June 30, 1974.

Although it appears that the GWI Board was looking to a viable medium-term work out of the SRP project, the Board was aware in December 1973 that prospects for such a work out were dim. In a confidential memorandum prepared for the December 14, 1973 Board of Directors' meeting, GWI's president analyzed GWI's present status and the implications for its future considering recently completed SRP cash flow projections. Accordingly to these projections \$600,000 to \$840,000 was needed for SRP for the year ending September 30, 1974. GWI's own operating expenses were running \$25,000 per month or \$300,000 a year. To meet these needs, GWI had \$300,000 in cash, an additional \$250,000 which could be raised from the sale of freely traded securities and, at current market, \$385,000 from the sale of Solid State shares pursuant to Rule 144. GWI's president made it clear that after mid-1974, the sale of Solid State shares



would represent the only real source of funds to meet the cash flow requirements. The stock was then trading at \$13 3/4 per share. The memorandum stated:

To meet our future needs assuming SRP requires \$4.5 million through 1977, and GWI's operating requirements average \$250,000 per year . . . Solid State [shares] would have to be sold for \$5 million . . . or an average of \$50 per share. While this price is at least possible in terms of some analysts' estimates of the company's prospects, we will run the risk of both general market conditions and Solid State's own operating performance during the intervening years. Clearly, GWI must develop alternative sources for financing SRP's needs.

This cash flow analysis makes clear the likelihood, eventually borne out, that GWI would be unable to continue to support SRP, resulting in an event of default on the CMI loan.

In January 1974, GWI's president prepared another memorandum to the Board to facilitate its valuation of the SRP investment. Appendix A thereto presented a modified five-year CMI work-out analysis, which projected that with an additional \$2 million investment by GWI, and CMI forgiveness of all future interest, the CMI loan would be repaid in full at the end of 1978 (three years after the original maturity date of the loan). The total value of residual property would be \$4.4 million, more than enough to recover the \$2 million additional investment and to support the \$1.5 million valuation the Board placed upon its investment at December 31, 1973.

However, there were problems with most of the assumptions of this analysis, which had manifested themselves by June 30, 1974. In short, by June 1974 the Board of Directors was aware of information which made it unlikely that the work-out analysis prepared by GWI's president in January 1974 was viable, and that a more realistic analysis, which assumed no forgiveness of CMI interest, painted a very bleak picture: GWI would be unable to recover any of its investment after five years of selling most of SRP's assets.

GWI points out that it had decreased the valuation of its equity investment in SRP by \$564,528 during the first half of 1974 and by \$2,226,284 since June 30, 1973; the Board states that it believes that this reasonably reflected the SRP deterioration as of June 30, 1974, based on facts then known. As to the analyses, the Board's position is that they had been prepared to stimulate the Board's thinking about the problem; none was ever claimed to be the probable outcome; and none ever formed the sole and explicit basis for an SRP valuation.

At June 30, 1974, the GWI Board states that it recognized that property sales lagged expectations and that a significant negative cash flow continued which was aggravated by rapidly accelerating interest rates. Although the latter represented a serious burden, GWI was advancing the funds to cover SRP's cash needs, including interest payments on the two REIT loans, intending to maintain the project as a going concern. The effort to find a joint venture partner had resulted in one serious expression of interest believed to be viable at June 30, 1974. Also, consultants who had been commissioned to evaluate SRP's potential as a second home/recreation/retirement project gave encouragement in a June 15, 1974 report that this offered a viable alternative for accelerating property sales. Their report stated that the project "presents a very competitive face. The quality of the site planning and physical layout, the character and finish of the principal amenities including the golf course, and the overall project scale at 2,000 acres make it unique in the immediate market area . . . it could form the solid base for any expanded project concept and merchandising program." The report went on to suggest, however, that a further study should be done to develop appropriate sales targets, establish a marketing strategy and evaluate sales cost efficiency since such costs could be substantial. (GWI did not have the funds needed and was looking to a joint venture partner to provide them.) In addition, the report observed that SRP's existing product offerings were priced at or near the top end in the single family sales market in the Biloxi-Pascagoula market; however, the report goes on to state that they "established the standard of quality and value in the immediate market area." Under these circumstances, valuation at a level which depreciated the SRP investment by nearly \$3,000,000, which represented a 67% diminution from cost, was deemed appropriate by the Board.

Furthermore, in allocating a valuation among the investment elements of the package, GWI's procedure was to apply the depreciation first to the most junior securities and only when it exceeded their cost was it allocated to the debt elements. The SRP investment package consisted of common and preferred stock, a convertible debenture (held by the SBIC) and cash advances. In determining and allocating the valuation of this investment, the Board of Directors states that it relied primarily on the equity book value, after operating losses and write-down of assets to net realizable value. Consequently,

at June 30, 1974 the \$3 million of SRP common and preferred stock which GWI held was written down by \$2,940,221, or 98 percent, while the debt elements aggregating \$1,369,371 were left at cost.

The GWI Board, with the 67% write-down of the investment package, valued its investment in SRP at \$1.4 million at June 30, 1974. The Commission believes that the GWI Board of Directors was aware of information which called into question the previously appraised value of SRP's assets, that management was having serious problems in trying to interest other developers in purchasing SRP, that GWI was experiencing a severe cash flow problem which made its continued payment of SRP's debt service doubtful, and that management's own long-term work-out analysis indicated little likelihood GWI would recover anything on its investment in SRP. Under the prevailing conditions, the Commission believes that the GWI Board's valuation of the investment at \$1.4 million at June 30, 1974, which included the valuation of SRP's debt instruments at cost, was overly optimistic and underestimated the realities of the SRP situation; and that the Board cannot rely on a benchmark such as cost in the valuation of the debt component of the investment, notwithstanding the write-down of the equity component, when there are clear indications that there has been a substantial change in the affairs of the issuer.

## 2. International Management Services/ McKee – Berger – Mansueto, Inc. (IMS/MBM)

At June 30, 1974, the GWI Board of Directors valued its investment in IMS/MBM (a \$150,000 note, a \$200,000 note and \$363,150 of common and preferred stock) at cost: \$713,150, approximately 7.5% of the value of GWI's consolidated portfolio. MBM provides construction project management services. It was acquired in 1972 by IMS, a company which provided consulting services in marketing, radio and television and which owned interests in hotels and radio stations in the Middle East. No interest payments had been made on either note since they were issued in 1972. The parent company, IMS, suffered severe cash flow problems and preliminary 1973 consolidated figures available to the GWI Board of Directors in June 1974 indicated a \$788,000 loss. In addition, IMS had failed to produce reliable financial statements. IMS was highly leveraged with a deficit working capital position and a deficit in tangible net worth. It had consistently failed to meet earnings projections. The \$788,000 loss reported in June 1974 was in contrast to the \$440,000 profit which had been projected. The Board of Directors has stated that it weighed these negative factors against certain positive considerations, among which were the following: advice from IMS management that IMS was seeking additional financing through sales of assets and the issuance of securities, and that IMS was believed to be in an exceptionally good position to benefit from rapidly developing oil wealth and had a preeminent reputation in Middle East market consulting as well as in construction project management through MBM. The Board further states that IMS also had a proven capability in hotel management and media operations, which were potential growth areas in the Middle East. This included a 20-year exclusive franchise to operate a commercial radio/television station in Bahrain, which would cover Saudi Arabia as well. MBM was reporting good sales and earnings, but this was in the context of a consistent failure to produce reliable financial statements and to meet projections. In 1973 it had won major fee-generating projects from the Chicago Board of Education and in Puerto Rico. IMS had also arranged bank borrowings of approximately \$1,500,000 in 1973, and obtained a \$729,000 equity private placement from six individuals, including a close friend of an IMS principal at a price in excess of GWI's valuation. In 1974 IMS borrowed an additional \$150,000, but was having substantial trouble raising additionally needed funds. Accordingly, the GWI Board states that it determined that the positive and negative factors were sufficiently balanced that valuation at cost was appropriate.

The Commission believes that the Board of Directors, in valuing its IMS/MBM investment at cost, placed too much emphasis on anticipated operational and market developments and proposed additional financing, and considered sales of securities to friends of management as an accurate reflection of the value of GWI's own investment. The Commission believes that the valuation should have given more consideration to the hard economic realities of the IMS/MBM situation, including substantial losses, unreliable preliminary financial statements, deficit working capital position, a deficit net worth, a severe cash shortage, unrealized projections and the fact that there had been no payment of principal or interest on the debt securities since their issuance in December 1972.

## V. Disclosures in Stockholder Reports

Although it does not appear that the GWI Board of Directors decided to stop funding SRP's payment of CMI interest until September 1974, thereby creating a basis for default on the loan obligation which would allow CMI to exercise its option, both the 1973 Annual and 1974 Semi-Annual Reports by footnote and letter to shareholders mention such

a possibility. Because default was a distinct possibility, the Commission believes that disclosure of the distress value of GWI's portfolio, similar to that undertaken in an internal memorandum of September 14, 1974 to the Board by GWI's president, should have been made. The memorandum estimated that GWI's consolidated portfolio, excluding SRP, could be liquidated on an immediate sale basis for only \$2.4 million, which would have been insufficient to cover the \$2.9 million obligation on the option in December 1973 or June 1974.

GWI points out that the \$2.4 million "distress value" of the portfolio was actually the rough estimate by GWI's president of the cash resources that might be generated under one particular alternative for dealing with the CMI contingent liability. It assumed that SRP, whose net assets then actually exceeded the CMI obligation by over \$900,000, was given to CMI in partial settlement; consequently, the remaining contingent obligation would have been significantly less than \$2.9 million. Furthermore, except for one private holding which was reduced to its cost, it actually valued all of the portfolio securities at the equivalent of their June 30, 1974 valuations rather than on a distress sales basis; the additional reduction from the reported June 30 net asset value was due simply to the arbitrary assumption that the SBIC was sold intact for 37 percent of its June 30 valuation which reflected the average discount from net asset value at which public SBIC's were then trading.

The Board believes extensive disclosure of the possible impact of the option on the company had been made in GWI annual reports and that the stockholders' understanding of that disclosure is reflected by the fact that the over-the-counter market "bid" price of GWI shares in November 1974, when the Commission suspended trading, was a mere \$1/8 bid, or 2-1/2 percent of the June 30, 1974 net asset value. GWI had included the full audited SRP financial statements, including the auditors' qualification that SRP's sources of revenue were not considered sufficient to support operations and permit payment of interest and principal on notes payable, in its 1973 Annual Report to Shareholders, and included condensed interim financial statements in its June 30, 1974 Semi-Annual Report. In addition, the shareholders letter which was incorporated in each report identified the detailed problems which SRP faced and the uncertainties which the option presented. When SRP ceased paying interest on its CMI loan, thereby creating the basis for a potential default, GWI made extensive additional disclosure of the situation and its possible impact on the company in a September-October newsletter sent to GWI shareholders and the press, pointing out that "if a totally pessimistic approach [to valuation] were taken, essentially a zero net asset value would result" and "any valuation yielding a net asset value above zero would be so imprecise that it easily could be several million dollars in error in one direction or the other." Further, the Board was informed by GWI's president that CMI, on a staff level, had expressed willingness to be cooperative and work with SRP in solving its problems, thus rendering unlikely, in the Board's judgment, any attempt by CMI to exercise the option.

Another problem the Commission has with disclosures in the 1973 Annual and the 1974 Semi-Annual Reports is the failure to disclose delinquencies in interest and principal payments on securities of portfolio companies.

GWI points out that its venture investments traditionally have been interrelated packages of securities with equity participation the principal reason for the investment. The fact that such collections may be overdue is one of the many considerations for the GWI Board in valuing portfolio investments. Singling this factor out for special reporting, particularly when GWI concludes that it is not in its interest to pursue immediate collection, could be misleading and might unnecessarily affect adversely the particular portfolio companies, and hence, GWI's investment in them. Subsequent to initiation of the investigation, GWI's general counsel advised specifically against including such information in GWI's shareholder reports. The GWI Board believes that the disclosures concerning these matters were adequate. It notes that its outside auditors, who annually reviewed GWI's accounting procedures and underlying documents, did not take exception to such procedures or documentation nor to any valuation in the 1973 Annual Report, and believes that its disclosures were customary for the industry.

The Commission nevertheless believes that such disclosure should have been made so that investors could better judge the quality of their investment.

## **VI. Current Status of the Matters Discussed Herein**

As a result of the passage of a substantial amount of time since the 1972-74 period when the matters described herein occurred, the Commission believes that it is appropriate also to report the current status thereof. To this end, GWI has

assured the Commission that, it is in compliance with the views of the Commission expressed herein to the extent that they are currently applicable.

With respect to the Commission's views on Section 18 of the 1940 Act, the matter is now moot since, as a result of GWI's June 30, 1978 reorganization as a federally licensed Small Business Investment Company, it is now statutorily exempt from the asset coverage requirements of Section 18(a)(1)(A) of the 1940 Act.

Concerning that evaluation of portfolio securities, GWI has advised the Commission that it has formally adopted policies with respect to adjusting its valuations of debt securities to reflect changes in market interest rates and, consistent with its statutory duty to determine "fair value," discounting "restricted securities" from market. At June 30, 1973, GWI held only one debt security with an interest rate below 12%; it was valued at a 26% discount from its face amount. This affected portfolio value by 0.2%. GWI held only one "restricted security" at June 30, 1978 which was valued at cost, representing a 23% discount from market. This affected portfolio value by 0.5%.

Finally, with respect to the Commission's views on the disclosure of delinquencies in principal and interest payments, GWI reports that commencing with its June 30, 1978 report to shareholders, any such delinquencies are being noted.

## IN THE MATTER OF THE BANK OF CALIFORNIA, N.A.

Release No. IC-19545

Administrative Proceeding File No. 3-8084

June 28, 1993

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 9(f) OF THE INVESTMENT COMPANY ACT OF 1940 AND FINDINGS AND ORDER OF THE COMMISSION

### I.

The Securities and Exchange Commission (Commission) deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 9(f) of the Investment Company Act of 1940 (Investment Company Act) to determine whether The Bank of California, N.A. (the Bank) caused violations of Sections 22(c) and 31(a) of the Investment Company Act and Rules 22c-1 and 31a-1 thereunder.

### II.

In anticipation of the institution of these administrative proceedings, the Respondent has submitted an offer of Settlement which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or to which the Commission is a party, and without admitting or denying the findings herein, the Respondent consents to the entry of this Order Instituting Proceedings Pursuant to Section 9(f) of the Investment Company Act (Order), Making Findings and Imposing a Cease and Desist Order.

### III.

The Commission finds the following:

#### A. Respondent

The Bank of California, N.A. is a national banking association whose headquarters are located in San Francisco, California. At all times relevant, the Bank served as the fund accountant for the investment portfolios of The HighMark Group, a registered investment company. In that capacity, the Bank was responsible for, among other things, calculating the net asset value per share of the Tax-Free Fund, a money market portfolio within The HighMark Group. In addition, the Bank served as investment adviser to The HighMark Group.

#### B. Other Relevant Entities

1. The Tax-Free Fund (Fund) is one of eight investment portfolios in The HighMark Group, an open-end series investment company registered under the Investment Company Act. At all times relevant, the amortized cost method, as permitted under Rule 2a-7 of the Investment Company Act, was utilized to value the Fund's portfolio securities. The amortized cost method allows a money market fund to maintain a stable net asset value per share while allowing it to forego marking the portfolio to market on a daily basis, provided that all of the conditions of Rule 2a-7 are met. Once each week, the Bank performed a market based calculation of the Fund's assets in order to measure the deviation from the Fund's constant \$1.00 price per share.

In addition, the Fund was required to maintain and keep current its accounting records which formed the basis for the financial statements required to be filed with the Commission pursuant to the Investment Company Act.

2. Guaranteed Multi-Family Housing Bonds, Series 1984 (Rancho Ladera Development) issued by the Industrial Redevelopment Authority of the City of Phoenix, Arizona (the Phoenix Bond) was a tax exempt bond that had its payments of principal and interest guaranteed by the Mutual Benefit Life Insurance Company of Newark, New Jersey (Mutual Benefit). The Fund purchased \$1 million principal amount of the Phoenix Bond in or about October 1990. In July 1991, Mutual Benefit was seized by the New Jersey Insurance Commission. As a result, Mutual Benefit was not allowed to honor the Phoenix Bond guarantee. This action resulted in a significant drop in the market price of the Phoenix Bond from par to 70 in mid-July 1991.

### C. Summary

This proceeding involves acts and omissions by the Bank which caused the Fund to violate the pricing and books and records provisions of the Investment Company Act. In August 1991, counsel for the Fund informed the staff of the Commission that, for approximately a five week period, the Bank had erroneously priced the Phoenix Bond in the Fund's portfolio at over 42% more than its market value. Consequently, the Bank incorrectly computed the Fund's net assets and the Fund sold and redeemed shares at a price other than its correct net asset value per share. The Bank's pricing error relating to the Phoenix Bond was primarily caused by the actions of an employee in the fund accounting department of the Bank. However, the Bank's internal control procedures and systems were inadequate in that they allowed the pricing problem to occur and remain undetected for a substantial period of time. As a result, the Bank caused the Fund to violate Sections 22(c) and 31(a) of the Investment Company Act and Rules 22c-1 and 31a-1 thereunder.

#### 1. The Bank's Incorrect Pricing of the Phoenix Bond

On or about July 25, 1991, while marking to market the securities in the Fund's portfolio in order to compare the market prices to the Fund's amortized cost, the Bank's fund accounting department received a market price of 70 for the Phoenix Bond from the Fund's pricing service.<sup>3</sup> This price was significantly lower than the previously reported price of par and was improperly treated as a "transmission error" although no evidence existed that such an error had occurred. Thereafter, the 70 price was manually overridden and par value for the Phoenix Bond was entered on the pricing worksheet, which was prepared in calculating the Fund's net asset value per share. As a direct result of the failure to accurately account for the price of the Phoenix Bond, the Bank did not accurately calculate the Fund's net asset value per share. Therefore, the Fund's net asset value per share for July 25, 1991 was not \$1.00, but was in fact \$ .9936.

In the intervening weeks between July 25, 1991 and August 28, 1991, the Bank continued to account for the Phoenix Bond at par on the pricing worksheet, notwithstanding the fact that the pricing service continued to quote a price of 70. The Fund redeemed approximately 20,000,000 shares and sold approximately 15,000,000 shares at incorrect prices during this five week period. The pricing problem was finally uncovered in late August 1991. At that time, the custody department of the Bank asked for instructions regarding the put feature of the Phoenix Bond whereby the Bank could put the security back to Mutual Benefit. After discovering the substantial reduction in the price of the Phoenix Bond and its impact upon the Fund's net asset value, the Bank informed the Fund's Board of Trustees of the problem and purchased the bond from the Fund at par value plus interest.

#### 2. The Bank's Lack of Adequate Internal Controls

Because the Fund elected to use the amortized cost method of valuing its portfolio securities, it was important that the Bank have a system designed to quickly identify price deviations of securities. A significant requirement of Rule 2a-7 is the necessity of comparing the amortized cost basis of portfolio securities with their current market prices at regular intervals. Under the rule, if a deviation greater than ½ of 1 percent exists between the amortized cost and the market price, the money market fund's board of directors must meet to consider what action, if any, is appropriate to eliminate any dilution to fund shareholders caused by the price deviation. However, the Bank failed to resolve the deviation of greater than ½ of 1 percent caused by the drop in the market value of the Phoenix Bond in a timely fashion and continued to calculate the Fund's net asset value per share based upon the amortized cost of the Fund's portfolio securities.

The Bank repeatedly mispriced the Phoenix Bond, which resulted in an inaccurate mark-to-market valuation of the Fund's portfolio securities. That repeated mispricing was caused by the Bank's failure to have a system of internal controls sufficient to reasonably prevent one employee's actions from having such significant consequences and to alert management in a timely fashion to the existence of a problem. The Bank's system allowed the same individual

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<sup>3</sup> Another division of the Bank had an earlier opportunity to discover, independent of the fund accounting department, the problems related to the Phoenix Bond. In approximately mid-July, the Fund's administrator contacted the Bank and asked it to check the records of the securities held in the HighMark Group's portfolios for securities backed by guarantees issued by Mutual Benefit, in order to alert the adviser of Mutual Benefit's developing problems. At that time, the portfolio managers for the Fund had been recently hired and were not the managers at the time of the Phoenix Bond purchase. The portfolio managers reported that the Fund did not have any securities backed by Mutual Benefit because the Bank's system did not adequately "flag" the securities in the portfolio which had credit enhancement features.



who received the market values of Fund securities to price the portfolio and resolve any price deviations. There was no oversight or review of deviations and their resolution by senior Bank management. In this case, although no Bank procedure or policy authorized the manual override of the 70 price with a price of par, no controls were in place to alert senior Bank management that such a price alteration had occurred. Further, no controls existed which allowed Bank personnel to examine whether a price received had been overridden. Finally, the Bank's investment advisory records did not adequately "flag" portfolio securities in the Fund which had credit enhancement features which were tied to entities other than the issuer of the securities. Thus, even when the Bank was notified of the developing problems of Mutual Benefit, the Bank's system was unable to identify those securities affected.

#### D. Applicable Law

##### 1. Rule 22c-1 of the Investment Company Act

Rule 22c-1, promulgated pursuant to Section 22(c) of the Investment Company Act, states, in pertinent part, that no registered investment company issuing redeemable securities "shall sell, redeem, or repurchase any such security except at a price based upon the current net asset value of such security. . . ." Section 2(a)(41) of the Investment Company Act defines value, with respect to securities for which market quotations are readily available, as the fair market value of those securities. However, Rule 2a-7, promulgated pursuant to Section 2(a)(41) of the Investment Company Act, allows money market funds to value securities using the amortized cost method subject to certain conditions. One such condition imposes a limitation of  $\frac{1}{2}$  of 1 percent on the amount of allowable dilution as expressed by the difference between the market value of a fund's portfolio securities and the amortized cost value of those securities.

The Bank failed to accurately record the actual values obtained during the periodic mark-to-market valuation of the Fund's portfolio securities. The substantial decrease in the market value of the Phoenix Bond caused a decrease in the Fund's aggregate portfolio market value of over  $\frac{3}{5}$ ths of 1%, well over the  $\frac{1}{2}$  of 1% maximum allowed in Rule 2a-7.<sup>1</sup> As a result, during the period between July 25, 1991 and August 28, 1991, over 20,000,000 shares were redeemed by the Fund at an inflated value, which diluted the value of the remaining shareholders' assets. During the same period, over 15,000,000 shares of the Fund were purchased at a price which exceeded the value of the assets purchased. The Fund violated Rule 22c-1 when it sold and redeemed shares at a value that did not reflect a correct net asset value. Because the Bank prepared the inaccurate valuation reports that were used to calculate the price of Fund shares, the Bank caused the Fund's violations of the pricing requirements of Rule 22c-1 of the Investment Company Act.

##### 2. Section 31(a) of the Investment Company Act and Rule 31a-1 Thereunder

Rule 31a-1, promulgated pursuant to Section 31(a) of the Investment Company Act, requires investment companies to maintain and keep current "the accounts, books and other documents relating to its business which constitute the record forming the basis for financial statements required to be filed pursuant to Section 30 of the Investment Company Act of 1940 and of the auditor's certificates related thereto." As noted above, Rule 2a-7 requires a periodic comparison of the market value to the amortized cost value of a money market fund's securities. The Bank prepared, among other things, a pricing worksheet which purported to record the market values of the Fund's portfolio securities and the amortized cost values of those securities in order to demonstrate the Fund's compliance with Rule 2a-7. However, the market value of the Phoenix Bond was entered inaccurately on the Fund's records for a five week period. Consequently, the Fund's records forming the basis for the annual financial statements were improperly maintained by the Bank. Therefore, the Bank caused the Fund's violations of Section 31(a) of the Investment Company act and Rule 31a-1 thereunder.

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<sup>1</sup> Once this threshold was crossed, the Fund was no longer able to rely on Rule 2a-7 and the market value of the Fund's portfolio securities should have been used by the Bank to calculate the net asset value per share. Instead, the Bank continued to use amortized cost to price the portfolio securities and shares of the Fund continued to be sold and redeemed at \$1.00 per share.



**IV.**

In view of the foregoing, the Commission has determined to accept the offer of Settlement submitted by the Bank. In determining to accept this offer, the Commission considered remedial acts promptly undertaken by the Bank and the cooperation the Bank afforded the Commission staff.

Therefore, It Is Hereby ORDERED, pursuant to Section 9(f) of the Investment Company Act, that:

The Bank permanently cease and desist from committing or causing any violation, and from committing or causing any future violation, of Sections 22(c) and 31(a) of the Investment Company Act and Rules 22c-1 and 31a-1 thereunder.

By the Commission.

## IN THE MATTER OF VAN KAMPEN AMERICAN CAPITAL ASSET MANAGEMENT, INC.

Release No. IA-1525

Administrative Proceeding File No. 3-8846

September 29, 1995

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS

### I.

The Securities and Exchange Commission (the “Commission”) deems it appropriate and in the public interest to institute public administrative proceedings pursuant to Section 203(e) of the Investment Advisers Act of 1940 (“Advisers Act”) against Van Kampen American Capital Asset Management, Inc. (“American Capital”).<sup>1</sup>

### II.

In anticipation of the institution of this proceeding, American Capital has submitted an offer of Settlement (“offer”) to the Commission, which the Commission has determined to accept. Solely for the purpose of this proceeding, and any other proceeding brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the matters set forth herein, except that American Capital admits the jurisdiction of the Commission over it and over the subject matter of this proceeding and paragraphs III A. and III B., American Capital consents to the issuance of this Order Instituting Proceedings, Making Findings and Imposing Remedial Sanctions (“Order”), and to the entry of the findings and the order set forth below.

Accordingly, IT IS ORDERED that an administrative proceeding pursuant to Section 203(e) of the Advisers Act be, and hereby is, instituted.

### III.

On the basis of this Order and the offer submitted by American Capital, the Commission finds that:<sup>2</sup>

#### Respondent

A. American Capital is a Delaware corporation located in Houston, Texas, and has been registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act since April 6, 1958. American Capital is now a subsidiary of Van Kampen American Capital, Inc. In December 1994, the adviser’s parent company was purchased by and merged into The Van Kampen Merritt Companies, Inc.; the surviving entity changed its name to Van Kampen American Capital, Inc.

#### Other Relevant Entity and Individual

B. American Capital Federal Mortgage Trust (“ACFMT” or the “Fund”) located in Houston, Texas, has been registered with the Commission as an investment company pursuant to Section 8 of the Investment Company Act of 1940 (“ICA”) since November 21, 1985. American Capital has served as the investment advisor to ACFMT from May 1986 to the present.

C. Thomas M. Rogge (“Rogge”) was employed by American Capital as a vice president and the portfolio manager for ACFMT from January 1991 until September 2, 1993.

<sup>1</sup> Van Kampen American Capital Asset Management, Inc. was formerly known as American Capital Asset Management, Inc.; as discussed below, the firm’s parent company was purchased by and merged into The Van Kampen Merritt Companies, Inc. in late 1994.

<sup>2</sup> The findings herein are made pursuant to American Capital’s offer of Settlement and are not binding on any other person or entity named as a respondent in this or any other proceeding.

## Summary

D. This proceeding involves the intentional mispricing of certain derivative securities held in the portfolio of ACFMT, known as Planned Amortization Class Interest Only (“PAC IO”) securities, by the Fund’s portfolio manager, Rogge. During the period from August 4 to August 26, 1993, Rogge deliberately mispriced as many as five of the PAC IOs in an attempt to conceal their declining value in violation of the federal securities laws. By the time American Capital discovered the scheme on August 27, 1993, the PAC IOs were overvalued by as much as \$6.88 million and the Fund was calculating an inflated net asset value by as much as 76 cents per share. American Capital had inadequate policies and procedures in place to detect and prevent Rogge’s violations. As a result, American Capital failed reasonably to supervise Rogge with a view to preventing his violations of Section 34(b) of the ICA and willful aiding and abetting violations of Section 31(a) of the ICA and Rules 22c-1(a) and 31a-1 thereunder and Sections 206(1) and (2) of the Advisers Act.

## Background

E. After consulting with his supervisors in general about the appropriateness of PAC IO securities for the Fund, during the period from September 1992 through August 1993, Rogge purchased PAC IOs for the Fund’s portfolio. As of August 4, 1993, the Fund held seven PAC IOs in its portfolio constituting 21.4 percent of the Fund’s total net assets.<sup>3</sup>

F. According to ACFMT’s policies and procedures, as stated in its prospectus and Statement of Additional Information (“SAI”), the Fund was required to determine the market value of its PAC IO holdings, as well as certain other portfolio securities, by obtaining daily bid side market prices from broker-dealers. Prices for the PAC IOs were recorded on daily derivative pricing sheets and were submitted to American Capital’s accounting department, which used this information to calculate the Fund’s daily net asset value. The responsibility for oversight of the daily security pricing process for ACFMT’s portfolio securities, including the manual pricing of PAC IOs, was shared by ACFMT’s portfolio manager and his investment assistants. Either Rogge or one of his investment assistants obtained daily prices for the Fund’s PAC IOs from approximately five broker-dealers.

## Falsification of the Fund’s Books and Records and Aiding and Abetting the Fund’s Pricing Violation

G. On or about March 31, 1993, two registered broker-dealers ceased providing daily prices to the Fund for four PAC IOs in the Fund’s portfolio. Instead of obtaining bid side market prices from other broker-dealers as required by the Fund’s prospectus and SAI, Rogge began pricing the four PAC IOs himself on a daily basis.<sup>4</sup> During that time, he falsified the Fund’s daily pricing sheets by indicating that the prices had been obtained from the two formerly participating broker-dealers rather than indicating that he was the source of the prices. Moreover, from August 4 through August 26, 1993, Rogge provided the Fund with prices for the 93-15 L PAC IO that were materially higher than bid side market prices and recorded or caused these inflated prices to be recorded on the Fund’s daily pricing sheets. Accordingly, Rogge willfully violated Section 34(b) of the ICA.

H. At various times during the period from August 4 to August 26, 1993, Rogge supplied a registered representative at a broker-dealer with pricing assumptions (i.e., spreads to U.S. Treasury securities and mortgage prepayment rates) for between one and three of the PAC IOs held in the Fund’s portfolio.<sup>5</sup> At Rogge’s request, the registered representative utilized the assumptions Rogge provided, rather than consulting with the broker-dealer’s trading desk, to price the PAC IOs.

I. Similarly, during the period from August 4 to August 10, 1993, Rogge convinced a registered representative at another broker-dealer to provide him with prices for two PAC IOs in the Fund’s portfolio based upon assumptions he provided, rather than consulting with the broker-dealer’s trading desk.<sup>6</sup> Beginning on August 10, 1993, and continuing until

<sup>3</sup> The following seven PAC IOs were held in the Fund’s portfolio as of August 4, 1993: FH 1393 K, FN 92-187 JA, FN 92-193 JB, FN 93-15 L, FN 92-23 PL, FN 92-156 G, and FH 1385 K.

<sup>4</sup> Specifically, Rogge priced the FN 92-15 L PAC IO from at least March 31, 1993 until August 26, 1993, the 92-187 JA PAC IO from at least March 31, 1993 until August 4, 1993, and the FN 92-193 JB and FN 92-156 G PAC IOs from at least March 31, 1993 until August 17, 1993.

<sup>5</sup> Rogge provided pricing assumptions for the FH 1385 K PAC IO during the period from August 4 to August 26, 1993. Similarly, during the period from August 17 to August 26, 1993, Rogge supplied the registered representative with pricing assumptions for the FN 92-193 JB and FN 92-156 G PAC IOs held in the Fund’s portfolio.

<sup>6</sup> Specifically, the FN 93-23 PL and FN 92-187 JA PAC IOs.

August 26, 1993, Rogge obtained offered, rather than bid side, daily market prices for these two PAC IOs from the registered representative, based upon pricing assumptions he provided.

J. As a result of Rogge's actions, the prices obtained from the two broker-dealers, as calculated based on assumptions which he provided, or offered side market prices, were materially higher than the actual bid side market prices for these securities. By obtaining offered, rather than daily bid side market prices, Rogge violated the Fund's policies and procedures, as set forth in its prospectus and SAI, which required the PAC IOs to be priced at bid side market prices. Rogge caused the inflated prices for these five PAC IOs to be recorded on the Fund's daily pricing sheets. These inflated prices, as obtained by Rogge, in addition to the inflated prices provided by Rogge for the FN 93-15 L PAC IO, were then utilized for calculating a materially inaccurate and inflated daily net asset value for the Fund.

K. By causing the Fund to use inflated prices for the PAC IOs, securities for which market quotations were readily available, Rogge caused the Fund to calculate its net asset value on inflated values rather than the current market value of the Fund's portfolio securities as required by Section 2(a)(41) of the ICA and Rule 2a-4 thereunder. As a result of the aforementioned conduct, Rogge caused the Fund to calculate an incorrect daily net asset value resulting in the Fund's sale and redemption of 290,000 and 562,000 shares, respectively, at an inflated price and caused the Fund to improperly maintain its books and records in support of its financial statements from August 4 through August 26, 1993. Accordingly, Rogge willfully violated Section 34(b) of the ICA and aided and abetted the Fund's violations of Section 31(a) of the ICA and Rules 22c-1 and 31a-1 thereunder. Rogge's actions also defrauded the Funds and its shareholders. As a result, Rogge willfully aided and abetted violations of Sections 206(1) and 206(2) of the Advisers Act.

#### **Discovery of the Scheme**

L. Based upon their review of the PAC-IO securities held by the Fund in July 1993, Rogge's supervisors instructed him to immediately begin to systematically reduce the PAC-IO position in the Fund and, if certain market conditions developed, to expedite the sale of the PAC IOs. Three PAC IOs were sold between July 16 and August 2, 1993 at prices approximating their market value. On August 24, 1993, the pre-defined market conditions occurred but Rogge took no action to reduce the Fund's position in the PAC IOs at that time. When Rogge failed to act, his immediate supervisor ordered him to sell at least one of the PAC IOs by the end of the day on August 26, 1993. As instructed, Rogge liquidated one PAC IO at approximately 4:00 p.m. that day. The selling price for this PAC IO was approximately 30 percent less than the previous day's price that had been used in the Fund's net asset value calculation. Rogge's immediate supervisor discovered the scheme on August 27, 1993 after conferring with the registered representatives that had supposedly been pricing the Fund's PAC IOs.

M. On Monday, August 30, 1993, American Capital notified the Fund's Board of Trustees and the Commission staff of the PAC IO pricing situation. American Capital elected to sell the remaining PAC IOs and reimburse the Fund. As a result of the sale of the PAC IOs, the Fund suffered a loss of \$6.88 million, which was reimbursed by American Capital out of its own assets. A further consequence of the scheme was that the Fund incorrectly calculated its net asset value by as much as 76 cents per share from at least between August 4 through August 26, 1993. American Capital fired Rogge on September 2, 1993.

#### **American Capital's Failure to Supervise Rogge**

N. American Capital did not establish procedures, or a system for applying such procedures, which could reasonably have been expected to prevent or detect Rogge's violations. Specifically, American Capital had no written procedures to implement the Fund's policy to use bid side market prices for valuing securities with current market quotations available, such as the PAC IOs.<sup>7</sup> The firm's practices concerning the daily pricing of the portfolio were insufficient in that they, among other things, gave Rogge too much control over the pricing process with little or no oversight by anyone in a supervisory capacity. In addition, there was no procedure in place to alert American Capital when bid side market prices for securities were not available. American Capital did not independently verify the daily prices provided to American Capital's accounting department with the pricing source or any secondary sources.

<sup>7</sup> According to American Capital's internal policy, the Fund's prospectus and SAI were considered to be the primary compliance documents for portfolio managers. Although the prospectus and SAI do provide guidelines and restrictions applicable to the Fund, these documents do not specify internal controls and procedures necessary to ensure compliance with those requirements.

O. American Capital's failure to have written procedures, or a system for applying such procedures, enabled Rogge to choose broker-dealers for daily pricing purposes, to change pricing sources without approval from his supervisors, to directly obtain daily prices from broker-dealers, and to record prices on the Fund's daily derivative pricing sheets without any verification by a third party.

P. Pursuant to Section 203(e)(5) of the Advisers Act, the Commission can impose sanctions on any investment adviser for failure reasonably to supervise, with a view to preventing violations, any person who commits a violation of the federal securities laws or any rules and regulations thereunder if that person is subject to the adviser's supervision. The aforementioned policies and procedures of American Capital were inadequate reasonably to detect and prevent Rogge's violations. For this reason, American Capital failed reasonably to supervise Rogge with a view to preventing his violations of the federal securities laws.

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions which are set forth in the offer submitted by American Capital. In determining to accept the offer, the Commission has considered remedial acts undertaken by American Capital and cooperation afforded the Commission staff.

Accordingly, It Is Hereby ORDERED That:

A. American Capital shall be, and hereby is, censured;

B. American Capital shall certify, contemporaneously with the entry of this Order, that it has previously adopted and implemented comprehensive written policies and procedures reasonably designed to ensure compliance with Section 2(a)(41) of the ICA and Rule 22c-1 thereunder, and that it will undertake to maintain and comply with such policies and procedures; and

C. American Capital shall pay a civil penalty, in the amount of \$50,000, within five days of the issuance of this Order to the United States Treasury, pursuant to Section 203(i) of the Advisers Act. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check, or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered to the Comptroller, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549; and (D) submitted under cover letter which identifies American Capital as Respondent in these proceedings, the file number of these proceedings, and the Commission's case number (FW-1978), a copy of which cover letter and money order or check shall be sent to T. Christopher Browne, District Administrator, Fort Worth District office, Securities and Exchange Commission, 801 Cherry Street, 19th Floor, Fort Worth, Texas 76102.

By the Commission.

## IN THE MATTER OF MITCHELL HUTCHINS ASSET MANAGEMENT INC.

Release Nos. 33-7444; 34-39001; IA-1654; IC-22805

Administrative Proceeding File No. 3-9383

September 2, 1997

### ORDER INSTITUTING PUBLIC PROCEEDINGS, MAKING FINDINGS, IMPOSING REMEDIAL SANCTIONS, AND ISSUING CEASE-AND-DESIST ORDER

#### I.

The Securities and Exchange Commission (the “Commission”) deems it appropriate and in the public interest to institute public administrative proceedings pursuant to Section 8A of the Securities Act of 1933 (the “Securities Act”), Section 21C of the Securities Exchange Act of 1934 (the “Exchange Act”), Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (the “Advisers Act”), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (the “Investment Company Act”), against Respondent Mitchell Hutchins Asset Management Inc. (“Mitchell Hutchins”).

In anticipation of the institution of these proceedings, Mitchell Hutchins has submitted an Offer of Settlement to the Commission, which the Commission has determined to accept. Solely for the purpose of these proceedings, and any other proceedings brought by or on behalf of the Commission, or in which the Commission is a party, and prior to a hearing pursuant to the Commission’s Rules of Practice, *17 C.F.R. 201.100, et seq.*, and without admitting or denying the findings set forth herein, except as to the Commission’s jurisdiction over it and the subject matter of this proceeding, which Mitchell Hutchins admits, Mitchell Hutchins consents to the entry of this Order Instituting Public Administrative Proceedings, Making Findings, Imposing Remedial Sanctions and Issuing Cease-and-Desist Order (“Order”).

#### II.

Accordingly, IT IS ORDERED that an administrative proceeding pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(e) and 203(k) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act be, and hereby is, instituted.

#### III.

On the basis of this Order and the Offer of Settlement submitted by Mitchell Hutchins, the Commission finds that:<sup>1</sup>

##### A. Respondent

Mitchell Hutchins is a broker-dealer registered under the Exchange Act and an investment adviser registered under the Advisers Act. It is wholly owned by PaineWebber Inc. (“PaineWebber”), a registered broker-dealer. Mitchell Hutchins serves as the investment adviser and administrator of the PaineWebber Short-Term U.S. Government Income Fund. Mitchell Hutchins also acts as the distributor of each class of the Fund’s shares.

##### B. Other Relevant Entity

The PaineWebber Short-Term U.S. Government Income Fund (the “Fund”), a diversified series of an open-end, management investment company, commenced operations on May 3, 1993.<sup>2</sup> The Fund’s assets totaled approximately \$1.7 billion as of November 30, 1993, and approximately \$1 billion as of May 31, 1994.

##### C. Summary

This proceeding involves Mitchell Hutchins’ management of the PaineWebber Short-Term U.S. Government Income Fund, which the firm marketed as a higher-yield and somewhat higher-risk alternative to money market funds and bank certificates of deposit. The prospectus disclosed that the Fund’s investment objective was to achieve the highest level

<sup>1</sup> The findings made herein and the entry of this Order are made pursuant to Respondent’s Offer of Settlement and shall not be binding on any other person or entity in this or any other proceeding.

<sup>2</sup> The Fund later was renamed The PaineWebber Low Duration U.S. Government Income Fund.



of income consistent with preservation of capital and low volatility of net asset value (“NAV”). The appendix to the prospectus also disclosed that the Fund had “no present intention” of investing in certain classes of interest only (“IO”) and principal only (“PO”) stripped mortgage-backed securities (“SMBS”).

Mitchell Hutchins violated the antifraud provisions of the federal securities laws because it marketed the Fund as a low volatility investment, when ultimately it was not. Contrary to the Fund’s investment objective and “no present intention” statement, the Fund began investing in certain inappropriate IO and PO securities in the fall of 1993. For the next seven months, Mitchell Hutchins failed to review the securities purchased by the Fund’s portfolio manager or to otherwise ensure that the Fund’s investments were consistent with the prospectus and other public disclosures. In fact, Mitchell Hutchins recklessly disregarded certain indications that might have led it to discover the portfolio manager’s improper conduct in pricing and managing the Fund’s securities portfolio. When interest rates increased sharply beginning in February 1994, the Fund incurred significant losses, performing well below comparable funds.

#### **D. Mitchell Hutchins’ Disclosures and Representations**

The Fund was offered and sold to the public using a prospectus and other documents prepared by Mitchell Hutchins. The prospectus stated that “the Fund’s investment objective is to achieve the highest level of income consistent with the preservation of capital and low volatility of net asset value.” In addition, the prospectus disclosed that the Fund would invest in U.S. Government securities, including mortgage-backed securities. The appendix to the prospectus said that the Fund had “no present intention” of investing in certain mortgage-backed securities—IO and PO strips of collateralized mortgage obligations (“CMOs”) that were not planned amortization class bonds (“non-PAC IOs and POs”).<sup>3</sup>

Mitchell Hutchins also prepared and disseminated to PaineWebber’s retail sales force marketing materials containing a number of false and misleading statements about the Fund and its expected performance. For example, certain of these materials stated that an investment in the Fund carried somewhat more risk than an investment in a money market fund or a certificate of deposit, but investors could expect returns of 1.5% to 2% more than a money market investment. Based on the performance of a “hypothetical portfolio” prepared by Mitchell Hutchins for marketing purposes,<sup>4</sup> certain marketing materials also stated that a 100 basis point increase in interest rates would cause the Fund’s NAV to decrease by only \$ .02 per share, while a 200 basis point increase would cause the NAV to decrease by only \$ .04 per share. Finally, certain marketing materials also stated that the Fund would not invest in IOs, POs, or derivatives, or engage in option writing or leverage transactions.<sup>5</sup> In selling the Fund’s shares to the investing public, oral representations were made to certain customers based on these marketing materials.

#### **E. The Fund Invested in Certain IO and PO Securities That Were Inconsistent with the Fund’s Prospectus Disclosures**

In September 1993, Mitchell Hutchins hired a person to act as the Fund’s co-portfolio manager, with day-to-day responsibility for managing the Fund’s investments (the “portfolio manager”). At that time, the portfolio manager’s supervisor and another senior co-portfolio manager told him that IOs and POs without PAC protection were not permitted in the Fund.

Despite these instructions, on September 30, 1993, the portfolio manager purchased a non-PAC PO for more than \$15 million. That security was inconsistent with both the prospectus’ “no present intention” statement and the Fund’s low-volatility investment objective. Thereafter, between September 30, 1993, and February 14, 1994, he bought a total of six non-PAC POs and three non-PAC inverse IOs for an aggregate purchase price of more than \$162 million. By February

<sup>3</sup> IOs and POs with prepayment protection, or “PAC bonds,” are designed to provide relatively predictable payments according to an established schedule, provided that prepayments on the underlying mortgage assets fall within a certain range (i.e., as long as early pay-offs by mortgagors fall within certain parameters.) Non-PAC IOs and POs, on the other hand, are significantly more volatile because, among other things, they lack prepayment protection and absorb the effects of changes in prepayments for PAC classes. The Fund’s prospectus stated that non-PAC IOs and POs “are extremely sensitive to the rate of principal payments (including prepayments) on the underlying mortgage assets.”

<sup>4</sup> Created before any securities were purchased for the Fund’s actual portfolio, the “hypothetical portfolio” showed the Fund’s anticipated volatility in response to interest rate changes.

<sup>5</sup> These statements in the marketing materials were inconsistent with disclosures in the prospectus. For example, the prospectus provided that the Fund could purchase certain derivatives (including PAC IOs and POs, which were purchased from its inception), could write options (which it did starting in January 1994), and could enter into leverage transactions.



1994, non-PAC IOs and POs constituted approximately 6% of the Fund's portfolio. During October 1993 through January 1994, the portfolio manager purchased five PAC inverse IOs for a total purchase price of more than \$34 million. The PAC inverse IOs also were inconsistent with the Fund's investment objective.<sup>6</sup>

In addition, in March 1994, the portfolio manager purchased two "structured floater" securities for a total purchase price of approximately \$203 million. These complex, interest-rate sensitive securities were created by bundling together IO, PO and other components (some lacking PAC protection) of various mortgage transactions. When the portfolio manager purchased the two structured floaters, his supervisor was not aware of the existence of non-PAC IOs and POs and inverse floaters in the portfolio. As a result, these two structured floaters were purchased without adequate consideration of how they might impact the Fund's overall portfolio.

For the first three quarters after its inception, the Fund showed a strong performance. For example, for the period January 1 through March 31, 1994, the A shares, B shares, and D shares ranked 2, 9, and 7, respectively, out of 103 comparable funds.

When interest rates increased sharply in the first half of 1994, however, the Fund incurred significant losses. For example, the Fund's NAV fell \$ 0.21 per share from March 31 to June 30, 1994, placing the Fund's performance among the bottom four of 105 comparable funds during the second quarter of 1994.

#### **F. Mitchell Hutchins Failed to Ensure That the Fund's Investments Were Consistent with Disclosures in the Prospectus and Certain Marketing Materials**

Until late April 1994, Mitchell Hutchins failed adequately to monitor the Fund's purchases of securities to ensure adherence to the "no present intention" statement and to have a reasonable basis for continuing to characterize the Fund as a low-volatility investment. No one in a supervisory role reviewed the contents of the Fund's securities portfolio to determine consistency with the "no present intention" statement. Other than reviewing aggregate duration calculations, Mitchell Hutchins did not test the Fund's portfolio to determine whether it would perform in the manner described in the marketing materials. While Mitchell Hutchins required portfolio managers to complete a monthly checklist indicating adherence to investment restrictions and limitations, no form was completed for this Fund during the first eleven months of its operation.

When Mitchell Hutchins prepared an amendment to the Fund's prospectus, effective as of April 1, 1994, it failed to make reasonable efforts to determine whether the Fund was adhering to the "no present intention" statement and the low-volatility investment objective.

#### **G. Certain Fund Securities Frequently Were Mispriced**

Furthermore, certain of the Fund's portfolio securities frequently were mispriced. The Fund's prospectus and statement of additional information ("SAI") described the method it would use to value portfolio securities. The Fund's SAI disclosed that it would value its portfolio securities based on their current market value where market quotations were readily available. Where market quotations were not readily available, or did not adequately reflect, in Mitchell Hutchins' judgment, a security's "fair value," the SAI said that portfolio securities would be valued based on appraisals received from a pricing service or appraisals based on information provided by recognized dealers in those or similar securities. Finally, in the absence of any of the foregoing market indicators, the SAI stated that portfolio securities would be "valued at fair value as determined in good faith by or under the direction of the Trust's board of trustees."

The Fund's portfolio was valued as of the end of each business day. The Fund received from its custodian bank (the "custodian") a daily report of prices for each of the portfolio securities where dealer quotations could be obtained; these prices, in turn, provided the principal basis for the daily calculation of the Fund's NAV. Pursuant to the Fund's stated valuation method, the custodian-provided prices, in most instances, reflected quotations received from a pricing service or from a dealer (usually the dealer that sold the security to Mitchell Hutchins). Consistent with the firm's procedures, the Fund's day-to-day portfolio manager could substitute his own price for a custodian-provided price if he determined

<sup>6</sup> Inverse IOs generally are more volatile than other IO securities because of their extreme sensitivity to interest rate fluctuations. Inverse IOs, which may be either PAC or non-PAC, vary inversely with the London interbank offered rate ("LIBOR").

that the latter did not adequately reflect a security's "fair value." However, Mitchell Hutchins had no written procedures to guide portfolio managers in making those pricing determinations.

Prior to the time the portfolio manager assumed day-to-day responsibility for managing the Fund, price overrides were relatively infrequent. By contrast, during his tenure at the Fund from October 1993 through April 1994, the portfolio manager frequently overrode prices provided by the custodian, altering the prices of approximately 5 to 25 securities on many days. On more than 40 occasions, the portfolio manager overrode custodian-provided prices for a particular security for more than a two-week period. Moreover, the portfolio manager overrode custodian-provided prices for two of the non-PAC securities for almost the entire time they were held by the Fund.<sup>7</sup>

The portfolio manager overrode custodian-provided prices with prices he derived based on his own method, which did not take into account whether the securities currently could be sold at the prices he calculated. The portfolio manager kept no documentation to support his calculations.

When the portfolio manager overrode custodian-provided prices, in most cases, he replaced them with higher prices. For example, from November 29, 1993, to April 22, 1994, he overrode at least 17 securities in the Fund's portfolio, including non-PAC IOs and POs and PAC inverse IOs, by amounts ranging from approximately 9% to 62% higher than the available dealer quotations.

Because the Fund's NAV is a function of the value of its securities portfolio, the portfolio manager's overrides caused the Fund's NAV to be overstated. For example, following the increase in interest rates during February through April 1994, the portfolio manager overrode custodian-provided prices for a substantial number of securities, resulting in inflation of the Fund's NAV by more than \$ 0.01 per share for a total of 36 days during the period from March 1 to April 25, 1994.

The portfolio manager's overrides had the effect of obscuring the volatile effect of the non-PAC IOs and POs and inverse IOs on the Fund's NAV. This, in turn, had the effect of obscuring his purchases of those securities.

Instead of reviewing the actual securities purchased by the portfolio manager, the portfolio manager's supervisor relied on his reported allocation of portfolio securities among various broad classes (e.g., IOs, POs, pass-throughs, etc.), which did not indicate the presence of non-PAC IOs and POs. In monitoring the Fund's volatility, the supervisor relied principally on daily reports of NAV calculated out to five decimal places (the accuracy of which depended on the portfolio manager's accurate valuation of portfolio securities) and on his calculation of aggregate duration, which measures the percentage change in the portfolio's value in response to specified changes in interest rates. By failing to have in place a process to review the support for these aggregate indicators, Mitchell Hutchins failed to detect the portfolio manager's conduct.

#### **H. Mitchell Hutchins Did Not Adequately Monitor the Portfolio Manager's Conduct**

During this period, there was an indication that could have alerted Mitchell Hutchins to the portfolio manager's conduct in purchasing and pricing the Fund's portfolio securities. In November 1993, a Mitchell Hutchins chief investment officer ("CIO"), who reviewed and initialed price overrides in several funds administered by the firm, reported to the then-general counsel that the portfolio manager's overrides were "persistent" and "high" in number. The CIO also reported that the portfolio manager's override documentation precluded a substantive review of his overrides because, among other things, it did not precisely identify the securities at issue. The then-general counsel thereafter brought this matter to the attention of Mitchell Hutchins' president.

Four months following the CIO's report, in late March 1994, there was a meeting at Mitchell Hutchins (involving, among others, the CIO, the then-general counsel and the portfolio manager's supervisor) to discuss price overrides. Following this meeting, the CIO refused to initial any additional overrides processed by the Fund's portfolio manager. Mitchell Hutchins did not investigate the portfolio manager's override practices until a month later.

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<sup>7</sup> On September 30, 1993, the portfolio manager purchased the first non-PAC PO; he subsequently overrode custodian-provided prices for that security from October 18 until January 25, 1994, when he sold it. He purchased a non-PAC IO on October 20, 1993, and overrode its custodian-provided prices every day from November 2, 1993, through February 14, 1994, when he sold it.

## I. Mitchell Hutchins' Discovery of the Portfolio Manager's Improper Conduct and Its Response

In late April 1994, Mitchell Hutchins discovered a clerical pricing error affecting a security in the portfolio of an offshore fund also managed by the Fund's portfolio manager under the same supervisor. On the day it discovered that pricing error, Mitchell Hutchins undertook a review of the valuation of the Fund's portfolio securities. During that review, the firm examined the portfolio manager's pattern of overriding custodian-provided prices and his failure to maintain documentation substantiating those overrides. The firm also discovered the presence of certain portfolio securities that were inconsistent with the Fund's "no present intention" statement and low-volatility investment objective. The firm then recalculated the Fund's NAV and amended the Fund's prospectus to disclose that the Fund had "no present intention" of investing more than 3% of its assets in certain non-PAC IO and PO SMBS classes.

During this period, Mitchell Hutchins contacted Commission staff concerning the problems with the Fund and the firm's possible purchase of securities from the Fund.<sup>8</sup> Thereafter, Mitchell Hutchins purchased certain IOs and POs from the Fund and paid Fund investors \$33 million, which was the amount estimated by the firm as the losses associated with those securities, thereby settling two related class action lawsuits. The firm replaced the firm's president and all persons with direct involvement for the Fund's management and supervision, including the portfolio manager and his supervisor, and revised certain of its policies and procedures. In addition, Mitchell Hutchins paid \$145 million to purchase from the Fund certain IO and PO securities and certain structured floater securities.

### Legal Analysis

#### Mitchell Hutchins Violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder, and Sections 206(1) and (2) of the Advisers Act

Section 17(a) of the Securities Act makes it unlawful, in the offer or sale of securities, (1) to employ any device, scheme or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary to make the statements made, in light of the circumstances in which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business that operates as a fraud or deceit upon a purchaser. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder make it unlawful to employ any device, scheme or artifice to defraud in connection with the purchase or sale of securities. Section 206(1) of the Advisers Act makes it unlawful for an investment adviser to employ any device, scheme or artifice to defraud any client or prospective client. Section 206(2) makes it unlawful for an investment adviser to engage in any transaction, practice, or course of business that operates as a fraud or deceit upon any client.

Mitchell Hutchins willfully violated each of the foregoing antifraud provisions. The portfolio manager purchased non-PAC IOs and POs that rendered materially false and misleading the "no present intention" statement in the Fund's prospectus. These securities together with certain other securities purchased by the portfolio manager also rendered materially false and misleading the characterization of the Fund as a low-volatility investment.

No one in a supervisory capacity reviewed the portfolio manager's purchases of portfolio securities until late April 1994. Nor did the firm undertake any other reasonable effort to ensure that the portfolio manager's investment practices complied with the Fund's prospectus. Moreover, the purchase of non-PAC IOs and POs and certain other securities rendered materially false and misleading statements in certain marketing materials about the anticipated effect on the Fund's NAV of specified changes in interest rates. As a result, the firm acted recklessly with respect to its public disclosures concerning the Fund's performance, investment objective and permissible investments.

Mitchell Hutchins also acted recklessly with respect to its reporting to the Fund of the value of portfolio securities and NAV. Despite an indication that might have led the firm to discover the portfolio manager's improper overriding of custodian-provided prices for portfolio securities, Mitchell Hutchins did not review his override practices until late April 1994. As a result, Mitchell Hutchins reported overstated prices for certain of the securities, thereby causing the Fund's NAV to be overstated. This overstatement, in turn, obscured the volatile effect of the non-PAC IOs and POs and inverse IOs on the Fund's NAV, thereby obstructing the Fund's ability to discover the purchase of those securities.

<sup>8</sup> The staff ultimately issued a no-action letter indicating that it would not object to the purchase of the securities from the Fund under Section 17(a) of the Investment Company Act.

### **Mitchell Hutchins' Violations of the Investment Company Act**

Section 34(b) of the Investment Company Act makes it unlawful to, among other things, make any untrue statement of material fact in any registration statement. Because the Fund's prospectus was incorporated into its registration statement, Mitchell Hutchins willfully violated that provision by rendering materially false and misleading certain prospectus disclosures described above.

Section 13(a)(3) of the Investment Company Act provides that, unless authorized by the vote of a majority of its outstanding voting securities, no registered investment company shall deviate from any investment policy that is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to Section 8(b)(3) of that Act. The Fund's prospectus disclosed that its low-volatility investment objective was a "fundamental policy that may not be changed without shareholder approval." Mitchell Hutchins caused the Fund to deviate from this fundamental policy by purchasing securities that were inconsistent with this objective. Neither Mitchell Hutchins nor the Fund ever sought shareholder approval to change the investment objective. As a result, Mitchell Hutchins willfully aided and abetted and caused a violation of Section 13(a)(3).

Under Section 31(a) of the Investment Company Act and Rule 31a-1(a) thereunder, registered investment companies are required to maintain and keep current such books, accounts and other documents constituting the basis for financial statements required to be filed with the Commission under Section 30 of the Investment Company Act, which include balance sheets showing the aggregate value of securities held and the amounts and values of securities owned as of the date thereof. For the period from October 1993 through April 1994, the portfolio manager did not maintain documentation regarding the basis for overriding the prices of securities held in the Fund's portfolio or the methodology and calculations he used to derive override prices. As a result, the Fund did not maintain records necessary to show the basis for the NAV and securities valuations reported in its balance sheets. Therefore, Mitchell Hutchins willfully aided and abetted and caused a violation of the aforementioned recordkeeping requirements.

### **Mitchell Hutchins Failed Reasonably to Supervise the Fund's Portfolio Manager**

Pursuant to Section 203(e)(5) of the Advisers Act, the Commission is authorized to impose sanctions on an investment adviser for failure reasonably to supervise, with a view toward preventing violations, any person who violates the federal securities laws, if that person is subject to the adviser's supervision. Mitchell Hutchins' supervisory practices, policies and procedures at the time were inadequate reasonably to detect and prevent the above-described violations of the federal securities laws by the portfolio manager. Accordingly, Mitchell Hutchins failed reasonably to supervise him.

Mitchell Hutchins did not establish adequate procedures, or a system for applying such procedures, which reasonably could have been expected to prevent or detect the portfolio manager's violations. Specifically, Mitchell Hutchins did not have adequate procedures to implement or monitor the Fund's low-volatility investment objective, the "no present intention" statement in the prospectus, or the Fund's stated valuation method. Moreover, the firm's supervisory practices concerning these matters were insufficient in that they, among other things, gave the portfolio manager too much control over the purchase and valuation of the Fund's portfolio securities with inadequate oversight.

Mitchell Hutchins' supervisory practices, and its failure to establish adequate procedures, or a system for applying such procedures, enabled the portfolio manager to purchase non-PAC IOs and POs and certain other securities contrary to the Fund's low-volatility investment objective and "no present intention" statement.

#### **IV.**

In determining to accept the Offer of Settlement submitted by Mitchell Hutchins, the Commission considered remedial measures adopted and implemented by Mitchell Hutchins.

#### **V.**

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions set forth in Mitchell Hutchins' Offer of Settlement.

Accordingly, IT IS ORDERED THAT:

A. Mitchell Hutchins shall be, and hereby is, censured;

B. Mitchell Hutchins shall cease and desist from committing any violation and any future violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1) and 206(2) of the Advisers Act, and Section 34(b) of the Investment Company Act, and shall cease and desist from causing any violation and any future violation of Sections 13(a)(3) and 31(a) of the Investment Company Act and Rule 31a-1(a) thereunder;

C. Mitchell Hutchins shall pay a civil money penalty of \$500,000 to the United States Treasury within seven days of the entry of this Order. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the Securities and Exchange Commission; (3) hand-delivered to the Office of the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (4) submitted under cover of a letter identifying Mitchell Hutchins as the Respondent in these proceedings, the name and file number of these proceedings, and the Commission's case number (HO-2955), a copy of which shall simultaneously be sent to Richard Sauer, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 8-3, Washington, D.C. 20549; and

D. Mitchell Hutchins shall comply with its undertakings to:

1. retain within 60 days of the entry of this Order, at Mitchell Hutchins' expense, an Independent Consultant ("Consultant") not unacceptable to the Commission's staff to, among other things, review and make any appropriate recommendations concerning the policies and procedures adopted by Mitchell Hutchins prior to the date of this Order and continuing in effect in the following areas:
  - a. Mitchell Hutchins' preparation, review and approval of publicly disseminated sales materials and broker-only sales and marketing materials concerning registered investment company shares;
  - b. compliance with the terms of registered investment company prospectuses and SAIs relating to fundamental investment policies and investment restrictions and limitations;
  - c. the valuation of securities held by registered investment companies managed by Mitchell Hutchins and the records maintained to support such valuation;
  - d. the calculation of NAV for registered investment companies managed by Mitchell Hutchins; and
  - e. any policies and procedures designed reasonably to prevent and detect, insofar as practicable, violations of the federal securities laws in connection with the matters described in paragraphs D.1. a - d above;
2. require the Consultant, at Mitchell Hutchins' expense, to prepare a report to Mitchell Hutchins' Board of Directors within six months of the issuance of this Order setting forth the review and recommendations as to the matters described in paragraph D.1 above;
3. authorize the Consultant to provide copies of the report to the Commission's staff, which may make such further use thereof as it may, in its discretion, deem appropriate;
4. adopt and implement, no later than six months after receipt of the report, or such other time as the Consultant believes is necessary, such policies and procedures as recommended by the Consultant; provided, however, that as to any of the Consultant's recommendations that Mitchell Hutchins determines is unduly burdensome or impractical, Mitchell Hutchins may propose an alternative procedure reasonably designed to accomplish the same objectives. The Consultant shall reasonably evaluate any such alternative procedure and, if appropriate, either approve the alternative procedures or amend the recommendation. Mitchell Hutchins shall abide by the decision of the Consultant and adopt and implement the alternative procedures or amended recommendation within the time period set by the Consultant in light of the nature of the procedure;
5. provide to the Commission staff, within six months after the issuance of the report a letter attesting to, and setting forth the details of, its implementation of the recommendations contained in the report;

6. cooperate fully with the consultant, including obtaining the cooperation of Mitchell Hutchins employees or other persons under its control;

7. require the Consultant to enter into an agreement providing that: (a) for the period of the engagement and for a period of two years from the completion of the engagement, the Consultant shall not enter into any employment, consulting or attorney-client relationship with Mitchell Hutchins, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such; and (b) any firm with which the consultant is affiliated or of which the Consultant is a member, and any person engaged to assist the Consultant in performance of his duties under this Order shall not, without prior written consent of the Commission, enter into any employment, consulting or other professional relationship with Mitchell Hutchins or any of its present or former directors, officers, employees, or agents in their capacity as such for the period of the engagement and for two years thereafter; and

8. reasonably cooperate, and use all reasonable efforts to cause its present or former officers, directors, agents, servants, employees, attorneys-in-fact, assigns and all persons in active concert and participation with them to reasonably cooperate with investigations, administrative proceedings and litigation conducted by the Commission arising from or relating to the matters described in this Order.

By the Commission.

**IN THE MATTER OF PARNASSUS INVESTMENTS, ET AL.**

Release No. 34-40534

Administrative Proceeding File No. 3-9317

October 8, 1998

**ACTION: NOTICE THAT INITIAL DECISION HAS BECOME FINAL**

The time for filing a petition for review of the initial decision in this proceeding has expired. None of the Respondents has petitioned for review, and the Commission has not chosen to review the decision on its own initiative.

Accordingly, notice is hereby given, pursuant to Rule 360(e) of the Commission's Rules of Practice, that the decision of the administrative law judge \* has become the final decision of the Commission. The order contained in that decision required that Parnassus Investments and Jerome L. Dodson cease and desist from committing or causing any violations or future violations of Sections 13(a)(3), 21(a), and 17(e)(1) of the Investment Company Act of 1940 and Section 207 of the Investment Advisers Act of 1940 and that Parnassus Investments, Jerome L. Dodson, David L. Gibson, and Marilyn M. Chou cease and desist from committing or causing any violations or future violations of Rule 22c-1 promulgated under Section 22(c) of the Investment Company Act of 1940. That order is hereby declared effective.

\* Parnassus Investments, Jerome L. Dodson, Marilyn Chou and David L. Gibson, Initial Decision Rel. No. 131 (September 3, 1998), SEC Docket.

For the Commission by the Office of the General Counsel, pursuant to delegated authority.



## IN THE MATTER OF PARNASSUS INVESTMENTS, ET AL.

SEC Initial Decision Release No. 131

Administrative Proceeding File No. 3-9317

September 3, 1998

APPEARANCES: Karen G. Kwong and John S. Yun for the Division of Enforcement, Securities and Exchange Commission

Richard M. Phillips, Neil S. Lang and Holly S. Haskew for the Respondents

BEFORE: Robert G. Mahony, Administrative Law Judge

### I. Introduction

The Securities and Exchange Commission (Commission) initiated this proceeding by an Order Instituting Proceedings (OIP) on May 29, 1997, pursuant Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 (Advisers Act) and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (Investment Company Act).

The OIP sets out three allegations. First, it alleges that the four named Respondents<sup>1</sup> overstated the net asset value (NAV) of the Parnassus Fund (Fund) from December 1990 to January 1993 (the relevant period), thereby willfully aiding and abetting the Fund's violations of Rule 22c-1, promulgated pursuant to Section 22 of the Investment Company Act, when sales and redemptions of Fund shares were made at the overstated NAV. According to the OIP, the overvaluations were caused by the Board of Trustees' (Board or Trustees) decisions regarding the Fund's investment in Margaux, Inc. (Margaux). Second, the OIP alleges that Parnassus Investments and Dodson improperly directed the Fund to make a \$100,000 loan. Third, and finally, the OIP alleges that Parnassus Investments and Dodson improperly used soft dollar credits from 1989 to 1995.

A hearing was held in San Francisco, California on September 22-26, 1997. The Division filed its Post Hearing Brief and Proposed Findings of Fact and Conclusions of Law on February 18, 1998, Respondents filed their Post Hearing Brief and Proposed Findings of Fact and Conclusions of Law on April 8, 1998, and the Division filed its Reply Brief and Supplemental Findings of Fact and Conclusions of Law on April 28, 1998.<sup>2</sup> The Division requests that cease and desist orders be entered against all Respondents, that Parnassus Investments and Dodson be ordered to pay \$10,000 each in civil penalties, and that Respondents Gibson and Chou be ordered to pay \$5,000 each in civil penalties.

### II. Findings of Fact

#### A. Respondents<sup>3</sup>

Respondent Dodson founded Parnassus Investments in 1984 and is currently its president. (Tr. 180, 187.) He and his wife jointly own all of its common stock. (Tr. 180.) Dodson is also president of the Fund and a member of its Board of Trustees (Trustees), as well as the Fund's portfolio manager. (Tr. 180.) Dodson is a graduate of the University of California at Berkeley and possesses a Masters of Business Administration degree from Harvard. (Tr. 182.) He was founder and Chief Executive officer of Continental Savings of America. (Tr. 185.)

Respondent Gibson is and has been an independent Trustee of the Fund since 1986. (Tr. 189, 545.) Gibson is a licensed attorney who specializes in tax and business matters. (Tr. 544-45.) Gibson was formerly tax counsel and Director of Public Affairs for Crown Zellerbach. (Tr. 544-45.) He was formerly both a director and an officer of California Wine Company and Ceracon Incorporated. (Tr. 544-45.) Gibson received an undergraduate business degree from Columbia

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<sup>1</sup> Respondents Dodson, Chou, and Gibson served as the Parnassus Fund's Board of Trustees.

<sup>2</sup> Citations to exhibits offered by the Division and the Respondent will be noted as "Div. Ex. \_\_\_" and "Resp. Ex. \_\_\_," respectively. "Tr. \_\_\_" refers to the transcript of the hearing and "PH Tr. \_\_\_" refers to the transcript of the prehearing held on September 17, 1997.

<sup>3</sup> Prior to this action, none of the Respondents had been the subject of an enforcement action.

Tech, a law degree from Washington University, a Masters of Law in Taxation from the College of William and Mary, and a Masters of Business Administration from Golden Gate University. (Tr. 543.)

Respondent Chou was an independent Trustee of the Fund from 1984 to 1995. (Tr. 426.) She left the Fund's Board in 1995 and presently has no connection with the securities industry. (Tr. 426.) Chou is executive vice president of a medical device company called Xintec Corporation. (Tr. 423.) She is also the company's chief financial officer. Chou was formerly an officer and owner of a real estate organization known as Dana Properties. (Tr. 423.) Chou graduated from San Francisco State University and received a Ph.D. in sociology from the University of California at Berkeley. (Tr. 420.)

### **B. Parnassus Investments**

Parnassus Investments, formerly known as Parnassus Financial Management, is an investment advisor registered with the Commission pursuant to the Advisers Act. (Tr. 181.) Parnassus Investments directs the investments of the Fund and provides the Fund with management, administrative, transfer agency and distribution services necessary for the operation of the Fund. (Tr. 384.) Parnassus Investments is also the distributor of the Fund's shares which are sold with a maximum commission or "load" of 3.5%. (Div. Ex. 112 at 11.)

### **C. Parnassus Fund**

The Fund is a diversified open-end investment company registered with the Commission under the Investment Company Act. (Tr. 187.) The Fund's principal objective is long-term capital growth. (Resp. Ex. 61 at 6.) It adheres to a contrarian investment policy, whereby it purchases stocks that are currently "out of favor with the investment community," but exhibit good future prospects and solid intrinsic value. (Div. Ex. 110 at 6.) The price of each share is set for purposes of sales and redemptions according to the Fund's total NAV<sup>4</sup> divided by the number of outstanding shares. (Div. Ex. 112 at 12.) The Fund's NAV is calculated each business day by the Fund or its agent according to the current value of each investment in the Fund's portfolio.

(Div. Ex. 112 at 12.)

The Fund's prospectus, dated May 1, 1989, limited the types of "equity securities" in which the Fund could invest to stocks and convertible instruments. (Div. Ex. 112 at 7.) The Fund's statement of additional information, dated May 1, 1988, prohibited loans, except repurchase agreements, without prior shareholder approval. (Div. Ex. 111.) Dodson was aware of the investment policies in the Fund's statement of additional information. (Tr. 202-03.) In particular, Parnassus Investments and Dodson were aware of the Fund's restrictions on loans. (Tr. 203-04.)

### **D. The Fund's Investment in Margaux**

Margaux was a manufacturer and marketer of large, energy-efficient refrigeration units for grocery stores and supermarkets. (Tr. 70, 558.) Margaux's innovative technology conserved energy by producing more constant temperatures in refrigeration display cases. (Tr. 70.) During the relevant period, its most important customer was Food Lion, Inc. (Food Lion), one of the fastest growing supermarket chains in the United States. (Tr. 80-81, 165, 231.) In 1989, Margaux became the exclusive provider of refrigeration equipment to Food Lion nationally. (Tr. 176.) Beginning in 1986, Margaux's common stock traded on the National Association of Securities Dealers Automated Quotation System (NASDAQ). (Tr. 87.)

Among the Fund's investments was an accumulation of Margaux common stock shares. (Tr. 153.) Dodson became aware of Margaux in 1986 through research provided by Shearson Lehman Hutton. (Tr. 208.) Believing Margaux met the desired criteria for prospective investments, Dodson caused the Fund to make significant purchases of Margaux common stock. (Tr. 208-10.) By early 1989, the Fund held 640,000 shares of Margaux at an average cost of \$1.26 per share. (Tr. 223-24, 247; Resp. Ex. 2 at 3.)

On March 20, 1989, Margaux and its wholly owned subsidiary Engineered Refrigeration Systems (ERS) filed petitions for relief pursuant to Chapter 11 of the Bankruptcy Code. (Tr. 25, 211.) At the time, Margaux and ERS owed \$1.9 million to Citizens and Southern Bank, their primary secured lender. (Div. Ex. 6 at 3.) Dodson, although aware of

<sup>4</sup> The Fund's total NAV is calculated by taking the value of the Fund's investments and then deducting any liabilities. (Div. Ex. 112 at 12.)

Margaux's current financial condition, had no advance knowledge of Margaux's intention to file for bankruptcy. (Tr. 212-13.) Despite the bankruptcy, Dodson believed Margaux was still "undervalued" and caused the Fund to purchase another 250,000 Margaux common stock shares at \$0.28 per share just two days after the bankruptcy petitions were filed. (Tr. 230-31; Div. Ex. 153.)

On April 10, 1989, Citizens and Southern Bank obtained an order from the bankruptcy court protecting its security interest by prohibiting Margaux from spending its cash on hand. (Tr. 69, 236.) Shortly thereafter, Stephen Clark, Margaux's chief executive officer, contacted Dodson who was traveling out of the country and informed him that Margaux was in urgent need of new capital in order to remain a going concern. (Tr. 27-28, 235-36.) Dodson agreed to provide Margaux with a portion of the new capital, then thought to be \$500,000. (Tr. 237-39, 246.) Clark and Dodson agreed that the transaction would be characterized as a debenture which would be convertible into Margaux common stock after obtaining approval from the bankruptcy court. (Tr. 75.) On April 14, 1989, the bankruptcy court authorized Margaux and ERS to borrow - on a subordinated basis - up to \$450,000 from a group of lenders that included the Fund. (Div. Ex. 6 at 3.) Subsequently, Dodson caused the Fund to lend \$100,000 to Margaux and ERS pursuant to a loan agreement. (Tr. 237-39, 246; Div. Ex. 2.) Dodson signed the loan agreement on behalf of the Fund and Parnassus Investments. (Div. Ex. 2 at 12-13.) In exchange for the \$100,000, the Fund received a Note and Security Agreement, both dated April 28, 1989. (Div. Exs. 1, 3.) Despite Clark and Dodson's agreement regarding conversion rights, neither the Note nor the Security Agreement contained any provision for conversion into common stock. (Div. Exs. 1, 2.)

Dodson was aware that any proposed conversion right was subject to the approval of the bankruptcy court. (Tr. 242.) Nevertheless, in a letter to the Fund's shareholders, dated July 24, 1989, Dodson characterized the Note as "the \$100,000 convertible debenture you see in the portfolio." (Div. Ex. 124 at 2.) On September 14, 1989, Margaux and ERS submitted a Reorganization Plan to the bankruptcy court. The Reorganization Plan, approved by the bankruptcy court on October 5, 1989, provided that "prior to payment . . . [the Note] may be converted to common stock of Reorganized Margaux . . ." (Div. Ex. 22 at 5.) At this point, the Fund held a subordinated convertible note with a face value of \$100,000, which paid interest at the rate of 12% per year and was convertible at the holder's option into 1.5 million shares of Margaux common stock, fifteen shares for every dollar (approximately \$0.06 per share).<sup>6</sup> (Tr. 118, 250, 287.) All of the 1.5 million shares were restricted stock that had not been registered for sale with the Commission. (Div. Ex. 32.) Without registration, the stocks could not be publicly sold for at least two years.<sup>7</sup> At the time the conversion right was approved, Margaux's unrestricted common stock was trading on the NASDAQ at approximately \$0.44 per share. (Div. Ex. 50 at 2.)

#### **E. Valuing the Note: The Switch from Face Value to Conversion Price**

Initially, the Trustees voted to carry the Note on the Fund's books at its \$100,000 face value.<sup>8</sup> (Tr. 127, 258-59.) The Fund carried the Note at face value through December 31, 1989 in its annual report. (Div. Ex. 126 at 12.) On January 9, 1990, Dodson decided that the Note should be valued at its conversion price,<sup>9</sup> i.e., the NASDAQ market price of Margaux common stock times the number of shares into which the Note was convertible. Gibson and Chou agreed to the change despite the fact that they cannot recall any significant development in Margaux's business in the nine

<sup>5</sup> The Reorganization Plan also extended the Note's maturity from April 1990 to April 30, 1991, and subordinated the Note to Margaux's primary and secured revolving line of credit. (Div. Ex. 22.)

<sup>6</sup> At this time, Margaux was paying other commercial lenders a large premium over the 12% it agreed to pay the Fund. Margaux reported in its December 31, 1991 Form 10-K that it was paying a weighted average interest of 27.5% for short-term borrowing. (Div. Ex. 13.)

<sup>7</sup> The Note's convertibility, if exercised, would entail a minimum two-year holding period from the date of conversion before the shares could be freely traded, and only then in quarterly amounts limited by the greater of trailing 90 day volume or 1% of shares outstanding. Were the Fund to be deemed an affiliate of Margaux, the minimum time frame over which the 1.5 million restricted common shares could be sold would be twelve quarters, or three years from the end of the initial two-year holding period from the date of the Note's conversion. (Report of Robert Conner, Division's Expert, at 5.)

<sup>8</sup> One day prior to it becoming convertible, the Trustees chose to continue valuing the Note at face value, citing a "thin" trading market. The Fund's minutes, dated October 4, 1989, read: RESOLVED, that the secured debt of Margaux, Incorporated in the principal amount of \$100,000 currently owned by the Fund shall continue to be valued by the Fund at \$100,000, notwithstanding the fact that such debt may shortly become convertible into common stock at a significantly lower price, because the thin market for Margaux Incorporated common stock does not produce a reliable value for that security . . . (Div. Ex. 50 at 2-3.)

<sup>9</sup> Dodson recommended and the Trustees adopted a \$0.50 per share price cap on the conversion price. (Res. Ex. 7; Tr. 261-62.)

days between December 31, 1989 and January 9, 1990. (Div. Ex. 53; Tr. 465-66, 562.) Dodson stated that he believed the change in valuation better reflected Margaux's "fair value." (Tr. 261.) At the time of the change in valuation, Dodson conceded that he was not aware that the relevant shares of Margaux common stock were restricted. (Tr. 264.) Gibson considered the restriction of "[n]o particular importance," while Chou was unaware and/or lacked adequate understanding of the concept of restricted stock. (Tr. 580-81, 537.) From January 1990 until Margaux was delisted in August 1990, the Note was priced at its conversion value. (Tr. 275-76.) In August 1990, the Trustees added a 10% premium to the price of the Margaux common stock shares underlying the Note. (Tr. 276, 639.) Dodson and the Trustees claimed that because the Note was convertible the premium accurately reflected the added value of the interest stream payments and seniority of the Note over common stock in the event of Margaux's liquidation. (Tr. 276, 476.)

Shortly after it was valued as converted, the Note was shown as being worth \$375,000 in the Fund's quarterly report for the period ending March 31, 1990. (Div. Ex. 127 at 1.) For the year ending December 31, 1990, the Fund's 1990 Annual Report shows the Note as being worth \$562,500. Thus, the Note produced an "unrealized gain" for the year of \$462,500. (Div. Ex. 127 at 1.) of that gain, \$46,500 was attributable to the 10% premium, while \$416,000 was attributable to valuing the 1.5 million restricted shares of Margaux common stock as converted at \$0.344 per share. (Div. Ex. 130.)

#### **F. The Decision to "Fair Value" the Margaux Holdings**

For the fiscal year ending March 31, 1990, Margaux showed a loss of \$2.353 million and a negative net worth of \$485,000. (Div. Ex. 6 at 22-23.) Because of the negative net worth, on August 29, 1990, Margaux was delisted from the NASDAQ exchange.<sup>10</sup> (Tr. 87, 154, 275-76, 576.) Prior to delisting, the Fund carried the Margaux investment at the recorded closing NASDAQ price, or in the absence of such price, at the mean between the last recorded bid and asked quote. (Tr. 457-58.) The last available NASDAQ "market quote" for Margaux common stock shares was \$0.344 per share. (Tr. 278-79.) After delisting, Margaux stock was quoted only in the National Daily Quotation Bureau's "pink sheets." (Tr. 67, 278.)

In December 1990, consistent with Section 2(a)(41) of the Investment Company Act, Dodson recommended to the Trustees that the Margaux holdings be valued at "fair value" rather than market value. (Tr. 261, 342.) To determine fair value, Accounting Series Release (ASR) 113 required the Trustees to value the 1.5 million restricted Margaux shares at "the amount which the owner might reasonably expect to receive for them upon their current sale" by applying a discount from the price of unrestricted Margaux shares "except for most unusual circumstances." (Div. Ex. 144.) The Trustees were further instructed by ASR 118 to value the 565,000 unrestricted Margaux shares then held by the Fund according to what the Fund "might reasonably expect to receive for them upon current sale," and to disclose in the Fund's annual reports any methodology or factors that were used to perform fair valuations and to document the information considered in the Board minutes for independent review by the Fund's outside auditors. (Div. Ex. 145.) See, Conclusions of Law, *infra*.

Dodson believed that "selling [the Margaux holdings] on the open market was not a real test of [Margaux's] fair value or current value." (Tr. 284.) Rather, Dodson believed fair value to be based on what the Fund might receive if Margaux's "true" value were realized in a sale in an active, orderly market. (Tr. 231-32, 310, 406-08; Div. Ex. 154 at 4.) Respondents admit, however, that during the relevant period there was no orderly, liquid market for Margaux common shares. (Tr. 475.) Further, a transaction such as the one favored by Dodson would have required a sale of the entire company or at least a controlling position therein. (Tr. 489, 584; see also Report of Abe Halati, Respondents' Expert, at 5.) Even if the Note was converted, however, the Fund's stake in Margaux represented less than 15% of the outstanding shares of the company. Therefore, the Fund was unable to affect a sale of Margaux or a controlling position therein. Insofar as relevant to this proceeding, efforts to find a buyer for Margaux ended in late 1990 when the only entity to express any interest failed to put a bid on the table. (Tr. 51-53; Report of John M. Lacey, Division's Expert, at 20.)

#### **G. Fair Valuing the Margaux Holdings: The Board of Trustees Meetings**

(i) December 19, 1990

The Trustees made their initial fair valuation of the Fund's 565,000 unrestricted Margaux shares and the Note during the December 1990 Board meeting. (Div. Ex. 64 at 5-6.) Dodson informed the Trustees that Margaux's revenues for the

<sup>10</sup> Margaux was delisted when its shareholder equity dropped below the required minimum threshold of \$375,000. (Tr. 275-76.)

nine months ending December 31, 1990 were estimated to be \$14 million and that net income for the same period would be just \$50,000. (Div. Ex. 64 at 5; Div. Ex. 65.) He also informed the Trustees that Margaux projected \$21 million in revenues for the full calendar year of 1991, along with net income of \$1 million after deducting interest expenses. (Div. Ex. 64 at 5; Div. Ex. 65.) Further, Dodson reported to the Trustees that the most recent pink sheet prices for Margaux were in the range of “\$0.05 to \$0.10 per share.”<sup>11</sup> (Tr. 495.) Dodson, however, believed that Margaux was too thinly traded to be valued solely or primarily on the basis of the pink sheet bid and asked quotations. (Tr. 278, 342.)

The Trustees determined that the price for the Margaux shares as reported in the pink sheets “[did] not constitute a true measure of the value of the Margaux securities held by the Fund” and resolved to maintain the value of the Margaux common stock at \$0.344 per share. (Resp. Ex. 190; Tr. 286, 342-43.) Although the minutes do not reflect any such analysis, Dodson testified that the Trustees’ determination represented a market assessment of Margaux’s value that both fully discounted the impact on Margaux of its reorganization in bankruptcy, its current financial difficulties, and its future prospects. (Tr. 579.) Further, Dodson and the Trustees noted that in addition to the quantitative financial data available, they considered of critical importance Margaux’s refrigeration technology, its management, and its relationship with its principal customer, Food Lion. (Tr. 340-44, 470, 579.)

(ii) March 20, 1991

In a letter dated February 20, 1991, Margaux informed Dodson of its financial results for the final nine months of 1990. Margaux had a net loss of \$283,000—instead of a \$50,000 profit—in the final nine months of 1990. Margaux also notified Dodson that it had revised downward its projected earnings for the calendar year of 1991 from \$1 million to \$505,000. Margaux further disclosed to Dodson that it had to renegotiate its unsecured debt repayment schedule because it could not make the payments and that it would be unable to pay-off the \$425,000 in convertible notes that were coming due. (Div. Ex. 68.) At the March 20, 1991 Board meeting, the Trustees discussed Margaux’s operating results for the nine months ending December 31, 1990. (Tr. 321; Div. Ex. 170.) The Trustees also received a report from Deloitte & Touche, the Fund’s auditors. (Tr. 322-23.) In large part because Margaux was so thinly traded, the auditors considered the valuation of the Margaux holdings the most sensitive area of judgment in the financial statements. (Tr. 613.) The auditors reviewed the valuation and the methodologies employed by the Trustees in arriving at that valuation, finding them in accordance with generally accepted accounting procedures.<sup>12</sup> (Tr. 613, 616.) At the close of their Board meeting, the Trustees chose not to adjust their valuation of the Margaux holdings.

(iii) July 10, 1991

On April 22, 1991, Margaux announced that it had made a \$16,000 profit for the quarter ending March 31, 1991.<sup>13</sup> (Div. Ex. 72.) The Trustees claim to have spent only a short time discussing Margaux at the July 10, 1991 Board meeting because there had been, according to Dodson, “no significant developments.” (Tr. 325.) Yet, there is no reflection of any discussion of Margaux in the minutes of the July 1991 Board meeting. (Div. Ex. 74.) Following the Board meeting, the valuation of the Fund’s Margaux holdings remained unchanged.

(iv) December 18, 1991

On August 2, 1991, Margaux announced a \$45,000 net loss for the quarter ending June 30, 1991.<sup>14</sup> (Div. Ex. 75.) On November 1, 1991, Margaux announced it had a further net loss of \$349,000 for the quarter ending September 30, 1991.<sup>15</sup> (Div. Ex. 76.) At the December 18, 1991 meeting, Dodson testified that the Trustees had extensive discussions regarding Margaux’s financial statements and its methodology for fair valuing the Margaux holdings. (Tr. 343.) He delivered to the Trustees a memorandum containing an income statement of Margaux for 1991, a Margaux budget

<sup>11</sup> During the relevant period, Margaux’s stock traded at prices ranging from a low of \$0.01 per share to a high of \$0.15 per share. (Div. Exs. 9, 13, 17, 18.)

<sup>12</sup> Under cross examination, Mr. Marco Vanderlaan, the audit manager of the Fund from Deloitte & Touche, clarified that any reports to the Trustees did not reflect upon whether the Trustees were in compliance with the guidelines imposed by ASR 118. (Tr. 648.)

<sup>13</sup> Margaux had originally forecast 1991 net income at \$1 million after deducting interest expenses. (Div. Ex. 64.) Soon thereafter, that number was revised downward but was still forecast to be \$505,000. (Div. Ex. 68.)

<sup>14</sup> *Supra*, note 13.

<sup>15</sup> *Supra*, note 13.



forecast for 1992, and a form 10-Q of Margaux, dated November 8, 1991. (Div. Ex. 79.) Dodson acknowledged that the results for 1991 had been less than favorable and failed to meet Margaux's prior projections. (Tr. 343.) Moreover, he reported that Margaux was behind schedule in its efforts to diversify its client base: the Food Lion account continued to represent 65% of Margaux revenues. (Div. Ex. 79.) The Trustees, nonetheless, citing positive cash flow, an improved financial forecast for 1992,<sup>16</sup> and continued strong business fundamentals, declined to change their valuation of the Fund's Margaux holdings. (Div. Ex. 79; Tr. 342-44, 505.)

(v) March 11, 1992

In March 1992, Margaux announced it had suffered a \$927,000 net loss for the year of 1991 on revenues of \$19,451,000.<sup>17</sup> (Div. Ex. 81.) The auditors from Deloitte & Touche returned and gave a presentation to the Trustees similar to that from March 1991. (Tr. 345; Resp. Ex. 181.) The Trustees were told that the valuation of the Margaux holdings, although it continued to warrant special attention, "appear[ed] reasonable." (Resp. Ex. 181.) Similar to July 1991, there is no reflection of any discussion of Margaux in the minutes of the March 1992 Board meeting. Despite Margaux's failure to meet management's financial projections,<sup>18</sup> the valuation of the Fund's Margaux holdings remained unchanged. (Div. Ex. 81.)

(vi) July 29, 1992

At the July 29, 1992 Board meeting, Dodson reported that Margaux's results of operations for the six months ended June 30, 1992 had improved when measured against the results for the same period for the previous year. (Div. Ex. 84, 85.) Margaux had earned a profit, reporting a net gain before taxes of \$367,000.<sup>19</sup> (Div. Ex. 84.) Dodson told the Board that on a fully diluted basis, the second quarter earnings annualized to \$0.08 a share.<sup>20</sup> (Div. Ex. 85.) Moreover, the Trustees were told Margaux was in a position to benefit from a tax loss carryforward and increased Food Lion expansion. (Div. Ex. 85.) The Board, however, also discussed Margaux's dependence on its relationship with Food Lion and the continued "thin market" for Margaux shares. (Div. Ex. 85.) After giving some consideration to increasing the valuation of the Fund's Margaux holdings, the Trustees determined to maintain the current valuation. (Div. Ex. 85.)

(vii) December 16, 1992

At the December 16, 1992 Board meeting, the Trustees discussed the impact on Margaux of extremely negative publicity regarding Food Lion. (Tr. 354, 523-25.) The Trustees worried that the negative publicity might adversely affect Margaux's prospects. (Tr. 354-55, 523-25.) At the time of the Board meeting, Dodson was unable to obtain any information regarding the continued viability of Food Lion's expansion plans, the one factor that clearly would have had a serious impact on Margaux's prospects. (Tr. 356.)

Dodson also informed the Trustees that in the September or October of that year he received a call from Clarke who told him of a potential buyer's indication of interest in the Fund's Margaux holdings. (Tr. 353.) The buyer was not identified and no formal offer was made, but the inquiry, according to Dodson, was "somewhere around \$0.25 to \$0.30 a share." (Tr. 353.) Dodson, however, told the Trustees that he informed Clarke that the Fund was not interested in selling its holdings for less than \$0.34 a share. (Tr. 353.)

The Trustees also discussed Margaux's recent operating results. (Tr. 351-52.) The Board focused on earnings for the first three quarters of the year. Margaux reported net income of \$557,000 on revenues of \$20,984,000 for the three quarters ending September 30, 1992. This compares to a net loss of \$378,000 on revenues for \$14,894,000 for the same period the previous year. (Div. Ex. 86.) Balancing the favorable and unfavorable news, the Trustees ultimately determined to

<sup>16</sup> The source for the improved financial forecast was Margaux's management.

<sup>17</sup> At the time of the meeting, Dodson and the Trustees were aware of Margaux's operating results for 1991, despite the fact that Margaux's Form 10-K was not filed until March 31, 1992. (Tr. 347-50.)

<sup>18</sup> As previously noted, at the December 1990 Board meeting, Dodson told the Trustees that Margaux expected \$21 million in revenues in 1991, with a net income of \$1 million (later revised downward to \$505,000) after deducting interest expenses. (Div. Ex. 64.)

<sup>19</sup> For the same six month period the previous year, Margaux had reported a net loss before taxes of \$29,000. (Div. Ex. 84.)

<sup>20</sup> If earnings for the full six month period are annualized, that figure drops to \$0.06 per share. (Div. Ex. 84.)

maintain its valuation of Margaux at \$0.344 per share until the impact of the adverse publicity could be evaluated. (Resp. Ex. 52; Tr. 355-56, 526-27.)

#### H. Changing the Fair Value of the Margaux Holdings

On December 24, 1992, Food Lion issued a press release announcing reductions in its planned expansion. (Resp. Ex. 53; Tr. 358.) When he became aware of the press release after the first of the year, Dodson attempted to contact Margaux's president, Clarke, to determine what impact the announcement would have on Margaux. (Tr. 357-58.) Clarke, however, was on vacation until January 14, 1993, and could not be reached. (Tr. 358.)

On or about January 8, 1993, Dodson became aware of a research memorandum issued by Morgan Stanley, dated January 8, which, in light of the recent adverse publicity and curtailment of expansion plans, downgraded Food Lion shares from buy to a hold. (Resp. Ex. 186.) On January 14, 1993, Dodson reached Clarke and confirmed what was already known, that Food Lion would be scaling back its expansion plans. (Tr. 359.) After speaking to Clarke, Dodson immediately began a new analysis of the factors used to value Margaux. (Tr. 359-60.)

Later that same day, after speaking to Chou and Gibson regarding the recent events, Dodson determined that the Margaux holdings needed to be revalued. (Tr. 360.) The carrying value of the Margaux stock was reduced from \$0.344 to \$0.20 per share based on Margaux's "prospects for the future." (Resp. Ex. 57.) According to a pricing memorandum to the Margaux file authored by Dodson, the price reduction reflected, among other things, "Food Lion's moratorium on signing leases, diminished sales in Food Lion's Texas supermarkets and unfavorable publicity about Food Lion." (Resp. Ex. 57.) The memorandum stated that Margaux's 1992 earnings could "easily support a stock price of \$0.344 a share," but that the prospects for 1994 were less clear due to uncertainty about how many Food Lion stores would open and whether Margaux could make up for lost Food Lion business with other customers. (Resp. Ex. 57; Tr. 359.) At the March 24, 1993 Board meeting, the Trustees, after having been briefed by Dodson on the latest developments regarding Margaux, ratified the January 14, 1993 reduction in Margaux's carrying value to \$0.20 per share. (Div. Ex. 98; Tr. 530-31.) The Trustees also reduced the 10% premium on the Note to zero. (Div. Ex. 98; Tr. 360.)

#### I. Subsequent Developments Regarding Margaux

From January 14, 1993 and until July 12, 1994, the Fund valued its Margaux holdings at \$0.20 per share. On July 12, 1994, the Fund further reduced the carrying value of its Margaux holdings to \$0.15 per share as a result of Margaux's earnings problems connected to a decline in its Food Lion business and uncertain future prospects. (Tr. 372-73, 533-34.) In the fall of 1994, Margaux reached an agreement to sell its assets. (Resp. Ex. 82; Tr. 96, 375-76, 534.) The sale produced a net price of \$0.27 per share. (Tr. 96, 376, 534.)

#### J. Soft Dollar<sup>21</sup> Allegations

Between January 1989 and June 1995, the Fund earned \$186,844 in soft dollar credits as a result of directing brokerage commissions to a national wirehouse firm. (Div. Ex. 148; Resp. Ex. 89.) The Fund used a portion these soft dollar credits to purchase products and services for itself. (Div. Ex. 99.) Among the purchases was \$104,792 in computers, one-half of which was used for fund accounting and transfer agent functions—services the Fund was paying Parnassus Investments to perform. (Div. Ex. 50, 148; Resp. Ex. 89.) Parnassus Investments also purchased Advent software and updates, the primary purpose of which is accounting, with \$14,629 in soft dollars. (Resp. Ex. 89.) Parnassus Investments failed to disclose in its Forms ADV that it was using the Fund's soft dollar credits to purchase these non-research related products and services. (Div. Exs. 160-72.)

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<sup>21</sup> Soft dollars can be described as follows:

When investment managers buy or sell stock, the price of executing the transaction includes price paid or received for the stock and the brokerage commission. The brokerage commission includes: actual costs of the trading function; principally executing the trade; clearing; settling; custody; and the brokerage firm's profit. The brokerage firm may give up part of their profit to provide credits for investment managers or consultants who use these credits to pay for research and/or other costs associated with the investment process. The commission dollars that a brokerage firm relinquishes in this manner are termed "soft dollars." Mari-Anne Pisarri, *Soft Dollars and Directed Brokerage*, SC49 ALI-ABA 185, 211 (1998).



Dodson initially believed using soft dollars to pay for fund accounting and transfer work was proper under the securities laws. (Tr. 297, 384-85.) In December 1993, however, Dodson conceded that the purchases related to transfer agent activities did not fall within the safe harbor of Rule 28(e) of the Securities Exchange Act of 1934 (Exchange Act), but defended the practice because it benefited shareholders by reducing the cost of transfer agent services. (Div. Ex. 93; Resp. Ex. 89.) He continued to maintain that using soft dollar credits for fund accounting activities was entirely proper under Rule 28(e). (Div. Ex. 93; Resp. Ex. 89.) According to Dodson, when Parnassus Investments negotiated with the Board to provide fund accounting and transfer agent services it agreed to charge below market rates to the Fund in exchange for permission to use soft dollar credits to defray the costs of the two services. (Tr. 385-86; Div. Ex. 93; Resp. Exs. 89, 164.) Nevertheless, after receiving a deficiency letter from the Commission in February of 1994, Dodson and Parnassus Investments repaid \$66,000 to the Fund. (Tr. 398; Div. Ex. 96.) Dodson voluntarily repaid the money because he did not want his integrity questioned and he thought it was the “the proper thing [to do.]”<sup>22</sup> (Tr. 399.)

## IV. Conclusions of Law

### A. The Loan to Margaux Violated Sections 13(a)(3) and 21(a)

Section 13(a)(3) of the Investment Company Act protects investors by requiring mutual funds to limit their investment risks to the types disclosed. It provides that “[n]o registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities . . . deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to Section 8(b)(3).” 15 U.S.C. 80a-13(a)(3).<sup>23</sup> Section 21(a) provides a similar protection by prohibiting registered investment companies from lending money or property if “the investment policies of such registered investment company, as recited in its registration statement and reports filed under this title, do not permit such a loan . . .” 15 U.S.C. 80a-21(a).

The Fund’s statement of additional information, dated May 1, 1988, clearly limited loans to repurchase agreements. Additionally, the Fund’s prospectus, dated May 1, 1989, limited the types of “equity securities” in which the Fund could invest to stocks and convertible instruments.

In April 1989, in exchange for a Note and Security Agreement, the Fund lent \$100,000 to Margaux and its subsidiary ERS. At the time, neither document contained any provision for conversion into common stock. On October 5, 1989, the bankruptcy court approved Margaux’s Reorganization Plan which provided that the Note could be converted into Margaux common stock at a ratio of fifteen shares per \$1 of note. Thus, when the Fund lent \$100,000 to Margaux and ERS it executed a straight loan, and until the bankruptcy court approved the Reorganization Plan over five months later the Fund was in possession of a straight debt instrument.

When he signed the loan agreement on behalf of Parnassus Investments, Dodson was aware that neither the Note nor the Security Agreement contained a stock conversion feature. On September 17, 1997, pursuant to the Division’s Motion for Partial Summary Disposition, I concluded that the Note constituted an unauthorized loan and that the Fund was in violation of Sections 13(a)(3) and 21(a) of the Investment Company Act until the Note became convertible. (PH Tr. 4-5.) The findings and conclusions of the September 17, 1997 prehearing conference that relate to the issue of whether the \$100,000 Note represented an unauthorized loan are incorporated by reference herein.

To establish an aiding and abetting violation, the Division need only demonstrate: (i) a primary violation of the securities laws, (ii) the aider or abettor’s general awareness or reckless disregard of their participation in an improper transaction, and (iii) the aider and abettor’s knowing and substantial assistance of the conduct constituting the securities violation. See, e.g., *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir.), cert. denied, 449 U.S. 919 (1980); *IIT v. Cornfield*, 619 F.2d 84, 94-97 (5th Cir. 1975).

The ruling on the Division’s Motion for Partial Summary Disposition established the primary securities violation of Sections 13(a)(3) and 21(a). With respect to the second element, Parnassus Investments and Dodson were aware of the Fund’s prohibitions on loans and knew or recklessly disregarded the fact that until the conversion feature on the Note

<sup>22</sup> Additionally, in early 1994, the Fund amended its Statement of Additional Information to explicitly state: [T]he Advisor may use brokerage commissions to acquire computer software and hardware (including peripherals) for use with the Fund’s transfer agent and fund accounting work if such use benefits fund shareholders by reducing expenses. (Div. Ex. 99.)

<sup>23</sup> Section 8(b)(3) of the Investment Company Act refers to policies that are designated as “fundamental.”

was approved by the bankruptcy court, the Note represented an unauthorized loan. With respect to the third and final element, I conclude that it was Parnassus Investments and Dodson who knowingly caused the Fund to enter into an unauthorized loan in violation of Sections 13(a)(3) and 21(a) of the Investment Company Act. Thus, it is clear that the elements of aider and abettor liability are satisfied. I conclude, therefore, that Parnassus Investments and Dodson aided and abetted the Fund's violation of Sections 13(a)(3) and 21(a) of the Investment Company Act.

**B. The Fund Violated Rule 22c-1 Because Respondents Did Not Use a Current Sale Methodology to Fair Value the Fund's Margaux Holdings**

(i) Rule 22c-1's Requirement for Using a Current Net Asset Value

Respondents are charged with willfully aiding and abetting a Rule 22c-1 violation, which allowed the Fund to sell and redeem shares at a price other than the correctly calculated NAV. Section 22(c) of the Investment Company Act empowers the Commission to make rules regarding the prices at which mutual funds may buy and sell redeemable shares. Rule 22c-1(a) mandates that mutual funds use their current NAV in selling and redeeming shares:

No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security

....

17 C.F.R. 270.22c-1(a)

To calculate the current net asset value required by Rule 22c-1, mutual funds must follow Rule 2a-4 under the Investment Company Act. Rule 2a-4 sets forth the definition of "current net asset value" and provides that:

The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations . . . made in accordance with the following, with estimates used where necessary or appropriate:

(1) Portfolio securities with respect to which quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company . . .

17 C.F.R. 270.2a-4(a)(1)<sup>24</sup>

(ii) ASR Guidelines

In 1969 and 1970, the Commission, responding to a need to make clear what constituted "fair value . . . in good faith," published ASRs 113 and 118 (now codified within Section 403 and 404 of the Codification of Financial Reporting Policies), as a guideline to assist registrants having to deal with good faith valuation questions.

ASR 113 deals with the problem of valuing "restricted securities." ASR 113 describes the valuation problem created by restricted securities:

It is critically important that an investment company properly value its portfolio securities. It is obvious, for example, that any distortion in the valuation of a restricted security held by an investment company will distort the price at which the shares of the investment company are sold or redeemed . . .

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<sup>24</sup> Rule 2a-4 essentially adopts the definition of "value" set forth in Section 2(a)(41)(B) of the Investment Company Act. 15 U.S.C. 80-2(a)(41)(B)(i), (ii).

. . . Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder requires that in determining net asset value, “securities for which market quotations are readily available” must be valued at current market value while other securities and assets must be valued at “fair value as determined in good faith by the board of directors.”

Readily available market quotations refers to reports of current quotations for securities similar in all respects to the securities in question. No such current public quotations can exist in the case of restricted securities. For valuation purposes, therefore, restricted securities constitute securities for which market quotations are not readily available. Accordingly, their fair market values must be determined in good faith by the board of directors and this obligation necessarily continues throughout the period these securities are retained in the company’s portfolio.

Accounting Series Release No. 113, Investment Company Act Release No. 5847, SEC Accounting Rules (CCH) 3758-61, at 3682-86 (Oct.21, 1969).

ASR 113 also describes the accounting treatment to be afforded to restricted securities:

Restricted securities are often purchased at a discount, frequently substantial, from the market price of outstanding unrestricted securities of the same class. This reflects the fact that securities which cannot be readily sold in the public market place are less valuable than securities which can be sold, and also the fact that, by the direct sale of restricted securities, sellers can avoid the expense, time and public disclosure which registration entails. As a general principle, the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. This depends on their inherent worth, without regard to the restrictive feature. Consequently, the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for the most unusual circumstances, be improper.

*Id.* In the past, the Commission has interpreted ASR 113 as requiring a meaningful discount from the current price of the unrestricted shares that have an active trading market. See, e.g., *Robert F. Lynch*, 46 S.E.C. 5 (1975) (finding violation of anti-fraud provisions based upon investment adviser’s valuation of restricted securities at the active trading price of unrestricted shares).

Fourteen months after ASR 113, the Commission again addressed what constituted “fair value . . . in good faith.” ASR 118 sets forth standards for valuing securities and requires mutual funds to disclose any practice that differs from ASR 118’s standards:

In some circumstances value can be determined fairly in more than one way. Hence, the standards set forth below should be considered guidelines, one or more of which may be appropriate in circumstances of a particular case. These standards should be followed, and a company’s stated valuation policies should be consistent with them. Any variation from the standards should be disclosed in the financial statements or notes thereto even though the variation is in accordance with the company’s stated valuation policy. In addition, any deviation from a stated valuation policy, whether or not in conformity with the standards, should be disclosed in the financial statements or notes thereto.

Accounting Series Release No. 118, Investment Company Act Release No. 6295, SEC Accounting Rules (CCH) 3750-57, at 3678-82 (Dec. 23, 1970).

ASR 118 follows ASR 113’s lead in using a current sale principle to derive a current fair value:

No single standard for determining “fair value . . . in good faith” can be laid down, since fair value depends upon the circumstances of each individual case. As a general principle, the current “fair value” of an issue of securities being valued by the board of directors would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale.

*Id.* Methods which are in accord with the current sale principle are multiples of earnings or a discount from market of a similar freely traded security or a combination of these methods. *Id.* Factors that directors should consider in a good faith valuation include:

1) the fundamental analytical data relating to the investment, 2) the nature and duration of restrictions on disposition of the securities, and 3) an evaluation of the forces which influence the market in which these securities are purchased and sold. Among the more specific factors which are to be considered are: type of security, financial statements, cost at date of purchase, size of holding, discount from market value of unrestricted securities of the same class at time of purchase, special reports prepared by analysts, information as to any transactions or offers with respect to the security, existence of merger proposals or tender offers affecting securities, price and extent of public trading in similar securities of the issuer or comparable companies, and other relevant matters.

*Id.* ASR 118 also states that directors should take into account all indications of value available to them in determining fair value and that the information and judgment factors considered should be documented in the directors' meeting minutes. *Id.*

(iii) Good Faith and Current Sale Analysis

Good faith is the touchstone of the valuation process when determining the "fair value" of thinly traded, unlisted securities. To prevail on the charge that Rule 22c-1 under the Investment Company Act was violated because Respondents failed to properly fair value the Fund's Margaux holdings, the Division must, among other things, demonstrate that Respondents failed to act in good faith. For the reasons set forth below, I conclude that Respondent Dodson, Chou, and Gibson did not fair value the Fund's Margaux holdings in good faith within the meaning of ASRs 113 and 118.

The "current sale" principle set forth in ASRs 113 and 118 is the standard to measure Respondents exercise of good faith in their decisions associated with the attempts to fair value the Margaux holdings.

The American Institute of Certified Public Accountants (AICPA) defines current sale as an "orderly disposition over a reasonable period of time." AICPA, Audit and Accounting Guide, Audits of Investment Companies 2.32, at 26 (3d ed. 1987). Respondents argue that "orderly disposition" requires a reasonable market in which there are competing buyers and sellers and that the Commission never intended securities whose prices are not readily available to be priced on a basis resembling a "fire sale." Obviously, Respondents are correct in that fire sale pricing was never the intention of the Commission. However, while it is clear that the current sale principle recognizes a reasonable time frame in which to arrange sales, it does not ignore the fact that a security may suffer from a thin market or other unenviable variables. Regarding the definition of current sale and orderly disposition as applied to this proceeding, I find the testimony of the Division's expert, John M. Lacey, persuasive: "[Current sale] is the price that a reasonable buyer would be willing to pay for the stock of Margaux and the loan to Margaux, given the existing thin market for the stock and existing low-interest-rate loan and its convertibility into restricted stock which is thinly traded." (Rebuttal Report of John M. Lacey, Division's Expert, at 5.)

(a) ASR 113: Valuing the Restricted Margaux Shares

The Division contends that had the Fund chosen to convert the Note into 1.5 million shares of restricted Margaux stock or if the Fund had been correct in its decision to value the Note as converted, ASR 113 guidelines would have applied. Thus, the Division argues that the 1.5 million restricted shares into which the Note was convertible had to be discounted to derive a current sale price. Respondents, on the other hand, contend that ASR 113 does not apply because it does not deal with the pricing of securities which, like Margaux, have no market. While ASR 113 does warn that "the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for the most unusual situations, be improper," nowhere does it specifically exclude from its guidelines securities that have no active trading market.

During the relevant period, there is no evidence that establishes that Respondents ever discussed any unusual situation that would justify valuing the restricted securities at the same price as the unrestricted securities or that they considered discounting the restricted shares in accordance with ASR 113. Respondents counter that there was no reason to value the restricted shares differently from the unrestricted shares since both could only be sold in connection with a change in control of the company. Respondents' argument ignores the fact that the Fund did not own Margaux or even come close to a controlling interest therein. The Fund did not have the power to sell or force a sale of Margaux. Consequently, the Note and the 565,000 Margaux common shares were distinct investment vehicles. As such, Respondents were required

to consider, for each investment, in good faith, the guidelines and factors listed in ASRs 113 and 118. Respondents, however, failed to do so. The Board's decisions to value the restricted securities at the same price as the unrestricted securities were little more than rubber stamp approvals of Dodson's recommended valuations. The justifications for the valuation of the Note are inadequate and evident nowhere in the contemporaneous record of the relevant period. I conclude Respondents failed to consider the standards imposed by ASR 113, and thus did not fair value the Note in good faith.

From January 9, 1990 until Margaux was delisted in August 1990, the Note was valued as if converted and the share price for the restricted shares was the same as the unrestricted shares listed on the NASDAQ, subject to a \$0.50 per share price cap.<sup>25</sup> For the year ending December 31, 1990, the Fund's 1990 Annual Report shows the Note as being worth \$562,500. Respondents' decision to value the Note as if converted rather than at face value, thus, produced an unrealized gain for the year of \$462,500.<sup>26</sup> Respondents insist there was no need to discount the price of the restricted shares. The Division, on the other hand, contends that the Respondents should have discounted the price of the restricted shares. I credit the Division's contention and conclude that the failure to discount the restricted shares caused the Fund to overstate its NAV. The Division's expert, Glenn R. Daniel, suggests that a reasonable discount for the restricted shares realized upon conversion of the Note would have been 50%. (Report of Glenn R. Daniel (Daniel Report), Division's Expert, at 12.) I conclude that a discount of this magnitude is appropriate because it reflects the thin market for the stock and the significant liquidity constraints imposed by the restricted feature.

After applying the 50% discount, and assuming *arguendo* that Respondents correctly fair valued the unrestricted Margaux shares at \$0.344 per share, the current selling price for the restricted shares would be \$0.172 per share. To derive a per share NAV impact from the failure to discount the restricted shares, the number of Fund shares outstanding at the end of each quarter is divided into the total NAV impact of \$258,000 (\$562,500 Note valuation minus \$46,500 premium minus 50% discount). The calculations reveal that, over the course of the relevant period, the NAV impact of a 50% discount ranged from a high of \$0.20 per share on December 31, 1990 to \$0.14 per share on December 31, 1992.<sup>27</sup> Respondents' failure to apply a restricted share discount on the 1.5 million shares resulted in overstatement of the NAV and thereby violated Rule 22c-1 by allowing transactions in Fund shares at prices that were not based on the Fund's current NAV.<sup>28</sup> Further, Respondents' actions and decisions while serving as Trustees to the Fund caused the violation. Finally, Respondents failure to apply a restricted share discount demonstrated a reckless disregard for the proper computation of NAV. Having found all three elements satisfied, I conclude that Respondents Parnassus Investments, Dodson, Chou, and Gibson aided and abetted the Fund's violation of Rule 22c-1. See, e.g., *Investors Research Corp.*, 628 F.2d at 178.

#### (b) The 10% Premium

<sup>25</sup> Although the Fund's pricing of the Note during this period seems to mirror the type of conduct criticized by ASR 113, it occurred outside of the relevant period set forth in the OIP and will not be addressed.

<sup>26</sup> Of that amount, \$46,500 was attributable to the 10% premium, while \$416,000 was attributable to valuing the 1.5 million restricted shares of Margaux common stock as converted at \$0.344 per share.

<sup>27</sup> Throughout this opinion NAV impact per share has been rounded to the nearest penny.

<sup>28</sup> Respondents argue that even if one were to disregard the Trustees' valuations and to accept the Division's valuation of the Margaux common stock and the Note, the impact on the Fund's NAV would be immaterial on the basis of the total return, the standard measure of mutual fund performance. In support of their position, Respondents cite language from Rule 22c-1(b) and *SEC v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992). Rule 22c-1(b) requires investment companies to compute NAV at least once daily. The rule, however, sets forth three exceptions. The first exception provides relief from the daily pricing requirement on days where changes in the value of an investment company's portfolio securities will not "materially affect" the current NAV of the investment company's redeemable securities. See Rule 22c-1(b)(1)(i). I conclude that Rule 22c-1(b)(1)(i) addresses the frequency of an investment company's pricing requirements and cannot be read to impose a "materiality" test when pricing a security for the purposes of Rule 22c-1(a). In *Steadman*, the D.C. Circuit refused to accept the Commission's contention that "a penny a share [is] per se material . . . because mutual funds are priced and reported in newspapers to a penny a share." 967 F.2d at 643. *Steadman*, however, did not analyze the relevant language of Rule 22c-1 but, instead, discussed the concept of materiality as it exists under the antifraud provisions of the federal securities laws. Therefore, I disregard the dicta found in *Steadman*. Rule 22c-1 is a pricing provision, not an antifraud provision. It involves computing NAV, rather than making representations concerning NAV. Mispricing, standing alone, constitutes a violation of Rule 22c-1. Therefore, I concur with the Division's contention that Rule 22c-1 does not contain a materiality element.



Respondents argue that adding a 10% premium to the price of the \$100,000 Note and the shares into which it could be converted was based on common and acceptable business practices. Respondents contend that “[s]uch a premium reflects the fact that a convertible feature provides an investment with all of the potential for gain from an equity risk, but with the additional safety of a debt investment.” (Report of Clarence Sampson (Sampson Report), Respondents’ Expert, at 13.) Several factors, however, indicate that adding a premium to the Note was improper. First, Respondents testified that their valuations of Margaux were explicitly tied to the sale of Margaux as a “going concern.” Ignoring for the moment Respondents’ awareness of the decided lack of interest in Margaux, the fact still remains that upon the company’s sale the 12% coupon, part of the alleged basis for the premium, would become worthless because all interest payments would cease.<sup>29</sup> Second, when converted the 10% premium added \$46,500 to the Note’s value (1.5 million restricted shares x \$0.031 per share). Such a large premium represented nearly fifty percent of the \$100,000 protected by the Note. The record, however, indicates that the Trustees gave little, if any, serious consideration to the issue of the premium. The Trustees minutes, annual reports, and pricing memoranda are silent on whether a premium should have been added to the Note’s conversion value and on the appropriate amount of such a premium. I conclude, therefore, that Respondents’ attribution of the 10% premium violated ASR 118’s requirements that “all indications of value” be considered and “judgment factors considered by the board” be documented in the board’s minutes to justify a fair valuation analysis.

To determine the impact of the premium on per share NAV, the \$46,500 is divided by the number of Fund shares outstanding at the end of each quarter to calculate the per share NAV adjustment. The calculations reveal that, over the course of the relevant period, the NAV impact of the premium overstatement ranged from a high of \$0.04 per share on December 31, 1990 to a low of \$0.02 per share on December 31, 1992. Because a Rule 22c-1 violation occurs when NAV is misstated, I conclude that the Fund’s overstatement of NAV by applying an improper 10% premium constituted a violation of that rule. Additionally, I conclude that the Fund’s overstatement of NAV was caused by Respondents and demonstrated a reckless disregard for the proper computation of NAV. I conclude, therefore, that Respondents Parnassus Investments, Dodson, Chou, and Gibson aided and abetted the Fund’s violation of Rule 22c-1.

#### (c) ASR 118: Valuing the Unrestricted Margaux Shares

ASR 118 recognizes that value can be fairly determined in a variety of ways. Yet, ASR 118, similar to ASR 113, requires the use of an estimated “current sale” price in fair valuing securities for which market quotations are not available. The Division alleges that Respondents violated the current sale principle by employing a valuation methodology based on what it terms the “long-term sale of the company approach.” According to the Division, Respondents disregarded current conditions and improperly valued what the Fund did not own at the time—i.e., Margaux, the company—and never fair valued what the Fund did own—i.e., the \$100,000 Note and 565,000 unrestricted common shares. Respondents counter that their valuation methodology was based on “the notion of a sale at a fair price, within a reasonable time frame, assuming the existence of a reasonable market in which there are both buyers and sellers.” Sampson Report, at 8.

Respondents’ valuation methodology clearly accorded great weight to certain intangibles possessed by Margaux. Several times during their testimony Respondents referred to Margaux’s management, innovative technology, and relationship with its principle customer as the basis for its valuation methodology. ASR 118, however, requires directors to take into account all indications of value available to them in determining fair value. To aid directors, ASR 118 sets forth a list of specific and general factors which should be considered when determining the fair value of an unlisted security. See Part IV.b.(ii), *supra*. ASR 118 also instructs directors to document in the minutes of the directors’ meeting information and judgment factors considered in the valuation process. Failure to follow the guidelines imposed by ASR 118 when fair valuing unlisted securities raises the question of whether a director has acted in “good faith.”

For reasons discussed below, I conclude that Respondents ignored or failed to give adequate consideration to a number of the general and specific factors set forth in ASR 118. First, Respondents failed to carefully consider or document the

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<sup>29</sup> Further support for the proposition that the \$12,000 annual interest stream income was not deserving of a \$46,500 premium can be found in the fact that Margaux’s primary lender, Lighthouse Financial, was receiving 25% annual interest. This indicates that in an arms-length transaction a third party buyer would demand that the Note be substantially discounted in order to compensate for the lower interest stream. Any premium that approached the discounted value would likely meet with resistance from potential buyers. (Report of Robert E. Conner, Division’s Expert, at 7-8.)

implications of Margaux's NASDAQ delisting on the value of its stock.<sup>30</sup> Unquestionably, the delisting reduced the liquidity of the outstanding shares and reflected that Margaux was experiencing significant financial troubles. The record, however, fails to show any discussion of the delisting and an illiquidity discount in accordance with consideration of ASR 118's general factors of "the nature and duration of restrictions on disposition of the securities" or "an evaluation of the forces which influence the market in which these are purchased and sold."

Second, Respondents failed to give meaningful attention to the general factor of Margaux's "fundamental analytical data relating to the investment" or to the specific factor of Margaux's "financial statements," as required by ASR 118. Respondents had access to and discussed Margaux's financial statements and management's income projections. Nevertheless, despite years of continuing losses and the company's consistent failure to meet management's income projections, Respondents refused to adjust the valuation of the Fund's Margaux holdings.<sup>31</sup> Dodson indicated that the Trustees tended to discount management's income projections and the numerous instances when Margaux failed to meet them. Moreover, while acknowledging the significance of earnings, Dodson commented that current earnings were not necessarily "key things." (Tr. 292.) Dodson's comments are indicative of Respondents' general failure to accord meaningful and necessary attention to Margaux's fundamental analytical data and financial statements. Third, Respondents gave little, if any, consideration to the transactions and bid and asked prices on the "pink sheets." Following the delisting, Respondents took the view that the pink sheet transactions "[did] not constitute a true measure of value." (Div. Ex. 64 at 6.) Respondents' expert, Mr. Sampson, stated that quotations in the pink sheets do not adequately establish fair value because the transactions are too sporadic and generally involve only a small amount of shares. Additionally, Mr. Sampson contends that the pink sheet prices are "often impacted by factors other than the pure desire to complete an exchange at fair value—such as uninformed risk-taking by a buyer, an emergency need for cash by the seller, or a desire to reinvest in another security which (to the seller) has a better potential." Sampson Report at 4-5.

Admittedly, pink sheet prices are not the definitive amounts to be used when establishing the fair value of thinly traded, unlisted securities. Nonetheless, pink sheet transactions cannot be summarily dismissed or ignored altogether. ASR 118 expressly requires consideration of the general factor of market influences and the specific factor of "information as to any transactions or offers with respect to the security." Clearly, the pink sheet transactions represent market transactions for Margaux shares in the market that existed for them at that time. Moreover, as pointed out by the Division's expert, Mr. Lacey, the factors that motivate pink sheet transactions are exactly the same factors that may motivate trades on recognized exchanges and in NASDAQ trading. (Rebuttal Report of John M. Lacey, Division's Expert, at 4.) The record contains no evidence that Respondents ever attempted any analyses to test the reliability of the pink sheet prices to confirm Dodson's belief that they did not represent Margaux's true value. On the other hand, the Division presents persuasive evidence that the prices on the pink sheet bore a rational relation to Margaux's quarterly financial results. (Daniel Report at 12-13, 51-53; Daniel Rebuttal Report at 1, 13-15.)

Fourth, for the majority of the relevant period, Respondents ignored ASR 118's specific factor of "existence of merger proposals." This is important because Respondents' valuation methodology anticipated a future sale of Margaux. Yet, from December of 1990 until at least the fall of 1992 Respondents ignored the decided lack of interest in Margaux among outside suitors.<sup>32</sup> Respondents' decision to ignore the fact that Margaux was not in demand as an investment opportunity is at odds with its decision to use a "sale of the company" valuation.

In short, when valuing the Fund's Margaux holdings, Respondents ignored or failed to give adequate consideration to numerous general and specific factors set forth by ASR 118. I conclude that Respondents valued the Margaux holdings not according to what the Fund could receive under current, albeit unfavorable, conditions, but according to what the Fund might receive if the so-called "true" value were realized upon sale of the entire company or a controlling portion

<sup>30</sup> Chou testified that Margaux's delisting was "significant" and expressed concern with the fact that the Trustees now had to fair value Margaux. At no time, however, did Chou indicate that the Trustees had considered the implications of the delisting beyond the added duty to fair value Margaux. (Tr. 459.)

<sup>31</sup> Respondents were also aware that Margaux had to renegotiate the unsecured debt repayment schedule set forth in the Reorganization Plan because it could not make the required payments and that it would be unable to pay-off the \$425,000 in convertible notes that were coming due.

<sup>32</sup> In late September 1990, Margaux's chief financial officer commented that efforts to sell the company revealed that "[n]obody is interested in this industry."



therein. The Fund carried the 565,000 unrestricted Margaux shares on its balance sheet at \$194,219. (Div. Ex. 130 at 12.) In light of Margaux's precarious financial condition, the Division's expert, Mr. Daniel, suggests an illiquidity discount of 25%, which would reduce the Fund's total NAV by \$48,554.75. (Daniel Report at 12.) Respondents are critical of the Division's suggested illiquidity discount and contend that no such discount is warranted. Upon detailed review of the expert testimony, I credit the opinion of Mr. Daniel. To determine the per share NAV impact of the 25% discount, \$48,554.75 is divided by the outstanding Fund shares. Calculations reveal that the per share NAV impact of the discount ranged from a high of \$0.04 per share on December 31, 1990 to a low of \$0.03 per share on December 31, 1992. Because a Rule 22c-1 violation occurs when NAV is misstated, I conclude that the Fund's overstatement of NAV by not applying an illiquidity discount to the 565,000 unrestricted shares constituted a violation of that rule. Additionally, I conclude that the Fund's overstatement of NAV was caused by Respondents and, similar to the failure to impose a restricted share discount and the improper premium, demonstrated a reckless disregard for the proper computation of NAV. Therefore, I conclude that Respondents Parnassus Investments, Dodson, Chou, and Gibson aided and abetted the Fund's violation of Rule 22c-1.

### C. Parnassus Investments and Dodson Caused Soft Dollar Violations

The Division charges that Parnassus Investments and Dodson violated Section 207 of the Advisers Act and that Parnassus Investments, aided and abetted by Dodson, violated Section 17(e) Investment Company Act by acquiring, in return for Fund brokerage commissions (i.e., soft dollars), computer hardware that was used to provide accounting and transfer agent services to the Fund.

An investment adviser has a duty to disclose to clients all material information which might incline an investment adviser consciously or unconsciously to render advice which is not disinterested. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963). A fact is material if there is a substantial likelihood that a reasonable investor would consider it important. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988). Soft dollar arrangements are material because of the potential conflict of interest arising from an adviser's receipt of some benefit in exchange for directing brokerage on behalf of client accounts. See *Kingsley, Jennison, McNulty & Morse, Inc.*, 51 S.E.C. 904, 909 (Dec. 23, 1993); Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 23170, 35 SEC Docket 905, 909 (Apr. 23, 1986) (hereinafter "1986 Soft Dollar Release"). Moreover, disclosure of soft dollar arrangements is specifically required by Form ADV. See *S Squared Technology Corp.*, 62 SEC Docket 1560, 1564 (Aug. 7, 1996). Form ADV embodies mandatory disclosure requirements to ensure that material information regarding brokerage placement practices and policies is disclosed to investors. See Investment Adviser Requirements Concerning Disclosure, Recordkeeping, Applications for Registration and Annual Filings, Advisers Act Release No. 664, 16 SEC Docket 901 (Jan. 30, 1979); Disclosure of Brokerage Placement Practices By Certain Regulated Investment Companies and Certain Other Issuers, Advisers Act Release No. 665, 16 SEC Docket 837 (Jan. 30, 1979).

As relevant here, Section 17(e)(1) of the Investment Company Act makes it unlawful for an affiliated person of a registered investment company, when acting as an agent for the investment company, to receive any compensation (other than salary or wages) for the purchase or sale of any property to or for the registered investment company. 15 U.S.C. 80a-17(e)(1). Section 207 of the Advisers Act provides that it shall be unlawful for any person to willfully make any untrue statement of material fact in any registration, application, or report filed with the Commission, or to willfully omit to state in any such application or report any material fact required to be stated therein.<sup>33</sup> 15 U.S.C. 80b-7. A person violates Section 207 by filing false amendments to Form ADV or false Forms ADV S. *Stanley Peter Kerry*, 61 SEC Docket 431 (Jan. 25, 1996). Violations of Section 207 do not require a showing of scienter. *S Squared Technology Corp.*, 62 SEC Docket at 1566-67 (citing *Kingsley, Jennison, McNulty & Morse*, 50 SEC Docket 383, 415 (Nov. 14, 1991), *aff'd*, 51 S.E.C. 904 (Dec. 23, 1993)).

#### (i) Parnassus Investments and Dodson's Actions Fall Outside of Section 28(e)'s Safe Harbor

Section 28(e) of the Exchange Act establishes a "safe harbor" for persons who exercise investment discretion over beneficiaries' or clients' accounts to pay for research and brokerage services with commission dollars generated by account transactions. 15 U.S.C. 78bb(e). The statutory safe harbor was adopted in 1975, when Congress unfixed commission

<sup>33</sup> Section 204 of the Advisers Act and Rule 204-1 thereunder require periodic filing and amendment of Forms ADV by investment advisers. Pursuant to Rule 204-1(d), a Form ADV or an amendment thereto is a "report" within the meaning of Section 207.

rates. Section 28(e) was intended to allay the concerns of investment advisers and full-service brokers that an environment of fully negotiated commissions would prohibit the payment of anything other than the lowest possible commission rate.<sup>34</sup>

Subparagraph (3) of Section 28(e) defines the brokerage and research services that are protected. The statute states that a person provides brokerage and research services insofar as he:

- (A) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;
- (B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or
- (C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant.

Of the \$104,792 in soft dollar credits used to purchase computers, one-half was used for brokerage or research-related functions. The other one-half, however, was used for fund accounting and transfer agent functions – services the Fund was paying Parnassus Investments to perform. Parnassus Investments also purchased fund accounting software with \$14,629 in soft dollars. Together, these uses of Fund generated soft dollars totaled approximately \$67,000.

The touchstone for determining when a service is within the definition of Section 28(e)(3) is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities. 1986 Soft Dollar Release, 35 SEC Docket at 907. This determination pivots on whether the disputed product or service aids the money manager in his investment decision making process versus operating the Fund. The accounting and transfer agent services at issue did not assist Parnassus Investments or Dodson in the performance of their investment-making responsibilities, but rather aided in the administrative functions and operations of the Fund.<sup>35</sup> I conclude, therefore, that the services at issue do not fall within the definition of “research services” and are not covered by the safe harbor provisions set forth in Section 28(e).

(ii) Parnassus Investments and Dodson violated Section 17(e)(1)

Dodson contends that soft dollar arrangements outside Section 28(e)’s safe harbor do not automatically constitute a breach of fiduciary duty. (Respondents Post Hearing Brief at 81 (citing *Kingsley, Jennison, McNulty & Morse, Inc.*, 50 SEC Docket at 405)). He maintains that neither he nor Parnassus Investments realized any benefit from using the disputed computer hardware that performed the transfer agent and fund accounting services. He stresses that the Fund’s soft dollar arrangement was fully disclosed to the Trustees and that they agreed to the arrangement in order to avoid an increase in Fund transfer agent and accounting fees. Absent a benefit to Parnassus Investments or himself, Dodson argues that the use of brokerage commissions in this case did not constitute “compensation” within the meaning of Section 17(e).

The essence of a violation of Section 17(e)(1) is the mere receipt of compensation in connection with the purchase or sale of property to or from the investment company. *United States v. Deutsch*, 451 F.2d 98, 109 (2d Cir. 1971), cert. denied, 404 U.S. 1019 (1972). It is not necessary to show that a person was actually influenced by receipt of the compensation,

<sup>34</sup> To the extent that an investment adviser receives compensation pursuant to a disclosed soft dollar arrangement within the Section 28(e) safe harbor, the Commission has stated that the prohibition in Section 17(e)(1) of the Investment Company Act does not apply. See *1986 Soft Dollar Release*, 35 SEC Docket at 911 n.55. Section 28(e), however, does not excuse an investment adviser from Form ADV disclosure obligations. The safe harbor protects an investment adviser only from charges of breach of fiduciary duty for failing to obtain the lowest available commission rate where the amount of commissions is reasonable in relation to the value of brokerage and research services provided. *Id.* at 907.

<sup>35</sup> The *1986 Soft Dollar Release* provides: Computer hardware is [an] . . . example of a product which may have a mixed use . . . . [I]f the computer will be used in assisting the money manager in a non-research capacity (e.g., bookkeeping or other administrative functions), that portion of the cost of the computer would not be within the safe harbor.

that the receipt of the compensation caused economic injury to the investment company, or that the violator acted with scienter. *Id.*; *Investors Research Corp.*, 46 S.E.C. 1209 (1978), aff'd in part and vacated in part, 628 F.2d 168 (D.C. Cir. 1980); cert. denied, 449 U.S. 919 (1981). Additionally, the fact that “a soft dollar arrangement outside of Section 28(e) is disclosed would not cure a violation of Section 17(e)(1) because that provision reflects the Congressional determination that disclosure alone is not adequate protection in the investment company field.” 1986 Soft Dollar Release, 35 SEC Docket at 911. Finally, and most important, the term “compensation” under Section 36(b) and other provisions of the Investment Company Act has been broadly construed to include any economic benefit paid directly or indirectly to an adviser. *Id.* at 907 n.46; *Steadman Securities Corp.*, 46 S.E.C. 896, 910 (1977) rev'd on other grounds, 603 F.2d 1126 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981).

The soft dollar arrangement created a potential conflict of interest and may well have affected Parnassus Investments' ability to choose the Fund's broker-dealer with the complete objectivity that Section 17(e)(1) demands. The use of Fund brokerage to obtain below market transfer agent and accounting products and services may have benefited the Fund, but, nonetheless, also constituted a form of “compensation” proscribed by Section 17(e). Therefore, I conclude that Parnassus Investments violated Section 17(e)(1) and that Dodson caused and aided and abetted Parnassus Investment's violation of such.

(iii) Parnassus Investments and Dodson violated Section 207

The Division also alleges that Parnassus Investments and Dodson were required, but failed, to disclose in its Forms ADV that it received non-research related products and services from brokers in exchange for soft dollar credits earned by the Fund. Items 12 and 13 of Part II of the Form ADV require registrants to disclose soft dollar arrangements with broker-dealers. For investment advisers who have discretionary authority to select the broker-dealers to be used to execute trades in client accounts, Item 12.B. requires a description of the factors considered in selecting the brokers and determining the reasonableness of their commissions. Also, Item 12.B. requires advisers to describe the “products, research and services” received from brokers, if the value of the products, research and services are a factor in selecting the broker. See 1986 Soft Dollar Release, 35 SEC Docket at 909.

Parnassus Investment's answer in its Form ADV in effect in June 1992 stated that, normally, broker-dealers were chosen on the basis of “best execution.” The Form ADV, however, also stated that Parnassus Investments was:

authorized to consider whether [the] broker provides research services and commissions paid to such brokers may be higher than another broker would have charged. Registrant will use judgment in determining that the amount of commissions paid is reasonable in relation to the value of the brokerage and research services provided and need not place a dollar value on such services.

Thus, I find that Parnassus adequately described the factors considered in selecting brokers and determining the reasonableness of the commissions.

Parnassus Investments, however, also had a duty to describe any “products, research, and services” that were received from brokers, if the value of the benefits were a factor in its selection of a broker-dealer.<sup>36</sup> At the hearing, Dodson testified that Parnassus Investments chose broker-dealers solely on the basis of best execution. I am not persuaded, however, that Parnassus Investments would grant itself the power to “consider . . . research services,” and then not consider those research services as a factor in selecting its broker-dealers. I conclude that Parnassus Investments has not overcome the presumption that receipt of non-research and non-brokerage products or services, except where nominally valued, is a factor in the selection of brokers. Thus, although the June 1992 Form ADV disclosed Parnassus Investment's consideration of soft dollar arrangements, it was deficient in that it did not adequately describe the products, research and services received from broker-dealers. Item 13.A. of part II of the Form ADV requires that an investment adviser disclose and describe any arrangement whereby it is paid in cash by or receives some economic benefit, including non-research services, from a non-client in connection with giving advice to clients. These disclosure requirements are designed to “assist clients in determining whether to hire an adviser or continue a contract with an adviser, and permit them to

<sup>36</sup> There is a presumption that receipt of non-research and non-brokerage products or services, except where nominally valued, is a factor in the selection of brokers. *Disclosure of Brokerage Placement Practices By Certain Regulated Investment Companies and Certain Other Issuers*, Advisers Act Release No. 665, 16 SEC Docket at 842 n.6.

evaluate any conflicts of interest inherent in the adviser's arrangements for allocating brokerage." *Kingsley, Jennison, McNulty & Morse, Inc.*, 51 S.E.C. at 909. Parnassus Investment's "no" answer in its Form ADV in effect in June 1992 was false. Parnassus Investments was in fact receiving economic benefit from a broker-dealer, a non-client, in the form of soft dollar credits.

I conclude that Parnassus Investments and Dodson willfully violated Section 207<sup>37</sup> in that they willfully made untrue statements of material fact in Parnassus Investments Form ADV and failed to disclose the existence of a soft dollar arrangement and the products, research, and services received from that arrangement.

#### IV. Sanctions

The Division asks for cease and desist orders against each of the Respondents and civil monetary penalties

The starting point for assessing what sanction is appropriate in the public interest requires consideration of many factors, including deterrence and:

[t]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that his occupation will present opportunities for future violations.

*Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979) (quoting *SEC v. Blatt*, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)), *aff'd* on other grounds, 450 U.S. 91 (1981). The Court of Appeals for the District of Columbia explained that "[t]he 'public interest' standard is obviously very broad, requiring that the Commission consider a full range of factors bearing on the judgment about sanctions that the expert agency ultimately must render." *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1110 (D.C. Cir. 1988). The severity of sanctions depends on the facts of each case and the value of the sanction in preventing a recurrence of the violative conduct. *Berko v. SEC*, 316 F.2d 137, 141 (2d Cir. 1963); *Leo Glassman*, 46 S.E.C. 209, 211 (1975); *Richard C. Spangler, Inc.*, 46 S.E.C. 238, 254 n.67 (1976). Sanctions should demonstrate to the particular respondent, the industry, and the public generally that egregious conduct will merit a harsh response. *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 184 (2d Cir. 1976).

##### A. Cease and Desist Proceedings

Sections 203(k) of the Advisers Act and 9(f) of the Investment Company Act authorize the Commission to issue a cease and desist order if it finds that any person "is violating, has violated, or is about to violate any rule or regulation." The Commission may enter a cease and desist order against "such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation."

As concluded above, Parnassus Investments and Dodson caused and aided and abetted the Fund's violation of Sections 13(a)(3) and 21(a) of the Investment Company Act. Also, Parnassus Investments, Dodson, Gibson, and Chou caused and aided and abetted the Fund's violation of Rule 22c-1 of the Investment Company Act, and Parnassus Investments and Dodson committed violations relating to Parnassus Investment's use of soft dollar credits. Accordingly, it is appropriate to order Respondents to cease and desist from committing or causing any violations or future violations.<sup>38</sup>

##### B. Civil Money Penalty

Sections 203(i) of the Advisers Act and 9(d) of the Investment Company Act authorize the Commission to assess civil money penalties against any person who has willfully aided, abetted, counseled, commanded, induced, or procured a violation of any provision of the Exchange Act, the Investment Company Act, or the Advisers Act.

<sup>37</sup> Willfulness does not require that a Respondent have a specific intent to violate the law or an awareness that the law is being violated. *Kingsley, Jennison, McNulty & Morse, Inc.*, 51 S.E.C. at 911 n.28 (citations omitted).

<sup>38</sup> Cease and desist proceedings are remedial in nature and not subject to the five-year statute of limitations imposed by 28 U.S.C. 2462 and *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996). Therefore, I reject Respondents' contention that the instant proceeding is time-barred.

The assessment of a penalty depends on a finding that such an assessment is in the public interest. The factors that may be considered in determining the penalty amount are: (1) whether the act or omission for which the penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to other person(s) resulting either directly or indirectly from such act or omission; (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior; (4) whether the respondent previously has been found by the Commission, another regulatory agency or a self-regulatory organization to have violated federal or state securities laws or the rules of a self-regulatory organization or has been enjoined or convicted by a court of competent jurisdiction of violations of such laws or rules; (5) the need to deter respondent and others from committing such acts or omissions; and (6) such other matters as justice may require. *New Allied Development Corp.*, 63 SEC Docket 807, 821 n.33 (Nov. 26, 1996); *First Securities Transfer System, Inc.*, 60 SEC Docket 441, 446 (Sept. 1, 1995).

Respondents' actions did not involve fraud, but rather violations of technical provisions of the securities laws. Respondents' actions resulted in minimal harm to others and afforded them no unjust enrichment. Furthermore, prior to this proceeding, Respondents had never been the subject of an enforcement proceeding. Finally, I find the need for civil penalties to serve as a deterrent against future violation is wholly unnecessary.

Therefore, I conclude that a civil penalties are not appropriate in this case.

## V. Record Certification

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. 201.351(b) (1997), I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on July 30, 1998.

### ORDER

IT IS ORDERED that, pursuant to Section 203(k) of the Investment Advisers Act of 1940 and Section 9(f) of the Investment Company Act of 1940, Parnassus Investments and Jerome L. Dodson cease and desist from committing or causing any violations or future violations of Sections 13(a)(3), 21(a), and 17(e)(1) of the Investment Company Act of 1940 and Section 207 of the Investment Advisers Act of 1940.

IT IS FURTHER ORDERED that, pursuant to Section 203(k) of the Investment Advisers Act of 1940 and Section 9(f) of the Investment Company Act of 1940, that Parnassus Investments, Jerome L. Dodson, David L. Gibson, and Marilyn M. Chou cease and desist from committing or causing any violations or future violations of Rule 22c-1 promulgated under Section 22(c) of the Investment Company Act of 1940.

This order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. 201.360 (1997). Pursuant to that rule, a petition for review of this initial decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within twenty-one days after service of the initial decision upon him, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this initial decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the initial decision shall not become final as to that party.

Robert G. Mahony  
Administrative Law Judge



## IN THE MATTER OF PIPER CAPITAL MANAGEMENT, INC., ET AL.

Rel. Nos. 33-8276; 34-48409; IA-2163, IC-26167

Administrative Proceeding File No. 3-9657

August 26, 2003

OPINION of THE COMMISSION  
CEASE-AND-DESIST PROCEEDING  
INVESTMENT ADVISER PROCEEDING  
INVESTMENT COMPANY PROCEEDING

### Grounds for Remedial Action

Antifraud Violations  
Violations of Disclosure Requirements  
Fraudulent Pricing of Net Asset Value  
Accounts and Records Violations  
Falsification of Reports  
Aiding, Abetting, and Causing Unlawful Change of Investment Policy

Registered investment adviser and associated person made fraudulent statements and omitted material facts in connection with the offer and sale of fund securities. Adviser aided, abetted, and was a cause of changes in managed fund's investment policy without shareholder approval.

Adviser and associated persons fraudulently priced managed fund's net asset value, placed false information on the fund's daily reports, and willfully aided and abetted and were causes of that fund's selling, purchasing, and redeeming shares at prices that were not based on the fund's current net asset value, and fund's failure to maintain appropriate books and records.

Held, it is in the public interest to revoke the investment adviser's registration; order the investment adviser to pay a civil money penalty of \$2,005,000; censure respondents; and order respondents to cease and desist from committing or causing violations or future violations of the provisions that they were found to have violated.

### APPEARANCES:

Lawrence J. Field and Todd A. Noteboom, of Leonard, Street, and Deinard, for Piper Capital Management, Inc.

Philip M. Goldberg and Lisa L. Tharpe, of Foley & Lardner, and Todd A. Strother, of Bradshaw, Fowler, Proctor & Fairgrave, for Marijo A. Goldstein.

Robert J. Hennessey and Eric J. Peck, of Lindquist & Vennum, P.L.L.P., for Robert H. Nelson.

Stephen P. Bedell and Scott M. Murray, of Gardner, Carton & Douglas, for Amy K. Johnson.

Jodeen A. Kozlak and Andrew M. Luger, of Greene Espel, P.L.L.P., for Molly J. Destro.

Gregory P. Von Schaumburg, Randall J. Fons, and Thomas W. Szromba, for the Division of Enforcement.

Appeal filed: December 22, 2000

Last brief received: November 1, 2001

Oral Argument: July 31, 2003

## I.

Piper Capital Management, Inc. (“PCM”), Marijo A. Goldstein, Robert H. Nelson, Amy K. Johnson, Molly J. Destro (collectively, the “Respondents”), and the Division of Enforcement appeal from the decision of an administrative law judge.<sup>1</sup> The law judge found that PCM and Goldstein violated Section 17(a) of the Securities Act of 1933,<sup>2</sup> Section 10(b) of the Securities Exchange Act of 1934,<sup>3</sup> Exchange Act Rule 10b-5,<sup>4</sup> and Section 34(b) of the Investment Company Act of 1940<sup>5</sup> by making in various disclosure documents misrepresentations or omissions of material fact relating to the risks associated with an investment in a mutual fund PCM managed. PCM also caused that fund’s violations of IC Act Section 13(a)(3)<sup>6</sup> by aiding and abetting a material deviation from the fund’s stated investment objective without shareholder consent.<sup>7</sup>

The law judge found that the Respondents violated Securities Act Section 17(a), Exchange Act Section 10(b), Exchange Act Rule 10b-5, and IC Act Section 34(b), and willfully aided and abetted and were causes of violations of IC Act Rule 22c-1<sup>8</sup>, IC Act 31(a),<sup>9</sup> and IC Act Rule 31a-1,<sup>10</sup> by manipulating the fund’s net asset value on April 4, 5, and 6, 1994.

The law judge censured Respondents and ordered each of them to cease and desist from violating or causing violations of the federal securities laws. Additionally, the law judge revoked PCM’s registration as an investment adviser and assessed civil money penalties against it totaling \$2,005,000.<sup>11</sup>

The Respondents appeal the findings of violation against them and the sanctions imposed. The Division also appeals the sanctions imposed, and whether the Fund’s net asset value was calculated only weekly, rather than daily, in violation of the IC Act. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

## II.

### A. The Respondents

1. **PCM.** PCM registered with the Commission as an investment adviser in 1983 and was a wholly-owned subsidiary of Piper Jaffray Companies Inc. In 1998, Piper Jaffray Companies Inc. merged with U.S. Bancorp. PCM represents that, after May 1, 1998, it ceased operations.

2. **Marijo Goldstein.** Initially, Goldstein served as a fund analyst. In 1989, Goldstein became a “co-manager” with Worth V. Bruntjen of the Institutional Government Income Portfolio (“PJIGX,” “Portfolio,” or the “Fund”). In 1991, Goldstein was promoted to vice-president at PCM and became a senior vice-president in 1993. Goldstein remained a Fund co-manager through June 1994 and a PCM senior vice-president through 1995.

<sup>1</sup> *Piper Capital Management, Inc.*, Initial Decision No. 175 (Nov. 30, 2000), 73 SEC Docket 3175. Originally, seven respondents were charged in this proceeding. Worth V. Bruntjen entered into a settlement with the Commission. *See* Worth V. Bruntjen, Securities Act Rel. No. 7634 (Jan. 26, 1999), 68 SEC Docket 3377. We make findings here with respect to Bruntjen solely for the purposes of this opinion.

<sup>2</sup> 15 U.S.C. § 77q(a). The law judge dismissed allegations that Goldstein violated Securities Act Section 17(a)(1).

<sup>3</sup> 15 U.S.C. § 78j(b).

<sup>4</sup> 17 C.F.R. § 240.10b-5.

<sup>5</sup> 15 U.S.C. § 80a-34(b).

<sup>6</sup> 15 U.S.C. § 80a-13(a)(3).

<sup>7</sup> The law judge also found that PCM violated Section 207 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-7, by making untrue statements of material fact concerning Bruntjen’s educational background in registration applications and reports filed with the Commission. PCM did not contest its willful violation of IA Act Section 207 or the \$5,000 civil money penalty that the law judge assessed for this violation. That determination is final.

<sup>8</sup> 17 C.F.R. § 270.22c-1.

<sup>9</sup> 15 U.S.C. § 80a-30(a).

<sup>10</sup> 17 C.F.R. § 270.31a-1.

<sup>11</sup> *See supra* note 7.



3. **Robert H. Nelson.** Nelson joined PCM in 1988 as an accountant in its operations department. Nelson became an officer of PCM in 1990 and was promoted to senior vice-president in 1993. From November 1993 to November 1997, Nelson was the manager of PCM's Mutual Fund Accounting Department and directly supervised Johnson and Destro.

4. **Amy K. Johnson.** Nelson hired Johnson in 1992 as operations coordinator to work with the Fund's transfer agent. Johnson, a certified public accountant, became an accounting manager in the summer of 1993 and had primary responsibility for 20 of the 38 funds managed by PCM, including PJIGX.

5. **Molly J. Destro.** Nelson hired Destro in 1991 as a mutual fund accountant. Prior to joining PCM, Destro had earned a bachelors degree in accounting, obtained series 7 and 63 licenses as a registered representative, and had auditing and mutual fund accounting experience. Destro had pricing responsibilities and acted as a liaison between PCM portfolio managers and pricing sources. In late 1992 or early 1993, Destro was promoted to accounting manager, and became a PCM vice-president in 1994.

## 6. Related Individuals.

a. **Worth V. Bruntjen.** Bruntjen, along with Goldstein, was a co-manager of the Fund from its inception in 1988 until his resignation from PCM in January 1998.<sup>12</sup>

b. **Marcy Winson.** Winson worked for PCM from March 1993 through January 1997. Winson served as an assistant portfolio manager for the Fund. Winson was not named as a respondent in this proceeding.

## B. Pass-Through Securities Valuation<sup>13</sup>

To provide a context for the disclosure violations, we briefly discuss mortgage-backed securities and their valuation. Mortgage-backed securities ("MBS") are bonds backed by monthly mortgage payments of a pool of mortgage loans. A mortgage originator will collect pools of mortgages with similar coupons and maturities, and bundle the cash flow of monthly payments into MBS.

The value of an MBS is a function of its underlying cash flow. MBS cash flow includes principal, interest, and any early return of principal due to a payoff or prepayment of a mortgage in the pool. As long-term interest rates fall, mortgage rates tend to follow, and mortgage holders have a greater incentive to refinance. Prepayment rates therefore generally increase when long-term rates fall, and fall when long-term rates rise.<sup>14</sup> Because prepayments can be made at any time, the cash flow of an MBS is uncertain.

A collateralized mortgage obligation ("CMO") is a type of MBS. CMOs may be structured into several classes or tranches of bonds, and may have different yield and price volatility characteristics than the underlying mortgages from which they were created.<sup>15</sup> CMO bond classes can be created with different kinds of interest rate structures, for example, fixed, floating, or inverse floating. The interest paid to floaters is directly linked to a specified floating reference interest rate (such as the London Interbank Offered Rate). The interest paid to inverse floaters is inversely linked to a specified floating reference interest rate.

Because inverse floater coupons move in the opposite direction of the floating reference interest rate, investors generally require higher yields to compensate for the risk of price decline. In order to increase the yield, inverse floaters are often structured with "multipliers" embedded in their coupon formulas, which magnify movements in the underlying floating reference interest rate and will increase any price decline experienced by inverse floaters. Inverse floater prices can be highly volatile because they are simultaneously exposed both to prepayment risk and coupon leverage.

<sup>12</sup> See *supra* note 1.

<sup>13</sup> For a detailed explanation of the various types of pass-through securities, see generally Frank J. Fabozzi, *Bond Markets, Analysis and Strategies* (1989) and *The Handbook of Fixed Income Securities*, 5th ed. (1997).

<sup>14</sup> The impact of declining interest rates is referred to as "prepayment" or "contraction risk." Conversely, the impact of rising interest rates is called "extension risk."

<sup>15</sup> The distinguishing feature of a CMO is that, unlike a pass-through MBS, the CMO allows for the distribution of prepayment risk among the various bond tranches.

One measurement for valuing pass-through securities is the rate, or “speed,” of prepayments. Another measurement is an instrument’s “weighted average life,” which is the average time that a dollar of principal is outstanding and earning interest before being returned to the security holder. Most fixed income investments pay interest at intervals and return principal at the final maturity or call date. Pass-through securities differ in that they return increments of principal over the life of the security. Therefore, because a pass-through security is subject to prepayment and extension risk, its weighted average life is computed in order to compare MBS to other fixed income securities. However, the weighted average life can change dramatically due to a small change in interest rates or a small change in the assumptions about future prepayment rates.

The expected interest rate sensitivity for CMOs is measured in terms of duration and convexity. Duration is a generic term that describes the responsiveness of a bond’s price to a change in interest rates. Duration is denominated in years. For example, in the event of a 1% increase in interest rates, a security with a duration of 15 years would be expected to experience an immediate 15% decline in its value.<sup>16</sup> A high duration indicates high price sensitivity to a change in interest rates, while a low duration indicates less price sensitivity. The duration of an entire portfolio is the weighted average of the duration of its individual securities.

For prepayment and interest-rate sensitive securities like CMOs, small shifts in interest rates may produce a substantial change in duration. In order to account for this, the sensitivity of a security’s duration to a change in interest rates is measured by “convexity.” A security with “negative convexity” will experience a decrease in duration as interest rates decline, and an increase in duration as interest rates rise. Most MBS exhibit negative convexity because mortgage borrowers tend to prepay their mortgages when interest rates decline. These prepayments shorten the average lives of the underlying mortgages and decrease the durations of the securities.

Some formulations of duration, including “implied” and “modified” duration, have limited use in assessing interest-rate sensitive CMOs. Modified duration assumes that the cash flows from a bond remains unchanged when interest rates change. Implied duration is a measure that accounts for the historical correlation between the bond price and interest rates. Implied duration is not a forward-looking measure. In order to overcome these shortcomings, analysts developed “effective duration,” which employs computer simulation techniques to project a security’s cash flows along a large number of possible interest rate paths.

### **C. The Fund’s Composition and Disclosures**

In 1988, the Piper Jaffray Investment Trust, Inc., an open-end, diversified management investment company, began offering the Fund to investors.<sup>17</sup> PCM was the Fund’s investment adviser. Bruntjen and Goldstein had a substantive role in the preparation of various publically-disseminated Fund disclosure documents and marketing materials. Bruntjen testified that Goldstein, who was knowledgeable about duration, had final and equal editorial authority over the contents of these documents.

The Fund had a stated investment objective of “a high level of current income consistent with preservation of capital.” The Fund stated that it would invest “exclusively in short/inter-mediate fixed income securities issued by the U.S. Government or governmental agencies or instrumentalities” or in repurchase agreements secured by those instruments. PCM highlighted the Fund’s AAAs rating by Standard & Poor’s Mutual Funds Rating Group.<sup>18</sup> PCM represented that the Fund would invest “only in U.S. Government securities.” PCM also asserted that the Fund would “not commit funds to options, futures or so called ‘derivative instruments.’” It recommended the Fund as an alternative to money market securities.

Initially, the Fund’s assets were invested almost exclusively in Treasury securities and pass-through MBS issued by government-chartered corporations, such as the Federal National Mortgage Association. In 1991, without the consent of shareholders, the Fund began to shift its investments into CMOs and other complex mortgage securities, including inverse floaters. These instruments were more sensitive to changes in interest rates.

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<sup>16</sup> Duration is defined as the percentage change in the value of a bond for a 1% change in the yield curve.

<sup>17</sup> The company subsequently changed its name to Piper Funds, Inc.

<sup>18</sup> A “AAA” rating meant that investments in the Fund had an overall credit quality of AAA.

By March 1993, the overwhelming proportion of the Fund's net assets (more than ninety percent) was invested in CMOs. Although CMOs became an increasingly large portion of its portfolio composition, the Fund did not revise its disclosures in any material respect. Rather, between 1991 and 1994, Fund disclosure documents and marketing materials emphasized the relatively conservative composition of the Fund's portfolio, and its investment objective, policy, and technique of seeking high current income while preserving principal investment by maintaining a "weighted average life" of its portfolio securities of three to five years. Although by this time nearly half of the Fund's portfolio was invested in inverse floaters, PCM excluded the inverse floaters from its calculation of the portfolio's "weighted average life." PCM compared the Fund's performance to that of the Merrill Lynch three- to five-year Treasury Bond Index as a benchmark, even though the securities in the Fund's portfolio were much more interest rate sensitive than the Merrill Lynch index.

The Fund used implied duration in its disclosure documents. From at least January 1991 through March 1994, PCM reported that the Fund had an implied duration of 3.0 to 4.3 years.<sup>19</sup> However, as early as September 1992, Bruntjen, in a speech to a group of state treasurers, stated that effective duration produced "a more useful analysis."<sup>20</sup> Goldstein testified that between 1991 and 1994 portfolio managers used implied, modified, and effective duration to measure a portfolio's sensitivity to changes in interest rates. Goldstein confirmed that she believed prior to May 1994 that effective duration "conveyed more information" regarding interest rate sensitivity.

The Fund also engaged in an ongoing series of transactions sometimes referred to as the "Sale/When-issued Program." Under the Sale/When-issued Program, the Fund made a "forward commitment" to purchase a security at a designated price on a designated future date. In the intervening period (usually within two months) between commitment and settlement, the Fund rolled its position over, reselling its purchase commitment to the seller and entering into another commitment to purchase such securities at a later date (the "dollar roll"). The Fund received the difference between the price at which the Fund sold its security position to a dealer and the lower price at which it agreed to purchase a similar position back (the "drop").<sup>21</sup> The Fund assumed any potential unrealized gain or loss arising out of the position's price on the date of the repurchase obligation in return for the drop. In its disclosure documents and marketing materials, the Fund described the drop as its "negotiated fee" or "fee income."

Because the Fund bore the full risk of the rollover security's change in value, the Sale/When-issued Program added leverage to the portfolio and increased the Fund's sensitivity to interest rate changes.<sup>22</sup> If the bond market rallied during the term of the dollar roll, the gains from the settlement or rolling forward of the commitment provided a direct gain to Fund. Conversely, if the bond market declined during the term of the dollar roll, any loss was borne by the Fund's shareholders. By March 1993, PCM had leveraged the Fund's total CMO investments to as much as 149% of net assets through its Sale/When-issued Program.

<sup>19</sup> During this period, the Fund's marketing materials included a pie chart disclosing the Fund's portfolio composition. Centered below the pie chart in each instance were two columns labeled "Average life" and "Implied duration" followed by the Fund's calculations (in whole or fractional years) for these measures.

<sup>20</sup> A copy of this speech was included in the marketing materials that Bruntjen and Goldstein presented in an August 1993 meeting with a potential Fund investor.

<sup>21</sup> The decision to invest in a dollar roll transaction depends on the value of the coupon (interest) received from the pass-through security in the intervening period between commitment and the settlement date. Assume the MBS is currently valued at 100. The investor believes that the market will drop. The investor therefore enters into a forward contract to purchase the security at 95. At settlement, if the MBS market price is higher than the forward price, the investor will have an unrealized gain from the transaction. Conversely, a lower market price results in an unrealized loss. Thus, if the market price is \$96, the investor purchases the MBS at the forward price of \$95, and simultaneously sells it at the market price for a \$1 profit. If, however, the market price at settlement is \$94, the investor must purchase the MBS at the \$95 forward price and incur a \$1 loss. In a dollar roll transaction, the investor both enters into a forward contract to sell the security in the future at 100 and enters into a contract to repurchase the security at 95. This 5 point spread is the "drop," which is the inducement to the investor to take the risk of entering into the contract. Sometimes, instead of delivering the security, the investor simply "rolls" his position over into a new forward contract and repurchase contract. If the investor has sufficient credit, the investor may engage in dollar roll transactions regardless of whether the investor owns the security. However, if the investor does not own the security, the investor is at risk for any change in market price for the security when the investor must fulfill the contract at settlement.

<sup>22</sup> As a result of the dollar roll transactions, the Fund was at risk for any price decline. If the securities' prices dropped and the Fund did not directly own the securities, it was still obligated to fulfill the forward contract at the higher price. This feature of dollar roll transactions classifies them as "leveraged" transactions and contributes to the sensitivity of the portfolio to interest rates.

Goldstein and Bruntjen knew that these activities increased the Fund's risk.<sup>23</sup> Nonetheless, each of the Fund's prospectuses from 1988 through February 1994 represented that Sale/When-issued Program transactions constituted a "hedge against anticipated changes in interest rates and prices" without disclosing the impact that this program had in leveraging the Fund.

Following the Fund's increased investment in CMOs, its returns significantly increased and it received increased publicity. This in turn attracted a large influx of new investor money. Between January 1992 and September 1993, the Fund's net assets increased by more than \$500 million and the Fund broke multiple sales records.

However, as described in Section IV.B. below, in 1994, the CMO market collapsed, and the Fund suffered significant losses. In its 1994 Semi-annual Report, the Fund disclosed that "mortgage-backed derivative securities" had been "pivotal" to the Fund's superior performance over the previous five-year period.<sup>24</sup> Until the 1994 Semi-annual Report, the Fund did not disclose the material changes to the Fund's investment objective, policy, techniques, strategy, or composition.

### III.

#### Disclosure and Investment Policy Violations

PCM and Goldstein are charged with violations relating to material misstatements and omissions in the Fund's disclosure documents. Securities Act Section 17(a) prohibits using the mails or the instruments of interstate commerce to engage in antifraud violations in the offer or sale of securities.<sup>25</sup> Exchange Act Section 10(b) and Exchange Act Rule 10b-5 provide that it is unlawful for any person, directly or indirectly, in connection with the purchase or sale of a security, to make an untrue statement of material fact, omit to state a material fact, use any device, scheme or artifice to defraud, or engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.<sup>26</sup> IC Act Section 34(b) prohibits any person from making false statements in registration statements, applications, and other records required under the IC Act. In addition, PCM is charged with adding and abetting the Fund's violation of IC Act Section 13(a)(3), which prohibits a registered investment company from deviating from its concentration of investments and its investment policy absent shareholder approval.

A. **PCM.** PCM does not challenge the law judge's finding that "PCM's risk disclosures for PJIGX contained misrepresentations or omissions of material fact." The PJIGX prospectuses, annual and semi-annual reports, and marketing materials emphasized the relatively conservative composition of the Fund portfolio. These documents did not disclose the effect of the Fund's being predominantly invested in CMOs, or that the percentage of CMOs contained in the portfolio significantly increased its sensitivity to changes in interest rates until the Fund's collapse in value in April 1994.

PCM materially deviated from the Fund's stated investment objective without shareholder consent. From the Fund's inception, PCM represented the Fund to be a conservative portfolio, investing only in short or intermediate term fixed income securities. However, the Fund's portfolio composition, duration, convexity, and leverage changed dramatically between late 1991 and early 1994, increasing Fund risk and volatility. Nonetheless, PCM failed to make meaningful

<sup>23</sup> For example, in an interview with Goldstein and Bruntjen published by Morningstar Closed-End Funds, Inc. barely a month after issuance of the January 1993 Fund prospectus, Bruntjen stated: "The [dollar] roll program is one that transfers risk from someone who doesn't have a use for it—the mortgage creator—to someone who is willing to assume that market risk for a limited period of time in exchange for a fee. Our funds are able to absorb the market risk of mortgages during the 90-to-120 day creation period that others, who are leveraged and have regulators looking over their shoulders, cannot tolerate. In this process, our funds serve as warehouses for mortgage originators." Goldstein added: "At times we will realize market losses and at times realize gains from that transaction. But the fee is always positive, and, especially in a steep yield-curve environment, those fees are very substantial."

<sup>24</sup> The "derivatives" referred to the Fund's CMOs, including inverse floaters, which at that time constituted 93% of the portfolio.

<sup>25</sup> Pursuant to Section 17(a)(1), it is unlawful "to employ any device, scheme, or artifice to defraud." Section 17(a)(2) proscribes obtaining money or property by means of any untrue statement or omission of material fact. Section 17(a)(3) makes it illegal "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon" a securities purchaser.

<sup>26</sup> Violations of Securities Act Section 17(a)(1), Exchange Act Section 17(b), and Exchange Act Rule 10b-5 require scienter. *See Aaron v. SEC*, 446 U.S. 680, 701-02 (1980). Scienter is satisfied by a showing of recklessness. *See, e.g., Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990). Violations of Securities Act Sections 17(a)(2) and (a)(3) do not require a showing of scienter. *See Aaron*, 446 U.S. at 697; *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997).

disclosures concerning the increased risk that the Fund had assumed or the impact of that risk on its conservative investment objective.

PCM further misled investors by comparing the Fund's performance to the Merrill Lynch three- to five-year Treasury Bond Index. The Merrill Lynch three- to five-year Treasury Bond Index, unlike the Fund, did not include CMOs. Thus, the Fund's increasing proportion of CMOs exposed it to interest-rate sensitivity not exhibited by the Merrill Lynch three- to five-year Treasury Bond Index.

PCM also emphasized weighted average portfolio life as an appropriate risk indicator. This was a misrepresentation because weighted average life is not an appropriate measure of interest rate risk for a portfolio holding inverse floaters. A small change in the interest rate or a small change in the assumptions about future prepayment rates can dramatically affect the weighted average life calculation. Inverse floaters ranged between 30.9% and 47.4% of the Fund's CMO holdings from March 31, 1993 to March 31, 1994, yet the Fund excluded these securities from its calculation of weighted average portfolio life. As a result, the Fund's reported weighted average life did not accurately reflect its true sensitivity to interest rates.

PCM also misrepresented the Fund's risks associated with the Sale/When-issued Program. Contrary to Fund disclosures, the Sale/When-issued Program did not "hedge" risk/volatility. Rather, its leverage increased that risk. Additionally, the "fee income" terminology used in the Fund's disclosure documents ignored the risks borne by the Fund in the event the leveraged securities declined in value.

The Fund reported implied duration, an inappropriate measure of the underlying portfolio's duration, in its disclosure documents. The implied duration calculations suggested a low to moderate portfolio volatility typically associated with risk-averse investment strategies. PJIGX's CMO-driven volatility was appreciably greater than the low to moderate range which the Fund's implied duration disclosures suggested. The Fund's prospectuses, statements of additional information, annual and semi-annual reports dating at least through the end of 1993 did not disclose that the Fund's implied duration figures might understate the portfolio volatility.

The record contains substantial un rebutted evidence that CMO managers of ordinary competence were aware that CMO securities' uncertain cash flow characteristics could render implied duration inadequate—even misleading—as a measure of price sensitivity/volatility, and that Bruntjen and Goldstein were aware of the inadequacy of implied duration as a measure of CMO price sensitivity long before March 1994.

Conceding its misstatements and omissions, PCM contends that it did not act with scienter because the law judge found, based upon PCM's expert witness testimony, that PCM's prospectuses and statements of additional information complied with industry standards.<sup>27</sup> While compliance with industry standards is a consideration, it is only one factor to be weighed.<sup>28</sup> The United States Court of Appeals for the Ninth Circuit has held that the standard of care by which

<sup>27</sup> The law judge made no finding with respect to compliance with industry standards for the Fund's semi-annual and annual reports, Fund summaries, and letters to shareholders.

<sup>28</sup> See, e.g., *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 857 (9th Cir. 2001) (industry standard is a relevant factor for determining the standard of care, but not the controlling standard); *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 274 (3d Cir. 1998) (even a practice that is universal within an industry may still be fraudulent) (citing *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171-72 (2d Cir. 1970)).



to measure conduct “is not defined solely by industry practice, but must be judged by a more expansive standard of reasonable prudence, for which the industry standard is but one factor.”<sup>29</sup>

PCM, through Brunjten, acted with scienter.<sup>30</sup> We conclude that PCM willfully violated Securities Act Section 17(a), Exchange Act Section 10(b), Exchange Act Rule 10b-5, and IC Act Section 34(b). Because the overall increase in the Fund’s risk/volatility profile constituted a material deviation from the Fund’s stated investment objective of high income with preservation of capital that did not receive shareholder approval, we also conclude that PCM willfully aided and abetted and was a cause of the Fund’s violation of IC Act Section 13(a)(3).<sup>31</sup>

**B. Goldstein.** The law judge found that Goldstein willfully violated Securities Act Sections 17(a)(2) and (a)(3) and IC Act Section 34(b).<sup>32</sup> Goldstein, like PCM, “is not challenging” the law judge’s finding that “PCM’s risk disclosures for PJIGX contained misrepresentations or omissions of material fact.” Rather, Goldstein challenges the law judge’s finding that Goldstein’s actual Fund management authority, responsibilities, and expertise, as well as her status as a “co-manager” of the Fund, made her liable for the Fund’s fraudulent disclosures.<sup>33</sup>

Goldstein participated in the review and issuance of the Fund’s disclosure documents. In particular, Goldstein admitted that she reviewed the accuracy of disclosures relating to the Fund’s duration in at least some of the Fund’s disclosure documents. Goldstein, a trained professional with significant fixed income analytical experience, had the knowledge

<sup>29</sup> *Dain Rauscher*, 254 F.3d at 856. PCM cites the district court decision in *Dain Rauscher*, which the Ninth Circuit reversed. Of the four other cases cited by PCM, none involved the adequacy of disclosures relating to investment strategy risks, and the analyses in those cases do not support PCM’s argument. See *Platsis v. E.F. Hutton & Co.*, 946 F.2d 38, 41 (6th Cir. 1991) (broker’s failure to disclose to customer the amount of the production credits and markups earned on inventory sales did not violate Rule 10b-5 as there was “no established regulatory duty to disclose these items” and therefore neither an intent to deceive nor an extreme departure from the standards of ordinary care); *Messer v. E.F. Hutton & Co.*, 847 F.2d 673 (11th Cir. 1988) (no violation of the Commodity Exchange Act in connection with unauthorized trading on a brokerage account and reference to “industry practice” was in regard to the brokerage’s decision to straddle the plaintiff’s account, not the brokerage’s decision to make unauthorized trades); *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885 (5th Cir. 1987) (broker’s failure to disclose to customer account executive compensation earned on trades does not itself establish scienter where customer did not establish that such information is ordinarily disclosed in the securities industry, which fact, if established, “might” have indicated to broker the danger of nondisclosure); *Broad v. Rockwell Int’l Corp.*, 642 F.2d 929 (5th Cir. 1981) (no violation of Rule 10b-5 where record overwhelmingly indicates that the parties thought themselves under no duty to disclose in detailed fashion in the prospectus and sales materials an indenture’s provisions for remote future contingencies, and plaintiff concedes insufficient evidence of scienter to establish continuing fraud).

<sup>30</sup> See, e.g., *Rent-Way Sec. Litig.*, 209 F. Supp.2d 493, 522 (W.D. Pa. 2002) (fraud of officer or employee is imputable to corporation when committed within scope of employment and for corporation’s benefit).

<sup>31</sup> Aiding and abetting requires a primary violation committed by another party; general awareness or knowledge by the aider and abettor that his or her actions are part of an overall course of conduct that is improper; and substantial assistance by the aider and abettor in the conduct that constitutes the violation. See, e.g., *Robert L. McCook*, Securities Exchange Act Rel. No. 47572 (Mar. 26, 2003), 79 SEC Docket 3421; *Sharon M. Graham*, 53 S.E.C. 1072, 1085 n. 35 (1998) (respondent that willfully aided and abetted another’s security law violations necessarily is a “cause” of those violations), *aff’d*, 222 F.3d 994 (D.C. Cir. 2000).

<sup>32</sup> The law judge found that Goldstein acted negligently but not recklessly with respect to the Fund’s disclosures. The Division did not appeal this finding. The law judge also found that Goldstein violated Exchange Act Section 10(b) and Rule 10b-5. We dismiss these allegations with respect to the Fund’s disclosures. See *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980) (scienter is an element of a violation of Exchange Act Section 10(b) and Rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (scope of Section 10(b) does not extend to negligent conduct). The law judge found that Goldstein was not liable for aiding and abetting or being a cause of the Fund’s violation of Section 13(a)(3), a finding that the Division has not appealed.

<sup>33</sup> Goldstein also asserts that she cannot be found liable for a primary violation of Securities Act Section 17(a) and IC Act Section 34(b) for disclosure violations in Fund disclosure documents, citing *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998); *Winkler v. Wigley*, 2000 WL 1786345 (2d Cir. 2002) (unpublished); *In re Silicon Graphics, Inc. Sec. Lit.*, 970 F. Supp. 746 (N.D. Cal. 1997); and *In re Gap Stores Sec. Lit.*, 457 F. Supp. 1135 (N.D. Cal. 1978). All of those cases involve liability of a “secondary actor” for a violation under Exchange Act Section 10(b). Unlike the individuals in those cases, Goldstein, as a result of her management authority over the Fund, and her authority over content of the disclosure documents and marketing materials, is a “primary” actor. Moreover, Goldstein fails to acknowledge that a secondary party can still be liable as a primary violator. Cf. *In re Enron Corp. Sec. Derivative & ERISA Lit.*, 235 F. Supp.2d 549, 588-91 (S.D. Tex. 2002) (adopting and applying as a reasonable interpretation of Section 10(b) text the Commission’s proposed test that a secondary party can be liable in a private suit as a primary violator of Section 10(b) if the person, acting with the “requisite scienter,” “creates” a misrepresentation relied upon by the plaintiff). See also *Silicon Graphics*, 970 F. Supp. at 759 (“group pleading doctrine” recognizes a presumption that statements in “prospectuses, registration statements, annual reports, press releases, or other group-published information,” are the collective work of those individuals with direct involvement in the day-to-day affairs of the company”) (citations omitted).

and experience to assess the accuracy of those documents. Moreover, as a co-manager of the Fund, Goldstein personally computed the average life of the Fund and reviewed average life computations of the Fund prepared by others, including employees that she had trained.

Goldstein suggests that she was a peripheral participant in the Fund and its disclosures. Although Goldstein attempts to minimize her involvement and casts Bruntjen as the primary (if not sole) manager of the Fund, her own admissions and the testimony of numerous witnesses all substantiate Goldstein's responsibility for the Fund. Goldstein's duties as a Fund co-manager included participating in client presentations and executing transactions. Goldstein also admitted that typically she or Bruntjen would make the "final decision on what gets purchased or sold" in the Fund.<sup>34</sup> Testimony from a PCM senior vice president, a communications department employee, and a CMO trader confirms that Goldstein was recognized, with Bruntjen, as the manager of the Fund.<sup>35</sup> Moreover, PCM held Goldstein out to the public in the pivotal role of Fund co-manager.<sup>36</sup>

Measuring Goldstein's accountability by a standard of reasonable prudence,<sup>37</sup> the record establishes that Goldstein was, at a minimum, negligent.<sup>38</sup> As the Fund's co-manager, and an experienced fixed income analyst who had evaluated security duration, Goldstein either knew or should have known that it was materially misleading to use an implied duration method to calculate the Fund's duration without disclosing its limitations when applied to the securities in the Fund's portfolio.<sup>39</sup> Goldstein's participation in this materially misleading disclosure constitutes a willful violation of Securities Act Sections 17(a)(2) and (a)(3) and IC Act Section 34(b).<sup>40</sup>

## IV.

### A. The Fund's Valuation Process

Under the IC Act, PCM was required to price all of the Fund's securities on a daily basis in order to determine an accurate net asset value ("NAV"). The Fund's prospectus described the valuation process as follows:

The value of certain fixed-income securities will be provided by an independent pricing service which determines these valuations at a time earlier than the close of the [New York Stock] Exchange. Pricing services consider such factors as security prices, yields, maturities, call features, ratings and developments relating to specific securities in arriving at securities valuations. Occasionally events affecting the value of such securities may occur between the time valuations are determined and the close of the Exchange. If events materially affecting the value of such securities occur over such period, or if the Portfolio's management determines for any other reason that the valuations provided by the pricing service are inaccurate, such securities will be valued at their fair value according to procedures decided upon in good faith

<sup>34</sup> At the hearing, Goldstein initially identified Bruntjen as the person who "typically" would make purchase and sale decisions for the Fund. However, when shown her investigative testimony from an NASD proceeding, Goldstein conceded that she had previously acknowledged that she or Bruntjen typically made these decisions.

<sup>35</sup> A Piper Jaffray broker also testified that he would direct substantive questions about the Fund's performance to Goldstein.

<sup>36</sup> For example, a "Quarterly Update" from 1989 used to solicit broker interest in selling the Fund contained a "PCM Profile" that interviews Bruntjen and Goldstein and identifies them as the "co-managers" of the Fund. Goldstein answered the majority of interview questions concerning management of the Fund. In marketing materials from an August 1993 presentation to a potential investor in the Fund, Goldstein is listed as one of the presenters. *See also supra* note 23 (describing Goldstein's interview with Morningstar).

<sup>37</sup> *See SEC v. Dain Rauscher, Inc.*, 254 F.3d 852 (9th Cir. 2001).

<sup>38</sup> *See supra* note 32.

<sup>39</sup> The law judge concluded that Goldstein either knew or should have known that characterizing the Fund's Sale/When-issued Program as a risk volatility hedge was materially misleading. Goldstein observes that this disclosure appears only in the Fund's prospectus. Goldstein notes that the law judge also found "the actual degree of Goldstein's participation in the substantive input with respect to PJIGX prospectuses [to be] indeterminate." In light of our finding of Goldstein's liability for materially misleading disclosures relating to the Fund's implied duration, we do not reach her liability for Fund Sale/When-issued Program disclosures.

<sup>40</sup> *See, e.g., Dowling v. Narragansett Cap. Corp.*, 735 F. Supp.1105, 1119 (D. R.I. 1990) ("While the line between half truths and untruths is sometimes difficult to draw, both trigger a duty to disclose any additional or contradictory facts that may be necessary to present shareholders with a complete picture and prevent them from being misled.").



by the Investment Trust's Board of Directors. In addition, any securities or other assets of the Portfolio for which market prices are not readily available will be valued at their fair value.<sup>41</sup>

In February 1993, the Fund's outside auditor expressed concern that the Fund's valuation of "derivative mortgage-backed securities, such as inverse floaters, interest and principal only strips, Z-tranche bonds and other complex products . . . [was] not being performed according to any prescribed procedures . . ." As a result, the Fund's board of directors approved a valuation methodology for determining the Fund's NAV. Under the methodology, PCM generally would utilize an outside pricing service to value Fund portfolio securities and would rely on the pricing service valuations to determine the Fund's NAV. In the limited circumstance that market prices were "not readily available," PCM was:

[To] value the security at the average of the highest current independent bid price and the lowest current independent asked price determined on the basis of reasonable inquiry. Such reasonable inquiry may include obtaining bid and asked prices from a recognized, reputable broker-dealer making a market in such security or asset, or obtaining such prices from a widely used quotation system such as Bloomberg or, with respect to foreign securities, Reuters.

In the event such bid and asked price quotations are not available, a security will be valued at fair value, taking into consideration yields or prices of securities of comparable quality, type of issue, coupon and maturity.

Although PCM's valuation policy contemplated using Bloomberg's quotation system to obtain bid and ask prices, Goldstein testified that, on rare occasions, she used Bloomberg to compute a bond's "fair value" and assign it a price when the Fund had not received a dealer mark<sup>42</sup> or PCM believed that the mark it had received was unreasonable.<sup>43</sup>

Around March 1994, Goldstein and Nelson discussed the process PCM would follow to "override," or fair value, the price of a bond in the Fund's portfolio, but they did not inform the Fund's board of directors that PCM might use Bloomberg analytics to fair value bond prices. Nelson confirmed that the Fund's board did not approve of PCM's use of internally generated Bloomberg analytics to obtain a fair value for a security and that there were no written procedures which specifically permitted this valuation procedure. Indeed, it was not until May 1994, after the events at issue, that Nelson drafted a document that, for the first time, proposed the use of Bloomberg analytics to override other sources for security prices. The board did not approve this proposed valuation procedure.

PCM employed Investors Fiduciary Trust Company ("IFTC") as its accounting services provider to calculate the Fund's daily NAV. IFTC was responsible for sending the daily NAV calculation to the Fund's transfer agent (by 7:00 p.m.) and reporting it to Nasdaq (by 4:30 p.m.) for publication in the financial media. By agreement dated September 30, 1993, PCM employed Kenny S&P Evaluation Service (and its affiliate, EJV Partners) (collectively "Kenny") to provide independent evaluations on a daily basis of securities in the Fund. Kenny used its internal valuation system to provide valuations for the simple MBS. Kenny engaged in so-called "direct pricing" for the Fund's CMOs. For direct pricing, PCM gave Kenny a list of dealers from whom Kenny would obtain valuations, or "marks." Usually, the dealers that originally had sold the securities to PCM were asked to provide current marks for the securities.<sup>44</sup>

Once Kenny received marks from dealers and completed its internal MBS valuations, it would electronically transmit those prices at approximately 3:00 p.m. for entry into the Portfolio Accounting System ("PAS"), an IFTC system on which IFTC relied.<sup>45</sup> The Fund's NAV report was transmitted to PCM around 4:00 p.m. The NAV report consisted of three separate documents: 1) a one-page snapshot valuation of the Fund at a given time; 2) an initial price stratification report listing all securities where the variance in price from the previous report exceeded a predetermined tolerance level; and 3) a "daily price make-up report" showing the Fund's real-time current holdings.

<sup>41</sup> Although there were a number of Fund prospectuses during the 1988 through April 1994 period, with minor variation, the quoted language remained consistent.

<sup>42</sup> A mark is a dealer's estimate of a security's market price, which ordinarily falls within the market's bid/offer spread.

<sup>43</sup> Goldstein described the "Bloomberg system" as an electronic system that communicated market news and information. Using this system, Goldstein was able to analyze financial data to "fair value" a bond. The Respondents refer to this process as "Bloomberg analytics."

<sup>44</sup> Kidder Peabody & Co., which had sold to the Fund the majority of CMOs it held, was the primary source for the Fund's securities marks.

<sup>45</sup> IFTC purchased PAS to perform the accounting work of calculating the Fund's NAV.

Promptly upon receipt of the Fund's daily initial pricing/stratification reports, PCM operations department personnel checked for missing prices and other obvious errors, and worked directly with Kenny and securities traders to correct the reports prior to portfolio manager review.<sup>46</sup> The portfolio manager generally focused on the stratification report. After correcting obvious errors such as misplaced decimal points, the manager looked for any unusual or unexpected price changes. Goldstein, as the Fund's co-manager, unilaterally could challenge prices that she deemed unreasonable.

Actual price overrides customarily resulted from direct discussions between the portfolio manager and the pricing source, whether Kenny or the broker-dealer(s) who had provided the disputed mark. If the pricing source agreed to revise the challenged mark to an amount that the portfolio manager considered reasonable, the revised price was used to calculate the Fund's NAV. If the pricing source did not revise the challenged mark, the portfolio manager generally either accepted the source's original mark or sought marks from different traders. A portfolio manager like Goldstein was required to explain to the operations department the basis for any security price override before the operations department conveyed the override to IFTC.<sup>47</sup> When she was satisfied with the Fund's NAV, Goldstein would sign off on the final NAV for the day, which would be relayed to IFTC for dissemination to Nasdaq and the transfer agent. Operations personnel maintained a daily pricing file for the Fund and were responsible for collecting the documentation, including Bloomberg analytics,<sup>48</sup> that were used to support any price override.

## B. The Violative Pricing

1. **Background.** By March 31, 1994 the CMO market was in turmoil. Earlier in the year, the Federal Reserve Board had initiated a series of interest rate increases. These increases negatively affected the values of most CMO securities, and funds holding these securities suffered significant losses. These losses in turn caused funds to sell off CMOs, further depressing CMO values as these securities flooded the market. From October 1993 through March 30, 1994, the Fund's NAV declined almost fourteen percent, from \$12.23 to \$10.55 per share.

The general decline in the CMO market accelerated on March 30, 1994, as a result of a default by Askin Capital Management, Inc. ("Askin"), a large hedge fund manager, on broker-dealer margin calls. In response, traders immediately liquidated several hundred million dollars in CMOs from Askin's portfolios. The following day, March 31, 1994, was the Thursday before an extended holiday weekend (since the markets were closed the following day in observance of Good Friday) and the last day for transactions to be included in the Fund's semi-annual report.<sup>49</sup>

On the morning of March 31, Winson and Destro discovered that Kenny's prices for a number of Fund securities were stale (and therefore unreliable) because Kenny for some period of time had not included in its valuation system all of the marks it had received. Destro informed Nelson, Johnson, and later Goldstein about the discovery of stale securities prices.<sup>50</sup> Winson, Destro, and Johnson tried for several hours to determine the extent of the pricing problems and to correct them. Johnson testified that discussions with Kenny disclosed that "something had broken down between the way Kenny was going out and requesting prices and getting those prices" to the Fund. These inquiries revealed that "there were securities for which [the Fund wasn't] getting current prices for some significant period of time." Ultimately they determined that "several dozen" securities, all sold to the Fund by Kidder Peabody & Co. ("Kidder"), probably had stale prices.

<sup>46</sup> Goldstein had primary responsibility for the Fund's daily portfolio manager review. If Goldstein was unavailable, Winson performed this review for the Fund.

<sup>47</sup> In the event that Goldstein elected to override a mark received from IFTC, she would direct either Destro or Johnson to contact IFTC with the substitute mark. Goldstein was physically present in the PCM operations department when operations notified IFTC of the override.

<sup>48</sup> Prior to March 1994, a portfolio manager on only rare occasions resorted to Bloomberg analytics to extrapolate a price for the security.

<sup>49</sup> PCM was also calculating the NAV for all of its 38 funds, as the numerous closed-end funds administered by PCM were priced only on Thursdays.

<sup>50</sup> Destro testified that she did not inform the Fund's board about the stale prices and could not recall hearing that anyone else informed the board.

Destro, Goldstein, and Nelson all left PCM's offices by 5:00 p.m., but Winson and Johnson continued their attempts to determine the suspect securities' current prices by various means. They missed both the 4:30 p.m. Nasdaq publication deadline and the 7:00 p.m. transfer agent deadline.<sup>51</sup>

PCM's efforts to secure accurate marks through Kenny and individual traders for the securities in the Fund's portfolio were also hampered because the markets would be closed the next day and traders were unavailable to provide marks. The Kidder trader from whom Winson secured some marks could not provide prices for all of the suspect securities, and Winson deemed the marks that she did receive to be unreasonably low. Winson therefore valued these securities by using PCM's internal Bloomberg analytic system to derive prices. Johnson assisted Winson by recalculating the Fund's NAV each time Winson derived another security's price on the Bloomberg system.<sup>52</sup> Either Winson or Goldstein orally approved the resulting NAV of \$10.40 per share, which Johnson relayed to IFTC.<sup>53</sup>

**2. April 4, 1994.** Over the weekend, interest rates rose by 30-40 basis points. On the morning of April 4, 1994, Winson secured marks from Kidder for the Fund's stale-priced securities, solely in an attempt to validate the prices used to calculate the Fund's NAV on March 31, 1994, and not to secure new marks for April 4, 1994.<sup>54</sup> Winson received marks that approximated those Kidder had provided on March 31. These marks were substantially lower than the values Winson had computed on March 31 using the Bloomberg analytics. Winson and other fund managers,<sup>55</sup> however, were concerned that the marks did not reflect accurate values for the securities.<sup>56</sup>

PCM staff began to consider whether PCM should gradually reduce the stale-priced security values over a few days in order to provide additional time for PCM to confirm the securities' appropriate market values. According to Winson, PCM's staff reached a general consensus to incorporate gradually or "ratchet" the lower security prices into the Fund and the Manager's Fund, another closed-end fund managed by PCM,<sup>57</sup> over the intervening days before the next comprehensive fund pricing on Thursday, April 7, 1994. Winson asserts that she was to implement the gradual incorporation of losses for the Manager's Fund, while Goldstein was to implement it for the Fund. Winson testified that there was a "group" discussion and that she was uncomfortable with it. The Respondents assert that Winson initiated the proposal to reduce gradually security values in the Fund.

Winson created a pricing sheet to obtain the stale-priced securities' current marks for April 4, 1994 (the "Pricing Sheet"). This document incorporated three columns designated "New Price," "Old Price," and "Change," with values typed into each column for each of the stale-priced securities.<sup>58</sup> This document also contains the following handwritten notations:

<sup>51</sup> Johnson requested and received from IFTC a one-hour extension of the 7:00 p.m. transfer agent deadline. This extension was an extraordinary accommodation because it delayed IFTC from processing the day's transactions for all brokerages using IFTC as their transfer agent.

<sup>52</sup> The law judge did not find any violations with respect to the March 31, 1994 NAV calculations. That finding has not been appealed.

<sup>53</sup> Respondents dispute who approved the Fund's NAV for March 31. Although Goldstein was out of the office by the time that the Fund's NAV was finally calculated, the record indicates that she was in telephone contact with Johnson that evening. Winson denies that she orally approved the final NAV. On March 31 Winson could not have provided written authorization for the final NAV because IFTC took its system off-line to process the day's transactions immediately after PCM reported the final number and PCM was unable at that time to print a final report. Therefore, a final March 31, 1994 NAV report was not generated until the next business day, April 4, 1994. Goldstein initialed the final report that morning.

<sup>54</sup> Winson also requested March 31, 1994 prices from various non-Kidder traders for these securities in order to "after-the-fact cross-check" the fair market values that PCM had assigned to the securities on March 31, 1994. According to Winson, she purposely sent the list to non-Kidder traders because she wanted "new eyes from a different viewpoint who didn't typically look at the bonds to try and put a valuation on the bonds." With few exceptions (and small variances in the amounts), the responses from other dealers confirmed the substantially reduced marks that PCM received for the securities on March 31.

<sup>55</sup> Johnson, without identifying the "fund managers" by name, testified that "they really believed" that the marks they had received "were really low given where they thought the real value of these securities was, and it presented a problem for the fourth [of April]."

<sup>56</sup> The record suggests that broker-dealers may have under-valued securities liquidated from the Askin funds in order to maximize their claims as creditors in Askin's bankruptcy proceedings. The record further suggests that broker-dealers provided one another with artificially low "accommodation bids" for Askin securities. Whether broker-dealers engaged in such activities, however, is not before us in this proceeding.

<sup>57</sup> PCM served as a sub-adviser for the Manager's Fund, which held some of the same securities as PJIGX and for which Winson had primary portfolio manager authority.

<sup>58</sup> The record is unclear about the source of the figures in the "New Price" and "Old Price" columns.

Managers (ratchet by 1/2) Marcy will take care of

Our funds —> ^ over 4 days if moved on Thurs

^ over 3 days if no ^ on Thurs

Johnson acknowledged that she wrote the notations, and testified that the delta signs represent the word “change.” Johnson denies any recollection of the notations’ underlying meaning, or that they reflect what actually was done with respect to the Fund’s securities or NAV.<sup>59</sup>

There are a number of recorded telephone conversations among PCM and IFTC personnel.<sup>60</sup> At approximately 10:30 a.m. on April 4, 1994, Johnson, referring to the Pricing Sheet, informed IFTC: “We would like to just slam all these things through today,”<sup>61</sup> i.e., adjust the prices with the new marks. Portions of this and other recorded conversations provide a fuller context for this statement. Johnson testified that she wanted IFTC “to figure out for me the NAV impact of these.” Thus, Johnson asked IFTC to compute “how much of a hit would we have to NAV if we just took everything right down to the new price?” Johnson then explained, “Cuz, these are the ones where they’ve been mispriced for a while and so we’ve been taking them down a little bit at a time.”

Destro also spoke with IFTC on April 4. PCM had calculated, based on the figures in the Pricing Sheet, that the Fund’s NAV would be reduced by approximately \$0.15 per share. Destro told IFTC that PCM wanted to compute the NAV using all the updated marks. She stated that because the market went down again on Friday, PCM “could substantiate more price drops.” However, Destro also expressed concern that, if the market rose, it would prevent PCM from continuing to reduce the NAV.

Around 2:00 p.m. on April 4, Destro informed IFTC that she had telecopied the Pricing Sheet, which contained the March 31 prices, to Kenny with urgent instructions directing Kenny to include these values in Kenny’s April 4 pricing report. Destro also instructed IFTC to ensure that the telecopied prices in the Pricing Sheet were reflected in IFTC’s April 4 initial pricing reports to PCM. Destro confirmed that PCM anticipated the resulting decline in the Fund’s NAV would be approximately \$0.15 per share.

IFTC used all but six of the 41 values reflected in the Pricing Sheet’s “New Price” column to determine the NAV that the Fund reported on April 4. However, as discussed above, Winson had obtained the Pricing Sheet by 10:15 a.m. in an attempt to validate the prices used on March 31, 1994, not to obtain then-current prices for April 4, 1994. Moreover, the CMO market had continued to decline throughout the day on April 4, 1994. Kidder specifically cautioned Bruntjen and Goldstein that this decline would have a significant impact on the Fund. In fact, IFTC’s initial pricing reports computed that the Fund’s NAV had dropped by approximately \$0.40 per share, to \$10.01 per share.

Thereafter, PCM submitted a number of price changes to IFTC that raised the Fund’s April 4th NAV to \$10.10 per share. Some of these price changes increased the prices of securities reflected on the Pricing Sheet. All but one of the changes (apparently written by Goldstein) to IFTC’s initial pricing report are in Nelson’s handwriting. PCM’s daily pricing file maintained by its operations department to substantiate price changes, however, does not evidence the basis for these changes.

In calculating the Fund’s NAV, several securities were priced with stale “Old Prices” instead of “New Prices.” For example, a CMO derivative designated as CUSIP 31358UA63<sup>62</sup> was one of the stale-priced securities. The Pricing Sheet listed its “New Price” as 55. Although this security was included in IFTC’s initial pricing report at 55, in accordance

<sup>59</sup> The law judge observed that Johnson “exhibited extraordinary recollection and attention to detail at the hearing, and her inability to recall the underlying meaning/purpose of such a suggestive piece of evidence as her handwritten notations” seemed “improbable.”

<sup>60</sup> The Division and PCM submitted separate written transcripts of these conversations. In some instances, the transcripts are inconsistent and the parties did not agree at the hearing to one set of written transcripts. Nonetheless, the parties submitted compact discs and the Division also submitted audio tapes containing these recorded conversations. For purposes of this opinion we have relied on the recordings rather than the parties’ transcriptions.

<sup>61</sup> The person at IFTC who is recorded on virtually all the conversations is Kelly Kovac.

<sup>62</sup> A CUSIP—or Committee on Uniform Securities Identification Procedures—number is used by dealers and institutional investors to identify securities, including CMO derivatives.

with PCM's specific instructions, IFTC used the security's "Old Price" of 88 to calculate the Fund's final NAV for April 4, 1994. That security's price was reduced to 75 on April 5th, even though the market rallied somewhat on that day and Kidder's mark for it actually increased.

3. **April 5, 1994.** The CMO securities market rebounded somewhat on April 5, 1994. In Johnson's absence,<sup>63</sup> Destro managed the accounting operations for the Fund's daily valuation. IFTC's April 5 initial pricing reports to PCM reflected an NAV of \$10.04 per share. After incorporating various securities price changes, IFTC informed Destro at approximately 4:17 p.m. that the indicated NAV had increased to \$10.05 per share. Destro called IFTC with a price change, observing:

Destro: I'm going to jail, Kelly. I'm sorry.

IFTC: I know. The people at Nasdaq are like, what? and I'm like, just put it in.

Destro then told IFTC to "put back" the price of CUSIP 3133T4SJ6 to 10.9, saying, "That got us a penny last time . . . . Let's hope it gets us a penny this time."<sup>64</sup> The following exchange then occurred:

IFTC: See where that baby goes. The wheel is spinning. Cha, cha, cha, cha, cha, cha, cha. Come on. You're right. 10.10.

Destro: It's at 10.10 now. With that one.

Unidentified: See, I told you. (laughter) Just keep changing . . .

Goldstein: That's one of our favorite securities of all time. (laughter)

As a result of the price change to CUSIP 3133T4SJ6, the Fund's final NAV for April 5, 1994 was \$10.10 per share. During this exchange, Winson warned the others that the price of this security would have to be reduced again in the near future, and Destro agreed.

4. **April 6, 1994.** On the morning of April 6, 1994, Destro informed IFTC that she was telecopying a comprehensive list of all the Fund security price changes from the previous day. Destro told IFTC that she had transmitted the same document to Kenny and emphasized that it was imperative that these prices be used on April 6, 1994 for the Fund and "[e]verything that's remotely connected to Piper . . . ."<sup>65</sup> After receiving IFTC's initial pricing reports, Goldstein, Winson, Johnson, and Destro conveyed numerous security price changes to IFTC. With less than a minute remaining before the 4:30 p.m. Nasdaq publication deadline, IFTC informed Goldstein that the Fund's indicated NAV was \$10.09 per share. At this point, the following exchange occurred:

Johnson: Yeah. Do you want to go with 10.10?

Goldstein: I'd like to go with 10.10.

Johnson [Instructing IFTC]: Go 10.10, we'll get it there.

In accordance with Johnson's instructions, IFTC immediately reported an April 6, 1994 Fund NAV of \$10.10 per share to Nasdaq for publication. Thereafter, Goldstein, Winson, Johnson, and Destro<sup>66</sup> called IFTC to confirm that IFTC had submitted the Fund's NAV in time for the Nasdaq publication deadline. During this conversation, Goldstein and Johnson inquired about the Fund's NAV, with Goldstein asking: "How much do we need to round up a penny?" IFTC responded that an increase of less than half a cent would be sufficient to round up the fractional NAV amount by a penny.

<sup>63</sup> Johnson left PCM's offices at approximately noon on April 4 to attend a professional seminar and did not return to PCM until April 6. During her absence, Johnson did not participate in the Fund valuation process.

<sup>64</sup> The April 5 initial stratification report indicated that CUSIP 3133T4SJ6 had a reported price on April 4 of 10.9, but had dropped in value on April 5 to 10.06. Therefore, "putting back" this CMO's price to 10.9 increased its value to the prior reported level.

<sup>65</sup> The law judge found that Kenny incorporated 43 of the 44 prices from Destro's list into the April 6 pricing transmission that Kenny forwarded to IFTC.

<sup>66</sup> Although the transcript of this conversation does not include Destro, Kelly Kovac, the IFTC representative, testified at the hearing that she recognized Destro's voice and thought she heard it in the background of this recording.



Following Goldstein's statement, "I don't see, like, a whole half a penny," Johnson indicated that PCM would have to call IFTC back.

Shortly after this conversation, Johnson again called IFTC. Johnson requested price increases to CUSIP 33133T2SL5, from 59 1/2 to 62, and CUSIP 3129145D2, from 33 to 35, the very same two securities that PCM had reduced in price only shortly before the Nasdaq reporting deadline. At this point, the following exchange occurred:

Johnson: See if that gets us there.

IFTC: It does, and just barely.

Johnson: Just barely is all we wanted.

As a result of these two changes, the Fund's final NAV for April 6, 1994 increased to \$10.10 after this amount had already been reported to the Nasdaq for publication, and prior to the deadline for IFTC to send the Fund's final NAV to the transfer agent.<sup>67</sup>

## V.

### A. Violations in Connection with Pricing of Fund NAV

The Fund represented that it would be priced daily by an independent pricing service. It further represented that in determining securities valuations, the pricing service would consider such factors as security prices, yields, maturities, call features, ratings and developments relating to specific securities. Moreover, the Fund stated that it would use these valuations unless "market prices are not readily available." Any "fair value" determination would be made in accordance with the valuation procedures decided upon in good faith by the board of directors.

By March 31, 1994, Respondents knew that they had stale prices for securities in the Fund's portfolio. On the morning of April 4, 1994, Respondents also knew from the Pricing Sheet that the prices that the Fund had reported and used to calculate the Fund's March 31, 1994 NAV were too high, and they anticipated that the Fund's NAV would be reduced by a further \$0.15 per share if the marks from the Pricing Sheet were used to calculate the NAV. Although they contest it, the record shows that Respondents determined to smooth or ratchet down gradually the Fund's NAV over a period of days. It appears that Respondents sought to prevent an abrupt drop in the Fund's NAV as a result of updating the stale prices. They also wanted to slow the reduction of the NAV in case the market rebounded.

Interest rates continued to rise between March 31, 1994 and April 4, 1994. Nonetheless, Respondents used the stale March 31, 1994, marks for several securities in the Fund in order to calculate the Fund's NAV for April 4, 1994. Although Respondents anticipated a \$0.15 decrease in NAV, the further diminution in value of CMOs caused a decrease in NAV of \$0.40 per share. The law judge found that dealer marks were readily available. Nonetheless, Respondents resorted to a series of prices for Fund securities that have no obvious basis in the record. Respondents assert that a number of the prices used to calculate the Fund's April 4 NAV were derived using Bloomberg analytics, but many of these analytics in the record were performed over a month after the NAV was calculated. This pattern repeated itself on April 5 and 6, 1994 where initial NAV reports from IFTC indicated a lower NAV and Respondents submitted price changes in the hope that "it gets us a penny this time."

PCM and Goldstein concede that they misstated the values of certain securities in the Fund on April 4 through 6, 1994 and that they purposefully attempted to manipulate the Fund's NAV.<sup>68</sup> Respondents nonetheless argue that the resulting NAV prices were not materially misstated. PCM and Goldstein argue that the Division had to prove: (1) what constituted

<sup>67</sup> The Order Instituting Proceedings alleged that manipulation of the Fund's NAV occurred during the period of March 31, 1994 through at least April 8, 1994. The law judge found that no manipulation occurred on March 31. After concluding that the Fund's NAV was fraudulently mispriced on April 4-6, 1994, the law judge "deem[ed] it unnecessary to evaluate Respondents' actions on April 7-8, 1994." The parties have not appealed the law judge's March 31 finding or his decision not to make findings with respect to the Respondents' pricing on April 7-8, 1994.

<sup>68</sup> Nelson, Johnson, and Destro do not expressly concede that they misstated values or attempted to manipulate the Fund's NAV. However, each of them argues in general that misstatements in the value of securities in the Fund's portfolio did not result in a materially inaccurate NAV.

reasonable values for each CMO security at issue; (2) whether PCM's valuations fell within that range; and (3) if not, what, if any, effect PCM's mispricing had on the Fund's NAV.

Relying on the testimony of their expert witness, Respondents assert that the range of reasonable marks for a CMO can vary by 20% to 30%, particularly in turbulent market conditions. However, that witness admitted that he neither traded CMOs nor studied particular ranges during the relevant period for specific CMOs at issue in this proceeding.<sup>69</sup> Further, because PCM and Kenny secured marks directly from traders with knowledge of contemporaneous market conditions, they generally received a single mark (not a range) for almost all of the securities at issue.<sup>70</sup>

PCM and Goldstein then argue that most of the securities identified by the law judge fall within this hypothetical 30% range. For those that do not, they insist that the impact on the Fund's NAV was negligible.

Contrary to Respondents' assertions, "[t]he materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula."<sup>71</sup> A reasonable investor would want to know that the prices used to value the Fund's securities were stale, that the Fund was smoothing the decline in value and manipulating its NAV, and that to achieve this result the Fund was mispricing some securities.<sup>72</sup> The numerous recorded conversations between PCM personnel and IFTC demonstrate that PCM was concerned about slowing the reduction in the Fund's NAV and artificially maintaining its price. For example, in an April 5 conversation in which IFTC was instructed to change certain prices, Destro stated: "That got us a penny last time . . . . Let's hope it gets us a penny this time." Even more telling, Goldstein and Johnson, in their April 6 conversation with IFTC, with Winson and Destro physically present, instructed IFTC to report for the Nasdaq publication deadline that the Fund's NAV was \$10.10, knowing that IFTC currently calculated the Fund's NAV at \$10.09. It was not until after \$10.10 had already been reported for publication that Respondents notified IFTC to increase security prices that they had earlier reduced in order to round up by a penny the Fund's NAV to \$10.10 per share.

Respondents acted with scienter. Contrary to PCM's daily pricing file policy, changes to individual security prices used to calculate the Fund's final NAV for April 4-6, 1994 were, in some cases, implemented without written substantiation.<sup>73</sup> In other cases, PCM inappropriately superseded the current mark for a security with its "Old Price." These changes were deliberately inaccurate and conversations among the Respondents and documentary evidence confirm that Respondents

<sup>69</sup> PCM's expert also confirmed that he had "no opinion of any kind" concerning the specific prices used by the Fund for CMOs during the period of March 31, 1994 through April 8, 1994, or the methods used by PCM to determine those prices.

<sup>70</sup> Respondents PCM, Goldstein, Johnson, and Destro all cite an allegedly mispriced security as an example (CUSIP 3133T2FA3). On April 7 (a date not at issue in this appeal), Kidder marked the bond at 80 while First Boston Corporation marked the same bond at 67, "a difference of 20%." From this they conclude "that the Commission should find that the marks for CMOs vary by at least 20% in normal market conditions." However, this is the only example on the Division's 18-page chart where two brokers provided different marks. Moreover, although PCM used the highest price (80) as the price of the bond on April 7, even though the midpoint between the two quotes was 73.5 and Kenny supplied a price of 74, Respondents provide no explanation for this choice.

<sup>71</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 236, n. 14 (1988) (citation omitted). PCM also argues that the law judge, in contravention of *Basic*, impermissibly applied a bright-line standard that an artificially inflated NAV, regardless of any degree, is material. However, the law judge expressly rejected "a bright-line per share deviation (e.g., one percent/one penny) benchmark" for determining materiality. As discussed above, we do not apply a bright-line test here.

<sup>72</sup> See *Basic*, 485 U.S. at 231-32 (an omitted fact is material if there is a substantial likelihood that its disclosure "would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available") (quoting, *TSC Indus., Inc., v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

<sup>73</sup> For example, PCM made a number of price changes to IFTC's April 4 initial report, but the file that PCM maintained to substantiate price changes does not evidence the basis for these changes. The record does not indicate that broker-dealer marks were unavailable on April 4, so it is at best questionable why PCM resorted to Bloomberg analytics for many of the changes. Of the Bloomberg printouts in the file, some do not provide any analytic basis for their indicated prices and others indicate on the face of the printouts that they were generated more than a month after April 4, 1994.



all knowingly were participating in a process intended to alter the Fund's NAV. We find that Respondents' actions at best were reckless.<sup>74</sup>

## B. Respondent Specific Issues<sup>75</sup>

1. **Goldstein.** Goldstein argues that the valuation of CMOs entails some judgment, which she was exercising. Nevertheless, Goldstein does not cite to any evidence that on April 4, 5, or 6, PCM received marks for any particular security from two different traders on the same day. Thus, Goldstein's general observation that fund management can make a judgment as to which of two broker quotes is likely to be the best indicator of the market is not applicable to the facts in this case.

Goldstein also stresses that the law judge identified "only a small number of securities that were actually mispriced during this period of disastrous circumstances." However, the law judge stated that he referred to "specific securities and prices only where instructive with respect to the activity at issue."

The law judge also found that Goldstein's and the other Respondents' explanations for what happened on April 4, 1994 were "not plausible" in light of the evidence,<sup>76</sup> and that the Respondents' after-the-fact "justifications" for the Fund NAVs reported to Nasdaq on April 5 and 6 were "spurious."<sup>77</sup> In particular, Goldstein was responsible for "signing off" on the Fund's NAV. In the recorded conversation from April 5, 1994, she was present when Destro requested a sufficient increase in price for CUSIP 3133T4SJ6 to raise the Fund's NAV by a penny and applauded the success of the price increase.<sup>78</sup> On April 6, she ordered a final NAV of \$10.10 just seconds before the newspaper publication deadline when the NAV as calculated by IFTC stood at \$10.09. Goldstein then asked how much she "need[ed] to round up a penny." Within moments, Johnson instructed IFTC to change two security prices whose change "just barely" achieved a rounding up of the NAV to \$10.10 on that day. Goldstein personally approved the inflated Fund NAV figures that were published from April 4 through April 6, 1994.

2. **Destro.** Destro asserts that she "never had the authority to determine the propriety of any price assigned to a Fund security" or to approve the Fund's NAV, and that she lacked the expertise to value a security. However, Destro was actively involved in the pricing of the Fund's securities and calculation of its NAV. She admitted that, on April 5, 1994, she was responsible for "any accounting issues that [came] up that day or pricing that might come up that day." Destro testified that she was the one who had to "make sure that all the funds are priced, everything is to the paper, handling any price changes that might come through the portfolio managers, et cetera."

When combined with Destro's recorded conversations with IFTC, her statements support the finding that Destro actively participated in fraudulently pricing the Fund's NAV. Destro participated in a price change to CUSIP 3133T4SJ6 designed to raise the Fund's NAV to \$10.10 per share—a level that apparently already had been reported to Nasdaq. Destro had commented to IFTC on April 4, 1994 that the Fund's NAV could not be "knocked down" if there were a market rebound—as occurred on April 5. Given the rebound, the NAV had to remain constant at the previous day's

<sup>74</sup> Johnson, Destro, and Nelson argue that the law judge found that they "purposefully conspired" to misrepresent and manipulate the Fund's NAV, but that the Division charged them as primary violators, not conspirators. Although the law judge used the word "conspiracy" in the Initial Decision (primarily in his initial summary of the case), the law judge did not apply the law of conspiracy to the evidence. The Order Instituting Proceedings charged these Respondents as primary violators who "engaged in a scheme" to override dealer quotations and gradually lower or "ratchet down" prices of derivatives in the Fund over the course of several days. As the United States Court of Appeals for the Second Circuit held, "[p]rimary liability may be imposed 'not only on persons who made fraudulent misrepresentations, but also on those who had knowledge of the fraud and assisted in its perpetration.'" *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996)(quoting *Azzielli v. Cohen Law Offices*, 21 F.3d 512, 517 (2d Cir. 1994)). A respondent may not escape primary liability by claiming that he or she was simply following another's orders. *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998).

<sup>75</sup> Johnson raises arguments virtually identical to the arguments raised by the other individual Respondents. We do not separately address her arguments and resolve them consistent with our resolution of the other Respondents' assertions.

<sup>76</sup> For the most part, the law judge did not specifically identify which Respondent explanations he found implausible. Rather, he made this determination after weighing the various claims among the parties. *Cf. supra* note 59.

<sup>77</sup> In particular, the law judge identified changes to certain securities just prior to or immediately after the reporting of the Fund's NAV to Nasdaq where "the sole identifiable purpose of each of these price changes was simply to boost the April 5th and April 6th NAVs from the indicated \$10.09 per share to the preferred \$10.10 per share."

<sup>78</sup> Following IFTC's disclosure that the price increase to CUSIP 3133T4SJ6 raised the Fund's NAV, Goldstein described that security as one of "our favorite securities of all time."

level. The exchange between Destro and Winson confirms that each of them understood that CUSIP 3133T4SJ6 was priced too high at 10.9 and that they would need to reduce it subsequently to an appropriate level.<sup>79</sup> Destro's comment, "I'm going to jail, Kelly," reflects that she recognized the violative nature of her conduct.

Destro notes that the law judge found that her actions were "not egregious in light of the totality of circumstances" which she confronted. However, we believe that Destro clearly realized she was engaged in a process that created an artificial NAV. Destro also fails to acknowledge that the law judge also found her conduct "inappropriate and reckless in significant degree."

3. **Nelson.** Nelson argues that there is no evidence linking him to any scheme to alter the Fund's NAV. Nelson argues that the evidence placed him "in exactly one conversation" on April 4, 1994, in which Johnson and Destro "ran Ms. Winson's smoothing suggestion past Mr. Nelson." Nelson emphatically denies agreeing to this proposal, asserting that he instructed them to take the "full hit" by reducing the Fund's NAV to reflect current prices for securities in the portfolio.

Destro and Johnson each testified that they spoke with Nelson about smoothing prices in the Fund. Johnson explained that "the idea that was floated was as a practical way to try to deal with the situation, should they start moving these prices down over a period of days while they spent time figuring out if these were the real prices." In discussing this issue with Nelson, Johnson stated that Nelson instructed that "you need to take the full hit."<sup>80</sup> She added, however, that he qualified the instruction to "take the full hit" with "unless there's a specific reason to not take one . . ."<sup>81</sup>

Nelson concedes that the "Pricing Stratification" initial report that IFTC sent to PCM on April 4 at 4:04 p.m. includes his handwriting.<sup>82</sup> The handwritten notations reflect price overrides in several securities as to which PCM rejected the prices submitted by Kenny and, according to Nelson, substituted prices "which the portfolio managers deemed more accurate." He further concedes that these overrides were in fact incorporated into the Fund's final NAV for April 4, thereby raising the Fund's NAV from \$10.01 per share to \$10.10 per share.

In spite of his handwriting on the Pricing Stratification report, Nelson denies any involvement in pricing Fund securities on April 4, 1994. Instead, Nelson claims that the record demonstrates the Destro "almost certainly" performed the Fund's pricing duties on April 4. Nelson therefore posits that he could not, on April 4, have "handled PJIGX's daily pricing," asserting instead that he must have written on the Pricing Stratification Report at some later point in time.<sup>83</sup>

In the hearing below Nelson did not suggest that Destro made the changes on April 4—as he does for the first time in his initial brief to the Commission. Moreover, while Nelson cites to Destro's hearing testimony to support this suggestion, her testimony related to accounting issues in connection with the valuation of the Fund on a different date, i.e., April 5, 1994. Further, Johnson testified that Nelson would occasionally perform accounting duties related to the Fund. In her investigative testimony, Johnson stated that Nelson appeared to be the one who "did all of these changes on that day"

<sup>79</sup> See *supra* page 28.

<sup>80</sup> Winson also testified that Nelson was aware of the smoothing procedure adopted on April 4. Winson stated that Goldstein and Nelson instructed her to smooth prices when Winson questioned them about the propriety of doing so. Nelson's only response to Winson's direct testimony on this issue was an implicit attack on Winson's credibility. Specifically, Nelson noted in his brief that Winson identified his voice in the background on one of the recorded conversations from the afternoon April 6, 1994, at a time when Nelson was out of the office attending a meeting in New York.

<sup>81</sup> The Division asserts in addition that Nelson's instruction related to the "New Prices" that the Fund received on the morning of April 4, 1994 to substantiate its March 31, 1994 NAV calculation—not to current prices for April 4, 1994. Thus, Nelson's instruction to take the "full hit" would not have resulted in a correct NAV since the prices to which he referred were not current.

<sup>82</sup> As for the Pricing Sheet, Nelson argues that there is no evidence in the record establishing that he knew of the existence of the Pricing Sheet on April 4, 1994 or that he ever saw the Pricing Sheet. Johnson, however, testified that Nelson specifically referred to the "new price column" during the "full hit" conversation among herself, Destro, and Nelson. Moreover, Destro, Johnson, and Winson all testified that they and Nelson discussed "smoothing" the prices reflected in the Pricing Sheet.

<sup>83</sup> Nelson asserts that "almost certainly" his writing on the Pricing Stratification report was part of a review of the Fund's pricing procedures conducted by its auditor in May 1994. Nelson does not address why, a month after the events at issue, he would have memorialized on the initial Pricing Stratification report the April 4 price changes to securities in the Fund or why such memorializations were not made to the final report on that date.

to the Fund's April 4 Pricing Stratification report. We therefore reject Nelson's argument that he had no involvement on April 4 with the price changes made to securities in the Fund's portfolio.<sup>84</sup>

Nelson alternatively asserts that, "assuming" that he lent "operations support to Ms. Goldstein on April 4" and "made the price changes reflected" in the Pricing Stratification report, "portfolio managers, not operations employees, decided how to price securities in PJIGX." In essence, Nelson argues that, to the extent he engaged in price overrides of Fund securities on April 4, his actions were ministerial in nature. Nelson contends that Goldstein decided whether to override securities prices in the Fund, and argues that he had a good faith belief that Goldstein honestly discharged her professional duties. In this regard, Nelson stresses that he was not a certified public accountant and had no ability to question Goldstein's subjective valuation decisions. Thus, Nelson argues that "even if [he] did facilitate Goldstein's price changes on April 4, 1994, that is not evidence that he committed securities fraud."

While Nelson asserts that, if he made the changes in April 4, he did so in good faith, the record indicates that appropriate broker-dealer marks were readily available on April 4, 1994, calling into question Nelson's asserted belief that Goldstein's overriding of prices was appropriate. For example, one bond, CUSIP 3133T4SJ6, appeared in the Kenny price transmission and the preliminary NAV report for April 4 priced at 10.2. As Nelson's handwriting reflects, this price was overridden and the Fund's NAV was calculated on April 4 using the final and higher price of 10.9 for that bond. According to Johnson, the final 10.9 price was "arrived at using a Bloomberg analysis," yet the Bloomberg screen included in PCM's pricing support file to support the override was printed out more than a month later.<sup>85</sup> According to Nelson, PCM's pricing procedures required that Goldstein provide PCM's operations department with an explanation to support the April 4 override prior to the operations department forwarding the change to IFTC. Although Goldstein generated an after-the-fact Bloomberg screen to document this override, she testified that she did not know the source of the final 10.9 price that was used and provided to IFTC. Thus, at the time that Nelson made the price change to CUSIP 3133T4SJ6 on April 4, no documentation existed indicating the source of the new price and Nelson had no reason to believe that the price change had a legitimate basis.<sup>86</sup>

Nelson was aware of a plan to "smooth" the Fund's NAV and admits participating in discussions with Johnson and Destro about gradually reducing prices of securities in the Fund's portfolio. While Nelson asserts that he instructed the Fund to "take the full hit," he nonetheless participated in creating an artificial NAV. Other than a belated attempt to cast Destro as the PCM accounting person responsible for the April 4 changes in Fund portfolio security values, Nelson raises the same arguments that the law judge rejected.<sup>87</sup>

\* \* \* \*

Based upon the foregoing, we find that PCM, Goldstein, Destro, Johnson, and Nelson willfully violated Securities Act 17(a), Exchange Act 10(b), Exchange Act Rule 10b-5, and IC Act Section 34(b) with respect to the pricing of the Fund's NAV on April 4, 5, and 6, 1994. We further conclude that the Respondents willfully aided and abetted and were causes of the Fund's violations of IC Act Rule 22c-1, by causing the Fund to sell, purchase, and redeem shares at prices that were not based on the Fund's current NAV, and of IC Act Section 31(a) and IC Rule 31a-1 by failing to maintain appropriate books and records in support of the Fund's financial statements.<sup>88</sup>

<sup>84</sup> However, we agree with Nelson that there is insufficient evidence that he had any involvement with the Fund's pricing on April 5, 1994. Destro testified to the effect that she was "completely responsible" for the operations aspects of the Fund's pricing on that day. While Nelson was in the office on the morning of April 6, it is undisputed that he left the office at approximately noon to attend a conference out of state and did not return to PCM's offices until sometime in the afternoon of April 8.

<sup>85</sup> Goldstein testified that Johnson requested the Bloomberg screen in order to have some documentation on file.

<sup>86</sup> In this regard, notes maintained by a Commission staff examiner of telephonic interviews with Nelson indicate that Nelson, in November 1994, conceded to the examiner that he, Goldstein, and Winson had "tried to do their best" in March and April 1994 to obtain market maker valuations, but that a number of prices used were internal "fair values." These notes further corroborate Nelson's involvement in mispricing the Fund's securities and his knowledge that PCM was not using market prices to calculate the Fund's NAV.

<sup>87</sup> Having considered Nelson's arguments and the evidence, the law judge found that the "Respondents' [including Nelson] explanations of what took place on April 4, 1994 simply are not plausible."

<sup>88</sup> Johnson asserts that she should not be found liable for any books and records violations based upon a failure to maintain complete pricing files because she delegated "these record-keeping functions to her staff." Here, the incomplete files at issue relate to Fund pricing operations that she personally performed. We find her delegation claim to be without merit.

## VI.

### Weekly Pricing of the Fund

IC Act Rule 22c-1(b), with certain limited exceptions, required the Fund to calculate its NAV each business day.<sup>89</sup> The Fund's prospectus stated this requirement. The Division asserts that, although PCM transmitted an NAV for the Fund on a daily basis, the majority of securities in the Fund were priced only weekly. The Division notes that Kidder employees testified that they supplied marks to Kenny, with copies to PCM, only on Thursdays. PCM and Piper Jaffray personnel stated that Bruntjen and Goldstein discussed weekly CMO pricing. The IFTC daily stratification reports reflect that the number of securities showing a change in value (up or down) beyond the set tolerance level was, on average, over four times greater on Thursdays than any other day of the week.

We are unable to conclude that PCM acted with scienter in this regard. PCM contracted and continuously paid Kenny, a reputable provider, for a daily pricing service. PCM directed Kenny to rely on a variety of bond traders for Fund security price information. Even if, as alleged, PCM had actual knowledge that Kidder was providing marks to Kenny only on Thursdays, this does not prove that no other trading firm provided marks to Kenny on other days of the week or that PCM was aware that no other firms were providing marks.<sup>90</sup> Other factors also could have influenced the Fund's pattern of Thursday security price changes. For example, on Thursdays weekly Consumer Price Indices were announced, 52-week Treasury bill auctions occurred, and Federal Reserve business surveys were announced. Accordingly, we find insufficient evidence to conclude that PCM violated Securities Act Section 17(a) or Exchange Act Section 10(b) for a failure to calculate the Fund's NAV on a daily basis.<sup>91</sup>

## VII.

The Division and all of the Respondents appeal the sanctions imposed by the law judge. The Division seeks an increased civil money penalty as to PCM and bars and civil penalties for the individual Respondents. Respondents assert that no sanctions are warranted.<sup>92</sup> We are vested with discretion to determine what sanctions are appropriate in the public interest.<sup>93</sup>

A. **PCM.** The law judge assessed a \$2,005,000 civil money penalty against PCM based upon the numerous violations he found that PCM had committed.<sup>94</sup> In considering whether a penalty is in the public interest, the Commission may consider six factors: 1) fraud; 2) harm to others; 3) unjust enrichment; 4) previous violations; 5) deterrence; and 6) such other matters as justice may require.<sup>95</sup>

PCM contends that it made full restitution to Fund shareholders and was not "unjustly enriched." It represents that it paid to shareholders more than five times the approximately \$17.3 million in gross revenues that PCM earned over

<sup>89</sup> 17 C.F.R. § 270.22c-1(b) ("The current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday . . .").

<sup>90</sup> We also note that PCM's closed-end funds were priced only on Thursdays. Thus, while Kidder personnel testified about Thursday pricings, it is understandable that Kidder would provide the bulk of its marks to Kenny and PCM on Thursdays.

<sup>91</sup> We agree with the Division's observation that "the Commission cannot allow a mutual fund adviser to hide behind a contract with a pricing service while knowingly or recklessly calculating an NAV with securities prices that it knows to be stale," as evidenced by our holding in Section V. Here, we find only that the record does not support the allegation that PCM had scienter with respect to the statement in the prospectus that the Fund's securities were priced on a daily basis.

<sup>92</sup> All Respondents argue that, because the evidence does not support a finding of violation, no sanctions are appropriate. For the reasons set forth above, we have found that Respondents committed securities law violations.

<sup>93</sup> See, e.g., *Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 185-86 (1973) (where Congress has entrusted an administrative agency with responsibility of selecting means of achieving statutory policy, choice of sanction is not to be overturned unless it is unwarranted in law or without justification in fact); *Valicenti Advisory Servs., Inc. v. SEC*, 198 F.3d 62, 66 (2d Cir. 1999) (SEC's imposition of sanctions is reviewed for an abuse of discretion).

<sup>94</sup> See *supra* note 7 and accompanying text. PCM has not appealed the revocation of its registration, but rather, states that the "unchallenged administrative sanction to revoke PCM's registration ensures that PCM will not have any future conduct."

<sup>95</sup> 15 U.S.C. §§ 78u-2(c), 80a-9(d)(3), 80b-3(i)(3). See, e.g., *New Allied Dev. Corp.*, 52 S.E.C. 1119, 1130, n.33 (1996).

the life of the Fund.<sup>96</sup> PCM states it entered into “prompt and generous” settlements with shareholders who filed a class action against the Fund, paying approximately \$70 million.<sup>97</sup> PCM also notes that it settled with various state regulators<sup>98</sup> and the National Association of Securities Dealers, Inc. (“NASD”). As a result, it paid nearly \$2 million in fines and other payments. PCM contends that during the time that it continued to operate, it also instituted a number of remedial steps to enhance Fund compliance, oversight, and pricing procedures. PCM stresses that it has shown contrition and openly acknowledged its mistakes.

While PCM claims that it made “full restitution” to shareholders through “prompt and generous” settlements, the class action settlement paid shareholders slightly less than fifty cents on the dollar, before attorneys’ fees and costs.<sup>99</sup> Some of the procedures to enhance PCM’s compliance, oversight, and pricing that PCM claims to have initiated were required under orders entered against PCM and Piper Jaffray by the State of Minnesota and the NASD.<sup>100</sup>

We reject PCM’s assertion that its conduct was not egregious because it complied with industry standards. PCM engaged in a variety of fraudulent and deceitful conduct, as well as deliberate and reckless disregard of various regulatory requirements.<sup>101</sup>

PCM argues that, if a civil money penalty is appropriate, a \$2 million penalty is excessive. PCM states that the law judge imposed sanctions based on a determination that PCM committed four violations of the securities laws. PCM posits that this amount was calculated based on “third tier” penalties which provide for a penalty of up to \$500,000 for each violation.<sup>102</sup> The law judge did not impose sanctions based on a determination that PCM committed four violations. Rather, the law judge determined that the Respondents, including PCM, “committed a minimum of four general categories of securities law violations which would constitute ‘third tier’ violations.”<sup>103</sup> The law judge also stated that there was “no doubt whatsoever that Division’s recommended monetary penalty of \$25 million could be substantiated by multiplying culpable Respondents’ numerous individual violations by the appropriate ‘tier’ penalties.”

PCM argues that there is no likelihood of its committing future violations, as the law judge revoked its registration, the Fund no longer exists, and none of the Fund’s former portfolio managers serves as a portfolio manager today. PCM asserts that, because it has ceased operations and has no likelihood of committing future violations, there is no basis

<sup>96</sup> PCM contends that of the “total losses” that investors sustained, most recovered between one-half and two-thirds of their losses through a class action settlement. PCM states, however, that it is “axiomatic that investors in the Fund were prepared to accept certain risks when they invested” and that “no investor can reasonably expect PCM to make restitution for losses that resulted from accepted risks.” Thus, PCM asserts that the shareholders received “full restitution” after factoring in these “accepted risks.”

<sup>97</sup> For the 50 or so shareholders who opted out of this settlement, PCM notes that it settled with them and paid \$18.1 million. Of the three shareholders who elected to arbitrate their claims, PCM asserts that only one shareholder received more through arbitration than it would have received under the class action settlement.

<sup>98</sup> PCM settled with the States of Maryland, Minnesota, Montana, North Dakota, and South Dakota.

<sup>99</sup> Moreover, William J. Brody, a lawyer whose firm, Frederickson & Byron, had invested in the Fund and arbitrated its claim following the Fund’s losses, testified that, following an award to the law firm in excess of \$2.5 million in compensatory damages, punitive damages, and fees, PCM appealed the award three times before finally reimbursing the law firm for its losses.

<sup>100</sup> *Piper Jaffray, Inc. and Piper Capital Management, Inc.*, Consent Order SE9404156/TMF (Minn. Comm’r of Commerce Mar. 3, 1996); *Notice of Acceptance of Acceptance, Waiver and Consent*, Comp. No. C04960008 (NASD Mar. 4, 1996).

<sup>101</sup> PCM also asserts that its conduct was not egregious because the mispricing of the Fund occurred “on only three of the six days challenged by the Division,” and that “the magnitude of that mispricing is, at most, a few cents per share.” For the reasons discussed above, we do not find this assertion mitigating. We agree with the law judge that PCM used prices for certain CMOs that “had no legitimate basis whatsoever.”

<sup>102</sup> See 15 U.S.C. §§ 78u(d)(3)(B)(iii), 80a-9(d)(2)(C), 80b-3(i)(2)(C). According to PCM, absent a finding of additional violations, the law does not permit any increase in the monetary penalty already imposed and there is no basis for the Division’s demand that the penalty be increased.

<sup>103</sup> PCM also argues that proceedings involving “sufficiently similar facts and allegations” in which the Commission settled for lower awards should serve as a guide for the appropriate level of sanctions here. However, “it is well established that respondents who offer to settle may properly receive lesser sanctions than they otherwise might have received based on ‘pragmatic considerations such as the avoidance of time-and-manpower-consuming adversary proceedings.’” *David A. Gingras*, 50 S.E.C. 1286, 1294 (1992) (quoting *Nassar & Co.*, 47 S.E.C. 20, 26 (1978)). PCM also cites one case, *Abraham and Sons Cap., Inc.*, I.D. Rel. No. 135 (Jan. 28, 1999), 68 SEC Docket 3525, in which a law judge imposed a third tier sanction but at less than the maximum amount. However, as the Supreme Court has made clear, a sanction imposed in one case is not invalid because it is in excess of sanctions imposed in other cases. See *Butz v. Glover Livestock Comm’n Co.*, 411 U.S. 182, 187 (1973).



for imposing a monetary penalty. Although the likelihood that the respondent's occupation will present opportunities for future violations is a factor to consider when determining the public interest, it is not the exclusive factor. As the law judge properly noted, a monetary penalty serves to deter other persons and entities in the securities industry from committing in the future the violations that PCM committed in this case.<sup>104</sup> Accordingly, the deterrent effect that a monetary penalty against PCM will have must be weighed in determining whether the penalty (including the appropriate amount) is in the public interest.

The Division asserts that an appropriate penalty is \$25 million, noting that PCM established a litigation reserve of \$24 million in 1997 in contemplation of this proceeding.<sup>105</sup>

Although the law judge concluded that a \$25 million sanction against PCM could be substantiated, he deemed this amount to be excessive.<sup>106</sup> While we agree with the Division that PCM engaged in wide-ranging egregious conduct, PCM has ceased operations and exists in name only. Under these circumstances, we do not believe that it is necessary to impose a \$25 million sanction.

Based upon our previous finding of fraud by PCM, we censure PCM and order it to cease and desist from violating or committing future violations of the federal securities laws. We revoke PCM's registration as an investment adviser and assess civil money penalties totaling \$2,005,000.<sup>107</sup>

**B. Individual Respondents.** The individual Respondents argue that sanctions against them are unwarranted. They assert that the law judge found that they have been "adequately sanctioned and rehabilitated through the conduct of this proceeding." The law judge did not elaborate on what he meant by this statement. In any event, in imposing sanctions, we use the factors articulated in *Steadman v. SEC*<sup>108</sup> to assess the public interest. We assess the risk of future violations in determining the appropriateness of a cease-and-desist order.<sup>109</sup>

The Division appeals the adequacy of the sanctions imposed against the individual Respondents, asserting that the law judge failed to "mete out meaningful sanctions." The Division argues that, by finding that the individual Respondents' actions were not egregious, the law judge contradicted his numerous other findings, including that the Respondents "all knowingly were participants in a process" fraudulently to inflate the Fund's NAV, and that none of them "demonstrated any meaningful recognition or acknowledgment of the wrongful nature of their conduct." The Division requests that these Respondents be barred from association with an investment adviser or investment company and assessed monetary penalties.

We cannot agree with the Respondents that sanctions are unwarranted in this case. The violations we have found involving the Fund's NAV were not merely errors in judgment. On the contrary, the individual Respondents, all experienced professionals, engaged in the deliberate fraudulent pricing of the Fund's NAV. The NAV is critical information that investors receive about an investment company's performance. This conduct undermined the pricing

<sup>104</sup> See 15 U.S.C. §§ 78u-2(c)(3), 80a-9(d)(3), 80b-3(i)(3) ("In considering under this section whether a penalty is in the public interest, the Commission may consider . . . the need to deter such person and other persons from committing such acts or omissions . . .").

<sup>105</sup> A PCM employee testified at the hearing that the reserve was taken against various outstanding litigation matters, including this proceeding.

<sup>106</sup> The Division believes that the law judge improperly used the state regulatory penalties paid by PCM as a ceiling or cap on the amount of penalties assessed in this proceeding, and argues that the civil money penalty fails as a deterrent and does not serve the public interest. We do not believe, as the Division suggests, that the law judge "improperly linked" PCM's penalty to the fines already assessed by state regulators. We wish to make clear that settlements with other regulators do not serve to limit the amount of civil money penalties that may be assessed in any Commission action.

<sup>107</sup> See *supra* notes 7 and 94.

<sup>108</sup> 603 F.2d 1126, 1140 (5th Cir. 1979) (imposition of sanctions in the public interest determined by weighing the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter, the sincerity of the respondent's assurances against future misconduct, the respondent's recognition of the wrongful nature of the conduct, and the likelihood that the respondent's occupation will present opportunities for future violations), *aff'd*, 450 U.S. 91 (1981).

<sup>109</sup> *KPMG Peat Marwick LLP*, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 74 SEC Docket 384, 429 (in assessing risk of future violations, though "some" risk is necessary, it need not be very great to warrant issuing a cease-and-desist order and, absent evidence to the contrary, a finding of violation raises a sufficient risk of future violation), petition denied, 289 F.3d 109 (D.C. Cir. 2002). See also *Herbert Moskowitz*, Exchange Act Rel. No. 45609 (Mar. 21, 2002), 77 SEC Docket 481, 496-97 (same).

process upon which fund investors rely.<sup>110</sup> In addition, Goldstein committed disclosure violations. We therefore believe that the individual Respondents present a risk of future violations and that the imposition of sanctions is in the public interest.<sup>111</sup>

Examining all of the factors, we conclude that the sanctions imposed by the law judge are sufficient. In particular, we note that the conduct at issue in this proceeding was isolated and occurred over a short period of time. The individual Respondents otherwise have unblemished records in the securities industry and it appears that none of them personally benefitted from his or her wrongdoing.

Based upon our previous findings, we censure Goldstein, Johnson, Destro, and Nelson and order each of them to cease and desist from violating or committing future violations of Securities Act Section 17(a), Exchange Act Section 10(b), Exchange Act Rule 10b-5, IC Act Sections 31(a) and 34(b), and IC Act Rules 22c-1 and 31a-1.

An appropriate order will issue.<sup>112</sup>

By the Commission (Chairman Donaldson and Commissioners Glassman and Atkins); Commissioners Goldschmid and Campos, not participating.

Jonathan G. Katz  
Secretary

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<sup>110</sup> While the individual Respondents place great weight on the law judge's conclusion that their conduct was not egregious in light of the totality of the circumstances, they ignore that the law judge found that PCM's conduct was egregious. The violations that were attributable to PCM were caused by, and the responsibility of, all of the individual Respondents.

<sup>111</sup> See, e.g., *KPMG*, 74 SEC Docket at 429.

<sup>112</sup> We have considered all of the parties' contentions. We have rejected or sustained these contentions to the extent that they are inconsistent or in accord with the views expressed in this opinion.



**IN THE MATTER OF PIPER CAPITAL MANAGEMENT, INC., ET AL.**

Rel Nos. 33-8276; 34-48409; IA-2163; IC-26167

Admin. Proc. File No. 3-9657

August 26, 2003

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is,

ORDERED that Piper Capital Management, Inc. (PCM) be, and it hereby is, censured; and it is further

ORDERED that PCM shall cease and desist from committing or causing any violation or future violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 13(a)(3) of the Investment Company Act of 1940, Rule 22c-1 promulgated pursuant to Section 22(c) of the Investment Company Act of 1940, Section 31(a) of the Investment Company Act of 1940 and Rule 31a-1 thereunder, Section 34(b) of the Investment Company Act of 1940, and Section 207 of the Investment Advisers Act of 1940; and it is further

ORDERED that PCM's registration as an investment adviser be, and it hereby is, revoked; and it is further

ORDERED that PCM be, and it hereby is, assessed a civil money penalty of \$2,005,000 payable, in accordance with Rule 601(a), 17 C.F.R. § 201.601(a), no later than 21 days after the service of this order; and it is further

ORDERED that Marijo A. Goldstein be, and she hereby is, censured; and it is further

ORDERED that Goldstein shall cease and desist from committing or causing any violation or future violation of Securities Act Section 17(a), Exchange Act Section 10(b) and Rule 10b-5 thereunder, IC Act Rule 22c-1, IC Act Section 31(a) and Rule 31a-1 thereunder, and IC Act Section 34(b); and it is further

ORDERED that Robert H. Nelson be, and he hereby is, censured; and it is further

ORDERED that Nelson shall cease and desist from committing or causing any violation or future violation of Securities Act Section 17(a), Exchange Act Section 10(b) and Rule 10b-5 thereunder, IC Act Rule 22c-1, IC Act Section 31(a) and Rule 31a-1 thereunder, and IC Act Section 34(b); and it is further

ORDERED that Amy K. Johnson be, and she hereby is, censured; and it is further

ORDERED that Johnson shall cease and desist from committing or causing any violation or future violation of Securities Act Section 17(a), Exchange Act Section 10(b) and Rule 10b-5 thereunder, IC Act Rule 22c-1, IC Act Section 31(a) and Rule 31a-1 thereunder, and IC Act Section 34(b); and it is further

ORDERED that Molly J. Destro be, and she hereby is, censured; and it is further

ORDERED, that Destro shall cease and desist from committing or causing any violation or future violation of Securities Act Section 17(a), Exchange Act Section 10(b) and Rule 10b-5 thereunder, IC Act Rule 22c-1, IC Act Section 31(a) and Rule 31a-1 thereunder, and IC Act Section 34(b); and it is further

ORDERED that payment of the amount ordered herein shall be made by certified check, U.S. Postal money order, bank cashier's check, or bank money order payable to the Securities and Exchange Commission. The check and a cover letter identifying the respondent and the proceeding designation, Administrative Proceeding File No. 3-9657, shall be mailed or delivered by hand to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22812. A copy of the cover letter shall be sent to Gregory P. Von Schaumburg, Esquire, Securities and Exchange Commission, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

By the Commission.

Jonathan G. Katz  
Secretary

## IN THE MATTER OF THE ROCKIES FUND, INC., ET AL.

Release Nos. 34-48590; IC-26202

Administrative Proceeding File No. 3-9615

October 2, 2003

### Order Imposing Sanctions

Edward J. Meehan, Roberto Iraola, Louis D. Greenstein, and David E. Carney, of Skadden, Arps, Slate, Meagher & Flom, LLP, for The Rockies Fund, Inc., Stephen G. Calandrella, Charles M. Powell, and Clifford C. Thygesen.

David A. Zisser, of Isaacson, Rosenbaum, Woods & Levy, P.C.

Robert M. Fusfeld and Julie K. Lutz, for the Division of Enforcement.

Opinion of the Commission

Investment Company Proceeding

Cease-And-Desist Proceeding

Grounds for Remedial Action

Fraud in Connection with Reporting Requirements

Violating, Aiding and Abetting, and Causing Violations of Reporting Requirements

Manipulation through Matched Orders and Wash Sales

Improper Acceptance of Compensation by Agent of an Investment Company

Investment company and its directors violated antifraud provisions of the Exchange Act by filing periodic reports containing material misstatements; investment company violated provisions of the Exchange Act and directors aided and abetted and were a cause of reporting violations by filing reports not in compliance with GAAP and containing material misstatements; director of investment company and another individual violated antifraud provisions of the Exchange Act by manipulating the price of securities through matched orders and prearranged trades; and director violated Investment Company Act Section 57(k)(1) and Exchange Act antifraud provisions by improper acceptance of compensation. Held, it is in the public interest that: (1) director be barred in all capacities from association with an investment company; (2) independent directors be barred from associating with an investment company for three years; (3) Respondents cease and desist from committing or causing any violations or future violations of the provisions that they are held to have violated; (4) director be ordered to pay a civil money penalty of \$500,000; and (5) independent directors each be ordered to pay a civil money penalty of \$160,000.

Appeal filed: March 30, 2001

Last brief received: August 10, 2001

Oral argument: September 24, 2003

I

The Rockies Fund, Inc. (“Rockies Fund” or “Fund”), a closed-end investment company, Stephen G. Calandrella, president and director of the Rockies Fund, Charles M. Powell and Clifford C. Thygesen, independent directors of the Rockies Fund, (the four together, the “Rockies Respondents”), as well as John C. Power (J. Power), president of Redwood MicroCap Fund, Inc. (“Redwood”), a closed-end investment company not charged in this proceeding, appeal from the decision of an administrative law judge. The law judge found that the Rockies Respondents violated Section 10(b) of

the Securities Exchange Act of 1934<sup>1</sup> and Rule 10b-5 thereunder<sup>2</sup> by making untrue statements of material facts in the Rockies Fund's annual and quarterly reports. The law judge also found that the Rockies Fund violated, and Respondents Calandrella, Powell, and Thygesen "aided and abetted and caused" the Fund's violations of Section 13(a) of the Exchange Act,<sup>3</sup> and Rules 12b-20, 13a-1, and 13a-13<sup>4</sup> by filing reports that contained untrue statements of material facts and that did not comply with Generally Accepted Accounting Principles ("GAAP") and Regulation S-X.<sup>5</sup> The law judge further found that Respondents Calandrella and J. Power violated Section 10(b) of the Exchange Act and Rule 10b-5 by manipulating the market for Premier Concepts, Inc. ("Premier") common stock, a stock held in the Fund's investment portfolio, through engaging in matched orders and wash sales. Additionally, the law judge found that Respondent Calandrella violated Section 57(k)(1) of the Investment Company Act,<sup>6</sup> and Exchange Act Section 10(b) and Rule 10b-5 thereunder by causing the Rockies Fund to purchase shares of Premier stock to settle a legal claim threatened against Calandrella personally without disclosing the settlement to the independent board members of the Rockies Fund.

The law judge ordered all Respondents to cease and desist from further violations of Exchange Act Section 10(b) and Exchange Act Rule 10b-5. The law judge ordered the Rockies Fund to cease and desist from committing or causing, and Calandrella, Thygesen, and Powell to cease and desist from aiding and abetting or causing, any further violations of Exchange Act Section 13(a) and Exchange Act Rules 12b-20, 13a-1, and 13a-13. The law judge ordered Calandrella to cease and desist from further violations of Investment Company Act Section 57(k)(1). The law judge further ordered Calandrella to pay a civil money penalty of \$500,000 and Thygesen and Powell each to pay a civil money penalty of \$160,000. Additionally, the law judge permanently barred Calandrella and, for a period of three years barred Thygesen and Powell, from associating with or acting as an affiliated person of an investment company.

All Respondents challenge the law judge's findings of violations and contend that the sanctions imposed are excessive. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

## II.

### Respondents

The Rockies Fund, incorporated in 1983, is a closed-end investment company which elected to be treated as a business development company ("BDC") under the Investment Company Act.<sup>7</sup> In fulfilling its function as a BDC, the Rockies Fund invested primarily in new, developing, and often struggling companies, and provided capital as well as management expertise with the goal of achieving capital appreciation from those companies. The Fund's directors, Respondents Calandrella, Thygesen, and Powell, all had been friends and business associates for many years prior to the period at issue and had been investors in, or directors of, various of each others' business entities.

Respondent Calandrella has been the president and a director of the Rockies Fund since February 1991 and has been the chief executive officer and treasurer of the Fund since January 1994. In addition, Calandrella was, during the events at issue, the principal buyer and one of the largest holders of Rockies Fund stock. As of March 1995, Calandrella owned 31.2% of the Fund's outstanding common stock. Calandrella and entities with which he was affiliated also made substantial loans to the Fund. At the hearing, Calandrella could not state with certainty the amount of such loans, but he believed the loans totaled "less than several hundred thousand dollars."

Respondent J. Power is a longtime friend and associate of Calandrella. He was president of Redwood, a closed-end investment company that became involved in the events at issue.

### The Formation of Premier Concepts, Inc.

<sup>1</sup> 15 U.S.C. § 78j(b).

<sup>2</sup> 17 C.F.R. § 240.10b-5.

<sup>3</sup> 15 U.S.C. § 78m(a).

<sup>4</sup> 17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-3.

<sup>5</sup> 17 C.F.R. § 210.

<sup>6</sup> 15 U.S.C. § 80a-56(k)(1).

<sup>7</sup> 15 U.S.C. § 80a-2(a)(48). The Rockies Fund withdrew this election in December 1999.

This proceeding concerns the Rockies Fund's holdings of Premier securities. In 1993, Respondent J. Power, his brother Mark Power, and Raymond Stanz formed Mirage Concepts, Inc., a private company that operated three faux jewelry stores in Arizona and San Francisco. J. Power and Mark Power each owned 25% of Mirage; Stanz owned 50%. When J. Power and Stanz learned that American Fashion Jewels, Inc., a nationwide chain of faux jewelry stores operating under the name "Impostors," had declared bankruptcy in May 1993, they became interested in expanding Mirage by purchasing the assets of the bankrupt entity.

Initially, they planned that Redwood, J. Power's company, would purchase Impostors. However, realizing that the acquisition cost of Impostors would be in the range of \$1 million, J. Power invited Calandrella to participate in the transaction. Calandrella recommended that, given the steep capital investment required, the appropriate vehicle with which to acquire Impostors would be a company he controlled, Premier.<sup>8</sup> Calandrella, J. Power, and Stanz agreed to this plan.

Calandrella signed a Commitment Letter for Funding of Debtors' Joint Plan of Reorganization of Impostors dated January 4, 1994. The bankruptcy court approved Premier's acquisition of Impostors, and Impostors' Amended Plan of Reorganization (the "Amended Plan") became effective on March 3, 1994. Among other things, the Amended Plan required Premier to have assets of \$1 million in cash or cash equivalents.

In order to raise this \$1 million, Premier conducted a private offering of Premier stock and warrants (the "1994 Private Placement"). The offering of 500,000 units, consisting of two shares of common stock and one Class C warrant exercisable to purchase one additional share of common stock at \$2.00 per share, occurred in February 1994. The Premier Board of Directors resolution authorizing the private offering specified that the shares and warrants were "restricted securities" under the Securities Act of 1933, as amended, and certificates evidencing same should bear the Company's customary restrictive legend." As indicated in the private offering's January 1994 Commitment Letter and February 1994 Investment Term Sheet, Premier intended to register the shares as soon as was practicable and to qualify for trading on the Nasdaq stock market.<sup>9</sup> Calandrella was optimistic that Premier would raise the capital necessary to achieve these results and that the newly acquired Impostors stores, then operating at a loss, would be profitable. The Rockies Fund, Redwood, and Mirage, among others, invested in the 1994 Private Placement. Shortly after the 1994 Private Placement was conducted, Premier acquired the Mirage stores.

Premier's financial condition did not improve and did not show the profitability anticipated by Calandrella. In 1994, Premier operated at a loss, additional capital was needed to execute its business plan, and auditors expressed a going concern qualification in the company's year-end audit. Sissel Greenberg, a subsequent president of Premier, testified that, in 1995, Premier's financial condition improved, but the company still was operating at a loss and needed capital to fund the business.

## Management of Premier

At the time of the Impostors acquisition through August 1994, Stanz, serving as chief operating officer of Premier, and J. Power, having no formal title, operated the former Impostors stores. Sometime around April or May 1994, hostility arose between Calandrella and J. Power. The record is not clear as to the precise details, but, in essence, Calandrella was unhappy with the manner in which J. Power was running Premier. Calandrella recruited Greenberg to serve as president of Premier, a move which angered both J. Power and Stanz. J. Power and Stanz questioned Greenberg's competency in making retail and merchandising decisions in the jewelry business, an industry Stanz knew well. The discord resulted in Stanz leaving Premier in August 1994 and threatening legal action against Calandrella.

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<sup>8</sup> When the discussions concerning the acquisition of Impostors began, Premier was named Silver State Casinos, Inc. The company changed its name to Premier Concepts, Inc. on February 21, 1994. Silver State Casinos, Inc. had operated real estate and gaming businesses. Before acquiring Impostors, the company abandoned these activities. Thus, after March 1994, Premier was involved solely in the retail jewelry business.

<sup>9</sup> The record indicates that Premier sought information about acquiring a listing on the Nasdaq SmallCap Market in late 1993. At that time, the Nasdaq SmallCap Market required total stockholder equity of \$2 million. Premier finally met the requirements to obtain a listing on Nasdaq in April 1997.

With this background, we can now examine the specific charges against Respondents.

### III.

#### A.

The manipulation charges against Calandrella and J. Power center on trading in the stock of Premier between June 10 and October 21, 1994. Thirteen sets of trades of Premier are at issue with respect to these charges. Most of these trades occurred between accounts at Hanifen Imhoff, the single market maker for Premier, and accounts at McDermid St. Lawrence Chisholm Ltd. (“McDermid”), a broker-dealer in Vancouver, Canada.

A portion of the trades at issue relates to the disposition of 200,000 Premier shares originally purchased in the 1994 Private Placement by Ranald Butchard, a registered representative of McDermid and a friend and business associate of both Calandrella and J. Power. These shares represented a substantial portion of Premier’s outstanding shares. According to Butchard, he understood at the time of his investment that Premier was applying for and would acquire a Nasdaq listing. When he learned that a Nasdaq listing was not imminent, Butchard asked both Calandrella and J. Power if they would purchase his shares or if they knew of other potential buyers. Calandrella and J. Power agreed to find buyers for his shares. J. Power testified that he did not want his friend to lose money on his investment.

Butchard sold 180,000 of his Premier shares in several blocks to Hanifen at or near the bid price. Within a short time after Butchard sold each block, the same number of shares would be purchased (in smaller blocks) at or near the ask price. In turn, some of those purchasers sold their shares. All of those involved in these transactions were friends, relatives, business associates, or business entities of Calandrella, J. Power, or Butchard.

The trades occurred as follows:

Date	Customer	Acct At	Buy/Sell	# of Shares	Price
6/10	R. Butchard	McDermid	S	50,000	1.100
6/15	N. Katz	Hanifen	B	25,000	1.125
6/15	Power Curve	McDermid	B	25,000	1.125
6/17	R. Butchard	McDermid	S	25,000	1.000
6/17	Huebner	Hanifen	B	8,000	1.000
6/17	Brian Power	Hanifen	B	7,000	1.03125
6/17	Neon Rainbow	McDermid	B	10,000	1.03125
6/21	R. Butchard	McDermid	S	50,000	1.000
6/22	Barr	McDermid	B	1,000	1.010
6/22	K. Phillips	McDermid	B	19,000	1.010
6/22	B. Butchard	McDermid	B	30,000	1.010
6/29	B. Butchard	McDermid	S	20,000	1.250
6/29	K. Phillips	McDermid	S	17,000	1.250
6/29	Gecko Holdings	McDermid	B	35,000	1.250
6/29	J. Crone	McDermid	B	1,000	1.250
6/29	M. Butchard	McDermid	B	1,000	1.250
6/23	B. Butchard	McDermid	S	25,000	1.040
6/23	Redwood	Hanifen	B	25,000	1.050
6/28	R. Butchard	McDermid	S	10,000	1.250
6/30	N. Katz	Hanifen	B	10,000	1.250
8/9	R. Butchard	McDermid	S	10,000	1.500
8/19	N. Katz	Hanifen	B	10,500	1.53125
8/23	R. Butchard	McDermid	S	10,000	1.750
8/30	A. Nacht	Cohig	B	10,000	1.78125

There is no evidence, and the Division does not argue, that the June 17 trade of Richard Huebner, a compliance officer at Hanifen, was part of the manipulative scheme.

Calandrella and J. Power recommended Premier stock, and at times, recommended a “limit order price,” to many of the purchasers.<sup>10</sup> Calandrella and J. Power knew that these purchasers, in essence, were buying the shares Butchard was selling. Calandrella monitored the trading of Premier and would discuss trades with which he was unfamiliar with J. Power or with Hanifen.

Calandrella recommended Premier purchases to Nathan Katz, a longtime business associate, and to Arthur Nacht, a friend of many years. Calandrella admits that he loaned money to Katz for some of Katz’s Premier purchases. Katz purchased Premier shares on three occasions, June 15, June 30, and August 19, 1994, each in close proximity to sales made by Butchard. Calandrella acknowledges that he knew he was recommending stock to Katz that Butchard was selling and that “certainly it was possible” he recommended the price to Katz. As for Nacht’s purchase, Calandrella often gave investment advice to Nacht and had limited authorization to trade in one of Nacht’s brokerage accounts. Nacht bought on August 30, 1994, through his account at Cohig & Associates, Inc. (“Cohig”), Premier shares that Butchard sold on August 23.

Other purchases of Butchard’s shares were arranged by J. Power. In two instances, companies J. Power controlled purchased Premier shares. Power Curve, a private company owned by J. Power, purchased shares of Premier on June 15,

<sup>10</sup> The record does not make clear if the orders were actually placed as limit orders.

1994, sold by Butchard on June 10, and Redwood purchased shares on June 23, 1994, sold by Butchard that same day. J. Power acknowledged that the companies were essentially purchasing the Premier shares Butchard had sold to Hanifen.

In addition, J. Power influenced the purchase of Premier stock by his brother, Brian Power, and by a friend and business associate, Allen Williams, the owner of Neon Rainbow. Brian Power purchased Premier shares on June 17, 1994, that Butchard had sold that day. Brian Power testified that his investments, including the number of shares to purchase and the price, were often made upon the advice of J. Power. J. Power recommended that Williams purchase 10,000 shares of Premier and believed he recommended a limit order price.

Butchard appears to have arranged certain trades with his customers and family. The 50,000 shares of Premier that Butchard sold on June 21, 1994, were purchased the next day by two of Butchard's customers and his brother, Brad Butchard, at \$1.01 per share. On June 29, Brad Butchard and one of the customers sold 37,000 of the shares they had purchased to three others, including a company owned by Butchard, for \$1.25 per share. Butchard argued variously that his company repurchased the shares from his brother for tax reasons or possibly because his company was where he had the funds to purchase the shares. In addition, J. Crone and Butchard's mother each bought 1,000 shares at \$1.25 per share.

Another series of trades at issue during the relevant time period were made by J. Power, his brother Brian, and entities they controlled. The trades again involved the sale of Premier shares to, and the purchase of Premier shares from, either Hanifen or McDermid. Calandrella does not appear to have been involved in these transactions.

The trades occurred as follows:

Date	Customer	Acct At	Buy/Sell	Buyer/Seller	# of Shares	Price
7/6	B. Power	Hanifen	S	Hanifen	5,000	1.4375
7/8	Power Curve	McDermid	S	Hanifen	14,000	1.5000
7/8	J. Power	Hanifen	B	Hanifen	19,000	1.5150
7/25	J. Power	Hanifen	S	McDermid	17,000	1.5000
7/25	Power Curve	McDermid	B	McDermid	17,000	1.5000
8/17	Power Curve	McDermid	S	Hanifen	14,000	1.7500
8/17	B. Power	Hanifen	B	Hanifen	14,000	1.7500
8/25	B. Power	Hanifen	S	McDermid	14,500	1.7500
8/25	J. Power	McDermid	B	McDermid	14,500	1.7500
9/19	B. Power	Hanifen	S	Hanifen	1,500	1.87500
9/19	Power Curve	McDermid	B	Hanifen	1,500	2.00000
10/21	J. Power	McDermid	S	Hanifen	4,250	2.50000
10/21	J. Power IRA	YDSA	B	Hanifen	2,500	2.56250
10/21	A. Power	Hanifen	B	Hanifen	1,750	2.50000

J. Power claims that he arranged these trades to take advantage of the more lenient Canadian settlement rules which allowed more time for settling trades. He claims that this longer settlement period allowed him and his brother to get cash temporarily when needed for business or other purposes. Brian Power testified that his brother recommended the number of Premier shares to purchase, and he assumed that his brother also recommended the sale price for the Premier shares he sold, though he could not directly recall. These trades, assertedly for the purpose of generating credit and needed cash, occurred at a high cost. Brian Power acknowledged that he bought Premier stock 5 times and sold it 4 times during the relevant period. Due to the rising price of Premier and the commissions on these transactions, Brian Power spent almost \$28,000 more on the purchases than he received from the sales.



**B.**

Exchange Act Section 10(b) and Exchange Act Rule 10b-5 thereunder generally make it unlawful for any person to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Manipulation of the market for a security traded in the over-the-counter market is encompassed within the proscriptions of Rule 10b-5.<sup>11</sup>

Manipulation includes the use of matched orders<sup>12</sup> and wash sales<sup>13</sup> that create a false or misleading appearance of active trading, or that otherwise create a false or misleading appearance with respect to the market for a particular security.<sup>14</sup> For purposes of Rule 10b-5, it is not necessary to show a specific manipulative purpose in inducing others to trade as is required under Section 9; a showing that Respondents engaged in fraud or deceit as to the nature of the market for the security is sufficient.<sup>15</sup> It is not relevant whether investors sustained losses as a result of the manipulative activity.<sup>16</sup>

In order to establish that the manipulative conduct at issue constitutes a violation of Exchange Act Section 10(b) and Rule 10b-5, we must find that J. Power and Calandrella acted with scienter, defined as “a mental state embracing intent to deceive, manipulate, or defraud.”<sup>17</sup> A finding that Respondents acted recklessly can satisfy the scienter requirement.<sup>18</sup> The courts have defined recklessness in this context as “an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”<sup>19</sup>

Virtually all of the transactions involving the trading of the Butchard shares were matched orders in that they were entered with the knowledge that orders of substantially the same amount, at substantially the same time, would be entered. J. Power admitted that he and Calandrella agreed to help Butchard find purchasers because “Mr. Butchard would have lost money.” Moreover, the coincidence of timing and size of the trades, and the fact that the trades were virtually

<sup>11</sup> See *Swartwood, Hesse, Inc.*, 50 S.E.C. 1301, 1307 n. 14 (1992) (and cases cited therein). Specifically, the manipulative conduct proscribed by Section 9 of the Exchange Act, 15 U.S.C. § 78i, pertaining to securities registered on a national securities exchange, is deemed to be prohibited by Section 10 and Rule 10b-5 thereunder. *Id.*

<sup>12</sup> *Edward J. Mawod & Co.*, 46 S.E.C. 865, 869 (1977), *aff'd* 591 F.2d 588 (10th Cir. 1979) (defining matched order as “one placed with the knowledge that an offsetting order on the other side has already been or is about to be placed”). See also Exchange Act Section 9 (describing a matched order as the entering of an order for the purchase of a security with the knowledge that an order of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties).

<sup>13</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 205 n. 25 (1976) (defining wash sales as “transactions involving no change in beneficial ownership”). Similarly, Exchange Act Section 9 prohibits, for the purpose of creating a false or misleading appearance of active trading in a security or of the market for a security, any person from effecting a transaction in such a security which involves no change in the beneficial ownership thereof.

<sup>14</sup> Exchange Act Section 9(a)(1).

<sup>15</sup> See *United States v. Charnay*, 537 F.2d 341, 350 (9th Cir. 1976). J. Power’s contention that the Division must prove a manipulative purpose to increase the price of Premier to find a violation under Section 10(b) and Rule 10b-5 is incorrect. Junius Peake, Respondents’ expert witness, asserted that market manipulation is evidenced when: (1) one or more insiders promote the sale of their own securities to public investors at overvalued prices or when insiders sell their securities at higher prices unrelated to those obtained in the open market; and (2) such promotion is accompanied by written or oral communications. Because these factors were not present here, Peake concluded that no manipulation occurred.

There is nothing in the relevant case law to support Peake’s narrow definition of manipulation. In fact, on cross examination, Peake stated that he was not a lawyer and was not “responding to the legal definition of insider trading.” He demonstrated a lack of familiarity with several landmark Commission cases addressing manipulation and disagreed with the statutory definition of wash sales in Exchange Act Section 9. He offered no facts to substantiate his conclusions. As a whole, his testimony was unpersuasive.

<sup>16</sup> *Mawod*, 46 S.E.C. at 871 (“The evil sought to be remedied is not victimization but deception. When investors and prospective investors see activity, they are entitled to assume that it is real activity.”).

<sup>17</sup> *Hochfelder*, 425 U.S. at 193 n.12.

<sup>18</sup> *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998) (finding allegation of reckless participation in a market manipulation sufficient to state a claim of violation of 10(b)).

<sup>19</sup> *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okl. 1976)). *SEC v. Ogle*, 2000 WL 45260, at \*7 (N.D.Ill. 2000) cited by Respondents for the proposition that “recklessness is not sufficient to state a market manipulation claim; unintentional false representations are not actionable,” is inconsistent with this long-standing Seventh Circuit precedent.

all made by friends and family members of Butchard, J. Power, and Calandrella, make apparent that the various different sales and purchases were matched with each other.<sup>20</sup>

It is equally apparent that the second group of trades were wash sales. They occurred among J. Power and various entities controlled by him either through his ownership or through familial relationships, and thus involved no change in beneficial ownership. Indeed, J. Power said that the trades were arranged for the purpose of temporarily generating cash for him and his brother during the extended Canadian settlement period, rather than for long-term disposition of the securities.

In arranging these matched orders and wash sales, respondents Calandrella and J. Power engaged in fraud as to the nature of the market for Premier securities. As we have previously stated:

Proof of a manipulation almost always depends on inferences drawn from a mass of factual detail. Findings must be gleaned from patterns of behavior, from apparent irregularities, and from trading data. When all of these are considered together, they can emerge as ingredients in a manipulative scheme designed to tamper with free market forces.<sup>21</sup>

The hallmarks of a manipulation include the appearance of market activity in an otherwise thinly traded security as well as a rapid surge in prices despite the absence of any known prospects for the issuer or favorable development affecting it.<sup>22</sup> But for the trades at issue, Premier was an extremely thinly traded security, reflecting low investor interest. Respondents' conduct falsely created the appearance of active interest in Premier and caused the bid price to increase.

During the course of this trading, the bid price for Premier rose from \$1.00 per share to \$2.25. Premier was operating at a loss throughout 1994. The company issued no press releases and engaged in no other promotional efforts that might have affected the price. Respondents' trading alone appears to account for the steep increase in the price of Premier stock. At the cessation of the alleged period of price manipulation, the bid price of Premier declined rapidly.

Although it is not necessary to establish a specific manipulative intent under Rule 10b-5, the conclusion that Respondents' conduct was designed to create a false appearance of activity and to move the price of Premier upwards is inescapable. All of the trading was done with Premier's market makers Hanifen and McDermid on a principal basis. If, as Respondents claim, the Butchard trades were effected to help a friend dispose of unwanted securities without losing money, they could have been handled privately to avoid transaction costs.<sup>23</sup> The only conceivable reason for the trades to have been placed in the public market was to ensure that the trades would be reported in order to create an appearance of market activity and to cause the market maker's bids to rise in response to the increased customer interest.

Calandrella claims that he did not participate in the trading at issue. This claim is belied by the record evidence. Four sets of trades of the Premier shares involved Katz, a business associate and friend of Calandrella, and Nacht, a longtime friend of Calandrella. Calandrella recommended these purchases of Premier, at particular times, at suggested prices. In fact, Calandrella placed one order of Premier on behalf of Nacht.

Calandrella also claims that his relationship with J. Power during this period was so strained that the two could not have cooperated in orchestrating any manipulative scheme. The record does not support such a claim. The alleged strain between J. Powers and Calandrella centered on the management of Premier. It is perfectly plausible that the two could have disagreed on management matters but still cooperated in arranging the trades at issue. Calandrella testified that he monitored trading in Premier and discussed with J. Power any trades of which he was unaware. Moreover, the pattern of trading is highly suggestive of coordination between Calandrella and J. Power in June and in August 1994.

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<sup>20</sup> Peake conceded that the trades at issue here were matched orders although he used the term "crossed order," but did not concede that they were part of a manipulative scheme. We agree with his factual analysis, but disagree with the legal conclusion based on these facts.

<sup>21</sup> *Pagel, Inc.*, 48 S.E.C. 223, 226 (1985), *aff'd* 803 F.2d 942 (8th Cir. 1986).

<sup>22</sup> *Castle Sec. Corp.*, 53 S.E.C. 406, 410 (1998); *Dlugash v. SEC*, 373 F.2d 107, 109 (2d Cir. 1967) (finding that "rapidly rising prices in absence of any demand are well-known symptoms of" manipulation).  
*Cf. Swartwood*, 50 S.E.C. at 1307 (finding manipulation even though hallmarks of a classic manipulation were absent).

<sup>23</sup> Butchard claims that he sold the stock to his customer accounts at McDermid through Hanifen because Neuman, Premier's counsel, had advised him that he had to sell the shares in a market sale to eliminate the restriction. Neuman was not questioned on this point.

J. Power argues that he participated innocently in the wash sales with no intent to increase the price of Premier. As noted above, it is not necessary to establish a specific manipulative intent with respect to claims under Rule 10b-5.<sup>24</sup> However, J. Power's "innocent" explanation that the sales provided needed quick cash is highly suspect given the amount of money lost in transaction costs. Moreover, a need for quick cash does not explain why the price of Premier rose with each transaction. J. Power's trades cannot be viewed in isolation. As we have said before, investors should be able to assume that the prices of securities are reflective of actual market conditions and not a result of manipulation. The fact that, despite poor financial prospects, the price of Premier rose steadily upward while J. Power was involved in recommending Premier trades at suggested prices creates an unmistakable pattern of manipulative activity.

Calandrella and J. Power manufactured a pattern of trading that deceived market participants about the nature of the market for and the price of Premier stock. We therefore find, that Calandrella and J. Power, acting with scienter, manipulated the market for Premier securities in willful violation of Exchange Act Section 10(b) and Rule 10b-5.

#### IV.

Also at issue in this proceeding are allegedly fraudulent misrepresentations in the Rockies Fund's quarterly and annual reports concerning: (1) the classification of the Premier shares; (2) the valuation of the Premier shares; and (3) the ownership of certain Premier shares. Exchange Act Section 10(b) and Rule 10b-5 thereunder make it unlawful for any person, in connection with the purchase or sale of a security, "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."<sup>25</sup> A misstatement or omission is material if there is a substantial likelihood that a reasonable investor would consider the misstated or omitted information to be important in making an investment decision.<sup>26</sup> Moreover, in order to find a violation of these provisions, we must find that alleged misrepresentations and omissions were knowing or at least reckless.<sup>27</sup>

##### A. Classification of Premier Shares

The Rockies Respondents were charged with making fraudulent statements concerning the classification of Premier stock. In 1994, the Fund's June and September Forms 10-Q and its Form 10-K stated that all of its holdings of Premier were unrestricted stock. This representation was repeated in the first two Forms 10-Q filed by the Fund in 1995. It is undisputed that these representations were false; in fact, all but 750 of the Premier shares held by the Fund were restricted.<sup>28</sup>

We find the misclassification of the Premier shares in the periodic reports to be material. Correct classification of securities can have a material impact on financial statements.<sup>29</sup> In addition to having an impact on the value of the securities, misclassification can affect the validity of financial statements by making a portfolio appear more liquid by presenting shares as freely saleable when, in fact, they are not.<sup>30</sup> Where, as here, the number of shares incorrectly classified is material to the Fund's total assets,<sup>31</sup> the misclassification is material.

<sup>24</sup> See *supra* note 17.

<sup>25</sup> 17 C.F.R. § 240.10b-5.

<sup>26</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

<sup>27</sup> See discussion of requisite mental state, *supra* notes 19-21 and accompanying text.

<sup>28</sup> The Fund's Form 10-Q for the period ending September 30, 1995 correctly classified the Fund's Premier holdings as restricted in the Schedule of Investments portion of the Form 10-Q, but in another section of the Form, the Notes to the Financial Statements, the Rockies Respondents continued to describe the Premier shares as unrestricted. The Form 10-K for the year ended December 31, 1995 finally classified the Premier shares correctly as restricted throughout the Form.

<sup>29</sup> See Financial Accounting Standards Board Concept Doc. No. 2 P 128(c) (1980).

<sup>30</sup> Respondents contend that the misclassification of the Premier shares was not material since the market price of Premier reported in the Fund's Forms 10-Q and 10-K incorporated an "illiquidity discount." We discuss the impact of the misclassification on valuation *infra*. Respondents ignore the impact on the financial statements of falsely informing investors that shares are freely tradeable.

<sup>31</sup> The Premier holdings at issue constituted between 10 and 40% of the Fund's portfolio for each periodic report.

The Rockies Respondents do not contend that they were unaware, when the misrepresentations were made, that the vast majority of Premier shares were in fact restricted. Rather, they claim that the misclassification was merely the result of a clerical error and not an attempt to deceive investors. The record does not support such a contention.

Calandrella, Thygesen, and Powell were each involved in the drafting and filing of the Fund's Forms 10-Q and Form 10-K which contained the misrepresentations regarding the restricted status of the Premier shares. Calandrella presented the information contained in the filings to the independent directors, Thygesen and Powell, and signed the Forms 10-Q and Form 10-K the Fund filed with the Commission. Both Thygesen and Powell reviewed all of the periodic reports and signed the Form 10-K.

It is implausible that, absent an extreme departure from standards of ordinary care, a "clerical error" of this magnitude could occur not just once, but in six different periodic filings. The Premier shares were the Fund's single largest asset and constituted a significant portion of the portfolio. Moreover, in connection with the valuation of Premier securities in each of the periodic reports for which Premier securities were mistakenly classified as unrestricted, the values given in the financial statements were described as the "quoted market price" or "quoted market value." Restricted stock, however, because it cannot be traded in the public market, does not have a "quoted market price"; such a term only makes sense in reference to unrestricted stock.<sup>32</sup>

Calandrella, Thygesen, and Powell all admit that they were intimately involved in the valuation process; they could not have been unaware that Premier was being valued at market prices as if the shares were unrestricted. Calandrella stated in his investigative testimony that he believed at least some of the restricted shares could be treated as unrestricted because they had demand registration rights.<sup>33</sup> Thygesen testified at the hearing that, because he thought the Premier securities had demand registration rights, he viewed Premier securities as "hybrids" that could be valued as though they were unrestricted. He does not, however, provide any basis for this erroneous conclusion. We believe this evidence demonstrates a reckless indifference to whether the Premier securities were correctly classified.<sup>34</sup>

Accordingly, we find that the Rockies Respondents willfully violated Exchange Act Section 10 and Rule 10b-5 thereunder by recklessly misrepresenting the classification of Premier's securities in the Fund's Forms 10-Q and 10-K from June 1994 through September 1995.

## **B. Value of Premier Shares**

The Rockies Respondents are charged with making material misstatements in the Fund's quarterly and annual reports from June 30, 1994, through December 31, 1995, in that the valuations of restricted Premier securities held by the Fund were not in compliance with policies disclosed by the Fund and were materially overstated. The Fund's 1983 prospectus ("the prospectus") set forth the procedures by which the Fund was required to value its securities. The prospectus provided that securities would be valued at either market value or in good faith at fair value.<sup>35</sup> The prospectus defined "fair value" as the amount the Fund could expect to realize from the current sale of the securities.<sup>36</sup>

The prospectus then described four methods for the valuation of the Fund's security portfolios and ranked them in order of preference. The most favored method, the "public market method," used the "bid" price for those securities traded on

<sup>32</sup> See Restricted Securities, Accounting Series Rel. No. 113, at 4 (Oct. 21, 1969) ("ASR-113").

<sup>33</sup> Demand registration rights typically obligate an issuer to file a registration statement with the Commission and to use its best efforts to have the statement declared effective. See *Kers & Co. v. ATC Communications Group, Inc.*, 9 F. Supp. 2d 1267, 1269 (D. Kan. 1998).

<sup>34</sup> We note that the Forms 10-Q and 10-K that were filed after the misclassification error was corrected describe the reported value of Premier securities as the "quoted market price." We believe this reflects continued indifference to the distinction between restricted and unrestricted securities.

<sup>35</sup> This language is drawn from the statutory definition of value in Investment Company Act Section 2(a)(41), 15 U.S.C. § 80a-2(a)(41).

<sup>36</sup> This language is drawn from Accounting for Investment Securities by Registered Investment Companies, Accounting Series Rel. No. 118 ("ASR-118"). The AICPA Audit and Accounting Guide: Audits of Investment Companies, (hereinafter "AAG"), is the source for GAAP regarding investment companies. The AAG references ASR-113 and ASR-118 as GAAP for valuation of securities for which market quotations are not readily available. AAG § 2.33.

a stock exchange.<sup>37</sup> The Fund's Board was to value restricted shares at a discount from the market price for unrestricted shares of the same issuer and class.<sup>38</sup>

The prospectus noted that it was "highly probable" that the securities of many of the portfolio companies would not have a public market. In that event, their valuation was to be based on the "private market method." This method valued the stock on the basis of actual or proposed third-party transactions. The third method, the "appraisal method," was to be used when there were no third-party transactions in the securities, and directed the Board to value shares by an appraisal that considered events that occurred since the purchase of the stock. Finally, if no other method was feasible, the prospectus directed the Board to value the shares at their cost to the Fund. These valuation procedures described in the prospectus were the only procedures disclosed to the investing public.

The Fund did not follow these procedures. As noted above, all of the periodic reports at issue stated that Premier was valued at the "quoted market price" or "quoted market value." According to the prospectus, where a market price was identified for unrestricted securities, restricted securities for the same issuer should have been valued at a discount from this price.

Even the determination of this "quoted market price" followed no logical pattern. Although the prospectus makes clear that market price is to be determined at the bid, the reported prices for Premier were sometimes the highest bid, and sometimes a price between the bid and the ask.<sup>39</sup> For example, in the June 30, 1994 Form 10-Q, the \$1.50 valuation was higher than the highest bid for that day, \$1.375. The Fund's valuation for Premier in its September 30, 1994 Form 10-Q and December 31, 1994 Form 10-K equaled the highest bid for unrestricted Premier shares. The first two quarters of 1995 reported a value that is the median between the bid and the ask. The third quarter and annual reports for that year (the two reports that correctly classify Premier shares as restricted) reported a value between the bid and ask but lower than the median price.<sup>40</sup>

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<sup>37</sup> The prospectus did not specify whether the bid to be used consists of a high, low, mean, closing, or some other possible bid price for the security to be valued. However, a Valuation Policy adopted by the Board clarified that the lowest bid price should be used.

<sup>38</sup> This language is also consistent with ASR-113, which notes that the restriction on sale in the public market makes restricted securities less valuable than their unrestricted counterparts and also that the price of unrestricted securities reflects the cost to the issuer of registration. ASR-113 concludes that "consequently, the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for the most unusual situations, be improper."

<sup>39</sup> All of the reports provided value based on the last trading day of the reporting period.

<sup>40</sup> ASR-118 provides that, in determining market price, an issuer can elect to use either the bid, or some calculation between the bid and the ask, as long as the methodology is consistent.

Date	Customer	Acct At	Buy/Sell	Buyer/Seller	# of Shares	Price
7/6	B. Power	Hanifen	S	Hanifen	5,000	1.4375
7/8	Power Curve	McDermid	S	Hanifen	14,000	1.5000
7/8	J. Power	Hanifen	B	Hanifen	19,000	1.5150
7/25	J. Power	Hanifen	S	McDermid	17,000	1.5000
7/25	Power Curve	McDermid	B	McDermid	17,000	1.5000
8/17	Power Curve	McDermid	S	Hanifen	14,000	1.7500
8/17	B. Power	Hanifen	B	Hanifen	14,000	1.7500
8/25	B. Power	Hanifen	S	McDermid	14,500	1.7500
8/25	J. Power	McDermid	B	McDermid	14,500	1.7500
9/19	B. Power	Hanifen	S	Hanifen	1,500	1.87500
9/19	Power Curve	McDermid	B	Hanifen	1,500	2.00000
10/21	J. Power	McDermid	S	Hanifen	4,250	2.50000
10/21	J. Power IRA	YDSA	B	Hanifen	2,500	2.56250
10/21	A. Power	Hanifen	B	Hanifen	1,750	2.50000

The Board also does not appear to have followed any of the alternate procedures articulated in the prospectus for securities with no public market. For example, the June 30, 1994 valuation of \$1.50 does not reflect actual or proposed third-party transactions, since on the same day Katz had purchased Premier shares for \$1.25 as part of the manipulative scheme. Any accurate appraisal valuation of the Premier shares would have to have taken into account “events occurring since the purchase of the stock.” No event indicating improved performance or prospects for Premier had occurred since the Fund’s acquisition of the shares. As discussed earlier in connection with the manipulation charges, Premier operated at a loss throughout 1994.<sup>41</sup> Similarly, the June 30, 1994 reported value does not reflect the cost to the Fund of the Premier securities, since all the Premier shares owned by the Fund as of that date had been purchased at \$1.00 a share. In fact, the periodic reports through June 30, 1995 consistently report values above Premier’s cost.

There is no contemporaneous evidence in the record showing how Respondents arrived at the Premier valuations.<sup>42</sup> The only explanations available are those given in Respondents’ testimony and pleadings. These materials assert variously that the Board met every quarter either in person or by telephone to discuss the valuations (Calandrella’s testimony), that perhaps they did not meet every quarter (testimony of Calandrella and Powell), that the Board “sometimes” considered factors such as the restricted status of shares (Powell’s testimony), that they never considered the restricted status as significant because of the illiquidity of the market for unrestricted shares (Rockies Respondents’ pleadings on appeal), that the Board “fair valued” Premier by looking at Premier’s operating results (testimony of Calandrella and Powell; Rockies Respondents’ pleadings on appeal), and that the Board did not “fair value” Premier because once Calandrella showed the Board a “market price” for Premier, that was the “end of the discussion” (Thygesen’s testimony). The Board adopted Calandrella’s recommended valuations consistently (Thygesen’s testimony). Moreover, after the misclassification of Premier securities was corrected, there was no change in the valuation procedures (Powell’s testimony).

We find that this record establishes that the Board adopted Calandrella’s proffered market price for Premier with little or no attention paid to the basis for Calandrella’s recommendations. The lack of contemporaneous records showing any discussion among the Board members of the fair value of Premier together with the characterization of the Premier value as the quoted market price and testimony indicating that Premier was valued at the market price all strongly support this

<sup>41</sup> This trend continued throughout 1995, as well.

<sup>42</sup> The only contemporaneous evidence in the record regarding the Fund’s valuation of portfolio securities are the Rockies Fund Board’s Consent Resolutions in which the Board “ratified, adopted and approved” the portfolio valuations, provided by Calandrella, to be included in the quarterly and annual filings. The Consent Resolutions contained an “Exhibit A” which listed each portfolio security and provided one or two sentences stating the security’s value, often explaining the value as the “quoted market price.” The Consent Resolutions did not reference the valuation policies. Moreover, neither the Consent Resolutions nor the Board Minutes reveal any discussions the independent directors may have had with Calandrella regarding the valuations he presented. The law judge credited the testimony of a Commission examiner who said that during a March 1994 examination Calandrella stated that the Board generally approved the valuations he submitted to them with very little discussion.



conclusion.<sup>43</sup> The inconsistency among the recollections of Calandrella, Powell, Thygesen, and the theories in the Rockies Respondents' pleadings further suggest post-hoc efforts to rationalize what was in reality a cursory and inconsistent valuation process.

The valuation of Premier at the market price resulted in the Premier valuations being materially overstated. The Board's valuation policy disclosed in the prospectus, as well as Accounting Series Release ("ASR") 113, require that restricted securities be valued at a discount from the market price for unrestricted securities.<sup>44</sup> The prospectus defines the valuation of market price for unrestricted securities as the bid price. We find that, pursuant to the Fund's disclosed valuation policies, the Premier shares should have been valued, at a minimum, at a discount from the bid price. We further find that the discount should have been substantially below the bid price.

ASR-113 cautions that there is "no automatic formula" by which to value restricted securities. However, ASR-118,<sup>45</sup> in providing further guidance, states:

The directors should take into consideration all indications of value available to them in determining the "fair value" assigned to a particular security. The information so considered together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decisions should be documented in the minutes of the directors' meeting and the supporting data retained for the inspection of the company's independent accountant.

Consideration of factors such as the poor financial condition of Premier and the uncertainty of the company's survival should have informed the Board's valuation process. Moreover, in many instances, Premier was valued at prices substantially higher than the Fund's own recent acquisition costs, even though no new developments justified appreciation in that value. These factors should have caused the Board to question the validity of the market prices it was using as an indicator of the value of Premier.<sup>46</sup>

The valuation of Premier, a substantial holding of the Fund, was important information for potential investors in the Fund. By overvaluing its Premier holdings, the Rockies Respondents distorted the actual performance of the Fund. We reject the Rockies Respondents' contention that the misrepresentations were not material because no actual harm to investors occurred. The record evidence does not establish that any harm occurred to investors, but we need not show actual reliance by and harm to investors to find a material misrepresentation.<sup>47</sup> Accordingly, we find that the overvaluation of Premier restricted shares was material.

We find that the Rockies Respondents' conduct evidenced a reckless disregard for the accuracy of the valuations of Premier reported in the Fund's periodic reports. We have already found that Respondents showed a reckless disregard for the correct classification of Premier stock, and the classification has a significant impact on the proper valuation method.

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<sup>43</sup> This conclusion holds true even after the misclassification of Premier as unrestricted was corrected, and the term "quoted market price" was not used in the Forms 10-Q and 10-K, since the only record evidence suggests that there was no change in valuation methodology at this point.

<sup>44</sup> ASR-113 states that "extraordinary circumstances" may provide an exception to this requirement. Respondents argue that Premier's thinly traded market constituted such an extraordinary circumstance. We disagree. Many companies have thinly traded markets, especially in the over-the-counter market.

<sup>45</sup> ASR-118 at 5.

<sup>46</sup> Robert F. Lynch, 46 S.E.C. 5 (1975) (finding the valuation of restricted securities at the price of free trading securities to be fraudulent). Moreover, even the market price for Premier was artificially inflated for much of the period at issue due to Calandrella's manipulative conduct. Thygesen and Powell, who were not charged with liability for the manipulation, bear no responsibility for the extent to which Premier was overvalued due to that scheme. As discussed in the text, however, Premier was substantially overvalued even assuming the market prices were valid.

<sup>47</sup> *Graham v. SEC*, 222 F.3d 994, 1001 n.15 (D.C. Cir. 2000); *Schellenbach v. SEC*, 989 F.2d 907, 913 (7th Cir. 1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985).



Moreover, as discussed above, the entire valuation process appears to have been haphazard, following no consistent methodology.<sup>48</sup>

The Rockies Respondents contend that, because the Premier stock was so illiquid, it was reasonable to value the restricted and unrestricted shares similarly. However, ASR-118 indicates that, where a market for a security is thinly traded, market quotes are not “readily available” for purposes of valuation, and should not be used. Moreover, the testimony at the hearing of the Fund’s auditor, Carroll Wallace, and the Rockies Respondents’ expert witness, Clarence Hein, a CPA and managing partner of Hein & Associates, LLP, does not advance the Rockies Respondents’ cause. Neither Wallace nor Hein reviewed written documentation supporting the Fund’s arrival at its Premier valuations. Wallace relied on conversations he claims to have had with Calandrella about what the Board considered, but as we have seen, Calandrella’s version of events differs from that of his fellow Board members.<sup>49</sup> Hein merely reviewed the Fund’s Forms 10-Q and 10-K as well as Calandrella’s investigative testimony in determining that valuations at the unrestricted share bid price or between the unrestricted bid and ask prices were reasonable.<sup>50</sup>

Thus we find that the Rockies Respondents’ valuations of Premier securities, which significantly overstated the Fund’s value and performance, were material misrepresentations made with scienter in willful violation of Exchange Act Section 10(b) and Rule 10b-5.

### C. Ownership of Premier Shares Acquired in the 1995 Private Placement

In the Form 10-Q filed by the Fund for the quarter ended September 30, 1995, the Fund reported ownership of 200,000 shares of Premier offered as part of a private placement. The purchase was not authorized by Premier’s Board of Directors until November 15, 1995, and the Fund did not pay for or sign a written contract for the shares until December 1995.<sup>51</sup> The Division alleges that claiming ownership of the shares in September 1995 was a fraudulent misrepresentation for which the Fund and Calandrella are liable.

The Fund and Calandrella claim that it was proper to include the 200,000 shares as assets in the 1995 third quarter Form 10-Q because the Fund had a valid oral agreement with Premier to purchase the shares as early as September 1995. They point to a document entitled Investment Term Sheet/Redwood MicroCap Fund, Inc. (“Investment Term Sheet”).<sup>52</sup> This document sets forth an agreement between Redwood and Premier for Redwood to purchase one million Premier shares of an anticipated private placement at a price of \$.25 per share.<sup>53</sup> The agreement makes reference to “other investors.”

Both J. Power and Neuman testified that J. Power negotiated this agreement on behalf of a group of investors which included the Rockies Fund. The Subscription Agreement for the 200,000 shares signed by Calandrella on behalf of the Fund on December 19, 1995 states that it is made pursuant to the Investment Term Sheet “dated as of September 30, 1995” and that, by executing the Subscription Agreement, the Fund “shall be deemed to be a party to the [Investment Term Sheet] as an associate of Redwood ...” The Fund made payment for the shares by a check dated December 14, 1995. The stock certificate for the 200,000 shares was dated January 22, 1996.

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<sup>48</sup> We note, furthermore, that Calandrella knew that the market price for Premier that he submitted to his fellow Board members was an artificial price because of the manipulative scheme engaged in by Calandrella and J. Power.

<sup>49</sup> We recently disciplined Wallace pursuant to our Rule of Practice 102(e), 17 C.F.R. § 201.102(e), finding that he recklessly violated Generally Accepted Auditing Standards in his 1994 and 1995 audits of the Fund. Carroll A. Wallace, Exchange Act Rel. No. 48372 (Aug. 20, 2003), SEC Docket.

<sup>50</sup> Because we do not find the testimony of Wallace and Hein to be particularly useful, we need not address the Rockies Respondents’ contention that the law judge improperly discounted Hein’s testimony because he has a disciplinary history and because he was associated with Premier as its auditor.

<sup>51</sup> Whether ownership of other blocks of Premier shares was reported properly was at issue in the initial proceeding. The law judge’s conclusions about the ownership of these other blocks are no longer contested.

<sup>52</sup> Although J. Power’s signature on behalf of Redwood is dated November 11, 1995, the printed date on the first page of the agreement is September 30, 1995.

<sup>53</sup> Although this was the price the Fund paid for its shares, the Fund’s reported value of its Premier shares for the third quarter of 1995 was \$0.875. Thus, the effect of the purchase was to transform a \$50,000 cash asset (the total purchase price of the 200,000 shares) to a \$175,000 securities asset (the total reported value of those shares).

ASR-113 provides guidance concerning when an investment company may claim ownership of restricted securities in its portfolio.<sup>54</sup> ASR-113 states that an investment company may make such a claim once it has an enforceable right to demand the securities from the seller. The release further provides that, on the date the investment company and the seller orally agree to the purchase price and amount of securities, “there would not seem to be any enforceable right of the investment company to demand the securities,” since in most states there is no enforceable right absent a valid written agreement.

The Fund and Calandrella argued below that, in 1995, Colorado law<sup>55</sup> provided that an agreement for the sale of securities is enforceable only when, “there is some writing signed by the party against whom enforcement is sought ... sufficient to indicate that a contract has been made for a sale of a stated quantity of described securities at a defined or stated price,” or, for an oral agreement, if such a writing is received within a reasonable time thereafter by the party against whom the enforcement is sought.<sup>56</sup> The implication of their argument is that their purported oral agreement meets the requirements of this statute, presumably because the written agreement signed by the Fund in December was received within a reasonable time after the oral agreement.

We do not need to reach the issue whether, under Colorado law, a two-month lapse meets the “reasonable time thereafter” standard, because the Respondents’ argument fails for another reason. Although the Investment Term Sheet specifies a purchase price and an aggregate amount of one million shares to be purchased by the group of investors, and although both J. Power and Neuman testified that the Fund was understood to be part of that group as early as September 1995, there is no evidence in the record that an oral agreement was made on the Fund’s behalf in September to purchase a specific amount of the Premier private placement shares. To the contrary, Neuman testified that the list identifying the investors and the amounts to be purchased by each “probably” did not exist at the time the Investment Term Sheet was circulated and signed. Neuman stated that in situations where Redwood and the Fund and other parties identified investment opportunities such as the Premier purchase, it “was a matter of routine practice” to get an agreement on behalf of the group circulated and signed and to develop later the specific amount of the total that each of the participants would buy. This testimony compels the conclusion that as of September 30, 1995, the date on the front of the Term Investment Sheet, there was no agreement, oral or otherwise, as to the specific portion of the one million Premier shares to be purchased by the Fund.

ASR-113 and the Colorado law cited by the Fund and Calandrella are both unambiguous that, in the limited circumstances in which an oral agreement might be deemed enforceable by a party, it must be specific as to both price and amount. The Respondents’ purported oral agreement does not meet this test. ASR-113 is clear that, if there is no enforceable agreement to purchase securities in place, an investment company may not claim ownership of such securities. Accordingly, we conclude that the statement in the Fund’s Form 10-Q for the quarter ending September 30, 1995 that it owned the 200,000 Premier shares from the December private placement was false.

The misstatement was material. The reported value of 200,000 shares, \$175,000, was 46% of the Fund’s total Premier holdings of \$377,781 and 11% of the Fund’s total reported investments in securities of \$1,583,430.

Calandrella acted with scienter in stating in the Form 10-Q for the quarter ending September 30, 1995 that the Fund owned the 200,000 shares as of that date. Calandrella personally participated in the transactions to purchase the Premier shares, and knew that no agreement had been reached as of September 30, 1995, as to the specific amount of securities that the Fund would purchase from the one million share private placement. His participation in preparing and signing

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<sup>54</sup> ASR-118 provides further guidance for unrestricted securities purchased or sold other than through a broker-dealer, stating that the date an investment company obtains an enforceable right to demand securities is “difficult to determine” and suggesting that, in instances where a question may arise about the propriety of an ownership claim, an investment company should obtain a legal opinion to be made available to the company’s independent accountant. The Rockies Fund did not secure such an opinion.

<sup>55</sup> Colo. Rev. Stat. § 4-8-319, repealed by Laws 1996, S.B. 96-132 § 2, effective July 1, 1996.

<sup>56</sup> Thus, arguably, an oral agreement meeting the requirements of then-existing Colo. Rev. Stat. § 4-8-319 would fall within the narrow exception contemplated by ASR-113 for oral agreements to purchase securities sanctioned under state law. On appeal, the Fund and Calandrella argue that the law judge erred by ignoring the testimony of J. Power and Neuman that an oral agreement existed. The law judge did, in fact, find that no oral agreement existed on the grounds that the only evidence to support it was Calandrella’s “self-serving” testimony.

the September 1995 Form 10-Q containing the misstatement was, at a minimum, reckless. Accordingly, we find that the Fund and Calandrella willfully violated Exchange Act Section 10(b) and Rule 10b-5.

## V.

The Rockies Fund is charged with violating, and Calandrella, Powell, and Thygesen are charged with aiding and abetting and causing, the Fund's violations of Exchange Act Section 13(a)<sup>57</sup> and Rules 12b-20, 13a-1, and 13a-13 thereunder<sup>58</sup> in the filing of the Fund's quarterly and annual reports at issue here. Exchange Act Section 13(a) and Exchange Act Rules 13a-1 and 13a-13 require issuers to file quarterly and annual reports. The obligation to file these reports includes an obligation that the filings be accurate.<sup>59</sup> The rules require that the reports comply with Regulation S-X,<sup>60</sup> which in turn requires that financial statements be prepared in conformity with GAAP. Rule 12b-20 requires an issuer to provide any additional information in the reports necessary in order to make the reports not misleading.

Based on our findings above that the Fund's Form 10-K and Form 10-Q filings contained materially false and misleading information about its Premier holdings, and that the valuations in the financial statements were not in accordance with GAAP, we find that the Fund willfully violated Exchange Act Section 13(a) and Rules 12b-20, 13a-1 and 13a-13. We further find that Calandrella, Powell, and Thygesen willfully aided and abetted these violations based on our findings above with respect to their scienter.<sup>61</sup> Because we find Calandrella, Thygesen, and Powell aided and abetted the violations, they were necessarily a cause of the violations.<sup>62</sup>

## VI.

The final violation, charged against Calandrella, involves the Fund's purchase of 85,000 Premier shares from Stanz, the former chief operating officer of Premier. The law judge found that Calandrella willfully violated Investment Company Act Section 57(k)(1) by accepting compensation for the Fund's purchase of Premier securities and that Calandrella violated Exchange Act Section 10(b) and Rule 10b-5 thereunder by failing to disclose this compensation to the Fund's independent directors. On behalf of the Fund, he entered into an agreement to pay Stanz \$85,000 for 85,000 Premier shares in return for Stanz's agreement to forgo a potential legal claim against Calandrella and Premier, without disclosing the facts to the independent members of the Fund's Board or any other independent representative of the Fund.

Stanz had several grievances against Calandrella. Stanz objected to Calandrella's having made Greenberg chief executive officer of Premier. Stanz did not think Greenberg was performing competently. In addition, Stanz claimed that Calandrella, at the time of the Impostors acquisition, had misrepresented the condition of Silver State Casinos, Premier's precursor, by failing to disclose information about the company's liabilities which prevented Premier from acquiring a Nasdaq listing.

As a result of these disputes, Stanz requested, among other things, that Premier repurchase his 85,000 shares. In an August 1994 letter, Calandrella told Stanz that Premier was unable to repurchase Stanz's outstanding shares at that time, but that "certain members of the 'Rockies' group have an interest in acquiring additional shares of Premier at an agreeable price." On October 4, 1994, Stanz wrote Neuman threatening legal action against Premier and Calandrella. On October 13, 1994, Stanz, the Rockies Fund, Premier, Redwood, and J. Power entered into a settlement agreement

<sup>57</sup> 15 U.S.C. § 78m(a).

<sup>58</sup> 17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-3.

<sup>59</sup> See SEC v. IMC Int'l Inc., 384 F. Supp. 889, 893 (N.D. Tex. 1974), aff'd, 505 F.2d 733 (5th Cir. 1974) (Table, No. 74-1170).

<sup>60</sup> 17 C.F.R. § 210.

<sup>61</sup> Liability for aiding and abetting a violation requires that a principal committed a primary violation, that the aider and abettor provided substantial assistance to the primary violator, and that the aider and abettor rendered such assistance knowingly or recklessly. See *Graham v. SEC*, 222 F.3d 994, 1000 (D.C. 2000). Thygesen and Powell were not charged with aiding and abetting the misstatements concerning the ownership of the 200,000 shares of Premier in the September 30, 1995 Form 10-Q; our finding that they aided and abetted Premier's violations does not encompass that particular misstatement.

<sup>62</sup> Sharon M. Graham, 53 S.E.C. 1072, 1085 n.35 (1998), aff'd, 222 F.3d 994 (D.C. Cir. 2000).

that provided, among other things, that the Fund would buy from Stanz 85,000<sup>63</sup> restricted Premier shares for \$85,000,<sup>64</sup> and that the parties would sign a Mutual General Release (attached to the October 13 agreement as Exhibit C).<sup>65</sup> The Mutual General Release, signed by the parties on October 24, 1994, released all of the parties from liability to each other from actions arising out of, among other things, Premier's acquisition of Impostors and Premier's purchase of Mirage. Calandrella signed the settlement agreement and the release on behalf of the Fund. He did not consult Powell or Thygesen regarding the transaction.

Investment Company Act Section 57(k)(1)<sup>66</sup> makes it unlawful for any person associated with a BDC, other than a broker or underwriter, "to accept from any source any compensation (other than a regular salary or wages from the business development company) for the purchase or sale of any property to or for such business development company." Calandrella used Fund assets to reach a settlement with Stanz concerning Stanz's claims against Calandrella. The release from liability was a form of compensation to Calandrella; it benefitted Calandrella by ensuring that he would not be held liable to Stanz in the event Stanz sued Calandrella. Accordingly, we conclude that Calandrella willfully violated Investment Company Act Section 57(k)(1).

To find that Calandrella violated Exchange Act Section 10(b) and Rule 10b-5, we must find that Calandrella's failure to disclose the existence of his compensation to Thygesen and Powell was material. The essence of the information Calandrella failed to disclose was that he had a conflict of interest in entering into this transaction on behalf of the Fund. The independent members of the Fund's Board stand in the place of the investors in the Fund, and a reasonable investor would want to know that an investment decision was made on behalf of the Fund by someone with a self-interest in such decision. Accordingly, we find that Calandrella's failure to disclose his compensation was material.<sup>67</sup>

Calandrella contends that an agreement to purchase Stanz's shares had been made prior to his dispute with Stanz. He also argues that the purchase was a good investment for the Fund. These arguments are beside the point. The issues are whether Calandrella received compensation for the purchase and whether the Fund's Board was properly informed of the benefit to Calandrella from the Fund's purchase.

In addition, Calandrella contends that the settlement was not a form of compensation, because Calandrella was not truly threatened by litigation—since Stanz's legal claims were without merit. We disagree. Neither we nor Calandrella can know the outcome of litigation that did not take place. However, by getting Stanz to release him from liability, Calandrella avoided the risk that he might lose any such litigation. The avoidance of that risk had value to Calandrella.<sup>68</sup>

Accordingly, we find that Calandrella received compensation for the Fund's purchase of Stanz's 85,000 shares of Premier in willful violation of Section 57(k)(1) of the Investment Company Act and that he failed to disclose the compensation to the independent members of the Board in willful violation of the antifraud provisions of the Exchange Act.

<sup>63</sup> Stanz's 85,000 shares were derived from: (1) half of the 35,000 (17,500) shares Mirage had acquired in the 1994 Private Placement (which Stanz received as half owner of Mirage); and (2) half of the 135,000 (67,500) shares Premier had agreed to pay Mirage to acquire Mirage. Because Premier ultimately paid only 100,000 Premier shares to acquire Mirage, Stanz had merely 50,000 shares to sell. Power Curve and Calandrella gave a total of 17,500 shares to the Fund to make up the difference.

<sup>64</sup> The Fund made payment for the shares by checks dated October 4, 1994, and December 19, 1994.

<sup>65</sup> The settlement agreement was signed by Calandrella, for the Rockies Fund and for himself individually, by Greenberg, for Premier, by J. Power, for Redwood and for himself individually, and by Stanz, for himself.

<sup>66</sup> 15 U.S.C. § 80a-56(k)(1).

<sup>67</sup> *Cf. Goldberg v. Meridor*, 567 F.2d 209, 219 (2d Cir. 1977) (finding that the complaint sufficiently stated a Section 10(b) claim where a member of management did not disclose a conflict of interest in a corporate decision); *Monetta Financial Services, Inc., Securities Exchange Act Rel. No. 48001* (June 9, 2003), 80 SEC Docket 1437, 1448, appeal pending, No. 03-3073 (7th Cir.) (explaining that where a conflict of interest exists which could compromise the judgment of an independent director, the conflict initially should be disclosed and approved by the other independent directors).

<sup>68</sup> Calandrella insists that the execution of the release was at the behest of Stanz, who initially requested the release, and Neuman, who recommended releases as a general practice. Calandrella argues that Neuman's knowledge of the agreement, and Neuman's obligation to "look out for the Fund's interests" satisfied the need for independent review of the transaction. Section 57(k)(1) prohibits the receipt of compensation regardless of whether counsel or anyone else independently reviewed the transaction for which compensation was received. For purposes of the Rule 10b-5 violation, the issue is disclosure to the Fund's independent board members. Nothing in the record suggests that Calandrella had a basis for believing that Neuman, or anyone else, told Thygesen and Powell about the litigation release Calandrella received in exchange for the Fund's purchase of the shares.

## VII.

Respondents make a variety of evidentiary and procedural arguments. For the reasons set forth below, we conclude that their arguments have no merit.

### Evidentiary Issues

Respondents contend that the law judge improperly admitted hearsay evidence proffered by the Division in the form of transcripts of investigative interviews of Nathan Katz, by Commission staff members, and of Randal Butchard, conducted by staff from the British Columbia Securities Commission.<sup>69</sup> We have held repeatedly that hearsay is admissible in administrative proceedings and may even constitute the sole basis for findings of fact.<sup>70</sup> We apply a multi-factor test to evaluate the probative value, reliability and fairness of its use, including: the possible bias of the declarant; the type of hearsay at issue; whether the statements are signed and sworn to; whether the statements are contradicted by direct testimony; whether the declarant was available to testify; and whether the hearsay is corroborated.<sup>71</sup>

The testimony at issue meets a number of these factors, and we therefore find it was properly admitted. Katz's testimony was sworn and Butchard's compelled pursuant to a summons. The hearsay is corroborated by the testimony of Calandrella and J. Power.<sup>72</sup> In addition, Butchard and Katz, both residing outside of the United States, were unavailable to testify at the hearing.

Respondents argue that they should have been permitted to supplement the record with an affidavit or interview of Butchard "placing in context" the statements he made in his investigative interview. The law judge denied the introduction of such an affidavit, questioning the reliability of recollections about statements Butchard made over two years ago. We find nothing improper in this determination.

Respondents further contend that they were denied the opportunity to depose a former Commission staff member, James Nearen, to determine whether the charges brought against Calandrella were the result of Nearen's personal grudge. To dispute this claim of staff bias, the Division introduced an affidavit of Daniel F. Shea, Regional Director of the Central Regional Office, dated June 30, 1998, declaring that Nearen had no involvement whatsoever in either the examination or subsequent enforcement investigation of this matter. Given this affidavit, we find that any purported bias of Nearen would not be relevant to the issue of the fairness of this proceeding.<sup>73</sup>

Respondents claim that the law judge incorrectly discounted the direct testimony of several witnesses.<sup>74</sup> Credibility determinations by a law judge are entitled to great weight and can be overcome only where they are inconsistent with the weight of the record evidence.<sup>75</sup> Here, the law judge's conclusions are supported by the record as a whole. We see no basis to disagree with them.

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<sup>69</sup> This interview was conducted pursuant to a Memorandum of Understanding between the Commission and the British Columbia Securities Commission.

<sup>70</sup> Harry Glikzman, Exchange Act Rel. No. 41628 (Dec. 20, 1999), 71 SEC Docket 892, 901, aff'd, 24 Fed. Appx. 702 (9th Cir. 2001).

<sup>71</sup> Charles D. Tom, 50 S.E.C. 1142, 1145 (1992).

<sup>72</sup> Respondents argue that Katz's transcript is not reliable because of the animus which existed between Calandrella and Katz. Calandrella, however, corroborated all of the significant relevant statements made by Katz.

<sup>73</sup> We also reject Respondents' contention that they were wrongly denied the introduction of evidence regarding how other BDCs value their portfolio holdings. The practice of other BDCs is not helpful in addressing the issue of the accuracy of Respondents' valuations. See *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 274 (3d Cir. 1998) (finding that universal industry practices may be fraudulent).

<sup>74</sup> Respondents also complain that the law judge did not weigh the evidence in the record correctly, that she placed too much importance on the deposition transcripts of Katz and Butchard, and that she did not adequately articulate how she evaluated all of this evidence to arrive at her legal conclusions. We conduct a *de novo* review of the record and make our own findings of fact. Keith Springer, Exchange Act Rel. No. 45944 (May 16, 2002), 77 SEC Docket 2087, 2089 n.4; Kenneth C. Krull, 53 S.E.C. 1101, 1109 (1998), aff'd, 248 F.3d 907 (9th Cir. 2001).

<sup>75</sup> Keith Springer, Exchange Act Rel. No. 45439 (Feb. 13, 2002), 76 SEC Docket 2726, 2734-35.



## Estoppel

Respondents argue that, because the Division took an inconsistent position in the related proceeding against the Fund's auditor, Carroll Wallace, the Division is estopped from asserting manipulation charges here. Respondents claim that the Division argued in the Wallace proceeding that Calandrella and J. Power were not cooperating during the time of their alleged manipulation and that, therefore, the Division cannot argue that they in fact cooperated for the purposes of proving manipulation in this proceeding. Respondents point to a four-page portion of the Wallace transcript in which the Division suggests that J. Power and Calandrella, because they were not getting along, did not own a control block of Premier stock. The argument that there was such a control block was important to Wallace, because, Wallace alleged, it meant that the valuation of the stock could include a "control premium."

In order for a governmental entity to be estopped from arguing a particular position, the position, "(1) ... must be clearly inconsistent with the earlier position; (2) the facts at issue should be the same in both cases; and (3) the party to be estopped must have convinced the first court to adopt its position."<sup>76</sup> None of these factors has been established here. The Division did not argue inconsistent positions or file inconsistent pleadings in these two proceedings. The cited questioning of Calandrella by the Division was solely for the purpose of challenging testimony by Calandrella on direct examination that Calandrella had a control block of Premier. Although many facts at issue here were part of the record in the Wallace matter, manipulation of Premier stock was not at issue, and no evidence concerning manipulation was adduced at the hearing. Moreover, the Commission, in its opinion in Wallace, did not take a position on the issue of control or on whether Calandrella and J. Power were cooperating for the purposes of proving manipulation. Therefore, we find that the Division did not make an argument or take a position that estops it from pursuing manipulation charges in this proceeding.

Respondents argue that the law judge improperly denied their introduction of evidence concerning communications they had with Commission staff members in connection with a Spring 1994 audit of the Fund. Respondents claim these documents show that the staff never raised concerns about the Fund's valuation of its portfolio holdings as part of the examination. Even if the examination staff did not find improprieties in the Fund's valuation procedures, the Commission would not be estopped from instituting proceedings against the Fund and its directors for violations regarding the valuations. We have held that, "A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation."<sup>77</sup>

## VIII.

Respondents argue that the sanctions imposed by the law judge are excessive and unjustified, and more severe than those imposed in similar cases.

We have consistently held that "the appropriate remedial action depends on the facts and circumstances of each particular case, and cannot be precisely determined by comparison with action taken in other cases."<sup>78</sup> Instead, in order to determine appropriate sanctions, we consider factors such as: the egregiousness of the violations, the isolated or recurrent nature of the violations, the degree of scienter involved, the sincerity of respondents' assurances against future violations, respondents' recognition of the wrongful nature of their conduct, and respondents' opportunity to commit future violations. In determining whether to issue cease-and-desist orders, we also consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings.<sup>79</sup>

Respondents' conduct in this case was egregious. The Rockies Respondents engaged in serious misconduct when they made material misstatements in periodic reports. Similarly, Calandrella and J. Power engaged in serious misconduct when they manipulated the price of Premier. Respondents have not made assurances against future violations. Moreover, Respondents' occupations present opportunities for future violations.

<sup>76</sup> *United States v. Hook*, 195 F.3d 299, 306 (7th Cir. 1999), citation omitted.

<sup>77</sup> *William H. Gerhauser, Sr.*, 53 S.E.C. 933, 940 (1998) (quoting *Variable Inv. Corp.*, 46 S.E.C. 1352, 1354 n. 6 (1978)).

<sup>78</sup> *Patricia H. Smith*, 52 S.E.C. 346, 348 (1995). *See also Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973).

<sup>79</sup> *KPMG Peat Marwick LLP*, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 74 SEC Docket 384, 436, reh'g denied, Exchange Act Rel. No. 44050 (Mar. 8, 2001), 74 SEC Docket 1351, petition denied, 289 F.3d 109 (D.C. Cir. 2002).

We reject Respondents' contention that their reliance on the opinions of the Fund's independent auditor and legal counsel should mitigate the sanctions imposed against them. We see no reason that the auditor's review of the Fund's reports should mitigate our view of Respondents' culpability. Given the recklessness with which the relevant Forms 10-Q and 10-K were prepared by Respondents, they can take no comfort now that the Fund's auditor failed to spot their mistakes. As for the Fund's reliance on counsel, Respondents proffered no evidence that they asked for any advice or received a legal opinion about the propriety of particular actions.<sup>80</sup> Accordingly we find that it is in the public interest to bar Calandrella from associating with or acting as an affiliated person of an investment company and to bar Thygesen and Powell from associating with or acting as an affiliated person of an investment company, with the right to reapply in three years. We further find it is in the public interest to order that all of Respondents cease and desist from committing or causing violations of the statutes they were found to have violated or to have aided and abetted.

We further believe that the public interest warrants a substantial civil money penalty against Calandrella, Thygesen, and Powell.<sup>81</sup> Respondents argue that the amount of the civil penalty is excessive and that the violations do not warrant third-tier penalties. Investment Company Act Section 9(d)<sup>82</sup> authorizes the Commission to impose a civil money penalty when such penalty is in the public interest. Once a public interest determination is made, Section 9(d)(2)<sup>83</sup> establishes a three-tier system for assessing the amount of the penalty to be imposed. The first tier provides for a maximum of \$5,000 for each act or omission. The second tier provides for a maximum of \$50,000 for each act or omission if the conduct involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. The third tier provides for a maximum of \$100,000 for each act or omission if the conduct (a) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and (b) resulted in, or created a significant risk of, substantial loss to others or resulted in substantial pecuniary gain to the person who committed the act or omission.

As set forth in this opinion, we find that Calandrella, Thygesen, and Powell's conduct involved fraud, deceit, manipulation, and a deliberate or reckless disregard of the antifraud provisions of the securities laws, and the conduct created a significant risk of loss to others. The law judge imposed a civil penalty of \$500,000 on Calandrella (\$50,000 for each misstated filing and \$100,000 for manipulation) and a penalty of \$160,000 each on Thygesen and Powell (\$20,000 for each misstated filing). We agree with the law judge's determination to impose third-tier penalties for the violations in which each Respondent was involved.

An appropriate order will issue.<sup>84</sup>

By the Commission (Chairman Donaldson and Commissioner Glassman and Atkins); Commissioners Goldscmid and Campos, not participating.

On the basis of the Commission's opinion issued this day, it is

ORDERED that Stephen G. Calandrella be, and he hereby is, barred from serving or acting as an employee, office, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and it is further

ORDERED that Charles M. Powell and Clifford C. Thygesen are barred from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, subject to a right to reapply after three years; and it is further

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<sup>80</sup> A valid defense of reliance on counsel must be predicated on a showing of the four elements: (i) a request for advice on the legality of a proposed action; (ii) full disclosure of the relevant facts; (iii) receipt of advice that the action to be taken will be legal, and (iv) reliance in good faith on counsel's advice. *SEC v. Savoy Indus., Inc.*, 665 F.2d 1310, 1314 n. 28 (D.C. Cir. 1981). Respondents failed to prove any of these elements.

<sup>81</sup> The Division did not seek a civil money penalty against the Fund.

<sup>82</sup> 15 U.S.C. § 80a-9(d).

<sup>83</sup> 15 U.S.C. § 80a-9(d)(2).

<sup>84</sup> We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.



ORDERED that The Rockies Fund, Inc. cease and desist from committing or causing any violations or future violations of Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, and 13a-13; and it is further

ORDERED that Stephen G. Calandrella cease and desist from committing or causing any violations or future violations of Section 10(b) of the Exchange Act and Rule 10b-5, and of Section 57(k)(1) of the Investment Company Act of 1940; and from causing any violations or future violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13; and it is further

ORDERED that Charles M. Powell and Clifford C. Thygesen cease and desist from committing or causing any violations or future violations of Section 10(b) of the Exchange Act and Rule 10b-5; and from causing any violations or future violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13; and it is further

ORDERED that John C. Power shall cease and desist from committing or causing any violations or future violations of Section 10(b) of the Exchange Act and Rule 10b-5; and it is further

ORDERED that Stephen G. Calandrella is assessed a civil money penalty of \$500,000; and it is further

ORDERED that Charles M. Powell and Clifford C. Thygesen each are assessed a civil penalty of \$160,000.

Respondents payments of civil money penalties shall be: (i) made by United States postal money order, certified check, bank cashier's check, or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) mailed or delivered by hand to the Office of Financial Management, Securities and Exchange Commission, 6432 General Green Way, Alexandria, VA 22312 within thirty days of the date of this order; and (iv) submitted under cover letter which identifies Respondents in this proceeding, and the file number of this proceeding. A copy of this cover letter and check shall be sent to Robert M. Fusfeld, Counsel for the Division of Enforcement, Securities and Exchange Commission, Central Regional Office, 1801 California Street, Suite 4800, Denver, Colorado 80202-2648.

By the Commission.

## IN THE MATTER OF FT INTERACTIVE DATA

Release Nos. IA-2201; IC-26291

Administrative Proceeding File No. 3-11352

December 11, 2003

ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940

### I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest to institute public administrative and cease-and-desist proceedings pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against FT Interactive Data (“Interactive Data” or “Respondent”), formerly known as Interactive Data Corporation and Muller Data Corporation.

### II.

In anticipation of the institution of these proceedings, Respondent has submitted an offer of Settlement (the “offer”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940.

### III.

On the basis of this Order and Respondent’s offer, the Commission finds that:<sup>1</sup>

#### A. Respondent

1. Respondent, FT Interactive Data, formerly known as Interactive Data Corporation and Muller Data Corporation, is the major operating division of Interactive Data Corporation, a global provider of financial and business information to institutional and individual investors. Interactive Data Corporation, in turn, is a Delaware corporation headquartered in Bedford, Massachusetts with offices in New York and elsewhere. Respondent has been registered with the Commission as an investment adviser since March 3, 1998, and provides valuations for fixed income and equity securities to investment companies, investment advisers, broker-dealers, insurance companies, banks, trust companies, and other institutional investors (among others). In addition, Respondent is a “NRMSIR” (Nationally Recognized Municipal Securities Information Repository), or an entity designated by the Commission to serve as a clearinghouse for official statements, interim and annual financial statements, continuing disclosure documents and material event notices pertaining to municipal securities. Respondent is one of only a few pricing services that regularly values high-yield municipal bonds. On July 29, 1999, Muller Data Corporation, a wholly owned subsidiary of Interactive Data Corporation, merged into Interactive Data Corporation. Muller Data was a Delaware corporation engaged in analyzing and collecting financial information and pricing securities.

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<sup>1</sup> The findings herein are made pursuant to Respondent’s offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

## B. Other Relevant Entities

1. **Heartland Advisors, Inc.** (“Heartland Advisors”), was founded in 1982 and maintains its principal place of business in Milwaukee, Wisconsin. Heartland Advisors has been dually registered with the Commission since June 1983 as an investment adviser and as a broker-dealer, and provides investment advisory and brokerage services to individuals, institutions and retirement plans. In addition, Heartland Advisors manages the mutual fund portfolio series of Heartland Group, Inc. (“Heartland Group”), subject to the authority and oversight of Heartland Group’s Board of Directors, and serves as the principal underwriter of Heartland Group’s securities. During the period relevant to this Order, Heartland Group offered seven different series of mutual funds, including three equity and four fixed income funds. On March 21, 2001, the Commission obtained an order of permanent injunction and other equitable relief against Heartland Group for violations of Sections 30(b)(2), 30(e) and 30(g) of the Investment Company Act and Rules 30b2-1, 30d-1(a) and 30d-1(c) promulgated thereunder, which froze the assets of Heartland Group’s High Yield Municipal Bond Fund (“High Yield Fund”), Short Duration High-Yield Municipal Fund (“Short Duration Fund”), and Taxable Short Duration Municipal Bond Fund (“Taxable Fund”). In addition, a receiver was appointed over the three funds, who was authorized to suspend redemptions in, manage, and, if appropriate, liquidate the three funds.

## C. Background

1. This matter arises from Heartland Advisor’s fraudulent pricing of certain bonds held in the High Yield and Short Duration Funds (collectively, the “Funds”) beginning in Spring 2000. During the period relevant to this Order, Heartland Advisor’s Pricing Committee was charged with oversight of the valuation of the Funds’ portfolio securities, and implementation and administration of the Board of Directors’ procedures for valuing such securities. Specifically, because the Board had previously determined that market quotations for the Funds’ securities were not readily available, the pricing procedures directed the Pricing Committee to use valuations provided by Respondent as benchmarks to fair value the Funds’ securities and to determine the Funds’ daily net asset values per share (“NAVs”). Members of the Pricing Committee reviewed the valuations provided by Respondent daily. The pricing procedures also required the Pricing Committee to review Respondent’s valuations to ensure they were sufficiently timely and accurate. In those instances where the Funds’ portfolio managers believed that Respondent’s valuations did not reflect the securities’ fair value, and where such disagreements could not be resolved with Interactive Data, the pricing procedures directed the portfolio managers to submit the dispute to a quorum of the Pricing Committee for the purpose of making a final, fair value determination. Any time the Pricing Committee made a fair value determination, the Pricing Committee was required to document its reasons for doing so.
2. Respondent, in turn, provided Heartland Advisors valuations for securities based in part on information obtained from Heartland Advisors itself. Respondent knew that the valuations it provided to Heartland Advisors would be used to price the Funds’ bonds and, therefore, to calculate the Funds’ NAVs.
3. With respect to a number of bonds held in the Funds, Heartland Advisors suggested that Respondent lower the bonds’ valuations gradually in order to “smooth out” the negative impact that a precipitous drop in the bonds’ values would have on the Funds’ NAVs, and thereby protect the reported performance of the Funds in which those bonds were held. Specifically, on more than one occasion Heartland Advisors’ portfolio managers received negative information regarding particular bonds and communicated that information to Respondent. Respondent, however, failed to reduce the valuations of those bonds immediately to account for the negative information. Instead, Respondent and Heartland Advisors agreed to reduce the values of the bonds in incremental amounts over time, which improperly “smoothed out” the negative impact of the bonds’ decrease in value on the Funds’ NAVs.
4. Between March 7, 2000 and May 8, 2000, at the request of the Funds’ portfolio managers, Respondent devalued six bonds in this manner. On March 7, 2000, the carrying values Heartland Advisors assigned to these bonds, based on Respondent’s values, ranged from approximately 87 percent of par value to 98 percent of par value. Beginning on that day, and continuing through at least May 8, 2000, the carrying values of the six bonds were reduced daily in increments of .5 percentage points until the bonds’ carrying values reached 80 percent of par value. The bonds with initially lower carrying values dropped to 80 percent of par value in March 2000 while those with initially higher carrying values reached the 80 percent of par value carrying value in April or May 2000.

5. Of these six bonds, one remained at the 80 percent of par carrying value until July 2000. In July, the value of that bond was gradually reduced again by increments of .5 percentage points until it reached the price of 75 percent of par value, where it remained until September 28. The other bonds remained valued at 80 percent of par value until September 28, 2000. During approximately the same time period, the Funds' portfolio managers and Interactive Data gradually reduced the values of at least four other bonds by similar incremental amounts over time.

6. These incremental price movements were not based on any contemporaneous market or credit-related events, or other external factors affecting the individual securities, and did not reflect the portfolio managers' assessment of the bonds' fair values.

#### D. Findings

1. Based on the foregoing, Heartland Advisors willfully violated Sections 206(1) and 206(2) of the Advisers Act.<sup>2</sup> Section 206(1) prohibits an investment adviser from employing "any device, scheme or artifice to defraud any client or prospective client." Section 206(2) prohibits an investment adviser from engaging "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." Specifically, Heartland Advisors violated Sections 206(1) and 206(2) by "smoothing" the prices of certain bonds held in the Funds, as described above.

2. Respondent, in turn, caused and willfully aided and abetted Heartland Advisors' violations of Sections 206(1) and 206(2) of the Advisers Act. A respondent will be liable for aiding and abetting a primary violation of the securities laws where: (1) there exists an independent primary violation, (2) the respondent had knowledge or a general awareness that his or her role was part of an overall activity that was improper, and (3) the respondent provided substantial assistance in the commission of the primary violation. Here, Respondent knowingly provided substantial assistance to Heartland Advisors' portfolio managers in gradually decreasing the prices assigned to bonds held in the Funds, which actions constituted a primary violation of Sections 206(1) and 206(2) of the Advisers Act, as described above. Further, Respondent provided this assistance even though it knew or was reckless in not knowing that the price decreases did not reflect the fair value of the bonds and were not tied to any daily market or credit-related events that would have affected the value of the individual bonds by the same amount each day.

3. Based on the foregoing, Heartland Advisors, Inc. also willfully violated Rule 22c-1(a), promulgated pursuant to Section 22(c) of the Investment Company Act. Rule 22c-1(a) provides that no registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of or dealer in any such security shall sell, redeem, or repurchase any such security except at a price based on the current NAV of such security. Under Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder, current NAV calculations must be based on current market value or, if market quotations are not readily available, fair value as determined in good faith by the board of directors. Heartland Advisors, Inc., the investment adviser of the Funds and the principal underwriter of Heartland Group, Inc.'s securities, willfully violated Rule 22c-1(a) by selling, redeeming and repurchasing Fund shares at NAVs calculated using "smoothed" bond prices that were not based on the bonds' fair value as determined in good faith, which consequently resulted in incorrect NAVs for the Funds.

4. Respondent, in turn, caused and willfully aided and abetted Heartland Advisors, Inc.'s violation of Rule 22c-1(a) under the aiding and abetting standard set forth above. Specifically, Respondent knowingly provided substantial assistance to Heartland Advisors' portfolio managers in gradually decreasing the prices assigned to bonds held in the Funds, which actions constituted a primary violation of Rule 22c-1(a), as described above. Further, Respondent provided this assistance even though it knew or was reckless in not knowing that the daily gradual price decreases did not reflect the fair value as determined in good faith of the bonds and were not caused by any market or credit-related events affecting the value of the individual bonds.

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<sup>2</sup> "Willfully" as used in this Order means intentionally committing the act that constitutes the violation. See *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he or she is violating one of the Rules or Acts.

## E. Undertakings

1. Respondent shall provide its customers with valuations for high yield municipal bonds that are not based solely on information received from a single investment company or investment adviser customer (including any investment adviser to, or officer, employee or agent of such customer) and have been verified by information from a third party other than that customer.
2. Respondent also shall assign valuations each day to such securities based solely on objectively verifiable information derived from or clearly relevant to the market for such securities, and shall not assign valuations to such securities based on the special circumstances or needs of one of the Respondent's customers or any group of Respondent's customers. On any given day, Respondent shall provide all of its investment company and investment adviser customers with the same valuations for the same security.
3. Respondent also shall comply with the Commission's guidelines governing the fair valuation of securities for which market quotations are not readily available. Specifically, Respondent shall assign valuations to such securities based on what it believes, in good faith, buyers in the marketplace would pay for the securities in a current sale, and not based on the special circumstances or needs of the Respondent's customers. Furthermore, such valuations shall take into consideration any bids to purchase a security of which Respondent is aware, whether or not such bids are motivated by factors other than a desire to consummate a sale at fair value, such as speculation by a buyer or a seller's urgent need to raise cash. Respondent shall make reasonable efforts to ascertain from its investment company and investment adviser customers whether those customers have received any bids for the securities Respondent is valuing.
4. Respondent shall also keep written records in the format and for the period provided in Advisers Act Rule 204-2 reflecting the basis for each of its valuations, in sufficient detail to permit the Commission to evaluate Respondent's compliance with these undertakings.

## IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions specified in Respondent Interactive Data's offer.

Accordingly, it is hereby ORDERED:

- A. Pursuant to Section 203(e) of the Advisers Act and Section 9(b) of the Investment Company Act, that Respondent Interactive Data be, and hereby is, censured.
- B. Pursuant to Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act, that Respondent cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the Advisers Act, and cease and desist from committing or causing any violations and any future violations of Rule 22c-1(a) promulgated pursuant to Section 22(c) of the Investment Company Act.
- C. It is further ordered that Respondent shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$125,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Interactive Data as a Respondent in this proceeding, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David S. Slovick, Senior Attorney, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., 9th Floor, Chicago, Illinois 60604; and
- D. Respondent shall comply with the undertakings enumerated in Section III, above.

By the Commission.

Jonathan G. Katz  
Secretary

## IN THE MATTER OF JON D. HAMMES, ALBERT GARY SHILLING, ALLAN H. STEFL, AND LINDA F. STEPHENSON

Release Nos. 33-8346; IC-26290

Administrative Proceeding File No. 3-11351

December 11, 2003

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 9(f) OF THE INVESTMENT COMPANY ACT OF 1940

### I.

The Securities and Exchange Commission (“Commission”) deems it appropriate to institute cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”) and Section 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Jon D. Hammes (“Hammes”), Albert Gary Shilling (“Shilling”), Allan H. Stefl (“Steff”), and Linda F. Stephenson (“Stephenson”) (also referred to collectively as “Respondents”).

### II.

In anticipation of the institution of these proceedings, Respondents have submitted offers of Settlement (the “offers”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 9(f) of the Investment Company Act of 1940.

### III.

On the basis of this Order and Respondents’ offers, the Commission finds that:<sup>1</sup>

#### A. Respondents

1. **Hammes**, a 55-year-old resident of Mequon, Wisconsin, was an Independent Director of Heartland Group, Inc. (“Heartland Group”), from its inception to 1987, and from 1991 to January 2003. Hammes was also a member of the Audit Committee of Heartland Group during the same periods.
2. **Shilling**, a 66-year-old resident of Short Hills, New Jersey, was an Independent Director of Heartland Group from 1995 to November 2003. Schilling was also a member of the Audit Committee of Heartland Group during the same period, and was the Chairman of the Audit Committee during the period relevant to this Order.
3. **Steff**, a 60-year-old resident of Malibu, California, was an Independent Director of Heartland Group from October 1998 to April 2003. Stefl was also a member of the Audit Committee of Heartland Group during this period.
4. **Stephenson**, a 62-year-old resident of Milwaukee, Wisconsin, was an Independent Director of the Heartland Group and a member of Heartland Group’s Audit Committee from 1993 to October 2003.

#### B. Other Relevant Entities

1. **Heartland Group, Inc.** is a Maryland corporation formed in 1986 that maintains its principal place of business in Milwaukee, Wisconsin. Heartland Group has been registered with the Commission as an open-end, management investment company since January 1987. During the period relevant to these proceedings, Heartland Group offered

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<sup>1</sup> The findings herein are made pursuant to Respondents’ offers of Settlement and are not binding on any other person or entity in this or any other proceeding.



seven different series of mutual funds, including three equity and four fixed income funds. On March 21, 2001, the Commission obtained an order of permanent injunction and other equitable relief against Heartland Group for violations of Sections 30(b)(2), 30(e) and 30(g) of the Investment Company Act and Rules 30b2-1, 30d-1(a) and 30d-1(c) promulgated thereunder, which froze the assets of Heartland Group's High Yield Municipal Bond Fund ("High Yield Fund"), Short Duration High-Yield Municipal Fund ("Short Duration Fund"), and Taxable Short Duration Municipal Bond Fund ("Taxable Fund"). In addition, a receiver was appointed over the three funds, who was authorized to suspend redemptions in, manage, and, if appropriate, liquidate the three funds.

2. **Heartland Advisors, Inc.** ("Heartland Advisors"), was founded in 1982 and maintains its principal place of business in Milwaukee, Wisconsin. Heartland Advisors has been dually registered with the Commission since June 1983 as an investment adviser and as a broker-dealer, and provides investment advisory and brokerage services to individuals, institutions and retirement plans. In addition, Heartland Advisors manages the mutual fund portfolio series of Heartland Group subject to the authority of, and supervision by, Heartland Group's Board of Directors, and serves as the principal underwriter of Heartland Group's securities. Specifically, Heartland Advisors managed the funds until the Commission obtained an order placing the funds into receivership in March 2001.

3. Heartland Group's Short Duration High-Yield Municipal Fund began operating on July 2, 1997. Its stated investment objective was a high level of federally tax-exempt current income with a low degree of share price fluctuation.

4. Heartland Group's High-Yield Municipal Bond Fund also began operating on July 2, 1997. Its stated investment objective was to maximize after-tax total returns by investing in a high level of federally tax-exempt current income.

### C. Background

1. This matter stems from Heartland Advisors' fraudulent mispricing of the bonds held in Heartland Group's High Yield and Short Duration Funds (collectively, the "Funds"). Heartland Group's Independent Directors failed adequately to assure that those bonds were priced at "fair value" or adequately to monitor and assure the bonds' liquidity. Heartland Group's Board of Directors, including Respondents, approved pricing procedures that charged Heartland Advisors' Pricing Committee with the day-to-day valuation of the Funds' portfolio securities.<sup>2</sup> Those procedures stated, in part, that because the Board had previously determined that market quotations for the Funds' securities were not readily available, the Pricing Committee was required to use valuations provided by FT Interactive Data ("Interactive Data") as benchmarks to fair value the Funds' securities and to determine the Funds' daily net asset values per share ("NAVs").<sup>3</sup> Members of the Pricing Committee reviewed the valuations provided by Interactive Data daily. The pricing procedures also required the Pricing Committee to review Interactive Data's valuations to ensure they were sufficiently timely and accurate. In those instances where the Funds' portfolio managers believed that Interactive Data's valuations did not reflect the securities' fair value, and where such disagreements could not be resolved with Interactive Data, the pricing procedures directed the portfolio managers to submit the dispute to a quorum of the Pricing Committee for the purpose of making a final, fair value determination. Any time the Pricing Committee made a fair value determination, the Pricing Committee was required to document its reasons for doing so. The pricing procedures also required the Pricing Committee to periodically report to the Board on Interactive Data's performance, and required the Board of Directors to ratify any of the Pricing Committee's fair value determinations at the Board meeting subsequent to any such determination. Despite the Board of Directors' delegation to Heartland Advisors' Pricing Committee of the day-to-day pricing of the Funds' bonds, the Investment Company Act imposed on the Board the ultimate obligation to ensure that the prices of the Funds' securities reflected their fair value.

2. In addition to the Board's ultimate responsibility for pricing the Funds' securities, the Funds' May 1, 2000 Statement of Additional Information ("SAI"), which is incorporated by reference in the Funds' May 1, 2000 prospectus (as supplemented as of June 9, 2000), stated that both Heartland Advisors and Heartland Group's Board of Directors, including Respondents, would, among other things, monitor the issuers of the high yield bonds held in the Funds'

<sup>2</sup> Specifically, the Pricing Committee was charged with the responsibility for valuation of the Funds' portfolio securities, and implementation and administration of the Board of Directors' procedures for valuing such securities. During the relevant period, Heartland Advisors' General Counsel was the Chairperson of the Pricing Committee and its membership typically consisted of representatives of portfolio management, trading, Heartland Group, Inc.'s Accounting Department, and Paul Beste, Heartland Advisors' Chief Operating officer.

<sup>3</sup> Heartland Advisors assigned carrying values to the bonds in the Funds based on the valuations provided by Interactive Data.



portfolios to assess and determine whether the issuers had sufficient cash flow to meet required principal and interest payments, and to assure the continued liquidity of such bonds so that the Funds could meet shareholder redemption requests. The Directors did not, however, adequately monitor the financial liquidity of the bonds' issuers, or the liquidity of the Funds, to assure that the Funds could sell sufficient bonds to meet redemption requests.

3. During the relevant period, the Respondents encountered indications of the increasing illiquidity of the Funds and the mispricing of the securities held by the Funds. These indications included: the deteriorating credit quality and liquidity of the bonds in the Funds' portfolios; the Funds' growing borrowing and cash-flow problems; and Heartland Advisors' failure to sell sufficient bonds to meet redemptions at prices based on valuations provided by Interactive Data. As a result, the Respondents should have known that the prices at which the Funds carried their bonds did not reflect the bonds' "fair value" as required by the Board's pricing procedures, and that the bonds held by the Funds were not sufficiently liquid to meet redemption requests.

4. The Respondents were presented with the first of these indications regarding the Funds' liquidity problems beginning in at least the spring of 2000. At the Board of Directors' April 27, 2000 meeting, Heartland Advisors presented the Respondents with a list of illiquid securities held in the Funds that indicated that almost 18% of the bonds held by the High Yield Fund were illiquid, and 6% of the bonds in the Short Duration Fund were illiquid. At that time, Thomas Conlin, the Funds' co-portfolio manager, represented that, with respect to pricing, Heartland Advisors had been quick to provide Interactive Data with information. Conlin then misrepresented that the securities had been valued very conservatively. Conlin also stated at this time that the Funds were experiencing net redemptions, and that, therefore, they had not purchased any new bonds during the prior six months. Heartland Advisors refused or failed to sell sufficient bonds held by the Funds to meet redemption requests in large part because Heartland Advisors refused or failed to value the Funds' bonds at prices it could expect to receive in a current sale of the bonds. As a result, in order to meet such redemption requests, the Funds were required to borrow substantial amounts on a credit line established in 1999, purportedly for short-term borrowing.

5. In August 2000, the Respondents were presented with additional indications that should have alerted them to the fact that the liquidity problems raised at the April Board meeting had grown considerably worse, and that Heartland Advisors had refused or failed to cure those liquidity problems following the April meeting. In addition, the Respondents were presented with indications that should have alerted them to the fact that the Funds were experiencing pricing problems. For example, at a Board meeting, on August 10, 2000, the Respondents were presented with data reflecting bond sales in the Funds that indicated that the Funds had for some time not sold bonds in sufficient amounts to meet redemptions, and had been borrowing heavily against their credit lines in order to meet redemptions. Prior to the Board's August 10 meeting, the Board's counsel informed the Board that interest on the money borrowed by the Funds to meet redemptions was materially impacting the Funds' returns in a negative way. At the August 10 Board meeting, the Board was informed that redemptions from the High Yield Fund from June 1 to August 10, 2000 totaled approximately \$25 million, and redemptions from the Short Duration Fund totaled almost \$60 million for that same period. However, Heartland Advisors sold only \$8.5 million in bonds out of the High Yield Fund and \$28 million in bonds out of the Short Duration Fund between January 1 and August 10, 2000. The High Yield Fund's borrowings were up to \$12.2 million, or 18.5% of its assets, at the time of the August 10, 2000 Board meeting, while the Short Duration Fund's borrowings were approximately \$12.3 million, or 13.5% of assets, at the same time. The Board was made aware at the August 10 meeting that borrowings were up, that the watch list and list of defaulted securities were growing, and that the only way to reduce the Funds' borrowings was to sell portfolio securities.

6. Also at the August 10, 2000 Board meeting, Conlin admitted in response to a question that "a material percentage of the [High Yield Fund's] portfolio consisted of defaulted or watch list securities" which, combined with the "significant borrowings" utilized to meet redemptions gave rise to "some liquidity risk" which could be exacerbated by year-end tax loss selling. However, in response to another question, Conlin stated to the Board at the meeting that if forced to sell securities that day, he would need to take a discount, but misrepresented that he should be able to sell the bonds in one week in the ordinary course.

7. Respondent Hammes requested that Heartland Advisors prepare a special report for the Board explaining what it was doing to workout distressed securities in the Funds. Other Board members requested a quarterly progress report on the distressed securities, and a plan addressing how Heartland Advisors intended to reduce the credit line and to verify

that the Funds' securities were properly priced. In addition, the Respondents requested a report on possible redemption scenarios and their effect on the Funds. The Respondents also directed Conlin to sell securities to reduce the Funds' borrowings. Conlin failed to do so.

8. Respondents never received these reports and, although they did receive limited information, did not take adequate action to ensure that their requests were satisfied. In addition, Conlin failed to sell securities in the seven-day period and tendered his resignation to Heartland Advisors on August 18, 2000.

9. At the next Board meeting on September 11, 2000, the Board was informed that Conlin had resigned and that he had failed to eliminate the Funds' liquidity problems. In fact, the Board learned on September 11 that the percentage of the Funds' securities that were on the defaulted and watch lists, as well as the Funds' borrowings, had grown since the last Board meeting. Further, Paul Beste, Heartland Advisors' Chief Operating officer, reported to the Board at the meeting that he had done a comparison of another independent pricing service's prices to those being utilized by the Funds. Upon further questioning, Beste stated that, in the aggregate, the High Yield Fund's NAV would have been nearly one dollar lower using the alternative prices than the NAV calculated by Heartland Advisors. He also explained why Heartland Advisors believed that those alternative prices were unreliable. Additionally, Heartland Advisors' CEO misleadingly reported, among other things, to the Board that between \$3 million and \$4 million of bonds had been sold that day by the High Yield Fund at prices above their carrying value. Beste misrepresented that sales of securities by the Funds had generally been at or very close to Interactive Data's pricing year-to-date.

10. An additional indication of the Funds' deterioration was presented to the Board in late September 2000, when Respondents learned of the Funds' transfer of a group of bonds to the State of Wisconsin Investment Board ("SWIB"). On September 28, 2000, the Board held a special meeting at which Heartland Advisors informed the Respondents that, among other things, a purported sale of some of the Funds' worst bonds to SWIB would take place the next day. The Board was informed of the fact that those bonds would be sold to SWIB at a price below the price at which Interactive Data had been pricing the bonds, and of the implications of the sale of those bonds at the reduced price. In fact, the bonds involved in the SWIB transaction were transferred at prices approximately 50% below the value at which the Funds had been carrying those bonds in the normal course. Moreover, the transaction was only completed because Heartland Advisors' President, William Nasgovitz, personally guaranteed it, and because it included an agreement whereby SWIB could "put" the bonds back to Heartland Holdings, Inc., with a guaranteed annual return of 20%.<sup>4</sup> These events, of which the Board knew or should have known, should have indicated that the Funds' bonds were overvalued.

11. In response to a question from one of the Respondents, Heartland Advisors also discussed with the Respondents the possibility of increased redemptions following the SWIB transaction and the announcement of Conlin's resignation, planned for later that day. William Nasgovitz identified various alternatives in that event, including that as a last resort Heartland Advisors might ask the Commission to allow the Funds to suspend redemptions, a drastic measure that should have signaled the seriousness of the liquidity problems facing the Funds. The Respondents had still not received the plans and reports they requested on August 10.

12. On September 28, 2000, Heartland Advisors lowered the values of certain of the Funds' bonds due in large part to the SWIB transaction. This, in turn, reduced the NAV of the High-Yield Fund by 8.2% and the NAV of the Short Duration Fund by 2.1%. As a result, the Funds' NAVs dropped from \$8.75 to \$8.03 and \$9.10 to \$8.91, respectively, in one day.

13. Redemptions continued as expected after the SWIB transaction. On October 8, 2000, Nasgovitz informed the Respondents via e-mail that redemptions were continuing and that he was not sure they had seen the full impact. The Funds faced a cash crisis due to the fact that Heartland Advisors refused or failed to sell sufficient bonds held by the Funds to meet redemption requests, in large part because Heartland Advisors refused to value and sell the Funds' bonds at prices it could reasonably expect to receive in a current sale of those bonds (fair value).

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<sup>4</sup> Heartland Holdings, Inc. is the parent company of Heartland Advisors, Inc. As of the close of business on August 3, 2000, all of the stock of Heartland Advisors was exchanged for stock in Heartland Holdings, Inc. As a result of the transaction, Heartland Advisors became a wholly owned subsidiary of Heartland Holdings, Inc.

14. On October 12, 2000, the Board called another special meeting. At that meeting, Heartland Advisors informed the Respondents that 59% of the Short Duration Fund's bonds, and 74% of the High Yield Fund's bonds, were now identified as defaulted or watch list, and therefore illiquid, securities. The Funds' new portfolio manager explained to the Respondents that further credit deterioration in the portfolios was likely and that there was little, if any, market for the bonds still held by the Funds. He estimated that the Funds' fair value was approximately 70% of their then-current NAVs, which were based on Interactive Data's prices. At Respondents' request, Counsel for the Board also advised the Respondents of the Funds' duty to price securities daily and the Board's duty in that regard. Counsel also advised Respondents that, in light of the new portfolio manager's review and the limited success selling bonds, the Pricing Committee should reconsider using Interactive Data's prices to fair value the Funds' securities.

15. The Board's counsel discussed, with the Chairperson of the Pricing Committee present, that the fair value of the Funds' portfolio securities must be determined based on a consideration of all relevant factors and available information. Respondents directed the Pricing Committee to follow the Board's pricing policies and procedures. However, the respondents failed to instruct the Pricing Committee not to use Interactive Data's prices as benchmarks to calculate the fair values of the Funds' bonds. The Pricing Committee continued to use Interactive Data's prices to value the Funds' bonds that day, notwithstanding the fact that Interactive Data's prices did not reflect the current fair value of those securities.

16. The next day, Heartland Advisors' CEO, its General Counsel, Board Counsel and others reported to the Board on the Pricing Committee's actions on October 13, but the Board failed to override the Pricing Committee or retroactively correct the October 12 NAVs. The Board's counsel advised them that the likelihood of success of a request to suspend redemptions would be very low. However the Board allowed Heartland Advisors to seek permission from the Commission to authorize the Funds to suspend redemptions instead of "fair valuing" each bond held in the portfolio. At the same time, the Board also directed the Pricing Committee to price the bonds at fair value if the Commission denied Heartland Advisors' request to suspend redemptions. On October 13, the Commission's Division of Investment Management indicated that it would oppose any application for any order that would permit the Funds to suspend redemptions. As a result, the Pricing Committee purported to price the bonds at fair value.

17. Consequently, on October 13, 2000, the Pricing Committee finally proceeded to reprice the bonds. However, the Pricing Committee did not price the bonds on an individual basis at fair value. The Pricing Committee obtained from the Funds' portfolio managers their best estimates of the fair value of each bond held by the Funds. The prices provided by the portfolio managers were materially lower than the prices at which the Funds were carrying their bonds. The Pricing Committee then applied uniform reductions, or "haircuts," of 50% and 33%, respectively, to the proposed prices they were provided by the portfolio managers for bonds in the Funds. The result of Heartland Advisors' arbitrary pricing actions was to decrease the NAV of the High Yield Fund by an additional 69.4%, from \$8.01 to \$2.45, and the NAV of the Short Duration Fund by an additional 44.0%, from \$8.70 to \$4.87, from the previous day's NAVs.

18. Respondents' review of Heartland Advisors' improper devaluation of the Funds' bonds on October 13, 2000 was inadequate because they did not identify Heartland Advisors' failure to follow the Board's pricing policies or their failure to price the bonds at fair value as they were required to do. On October 16, 2000, the Board met to discuss the Pricing Committee's actions of October 13. Heartland Advisors' CEO, its General Counsel, Board counsel, members of the Pricing Committee and others informed the Respondents that the Funds' portfolio managers had suggested fair value prices for each of the bonds held by the Funds, but that the Pricing Committee then applied the additional, across-the-board haircuts to those prices based on, among other things, the Funds' internal liquidity problems unrelated to any particular bond or market event that would have effected all bonds equally. The Board was also informed that the Pricing Committee adjusted this discount with respect to bonds that the portfolio managers expressed confidence could be sold currently at a higher value based on recent bids, indications, or other information. However, Heartland Advisors applied the across-the-board haircuts without determining whether such a haircut was appropriate for each portfolio security on October 13, 2000 and did not review and adjust prices to result in fair values for each bond. This was in direct violation of the Board's pricing procedures, which required the Pricing Committee to "fair value" all debt securities held by the Funds when, as here, market quotations for those securities were not readily available. Moreover, the Pricing Committee failed to document the basis for each of the new values assigned by the Pricing Committee, also required by the Board's pricing procedures. Nevertheless, the Respondents did not take adequate steps to remedy the situation.

19. As a result of Respondents' negligent conduct, both before and after October 13, 2000, the Funds redeemed millions of shares in the Short Duration and High Yield Funds at incorrect NAVs.

#### D. Findings

1. Based on the foregoing, Respondents violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because they did not adequately monitor the liquidity of the bonds in the Funds' portfolios and to assure the continued liquidity of such bonds so the Funds could meet shareholder redemption requests. Respondents expressly undertook these duties in the Funds' SAI, which was incorporated into the Funds' prospectus. The Funds therefore sold shares in the Funds pursuant to an SAI and prospectus that contained an untrue statement of material fact that they knew or should have known to be untrue.

2. In addition, Respondents committed violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act because they did not adequately discharge their responsibility to participate meaningfully in the valuation of Funds. While mutual fund directors are permitted to delegate some responsibility for pricing a fund's securities to a separate committee, each director retains responsibility to be involved in the valuation process and may not passively rely on securities valuations provided by such a committee. See *In the Matter of Hartl and Lipman*, Release No. IC-19840, 1993 WL 468571, at \*4-5 (Nov. 8, 1993). Furthermore, a director's failure to review financial statements, reports, contracts, and other documents relevant to the financial condition of the issuers of a fund's securities can result in the director's personal liability. *Id.* Here, the Respondents failed to take adequate steps to follow up on their requests for information from Heartland Advisors, when they were on notice of the problems with the prices of the Funds' securities, in order to assure that the Funds' securities were priced at fair value. Further, Respondents committed violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act by permitting and not rectifying the haircut Heartland Advisors applied to the Funds on October 13, which Respondents knew or should have known resulted in prices that did not represent the fair values of the bonds affected.

3. Based on the foregoing, Heartland Advisors violated Rule 22c-1(a), promulgated pursuant to Section 22(c) of the Investment Company Act. Rule 22c-1(a) provides that no registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of or dealer in any such security shall sell, redeem, or repurchase any such security except at a price based on the current NAV of such security. Under Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder, current NAV calculations must be based on current market value or, if market quotations are not readily available, fair value as determined in good faith by the board of directors. Heartland Advisors, the investment adviser of the Funds and the principal underwriter of Heartland Group's securities, violated Rule 22c-1(a) by selling, redeeming and repurchasing Fund shares at NAVs calculated using bond prices that were not based on the bonds' fair value as determined in good faith, as discussed above, which resulted in incorrect NAVs for the Funds.

4. The Commission's Accounting Series Release Nos. 113 and 118, published in 1969 and 1979, respectively, provide guidance regarding pricing issues and factors that should be considered when fair valuing portfolio securities. As a general principle, the fair value of a portfolio security is the price that the fund might reasonably expect to receive for the security upon its "current sale." Funds must apply external factors to determine, on a daily basis, the amount a fund could reasonably expect to receive in a current sale for each security in the fund's portfolio. Ascertaining fair value requires a determination of the amount that an arm's-length buyer, under the circumstances, would currently pay for each security.<sup>5</sup> Here, Heartland Advisors failed to set prices for the bonds which reflected their fair value in a current sale and applied an inappropriate haircut which resulted in inaccurate NAVs for the Funds.

5. Respondents were a cause of Heartland Advisors violation of Rule 22c-1(a). The Commission can compel any person to cease and desist from committing or causing a primary violation of the Investment Company Act, or any rule or regulation promulgated thereunder, if that person is, was, or would be a cause of the primary violation due to an act or omission the person knew or should have known would contribute to such primary violation. Here, Respondents failed to expressly instruct Heartland Advisors to disregard Interactive Data's prices, or to correct the prices of the Funds' bonds, when they knew or should have known that those prices did not reflect the bonds' fair value, and consequently knew or

<sup>5</sup> Fair value cannot be based on what a buyer might pay at some later time, such as when the market ultimately recognizes the security's true value as currently perceived by the portfolio manager. Funds also may not fair value portfolio securities at prices not achievable on a current basis on the belief that the fund would not currently need to sell those securities.

should have known that Heartland Advisors was selling, redeeming and repurchasing shares of the Funds at prices that were not based on the Funds' current NAVs. As a result, Respondents were a cause of Heartland Advisors' violation of Rule 22c-1(a) promulgated under Section 22(c) of the Investment Company Act by permitting Heartland Advisors to sell, redeem and repurchase fund shares at a price not based on the Funds' current NAVs.

#### IV.

In view of the foregoing, the Commission deems it appropriate to accept the offers submitted by the Respondents and impose the sanctions specified in the offers.

Accordingly, it is hereby ORDERED:

Pursuant to Section 8A of the Securities Act and Section 9(f) of the Investment Company Act, that Respondents Jon D. Hammes, Albert Gary Shilling, Allan H. Stefl, and Linda F. Stephenson cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, and cease and desist from causing any violations and any future violations of Rule 22c-1(a) promulgated pursuant to Section 22(c) of the Investment Company Act.

By the Commission.

Jonathan G. Katz  
Secretary

## IN THE MATTER OF GARRETT VAN WAGONER AND VAN WAGONER CAPITAL MANAGEMENT, INC.

Release Nos. IA-2281; IC-26579

Administrative Proceeding File No. 3-11611

August 26, 2004

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940

### I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Garrett Van Wagoner (“Van Wagoner”) and Van Wagoner Capital Management, Inc. (“VWCM”) (collectively “Respondents”).

### II.

In anticipation of the institution of these proceedings, Respondents have submitted offers of Settlement (the “offers”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Order”), as set forth below.

### III.

On the basis of this Order and Respondents’ offers, the Commission finds that:

#### Summary

1. From 1999 through 2001, Van Wagoner and his investment advisory firm, VWCM, knowingly or recklessly misrepresented and omitted to state material facts regarding the Van Wagoner Funds (the “Funds”). Among other things, Van Wagoner and VWCM materially misrepresented the size, value of, and risk to shareholders from the Funds’ investments in illiquid securities.
2. The Funds’ disclosures to shareholders placed certain restrictions on the Funds’ investments in illiquid securities, which included both private companies’ securities and certain restricted public securities. The Funds’ disclosures provided, among other things, that the Funds would not acquire illiquid securities if such purchases would cause more than 15 percent of any of the Funds’ portfolios to be invested in illiquid securities.
3. Despite this, Van Wagoner and VWCM, which manages the Funds, continued to purchase new private securities for Funds that already had more than 15 percent of their assets in illiquid investments. This was so in spite of the unique risks inherent in private investments. As a result, Van Wagoner and VWCM misled the Funds’ investors about the size of the Funds’ illiquid investments, and thus the overall risks of the Funds’ investments.
4. In addition, because the private company securities that the Funds purchased were not publicly traded, no market-quoted prices existed for them. Accordingly, the federal securities laws required the Funds’ board of directors to “fair value” the private securities, and the Funds’ board delegated to VWCM the duty to fair value the securities in accordance



with policies adopted by the Funds' board. However, Van Wagoner and VWCM failed to do so. From December 2000 through the fall of 2001, Van Wagoner and VWCM knowingly or recklessly lowered the Funds' valuations for these private securities in an attempt to comply with the Funds' 15 percent limitation, causing the Funds to understate their net asset values. Each Fund's net asset value ("NAV") was the value of its assets minus its liabilities at the end of a given day, and the NAV was the basis of the price paid or received by shareholders who purchased or redeemed the Fund's shares.

5. Finally, Van Wagoner and VWCM failed to effectively oversee personal trading at the firm. Van Wagoner, who was the compliance officer, failed to adequately review the reports submitted by an employee of VWCM. The employee, through accounts in which she had an interest, traded in the same public equity securities the Funds traded and failed to report these trades. Van Wagoner also knew that a director of the Funds was investing in private securities in which the Funds were simultaneously investing. Those investments by the director were contrary to the rules against making such investments without prior Commission approval.

### **Respondents**

6. Garrett Van Wagoner, 48, resides in San Francisco, California. He is the president, sole director, and owner of VWCM. He has also been the president, a director, and the primary portfolio manager of the Funds since their formation.

7. Van Wagoner Capital Management, Inc. is a San Francisco, California investment adviser, which has been registered with the Commission since 1995. Incorporated in Delaware, VWCM has been the manager of the Funds since their formation. VWCM also manages investments for hedge funds and other clients.

### **Other Relevant Entity**

8. Van Wagoner Funds, Inc. (the "Funds"), incorporated in Maryland, is a diversified investment company, registered with the Commission since January 1, 1996. From January 1, 1998 through at least December 31, 2002, the Funds consisted of a series of five open-end, publicly sold funds, including the Emerging Growth Fund, the Micro-Cap Growth Fund, the Mid-Cap Growth Fund, the Post-Venture Fund and the Technology Fund.

### **Facts**

9. From 1999 through 2001, Van Wagoner frequently invested for the Funds in private placements of convertible preferred stock issued by private companies. Van Wagoner's goal was to invest in technology companies that anticipated completing initial public offerings of their securities ("IPOs") within a year. He made significant efforts to compete for opportunities to invest in these companies by becoming knowledgeable about the markets for these securities.

10. These investments offered the potential for significant growth and high returns if the companies successfully completed IPOs. However, they also presented unique risks due to their illiquidity, which meant that the securities could not be quickly sold to raise money or to change the investment mix of one of the Funds. The private securities were also difficult to value, which could lead to the inaccurate valuation of these securities. The private companies sold their securities in unregistered offerings, mostly to venture capitalists. They could not be resold to the public until after the companies completed an IPO. Even after an IPO, the Funds' shares in the companies were frequently subject to agreements not to sell the securities for six months ("lock-up agreements"), and other restrictions.

11. Because there were no market quotations available for the private securities, they had to be "fair valued" based on policies adopted by the Funds' board of directors. Fair valuing these securities proved to be difficult and subjective. As described in the Funds' disclosures to shareholders, valuation was left to VWCM and carried out by Van Wagoner, subject to the oversight of the Funds' board of directors.

12. VWCM and Van Wagoner failed to manage these risks and caused misleading representations to be made about the Funds' investments in illiquid securities, in two ways. First, from mid-1999 through mid-2001, Van Wagoner understated the amount of the Funds' investment in illiquid securities by treating all publicly traded securities subject to lock-up agreements owned by the Funds as liquid, and then continued to make new purchases of private placement securities, contrary to the representations in the Funds' disclosures to shareholders. Second, in late 2000 and during 2001, Van Wagoner reduced the valuations of groups of private securities without fair valuing them in accordance with the Funds' policies. These reductions in valuations caused the Funds to understate their NAVs.



### **Van Wagoner Understated the Funds' Investments in Illiquid Securities and Caused the Funds to Purchase New Private Securities Contrary to the Funds' Disclosures**

13. To address the risks of investing in private and other illiquid securities, the Funds disclosed to shareholders certain limitations on the Funds' investments in illiquid securities. The limitations were set forth in the Funds' Statement of Additional Information ("SAI"), which was attached to annual filings from 1999 through 2002. The SAI established the maximum level of illiquid investments: "Each Fund may invest up to 15% of its net assets in illiquid securities (i.e., securities that cannot be disposed of within seven days in the normal course of business at approximately the amount at which the Fund has valued the securities)." The SAI further disclosed that: "If through the appreciation of illiquid securities or the depreciation of liquid securities, a Fund should be in a position where more than 15% of the value of its net assets are invested in illiquid assets, including restricted securities which are not readily marketable, the Fund will take such steps as it deems advisable, if any, to reduce the percentage of such securities to 15% or less of the value of its net assets." The SAI further stated: "Each Fund may not: . . . Acquire illiquid securities if, as a result of such investments, more than fifteen percent (15%) of the Fund's net assets (taken at market value at the time of each investment) would be invested in illiquid securities." Although the Funds could have changed this second investment restriction against further purchases without shareholder approval, they did not. The board of directors did approve these purchases after they were made, but the Funds' disclosure on the 15 percent restriction was not amended.

14. During 1999 and 2000, several private companies in which the Funds had invested completed IPOs. After the IPOs, however, these companies' securities remained illiquid, because of "lock-up" agreements. These "lock-up" agreements committed the Funds to hold onto these securities for six months.

15. Despite these obstacles to their sale, Van Wagoner categorized all of these securities as liquid to the Funds' board in quarterly reports and to the Funds' shareholders in annual and semi-annual reports.<sup>1</sup> The mischaracterization caused the Funds to significantly understate their investments in illiquid securities. In the annual and semi-annual shareholder reports filed from June 1999 through December 2001, Van Wagoner caused the Funds to report that no Fund had exceeded the 15 percent limitation on illiquid investments, when in fact one or more of the Funds had more than 15 percent of its assets in such investments at the time. These misstatements were important, because under the Funds' SAI any Fund that exceeded the 15 percent limitation could not make additional investments in private or other illiquid securities.

16. During 1999 and 2000, Van Wagoner caused the Funds to repeatedly purchase new private company securities (which were illiquid) while the Funds' illiquid portfolios exceeded 15 percent of net assets, contrary to the restrictions against such new investments in the Funds' SAI. The Funds exceeded the 15 percent limitation because Van Wagoner had not treated as illiquid those securities that were subject to lock-up agreements.

17. Further, during 2001, several of the Funds' illiquid portfolios again exceeded 15 percent of net assets, based on their investments in private securities and not based on mischaracterized investments in illiquid, post-IPO securities. Van Wagoner again caused those Funds to purchase new, private securities on nine occasions. These purchases were likewise prohibited by the disclosures in the Funds' SAI.

### **Van Wagoner Made Across-the-Board Devaluations of the Funds' Private Securities without Fair Valuing the Securities**

18. Because the Funds' private securities could not be valued based upon market quotations, they had to be "fair valued" in good faith, in accordance with the policy adopted by the Funds' board. Investment Company Act Section 2(a)(41) (B) and Rules 2a-4(a)(1) and 22c-1. The "fair value" of a security is the price that the Funds would reasonably expect to receive on a current sale of the security. See Accounting Series Release No. 118 (Oct. 21, 1969). Such valuations are incorporated into the daily, reported NAVs for the Funds.

19. The Funds' fair valuation policy established the original fair value of a private security as the cost to the Funds in purchasing it. Thereafter, under the Funds' policy, certain events at the company, such as another round of private

<sup>1</sup> Although these restricted securities were identified by name in the Funds' semi-annual and annual reports to shareholders, which also noted that the resale of those securities to the public "may be limited due to certain restrictions," the Funds did not include those securities in the calculation of the percentage of illiquid securities in the Funds' portfolios.

financing, a completed IPO, or a merger, could require a change in the fair value. The policy also required VWCM to consider, on an ongoing basis, more subjective factors, such as “the operations of the issuer, change[s] in general market conditions,” or other information that affected the “fundamentals” of each private investment. Such “fundamental” changes could warrant a change in the fair valuation of the Funds’ investment in a private company.

20. VWCM was designated in the Funds’ SAI as responsible for conducting the day-to-day fair valuations of securities, under the supervision of the Funds’ board. Van Wagoner was the person at VWCM responsible for carrying out this duty. Correspondence between VWCM and the Funds’ administrator reflected changes in the private securities’ valuations. Changed valuations were also reflected, to a certain extent, in a report to the Funds’ board and in “updates” regarding contacts between VWCM and the private companies prepared by VWCM’s private equity analyst.

21. Until December 2000, Van Wagoner never changed the Funds’ price of any private investment based on fundamentals. Until late 2000, changes in the Funds’ private securities’ valuations occurred only because of new rounds of private financing, an IPO, or a merger or sale of the private company. However, during 2000, the public equity markets, particularly for technology stocks, fell precipitously, leading to a nearly 50 percent decline in the overall value of the Funds.

22. On November 29, 2000, the largest of the Funds, Emerging Growth, reported for the first time that its private securities portfolio (which did not include other illiquid securities such as those in companies that had a recent IPO) exceeded 15 percent of its net assets. This was significant to VWCM, because VWCM interpreted the limitation on investments in illiquid securities in the Funds’ SAI to apply only to private securities and to prohibit any further private investments by a Fund while it exceeded this limitation. VWCM was then negotiating and finalizing new private securities investments for the Funds.

23. On November 30, 2000, VWCM’s private equity analyst stated in an e-mail to VWCM’s chief financial officer: “i talked to [G]arrett [Van Wagoner] just now. He says that he is aware of the 15% issue and we will work on figuring out which companies are candidates for write-downs.” The private equity analyst understood that one means VWCM might use to address the size of the private portfolios was to reduce valuations of private securities to shrink the portfolio below 15 percent. Within three trading days, Van Wagoner reduced the Funds’ valuations of two private companies to zero. Until then, the Funds had priced those securities at their original cost, for a total carrying value to the Funds of \$30.6 million. As a result of the changed valuations, the Funds’ private portfolio shrank by \$30.6 million.

24. Van Wagoner wrote down valuations of two more private investments to zero later in December 2000 when the private portfolio of the largest Fund and another Fund again exceeded 15 percent of net assets, and while new private security purchases were being negotiated or finalized.

25. VWCM’s records created at the time, including the updates prepared by the private equity analyst, do not support the extreme devaluations. For instance, VWCM’s updates prepared shortly after the write-downs to zero suggested positive progress at the companies, such as revenue in line with plans or lower-than-expected expenses. Also, among the private companies that were valued at zero were those that had assets such as cash that implied a fair value greater than zero, and companies completing merger or sale transactions that suggested valuations greater than zero and that should have been considered under the Funds’ valuation policies. Since the Funds could reasonably have expected to receive more than zero in a current sale of the securities, they should not have been valued at zero.

26. In March 2001, Van Wagoner reduced valuations of private securities across the board, in an effort to shrink the Funds’ entire private portfolio to avoid the 15 percent limitation. Between February 28, 2001 and March 16, 2001, Van Wagoner reduced the Funds’ valuations of eight private companies to zero, which until that point had been carried at their original cost, for a total value of \$54 million. In a series of e-mails to her husband in early March, the private equity analyst stated that she had suggested to Van Wagoner that a valuation other than zero would be more appropriate for several companies which he had just written down to zero. In response to the question, “How did [G]arrett take your suggestion?” the analyst replied: “said yes, we will be more careful going forward here. Basically agreed with me, but he is focused on taking us down to 15% privates so will have to have combo of zeros and writedowns.” Over the succeeding days, Van Wagoner wrote down the Funds’ valuations of five private companies by approximately 75 percent, and another 10 other private companies by 50 percent. In all, the March write-downs reduced the Funds’ carrying values of these assets by more than \$130 million.

27. Information available at the time, and the records created at VWCM, again do not support the timing or level of the across-the-board write-downs in March 2001. Even among the companies whose valuations were reduced to zero, most had significant cash assets and had recently obtained, or were in the process of obtaining, new private rounds of financing, which provided objective evidence of fair values greater than zero. Indeed, later in 2001 and very early in 2002, VWCM increased the valuations of several private investments, including four of the companies whose securities Van Wagoner had reduced to zero in March. Similarly, VWCM's updates and other documentation within the firm did not suggest recent, negative information from the private companies that would have precipitated the large overnight declines in values, or that in a current sale the Funds would have expected to receive such values.

28. In the fall of 2001, VWCM again reduced the Funds' valuations of nearly all of the private securities that still had positive valuations, without fair valuing them. In all, VWCM wrote down by half the valuations for 20 private securities, which constituted 80 percent of the private companies that still had positive valuations in the portfolio. This series of write-downs began on August 31, after the Funds' private portfolio had again significantly exceeded 15 percent of net assets for weeks. In September and November, Van Wagoner repeated the write-downs of 7 of the 20 securities.

29. During the fall, the Funds' auditors had begun to prepare for the year-end audit and noted the absence of sufficient documentation to support the changes in valuations. In documents prepared by VWCM after the write-downs, however, reasons for the reduced valuations were used that did not comport with the actual timing or basis for the decision to change the fair valuations. For instance, in an e-mail sent on September 10, 2001, to another VWCM employee, VWCM's private equity analyst stated: "Garrett wanted me to coordinate with you in writing down by an additional 50% the following companies this week: Calient, Lynx, Nayna, and Bandwidth9." The valuations of each of the securities were reduced by 50 percent within four trading days after September 11, 2001, the date of the terrorist attacks in New York City and Washington, D.C. However, written explanations provided to the Funds' auditors and to the board after the fact cited the impact on the market of the September 11th terrorist attack as the principal reason for reducing the valuations of two of the companies.

30. In connection with their annual audit, Van Wagoner told the Funds' auditors that the Funds' 15 percent limitation on illiquid investments did not influence his decision to change valuations of private securities. He also represented to the Funds' board that avoidance of the 15 percent limit played no role.

#### **VWCM and Van Wagoner Failed to Administer the Code of Ethics**

31. Van Wagoner designated himself the compliance officer, in charge of administering the Code of Ethics adopted both by the Funds and by VWCM to prevent fraudulent or violative trading by personnel at VWCM and affiliates of the Funds who were aware of the Funds' trading. The Code of Ethics prohibited persons with knowledge about the Funds' trading from purchasing or selling securities that the Funds also held or contemplated purchasing. Consistent with the Commission's rules, the code also required access persons at VWCM and the Funds' directors to report quarterly any securities purchases and sales.

32. In this role, Van Wagoner was supposed to review the quarterly transaction reports submitted by employees of VWCM or by the Funds' directors, but he did not review those reports. One employee of VWCM engaged in prohibited trading in public securities, which she did not report for more than a year, but Van Wagoner did not detect her omissions since he did not review her reports. When ultimately alerted to her prohibited trading based on new reports she submitted, Van Wagoner did not cause the trading to be halted, and did not discipline the employee. Van Wagoner also was aware of purchases by a director of the Funds in the same private securities the Funds purchased at the same time, which purchases by the director were made contrary to the rules prohibiting such investments without prior Commission approval.

#### **Legal Analysis**

33. Sections 206(1) and 206(2) of the Advisers Act prohibit fraud by an investment adviser upon any client or prospective client. Investment advisers owe their clients, including investment company clients, a fiduciary duty. *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195-97 (1963). Misstatements or omissions of fact by an investment adviser violate this fiduciary duty and constitute fraud when they are material, that is, when a reasonable investor would consider them important in making an investment decision. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

34. Van Wagoner's classification of illiquid securities as "liquid" was materially misleading. By understating the amount of the Funds' illiquid securities investments, Van Wagoner caused the Funds to understate the risks of investing in the Funds. Similarly, by causing the Funds to repeatedly purchase new private securities, contrary to the restrictions against such purchases when the Funds' illiquid portfolios were already greater than 15 percent of their net assets, Van Wagoner rendered the Funds' disclosures to shareholders materially false.

35. The knowing or reckless failure to fair value private securities that materially affects a fund's NAV constitutes fraud. "A reasonable investor would want to know that the prices used to value the Fund's securities were stale . . . and that . . . the Fund was mispricing some securities." *In re Piper Capital Management, Inc.*, Exch. Act Rel. 48409 (Aug. 26, 2003). See also *In re Robert F. Lynch*, 46 S.E.C. 5 (Oct. 15, 1975) (available at 1975 WL 160406) (false valuations of restricted securities that materially impacted fund's NAV were fraudulent).

36. Rule 22c-1 under the Investment Company Act prohibits the sale or redemption of shares in a registered investment company "except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security." "Value" as used in the rule is the value of the underlying securities. Where there are no market quotations, the "value" of a security is its "fair value as determined in good faith by the board of directors."

37. When Van Wagoner wrote down certain securities to zero and applied arbitrary discounts to groups of securities during December 2000, March 2001 and the fall of 2001, he failed to fair value the securities in good faith and caused understated NAVs to be reported. Van Wagoner also failed to follow the board's fair valuation policies, which did not permit the write-down in securities' valuations in an effort to shrink the entire portfolio. Van Wagoner also informed the Funds' board and its auditors that avoidance of the 15 percent limit played no part in the changed valuations, when the weight of the evidence suggests otherwise. The failure to fair value the underlying private securities caused the Funds to sell and redeem the securities they issued at prices other than prices based on the current NAVs of their securities.

38. Rule 17j-1(c)(2) under the Investment Company Act requires funds and investment advisers to use reasonable diligence and institute procedures reasonably necessary to prevent violations of the fund's or the investment adviser's code of ethics. Van Wagoner, who was the compliance officer, failed to administer the Code of Ethics, by the conduct described above, including his failure to review and detect prohibited investments by an employee of VWCM, and his awareness of a director's prohibited co-investments.

39. As a result of the conduct described above, VWCM willfully violated Sections 206(1) and 206(2) of the Advisers Act and Section 17(j) of the Investment Company Act and Rule 17j-1(c)(2) thereunder, and Van Wagoner willfully aided and abetted and caused VWCM's violations. As a further result of the above conduct, VWCM and Van Wagoner willfully aided and abetted and caused the Funds' violations of Investment Company Act Rule 22c-1.

### Undertakings

40. Respondent Van Wagoner represents that he has submitted his resignation from the Board of Directors of the Van Wagoner Funds effective December 31, 2004, and that he undertakes:

- a. To resign effective December 31, 2004, from his position as an officer of Van Wagoner Funds, Inc. (the "Funds"), and to neither serve nor act as officer or director of any registered investment company for a period of seven years from December 31, 2004;
- b. Not to serve, effective immediately, on the Pricing Committee of the Funds' Board of Directors;
- c. To abstain from being the person at Van Wagoner Capital Management, Inc. ("VWCM") who is responsible for making recommendations to the Funds' Pricing Committee about any valuation or pricing changes to private equities, for a period of seven years;
- d. To abstain from being the person at VWCM who is responsible for making recommendations to the Funds' Board of Directors about any determinations as to which securities are liquid or illiquid, for a period of seven years;

- e. To abstain from making any new private equity investments or any valuation changes of private equity investments for or on behalf of the Funds until after the new investments or valuation changes have been approved by the Funds' Pricing Committee;
- f. Not to transact any Fund business during the interim period while he remains an officer of the Funds without a second signatory; and
- g. To recommend to the Funds' Board of Directors that it add two independent directors not unacceptable to the staff of the Commission.

41. Respondent VWCM undertakes:

- a. To submit all future pricing changes regarding private equities and all future determinations of the liquidity or illiquidity of any securities to the Pricing Committee of the Board of Directors of the Van Wagoner Funds (the "Funds") in advance;
- b. To abstain from making any new private equity investments or any valuation changes of private equity investments for or on behalf of the Funds until after the new investments or valuation changes have been approved by the Funds' Pricing Committee;
- c. To hire, at its expense, an Independent Consultant not unacceptable to the Commission's staff to review the pricing and liquidity determinations for the next four quarters from the date of the Order and make a report with recommendations thereafter on VWCM's policies, procedures, and practices for pricing and liquidity determinations for private equity securities (the "Independent Consultant");
- d. At the end of that review, to require the Independent Consultant to submit the report and recommendations to VWCM and to Helene L. Morrison of the Commission's San Francisco District office, and to be bound to implement the final recommendations of the Independent Consultant, although VWCM may suggest alternative procedures to achieve the goals of any recommendations; and
- e. To require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with VWCM, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the San Francisco District office of the United States Securities and Exchange Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with VWCM, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

In determining whether to accept the offers, the Commission has considered the undertakings in paragraph 40.g., above.

#### IV.

In view of the foregoing, the Commission deems it appropriate, and in the public interest to impose the sanctions agreed to in Respondents' offers.

Accordingly, it is hereby ORDERED:

- A. Pursuant to Sections 203(e) and 203(f) of the Advisers Act, that Respondents VWCM and Van Wagoner are censured;
- B. Pursuant to Section 203(k) of the Advisers Act and 9(f) of the Investment Company Act, that Respondents VWCM and Van Wagoner cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the Advisers Act and Section 17(j) of the Investment Company Act and Rules 17j-1(c)(2) and 22c-1 promulgated thereunder;

C. Respondents Van Wagoner and Van Wagoner Capital Management shall, within 12 months of the entry of this Order, jointly and severally pay a civil money penalty in the amount of \$800,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Van Wagoner and VWCM as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Helene L. Morrison, District Administrator, San Francisco District office, Securities and Exchange Commission, 44 Montgomery Street, Suite 1100, San Francisco, California, 94104.

D. Respondent Van Wagoner shall comply with the undertakings enumerated in Paragraphs 40.a. through 40.f., above, and Respondent VWCM shall comply with the undertakings enumerated in Paragraphs 41.a. through 41.e., above.

By the Commission.

Jonathan G. Katz  
Secretary



## IN THE MATTER OF ALLIED CAPITAL CORPORATION

Release No. 34-55931

Administrative Proceeding File No. 3-12661

June 20, 2007

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

### I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against Allied Capital Corporation (“Allied” or “Respondent”).

### II.

In anticipation of the institution of these proceedings, Respondent has submitted an offer of Settlement (the “offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and over the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

### III.

On the basis of this Order and Respondent’s offer, the Commission finds that:

#### Respondent

1. **Allied Capital Corporation**, incorporated in Maryland and headquartered in Washington, D.C., is a closed-end management investment company that has elected to be regulated as a business development company (“BDC”) pursuant to Section 54 of the Investment Company Act of 1940 (“Investment Company Act”). Allied provides privately negotiated debt and equity financing to middle market companies, with a primary focus on private finance. Allied’s securities are registered pursuant to Section 12(g) of the Exchange Act. Allied makes periodic filings with the Commission pursuant to Section 13(a) of the Exchange Act.

#### Summary

2. From the quarter ended June 30, 2001 through the quarter ended March 31, 2003, Allied violated recordkeeping and internal controls provisions of the federal securities laws relating to the valuation of certain securities in its private finance portfolio for which market quotations were not readily available. During the relevant period, Allied failed to make and keep books, records, and accounts which, in reasonable detail, supported or accurately and fairly reflected certain valuations it recorded on a quarterly basis for some of its securities. In addition, Allied’s internal controls failed to provide reasonable assurances that Allied would value these securities in accordance with generally accepted accounting principles. Further, from the quarter ended June 30, 2001 through the quarter ended March 31, 2002, Allied failed to provide reasonable assurances that the recorded accountability for certain securities in its private finance portfolio was compared with existing fair value of those same securities at reasonable intervals by failing to: (a) provide its board of directors (“Board”) with sufficient contemporaneous valuation documentation during Allied’s March and September quarterly valuation processes; and (b) maintain, in reasonable detail, written documentation to support some of its valuations of certain portfolio companies that had gone into bankruptcy.

3. Allied has implemented new valuation processes, more detailed recordkeeping, and a series of additional controls and procedures over its valuation processes.



## Background

4. As a BDC, Allied is required to value its private finance security portfolio pursuant to the requirements in Section 2(a)(41) of the Investment Company Act. Because the large majority of Allied's investments in its private finance portfolio are securities for which market quotations are not readily available, Section 2(a)(41)(B)(ii) of the Investment Company Act requires that Allied's Board determine the fair value of its portfolio securities in good faith. The fair value of securities for which market quotations are not readily available is the price Allied would reasonably expect to receive on a current sale of the security.<sup>1</sup> By the end of the relevant period, Allied's private finance portfolio recorded at fair value grew to over \$1.7 billion, which represented approximately 65% of Allied's total assets, and included investments in approximately 152 portfolio companies.

5. From the quarter ended June 30, 2001 through the quarter ended March 31, 2003, however, Allied failed to make and keep books, records, and accounts which, in reasonable detail, supported the valuations of certain of its securities for which market quotations are not readily available ("private finance investments"). With respect to 15 private finance investments reviewed by staff, Allied could not produce sufficient contemporaneous documentation to support, or which accurately and fairly reflected, its Board's determination of fair value. Instead, in some instances, the written valuation documentation Allied presented to its Board for these investments failed to include certain relevant indications of value available to it (as further discussed below) and sometimes introduced changes to key inputs used to calculate fair value from quarter to quarter without sufficient written explanation of the rationale for the changes (e.g., changes from EBITDA to revenue-based valuations and in some instances, changes in multiples used to derive enterprise value). The written valuation documentation retained by Allied for these private finance investments does not reflect reasonable detail to support the private finance investment valuations recorded by Allied in its periodic filings during the relevant period.

6. The following are three examples of insufficient recordkeeping of Allied's private finance investments during the relevant period.

7. **Company A** - During the relevant period, Allied held a debt investment in Company A, a telecommunications company. Allied was unable to produce contemporaneous written documentation, in reasonable detail, to support its valuation of Company A during the quarters ended June 30, 2001 and September 30, 2001. Specifically, Allied's valuation of Company A for these quarters was derived, in part, by including revenues from discontinued lines of business to establish fair value. Allied maintains that it used a reduced multiple to offset any potential overstatement that would have otherwise resulted from the inclusion of those revenues, but it did not provide the Board with contemporaneous written documentation, in reasonable detail, to support this claim. In addition, Allied did not retain the valuation documentation it presented to the Board for Company A for the quarters ended December 31, 2001 and March 31, 2002. Allied valued its \$20 million subordinated debt investment in Company A at \$20 million (i.e., cost) in its Forms 10-Q for the quarters ended June 30, 2001 and September 30, 2001. In its 2001 Form 10-K and its Form 10-Q for the period ended March 31, 2002, Allied valued its \$20 million subordinated debt investment in Company A at \$10.3 million. Allied subsequently wrote down its subordinated debt investment in Company A to \$245,000 in its Form 10-Q for the quarter ended June 30, 2002.

8. **Company B** - During the relevant period, Allied held a subordinated-debt investment in Company B, a direct marketing company. Allied was unable to produce contemporaneous documentation, in reasonable detail, to support the basis for its valuation of Company B for the quarter ended March 31, 2003. Specifically, Allied's valuation was based, in large part, on a potential future buyout event by Allied that was preliminary in nature. Allied maintains that—as a general practice—the Board would have discussed why this particular potential future buyout event was significant enough to form the basis of its valuation of Company B, but it could not provide contemporaneous written documentation in reasonable detail to support this claim. Further, Allied's valuation documentation did not fully reflect Allied's consideration of competing buyout offers for Company B, which, if accepted, would have reduced the fair value of Allied's investment. Allied valued its \$16.5 million subordinated debt investment in Company B at \$14.3 million in

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<sup>1</sup> See *AICPA Audit and Accounting Guide: Investment Companies (Sect. 2.35-2.39)*, which incorporates Accounting Series Release No. 118 ("ASR 118"). The Commission has provided interpretative guidance related to financial reporting in the Accounting Series Releases, which is included in the Codification of Financial Reporting Policies. Thus, conformity with the ASR 118 is required by Commission rules and is consistent with GAAP. See also Articles 1-01(a) and 6.03 of Regulation S-X.

its Form 10-Q for the quarter ended March 2003. Allied subsequently wrote down its subordinated debt investment in Company B from \$14.3 million to \$50,000 in its Form 10-Q for the quarter ended June 30, 2003.

9. **Company C** - During the relevant period, Allied held a subordinated debt investment in Company C, an office supply company. Allied was unable to produce contemporaneous documentation, in reasonable detail, to support the basis for its valuation of Company C from the quarter ended September 30, 2001 through the quarter ended March 31, 2002. For example, Allied's written valuation documentation failed to include all relevant facts available to it regarding Company C's deteriorating financial condition, including the fact that Company C had lost one of its largest customers as a result of the terrorist attack on the World Trade Center. Allied valued its subordinated debt investment in Company C at \$8 million in its Forms 10-Q and Form 10-K for the quarters ended September 30, 2001 through March 31, 2002 and subsequently wrote that investment down to \$50,000 in its Form 10-Q for the quarter ended June 30, 2002.

10. Allied also failed to implement internal accounting controls relating to its private finance investment valuations that were sufficient to provide reasonable assurances that these valuations were fairly stated in accordance with generally accepted accounting principles, or other criteria applicable to its financial statements. For example, there were certain instances where Allied did not provide its Board (or its valuation committee) with sufficient written information to support the Board's determinations of fair value.<sup>2</sup> For example, in several instances, the written valuation documentation presented to the Board was incomplete or inadequate to support the fair value recorded by Allied (e.g., enterprise values were listed on worksheets without any explanation; necessary inputs and/or calculations were either missing or incomplete). In other instances, Allied's valuation documentation during the relevant period contained unexplained departures from, or changes to, key inputs from quarter to quarter. During the relevant period, Allied did not provide its Board with written valuation documentation from prior periods. At least one Board member, however, maintained prior period valuation documentation during a portion of the relevant period, but Allied did not regularly provide the Board with comparative information about prior period inputs until the quarter ended September 30, 2003.

11. In addition, from the quarter ended June 30, 2001 through the quarter ended March 31, 2002, the valuation documentation presented to Allied's Board during the March and September quarterly valuation processes consisted of quantitative worksheets that failed to provide an adequate explanation of the various inputs. For example, changes in valuations from quarter to quarter were not always explained in reasonable detail in the written documentation. Moreover, Allied did not prepare a written description of the quantitative and qualitative analyses used to develop its valuations until the quarter ended June 30, 2002. During this period, Allied also failed to maintain, in reasonable detail, written documentation to support some of its valuations of certain portfolio companies that had gone into bankruptcy. While Allied maintains that its Board members and employees engaged in discussions before and during the Board meetings to satisfy themselves with the recorded valuations for Allied's private finance investments, the written valuation documentation retained by Allied for certain private finance investments does not reflect reasonable detail to support the private finance investment valuations recorded by Allied in its periodic filings during the relevant period.<sup>3</sup>

12. During the relevant period, Allied private finance department personnel typically recommended the initial valuations on the investment deals on which they worked. While there were some existing independent checks of Allied's valuation process, these checks, standing alone, did not provide a sufficient assessment of the objectivity of valuations of the private finance investments. For example, the valuation committee assigned to review each investment on a quarterly basis was comprised, in large part, of private finance managing directors and principals. Allied has since implemented new valuation processes, more detailed recordkeeping, and a series of additional controls and procedures over its valuation processes, including, but not limited to: quarterly valuation assistance from third-parties; and the establishment of a new Chief Valuation officer position to oversee the valuation process.

<sup>2</sup> Allied's failure to provide the Board with such information is inconsistent with the guidance in ASR 118 that a fund's board must satisfy itself that "all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered . . ." See *supra* n.1.

<sup>3</sup> Commission guidance provides that ". . . directors should take into consideration all indications of value available to them in determining the 'fair value' assigned to a particular security. The information so considered together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decisions should be documented in the minutes of the directors' meeting and the supporting data retained for the inspection of the company's independent accountant." See ASR 118.

13. As a result of the conduct described above, Allied violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets. *See, e.g., In the Matter of Morgan Stanley*, Admin. Proc. File No. 3-11725, Exchange Act Release No. 50632, 2004 SEC Lexis 2573 (Nov. 4, 2004) (finding, in relevant part, that Morgan Stanley's failure to maintain documentation to support its bond valuations violated Section 13(b)(2)(A)).

14. As a result of the conduct described above, Allied also violated Section 13(b)(2)(B)(ii) of the Exchange Act, which requires reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, or other criteria applicable to its financial statements. *See, e.g., In the Matter of Morgan Stanley*, Admin. Proc. File No. 3-11725, Exchange Act Release No. 50632, 2004 SEC Lexis 2573 (Nov. 4, 2004) (finding, in relevant part, that Morgan Stanley's failure to maintain internal controls sufficient to ensure that it valued its bond positions and its aircraft in accordance with GAAP violated Section 13(b)(2)(B)).

15. As a result of the conduct described above, Allied also violated Section 13(b)(2)(B)(iv) of the Exchange Act, which requires reporting companies to provide reasonable assurances that the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

#### IV.

In determining to accept the offer, the Commission considered remedial acts that were undertaken by Respondent and the cooperation that Respondent afforded the Commission staff.

#### V.

##### Undertakings

Respondent has undertaken for a period of two years from the entry of this Order to:

1. Continue to employ a Chief Valuation officer, or a similarly structured officer-level employee, to oversee its quarterly valuation process.
2. Continue to employ third-party valuation consultants to assist in its quarterly valuation process for private finance investments in a manner consistent with the Respondent's current practices.

#### VI.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Allied's offer.

Accordingly, the Commission HEREBY ORDERS, pursuant to Section 21C of the Exchange Act, that:

- A. Respondent Allied cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A); 13(b)(2)(B)(ii) and 13(b)(2)(B)(iv) of the Exchange Act; and
- B. Respondent shall comply with the undertakings enumerated in Section V above.

By the Commission.

Nancy M. Morris  
Secretary

**IN THE MATTER OF HEARTLAND ADVISORS, INC.,  
WILLIAM J. NASGOVITZ, PAUL T. BESTE, THOMAS J. CONLIN, GREG D. WINSTON,  
KEVIN D. CLARK, KENNETH J. DELLA, AND HUGH F. DENISON, RESPONDENTS**

Release Nos. 33-8884; 34-57206; IA-2698; IC-28136

Administrative Proceeding File No. 3-12936

January 25, 2008

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 15(b)(4), 15(b)(6) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), Sections 15(b)(4), 15(b)(6) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Heartland Advisors, Inc. (“Heartland Advisors”), William J. Nasgovitz (“Nasgovitz”), Paul T. Beste (“Beste”), Thomas J. Conlin (“Conlin”), Greg D. Winston (“Winston”), Kevin D. Clark (“Clark”), Kenneth J. Della (“Della”), and Hugh F. Denison (“Denison”) (also referred to collectively as “Respondents”).

**II.**

In anticipation of the institution of these proceedings, Respondents have submitted offers of Settlement (the “offers”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders Pursuant to Section 8A of the Securities Act, Sections 15(b)(4), 15(b)(6) and 21C of the Exchange Act, Sections 203(e), 203(f) and 203(k) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act (“Order”), as set forth below.

**III.**

On the basis of this Order and Respondents’ offers, the Commission finds that:<sup>1</sup>

**A. Respondents**

1. **Heartland Advisors** was founded in 1982 and maintains its principal place of business in Milwaukee, Wisconsin. During the events relevant to this proceeding, Heartland Advisors was registered with the Commission as an investment adviser and broker-dealer. Heartland Advisors managed the mutual fund portfolio series of Heartland Group, Inc. (“Heartland Group”), a registered investment company, subject to the authority of, and supervision by, Heartland Group’s Board of Directors, and served as the principal underwriter of Heartland Group’s securities. Heartland Advisors managed Heartland Group’s High-Yield Municipal Bond Fund and Heartland Group’s Short Duration High-Yield

<sup>1</sup> The findings herein are made pursuant to Respondents’ offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

Municipal Fund (collectively, the “Funds”) until the Commission obtained an order placing the Funds into receivership in March 2001.<sup>2</sup>

2. **Nasgovitz**, of Milwaukee, Wisconsin, is the President, Chief Executive Officer and Chief Investment Officer of Heartland Advisors, and the President and a Director of Heartland Group. Nasgovitz is the majority owner of the holding company that owns Heartland Advisors.
3. **Beste**, of Brookfield, Wisconsin, is the Chief Operating Officer of Heartland Advisors and a Vice President of Heartland Group. He also is a member of Heartland Advisors’ Pricing Committee.
4. **Conlin**, of Wauwatosa, Wisconsin, was a co-portfolio manager of the Funds until September 2000. He was also, until September 2000, a Vice President of Heartland Advisors and a non-voting member of Heartland Advisors’ Pricing Committee. Conlin is no longer employed by Heartland Advisors.
5. **Winston**, of Sussex, Wisconsin, was, during the events relevant to this proceeding, a co-portfolio manager of the Funds. He was a Vice President of Heartland Advisors and an alternate member of its Pricing Committee. Winston is no longer employed by Heartland Advisors.
6. **Clark**, of Menomonee Falls, Wisconsin, is the Senior Vice President of Trading at Heartland Advisors. He also is a member of Heartland Advisors’ Pricing Committee.
7. **Della**, of Waukesha, Wisconsin, was, during the events relevant to this proceeding, a Senior Vice President and Treasurer of Heartland Advisors. He also was a member of Heartland Advisors’ Pricing Committee. Della is no longer employed by Heartland Advisors.
8. **Denison**, of Whitefish Bay, Wisconsin, was a non-independent Director of Heartland Group, from 1988 to 2003.

## **B. Other Relevant Entities**

1. **Heartland Group** is a Maryland corporation formed in 1986 that maintains its principal place of business in Milwaukee, Wisconsin. Heartland Group has been registered with the Commission as an open-end, management investment company since January 1987. During the period relevant to these proceedings, Heartland Group offered seven different series of mutual funds, including three equity and four fixed-income funds.
2. **Heartland Group’s Short Duration High-Yield Municipal Fund** (“Short Duration Fund”) began operating on January 2, 1997. Its stated investment objective was a high level of federally tax-exempt current income with a low degree of share price fluctuation.
3. **Heartland Group’s High-Yield Municipal Bond Fund** (“High Yield Fund”) also began operating on January 2, 1997. Its stated investment objective was to maximize after tax total return by investing for a high level of federally tax-exempt current income.<sup>3</sup>

## **C. Overview**

1. This matter stems from Heartland Advisors’ mispricing of certain bonds owned by the Funds and its failure to effectively communicate to the Heartland Group’s Board of Directors (“Directors”), and to investors, important facts concerning Heartland Advisors’ efforts to evaluate bond issuers.

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<sup>2</sup> On March 21, 2001, Heartland Group consented, without admitting or denying the allegations in the Complaint, to the entry of an order of permanent injunction and other equitable relief for violations of Sections 30(b)(2), 30(e) and 30(g) of the Investment Company Act and Rules 30b2-1, 30d-1(a) and 30d-1(c) promulgated thereunder, which froze the assets of the Funds. In addition, a receiver was appointed over the Funds. See *SEC v. Heartland Group, Inc.*, Case No. 01 C 1984 (N.D. Ill.), Litigation Release No. 16938 (March 22, 2001). The receiver subsequently liquidated the Funds.

<sup>3</sup> Heartland Group’s former Independent Directors previously settled a Commission administrative proceeding arising from the events relevant to this proceeding. See *In the Matter of Jon D. Hammes, Albert Gary Shilling, Allan H. Stefl, and Linda F. Stephenson*, Administrative Proceeding File No. 3-11351 (December 11, 2003).



2. From March 1, 2000 into October 2000, the Funds' portfolios included several municipal bonds that were valued by the Funds at prices above their fair values. As a result, on numerous days throughout that time period, the Funds' Net Asset Values ("NAVs") were incorrect, the Funds' shares were incorrectly priced, and investors purchased and redeemed Fund shares at prices that benefited redeeming investors at the expense of remaining and new investors.
3. During the relevant period, information was presented to the Directors which should have alerted the Directors, including Denison, that the bonds were becoming increasingly illiquid and may have been mispriced. As a result, the Directors, including Denison, should have known that the prices at which the Funds carried their bonds did not reflect the bonds' "fair value" as required by Heartland Group's pricing procedures.
4. Heartland Advisors was forced on October 13, 2000 to devalue the bonds, thereby resulting in approximately \$60 million in monetary losses to shareholders.

#### D. Background

1. The Funds invested primarily in non-rated, medium and lower quality municipal bonds. The majority of the municipal bonds owned by the Funds were below investment grade and illiquid. Market quotations were not readily available for most of the bonds owned by the Funds.
2. Open-end investment companies, such as the Funds, offer their own securities to investors on a redeemable basis. (Section 5(a) of the Investment Company Act [15 U.S.C. § 80a5(a)].) Each of the Funds was required to calculate its net asset value ("NAV") daily. (Investment Company Act Rule 22c-1(b) [17 C.F.R. § 270.22c-1(b)].) The price at which an investor can buy or redeem shares of a mutual fund is based on that fund's NAV. (Investment Company Act Rule 22c-1(a) [17 C.F.R. § 270.22c-1(a)].)
3. During 2000, persons residing throughout the United States purchased and redeemed shares of each of the Funds. During 2000, Heartland Advisors publicly disseminated the NAV of each of the Funds in interstate commerce every business day. Persons who purchased and redeemed shares of the Funds effected such transactions at prices based on the NAVs publicly disseminated by Heartland Advisors.
4. A mutual fund generally must value any security for which market quotations are not readily available at "fair value as determined in good faith by the board of directors[.]" (Investment Company Act, Section 2(a)(41)(b) [15 U.S.C. § 80a-2(a)(41)]; Investment Company Act Rule 22c-1(a) [17 C.F.R. § 270.22c-1(a)].) The fair value of a portfolio security generally is the price that a fund might reasonably expect to receive for the security upon its current sale. (Accounting Series Release No. 118, December 23, 1970 ("ASR 118").) The Directors considered fair value as the price that could be obtained from an arm's length buyer in a current sale.
5. The Directors delegated the day-to-day responsibility for operating the Funds to Heartland Advisors. Heartland Advisors made many decisions affecting the Funds' conduct through three committees, including the Pricing Committee.
6. Heartland Advisors' Pricing Committee was charged with the responsibility for the day-to-day valuation of the Funds' portfolio securities pursuant to Heartland Group's procedures for valuing those securities, and the implementation and administration of the Directors' procedures for valuing such securities.
7. The pricing procedures established by the Directors directed the Pricing Committee to use valuations provided by FT Interactive Data Corporation, f/k/a Interactive Data Corporation and Muller Data Corporation ("FT"), a pricing service, to fair value such securities in order to determine the Funds' daily NAVs. Heartland Group's pricing procedures required the Pricing Committee to review the evaluations provided by FT to ensure that those evaluations were "sufficiently timely and accurate."<sup>4</sup>
8. During 2000, Heartland Advisors created and preserved accounting records reflecting its calculations of the daily NAVs of the Funds.

<sup>4</sup> FT previously settled a Commission administrative proceeding arising from the events relevant to this proceeding. *See In the Matter of FT Interactive Data*, Administrative Proceeding File No. 3-11352 (December 11, 2003).

9. During late 1999 and early 2000, the Funds' portfolio managers learned that projects underlying several bonds held by the Funds had gone into default and other projects were failing. FT did not reduce its valuations of the affected bonds based upon that information, while Heartland Advisors did not consider fully the implications of these events for the valuations of the affected bonds, but continued to use the FT valuations.

10. Between March 2000 and May 2000, FT gradually lowered the valuations of certain bonds held by the Funds. For example, between March 7, 2000 and May 8, 2000, the valuations of certain bonds owned by the Funds uniformly decreased on a daily basis. The valuations of these bonds in March ranged from approximately 87 percent of par value to 98 percent of par value. From March into May, the valuations of those bonds were reduced daily in increments of 0.5 percentage points until the valuations reached 80 percent of par value. These incremental price reductions were not based on any contemporaneous market or credit-related events, or other external factors affecting the individual securities. Between March 2000 and May 2000 Heartland Advisors continued to use FT's valuations.

11. The effect of these incremental price reductions was to spread out and thereby minimize the impact of the total valuation declines on the Funds' NAVs and on the performance reported by the Funds.

12. The Funds' May 1, 2000, Statement of Additional Information ("SAI"), which was incorporated by reference in the Funds' May 1, 2000 prospectus, as supplemented as of June 9, 2000, represented that both Heartland Advisors and the Directors would, among other things, monitor the issuers of the high yield bonds held in the Funds' portfolios to assess and determine whether the issuers had sufficient cash flow to meet required principal and interest payments and to assure the continued liquidity of such bonds. Heartland Advisors and the Directors did not, however, adequately monitor the financial status of the bonds' issuers or the bonds' liquidity. Heartland Advisors publicly disseminated the May 1, 2000, SAI, the May 1, 2000, prospectus, and the June 9, 2000, supplement to that prospectus. The June 30, 2000, NAVs of the Funds were publicly disseminated by means of a semi-annual report dated July 1, 2000.

13. The Fund's June 9, 2000, prospectus represented that Heartland Advisors managed the risks associated with the Funds through "intensive credit research," pursuant to Heartland Advisors' proprietary method. In fact, by the late summer 2000, Heartland Advisors' Fixed Income Department was understaffed and performing what a senior manager described as "catch up research" on the Funds' portfolios.

14. Beginning in the Spring of 2000, the Funds were experiencing net redemptions, and the Funds had not been able to purchase any new bonds during the prior six months due to a lack of cash. Respondents failed to sell sufficient bonds held by the Funds to meet redemption requests in part because the Funds' portfolio managers made the determination not to sell bonds at prices below the Funds' valuations. As a result, the Funds borrowed heavily against a line of credit and used the borrowed money to meet redemption requests.

15. By the Spring of 2000, the Funds were also experiencing liquidity problems. For example, on April 27, 2000, almost 18% of the bonds held by the High Yield Fund were illiquid, and 6% of the bonds in the Short Duration Fund were illiquid. The fact that so many bonds held by the Funds were individually illiquid had the compounding effect of causing the portfolios of the Funds to be collectively illiquid, potentially exacerbating the Funds' liquidity problems.

16. At an August 10, 2000, meeting of the Directors, Conlin, one of the Funds' co portfolio managers, stated that if forced to sell bonds owned by the Funds that day, a discount from current valuation would be required but that Heartland Advisors should be able to sell the bonds owned by the Funds in one week in the ordinary course. The Directors directed Heartland Advisors to sell bonds owned by the Funds to reduce the Funds' borrowings. Heartland Advisors failed to do so.

17. Shortly after the August 10, 2000, Directors meeting, Conlin tendered his resignation.

18. The Funds' liquidity problems continued into September 2000. Through September, Heartland Advisors experienced difficulty in selling bonds at or near the Funds' valuations. During September, several of the Respondents contacted potential purchasers, discussed the Funds' holdings and received expressions of interest at prices significantly below the prices at which the Funds were valuing the bonds. Heartland Advisors believed these potential purchasers were "vulture funds" and other investors who were attempting to purchase the Funds' holdings at prices that Heartland Advisors believed to be unreasonably low.



- Although these expressions of interest did not establish valuation, Heartland Advisors should have given greater weight to such expressions in deciding whether to continue to utilize FT's valuations.
19. In late September 2000, Heartland Advisors sold some of the Funds' most illiquid bonds to the State of Wisconsin Investment Board ("SWIB"). The transaction was only completed because Naskovitz and a company he controlled agreed to guaranty to SWIB that it would recover its investment plus a 20% return. While Heartland Advisors disclosed the details of the SWIB transaction to the Directors, no public disclosure was made.
  20. On September 28, 2000, Heartland Advisors reduced the NAV of the High-Yield Fund by 8.2% and the NAV of the Short Duration Fund by 2.1%. As a result, the NAVs of the High Yield Fund and the Short Duration Fund dropped from \$8.75 to \$8.03 and \$9.10 to \$8.91, respectively, in one day.
  21. Heartland Advisors issued a press release on September 28, 2000, announcing that two individuals would join Winston as co-portfolio managers of the Funds. The press release also announced Conlin's resignation. The press release said nothing regarding the reduced valuations of the Funds or the liquidity problems of the Funds.
  22. On the evening of September 28, 2000, Winston decided to redeem some of his shares in the Funds. He then made a phone call to relatives. On September 29, 2000, Winston and his relatives redeemed a total of 9,530.75 shares of the Funds.
  23. On October 10, Della called in a trade to redeem 147.62 shares in the Short Duration Fund and 194.37 shares in the High Yield Fund. Della also called in a trade for an account over which he had discretionary authority and redeemed 1,946.71 shares in another Heartland Group Fund which also owned several of the bonds owned by the Funds.
  24. On October 12, the Chairperson of the Pricing Committee directed Heartland Advisors' Fixed Income Department to determine fair value prices of bonds held in the Funds' portfolios. The Fixed Income Department provided alternative valuations, but the Pricing Committee determined that it did not have any basis for concluding that these valuations were more reliable than FT's valuations. Thus the Pricing Committee continued to use FT's evaluations to value the Funds' bonds that day.
  25. Later on October 12, one of the Funds' new co-portfolio managers sent an email to the Chairperson of the Pricing Committee stating his belief that the prices used to value the Funds that day did not reflect the value of the bonds held in the Funds.
  26. On October 13, 2000, the Pricing Committee proceeded to assign new values to the bonds held by the Funds. Before doing so, the Pricing Committee asked the Fixed Income Department to provide fair values for the portfolio securities and were told that the Fixed Income Department could not provide such valuations. The Fixed Income Department provided alternative valuations which the Pricing Committee chose not to accept. Instead, the Pricing Committee further reduced the individual portfolio security evaluations recommended by the Fixed Income Department by an additional 33% for the Short Duration Fund and 50% for the High Yield Fund.
  27. As a result, on October 13, 2000, the NAV of the High Yield Fund decreased by 69.4%, from \$8.01 to \$2.45, and the NAV of the Short Duration Fund decreased by 44.0%, from \$8.70 to \$4.87 from the previous day.
  28. The Directors' review, including Denison's, of Heartland Advisors' devaluation of the Funds' bonds on October 13, 2000 was inadequate because they failed to identify the deficiencies in Heartland Advisors' pricing of the bonds on that day.
  29. As a result of the negligent conduct described above, Heartland Advisors did not properly fair value the bonds held by the Funds.
  30. As a result of the negligent conduct described above, the NAV of each of the Funds was materially overstated from March 1, 2000 to October 13, 2000. Heartland Advisors publicly disseminated the Funds' materially misstated NAVs.
  31. As a result of the negligent conduct described above, Heartland Advisors, the Funds' principal underwriter, effected purchases and redemptions of shares of the Funds at materially incorrect prices.

## E. Findings

1. As a result of the negligent conduct described above, the Commission finds that Respondents (other than Denison) willfully<sup>5</sup> violated the federal securities laws, as follows:

a. Heartland Advisors, Nasgovitz, Beste, Conlin, Winston, Clark and Della violated Sections 17(a)(2) and 17(a)(3) of the Securities Act;

b. Heartland Advisors, Nasgovitz, Beste, Conlin, Winston and Clark violated Section 34(b) of the Investment Company Act;

c. Heartland Advisors violated Rule 22c-1(a), promulgated pursuant to Section 22(c) of the Investment Company Act; and

d. Heartland Advisors violated Section 206(2) of the Advisers Act, and Nasgovitz, Beste, Conlin, Winston, Clark and Della were a cause of Heartland Advisors' violation of Section 206(2) of the Advisers Act.<sup>6</sup>

2. As a result of the negligent conduct described above, the Commission finds that Denison violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and was a cause of Heartland Advisors' violation of Rule 22c-1(a), promulgated pursuant to Section 22(c) of the Investment Company Act.

## IV.

In view of the foregoing, the Commission deems it appropriate to accept the offers submitted by the Respondents and impose the sanctions agreed to in Respondents' offers.

Accordingly, pursuant to Section 8A of the Securities Act, Section 15(b)(4), 15(b)(6) and 21C of the Exchange Act, Sections 203(e), 203(f) and 203(k) of the Advisers Act, and Section 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

1. Respondents cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and 17(a)(3) of the Securities Act.

2. Heartland Advisors, Nasgovitz, Beste, Conlin, Winston, and Clark cease and desist from committing or causing any violations and any future violations of Section 34(b) of the Investment Company Act.

3. Heartland Advisors cease and desist from committing or causing any violations and any future violations of Rule 22(c)-1(a) promulgated under the Investment Company Act.

4. Heartland Advisors cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act.

5. Nasgovitz, Beste, Conlin, Winston, Clark and Della cease and desist from causing any violations and any future violations of Section 206(2) of the Advisers Act.

6. Denison cease and desist from causing any violations and any future violations of Rule 22c-1(a) promulgated pursuant to Section 22(c) of the Investment Company Act.

7. Heartland Advisors, Nasgovitz, Beste, Conlin, Winston, Clark, and Della are censured.

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<sup>5</sup> A willful violation of the securities laws means merely "that the person charged with the violation knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

<sup>6</sup> A violation of Section 206(2) may be established by a showing of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992). Moreover, "cause," as used herein, is based upon negligence, which is "sufficient to establish liability for causing a primary violation that does not require scienter." *Matter of Warwick Cap. Mgmt., Inc., et al.*, Admin. Proc. File No. 3 12357, 2007 WL 505772, at \*10 (Feb. 15, 2007) (quoting *KPMG Marwick LLP*, 54 S.E.C. 1135, 1175 (2001), recon. denied, 55 S.E.C. 1 (2001), pet. denied, 289 F.3d 109 (D.C. Cir. 2002)).

8. Winston and Della are suspended from association with any broker, dealer, or investment adviser for a period of 12 months, effective on the second Monday following the entry of this Order.

9. Winston and Della are prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter for a period of 12 months, effective on the second Monday following the entry of this Order.

It Is Further ORDERED That:

A. Heartland Advisors shall, within 30 days of the entry of this Order, and jointly and severally with Nasgovitz, pay disgorgement of \$1 and a civil money penalty in the amount of \$3.5 million;

B. Beste shall, within 30 days of the entry of this Order, pay disgorgement of \$1 and a civil money penalty in the amount of \$95,000;

C. Conlin shall, within 30 days of the entry of this Order, pay disgorgement of \$1 and a civil money penalty in the amount of \$95,000;

D. Winston shall, within 30 days of the entry of this Order, pay disgorgement of \$46,274, prejudgment interest of \$21,687, and a civil money penalty in the amount of \$95,000;

E. Clark shall, within 30 days of the entry of this Order, pay disgorgement of \$1 and a civil money penalty in the amount of \$25,000; and

F. Della shall, within 30 days of the entry of this Order, pay disgorgement of \$2,833, prejudgment interest of \$1,297, and a civil money penalty in the amount of \$25,000.

G. Such payments of disgorgement, interest and penalties referenced in paragraphs A through F above shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies the payor as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John E. Birkenheier, Supervisory Trial Counsel, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL 60604.

H. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund is created for the disgorgement, interest and penalties referenced in paragraphs A through G above. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that Respondents shall not, after offset or reduction in any Related Investor Action based on Respondents' payment of disgorgement in this action, argue that Respondents are entitled to, nor shall Respondents further benefit by offset or reduction of any part of Respondents' payments of civil penalties in this action ("Penalty offset"). If the court in any Related Investor Action grants such a Penalty offset, Respondents agree that Respondents shall, within 30 days after entry of a final order granting the Penalty offset, notify the Commission's counsel in this action and pay the amount of the Penalty offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Nancy M. Morris  
Secretary

## IN THE MATTER OF EVERGREEN INVESTMENT MANAGEMENT COMPANY, LLC, AND EVERGREEN INVESTMENT SERVICES, INC., RESPONDENTS

Administrative Proceeding File No. 3-13507

Release Nos. 34-60059; IA 2888; IC 28759

June 8, 2009

Action: Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(B)(4) and 21c of the Securities Exchange Act of 1934, Sections 203(E) And 203(K) of the Investment Advisers Act of 1940, and Sections 9(B) and 9(F) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order

### I.

The United States Securities and Exchange Commission (the “Commission”) deems it appropriate and in the public interest that administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc. (collectively, “Respondents”).

### II.

In anticipation of the institution of these proceedings, the Respondents have submitted an Offer of Settlement (the “Offer”) that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings, except those findings pertaining to the jurisdiction of the Commission over Respondents and the subject matter of these proceedings, which are admitted, the Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934, Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”) as set forth below. The Order is instituted as to Evergreen Investment Management Company, LLC pursuant to Sections 203(e) and 203(k) of the Advisers Act and Sections 9(b) and 9(f) of the Investment Company Act. The Order is instituted as to Evergreen Investment Services, Inc. pursuant to Section 15(b)(4) and 21C of the Exchange Act, Section 203(k) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act.

### III.

On the basis of this Order and Respondents’ Offer, the Commission finds<sup>1</sup> that:

#### Summary

1. The Evergreen Ultra Short Opportunities Fund (the “Ultra Fund” or the “Fund”) was a mutual fund that invested primarily in mortgage-backed securities. The Fund’s investment adviser was Evergreen Investment Management Company, LLC (the “Evergreen Adviser”). From February 2007 through its closing on June 18, 2008, the Ultra Fund overstated its per share net asset value (“NAV”) by as much as 17%. The Fund’s NAV was overstated because the Evergreen Adviser, through the Fund’s portfolio management team, did not properly take into account various readily available information when recommending valuations to the Evergreen Valuation Committee (whose responsibility it was to value such securities) for certain residential mortgage-backed securities held by the Fund. For example, beginning at least in February 2007, the media widely reported that a benchmark asset-backed derivative index had substantially weakened, with the portion of the index based on subprime mortgages hitting record levels. This was a significant change in the market for securities held by the Ultra Fund, yet the Evergreen Adviser did not take this change into account when valuing mortgage-backed securities. Moreover, at certain times, the Fund’s portfolio management team withheld relevant negative information about certain residential mortgage-backed securities the Fund held from the Evergreen Valuation

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<sup>1</sup> The findings herein are made pursuant to the Respondents’ Offer and are not binding on any other person or entity in this or any other proceeding.

Committee. As a result, certain shareholders redeemed their shares at prices higher than they should have received—to the detriment of remaining shareholders—and certain shareholders purchased shares at higher prices than they should have paid. Moreover, due to its overstated NAV, the Ultra Fund appeared to be performing better than it actually was from February 2007 to June 2008 as compared to similar mutual funds. In terms of performance, the Ultra Fund was consistently ranked as one of the top five to ten funds of the 40-50 funds in its category during this period. If the Ultra Fund's NAV had been accurately reported, its performance would have ranked at or near the bottom of its fund category. Consequently, by causing the Ultra Fund to overstate its NAV from February 2007 to June 2008, the Evergreen Adviser denied the investors who owned Ultra Fund shares during this period and those investors considering purchasing Fund shares the opportunity to consider accurate information about the Fund's performance when deciding whether to retain, redeem, or purchase those shares.

2. The Ultra Fund's Board of Trustees decided to liquidate the Fund in June 2008 after a three-week period during which the Ultra Fund reduced the prices at which it valued numerous securities it held. Many of these re-pricings resulted not from market-related events but rather from a change in the way the Ultra Fund valued the securities it held. The repricings had a substantial negative impact on the Ultra Fund's reported NAV, causing the Fund's reported NAV to decline from \$9.20 per share on May 23, 2008, to \$7.48 per share on June 18, 2008, the date the Fund's board decided to liquidate the Fund (the "liquidation date"). After substantial reductions in the Fund's NAV on June 10 and 11, 2008, the Evergreen Adviser and its affiliated broker-dealer, Evergreen Investment Services, Inc. (the "Evergreen Distributor"), disclosed to select Ultra Fund shareholders or their financial intermediaries that the decreased NAV was the result of the re-pricings and that the re-pricings might continue. More specifically, the Evergreen Adviser provided information concerning the repricings to one of its clients, which promptly sold its position in the Ultra Fund. In addition, the Evergreen Distributor, with the knowledge of the Evergreen Adviser, directed its wholesalers to provide the information concerning the re-pricings that it had obtained from the Evergreen Adviser to: (a) those shareholders, registered representatives and broker-dealers who made incoming calls to the Evergreen Distributor about the recent decreases in the NAV; and (b) each registered representative of another broker-dealer affiliated with the Evergreen Adviser and the Evergreen Distributor who had customers who had invested in the Fund. The Evergreen Distributor also directed its wholesalers to provide this information to the representatives of certain other financial services providers. By limiting the dissemination of this important information, Respondents improperly gave some Ultra Fund shareholders, including customers of one of their own affiliates, an unfair advantage over other shareholders of the Fund. The shareholders who were provided the material nonpublic information were then able to use it in deciding whether to redeem their shares before further potential re-pricings of the securities held by the Fund. In fact, many of the shareholders who received this information then redeemed their shares in the Ultra Fund prior to the liquidation date—and at a higher price than those shareholders who held their shares in the Fund until the liquidation date. At no point during the three week period leading up to the liquidation date did the Respondents disseminate any press release or statement conveying this material, nonpublic information to the general investing public in a manner designed to reach all Ultra Fund shareholders and prospective shareholders. The significant decline in the Ultra Fund's NAV resulting from the re-pricing of securities, combined with the large number of redemption requests that could force the Fund to sell its illiquid securities, ultimately led the Fund's Board of Trustees to decide to liquidate the Fund and make a liquidating distribution to shareholders on June 18.

3. In addition, from as early as January 2008, the Evergreen Adviser caused the Fund to engage in prohibited securities transactions with other mutual funds in the Evergreen family of mutual funds. Finally, the Evergreen Distributor failed to preserve certain business-related electronic communications as required by federal securities laws and in violation of a Commission Order entered against it on September 19, 2007, in a separate enforcement action.

### Respondents

4. Evergreen Investment Management Company, LLC, is registered with the Commission as an investment adviser (SEC File No. 801-8327), with its principal place of business in Boston, Massachusetts. The Evergreen Adviser is the registered investment adviser for the Evergreen family of mutual funds, including the Ultra Fund, and received payment of advisory fees based on the NAV of each fund. As of December 31, 2008, the Evergreen Adviser had more than \$175 billion in assets under management. During the relevant period, the Evergreen Adviser was a wholly-owned subsidiary of Wachovia Corporation and currently is a wholly-owned subsidiary of Wells Fargo & Company, a San Francisco, California-based



company whose common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and is traded on the New York Stock Exchange.

5. Evergreen Investment Services, Inc. (the “Evergreen Distributor”) is the Evergreen Adviser’s affiliated broker-dealer that is registered with the Commission (SEC File No. 8-395), with its principal place of business in Boston, Massachusetts. The Evergreen Distributor is the principal underwriter of the Evergreen family of mutual funds, including the Ultra Fund, utilizing employees known as wholesalers to interact with broker-dealers who sell shares of the various mutual funds directly to customers. During the relevant period, the Evergreen Distributor was a wholly-owned subsidiary of Wachovia Corporation and currently is a wholly-owned subsidiary of Wells Fargo & Company

#### **Related Parties**

6. Evergreen Ultra Short Opportunities Fund is a series of the Evergreen Fixed Income Trust, an open-end management investment company (i.e., a mutual fund) registered with the Commission (SEC File No. 811-07246). The Ultra Fund invested primarily in commercial and residential fixed and variable rate mortgages-backed securities, including collateralized mortgage obligations, collateralized debt obligations, and other mortgage-related investments.

7. Wachovia Securities, LLC is a broker-dealer registered with the Commission (SEC File No. 8-37180), with its principal place of business in St. Louis, Missouri. During the relevant period, Wachovia Securities was a subsidiary of Wachovia Corporation and currently is a majority-owned subsidiary of Wells Fargo & Company.

#### **Background**

8. During the period from at least February 2007 through June 2008 (“the relevant period”), the prospectus for the Ultra Fund stated that the Fund would, as a general rule, value each security it owned at the price at which the security could be sold in the market. The prospectus stated that, for each security for which current market prices were available, the Ultra Fund would value the security in accordance with its market price. The prospectus stated that, for each security for which a market price was not readily available or was deemed unreliable, the Ultra Fund would determine a “fair value” for that security under policies established by the Fund’s Board of Trustees. The valuation policies established by the Ultra Fund’s Board of Trustees entrusted the determination of the valuation of fair-valued securities to the Evergreen Valuation Committee. The valuation policies directed that the Valuation Committee’s membership include the Evergreen Adviser’s chief investment officers for fixed income, equity, high yield and international products, as well as representatives from the Evergreen Adviser’s legal, risk management and fund administration departments. The valuation policies further required that the Valuation Committee report on a quarterly basis to the Audit Committee of the Board with respect to the results of the Valuation Committee’s determinations regarding fair valued securities. Given the nature of the securities held by the Ultra Fund—primarily residential mortgage-backed securities and collateralized debt obligations backed by such securities—there was no market price readily available for many of the Fund’s holdings. Accordingly, the process for fair valuing the Fund’s holdings was critical to the proper calculation of the Fund’s NAV.

9. During the relevant period, pursuant to procedures established by the Fund’s Board of Trustees, the Evergreen Valuation Committee employed a three-tier system in fair valuing securities held by the Ultra Fund. Under the first—and, according to the Valuation Committee, the most preferred—tier, securities were valued in accordance with prices provided by a third-party pricing vendor. Under the second tier, such securities were valued in accordance with prices provided by one or more third-party broker-dealers. Under the third—and, according to the Valuation Committee, least preferred—tier, such securities were valued in accordance with the prices recommended by the Fund’s portfolio management team. At least as far back as August 2007, and pursuant to the procedures established by the Fund’s Board, the Valuation Committee valued certain securities held by the Ultra Fund in accordance with the prices provided by a single broker-dealer or recommended by the Fund’s portfolio management team rather than in accordance with the prices provided by a third-party pricing vendor. The Valuation Committee referred to these types of valuations as “vendor overrides.”

### The Ultra Fund's NAV Was Overstated for at Least 17 Months

10. Since its inception, the Ultra Fund valued many of the securities it held in accordance with prices provided by a vendor such as Standard & Poor's, PricingDirect, Interactive Data Corporation, and Reuters. In addition, at least as far back as August 2007, the Ultra Fund valued one or more of the securities it held in accordance with prices provided either by a single broker-dealer or the Fund's portfolio management team—sometimes in the form of a vendor override (when a vendor price was available) and sometimes not (when no vendor price was available). However, as early as February 2007, the Ultra Fund failed to take into account in its valuation of certain vendor-priced, broker-priced and/or portfolio management team-priced residential mortgage-backed securities readily-available negative information concerning the value of those holdings. For example, beginning at least in February 2007, the media widely reported that, due to rising mortgage defaults and delinquencies, an index that served as a benchmark measure of the riskiness of residential mortgage-backed securities had substantially weakened, with the portion of the index based on subprime mortgages hitting record levels. In addition, on multiple occasions, the Fund's portfolio management team did not properly factor readily available data showing an increase in the default or delinquency rate for the subprime residential mortgages backing a collateralized debt obligation security ("CDO") owned by the Fund into the security's valuation. As a result, the Evergreen Adviser caused the Fund's NAV to be overstated from February 2007 through June 2008.

11. In addition, from at least July 25, 2007, to June 16, 2008, the Valuation Committee valued one or more of the securities owned by the Ultra Fund in accordance with prices obtained from an individual broker-dealer located in Florida, whose method for determining prices it had not reviewed or approved. On various occasions in 2007 and 2008, third-party pricing vendors reduced prices on securities held by the Ultra Fund, but rather than reducing the prices for purposes of calculating the Fund's NAV, the portfolio management team recommended—and the Valuation Committee approved—vendor overrides, through which the Fund valued the securities in question in accordance with prices provided by the Florida broker-dealer rather than in accordance with the prices provided by the vendor. By the middle of May 2008, the Evergreen Valuation Committee learned that: (1) despite its expectation that broker-dealers would only be used to price a security on an exception basis, the Ultra Fund's portfolio management team was using the Florida broker-dealer to price a significant portion of the Fund's holdings; and (2) far less due diligence was being conducted on the Florida broker-dealer than was being conducted on other pricing sources. Fifteen of the sixteen securities valued based on prices provided by the Florida broker-dealer were re-priced downward in June 2008, eight by more than 90%. Ten of these fifteen securities were overvalued from at least as far back as September 2007.

12. Moreover, at certain times from March 2008 to June 2008, the Ultra Fund's portfolio management team caused the Ultra Fund to overstate its NAV by withholding relevant negative information about one or more of the Fund's fair valued securities from the Evergreen Valuation Committee. For example, the Fund owned an interest in a CDO backed by subprime residential mortgage-backed securities issued by a company that shall be referred to herein as "Company A." The Ultra Fund's portfolio management team learned by at least March 27, 2008, that the tranche of this CDO owned by the Ultra Fund would not receive any more cash flow until the senior tranche had been repaid in full. The Fund's portfolio management team failed to disclose this information to the Valuation Committee. On June 10, 2008, the Valuation Committee finally became aware of this information and, based at least in part on this information, the Valuation Committee lowered the valuation on this security from \$53.72 (down from an issued value of \$100) to \$0. The Valuation Committee's decision to lower the value of the Company A security to \$0 decreased the Ultra Fund's NAV by nearly \$0.10 per share to \$8.95 per share. Because day-to-day volatility in the Fund's NAV was very low (for most of the prior year, the Ultra Fund's NAV had consistently been in a range of \$9.20-\$9.73 per share), this NAV change was significant.

13. In addition, after the close of trading on May 23, 2008, a different Evergreen mutual fund purchased a CDO backed by subprime residential mortgages issued by a company that shall be referred to herein as "Company B" for \$9.50 (down from an issued value of \$100). At that time, the Ultra Fund owned the same security and was valuing it at \$98.93. After learning of this transaction, the Ultra Fund's portfolio management team contacted the selling broker-dealer to determine whether the sale was "distressed" (and thus could potentially be disregarded for purposes of determining the fair value of the security). On May 28, 2008, the broker-dealer responded that the security was "not coming from a distressed seller, just one that wanted to get out." Notwithstanding this response, the Ultra Fund's portfolio management team informed the Valuation Committee that they believed the sale was distressed and did not disclose the broker-



dealer's statement to the Valuation Committee. Based at least in part on the assertion by the portfolio management team that the \$9.50 sale was distressed, the Ultra Fund failed to lower the value of this security to \$9.50 until June 2, 2008. The June 2, 2008, decision to lower the value of the Company B security to \$9.50 decreased the Ultra Fund's NAV by \$0.025 per share, which, for the Ultra Fund, was significant.

14. Because its NAV was overstated from February 2007 to June 2008 by as much as 17%, Ultra Fund shareholders who redeemed their Fund shares during this period received more money per share than they should have—to the detriment of the remaining shareholders—and those investors who purchased shares during this period paid more per share than they should have. Moreover, due to its overstated NAV, the Ultra Fund appeared to be performing better than it actually was from February 2007 to June 2008. In terms of performance, the Ultra Fund was consistently ranked by a national ranking firm as one of the top five to ten funds of the 40-50 funds in its category during this period based upon its reported NAV. If the Ultra Fund's NAV had been accurately reported, however, its performance would have ranked at or near the bottom of its fund category. Consequently, by causing the Ultra Fund to overstate its NAV from February 2007 through June 2008 (and by at least 10% from February 8, 2008, through June 13, 2008), the Evergreen Adviser denied the investors who owned Ultra Fund shares during this period and those investors considering purchasing Fund shares the opportunity to consider accurate information about the Fund's performance when deciding whether to retain, redeem, or purchase those shares. In addition, as a result of the overstated NAV, the Evergreen Adviser received higher advisory fees than it would have had the NAV been accurately reported.

#### **Selective Disclosure of Material, Nonpublic Information**

15. On June 11, 2008, the day after it decided to reprice the Company A security at \$0, the Evergreen Valuation Committee decided to stop using vendor overrides for securities held by the Ultra Fund due, in part, to growing concerns about the accuracy of valuations provided by the Fund's portfolio management team. (From August 2007 to June 4, 2008, the Company A security had been valued in accordance with prices provided by the Florida broker-dealer and from June 4, 2008, through June 9, 2008, it was valued in accordance with prices provided by the Fund's portfolio management team.) On June 11, 2008, the Valuation Committee re-valued approximately 11 securities owned by the Ultra Fund. The 11 securities had previously been valued either in accordance with the prices provided by the Florida broker-dealer or in accordance with prices provided by the Fund's portfolio management team. The Valuation Committee re-priced these securities in accordance with the prices provided by a third-party pricing vendor, almost all of which were lower than the previous valuations. This action resulted in a decrease of the Ultra Fund's NAV by \$0.12, reducing it to \$8.83 per share.

16. By June 12, 2008, the Evergreen Distributor determined that the decreases in the Ultra Fund's NAV might prompt inquiries from the Fund's shareholders as well as from broker-dealers whose customers owned Ultra Fund shares. There had been no public announcement, via a press release or otherwise, regarding the reasons for the Fund's NAV decreases. Consequently, the Evergreen Distributor began to gather from the Evergreen Adviser information about the reasons for the decreasing NAV. On June 12-13, 2008, the Evergreen Distributor prepared "talking points" consisting of material, nonpublic information it received from the Evergreen Adviser to enable its wholesalers to provide information in response to any inquiries about the NAV from shareholders or broker-dealers. The talking points indicated that the recent declines in the Ultra Fund's NAV were the result of a process of re-pricing of securities rather than market events and that the re-pricings may continue.

17. Specifically, on June 12, 2008, the Evergreen Distributor prepared talking points outlining the Evergreen Valuation Committee's decision on June 10, 2008 to re-price downward the security issued by Company A, the Valuation Committee's June 11 decision to reprice 11 additional securities, and the NAV declines associated with these decisions. The talking points further stated, "We continue to review pricing and will revalue securities as prudently as appropriate in this unique market environment. It is difficult to quantify to what extent we may reprice additional holdings."

18. On June 13, 2008, the Evergreen Distributor prepared a second set of talking points for use in responding to inquiries from shareholders or registered representatives, which stated:

For the third day in a row, Ultra Short experienced a significant NAV decline. Yesterday's decline of \$0.21 or 2.4% has been the largest so far. This NAV drop was the result of 3 additional securities being repriced; the [vendor] provided values are significantly below those at which we had been carrying the positions based on internal estimates of fair value. Over the last three days we have repriced 15 positions in total. As was previously mentioned it is difficult to assess how many additional positions will be subject to repricing. We continue to follow the situation closely and will share information with you as it becomes available.

19. The talking points provided insight into a process that was ongoing. A reasonable investor hearing the talking points would view this information as important in making the decision whether to redeem Ultra Fund shares. Consequently, the information concerning the Fund's process of re-pricing of securities constituted material, nonpublic information.

20. A senior officer of the Evergreen Distributor e-mailed both the June 12 and the June 13 talking points to most Evergreen Distributor wholesalers for use in responding to incoming telephone calls from shareholders or registered representatives concerning the Ultra Fund's recent NAV drops. Senior officers of the Evergreen Distributor explicitly informed a significant number of the wholesalers that they could convey to registered representatives of broker-dealers and shareholders who called all of the information included in the talking points. On the morning of June 13, 2008, a senior officer of the Evergreen Adviser received a copy of both sets of talking points and understood that the content of these talking points was intended to be shared with any Ultra Fund shareholder or registered representative who made an incoming call to any of the Evergreen Distributor's wholesalers to discuss the Fund's recent NAV decreases. In addition, this senior officer of the Evergreen Adviser forwarded both sets of talking points to an employee of the Evergreen Adviser who served as the client manager for a client of the Evergreen Adviser. The client manager conveyed the content of the talking points to the client, which promptly sold its position in the Ultra Fund.

21. In the early morning of June 13, 2008, citing "last evening's third significant decline in NAV," the Evergreen Distributor instructed its wholesalers assigned to the Wachovia Securities broker-dealer distribution channel to call each Wachovia Securities registered representative who had any customers who were shareholders of the Ultra Fund. Wachovia Securities was at the time an affiliate of the Evergreen Distributor and the Evergreen Adviser. From June 13 through June 17, 2008, the Evergreen Distributor's wholesalers initiated hundreds of telephone calls to Wachovia Securities registered representatives and relayed the June 12 and June 13 talking points concerning the recent drops in the Ultra Fund's NAV. Multiple wholesalers making these calls told registered representatives that their customers could transfer their Ultra Fund holdings to other Evergreen mutual funds that, according to the wholesalers, did not hold any of the same securities held by the Ultra Fund. From June 13 through June 17, many of the customers of the Wachovia Securities registered representatives who received the information in the talking points redeemed their Ultra Fund shares at an NAV that exceeded the Fund's liquidating per-share NAV of \$7.48 per share on June 18. On June 13 alone, approximately 20% of the Ultra Fund shares purchased through the Wachovia Securities channel were redeemed at a price of \$8.55, accounting for approximately 53% of all Fund shares redeemed that day. At some point between June 13 and midday on June 17, a senior officer of the Evergreen Distributor informed one or more senior officers of the Evergreen Adviser about the calls made to registered representatives of Wachovia Securities. In addition, starting on June 13, the Evergreen Distributor directed the wholesalers in certain of its other distribution channels to initiate similar out-going calls to representatives of certain other financial services providers concerning the recent drops in the Ultra Fund's NAV. However, the Evergreen Distributor did not direct the wholesalers in all of its distribution channels to initiate such calls to all financial services providers. Moreover, the Evergreen Distributor failed to make calls to many of the Wachovia Securities registered representatives prior to the Ultra Fund's liquidation date.

22. During the three-week period leading up to the closure of the Ultra Fund on June 18, 2008 (during which time the re-pricing was occurring and the Fund's NAV was dropping from \$9.20 per share to \$7.48 per share), Respondents never disseminated any press release or statement conveying the material, nonpublic information contained in the talking points to the general investing public in a manner designed to reach all Ultra Fund shareholders and prospective shareholders. Instead, the Evergreen Adviser and the Evergreen Distributor, with the knowledge of the Evergreen Adviser, provided information about the recent decreases in the Fund's NAV to select shareholders or their financial intermediaries. By limiting the dissemination of this important information, Respondents improperly gave some Ultra Fund shareholders, including customers of one of their own affiliates, an unfair advantage over other shareholders of the Fund. The shareholders who were provided the material nonpublic information were then able to use it in deciding

whether to redeem their shares before further potential re-pricings of the securities held by the Fund. In fact, many of the shareholders who received this information then redeemed their shares in the Ultra Fund and received a higher price than other shareholders—including those who did not receive the information—who held their shares until the Fund's liquidation date on June 18. Because these redemptions were made before the Fund had completed the process of repricing securities, the redeeming shareholders received a higher NAV than they should have. Consequently, these redemptions diluted the Ultra Fund's assets and thus harmed the Fund and its remaining shareholders. The significant decline in the Ultra Fund's NAV resulting from the re-pricing of securities, combined with the large number of redemption requests that could force the Fund to sell its illiquid securities, ultimately led the Fund's Board of Trustees to liquidate the Fund and make a liquidating distribution to shareholders on June 18.

23. During this period, neither the Evergreen Adviser nor the Evergreen Distributor established, maintained, or enforced written policies and procedures reasonably designed to prevent this type of misuse of material, nonpublic information by persons associated with them—i.e., the disclosure of material, non-public information about a fund they advised or distributed to select shareholders.

### **Prohibited Securities Transactions**

24. Beginning at least on January 23, 2008, the Evergreen Adviser caused other Evergreen mutual funds to purchase securities from the Ultra Fund. These funds were also managed by the Ultra Fund's portfolio management team. In order to make such trades, the Fund was required to follow specific procedures to ensure the transactions did not benefit another Evergreen mutual fund at the expense of the Ultra Fund. Rule 17a-7 under the Investment Company Act allows certain affiliated cross trades despite the general prohibition against affiliated transactions contained in Section 17(a) of the Investment Company Act. Among other things, affiliated cross trades must be executed at a price equal to the average of the highest current independent bid to purchase that security and the lowest current independent offer to sell that security (for securities other than NMS stocks, exchange-traded securities, or securities quoted on the NASDAQ system). Despite this requirement, the Evergreen Adviser caused other Evergreen mutual funds to purchase securities from the Ultra Fund at a price other than that average. In at least some instances, the Fund's portfolio management team did not even obtain the necessary price information to calculate the required average. In addition, these cross trades were made through one or more broker-dealers who received remuneration in connection with these transactions, thus precluding reliance on Rule 17a-7.

25. Moreover, on June 12, 2008, a trader for the Fund's portfolio management team received an indication from a broker-dealer that the broker-dealer would consider paying a higher price for a security held by the Ultra Fund if the broker-dealer would be allowed to re-sell that security to a third party rather than selling it back to another Evergreen mutual fund managed by the portfolio management team. In breach of the Evergreen Adviser's fiduciary duty to the Fund, the trader for the Fund's portfolio management team refused to discuss a higher price and, as a result, the Ultra Fund received less money for this security than it may have if this prospect for a higher offer had been pursued.

### **Evergreen Distributor Failed to Preserve Text and Instant Messages**

26. On September 19, 2007, in a different enforcement action, the Commission issued an order: (a) finding that the Evergreen Distributor had willfully violated Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder by failing to preserve certain communications related to its business as such, including e-mails, for a period of three years; and (b) ordering the Evergreen Distributor to cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Exchange Act and Rule 17a-4 thereunder. However, from at least September 19, 2007, to August 2008, the Evergreen Distributor issued to approximately 177 of its employees personal digital assistant devices that permitted these employees to send text messages and instant messages related to the Evergreen Distributor's business as such over certain messaging systems that the Evergreen Distributor had not configured for retention within its electronic communications archival system. Consequently, throughout this period, the Evergreen Distributor failed to preserve certain electronic communications in the form of text messages and instant messages related to its business as such.

## Violations

27. As a result of the conduct described above, the Evergreen Adviser willfully<sup>2</sup> violated Sections 206(2) of the Advisers Act in that it engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon clients or prospective clients. The Evergreen Adviser and the Evergreen Distributor, with the knowledge and acquiescence of the Evergreen Adviser, disclosed the information about the process of repricing of Ultra Fund holdings to select Ultra Fund shareholders or their financial intermediaries, specifically including shareholders who were customers of an affiliated broker-dealer, and failed to inform the Ultra Fund Board about these disclosures. The Evergreen Adviser knew or should have known that the selective disclosures would lead to substantial redemptions by shareholders at an inaccurately high NAV, which would dilute the Fund, and as a result, this conduct operated as a fraud or deceit upon the Fund.

28. As a result of the conduct described above, the Evergreen Distributor willfully aided and abetted and caused the Evergreen Adviser's violations of Section 206(2) of the Advisers Act in that it knowingly provided the Evergreen Adviser with substantial assistance by making the selective disclosure to certain shareholders of the Ultra Fund.

29. As a result of the conduct described above, the Evergreen Adviser willfully violated Sections 206(2) of the Advisers Act in that it engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon clients or prospective clients. Specifically, by providing an overstated NAV to the Fund (through its failure to factor readily-available negative information into its recommended valuations of certain securities and its recommending valuations for a significant portion of the Ultra Fund's holdings based on prices provided by the Florida broker-dealer), which in turn generated higher advisory fees paid by the Fund, the Evergreen Adviser breached its fiduciary duty to and defrauded the Ultra Fund.

30. As a result of the conduct described above, the Evergreen Adviser willfully violated Section 204A of the Advisers Act in that it failed to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of its business, to prevent the misuse of material, nonpublic information by it or any person affiliated with it. Specifically, the Evergreen Adviser disclosed material, non-public information about the Ultra Fund to one of its clients, which owned shares in the Fund. In addition, the Evergreen Adviser disclosed material, non-public information about the Ultra Fund to an affiliate, the Evergreen Distributor, without taking any steps to ensure that the Evergreen Distributor did not further disclose such information. The Evergreen Adviser's procedures were not reasonably designed to prevent the misuse of material, nonpublic information about the Ultra Fund through the disclosure of this information to, among others, registered representatives of an affiliated broker-dealer for the purpose of further disclosing such information to certain Ultra Fund shareholders.

31. As a result of the conduct described above, the Evergreen Distributor willfully violated Section 15(f) of the Exchange Act in that it failed to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of its business, to prevent the misuse of material, nonpublic information by it or any person with it. Specifically, the Evergreen Distributor's procedures were not reasonably designed to prevent the misuse of material, nonpublic information about the Ultra Fund through the disclosure of this information to, among others, registered representatives of an affiliated broker-dealer for the purpose of further disclosing such information to certain Ultra Fund shareholders.

32. As a result of the conduct described above, the Ultra Fund violated Rule 22c-1(a) promulgated pursuant to Section 22(c) of the Investment Company Act, and the Evergreen Adviser willfully aided and abetted and caused such violation. Specifically, by improperly pricing certain securities held by the Fund, the Evergreen Adviser caused the Ultra Fund to: (a) materially overstate its NAV from as early as February 1, 2007, through June 18, 2008; and (b) sell and redeem its shares at a price other than its current net asset value.

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<sup>2</sup> A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

33. As a result of the conduct described above, the Evergreen Distributor willfully violated Rule 22c-1(a) promulgated pursuant to Section 22(c) of the Investment Company Act in that, while acting as Ultra Fund's principal under-writer, it sold and redeemed shares of the Ultra Fund from at least June 13, 2008, through June 18, 2008, at a price that was not based on the current NAV of those shares in light of the Fund's overstated NAV.

34. As a result of the conduct described above, the Evergreen Adviser also willfully violated Section 206(2) of the Advisers Act in that it engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon clients or prospective clients. Specifically, by rejecting the prospect of an offer from a broker-dealer to pay a higher price for a particular security held by the Ultra Fund on the condition that the broker-dealer would be allowed to purchase the security outright rather than being required to immediately re-sell the security to another Evergreen mutual fund advised by the Evergreen Adviser, the Evergreen Adviser failed to seek to obtain best execution of the trade for the Ultra Fund and favored another client over the Ultra Fund in breach of its fiduciary duty.

35. As a result of the conduct described above, one or more Evergreen funds violated Section 17(a)(2) of the Investment Company Act, and the Evergreen Adviser willfully aided and abetted and caused such violations by causing such funds, acting as principal, to knowingly purchase securities from the Ultra Fund (other than NMS stocks, exchange-traded securities, or securities quoted on the NASDAQ system). The transactions were not exempt from the prohibition by virtue of Rule 17a-7 because the trades were not executed at a price equal to the average of the highest current independent bid to purchase that security and the lowest current independent offer to sell that security and that were made through one or more broker-dealers who received remuneration in connection these transactions.

36. As a result of the conduct described above, the Evergreen Adviser willfully violated Section 34(b) of the Investment Company Act because it was responsible for the inclusion of untrue statements of material fact in a registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Investment Company Act, or omitted to state therein, any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading. Specifically, in reviewing and approving the registration statements filed with the Commission by the Evergreen Distributor and the Fund prospectus incorporated therein, the Evergreen Adviser misrepresented the Fund's performance and NAV beginning on at least February 1, 2007.

37. The Evergreen Distributor willfully violated Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder, because it failed to preserve for three years certain communications related to its business as such, including text messages and instant messages.

### **Undertakings**

38. Independent Compliance Consultant.

a. The Evergreen Adviser and Evergreen Distributor shall retain, within 30 days of the date of entry of the Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission or to a majority of the independent Trustees of any Evergreen fund. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by the Evergreen Adviser or its affiliates. The Evergreen Adviser and Evergreen Distributor shall require the Independent Compliance Consultant to conduct a comprehensive review of: (1) the Evergreen Adviser's procedures for valuing portfolio securities and the enforcement of same; (2) the Evergreen Adviser's and the Evergreen Distributor's policies and procedures for preventing the misuse of material, nonpublic information and the enforcement of same; and (3) the Evergreen Adviser's policies and procedures for preventing prohibited cross trades of its registered investment company clients and the enforcement of same. The Evergreen Adviser and Evergreen Distributor shall cooperate fully with the Independent Compliance Consultant and shall provide the Independent Compliance Consultant with access to files, books, records, and personnel as reasonably requested for the review.

b. The Evergreen Adviser and Evergreen Distributor shall require that, at the conclusion of the review, which in no event shall be more than 180 days after the date of entry of the Order, the Independent Compliance Consultant shall submit a Report to it, the Trustees of each Evergreen fund, and the staff of the Commission. The Report shall address



the issues described in the subparagraph set forth above, and shall include a description of the review performed, the conclusions reached, the Independent Compliance Consultant's recommendations for changes in or improvements to policies and procedures of the Evergreen Adviser, the Evergreen Distributor and each Evergreen fund, and a procedure for implementing the recommended changes in or improvements to those policies and procedures.

c. The Evergreen Adviser and Evergreen Distributor shall adopt all recommendations contained in the Report of the Independent Compliance Consultant; provided, however, that, within 210 days after the date of entry of the Order, the Evergreen Adviser and shall, in writing, advise the Independent Compliance Consultant, the Trustees of each Evergreen fund and the staff of the Commission of any recommendations that one or the other of them considers to be unnecessary or inappropriate. With respect to any such recommendation, neither the Evergreen Adviser nor the Evergreen Distributor need adopt that recommendation at that time but shall propose, in writing, an alternative policy, procedure or system designed to achieve the same objective or purpose.

d. As to any recommendation with respect to the Evergreen Adviser or the Evergreen Distributor's policies and procedures on which the Evergreen Adviser or the Evergreen Distributor and the Independent Compliance Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 240 days of the date of entry of the Order. In the event the Evergreen Adviser or the Evergreen Distributor and the Independent Compliance Consultant are unable to agree on an alternative proposal, the Evergreen Adviser and Evergreen Distributor will abide by the determinations of the Independent Compliance Consultant.

e. Neither the Evergreen Adviser nor the Evergreen Distributor, either acting alone or in concert, (i) shall have the authority to terminate the Independent Compliance Consultant, without the prior written approval of the majority of the independent Trustees of each Evergreen fund and the staff of the Commission. The Evergreen Adviser shall compensate the Independent Compliance Consultant, and persons engaged to assist the Independent Compliance Consultant, for services rendered pursuant to the Order at their reasonable and customary rates. Neither the Evergreen Adviser nor the Evergreen Distributor shall be in or have an attorney-client relationship with the Independent Compliance Consultant and neither the Evergreen Adviser nor the Evergreen Distributor shall seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Compliance Consultant from transmitting any information, reports, or documents to the Trustees or to the Commission.

f. The Evergreen Adviser and Evergreen Distributor shall require that the Independent Compliance Consultant, for the period of the engagement and for a period of two years from completion of the engagement, shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Evergreen Adviser, the Evergreen Distributor or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The Evergreen Adviser and Evergreen Distributor shall require that any firm with which the Independent Compliance Consultant is affiliated in the performance of his or her duties under the Order shall not, without prior written consent of the independent Trustees and the staff of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Evergreen Adviser, the Evergreen Distributor or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

39. The Evergreen Adviser and the Evergreen Distributor have undertaken to make, within 10 business days of the entry of this Order, a payment, jointly and severally, to the Fair Fund established pursuant to this Order in the amount of \$33,000,000 to compensate shareholders for harm caused by the conduct set forth in this Order. This amount shall be deposited into the same account to be opened in the name of the Ultra Short Opportunities Fund Qualified Settlement Fund pursuant to Paragraphs IV.H. and IV.I. below.

40. The Evergreen Adviser has undertaken to review other Evergreen investment companies that held either the same securities as the Ultra Fund or securities for which the Ultra Fund portfolio management team was responsible for recommending valuations to determine the extent of any errors in the calculations of such investment companies' NAVs. To the extent the NAV of such funds was materially overstated as a result of errors in the valuations of such securities, the Evergreen Adviser has undertaken to compensate shareholders for any harm caused in the same manner in which it

will compensate Ultra Fund shareholders for the harm caused by the mispricing of that fund as set forth in this Order in a manner subject to the review and approval of the Commission staff. To the extent that the NAV of such funds was not materially overstated as a result of such errors, the Evergreen Adviser has undertaken to compensate the funds for any harm caused by processing transactions at an erroneous NAV. The Evergreen Adviser has also undertaken to report to the Commission staff the results of the review referred to above and any remedial steps taken in response thereto within 90 days of the entry of this Order.

41. The Evergreen Adviser has undertaken to review any cross trades that occurred during the relevant period between the Ultra Fund and any other Evergreen fund to determine whether they violate Section 17 of the Investment Company Act and, to the extent that such violations caused harm to any Evergreen fund, to compensate such fund or its shareholders for such harm in a manner subject to the review and approval of the Commission staff. The Evergreen Adviser has also undertaken to report to the Commission staff the results of the review referred to above and any remedial steps taken in response thereto within 90 days of the entry of this Order.

#### 42. Distribution of Funds.

a. Respondents shall be responsible for self-administering the distribution of sums ordered as disgorgement, pre-judgment interest and civil penalty in Paragraphs IV.H. and IV.I. below, as well as the payment Respondents have undertaken to make to the Fair Fund established pursuant to this Order referenced in Paragraph III.39. above (collectively, the "Settlement Funds").

b. Respondents shall identify and make distributions to the Ultra Fund shareholders using the Ultra Fund's records and those of its transfer agent to identify all direct investors, whether in direct purchase accounts, disclosed accounts, or non-disclosed accounts. Respondents will also identify and make distributions to the beneficial owners of Ultra Fund shares held in omnibus accounts. To that end, Respondents will use their best efforts to identify omnibus accounts that are reflected on the Ultra Fund's records and those of its transfer agent, determine the shares traded by each such omnibus account and estimate the total amount of money to be allocated to each such omnibus account using the methodology set forth in this Order. The Respondents will conduct an "Outreach Process" by which they will contact the intermediary associated with each omnibus account with provisional distributions of \$1,000 or more and request records for each account underlying the omnibus account, including, but not limited to, the closing share balance on January 31, 2007, any trades thereafter until the fund was liquidated, and the underlying account holder's name, address and tax identification number(s). In the event that, after receiving such data, Respondents become aware that an account underlying an omnibus account is itself an omnibus account, Respondents will use reasonable efforts to obtain the foregoing data through an Outreach Process, as described above, with respect to the intermediary associated with that underlying omnibus account. Respondents are not required to contact the intermediaries associated with (i) omnibus accounts with provisional distributions of less than \$ 1,000; or (ii) omnibus accounts that are held by an omnibus account within an omnibus account (i.e., no more than a second level omnibus account). As an alternative to providing Respondents with underlying account identifying information, omnibus account intermediaries may provide the relevant account activity data to Respondents pursuant to this paragraph by using unique identification numbers for underlying accounts. Respondents will apply the distribution methodologies described below to that underlying account data and shall provide the results to the intermediary sufficient for the intermediary to allocate distribution amounts to the individual underlying accounts consistent with the methodologies. Upon receipt by the Respondents of a certification by the account intermediary that it will distribute the funds consistent with the results provided, Respondent will make the appropriate distribution to the intermediary which shall then distribute the amounts to the underlying accounts within 45 days. Such intermediaries shall also certify that they will return any undistributed amounts to the Respondents within 90 days of disbursement of such amounts by the Respondents. Any such undistributed amounts returned to Respondents will be returned to the Settlement Funds. Under this paragraph, omnibus account intermediaries shall have 10 calendar days after being contacted by Respondents to notify Respondents as to whether they intend to produce the requested information pursuant to this paragraph and shall have 60 calendar days thereafter to provide the requested data to Respondents. Respondents will pay the reasonable administrative costs incurred by omnibus account intermediaries for providing data pursuant to this paragraph, and such costs will not be paid from the Settlement Funds. Requests for reimbursement from omnibus account intermediaries shall be made to Respondents within 60 days of submission of



all requested records to Respondents. Any omnibus account intermediary which elects to make the distribution to its underlying account holders pursuant to this paragraph shall bear all costs and expenses associated with that distribution.

c. With respect to direct accounts for which Respondents have transactional data, but do not have the complete account holder's name, address, and tax identification number ("non-disclosed accounts"), Respondents will conduct an Outreach Process by which they will contact the intermediary associated with each non-disclosed account for which a payment of funds is required under the methodology below and request such information for each account. When the Respondents receive such information, they will make the distribution to each account. As an alternative to providing Respondents with the account holder identifying information, a non-disclosed account intermediary may provide Respondents with a certification that it will distribute the funds from Respondents to the account holder and that they will return any undistributed amounts to the Respondents. If a certification is received, Respondents will make the appropriate distribution pursuant to this Order to the non-disclosed account intermediary which shall then distribute the amounts to the account holder within 45 days. Such intermediaries shall also certify that they will return any undistributed amounts to the Respondents within 90 days of disbursement of such amounts by the Respondents. Any undistributed amounts returned to Respondents by an intermediary will be returned to the Settlement Funds. Under this paragraph, non-disclosed account intermediaries shall have 10 calendar days after being contacted by Respondents to notify Respondents as to whether they intend to produce the requested information pursuant to this paragraph and shall have 30 calendar days thereafter to provide the requested data to Respondents. Respondents will pay the reasonable administrative costs incurred by non-disclosed account intermediaries for providing data pursuant to this paragraph, and such costs will not be paid from the Settlement Funds. Requests for reimbursement from non-disclosed account intermediaries shall be made to Respondents within 60 days of submission of all requested records to Respondents. Any non-disclosed account intermediary which elects not to provide account data and elects to make the distribution to its account holders pursuant to this paragraph shall bear the costs and expenses associated with that distribution.

d. The Respondents will keep records of each contact attempt for information from an omnibus account and non-disclosed account, each response received, if any, and the reason for not providing the requested information, if any. The Respondents will provide the Commission staff with information relating to each omnibus or non-disclosed account intermediary that does not provide the requested information under Paragraph III.42.b. and/or 42.c. This information will be provided to the staff within 5 business days after Respondents receive notice from any account intermediary that it will not provide the requested information under Paragraph III.42.b. and/or 42.c. or if no response is received, within 5 business days after the 10 day period provided for such response under Paragraph III.42.b. and/or 42.c. elapses.

e. For each omnibus account with a provisional distribution less than \$1,000 for which Respondents do not obtain records for the underlying accounts, the amount of Settlement Funds allocated to that omnibus account will remain in the Settlement Funds. In each instance where the Respondents' Outreach Process to an omnibus or non-disclosed account intermediary does not yield the data necessary to make a distribution to the investors who held Ultra Fund shares in the associated omnibus or non-disclosed account within 70 days of the request for such data (or such later date agreed to between Respondents and the omnibus account intermediary), the Respondents shall have the discretion, with the approval of the Commission staff, to consider and implement other means of distribution to the underlying shareholders. If the Commission staff and Respondents are unable to agree on an alternative means of distribution for any such omnibus account within 250 days of the entry of the Order, the amount of Settlement Funds allocated to the associated omnibus or non-disclosed account will remain in the Settlement Funds.

f. Retirement Plans:

"Retirement Plan" as used in this Order means an employee benefit plan, as such plans are defined in section 3(3) of ERISA, 29 U.S.C. § 1002(3), which is not an Individual Retirement Account (IRA), whether or not the plan is subject to Title I of ERISA.

Assets of Retirement Plans are held in trust by a trustee, and the trust is the legal owner of the assets. Plan fiduciaries and intermediaries, as defined in Department of Labor Field Assistance Bulletin No. 2006-01, April 19, 2006 (the "Field Assistance Bulletin"), of Retirement Plans are to distribute the monies received in accordance with their legal, fiduciary,

and contractual obligations and consistent with guidance issued by the Department of Labor, including, but not limited to, the Field Assistance Bulletin.

For the purposes of this Order, each Retirement Plan itself (and not the individual plan participants) shall be treated as the shareholder to receive the distribution, if any, of the Settlement Funds from Respondents. The fiduciary of a Retirement Plan receiving a distribution may distribute it pursuant to one of the following four alternatives: (1) Retirement Plan fiduciaries may allocate the distribution to current and former participants in the Retirement Plan using the methodology referenced in paragraphs Paragraphs III.42.g. and III.42.h. of this Order. Respondents will provide a description of the methodology to Retirement Plan fiduciaries that wish to utilize this option; (2) Retirement Plan fiduciaries may allocate the distribution pro rata (based on total account balance) among the accounts of all persons who are currently participants in the Retirement Plan (whether or not they are currently employees); (3) Retirement Plan fiduciaries may allocate the distribution per capita among the accounts of all persons who are currently participants in the Retirement Plan (whether or not they are currently employees); (4) To the extent that none of the three preceding alternatives is administratively feasible because the costs of effecting the allocation exceed the amount of the distribution, Retirement Plan fiduciaries may, to the extent permitted by the Retirement Plan, use the distribution amount to pay the reasonable expenses of administering the plan.

In view of, among other things, alternative methodologies available to Retirement Plans, plan fiduciaries and/or intermediaries will not be reimbursed the costs and expenses associated with administering the distribution received pursuant to this Order.

g. Within 270 days of the date of this Order, Respondents shall cause the distribution of the portion of the Settlement Funds that is necessary to compensate those Ultra Fund shareholders who were harmed as a result of the mispricing of the Ultra Fund's NAV from February 2007 through June 18, 2008, utilizing the methodology that has been reviewed and approved by the Commission staff. However, any material changes, additions or adjustments to that methodology must be reviewed and approved by the staff.

h. Within 280 days of the date of this Order, Respondents shall cause any remaining amount of the Settlement Funds to be distributed according to the following methodology: (1) all Ultra Fund shareholders who redeemed their shares on June 18, 2008, shall receive a pro rata share of the remaining amount of the Settlement Funds up to an amount equal to \$ 0.17 per share; and, if Settlement Funds remain, (2) all Ultra Fund shareholders who redeemed their shares on June 17, 2008 or June 18, 2008, shall receive a pro rata share of the remaining amount of the Settlement Funds up to an amount equal to \$ 0.29 per share; and, if Settlement Funds remain, (3) all Ultra Fund shareholders who redeemed their shares on June 16, 2008, June 17, 2008 or June 18, 2008, shall receive a pro rata share of the remaining amount of the Settlement Funds. Respondents shall not be required to make any disbursement to any Ultra Fund shareholder if that shareholder is due less than \$ 10 pursuant to the method approved by the Commission staff. Furthermore, Respondents shall not pay any Ultra Fund shareholder pursuant to this methodology any amount in excess of the difference between the Fund's reported NAV on June 13, 2008 and the actual NAV at which the shareholder redeemed his or her shares.

i. Respondents shall not be required to make any disbursement to any Ultra Fund shareholder if that shareholder is due less than \$ 10 in the aggregate under Paragraphs III.42.g. and III.42.h. above. In order to implement this de minimis distribution amount, Respondents will apply the Gross-Up Formula. The Gross-Up Formula requires that the distributions be ranked in descending order of the size of the provisional distribution. Respondents will then calculate the total amount of the distributions that were calculated to be less than \$ 10 (the "de minimis distribution"). Respondent will then redistribute the de minimis distribution in sequence to the accounts with the largest distributions less than \$ 10, sequentially assigning a distribution of \$ 10 to each account until the de minimis distribution is depleted.

j. All distribution checks shall bear a stale date of 90 days and shall be voided thereafter.

k. Any excess amounts, and any amounts Respondents are unable, due to factors beyond their control, to pay to any affected Ultra Fund shareholder, and any sums that are not paid to any Ultra Fund shareholder who is due less than \$10, shall be transferred to the Securities and Exchange Commission. Such payment shall be made when the final accounting

is submitted and shall be: (i) made by United States postal money order, certified check, bank cashier's check or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (iv) submitted under cover letter that identifies the Evergreen Adviser and the Evergreen Distributor as the Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Director, Division of Enforcement, Securities and Exchange Commission, 33 Arch Street, 23rd Floor, Boston, MA 02110.

l. Respondents may pay for any tax liabilities of the Settlement Funds from the Settlements Funds. Respondents agree to be responsible for all tax compliance responsibilities associated with the Settlement Funds and may retain any professional services necessary. The costs and expenses of any such professional services shall be borne by Respondents and shall not be paid out of the Settlement Funds. Respondents shall also retain the services of and be exclusively responsible for the compensation and expenses of an independent third party not unacceptable to the Commission's staff. The independent third party shall, at least 15 business days prior to the date Respondents make any distribution described in Paragraphs III.42.g. and/or III.42.h. above to the Ultra Fund shareholders who are due \$10 or more, submit for the Commission staff's review an initial accounting and certification of the payments to be made to shareholders pursuant to this Order. The initial accounting and certification shall be in a form not unacceptable to the Commission's staff, and shall include: (i) each payee's name and address; (ii) the amount to be paid to each payee; and (iii) the expected date of each payment.

m. Within 180 days of the date Respondents effect the distributions described above, Respondents shall submit to the Commission staff for the Commission's approval a final accounting and certification of the disposition of the monies paid pursuant to and referenced in this Order. The final accounting and certification shall be in a form not unacceptable to the Commission's staff, and shall include: (i) each payee's name and address; (ii) the amount paid to each payee; (iii) the date of each payment; (iv) the check number or other identifier of money transferred; (v) the date and amount of any returned payment; (vi) a description of any effort to locate a prospective payee whose payment was returned, or to whom payment was not made due to factors beyond Respondents' control; (vii) any amounts to be paid to the Commission with respect to any prospective payee who Respondents were unable to pay due to factors beyond their control, or who would be entitled to less than \$ 10 under the method set forth above; and (viii) a final statement totaling all payments and anticipated payment to the Commission, which shall reconcile with the amounts ordered under Paragraph IV.H. and Paragraph IV.I. below plus the payment referenced in Paragraph III.39. above. Any and all supporting documentation for the accounting and certification shall be provided to the Commission's staff upon request. Respondents shall cooperate with reasonable requests for information in connection with the accounting and certification.

n. After Respondents have submitted the final accounting to the Commission staff, the staff shall submit the final accounting to the Commission for approval and shall request Commission approval to send the remaining residual amount to the United States Treasury.

43. Certification. No later than 24 months after the date of entry of the Order, the chief executive officer of Respondents shall each certify to the Commission, in writing, that Respondent has fully adopted and complied in all material respects with the undertakings set forth in this section and with the recommendations of the Independent Compliance Consultant or, in the event of material non-adoption or non-compliance, shall describe such material non-adoption and non-compliance.

44. Recordkeeping. Respondents shall each preserve for a period not less than six years from the end of the fiscal year last used, the first two years in an easily accessible place, any record of Respondent's compliance with the undertakings set forth above.

45. Deadlines. For good cause shown, the Commission's staff may extend any of the procedural dates set forth above.

### Respondents' Cooperation and Remedial Acts

46. In determining to accept the Respondents' Offer, the Commission considered the cooperation afforded to the Commission staff and the remedial acts undertaken by Respondents. In determining whether to accept the Offer, the Commission has further considered the undertakings set forth in Paragraph III.39., Paragraph III.40., and Paragraph III.41. above.

### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in the Respondents' Offer. It is hereby ORDERED that:

A. Pursuant to Section 203(e) of the Advisers Act, the Evergreen Adviser is hereby censured. Pursuant to Section 15(b)(4) of the Exchange Act, the Evergreen Distributor is hereby censured.

B. Pursuant to Section 203(k) of the Advisers Act, the Evergreen Adviser shall cease and desist from committing or causing any violations and any future violations of Sections 204A and 206(2) of the Advisers Act.

C. Pursuant to Section 9(f) of the Investment Company Act, the Evergreen Adviser shall cease and desist from committing or causing any violations and any future violations of Sections 17(a) and 34(b) of the Investment Company Act, and Rule 22c-1 promulgated pursuant to Section 22(c) of the Investment Company Act.

D. Pursuant to Section 21C of the Exchange Act, the Evergreen Distributor shall cease and desist from committing or causing any violations and any future violations of Sections 15(f) and 17(a) of the Exchange Act and Rule 17a-4 thereunder.

E. Pursuant to Section 203(k) of the Advisers Act, the Evergreen Distributor shall cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act.

F. Pursuant to Section 9(f) of the Investment Company Act, the Evergreen Distributor shall cease and desist from committing or causing any violations and any future violations of Rule 22c-1 promulgated pursuant to Section 22(c) of the Investment Company Act.

G. The Evergreen Adviser and the Evergreen Distributor shall comply with the undertakings set forth in Paragraph III.38., Paragraph III.42., Paragraph III.43., and Paragraph III.44. above.

H. IT IS FURTHER ORDERED that Respondent Evergreen Adviser shall, within ten business days of the entry of this Order, pay: (1) disgorgement in the total amount of \$2,860,000 plus prejudgment interest thereon in the amount of \$265,000; and (2) pursuant to Sections 203(e) and 203(i) of the Advisers Act and Sections 9(b) and 9(d) of the Investment Company Act, a civil penalty in the amount of \$ 2,000,000 into an account opened in the name of the Ultra Short Opportunities Fund Qualified Settlement Fund consistent with the provisions of Paragraph III.42. above.

I. IT IS FURTHER ORDERED that Respondent Evergreen Distributor shall, within ten business days of the entry of this Order, pay: (1) disgorgement in the amount of \$1; and (2), pursuant to Section 21B(a) of the Exchange Act and Section 203(i) of the Advisers Act, a civil penalty in the amount of \$2,000,000 into the same account opened in the name of the Ultra Short Opportunities Fund Qualified Settlement Fund referenced in Paragraph IV.H. above and consistent with the provisions of Paragraph III.42. above.

J. There shall be, pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund established for the funds described in paragraphs IV.H. and IV.I. Regardless of whether any distribution is made from such Fair Fund, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalties, Respondents Evergreen Adviser and Evergreen Distributor agree that they shall not, after offset or reduction in any Related Investor Action based

on the Respondents' payment of disgorgement in this action and the payment described in Paragraph III.39. above, further benefit by offset or reduction of any part of the Evergreen Adviser or the Evergreen Distributor's payment of civil penalties in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, the Evergreen Adviser and the Evergreen Distributor agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalties imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against the Evergreen Adviser, the Evergreen Distributor or their affiliates, or all of them, by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

K. The obligations to pay prejudgment interest, disgorgement, and penalty are not fully satisfied until all funds are disbursed and the final accounting is approved by the Commission and any residual has been transferred to the Commission for disbursement to the United States Treasury. In the event the Commission must enforce these obligations to pay, additional interest shall accrue on the ordered amounts pursuant to Rule 600 of the Commission's Rules of Practice, 17 C.F.R. § 201.600, and/or 31 U.S.C. § 3717 until the obligations are paid in full.

By the Commission.

## IN THE MATTER OF ROBERT JOHN HIPPLE

Release Nos. 34-61688, IC-29173

Administrative Proceeding File No. 3-13543

March 11, 2010

Order Making Findings, Imposing Remedial Sanctions, and Issuing a Cease-and-Desist Order

### I.

On July 9, 2009, the Securities and Exchange Commission (“Commission”) instituted public administrative and cease-and-desist proceedings pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”), and Rule 102(e)(1) of the Commission’s Rules of Practice against Robert John Hipple (“Hipple” or “Respondent”).

### II.

In connection with these proceedings, Respondent Hipple has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, which are admitted, Hipple consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Sections 9(b) and 9(f) of the Investment Company Act of 1940, and Rule 102(e)(1) of the Commission’s Rules of Practice (“Order”), as set forth below.

### III.

On the basis of this Order and Hipple’s Offer, the Commission finds<sup>1</sup> that:

#### A. Summary

Robert Hipple, a lawyer and the former CEO and CFO of now-defunct business development company (“BDC”)<sup>2</sup> iWorld Projects & Systems, Inc. (“iWorld”), overstated the value of iWorld’s primary asset—its investment in several portfolio companies—in three consecutive quarterly filings in 2005. Hipple, who personally performed iWorld’s accounting and financial reporting functions, also misled iWorld’s auditors into believing that the company had independently evaluated the worth of its portfolio companies. As a result of his conduct, Hipple i) violated the antifraud provisions of the Exchange Act, filed false Sarbanes-Oxley executive certifications, misled iWorld’s auditors, falsified books and records, and knowingly circumvented internal controls; ii) violated Section 57(a)(1) of the Investment Company Act; and iii) aided and abetted and caused iWorld’s violations of the reporting, books and records, and internal controls provisions of the Exchange Act, and iWorld’s violations of the BDC books and records provision of the Investment Company Act.

#### B. Respondent

Robert John Hipple, age 64, resides in Cocoa, Florida. He is an attorney licensed in Florida and Georgia. Hipple and an associate controlled the management and operations of iWorld Projects and Systems, Inc. (“iWorld Florida”), a private Florida company, when it was acquired in early 2005 by iWorld Projects & Systems, Inc. (“iWorld”), a business development company. At the time, Hipple was the CEO of iWorld Florida. After the acquisition, Hipple formally

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<sup>1</sup> The findings herein are made pursuant to Respondent’s Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

<sup>2</sup> A BDC is a closed-end investment company authorized by Congress for the purpose of making capital more readily available to certain types of companies. Under the Investment Company Act, a closed-end company meeting certain eligibility criteria may elect to be regulated as a BDC by filing a notification with the Commission on Form N-54A. A company filing such a notification is regulated under Sections 55 through 65 of the Investment Company Act. These sections set forth rules governing the investments BDCs may make, transactions BDCs may enter into, and the governance of BDCs, as well as various other rules governing BDCs.



became iWorld's CEO and remained in that position until he resigned in March 2006. He also acted as iWorld's principal financial officer.

### C. Relevant Entities

iWorld Projects and Systems, Inc. ("iWorld") is a BDC that, during all relevant periods, was incorporated in Nevada and headquartered in Addison, Texas. iWorld has not filed a periodic report with the Commission since it filed its third quarter 2005 Form 10-Q in November 2005. The Nevada Secretary of State revoked iWorld's corporate charter on January 1, 2006, for failure to pay franchise taxes. iWorld filed for voluntary Chapter 7 bankruptcy in May 2008. In March 2009, the bankruptcy court closed the case because iWorld had no assets. On August 14, 2009, the Commission, pursuant to Section 12(j) of the Exchange Act, revoked the registration of each class of iWorld's registered securities.

iWorld Florida was, prior to its acquisition by iWorld, a privately held Florida corporation formed by Hipple in May 2004. iWorld Florida was dissolved on September 15, 2006.

### D. Facts

#### 1. Hipple Postures iWorld Florida for Acquisition by iWorld as BDC

a. Shortly after forming iWorld Florida in May 2004, Hipple and others caused it to acquire two small private companies in the project management services industry: Applied Management Concepts, Inc. ("AMC") and Process Integrity, Inc. ("PII") (together, "the subsidiaries"). iWorld Florida acquired the subsidiaries for a total of \$285,000 in working capital payments, \$200,000 in assumed liabilities, and 1.1 million shares of iWorld Florida common stock. This stock was not publicly traded and had no readily ascertainable market value.

b. When iWorld Florida acquired the subsidiaries, AMC had no operations, while PII had only limited revenues from sales of its only product, a piece of project management software. Specifically, during the six months before the acquisition, PII had total revenues of \$89,000 and was not profitable. Hipple knew these facts at the time.

c. Notwithstanding the subsidiaries' poor performance and negligible operations, Hipple accepted and adopted the financial forecasts presented to him. According to those forecasts, AMC and PII would generate \$2.4 million in revenue in the six-month period after their acquisition by iWorld Florida, and would generate in 2005 a total of \$5.5 million in revenue. Hipple had no objective information in his possession to support these forecasts.

d. In December 2004, Hipple initiated and directed a series of transactions to form iWorld. He first obtained two public, blank-check shell companies, Silesia Enterprises, Inc. ("Silesia") and Organic Solutions, Inc. ("Organic"). He then caused Silesia to file a Form N-54 election to become a BDC.

e. Hipple then directed and caused Silesia's merger into Organic. Among other things, Hipple caused Organic to issue convertible preferred shares to four of his designees, including his wife and a college-aged employee of one of his business partners. Hipple oversaw the conversion of the designee's preferred shares into common shares—which gave them control over Organic—and the voting of those shares to approve actions related to merging Organic with Silesia, with Organic as the surviving corporation. At the conclusion of these transactions, Hipple effectively controlled the post-merger company (a BDC), which, as part of the merger, changed its name to iWorld. Hipple thereafter obtained a new CUSIP number and trading symbol for iWorld's common shares so they could be publicly traded.

#### 2. Hipple Causes iWorld to Acquire iWorld Florida and Prepares False Filings Overstating iWorld Florida's Value

a. On February 25, 2005, iWorld filed a current report on Form 8-K announcing that it had agreed to acquire iWorld Florida through a merger. Hipple drafted the filing and caused it to be filed. The Form 8-K stated that the transaction was "valued at \$10 million, based on the number of shares issued, the market price of the shares, and the assets and businesses acquired." It then described iWorld Florida and the subsidiaries' business, concluding that "combined revenues from [iWorld Florida's] subsidiaries...for 2005 are expected to be in the range of \$25 to \$30 million, provided sufficient working capital is obtained."

b. The purported \$10 million valuation was materially false and misleading. Among other things, the Form 8-K failed to disclose that Hipple controlled both iWorld and iWorld Florida at the time of their merger. Consequently, and contrary

to the Form 8-K's description of the transaction, the merger did not involve arms-length negotiation and was in fact a related-party transaction. Furthermore, the Form 8-K failed to disclose that, because Hipple controlled both sides of the transaction, he was able to reverse-engineer the number of shares exchanged between iWorld and iWorld Florida to lend legitimacy to the \$10 million figure. In addition, there was no disclosure that iWorld Florida's sole asset—its investments in the subsidiaries—had been acquired during the summer of 2004 for only \$285,000 cash, \$200,000 in assumed liabilities, and 1.1 million shares of iWorld Florida's nonpublic stock—consideration that was worth, at best, only a fraction of \$10 million.

c. The Form 8-K's representations about the subsidiaries' prospects were also materially false and misleading, since they were wholly speculative and unsupported. As noted above, at the time iWorld Florida acquired them in the summer of 2004, PII and AMC had generated meager revenues over the preceding six months. Their performance after their acquisition by iWorld Florida was no better; indeed, as Hipple knew from internal company reports he received, PII and AMC consistently fell far short of their forecasted performance. Accordingly, Hipple knew or recklessly disregarded that the Form 8-K's assertions of subsidiary revenues of \$25 million to \$30 million were baseless.

### 3. Hipple Prepares and Certifies iWorld's False Quarterly Filings

a. After iWorld acquired iWorld Florida, Hipple became iWorld's Chairman, CEO, and CFO and performed the company's accounting and financial reporting functions. In this capacity, he maintained iWorld's books and records, was responsible for its system of internal controls, and drafted and filed with the Commission its periodic reports.

b. In 2005, iWorld filed three quarterly reports on Forms 10-Q: on May 20, 2005; August 12, 2005; and November 15, 2005. Hipple prepared, signed, and certified each of the filings.

c. Each of these quarterly reports contained financial statements and other disclosures representing that the subsidiaries (AMC and PII)—including two additional start-up operating companies iWorld had acquired—were valued at \$10 million. These subsidiaries—which the quarterly reports referred to as “portfolio companies”—comprised, as reported in the quarterly reports, approximately 96% of iWorld's total assets.

d. The reported \$10 million valuation was materially false and misleading. As described above, iWorld's initial valuation of the subsidiaries at \$10 million was itself false and misleading since it was not the product of arms-length negotiation, was far in excess of what iWorld Florida had paid to acquire the subsidiaries roughly six months earlier, and was unsupported by the subsidiaries' poor financial performance. None of these circumstances had changed by the time Hipple prepared and filed the quarterly reports. To the contrary, he had continually received information, including reports from the subsidiaries, demonstrating that their performance was deteriorating. For instance, by the time iWorld filed the first quarter Form 10-Q on May 20, 2005, Hipple knew from internal reports that all of the subsidiaries had continued to fall far short of internal projections, with some subsidiaries producing no revenues whatsoever. He also knew that iWorld's working capital—which was critical to the subsidiaries' survival—was rapidly diminishing. From these facts alone (which were not publicly disclosed), Hipple knew or recklessly disregarded that the subsidiaries' reported valuation was grossly overstated.

e. By the time iWorld filed its second quarter Form 10-Q on August 12, 2005, Hipple knew from internal reports the additional fact that, not only were the subsidiaries far below their financial projections, they were in fact deeply unprofitable. Indeed, only PII still had operations by August 2005, due in part to the fact that iWorld had exhausted its working capital, on which the subsidiaries depended. As iWorld's CEO and CFO, Hipple knew the subsidiaries were dependent on iWorld for working capital and that, without working capital, the subsidiaries would cease operations.

f. By the time iWorld filed its third quarter Form 10-Q on November 15, 2005, Hipple knew that meaningful subsidiary operations had ceased and that there was no prospect of iWorld's reviving them, since iWorld itself had no cash. Moreover, by December 2005, Hipple learned that PII's president had previously pledged PII's sole asset—rights to its software product—to a third party as security for a loan to PII to make payroll.

g. Hipple never revealed the subsidiaries' dire circumstances in iWorld's 2005 quarterly filings. To the contrary, each of the filings repeated the \$10 million valuation, which the second and third quarter filings amplified by asserting that “the Company's Investment Committee [has] determine[d] that the portfolio investments should be valued at \$10 million.”

This was false: iWorld’s investment committee never considered the valuation of the subsidiaries. Moreover, each of the quarterly filings represented that the subsidiaries were projected to earn tens of millions of dollars of revenue through the end of 2006. In view of the circumstances described above—including the subsidiaries’ continuous unprofitability and the depletion of iWorld’s working capital—these representations were completely unfounded and, consequently, were materially false and misleading.

h. Even after learning that PII’s president had pledged PII’s software to secure a loan to PII, Hipple made no effort to amend iWorld’s third quarter Form 10-Q.

#### **4. Hipple Materially Misleads iWorld’s Auditor**

a. As a BDC, iWorld was required under Section 2(a)(41) of the Investment Company Act (which applies to BDCs pursuant to Section 59 of that Act) to determine in good faith the fair value of the securities of its portfolio companies, since market quotations for those securities were not readily available. iWorld never made a good faith determination, either when it acquired iWorld Florida and its subsidiaries, or thereafter. Hipple knew, or was reckless in not knowing, that no such determination had been made.

b. Hipple, however, told iWorld’s auditor—in connection with the auditor’s review of iWorld’s first quarter 2005 Form 10-Q—that an “independent investment board” had approved the \$10 million valuation. Hipple knew, or was reckless in not knowing, that this statement was false.

#### **5. Civil Penalty**

Respondent has submitted sworn Statements of Financial Condition, dated October 2, 2009, and October 9, 2009, and other evidence, and has asserted his inability to pay a civil penalty.

#### **E. Violations**

1. Based on the foregoing, the Commission finds that Respondent Hipple willfully violated:

a. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities;

b. Section 34(b) of the Investment Company Act, made applicable to BDCs through Section 59 of the Investment Company Act, which provides, among other things, that in any registration statement, application, report, account, record, or other document filed or transmitted by iWorld pursuant to the Investment Company Act or kept by iWorld pursuant to Section 31(a) of the Investment Company Act, it shall be unlawful for any person so filing, transmitting or keeping any such document to make any untrue statement of material fact or to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading;

c. Rule 13a-14 under the Exchange Act, which required Hipple, as iWorld’s principal executive and financial officer, to certify in each quarterly and annual report filed or submitted by iWorld under Section 13(a) of the Exchange Act, that: (1) he had reviewed the report; and (2) based on his knowledge, the report did not contain any untrue statement of material fact, or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

d. Section 13(b)(5) of the Exchange Act, which provides that no person shall knowingly falsify any book, record, or account of an issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, or is required to file reports pursuant to Section 15(d) of the Exchange Act, or knowingly circumvent the registrant’s system of internal accounting controls;

e. Rule 13b2-1 under the Exchange Act, which provides that no person shall, directly or indirectly, falsify or cause to be falsified any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act;

f. Rule 13b2-2(a) under the Exchange Act, which prohibits an officer or director of an issuer from, directly or indirectly: (1) making, or causing to be made, a materially false or misleading statement; or (2) omitting, or causing to be omitted, a

statement of a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to an accountant in connection with a required audit, or the preparation or filing of a required document or report;

g. Section 57(a)(1) of the Investment Company Act, which prohibits persons “related” to a BDC, as defined in Section 57(b) of the Investment Company Act, from acting as principal knowingly selling to the BDC any securities in another company unless at least one of two conditions applies. The first condition is that the sale involves solely securities of which the buyer is the issuer. *See* Section 57(a)(1)(A). The second is that the sale involves solely securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities. *See* Section 57(a)(1)(B). Section 57(b)(2) defines a “related person of a BDC,” in pertinent part, as any person directly or indirectly “controlling” a BDC. Section (2)(a)(9) of the Investment Company Act, in turn, defines “control” as “the power to exercise a controlling influence over the management or policies of a company.” Hipple controlled iWorld when he sold, as a principal, his iWorld Florida shares to iWorld in iWorld’s acquisition of iWorld Florida. Hipple’s sale of his shares did not satisfy either of the two conditions set forth in Section 57(a)(1)(A) or (B). Thus, Hipple violated Section 57(a)(1);

2. Based on the foregoing, the Commission finds that Respondent Hipple willfully aided and abetted and caused iWorld’s violations of:

a. Section 13(a) of the Exchange Act and Rules 13a-11, 13a-13, and 12b-20 thereunder, which required iWorld to file information and documents as prescribed by the Commission, including current and quarterly reports, and to include in those reports any material information as may be necessary to make the required statements in those reports not misleading in light of the circumstances under which the statements were made;

b. Section 13(b)(2)(A) of the Exchange Act, which required iWorld, as a reporting company, to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflected its transactions and dispositions of its assets;

c. Section 13(b)(2)(B) of the Exchange Act which required iWorld, as a reporting company, to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles; and

d. Section 31(a) of the Investment Company Act made applicable to BDCs by Section 64 of the Investment Company Act, and Rule 31a-1 thereunder, which required iWorld to make and keep certain books and records, including, among other things, ledgers of all assets, liabilities, reserve capital, income and expense accounts reflecting account balances on each day, and corporate documents such as minutes from shareholder and board meetings.

#### IV.

In view of the foregoing, the Commission deems it necessary and appropriate in the public interest to impose the sanctions agreed to in Respondent Hipple’s Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

A. Hipple shall cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1, 13b2-2, and 13a-14 thereunder, and Sections 34(b) and 57(a) of the Investment Company Act, and from causing any violations of and any future violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13 thereunder and Section 31(a) of the Investment Company Act and Rule 31a-1 thereunder;

B. Pursuant to Section 21C(f) of the Exchange Act, Hipple is prohibited, for a period of five years, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act;

C. Pursuant to Section 9(b) of the Investment Company Act, Respondent Hipple is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter,

with the right to reapply for association after five (5) years to the appropriate self-regulatory organization, or if there is none, to the Commission;

D. Pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice, Hipple is denied the privilege of appearing or practicing before the Commission as an accountant;

E. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense; and

F. Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy  
Secretary

## IN THE MATTER OF MORGAN ASSET MANAGEMENT, INC., ET AL.

Release Nos. 34-64720, IA-3218, IC-29704

Administrative Proceeding File No. 3-13847

June 22, 2011

Corrected Order Making Findings, Imposing Remedial Sanctions, Issuing a Cease-and-Desist Order, and Imposing Suspension

### I.

On April 7, 2010, the Commission instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Morgan Asset Management, Inc. (“Morgan Asset”); Morgan Keegan & Company, Inc. (“Morgan Keegan”); James C. Kelsoe, Jr. (“Kelsoe”); and Joseph Thompson Weller, CPA (“Weller”); pursuant to Section 15(b)(4) of the Exchange Act against Morgan Keegan; pursuant to Section 15(b)(6) of the Exchange Act against Morgan Asset, Kelsoe and Weller; pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against Morgan Asset and Morgan Keegan; pursuant to Sections 203(f) and 203(k) of the Advisers Act against Kelsoe and Weller; and pursuant to Section 4C of the Exchange Act and Rule 102(e)(1)(iii) of the Commission’s Rules of Practice against Weller. Respondents Morgan Asset, Morgan Keegan, Kelsoe and Weller (collectively “Respondents”) have submitted an Offer of Settlement which the Commission has determined to accept.

### II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 4C and 15(b) of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, and Imposing Suspension Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e)(1)(iii) of the Commission’s Rules of Practice (“Order”), as set forth below.

### III.

On the basis of this Order and Respondent’s Offer, the Commission finds<sup>1</sup> that,

#### A. Respondents

1. Morgan Asset, incorporated in Tennessee on April 10, 1986, has been an investment adviser registered with the Commission at all relevant times. Morgan Asset’s principal place of business is in Birmingham, Alabama. Morgan Asset is a wholly-owned subsidiary of MK Holding, Inc., which in turn is a wholly-owned subsidiary of Regions Financial Corporation.

2. Morgan Keegan, incorporated in Tennessee on June 27, 1969, has been registered with the Commission as a broker-dealer at all relevant times and as an investment adviser since July 27, 1992. During the relevant time period, Morgan Keegan served as the principal underwriter and sole distributor of shares of the open-end Funds described in paragraph 5, below. Morgan Keegan’s principal place of business is in Memphis, Tennessee.

3. Kelsoe, 49 years of age, is a resident of Memphis, Tennessee. During 2007, Kelsoe was the senior portfolio manager for Morgan Asset. Kelsoe is a Chartered Financial Analyst and previously held Series 7 and 65 licenses. Kelsoe was associated

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<sup>1</sup> The findings herein are made pursuant to Respondents’ Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.



with Morgan Keegan at all relevant times, and was a registered representative of the firm from August 1994 through November 2008.

4. Weller, 46 years of age, is a resident of Memphis, Tennessee. Weller has been employed by Morgan Keegan since 1992. During the relevant period, he was Morgan Keegan's Controller and the head of its Fund Accounting Department reported to him. He holds Series 7, 27, and 66 licenses and is a CPA who was previously licensed in the State of Tennessee. That license is currently lapsed. Since at least January 1, 1993, Weller has been associated with the investment adviser arm of Morgan Keegan. Additionally, from at least December 1997 through the present, Weller has been a registered representative associated with the broker-dealer arm of Morgan Keegan.

## **B. Other Relevant Entities**

5. Helios Select Fund, Inc., formerly known as Morgan Keegan Select Fund, Inc. ("Select Fund"), incorporated in Maryland on October 27, 1998, has been an investment company registered with the Commission since its inception. In 2007, the Select Fund contained three open-end portfolios: the Select High Income portfolio, the Select Intermediate Bond portfolio, and the Select Short Term Bond portfolio.

6. Helios High Income Fund, Inc., formerly known as RMK High Income Fund, Inc., a closed-end fund incorporated in Maryland on April 16, 2003, has been an investment company registered with the Commission since its inception.

7. Helios Multi-Sector High Income Fund, Inc., formerly known as RMK Multi-Sector High Income Fund, Inc., a closed-end fund incorporated in Maryland on November 14, 2005, has been an investment company registered with the Commission since its inception.

8. Helios Strategic Income Fund, Inc., formerly known as RMK Strategic Income Fund, Inc., a closed-end fund incorporated in Maryland on January 16, 2004, has been an investment company registered with the Commission since its inception.

9. Helios Advantage Income Fund, Inc., formerly known as RMK Advantage Income Fund, Inc., a closed-end fund incorporated September 7, 2004, has been an investment company registered with the Commission since its inception.

## **C. Facts**

### **Overview**

10. Morgan Asset, through Kelsoe, as Portfolio Manager, managed the Helios Select Fund, Inc., the Helios High Income Fund, Inc., the Helios Multi-Sector High Income Fund, Inc., the Helios Strategic Income Fund, Inc., and the Helios Advantage Income Fund, Inc. (collectively, the "Funds") from at least November 2004 through July 29, 2008.

11. Respondent Morgan Keegan, a registered broker-dealer and registered investment adviser, was the principal underwriter and distributor of shares of the open-ended Funds. Each of the Funds' Boards of Directors was responsible for pricing the Funds' securities in accordance with the Funds' valuation policies and procedures ("valuation procedures"). Although the Funds' prospectuses stated that Morgan Asset would price the securities, each Fund's Board of Directors delegated the pricing responsibility to Morgan Keegan. Morgan Keegan priced each Fund's securities and calculated the Fund's daily net asset value<sup>2</sup> ("NAV") through its Fund Accounting Department ("Fund Accounting"). Weller was an officer and treasurer of the Funds. Weller, Morgan Keegan's Controller, along with other Morgan Keegan personnel, staffed a "Valuation Committee" that oversaw Fund Accounting's processes and evaluated the prices assigned to securities. Morgan Keegan and Weller failed to adequately fulfill Morgan Keegan's responsibilities, as delegated to it by the Funds' Boards of Directors, to price the Funds' securities in accordance with their valuation policies and procedures regarding valuation. For example, at various times from January 2007 through July 2007, Fund Accounting accepted unsubstantiated "price adjustments," submitted by Kelsoe, that inaccurately inflated the prices of certain securities, contrary to the Funds' valuation procedures. Fund Accounting failed to document justifications for such pricing adjustments.

<sup>2</sup> The "net asset value" or "NAV" of an investment company is the company's total assets minus its total liabilities. An investment company calculates the NAV of a single share (or the "per share NAV") by dividing its NAV by the number of shares that are outstanding.

12. The Funds' valuation policies and procedures required the comparison of fair values to prices provided by other sources. Pursuant to that requirement, Fund Accounting periodically obtained broker-dealer price confirmations for certain fair valued securities. Unbeknownst to Fund Accounting and the Funds' independent auditor ("Independent Auditor"), the Portfolio Manager, Kelsoe, actively screened and influenced a broker-dealer to change the price confirmations that Fund Accounting and the Independent Auditor obtained from the broker-dealer. Kelsoe also failed to advise Fund Accounting or the Funds' Boards of Directors when he received information indicating that the Funds' prices for certain securities should be reduced.

13. Each of the Funds held, in varying amounts, securities backed by subprime mortgages, and the market for such securities deteriorated in the first half of 2007. Morgan Keegan utilized practices which were not reasonably designed to determine that the Funds' NAVs were accurate. Morgan Asset, through Kelsoe, engaged in actions that forestalled declines in the NAVs of the Funds that would have occurred as a result of the deteriorating market, absent his intervention.

14. Many of the securities that were held by the Funds and backed by subprime mortgages lacked readily available market quotations and, as a result, were required by the Investment Company Act to be priced by the Funds' Boards of Directors, using "fair value" methods. Under Section 2(a)(41)(B) of the Investment Company Act, the Funds were required to use market values for portfolio securities with readily available market quotations and use fair value for all other portfolio assets, as determined in good faith by the board of directors. The fair value of securities for which market quotations are not readily available is the price the Funds would reasonably expect to receive on a current sale of the securities.<sup>3</sup>

15. The Funds adopted valuation procedures for pricing the Funds' portfolio securities and assigned the task of following those procedures to Morgan Keegan. The Funds' valuation procedures for fair-valued securities mandated that such securities should be valued in "good faith" by the Valuation Committee, considering a series of general and specific factors including, among others, "fundamental analytical data relating to the investment," "an evaluation of the forces which influence the market in which the securities are purchased or sold" and "events affecting the security." The procedures required the Valuation Committee to maintain a written report "documenting the manner in which the fair value of a security was determined and the accuracy of the valuation made based on the next reliable public price quotation for that security." The procedures also required that values assigned to securities be periodically validated through, among other means, broker-dealer price confirmations. Fund Accounting also used broker-dealer price confirmations to set current values. The procedures specified that prices obtained from a broker-dealer could only be overridden when there was "a reasonable basis to believe that the price provided [did] not accurately reflect the fair value of the portfolio security." Whenever a price was overridden, the procedures mandated the basis for overriding the price to be "documented and provided to the Valuation Committee for its review."

16. In filings with the Commission, the Funds stated that the fair value of securities would be determined by Morgan Asset's Valuation Committee using procedures adopted by the Funds' board of directors. In fact, the responsibility was delegated to Morgan Keegan, which primarily staffed the Valuation Committee. Morgan Keegan and the Valuation Committee did not reasonably satisfy their responsibilities under the Funds' procedures in several ways. Among other things: (i) the Valuation Committee left pricing decisions to lower level employees in Fund Accounting who did not have the training or qualifications to make fair value pricing determinations; (ii) Fund Accounting personnel relied on Kelsoe's "price adjustments" to determine the prices assigned to portfolio assets, without obtaining a reasonable basis for or documentation supporting the price adjustments or applying the factors set forth in the procedures; (iii) Fund Accounting personnel gave Kelsoe discretion beyond the parameters of the valuation procedures in validating the prices of portfolio securities by allowing him to determine which dealer price confirmations to use and which to ignore, without obtaining documentation to support his adjustments; and (iv) the Valuation Committee and Fund Accounting did not ensure that the fair value prices assigned to many of the portfolio securities were periodically reevaluated, allowing them to be carried at stale values for months at a time.

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<sup>3</sup> See AICPA Audit and Accounting Guide—Investment Companies (Sect. 2.35–2.39), which incorporates Accounting Series Release No. 118 ("ASR 118"). The Commission has provided interpretative guidance related to financial reporting in the Accounting Series Releases, which is included in the Codification of Financial Reporting Policies. Thus, conformity with the ASR 118 is required by Commission rules and complies with Generally Accepted Accounting Principles ("GAAP"). See also Articles 1-01(a) and 6.03 of Regulation S-X.

17. Morgan Asset adopted its own procedures to determine the actual fair value to assign to portfolio securities and to “validate” those values “periodically.” Among other things, those procedures provided that “[q]uarterly reports listing all securities held by the Funds that were fair valued during the quarter under review, along with explanatory notes for the fair values assigned to the securities, shall be presented to the Board for its review.” Morgan Asset failed to fully implement this provision of its pricing policy.
18. At various times between January 2007 and July 2007, Kelsoe had his assistant send “price adjustments” to Fund Accounting. The adjustments were communications by Kelsoe to Fund Accounting concerning the values of specific portfolio securities. In many instances, these adjustments were arbitrary and did not reflect fair value. The price adjustments were routinely entered upon receipt by the staff accountant into a spreadsheet used to calculate the NAVs of the Funds.
19. Fund Accounting did not generally request, and Kelsoe did not generally supply, supporting documentation for his price adjustments. Fund Accounting and the Funds did not record which securities had been assigned values by Kelsoe.
20. As part of the Funds’ valuation procedures, Fund Accounting sometimes requested third-party broker-dealer price confirmations as a means to validate the values it had assigned to the Funds’ fair valued securities. The Funds’ Independent Auditor used similar requests for third-party broker-dealer price confirmations as part of its annual year-end audits of the Funds. Fund Accounting or the Independent Auditor would periodically send such requests to broker-dealers asking them to provide price confirmations for various portfolio securities.
21. During the period from January through July 2007, when month-end dealer price confirmations were received by Fund Accounting, an employee of Fund Accounting performed a review to estimate whether they contained any securities prices that varied from current portfolio values by more than five percent. If so, then Kelsoe determined whether the current values should be maintained or a new value—which may or may not have been the price given by the broker-dealer—should be assigned to the security. Thus, Fund Accounting generally allowed Kelsoe to determine whether broker-dealer price confirmations were used or ignored. In some instances, when price confirmations were received that were substantially lower than current portfolio values, Fund Accounting personnel, acting at the direction of Kelsoe, lowered values of bonds over a period of days, in a series of pre-planned reductions to values at or closer to, but still above, the price confirmations. As a result, during the interim days, Fund Accounting did not price those bonds at their current fair value.
22. During the period from January through July 2007, Fund Accounting failed to record which bond values were not adjusted in response to dealer price confirmations at Kelsoe’s direction.
23. The head of Fund Accounting reported to Weller, and Weller was a member of the Valuation Committee. He knew, or was reckless in not knowing, of the deficiencies in the implementation of the valuation procedures set forth above, and failed to remedy them or otherwise make sure fair-valued securities were accurately priced and the Funds’ NAVs were accurately calculated. During the period from January through July 2007, Weller was aware that: (i) the Valuation Committee did not adequately supervise Fund Accounting’s application of the valuation factors; (ii) Kelsoe was supplying fair value price adjustments for specific securities to Fund Accounting but the members of the Valuation Committee did not generally know which securities Kelsoe supplied fair values for or what those fair values were, and did not generally receive supporting documentation for those values; and (iii) the only other pricing test regularly applied by the Valuation Committee was a “look back” test, which compared the sales price of any security sold by a Fund to the valuation of that security used in the NAV calculation for the five business days preceding the sale. The test only covered securities after they were sold; thus, at any given time, the Valuation Committee never knew how many securities’ prices could ultimately be validated by it. Weller nevertheless signed the Funds’ annual and semiannual financial reports on Forms N-CSR, filed with the Commission, including certifications pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of 2002.

24. During the period from January 2007 through July 2007, Morgan Keegan, acting through Weller and Fund Accounting, failed to employ reasonable procedures to price the Funds' portfolio securities and, as a result of that failure, did not calculate current NAVs for the Funds. Despite these failures, Morgan Keegan published daily NAVs of the Funds which it could not know were accurate and, as distributor of the open-end portfolios, sold and redeemed shares to investors based on those NAVs.

25. On various dates from January 2007 through July 2007, Morgan Asset, through Kelsoe, screened and influenced the price confirmations obtained from at least one broker-dealer ("the Submitting Firm"). Among other things, the Submitting Firm was induced to provide interim price confirmations that were lower than the values at which the Funds were valuing certain bonds, but higher than the initial confirmations that the Submitting Firm had intended to provide. The interim price confirmations enabled the Funds to avoid marking down the value of securities to reflect current fair value. Kelsoe was aware that use of the interim price confirmations was inconsistent with the valuation procedures and did not reflect fair value, that the Submitting Firm would be providing lower price confirmations in response to future pricing validation requests, and that the Funds would be required to further mark down the value of the securities to reflect their already diminished value, but that information was not disclosed to Fund Accounting, the Funds' Boards of Directors or the Independent Auditor. In some instances, even after causing the Submitting Firm to increase its price confirmations, Kelsoe subsequently provided price adjustments to Fund Accounting that were higher than even the Submitting Firm's increased price confirmations. These adjustments were not consistent with the Funds' procedures. In other instances, the Submitting Firm was induced to not provide price confirmations to Fund Accounting (or, depending on the period, to the Independent Auditor), where those price confirmations would have been significantly lower than the Funds' current valuations of the relevant bonds. Fund Accounting and the Funds' Boards were not advised that the Submitting Firm had proposed price confirmations which were lower than the current valuations recorded by the Funds, and that the Submitting Firm had refrained from submitting price confirmations to Fund Accounting or had submitted price confirmations at higher prices than it had originally planned.

26. In each of the Funds' annual and semiannual reports filed with the Commission on Forms N-CSR during the relevant period (including, among others, the Annual Report for the Morgan Keegan Select Fund, Inc. for the year-ended June 30, 2007, filed with the Commission on October 4, 2007), Kelsoe included a signed letter to investors reporting on the Funds' performance "based on net asset value." In fact, the performance reported was materially misstated. Untrue statements of material fact concerning the Funds' performance were made in the Funds' annual and semiannual reports filed with the Commission on Forms N-CSR. Morgan Asset, through Kelsoe, also provided a quarterly valuation packet reflecting inflated prices for certain securities to the Funds' Boards, failed to disclose to the Funds' Boards information indicating that the Funds' NAVs were inflated and that broker-dealer price confirmations were being screened and caused to be altered, and provided Fund Accounting with unsubstantiated price adjustments. In addition, the prospectuses incorrectly described Morgan Asset as responsible for fair valuation of the Funds' portfolios.

#### D. Violations

27. Investment advisers owe their clients, including investment company clients, a fiduciary duty. *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 195-97 (1963). Misstatements or omissions of fact by an investment adviser, such as those made to the Funds' boards, violate an adviser's fiduciary duty and constitute fraud when they are material. Similarly, the failure to disclose to the Funds' boards that Morgan Asset and Morgan Keegan were not complying with stated valuation procedures constitutes fraud. In addition, the knowing or reckless failure to value securities, for which market quotations are not readily available, consistent with fair value requirements under the Investment Company Act and that materially affects a fund's NAV constitutes fraud. See, *In re Piper Capital Management, Inc.*, Exch. Act. Rel.48409 (August 26, 2003). Section 206(1) of the Advisers Act makes it unlawful for an investment adviser to employ any device, scheme or artifice to defraud any client or prospective client. Section 206(2) makes it unlawful for an investment adviser to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client. As a result of the conduct described above, Respondent Morgan Asset willfully violated, and Kelsoe willfully aided and abetted and caused violations of, Sections 206(1) and 206(2) of the Advisers Act.

28. Section 206(4) of the Advisers Act prohibits fraudulent, deceptive or manipulative practices or courses of business by an investment adviser. Rule 206(4)-7 requires investment advisers to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation" of the Advisers Act and the rules thereunder by their supervised

persons. An adviser's failure "to have adequate compliance policies and procedures in place will constitute a violation of our rules independent of any other securities law violation." *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204, 68 F.R. 74714, 74715 (Dec. 24, 2003) ("Compliance Programs Release"). As a result of the conduct described above, Respondent Morgan Asset willfully violated, and Respondent Kelsoe willfully aided and abetted and caused violations of, Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

29. Section 34(b) of the Investment Company Act prohibits untrue statements of material fact or omissions to state facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, in any registration statement, report or other document filed pursuant to the Investment Company Act or the keeping of which is required pursuant to Section 31(a) of the Investment Company Act. Any person who makes a material misrepresentation concerning a Fund's performance in the Fund's annual and semiannual reports filed with the Commission, or in the records required to be maintained by the Fund, or submits inflated prices to be included in the Fund's NAV calculations and the records forming the basis for the Fund's financial statements, violates Section 34(b). As a result of the conduct described above, Respondents Morgan Asset and Kelsoe willfully violated, and Respondent Morgan Keegan willfully aided, abetted, and caused violations of, Section 34(b) of the Investment Company Act.

30. Rule 22c-1 under the Investment Company Act prohibits the sale or redemption of shares in a registered investment company "except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security." For an NAV to be deemed current, Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder require portfolio securities for which market quotations are not readily available to be valued at fair value. As a result of the conduct described above, Respondent Morgan Keegan willfully violated,<sup>4</sup> and Respondents Morgan Asset, Kelsoe and Weller willfully aided and abetted and caused violations of, Rule 22c-1 promulgated under the Investment Company Act.

31. Rule 38a-1 under the Investment Company Act requires that a registered investment company adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and to provide for oversight of compliance by the fund's investment adviser. Failure of a fund to have adequate compliance policies and procedures in place and/or to implement them will constitute a violation of Rule 38a-1 independent of any other securities law violations. Compliance Programs Release. Morgan Keegan and Morgan Asset knowingly and substantially assisted the Funds' failure to implement fair valuation procedures, which resulted in prices that did not reflect current NAVs. Morgan Keegan, Morgan Asset, Kelsoe and Weller thereby willfully aided and abetted and caused the Funds' violations of Rule 38a-1.

### Undertakings

32. Respondent Morgan Keegan undertakes as follows:

A. Morgan Keegan shall not, for a period of three years from the date of the Order, be involved in, or responsible for, recommending to, or determining on behalf of, a registered investment company's board of directors or trustees or such company's valuation committee, the value of any portfolio security for which market quotations are not readily available.

B. If, after three years but within six years from the date of the Order, Morgan Keegan becomes involved in, or responsible for, determining or recommending determinations to a registered investment company's board of directors or trustees or valuation committee of the value of any portfolio security for which market quotations are not readily available and which are held by or on behalf of such registered investment company, Morgan Keegan shall promptly notify Commission counsel identified below or his successor and within 30 days of beginning such valuation activity, shall hire, at its expense, an Independent Consultant ("Consultant") not unacceptable to the Commission's staff, to review the valuations provided by Morgan Keegan to any registered investment company for the next two quarters following the beginning of such valuation activity, and make an Initial Report with recommendations thereafter on Morgan Keegan's policies, procedures and practices with regard to such valuations. The Initial Report shall describe the review performed and the conclusions reached, and will include any recommendations deemed necessary to make the policies, procedures, and practices adequate and consistent with GAAP and the Investment Company Act. Morgan

<sup>4</sup> A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).



Keegan shall cooperate fully with the Consultant and shall provide the Consultant with access to its files, books, records, and personnel as reasonably requested for the review. Morgan Keegan shall cause the review to begin no later than 60 days after beginning such valuation activity.

C. At the end of that review, and in no event more than 200 days from after beginning such valuation activity, to require the Consultant to submit the report and recommendations to Morgan Keegan and to William P. Hicks of the Commission's Atlanta Regional Office or his successor.

D. Within 30 days of receipt of the Initial Report, Morgan Keegan shall in writing respond to the Initial Report. In such response, Morgan Keegan shall advise the Consultant and the Commission's staff of the recommendations from the Initial Report that it has determined to accept and the recommendations that it considers to be unduly burdensome. With respect to any recommendation that Morgan Keegan deems unduly burdensome, Morgan Keegan may propose an alternative policy, procedure or system designed to achieve the same objective or purpose.

E. Morgan Keegan shall attempt in good faith to reach agreement with the Consultant within 60 days of the date of the receipt of the Initial Report with respect to any recommendation that Morgan Keegan deems unduly burdensome. If the Consultant and Morgan Keegan are unable to agree on an alternative proposal, Morgan Keegan shall abide by the recommendation of the Consultant.

F. Within 90 days of the date of the receipt of the Initial Report, Morgan Keegan shall, in writing, advise the Consultant and the Commission's staff of the recommendations and proposals that it is adopting.

G. No later than one year after the date of the Consultant's Initial Report, Morgan Keegan shall cause the Consultant to conduct a follow-up review of Morgan Keegan's efforts to implement the recommendations contained in the Initial Report, and Morgan Keegan shall cause the Consultant to submit a Final Report to the Commission's staff. The Final Report shall set forth the details of Morgan Keegan's efforts to implement the recommendations contained in the Initial Report, and shall state whether Morgan Keegan has fully complied with the recommendations in the Initial Report.

H. Morgan Keegan shall cause the Consultant to complete the aforementioned review and submit a written Final Report to Morgan Keegan and to the Commission's staff within 400 days of the date of the Initial Report. The Final Report shall recite the efforts the Consultant undertook to review Morgan Keegan's policies, procedures, and practices; set forth the Consultant's conclusions and recommendations; and describe how Morgan Keegan is implementing those recommendations.

I. Morgan Keegan shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Consultant's Final Report.

J. To ensure the independence of the Consultant, Morgan Keegan: (a) shall not have the authority to terminate the Consultant without the prior written approval of the Commission's staff; (b) shall compensate the Consultant, and persons engaged to assist the Consultant, for services rendered pursuant to this Order at their reasonable and customary rates; (c) shall not be in and shall not have an attorney-client relationship with the Consultant and shall not seek to invoke the attorney-client or any other privilege or doctrine to prevent the Consultant from transmitting any information, reports, or documents to the Commission staff; and (d) during the period of engagement and for a period of two years after the engagement, shall not enter into any employment, customer, consultant, attorney-client, auditing, or other professional relationship with the Consultant.

K. Morgan Keegan shall cause the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Morgan Keegan, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Atlanta Regional Office Commission staff, enter into any employment, consultant, attorney-client, fiduciary, auditing or other professional relationship with Morgan Keegan, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period



of two years after the engagement. Notwithstanding the foregoing, the Consultant may serve as a Consultant for Morgan Asset, pursuant to paragraph 34 below.

L. *Certification of Compliance by Respondent.* Morgan Keegan shall certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to William P. Hicks, Associate Regional Director in the Commission's Atlanta Regional Office, or any other member of the Commission's staff identified to receive the report by the staff, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

33. Morgan Keegan further undertakes as follows:

**Ongoing Cooperation by Morgan Keegan.** Morgan Keegan undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order or involving, directly or indirectly, trading in or valuation of, the securities of the funds described in this Order. In connection with such cooperation, Morgan Keegan has undertaken:

To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff, or by the Distribution Agent to be appointed pursuant to the Order, with a custodian declaration as to their authenticity, if requested;

To use its best efforts to cause its employees and former employees to be interviewed by the Commission's staff, at the option of the staff with representatives of other government agencies present, at such times and places as the staff reasonably may direct. Live interviews on 72 hours notice at the Commission's Atlanta office or its headquarters office, or at any U.S or state government office in Memphis Tennessee, and telephone interviews on 48 hours notice, at the option of the staff, shall be deemed to be reasonable;

To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

In connection with any interviews of Morgan Keegan employees to be conducted pursuant to this undertaking, requests for such interviews may be provided by the Commission's staff to Morgan Keegan's General Counsel, or such other counsel that may be substituted by Morgan Keegan.

34. Respondent Morgan Asset undertakes as follows:

A. Morgan Asset shall not, for a period of three years from the date of the Order, be involved in, or responsible for, recommending to, or determining on behalf of, a registered investment company's board of directors or trustees or such company's valuation committee, the value of any portfolio security for which market quotations are not readily available.

B. If, after three years but within six years from the date of the Order, Morgan Asset becomes involved in, or responsible for, determining or recommending determinations to a registered investment company's board of directors or trustees or valuation committee of the value of any portfolio security for which market quotations are not readily available and which are held by or on behalf of such registered investment company, Morgan Asset shall promptly notify Commission counsel identified below or his successor and within 30 days of beginning such valuation activity, shall hire, at its expense, an Independent Consultant ("Consultant") not unacceptable to the Commission's staff, to review the valuations provided by Morgan Asset to any registered investment company for the next two quarters following the beginning of such valuation activity, and make an Initial Report with recommendations thereafter on Morgan Asset's policies, procedures and practices with regard to such valuations. The Initial Report shall describe the review performed and the conclusions reached, and will include any recommendations deemed necessary to make the policies, procedures, and practices adequate and consistent with GAAP and the Investment Company Act. Morgan Asset shall cooperate fully with the Consultant and shall provide the Consultant with access to its files, books, records, and personnel as reasonably

requested for the review. Morgan Asset shall cause the review to begin no later than 60 days after beginning such valuation activity.

C. At the end of that review, and in no event more than 200 days from after beginning such valuation activity, to require the Consultant to submit the report and recommendations to Morgan Asset and to William P. Hicks of the Commission's Atlanta Regional Office or his successor.

D. Within 30 days of receipt of the Initial Report, Morgan Asset shall in writing respond to the Initial Report. In such response, Morgan Asset shall advise the Consultant and the Commission's staff of the recommendations from the Initial Report that it has determined to accept and the recommendations that it considers to be unduly burdensome. With respect to any recommendation that Morgan Asset deems unduly burdensome, Morgan Asset may propose an alternative policy, procedure or system designed to achieve the same objective or purpose.

E. Morgan Asset shall attempt in good faith to reach agreement with the Consultant within 60 days of the date of the receipt of the Initial Report with respect to any recommendation that Morgan Asset deems unduly burdensome. If the Consultant and Morgan Asset are unable to agree on an alternative proposal, Morgan Asset shall abide by the recommendation of the Consultant.

F. Within 90 days of the date of the receipt of the Initial Report, Morgan Asset shall, in writing, advise the Consultant and the Commission's staff of the recommendations and proposals that it is adopting.

G. No later than one year after the date of the Consultant's Initial Report, Morgan Asset shall cause the Consultant to conduct a follow-up review of Morgan Asset's efforts to implement the recommendations contained in the Initial Report, and Morgan Asset shall cause the Consultant to submit a Final Report to the Commission's staff. The Final Report shall set forth the details of Morgan Asset's efforts to implement the recommendations contained in the Initial Report, and shall state whether Morgan Asset has fully complied with the recommendations in the Initial Report.

H. Morgan Asset shall cause the Consultant to complete the aforementioned review and submit a written Final Report to Morgan Asset and to the Commission's staff within 400 days of the date of the Initial Report. The Final Report shall recite the efforts the Consultant undertook to review Morgan Asset's policies, procedures, and practices; set forth the Consultant's conclusions and recommendations; and describe how Morgan Asset is implementing those recommendations.

I. Morgan Asset shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Consultant's Final Report.

J. To ensure the independence of the Consultant, Morgan Asset: (a) shall not have the authority to terminate the Consultant without the prior written approval of the Commission's staff; (b) shall compensate the Consultant, and persons engaged to assist the Consultant, for services rendered pursuant to this Order at their reasonable and customary rates; (c) shall not be in and shall not have an attorney-client relationship with the Consultant and shall not seek to invoke the attorney-client or any other privilege or doctrine to prevent the Consultant from transmitting any information, reports, or documents to the Commission staff; and (d) during the period of engagement and for a period of two years after the engagement, shall not enter into any employment, customer, consultant, attorney-client, auditing, or other professional relationship with the Consultant.

K. Morgan Asset shall cause the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Morgan Asset, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Atlanta Regional Office Commission staff, enter into any employment, consultant, attorney-client, fiduciary, auditing or other professional relationship with Morgan Asset, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period

of two years after the engagement. Notwithstanding the foregoing, the Consultant may serve as a Consultant for Morgan Keegan, pursuant to paragraph 32 above.

L. *Certification of Compliance by Respondent.* Morgan Asset shall certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to William P. Hicks, Associate Regional Director in the Commission's Atlanta Regional Office, or any other member of the Commission's staff identified to receive the report by the staff, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

35. Morgan Asset further undertakes as follows:

**Ongoing Cooperation by Morgan Asset.** Morgan Asset undertakes to cooperate fully with the Commission in any and all investigations, litigations, or other proceedings relating to or arising from the matters described in this Order or involving, directly or indirectly, trading in or valuation of, the securities of the funds described in this Order. In connection with such cooperation, Morgan Asset has undertaken:

To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff or by the Distribution Agent to be appointed pursuant to the Order, with a custodian declaration as to their authenticity, if requested;

To use its best efforts to cause its employees and former employees to be interviewed by the Commission's staff, at the option of the staff with representatives of other government agencies present, at such times and places as the staff reasonably may direct. Live interviews on 72 hours notice at the Commission's Atlanta office or its headquarters office, or at any U.S or state government office in Memphis Tennessee, and telephone interviews on 48 hours notice, at the option of the staff, shall be deemed to be reasonable.

To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

In connection with any interviews of Morgan Asset employees to be conducted pursuant to this undertaking, requests for such interviews may be provided by the Commission's staff to Morgan Asset's General Counsel, or such other counsel that may be substituted by Morgan Asset.

36. Morgan Keegan and Morgan Asset undertake to, pursuant to and in compliance with this Order and with orders being entered in Joint Administrative Proceedings (File Nos. SC-2010-0016 (Alabama), 2010-AH-021 (Kentucky) and 08011 (South Carolina), and the separate Tennessee matter File No. 12.06-107077J (collectively "the State Proceedings")), and the sanctions described in Financial Industry Regulatory Authority Letter of Acceptance, Waiver and Consent No. 2007011164502, jointly and severally pay the total sum of \$200 million, including the disgorgement, interest and penalties to be ordered in this matter.

37. Kelsoe undertakes to, pursuant to and in compliance with this Order and with orders being entered in the State Proceedings, to pay \$500,000 in penalties, including the penalties to be ordered in this matter pursuant to paragraph IV. L.

In determining whether to accept the Offer, the Commission has considered the undertakings in paragraphs 33, 35, 36, and 37, above.

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 4C and 15(b) of the Exchange Act, Sections 203(e), 203(f), and 203(k) of the Advisers Act, Sections 9(b) and 9(f) of the Investment Company Act, and Rule 102(e)(1)(iii) of the Commission's Rules of Practice, it is hereby ORDERED that:

A. Respondents Morgan Keegan and Morgan Asset are censured.

B. Respondent Morgan Keegan shall cease and desist from committing or causing any violations and any future violations of, Section 34(b) of the Investment Company Act and Rules 22c-1 and 38a-1 promulgated under the Investment Company Act.

C. Respondent Morgan Asset shall cease and desist from committing or causing any violations and any future violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and Section 34(b) of the Investment Company Act and Rules 22c-1 and 38a-1 promulgated under the Investment Company Act.

D. Respondent Kelsoe shall cease and desist from committing or causing any violations and any future violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and Section 34(b) of the Investment Company Act and Rules 22c-1 and 38a-1 promulgated under the Investment Company Act.

E. Respondent Weller shall cease and desist from committing or causing any violations and any future violations of Rules 22c-1 and 38a-1 promulgated under the Investment Company Act.

F. Respondent Kelsoe be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent, or nationally recognized statistical rating organization, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

G. Respondent Kelsoe be, and hereby is, barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent, or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

H. Respondent Weller be, and hereby is suspended from association in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent, or nationally recognized statistical rating organization, for a period of 12 months, effective on the second Monday following the entry of this Order, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, for a period of 12 months, effective on the second Monday following the entry of this Order.

I. Respondent Weller be, and hereby is, suspended from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent, or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock for a period of 12 months, effective on the second Monday following the entry of this Order.

J. Respondent Weller is denied the privilege of appearing or practicing before the Commission as an accountant.

After two years from the date of this Order, Respondent Weller may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent Weller's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent Weller, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent Weller, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

(c) Respondent Weller has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent Weller acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

The Commission will consider an application by Respondent Weller to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

K. Respondents Morgan Keegan and Morgan Asset shall jointly and severally pay disgorgement of \$20,500,000 and prejudgment interest of \$4,500,000 to the Securities and Exchange Commission, and a civil penalty of \$75,000,000 to the Securities and Exchange Commission, within ten (10) business days of the entry of this Order.

L. Respondent Kelsoe shall pay a civil penalty of \$250,000 to the Securities and Exchange Commission, within ten (10) days of this Order.

M. Respondent Weller shall pay a civil penalty of \$50,000 to the Securities and Exchange Commission, within ten (10) days of this Order.

N. All payments pursuant to paragraphs IV. K, L, and M, above, shall be made by certified check, bank cashier's check, or United States postal money order payable to the Securities and Exchange Commission. The payment shall be delivered or mailed to the Office of Financial Management, Accounts Receivable, Securities and Exchange Commission, 100 F Street, NE, Stop 6042, Washington DC 20549, and shall be accompanied by a letter identifying Respondent as a respondent in these proceedings; setting forth the file number of these proceedings; and specifying that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to William P. Hicks, Associate Regional Administrator, Securities and Exchange Commission, 3475 Lenox Rd., N.E., Suite 500, Atlanta, GA 30326-1232. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717 and/or SEC Rule of Practice 600.

Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the disgorgement, interest, and penalties described in Paragraphs IV. K, L, and M and any funds paid in connection with related actions pursuant to Paragraph III. 36, above. Regardless of whether any such distribution is made from such Fair Fund, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that any Respondent receiving such offset shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against any of the Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

O. The disgorgement, interest, civil penalties, and any other funds which may be paid to the Fair Fund through or as the result of related actions, shall be aggregated in the Fair Fund, which shall be maintained in an interest-bearing account, and shall be distributed pursuant to a distribution plan (the "Plan") to be administered in accordance with the Commission Rules on Fair Fund and Disgorgement Plans. A Fund Administrator (the "Administrator") shall be appointed by the Commission. The Administrator shall identify the investors in the Funds who suffered losses as a result of the violations determined herein, evaluate investor claims and propose and effectuate a plan to distribute the Fair Fund resulting from this order. The Fair Fund shall be used to compensate injured customers for their loss. Under no circumstances shall any part of the Fair Fund be returned to Morgan Keegan, Morgan Asset, Kelsoe, or Weller. Respondent Morgan Keegan shall pay all reasonable costs and expenses of such distribution within thirty (30) days after receipt of an invoice for such services.

P. Morgan Keegan shall comply with the undertakings specified in Paragraph 32 above.

Q. Morgan Asset shall comply with the undertakings specified in Paragraph 34 above.

By the Commission.

Elizabeth M. Murphy  
Secretary



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## OTHER VALUATION RESOURCES

### ICI PUBLICATIONS:

- » An Introduction to Fair Valuation (May 2005)
- » Fair Valuation: The Role of the Board (January 2006)

*Available to ICI members at [www.ici.org](http://www.ici.org):*

- » Valuation and Liquidity Issues for Mutual Funds (February 1997)
- » Valuation and Liquidity Issues for Mutual Funds, Supplement (March 2002)

### ACCOUNTING GUIDANCE:

- » FASB Accounting Standards Codification Topic 820—Fair Value Measurement
- » FASB Accounting Standards Codification Topic 946—Investment Companies
- » AICPA Audit and Accounting Guide: Investment Companies (May 1, 2011)  
(available from the AICPA)

### SEC GUIDANCE:

- » Valuation of Portfolio Securities and Other Assets Held by Registered Investment Companies—Select Bibliography of the Division of Investment Management



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