IN THE MATTER OF

INVESTORS PORTFOLIO MANAGEMENT, INC.

File No. 3-6729. Promulgated June 26, 1990

Investment Advisers Act of 1940

OPINION OF THE COMMISSION

INVESTMENT ADVISER PROCEEDINGS

Grounds for Remedial Action

Fraudulent Representations

Improper Borrowing by Fund

Sale and Redemption of Fund Shares at Prices not Based on their Current Net Asset Value

Payments by Fund for Advertising not Covered by Written Agreement

Failure to Comply with Recordkeeping Requirements

Where investment adviser to mutual fund made fraudulent representations with respect to the yield on fund shares and the tax exempt status of fund dividends, and aided and abetted improper borrowing by fund, fund's sale and redemption of shares at prices not based on their current net asset value, fund's failure to maintain proper records, and advertising payments by fund that were not covered, as required, by a written agreement, *held*, in the public interest to revoke adviser's registration.

APPEARANCES:

Donald T. Sheldon, for Investors Portfolio Management, Inc.

Barbara Brooke Manning, *Nanette A. King*, *Bradley Takahashi*, and *Kathryn A. Ashbough*, for the Commission's Division of Enforcement.

I.

Investors Portfolio Management, Inc. ("IPM"), a registered investment adviser, appeals from the decision of an administrative law judge. The law judge found that, during the period September 1984 through

September 1985, while acting as adviser to California Muni Fund ("Fund"), a registered investment company, IPM willfully violated antifraud provisions by misrepresentations with respect to the yield on Fund shares and with respect to the tax exempt status of Fund dividends. He also found that IPM willfully aided and abetted violations by Fund of those Investment Company Act provisions that prohibit a registered investment company from violating its investment policies, effecting the sale and redemption of shares at prices that do not reflect their current net asset value, failing to maintain proper records, and paying for distribution expenses that are not covered by a written agreement.

The law judge concluded that IPM's investment adviser registration should be revoked. Our findings are based on an independent review of the record except for findings of fact that IPM does not challenge on review.

II. VIOLATIONS OF ANTIFRAUD PROVISIONS

A. During the relevant period, Lance M. Brofman, IPM's president, acted as Fund's president, treasurer and portfolio manager. Fund was a municipal bond fund. Its prospectus stated that its objective was "to provide investors with as high a level of income . . . exempt from Federal and California income taxes as is consistent with the preservation of capital." The prospectus also stated that IPM was "responsible for maintaining . . . Fund's portfolio of investments in a manner consistent with the standards specified in this prospectus."

In order to increase the yield on Fund shares, IPM adopted an investment strategy that exposed Fund's capital to risks that were inconsistent with its stated investment objective. That strategy involved the purchase of bonds in odd lots (less than 100 bonds) and with "short settlement" dates (less than five business days after the date of purchase). Brofman's objective was to acquire bonds for Fund's portfolio that would not be delivered by the settlement date, thereby becoming so-called "failed bonds."[1] Failed bonds accrue interest from the settlement date even though they need not be paid for until they are delivered. Thus, when a bond "failed," Fund collected interest until the date of delivery without any expenditure of capital. Moreover, in the interim, IPM used the money that Fund would have paid out for the failed bonds to purchase additional bonds for Fund. In this way, Fund was able to collect two payments of interest on the same money. From October 9 to December 28, 1984, Fund made 58 bond purchases of which 53 "failed."

By adopting an investment strategy that deliberately sought to acquire

[1] Bonds with "short settlement" periods are likely to "fail" because the seller has less time physically to collect and deliver them. Odd lot purchases frequently "fail" because they are typically purchased from individuals—as opposed to institutions—who generally do not have any procedure in place that assures prompt delivery. Odd lots also "fail" because sellers tend to be less attentive to them due to the small number of bonds involved.

failed bonds, IPM was able to achieve high yields for Fund. By January 16, 1985, Fund had achieved an average seven-day yield of 15.22% and, by January 21, an average seven-day yield of 17.52%. At the same time, other comparable municipal bond funds were only achieving yields of 9% to 10%.

IPM was responsible for advertisements that emphasized Fund's high yields in newspapers, magazines and on radio. However, no disclosure was made that the high yields were unsustainable.[2] Brofman admitted that his "odd lot—short settlement" strategy was merely a temporary device destined for Fund's start-up period when there were no liquidations and Fund was simply buying, not selling, so that disposing of odd lots was not a burden.[3] In fact, Fund's purchases of odd lots declined from 97% of total purchases between October 9 and December 28, 1984, to only 21% of total purchases between January 4 and June 14, 1985. By mid-June, the yield on Fund shares had dropped to 8.91%.

In addition, IPM did not disclose to Fund's board of trustees, investors and potential investors the risks involved in the strategy IPM had adopted. As noted, IPM used money that was temporarily available because of the late delivery of failed bonds to purchase additional bonds for Fund. Indeed, Brofman stated that his objective was to maintain a "zero cash balance." At the same time, Fund had, as a fundamental policy set forth in its prospectus, a prohibition against borrowing in excess of 20% of its gross assets. Since the delivery date of a failed bond could not be predicted with any assurance, IPM ran the risk of Fund running short of money to pay for its purchases, particularly if a large number of failed bonds were delivered on the same date. In fact, on every day from January 18 through January 24, 1985, Fund did exceed its borrowing limit. As a result of exceeding that limit, IPM ran the risk that it might be forced to liquidate assets to raise sufficient cash to pay for its purchases. Had such a liquidation been required, Fund's investment strategy would have been disrupted, and Fund might have been forced to sell assets at unfavorable prices.

IPM argues that many mutual funds use the same strategy in their early stages that IPM employed for Fund, that the bond funds whose yields were compared to those of Fund had been in existence for much longer periods, that failure to disclose a legal and standard strategy such as the one IPM employed is not fraud, and that investors are "well aware" of the axiom "the higher the yield, the higher the risk."

These contentions are unpersuasive. IPM was responsible for making

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[2] While a notation appeared in some of the advertisements stating that Fund's current yield "[might] not be indicative of future yields," the notation did not appear in all of the advertisements. Moreover, this limited disclaimer hardly constituted full disclosure. In addition, while IPM disclosed Fund's current yield to telephone callers, only those who specifically inquired about the reason for the high yield were informed of Fund's high proportion of failed bonds.

[3] Brofman testified: "The only time you're buying odd lots is in the inception, during the early period when . . . it's a one way street. Money is just coming in and you don't have to sell . . . [T]hen very quickly you're not buying odd lots anymore and you're buying matches to the odd lots to have them become round lots."

full disclosure of all material facts concerning the strategy it employed. Instead, it deliberately misled Fund's board of trustees, investors and potential investors by failing to disclose that its advertised high yields were only temporary and that there were certain specific risks inherent in its strategy.[4]

We conclude that IPM willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b–5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act.

B. The law judge also found that IPM fraudulently represented that dividends paid by Fund were exempt from California income tax. The pertinent facts are as follows.

Section 17145 of the California Revenue and Tax Code limited the state tax exemption claimed by Fund to dividends distributed by corporations classified as "diversified management companies" under Section 5 of the Investment Company Act.[5] It is undisputed (indeed, it was recited in Fund's prospectuses) that from September 24, 1984, when Fund commenced operations, through September 1985, Fund was a non-diversified company within the meaning of that section. Nevertheless, Fund's prospectuses implied, and its newspaper and radio advertisements emphasized, the purported tax-free status of Fund dividends. IPM's representation that Fund dividends were tax exempt was, at the least, reckless.

IPM argues that it relied on the advice of its counsel in representing Fund's distributions as tax-free. In order to establish a claim of reliance on counsel, IPM was required to show (1) that advice was sought from counsel as to the legality of the particular matter at issue; (2) that full disclosure was made to counsel; (3) that counsel advised that the contemplated action was legal; and (4) that counsel's advice was relied on in good faith.[6] IPM presented no evidence that it even discussed the tax status of Fund dividends with counsel. James Alston, IPM's compliance officer, simply testified that IPM relied on the generalized opinion letter furnished by counsel in connection with Fund's filings with this Commission. IPM further contends that it relied on the statement of its certified public accountants, contained in Fund's December 31, 1984 annual report, to the effect that dividends were tax free. However, the item in Fund's annual report only related to federal income taxes.

We accordingly conclude that, in the foregoing respect, IPM willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange

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[4] IPM argues that the evidence does not establish that telephone callers were not informed of the risks created by its trading strategy. However, the testimony of James Alston, IPM's compliance officer, clearly establishes that callers were not informed of those risks.

[5] Section 5(b) of the Act defines a "diversified" management company as one where "[a]t least 75 per centum of the value of its total assets is . . . limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer." A "non-diversified company" means "any management company other than a diversified company."

[6] *See C.E. Carlson Inc. v. SEC*, 859 F.2d 1429, 1436 (10th Cir. 1988); *SEC v. Savoy Industries, Inc.*, 665 F.2d 1310, 1314 n.28 (D.C. Cir. 1981).

Act and Rule 10b–5 thereunder, and Section 206(4) of the Advisers Act and Rule 206(4)–1 thereunder.[7]

III. VIOLATIONS OF INVESTMENT COMPANY ACT

IPM appeals from the law judge's determination that it aided and abetted various violations of the Investment Company Act. To find aiding and abetting liability, three elements must be established: (1) another party has committed a violation; (2) the accused aider and abettor knowingly and substantially assisted the principal violation; and (3) the accused aider and abettor had a general awareness that his role was part of an overall activity that was improper.[8] The second element of aiding and abetting liability can be demonstrated in this case as a result of IPM's control over Fund.[9]

A. Section 13(a)(2) of the Investment Company Act prohibits a registered investment company from borrowing money "except . . . in accordance with the recitals of policy contained in its registration statement . . ." unless authorized by the vote of a majority of its outstanding voting securities. Section 13(a)(3) of the Act provides that an investment company may not "deviate from any investment policy which is changeable only if authorized by shareholder vote . . ." Fund prospectuses, dated August 23, 1984 and April 29, 1985, state that Fund borrowing will not exceed 20% of Fund's total assets, and that this policy may only be changed by a majority vote of shareholders. Nevertheless, it is undisputed that, without any such authorization, Fund exceeded its borrowing limitation on three separate occasions during the period January through July 1985.[10]

IPM argues that, since an open-end fund must be ready to make redemptions in any amount at any time, it can never predict in advance how much it may be required to borrow.[11] Here, however, Fund's borrowings were not the result of a sudden unexpected surge in redemptions but resulted from an investment strategy deliberately adopted by IPM. Although IPM could not know with certainty when it would need funds to pay for the delivery of previously failed bonds, it did not retain adequate funds for that purpose. We accordingly conclude that IPM willfully

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[7] Rule 206(4)–1 proscribes false or misleading advertising by an investment adviser.

[8] *See, e.g., Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94–95 (5th Cir. 1975).

[9] *Cf. Steadman Security Corp.*, 46 S.E.C. 896, 920 n.81 (1977) ("the investment adviser almost always controls the fund. Only in the very rare case where the adviser's role is simply that of advising others who may or may not elect to be guided by his advice . . . can the adviser realistically be deemed not in control.").

[10] In addition to Fund exceeding its borrowing limit in January 1985, IPM's compliance officer testified that Fund exceeded its borrowing limitation at least once in July 1985 and again in either April or July 1985.

[11] IPM also argues that Section 18(f)(1) of the Investment Company Act permitted Fund to borrow an amount up to 33 percent of its assets and to exceed that limit for periods of less than three business days. However, the basis of the charge in this case is that Fund had established a policy, to which the Act required adherence, that limited the amount of its borrowing to twenty percent of its assets. Accordingly, Section 18(f)(1) is not pertinent to this issue.

aided and abetted Fund's willful violations of Sections 13(a)(2) and 13(a)(3) of the Investment Company Act.

B. Rule 22c–1(a) under the Investment Company Act provides that any registered investment company issuing a redeemable security can only sell and redeem that security at prices based on the security's current net asset value. IPM determined the value of the bonds in Fund's portfolio by using the information provided by Inter-Active Data, an independent pricing service. However, as IPM was aware, the bond prices provided by Inter-Active were for round lots, not odd lots. Since odd lots are less attractive to buyers, they generally sell at prices that are 1 1/2% to 2% less than the price of round lots. Thus, from October 9 to December 28, 1984, when Fund's portfolio consisted almost entirely of odd lots, IPM caused Fund to overvalue its portfolio and, consequently, to sell and redeem Fund shares at prices that were not based on their current net asset value.

IPM argues that Fund's prospectus described the way in which it priced its securities and that our staff's own expert witness agreed that the method IPM used was in accordance with standard industry practice and "the only correct and practical way to price odd lot securities."

We do not agree. If Fund's prospectus disclosed a method of pricing its portfolio that would result in an inaccurate value, the prospectus should have been appropriately revised to describe an accurate method. The staff's expert witness did testify that pricing services are "the usual reference point" for valuing municipal bond funds, and that such services only provide round lot valuations. However, he did not agree that it was proper for a mutual fund with a portfolio consisting primarily of odd lots to price them on the basis of round lot valuations. On the contrary, he stated that such a practice would produce an inaccurate result.

IPM had an obligation to price Fund's shares on the basis of their net asset value. It was aware from its purchases of odd lots for Fund that odd lots are priced at a discount from round lot values and, consequently, that it was causing Fund to overvalue its portfolio. Even assuming that other bond funds priced odd lot portfolios in the same manner as Fund, that circumstance would not justify Fund's use of a pricing method that was clearly improper.[12] Accordingly, we conclude that IPM willfully aided and abetted Fund's willful violations of Section 22(c) of the Investment Company Act and Rule 22c–1 thereunder.

C. Rule 12b–1(b) under the Investment Company Act provides that a registered open-end management investment company may distribute its own securities provided that "any payments made . . . in connection with such a distribution are made pursuant to a written plan . . . and that all agreements with any person relating to implementation of the plan are

[12] *Cf. C.A. Benson & Co., Inc.*, 42 S.E.C. 107, 111 (1964) (advertising practices); *Amsbary, Allen & Morton, Inc.*, 42 S.E.C. 919, 922 (1966) (mark-up practice).

in writing . . ." There was a written distribution plan between Fund and IPM which authorized IPM to purchase advertising for Fund and provided for reimbursement for those expenses. However, beginning in January 1985, IPM caused Fund to make payments to Donald Sheldon Marketing Services ("DSMS") for advertising when no written agreement existed between Fund and DSMS.

We accordingly conclude that IPM willfully aided and abetted willful violations by Fund of Section 12(b) of the Investment Company Act and Rule 12b–1 thereunder.

D. Rule 31a–1(b) under the Investment Company Act requires that registered investment companies maintain, among other things, a record of each brokerage order showing the time of entry thereof. This requirement may be satisfied by maintaining order tickets that bear the required information. Brofman was responsible for completing order tickets. However, during the relevant period, 89 order tickets for Fund brokerage orders did not properly reflect the time of entry.

IPM contends that the missing times of entry could be obtained from other documents and that the order tickets in evidence probably do not show times of entry because of poor photocopies or because the ink was low in the time-stamp machine. We have consistently held that, even if required information may be obtained from other records, the records required by our rules must nevertheless be maintained.[13] In addition, IPM did not come forward with any evidence to support its claim of poor photocopies or inadequate printing by the time-stamp machine. Given the evidence before us, we find that IPM was aware that Fund was not properly maintaining required information.

Accordingly, we conclude that IPM willfully aided and abetted willful violations by Fund of Section 31 of the Investment Company Act and Rule 31a–1(b) thereunder.

IV.

As noted above, the law judge concluded that IPM's investment adviser registration should be revoked in the public interest. We agree.

We have found that IPM engaged in serious violations of antifraud provisions and aided and abetted serious violations of the Investment Company Act. In 1984, pursuant to an offer of settlement, we sanctioned IPM and Brofman for violations strikingly similar to those at issue here committed during the period 1981–1983.[14] At that time, IPM was investment adviser to New York Muni Fund, Inc. ("NYMF"), a registered

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[13] *See Frank W. Humpherys*, 48 S.E.C. 161, 164 (1985); *Frank DeFelice, Ph.D. & Associates, Inc.*, 47 S.E.C. 124, 129 (1979); *Eugene N. Owens*, 42 S.E.C. 149, 151 (1964); *Associated Securities Corporation*, 40 S.E.C. 10, 18 (1960), *aff'd*, 293 F.2d 738 (10th Cir. 1961).

[14] *Investors Portfolio Management, Inc.*, Securities Exchange Act Release No. 21016 (June 4, 1984), 30 SEC Docket 1010.

investment company. We found that IPM and Brofman violated antifraud provisions by disseminating sales literature that materially misstated NYMF's average 7-day yield, and that they aided and abetted violations of the Investment Company Act by NYMF by causing it to lend money to IPM and borrow money for investment purposes in contravention of its fundamental investment policies, and by causing it to sell and redeem its securities at prices that were not based on the securities' current net asset value. We also found that IPM and Brofman violated recordkeeping and reporting provisions, including their failure to record the time of entry of orders for the purchase and sale of portfolio securities.

In light of the extensive and serious misconduct we have found, IPM's record of prior violations, and the fact that our previous disciplinary action did not prevent IPM from quickly engaging in the same kind of misconduct, we conclude that the protection of public investors now requires that IPM's registration be revoked.

An appropriate order will ensue.[15]

By the Commission (Commissioners FLEISCHMAN, SCHAPIRO and LOCHNER); Chairman BREEDEN not participating.

[15] All of the contentions made by respondent and our staff have been considered. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.