

Mutual Fund Enforcement

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Outline

A Look at Some Cases that Illustrate Violations of the Investment Company Act and the Investment Advisers Act

- Front Running Fund Purchases
- Misrepresenting Risks
- Mispricing Fund Shares
- Misleading Fund Advertising
- Market Timing

Roger Honour Case: Front Running Fund Purchases

- Roger Honour — Portfolio Manager for two Mutual Funds and a Hedge Fund
- Employed by the Funds' Investment Adviser
- A very successful portfolio manager

Honour's Purchases

- On 25 separate occasions, Honour purchased a particular security for his own personal account just before he purchased a large block of the same security for the funds he managed.

Market Effect

- Trading volume for the security was small.
- The blocks purchased for the funds caused the price of the security to rise.
- Honour then sold the shares he had bought for his account.
- Honour's 25 trades netted him a profit of \$155,615.

Conflict of Interest

- Honour's trading for himself gave rise to a conflict of interest.
- Honour was personally profiting at the expense of the funds' shareholders, to whom he owed a fiduciary duty.
- Under the Investment Advisers Act and the Investment Company Act, such conflicts of interest must be disclosed.

Disclosure?

- Did Honour disclose this conflict of interest? No . . .
- In fact, the investment advisory firm at which he worked required him to report all personal trading.
- Honour failed to report any of these 25 trades to his firm.

SEC Administrative Proceeding

- SEC brought an enforcement action against Honour, charging that he violated the anti-fraud provisions of the Investment Company Act and the Investment Advisers Act.
- Honour was ordered to disgorge the profits he had made, plus interest, and pay a \$275,000 penalty.
- Honour was also ordered to send a copy of the SEC's Order finding violations to the funds' investors.

Van Wagoner Case: Misrepresentation and Mispricing

- Van Wagoner invested in private placements of convertible preferred stock issued by tech companies about to go public.
- Investments offered potential for significant growth — if the IPOs were completed.
- Investments also presented risks — they were illiquid.
- Investments also difficult to value.

Misrepresenting the Risks

- Van Wagoner told shareholders that it would limit investment in illiquid securities to 15% of the Fund's portfolio.
- Van Wagoner understated the amount of the Funds' investments in illiquid securities.
- In fact, the Funds repeatedly purchased new, private illiquid securities, misstating the risk that investors bore.

Mispricing Fund Shares

- To Make Shareholders Believe that the Funds were under the 15% threshold, Van Wagoner reduced the valuations of the private securities it held — sometimes writing them off entirely.
- For example, valuations of two securities written down from \$36 million to zero.

Mispricing Fund Shares

- Knowing or reckless failure to fair value private securities that materially affect a fund's NAV constitutes fraud.
- Failure to fair value the underlying private securities caused the Funds to sell and redeem shares at prices other than those based on the current NAV of the Funds' shares.

SEC Administrative Proceeding

- SEC brought an enforcement action against the investment adviser, charging that he violated the anti-fraud provisions of the Investment Company Act and the Investment Advisers Act.
- Van Wagoner settled the fraud charges, paying an \$800,000 penalty.
- Van Wagoner was barred for seven years from serving as an officer or director of a mutual fund.

Van Kampen Case: Misleading Advertising

- Van Kampen Investment Advisory Corp. — Investment Advisers to the Van Kampen family of mutual funds.
- Van Kampen has a series of funds; wanted to create and market new funds to attract new investments.

Van Kampen Case: Misleading Advertising

- Van Kampen created an “incubator fund” — the Van Kampen Growth Fund.
- Incubator Fund shares generally not available to the public.
- Instead, Van Kampen and affiliates provide seed money to create and start up the fund.

Van Kampen Case: Misleading Advertising

- Advisers create “Incubator Funds” to establish a fund performance track record.
- When the Advisers take the fund public, they can advertise the fund’s track record.
- The Van Kampen Growth Fund was remarkably successful in its first year: a 61.99% return.

Van Kampen Case: Misleading Advertising

- Van Kampen made the Growth Fund available to the Public.
- The new fund’s advertising prominently displays the 61.99% return —
 - The best performing fund in its class.
 - Second best fund has a return of 42%.
- Investors poured into the fund.
 - The Fund catapults from 14 to 14,833 shareholders
 - Assets under management soar from \$380,000 to \$110 million.

Van Kampen Case: Misleading Advertising

- Growth Fund really did earn a return of 61.99% in its first year.
- The problem: returns likely could not be repeated.
- During its first year, Van Kampen allocated hot IPO shares to the Growth Fund that Van Kampen had available because of its other fund business.

Van Kampen Case: Misleading Advertising

- Growth Fund invested in 31 hot IPO offerings.
- Bought only a few hundred shares in each hot IPO.
- But because of the Growth Fund's small size, these IPO investments significantly magnified the returns for the Fund.
- In fact, hot IPO investments accounted for more than half of the Fund's returns.

Van Kampen Case: Misleading Advertising

- Van Kampen knew that the IPO investments accounted for the Fund's outsize returns.
- In fact, the Chief Investment Officer had commissioned a study that showed exactly that.

Van Kampen Case: Misleading Advertising

- But . . . Hot IPOs are rare opportunities. Only a few of them, and everybody wants in.
- When the Growth Fund was small, a few hot IPO shares magnified the Fund's returns.
- But once the Fund got large, Van Kampen would never be able to get enough hot IPO shares to sustain those returns.

Van Kampen Case: Misleading Advertising

- Fund's advertising was . . . misleading.
- Van Kampen prominently advertised the Fund's #1 rating and the 61.99% return.
- But Van Kampen never disclosed the reason for the return, or that once the Fund grew large, that return could never be duplicated.

Van Kampen Case: Misleading Advertising

- But there's more . . .
- Van Kampen attributed the Fund's outsize returns to other investments, never mentioning the hot IPO shares.
- In fact, one Van Kampen representative told the financial press, "It's not as if the Growth Fund has had a bunch of hot IPOs."

SEC Administrative Proceeding

- SEC brought an action against the investment adviser and the Chief Investment Officer.
- The adviser and the Chief Investment Officer were both censured, ordered to cease and desist violating the securities laws.
- The investment adviser was fined \$100,000 and the Chief Investment Officer was fined \$25,000.
- The moral of the story: when advertising performance returns, you cannot tell only half of the story.

PIMCO Fund Case: Market Timing

- Market timing — short-term buying and selling of mutual fund shares.
- Harmful to mutual funds — increase trading and brokerage costs; disrupt portfolio management.
- Most mutual funds try to limit it and actively police against it.

PIMCO Fund Case: Market Timing

- PIMCO's policy was to limit market timing.
- Advised its investors that it would limit market timing and police market timing activities in order to protect the interests of the fund.

PIMCO Fund Case: Market Timing

- Canary Capital Partners was a large investor in PIMCO's funds.
- Canary Capital offered to invest "sticky assets" with PIMCO.
 - "Sticky assets" — long term investment in one fund . . . but in exchange for the ability to market time in other funds.

PIMCO Fund Case: Market Timing

- Canary Capital invested \$27 million in sticky assets into PIMCO funds.
- At the same time, Canary used over \$60 million in timing capacity in several different PIMCO mutual funds.

PIMCO Fund Case: Market Timing

- Disclosure: no.
 - PIMCO's prospectuses failed to disclose the market timing agreement with Canary.
 - In fact, PIMCO's prospectuses gave shareholders the impression that PIMCO's funds discouraged or limited market timing.

PIMCO Fund Case: Market Timing

- In a little over a year, Canary made over 100 round trip exchanges exceeding \$4 billion in overall dollar volume.
- At the same time, PIMCO prevented other shareholders from engaging in the same kind of rapid trading by issuing warning letter, freezing accounts, or blocking trades.

SEC Enforcement Action

- SEC filed a civil fraud charges against PIMCO's investment adviser, distributor, CEO, Chairman, and a portfolio manager, alleging violations of the anti-fraud provisions of the Securities Act, the Exchange Act, the Investment Company Act, and the Investment Advisers Act.
- PIMCO's adviser, sub-adviser, and distributor settled the SEC's charges. They were ordered to pay \$10 million in disgorgement and \$40 million in civil penalties. They also consented to cease-and-desist orders and to undertake compliance and mutual-fund governance reforms.

SEC Enforcement Action

- In a separate criminal proceeding, the Chairman was found guilty of committing securities fraud. He later settled the SEC's charges, paying \$572,000 in disgorgement, interest, and civil penalties. He also agreed to an injunction barring him from future violations of the antifraud provisions of the securities statutes, and agreed to a one-year bar from serving as an officer or director of an investment company.
- The moral of the story: it is illegal for a mutual fund adviser to enter into a secret, lucrative arrangement with a favored investor to permit that investor to engage in market timing.