Investment Management Industry News Summary - February 2001

FEBRUARY 1, 2001

This Summary, which draws from a wide range of sources, endeavors to condense important investment management regulatory news of the preceding week into one, easily digestible source. This Summary is not intended as legal advice. Readers should not act upon information contained in this Summary without professional legal counsel. This Summary may be considered advertising under the rules of the Supreme Judicial Court of Massachusetts.

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ICI asks the Department of Labor ("DOL") to change rules affecting mutual funds

February 25, 2001 1:56 PM

The ICI has urged the DOL to make several changes beneficial to fund companies that serve as retirement plan providers. These changes would make non-fund entities provide the same level of disclosure to plans as funds make in prospectuses, allow fund companies to provide investment advice, and allow electronic delivery of ERISA-required documents. The ICI comments came in the form of a response to a DOL request for comments on the disclosure obligations of pension fiduciaries.

In its comment letter, the ICI suggested that the DOL require non-fund entities to provide the same kind of disclosures to pension plan participants about fees and expenses as funds make in their prospectuses. "The [ICI] has consistently asked the department to address this matter," the letter said. As for investment advice, even without congressional action, the ICI said that the DOL could permit fund firms to provide advice on investment options to investors in self-directed plans under

ERISA. The department, the letter said, should replace the present ban on fund management advising plan participants with "a disclosure-based regime, coupled with ERISA's stringent fiduciary requirements."

The ICI also suggested the DOL permit electronic delivery of documents required by ERISA disclosure rules. "The department," the ICI said, "should permit electronic delivery to individuals, including beneficiaries and retirees, regardless of whether electronic access to documents is at the work site or elsewhere."

Finally, the ICI asked DOL to "avoid inconsistencies and redundancies with laws and regulations already in effect elsewhere. Financial transactions relating to investments in funds often are extensively regulated under securities, banking and other laws." Fund Action, February 25, 2001.

SEC charges investment advisory principal with operating a fraudulent soft dollar scheme

February 10, 2001 2:36 PM

On February 8, the SEC filed a complaint in the U.S. District Court for the District of Massachusetts alleging that between 1990 and 1997, an investment adviser defrauded a client of more than $1.1 million in an allegedly fraudulent soft dollar scheme. In its complaint, the SEC alleges that the adviser misappropriated the assets of the client, a small church, through fraudulent soft dollar practices and by fraudulently offering investments in his own advisory business to the church.

According to the complaint, the adviser misappropriated soft dollar credits generated by trades effected for the church's endowment fund, for which he served as investment adviser. The complaint alleges that the adviser fraudulently submitted invoices to a broker-dealer for soft dollar services that the broker-dealer purportedly provided. The SEC further alleged that in fact, the broker-dealer was a shell that the adviser controlled. After receiving soft dollar checks payable to the broker-dealer, the adviser deposited the checks into an account that he controlled. The adviser then withdrew the majority of the funds for his personal use.

In addition, the complaint alleges that the adviser, without disclosure to its clients, improperly used soft dollar credits to pay for over $180,000 in business and in undocumented expenses. The SEC also alleges that the adviser set the commissions paid by the church at a rate five times the average commission rate paid by other investment advisers for soft dollar trades and that the adviser churned the church's endowment account. Further, the complaint alleges that between 1990 and 1996 the adviser fraudulently induced the church to invest $250,000 in the adviser's affiliated investment advisory entities.

Finally, the SEC alleged that the Forms ADV filed with the SEC by the adviser's affiliated advisory businesses were false because they failed to disclose that the adviser's affiliates received economic benefits from non-clients, including soft dollars. As a result of the conduct described in the complaint, the SEC has charged the adviser with violations of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") and Rule 10b-5 thereunder, Section 17(a) of the Securities Act of 1933 (the "1933 Act") and Section 207 of the Investment Advisers Act of 1940 (the "Advisers Act"), and aiding and abetting the advisory affiliates' violations of Sections 206(1), and 206(2) of the Advisers Act. The SEC's complaint seeks injunctive relief, disgorgement of $1.1 million in improperly-obtained benefits, plus pre-judgment interest, and civil penalties. SEC v. Gordon J. Rollert, Civil Action No. 01CV10237-JLT, USDC, D. MA] (LR-16895).

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NASDR permits imposition of fee on redemptions of mutual fund shares

February 9, 2001 2:44 PM

The NASDR recently issued an interpretive letter informing an investment adviser/broker dealer and NASD member (the "Company") that it may charge its broker-dealer customers a transaction cost when a customer redeems his or her shares of open-end investment companies through the Company. The transaction costs are initially charged to the Company by its clearing firms (the "Clearing Firms").

The Company explained in its request for interpretive relief that it acts as agent in transactions of mutual fund shares on behalf of its customers. The Company has both advisory and broker-dealer only customers. The Company noted that the Clearing Firms charge the Company a transaction fee (the "Fee") or "ticket charge" when customers of the Company redeem their shares in the funds. The Company clarified that the Fee is not a redemption fee charged by the mutual funds to shareholders for redeeming their shares but a ticket charge charged by the Clearing Firms to the Company. Therefore, the fee is not disclosed in the mutual funds' prospectuses.

The Company noted that the Fee is usually about $12 to $14 per transaction. The Company further noted that its advisory customers pay the Fee, which the Company discloses in the Form ADV as a transaction cost, but for its broker-dealer only customers, the Company has absorbed the Fee. The Company stated that if the Company is permitted to charge the Fee to its broker-dealer customers, it intends to disclose the Fee in its customer confirmations.

NASDR noted that the Fee the Company is contemplating charging to its broker-dealer customers generally would not be prohibited under NASD rules. NASDR noted that under NASD Notice to Members ("NTM") 92-11, members are required under NASD Rule 2110 to provide their customers with written notification of any new or revised service charges, at least 30 days prior to implementing or charging such service charge. Accordingly, NASDR staff wrote that the Fee is considered a type of service charge, and therefore, the Company should notify its broker-dealer customers in writing at least 30 days prior to passing on the Fee to those customers.

NASDR also reminded member firms of their obligations under NASD rules in connection with the purchase and sale of mutual fund shares. NASDR stated that member firms must disclose material facts to investors when recommending the purchase or sale of mutual fund shares. NASDR noted that a fact is material in this context "if the circumstances surrounding the investment decision lead one to believe the investor would regard a fact as material to his [or her] decision whether to invest in the fund." Thus, if the Company or an associated person recommends the purchase or sale of mutual fund shares to a broker-dealer customer, and if one would believe that the Fee would be material to the customer's decision whether to invest, the Fee should be disclosed.

NASDR staff noted, however, that the imposition of the Fee may raise issues under the federal securities laws, including, for example, Section 22(d) of the Investment Company Act of 1940 (the "1940 Act"). The staff recommended that the Company review SEC staff no-action letters interpreting Section 22(d) or contact the SEC staff for further guidance. Barbara A. Mallon, Esq. NASDR Interpretive Letter, December 22, 2000.

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Financial Services Committee releases oversight plan for 107 th Congressional session

February 9, 2001 2:27 PM

The House Financial Services Committee (the "Committee") recently released its proposed oversight plan for the upcoming legislative session. Areas which the Committee has specifically listed in its oversight plan include, among other things:

- a review of the impact of the 1940 Act on "incubator funds" and other capital formation vehicles important to new economy businesses;
- an examination of the implications of increasing affiliations among financial services firms since the enactment of the Gramm-Leach-Bliley Act. The Committee specifically cited a review of restrictions under section 17 of the 1940 Act, which prohibits certain affiliated transactions; and
- monitoring of the implementation of the SEC’s new rules regarding disclosure of after-tax returns to mutual fund investors to "ensure these requirements maximize useful information for investors, consistent with efficiency and competition in the mutual fund marketplace."

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District court rules that investment adviser has no due diligence obligation to investigate representations in a private placement memorandum

February 2, 2001 2:47 PM

A district court found that an investment adviser did not have an obligation to investigate the accuracy of the representations made in the offering memorandum for certain securities. Read More

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