IN THE MATTER OF

FINANCIAL PROGRAMS, INC.
JOHN R. HURLEY
JAMES R. FRANKENTHALER

File No. 3-4610. Promulgated March 24, 1975

Securities Exchange Act of 1934

FINDINGS AND ORDER

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.[1] 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[2] under the Securities Exchange, Investment Company, and Investment Advisers Act.[3] 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.[4]

II

The prospectuses of Program's funds represented that they were professionally managed by competent persons. Actually, Programs

[1] Financial Industrial Fund, Inc., Financial Industrial Income Fund, Inc., Financial Dynamics Fund, Inc., Financial Venture Fund, Inc.

[2] Three other persons formerly associated with Programs are also named as respondents.

[3] 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.

[4] 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.

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.[5]

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.[6]

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.[7]

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." [8] 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

[5] 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.

[6] 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.

[7] 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.

[8] Compare *The Wolf Corporation,* 42 S.E.C. 1042, 1048 (1966); *National Lithium Corporation,* 40 S.E.C. 746, 752 (1961).

issued by the U.S. Government)." In practice, these limitations were sometimes disregarded.[9]

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.[10]

Moreover, Programs caused the funds to keep excessive cash balances on deposit with a certain bank.[11] 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.[12] 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.[13]

III

Programs failed to supervise its subordinate employees reasonably with a view to the prevention of the foregoing violations. This

[9] 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.

[10] This type of interpositioning was a breach of fiduciary duty. As the Commission said in *Delaware Management Company, Inc.*, 43 S.E.C. 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."

[11] 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).

[12] The period referred to ran from May of 1970 to September of 1972.

[13] 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.

breached the duty to supervise imposed by Section 15(b)(5)(E) of the Exchange Act.[14]

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 unreasonably high levels by the funds' own massive purchases. Hence those quotations were unrealistic guides to fair value.[15]

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 violated Section 22(c) of the Investment Company Act and Rule 22c–1(a) thereunder

[14] No finding is made under Section 203(e)(5) of the Investment Advisers Act. That section was not in effect during the relevant period.

[15] 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 non-delegable 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." (Emphasis added.)

which require that redemptions be made only at prices "based on the current net asset value." [16]

V

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 Program's own Code of Conduct.[17]

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.[18]

VI

Program's offer of settlement obligates it to:

(A) Refrain for 180 days from performing any investment advisory function for any new client; [19]

[16] 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."

[17] See part VII, *infra*.

[18] 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."

But see *Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961): "These antifraud provisions encompass the infinite variety of devices by which undue advantage may be taken. . . ." See also *S.E.C.* 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).

[19] This will not impair Program's ability to continue to act for the funds and for other existing clients.

(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 [20] even if their Boards of Directors decide to reject Program's settlement offer to them; [21]

(D) Employ (within 120 days from the date hereof) a special compliance officer satisfactory to the Commission,[22] who will:

(i) Review Program'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 Program's present procedures; and

(iii) Regularly monitor Program'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; [23] and

(G) Subject itself to the Commission's jurisdiction should questions arise about its compliance with its undertakings.[24]

VII

From what has thus far been said, it follows that Hurley and Frankenthaler:

[20] This $1.25 million fund has already been deposited with an escrow agent.

[21] Rejection will lead to the division of this $1.25 million among the funds in accordance with their respective losses.

To advance their shareholders' interests, 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 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 Program's settlement proposals.

[22] The Commission is not to withhold its approval of this person unreasonably.

[23] This commitment will take effect at the next annual meeting of the funds' shareholders.

[24] Program'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 Program'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.

(1) Willfully violated all of the statutory sections that Programs violated; and

(2) Willfully aided and abetted Program'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." [25]

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 purchase 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

[25] *Imperial Financial Services, Inc.*, 42 S.E.C. 717, 727 (1965).

sale of investment company assets other than his regular salary or underwriter's or broker's fees." [26]

Frankenthaler's prohibited transaction related to a single security.[27] 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

(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

[26] *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. . . ."

[27] 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.

person of such investment adviser, depositor, or principal underwriter; and it is further

ORDERED that James R. Frankenthaler be, and he 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.

IN THE MATTER OF

CHASE INVESTMENT SERVICES OF BOSTON, INC. ET AL.*

File No. 3-4635. Promulgated March 28, 1975

Investment Advisers Act of 1940

FINDINGS AND ORDER

I

John P. Chase ("Chase") has been in the investment advisory business in Boston for many years.[1] Chase is Chairman of the Board of John P. Chase, Inc. ("JPC"), a registered investment adviser.[2] JPC's clientele consists of institutions and of individuals with accounts of $500,000 or more.[3] JPC has about $475 million under management.

Chase Investment Services of Boston, Inc. ("CIS"), a wholly-owned subsidiary of JPC and itself a registered investment adviser, serves smaller accounts.[4] CIS's minimum account is $25,000. It manages about 480 accounts with aggregate assets of some $18 million.[5] CIS's policies are shaped by its parent, JPC.[6]

Lawrence M. Tilton and Jack W. Swenson were formerly associated with CIS and JPC. Tilton was CIS's president and directed the effort to market its services. He was also a vice president of JPC. Swenson, CIS's chief portfolio manager, was also its executive vice

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*John P. Chase, Inc.; John P. Chase; Lawrence M. Tilton; and Jack W. Swenson.

[1] His attorneys states that "he has been a leader in the financial community for over 42 years."

[2] Until April of 1974, Chase was also JPC's chief executive.

[3] The present JPC, a wholly owned subsidiary of Continental Investment Corporation (of which Chase is a director and a stockholder), is the successor to another corporation of the same name. References to JPC in this document relate to both the present company and its predecessor.

[4] Just as there was an old JPC and a new one, so too there was an old CIS and a new one. The old CIS was called Chase Investment Services, Inc. It did not have the phrase "of Boston" in its name. CIS is used in this document to refer to both companies.

[5] CIS's business used to be substantially larger. From the beginning of 1967 to the present CIS managed the accounts of over 2,400 clients. The assets in those accounts totaled over $100 million.

But in 1972, 1973 and 1974, over 1,000 clients cancelled their investment advisory contracts with CIS. Most of them did so after sustaining substantial losses. Until about March of 1973 CIS gave no rebates to clients who cancelled before the end of the period covered by the fee that they had already paid.

[6] Chase is CIS's treasurer and also serves on its Board of Directors.