

Administrative Proceedings  
File No. 3-8084

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In the Matter of	:	
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THE BANK OF CALIFORNIA, N.A.,	:	ORDER INSTITUTING PROCEEDINGS
	:	PURSUANT TO SECTION 9(f) OF
Respondent.	:	THE INVESTMENT COMPANY ACT OF
	:	1940 AND FINDINGS AND ORDER OF
	:	THE COMMISSION

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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>1/</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

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<sup>1/</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.

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 1/2 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 1/2 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 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 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 3/5ths of 1%, well over the 1/2 of 1% maximum allowed in Rule 2a-7. 2/ 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.

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2/ 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.

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.

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.

Jonathan G. Katz  
Secretary