

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2378 / April 28, 2005

INVESTMENT COMPANY ACT OF 1940
Release No. 26858 / April 28, 2005

ADMINISTRATIVE PROCEEDING
File No. 3-11914

In the Matter of

GERALD T. MALONE,

Respondent.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER PURSUANT TO
SECTIONS 203(f) AND 203(k) OF THE
INVESTMENT ADVISERS ACT OF 1940,
AND SECTIONS 9(b) AND 9(f) OF THE
INVESTMENT COMPANY ACT OF 1940**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Gerald T. Malone (“Malone” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Administrative and Cease-

and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent’s Offer, the Commission finds¹ that

Summary

1. This proceeding against Respondent Malone, a former officer of Alliance Capital Management, L.P. (“Alliance Capital”), a registered investment adviser to the Alliance Capital mutual funds (“Funds”), arises from Alliance Capital’s arrangement with its largest market timer. In return for investments in Alliance Capital’s hedge funds, Alliance Capital provided “timing capacity” in certain of its Funds to Daniel Calugar (“Calugar”), the owner and President of Security Brokerage, Inc. (“Security Brokerage”), a registered broker-dealer in Las Vegas, Nevada. Malone, the former portfolio manager of the Alliance Technology mutual fund (“Tech Fund”) and the Alliance Technology hedge fund (“Tech Hedge Fund”), aided and abetted Alliance Capital’s violative conduct by approving Calugar’s market timing capacity in the Tech Fund in return for investments at agreed ratios in the Tech Hedge Fund despite being aware of the negative impact caused by market timing by Calugar.

Respondent

2. **Malone**, age 50 and a resident of Irvington, New York, was Senior Vice President of Alliance Capital, portfolio manager and Senior Vice President of the Tech Fund, and portfolio manager of the Tech Hedge Fund. On November 15, 2003, Malone resigned at the request of Alliance Capital.

Other Relevant Entities

3. **Alliance Capital**, a Delaware limited partnership located in New York, New York, is an investment adviser registered with the Commission under the Advisers Act. It is an investment adviser to several mutual funds that had market timing arrangements. Alliance Capital provides investment advisory services to the Funds, and for these services, the Funds pay Alliance Capital a fee as a percentage of average daily net assets the Funds hold. As of September 30, 2003, Alliance Capital had approximately \$438 billion in assets under management.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

4. **Calugar**, age 49 and a resident of Las Vegas, Nevada, at all relevant times was the President of Security Brokerage, a registered broker-dealer located in Las Vegas, Nevada.

Facts

Market Timing at Alliance Capital

5. Mutual fund market timing is the practice of (a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing, while not illegal *per se*, can harm other mutual fund shareholders because it can dilute the value of their shares, if the market timer is exploiting pricing inefficiencies, or disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer.

6. Malone was aware of the harmful effects of market timing. As discussed below, he repeatedly experienced cash management problems caused by market timing in the Tech Fund.

7. The prospectus for the Tech Fund states: "You should consider an investment in the Fund as a long-term investment." Regarding the purchase and sales of shares of the Tech Fund, the prospectus states: "A Fund may refuse any order to purchase shares. In particular, the Funds reserve the right to restrict purchases of shares (including through exchanges) when there appears to be evidence of a pattern of frequent purchases and sales made in response to short-term considerations." Neither the prospectus, nor any public documents, disclosed Alliance Capital's practice of providing timing capacity to market timers in return for sticky asset investments.

8. The fee structure through which Alliance Capital earned management fees meant that Alliance Capital earned fees from the timing relationships at the expense of long-term shareholders. First, Alliance Capital earned fees from management of mutual funds based on a percentage of assets under management, generally one percent. Thus, to the extent timers increased assets under management, Alliance Capital earned greater fees. Malone personally benefited because his compensation was tied to the profitability of Alliance Capital.

9. Second, Alliance Capital also sponsored and managed hedge funds. In this respect, hedge funds were an additional way in which Alliance Capital could retain portfolio managers, such as Malone. The hedge fund is a potentially lucrative source of income, both to Alliance Capital and its portfolio managers. In addition to receiving a fee based on a percentage, generally one percent, of assets under management, Alliance Capital and the hedge fund portfolio manager also received a performance fee based on a percentage, generally 20 percent, of net return on investment. In 1999 alone (before Calugar invested in the Tech Hedge Fund), Malone earned approximately \$5 million in such hedge fund performance fees. With respect to Calugar's arrangement, Malone approved timing in the Tech Fund in return for sticky asset investments in the Tech Hedge Fund even though Malone was the same portfolio manager for both funds. Thus, Alliance Capital and Malone used timing capacity in its Tech Fund to sell, and ultimately to sustain, the Tech Hedge Fund.

Alliance Capital's Biggest Timer – Daniel Calugar

10. Alliance Capital's single largest timer was Calugar, the owner of Security Brokerage. At his peak in 2003, Calugar had \$220 million in timing capacity in Alliance Capital's Funds. Alliance Capital initiated its relationship with Calugar in April 2001, when an Alliance Capital hedge fund salesman negotiated an agreement with Calugar providing market timing capacity in certain Alliance Capital mutual funds in exchange for Calugar's investments in the hedge funds in a ratio of 10:1 mutual fund timing capacity to hedge fund investment. The terms of this agreement were summarized in the text of an April 24, 2001 note from Calugar to a hedge fund salesman:

I very much appreciate the \$10 million timing position that was given to me in Alliance Technology (ALTFX) and Alliance Growth (AGRFX). ... You indicated that the managers of these two funds also run hedge funds at Alliance. I have been an active investor in timing mutual funds for 15 years, and have never invested in a hedge fund or similar investment, however, I am willing to make an investment in Alliance hedge funds equal to 10% of the timing allocation that I maintain in your mutual funds. I will keep the hedge fund position as long as I have the timing allocation in the mutual funds. My understanding is that you would be able to give me an exit opportunity from the hedge funds at the end of any month, however, I would not exercise that opportunity as long as I continue to have the timing allocation on the mutual fund side.

Shortly thereafter, Calugar then began timing the Tech Fund and invested in the Tech Hedge Fund.

Renegotiation of the Calugar Arrangement

11. In January 2002, Malone complained about a large exchange Calugar made in the Tech Fund, and Alliance Capital cancelled Calugar's trade. In response, Calugar wrote an email reviewing in detail his arrangement with Alliance Capital, the amount that he was market timing in Alliance Capital mutual funds (\$215 million in two mutual funds), and his corresponding investments in Alliance Capital hedge funds (\$53 million in three hedge funds). Addressing the potential disruption of his trading to fund management, Calugar suggested the possibility of transferring some market timing funds from the Tech Fund to another one of the Funds, or redeeming part of his investments at Alliance Capital and investing his funds elsewhere. After this email was forwarded to Malone, Malone called the head of hedge fund sales and said he wanted to keep Calugar as a hedge fund client, but he wanted to get him out of the Tech Fund due to the negative impact of Calugar's frequent trading.

12. Thereafter, Calugar and Alliance Capital representatives had further discussions concerning the terms of his timing capacity in the Funds. Malone and other senior management at Alliance Capital then discussed the continuation of Calugar's timing trading at Alliance Capital on renegotiated terms.

13. On January 29, 2002, an Alliance Capital executive vice president (“EVP”) sent an email to Alliance Capital’s President and Chief Operating Officer (“President”), with a copy to Malone, which reviewed the details of Calugar’s timing arrangement and noted the potential for a renegotiated agreement:

Following our telephone conversation, I spoke with [the head of hedge fund sales and Malone] to get the latest on Dan Calugar who has placed roughly \$150 million of “timer” money into the Tech Fund and \$30 million into the Tech Hedge Fund. Calugar also placed \$55 million into Premier Growth as an offset to \$17 million into Alpha 20 and \$4 million in the Muni Hedge Fund. Apparently the original ratio of “timer” money to Hedge Fund investments was negotiated at 5 to 1 . . . This deal was negotiated outside the system that [the head of domestic mutual fund sales] set up . . . which generally discourages “timers” altogether, but controls the few we do have.

[The head of hedge fund sales] has spoken to Calugar, and thinks he can negotiate a better deal for Alliance. [The head of hedge fund sales] is also going to speak with [the Market Timing Supervisor] to set up better controls over the round trips in order to protect the fund shareholders. According to [Malone], this has not been an issue except for a brief volatile period in January when he was forced to reduce his cash position from 6% to 4% in order to cover a redemption. . . .

Obviously, [Malone and the head of hedge fund sales] and presumably the other portfolio managers want to keep the relationship. According to [the head of hedge fund sales,] [the Chief Executive Officer] is OK with this. From purely a Mutual Funds standpoint, we get very little out of this, and would not be disappointed to see Calugar go away. As you know, he has made a lot of money on this deal by trading the funds. [The head of hedge fund sales] points out that the Hedge Funds appear to be virtual loss leaders for his timing practice.

14. Thereafter, the head of hedge fund sales then renegotiated with Calugar the terms of his timing arrangement and sent an email to the EVP, with copies to Malone and others describing the new arrangement, including: (1) “ratios are reset from 5:1 mutual to hedge investment to 4:1 for Premier Growth and 3:1 for Tech;” (2) “Calugar’s mutual fund trades will be made in \$10MM ‘blocks’;” and (3) Calugar “will redeem all hedge fund positions” annually.

15. The renegotiated terms benefited Alliance Capital and Malone. The new ratios meant more money for the hedge funds for the same timing capacity. The annual redemption of Calugar’s hedge fund positions also benefited Alliance Capital. By Calugar agreeing to redeem and reinvest his hedge fund positions annually, Alliance Capital and Malone increased its opportunity to profit from Calugar’s hedge fund investments. Each time Calugar redeemed, Alliance Capital and Malone would be eligible to earn performance fees from any increase in value, without having first to earn back any prior losses.

Calugar's Market Timing Continued

16. Despite the impact Calugar's trading had on its mutual funds, Alliance Capital and Malone made substantial efforts to accommodate and retain Calugar's business. Thus, when another portfolio manager complained about Calugar's trading, Alliance Capital reduced Calugar's timing capacity in that mutual fund, only to increase his timing capacity in other Alliance Capital mutual funds. For example, in early 2003, the portfolio manager for the Premier Growth Fund complained about Calugar's trading in his mutual fund. Thereafter, Alliance Capital decreased Calugar's timing capacity in the Premier Growth Fund by \$20 million and increased his timing in the Tech Fund and another mutual fund by the same amount. As the head of hedge fund sales explained in an email to Calugar: "In order further to reduce your exchanges in Premier Growth Fund from \$70MM to \$50MM ... [a portfolio manager in another mutual fund] has agreed to increase your exchange limit ... from \$43MM to \$53MM and [Malone] has agreed to increase your exchange limit on Tech from \$100MM to \$110MM.

17. Calugar's investments were critical to Alliance Capital's hedge funds, including the Tech Hedge Fund. By early 2003, Calugar's investments in the Alliance Capital hedge funds became such a large percentage of the hedge fund assets that the hedge funds could not survive without Calugar. The head of hedge fund sales noted at the time that Calugar's investments were important to the continued survival of the hedge funds. In a meeting with Malone and other members of Alliance Capital management in or about January 2003, the head of hedge fund sales explained Calugar's investments in the Tech Hedge Fund and the importance as a percentage of its total fund assets:

<u>Hedge Fund</u>	<u>Calugar Investment</u>	<u>Total Hedge Fund Assets</u>	<u>Percentage</u>
Tech Partners	\$37.4MM	\$42.5MM	88%

18. In or about February 2003, following discussions regarding Calugar's market timing, Malone and other members of Alliance Capital senior management were advised that the linkage between Calugar's timing activity and hedge fund investments was improper. Thereafter, the EVP sent an email to the head of hedge fund sales, with a copy to Malone and others, explaining "we have to officially 'de-link' the mutual funds activity so as to not in any way suggest that it is conditional on hedge fund participation or vice versa." However, Calugar's timing of the Tech Fund and his investment in the Tech Hedge Fund continued.

19. Alliance Capital also changed an investment restriction in the Tech Fund to add futures trading capability in order, among other things, to accommodate Calugar. Such a change required approval of the Tech Fund board and its shareholders. In obtaining these approvals, Alliance Capital and Malone did not disclose to the Tech Fund Board that one of the reasons was to accommodate timers in the Tech Fund.

20. In the summer of 2002, Malone sought to trade futures in order to increase liquidity to accommodate Calugar and other approved timers. At that time, Malone explained that, among

other things, futures trading would provide a more liquid vehicle for dealing with highly volatile fund flows from market timers. In September 2002, Malone reduced Calugar's market timing capacity in the Tech Fund to \$50 million pending the Tech Fund's approval to trade futures.

21. Alliance Capital, however, did not act on the futures trading at that point. Nonetheless, on or about December 2002, Malone permitted an increase in Calugar's timing capacity in the Tech Fund to \$100 million.

22. The issue of using futures trading to accommodate market timers in the Tech Fund arose again in early 2003 at a meeting attended by Malone, the head of hedge fund sales and other members of Alliance Capital senior management concerning the arrangement with Calugar. In an email written shortly after that meeting, the head of hedge fund sales notified Calugar that Alliance Capital would seek approval to permit futures trading in the Tech Fund and that this would "better accommodate increasing your Tech Fund exchanges in the future."

23. Calugar's market timing harmed the Tech Fund. In May 2003, after Calugar informed Malone that he was withdrawing his market timing funds from the Tech Fund, Malone suspended market timing in the Tech Fund. In July 2003, at a meeting of the Tech Fund board of directors, Malone gave a presentation on performance of the Tech Fund. In a chart titled, "Impact From Market Timers," Malone stated his belief that, the performance of the Tech Fund was diminished by 1.4 percent during the first six months of 2003 due to market timers. Malone knew that, during the first six months of 2003, Calugar was the largest market timer in the Tech Fund.

24. In contrast, Calugar benefited from the relationship. From 2001 to 2003, Calugar generated approximately \$64 million in profits from timing the Tech Funds. During the same period, the net asset value of the Tech Fund declined substantially.

Violations

25. As a result of the conduct described above, Malone willfully aided and abetted and caused Alliance Capital's violations of Sections 206(1) and 206(2) of the Advisers Act. Specifically, Malone knowingly or recklessly and negligently: (1) approved excessive short-term trading by Calugar in the Tech Fund that was inconsistent with the terms of the Tech Fund's prospectus and that was harmful to the Tech Fund; and (2) failed to disclose to the Tech Fund Board or to the shareholders the conflict of interest created by Alliance Capital entering into a market timing arrangement with Calugar that was harmful to the Tech Fund, but that increased Alliance Capital's advisory fees from the Tech Fund and the Tech Hedge Fund.

26. As a result of the conduct described above, Malone willfully aided and abetted and caused Alliance Capital's violations of Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder, which make it unlawful for any affiliated person of, or principal underwriter for a registered investment company, or any affiliated person of such a person or principal underwriter, acting as principal to effect any transaction in which such registered company, or company controlled by such registered company, is a joint or a joint and several participant with such person, principal underwriter, or affiliated person, in contravention of such rules and regulations as

the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant. Rule 17d-1 makes it unlawful for any affiliated person to participate in any such joint arrangement unless it files an application regarding such joint enterprise or arrangement with the Commission. Specifically, Alliance Capital, as investment adviser, was an affiliated person of the Tech Fund and caused the Tech Fund to enter into joint arrangements whereby Alliance Capital accepted long-term assets from Calugar in the Tech Hedge Fund pursuant to an arrangement allowing Calugar to engage in market timing activities which were inconsistent with the Tech Fund's prospectus. Malone approved the arrangements, and the Commission never granted an order approving the transactions.

27. In determining to accept the Offer, the Commission considered the cooperation Malone provided to the Commission staff during its investigation.

Undertakings

28. Respondent undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings brought by the Commission relating to or arising from the matters described in the Order and agrees:

- a. To comply with any and all reasonable requests by the Commission's staff for documents or other information;
- b. To be interviewed at such times as the Commission's staff reasonably may direct;
- c. To appear and testify in such investigations, depositions, hearings or trials as the Commission's staff reasonably may direct; and
- d. That in connection with any (i) testimony of Respondent to be conducted by testimony session, deposition, hearing or trial, or (ii) requests for documents or other information, that any notice or subpoena for such may be addressed to Respondent's counsel, and be served by mail or facsimile.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Malone's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act, that Respondent Malone cease and desist from committing or causing any violations

and any future violations of Sections 206(1) and 206(2) of the Advisers Act and Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder;

B. Pursuant to Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act, that Respondent Malone shall be, and hereby is, suspended from association with any investment adviser for a period of twelve months, effective on the date of entry of the Order; and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter for a period of twelve months, effective on the date of entry of the Order.

C. For three years from the date of the Order, Respondent Malone shall not serve as a chairman, director, or officer of any investment adviser or registered investment company.

D. Respondent Malone shall, within ten days of the entry of this Order, pay a civil penalty in the amount of \$150,000 and disgorgement in the amount of \$1 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Gerald T. Malone as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Helene Glotzer, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 233 Broadway, New York, NY 10279. Such civil money penalty may be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 ("Fair Fund distribution"). Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that he shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action"

means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Jonathan G. Katz
Secretary