ADMINISTRATIVE PROCEEDING
FILE NO. 3-3115

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

ROBERT F. LYNCH

INITIAL DECISION

(Private Proceeding)

June 29, 1973
Washington, D.C.

David J. Markun
Administrative Law Judge

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APPEARANCES: Theodore Altman, Branch Chief, Franz F. Opper, Gary N. Sundick, and Geoffrey H. Bobroff, Attorneys, for the Division of Enforcement.

Robert F. Lynch, pro se, for Respondent.

BEFORE: David J. Markun, Administrative Law Judge

THE PROCEEDING

This private proceeding was instituted by an order of the Commission dated June 30, 1971 ("Order") against Respondent Robert F. Lynch ("Lynch" , or "Respondent") and three other respondents [1/]

1/ The other respondents named in the Order are Waddell & Reed, Inc. ("W&R"), a registered broker-dealer; Waddell & Reed International, Ltd. ("WRI"), also a registered broker-dealer; and Frederick M. Oppenheimer.

pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") to determine whether the respondents committed various charged violations of the antifraud provisions of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77a et seq., of the Exchange Act, 15 U.S.C. 78a, et seq., and of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. 80b-1 et seq., and the remedial action, if any, that might be appropriate in the public interest.[2/]

The proceeding has been resolved as to all respondents other than Respondent Lynch in the Commission's Findings and Order Imposing Remedial Sanctions dated September 25, 1972.[3/] Thus, this initial decision has application only to Respondent Lynch; nevertheless, the decision necessarily includes certain findings respecting the other respondents in view of the nature of the charges and of the factual circumstances involved and in view of the fact that the interrelationships of the respondents and their respective functions are germane to the defense asserted by Respondent Lynch that the Commission lacks jurisdiction to adjudicate the alleged violations of law.

2/ The charged violations are alleged to have occurred during a period from about December 1, 1967 to about December 10, 1969, sometimes referred to herein as the "relevant period" or the "charging period".

3/ Securities Exchange Act Release No. 9790; Investment Company Act Release No. 7384.

A private hearing respecting the charges against Respondent Lynch was held in Washington, D.C. on August 21st and 22d, 1972. Thereafter the parties filed successive proposed findings of fact, conclusions of law, and supporting briefs pursuant to Rule 16 of the Commission's Rules of Practice, 17 CFR 201.16.

The findings and conclusions herein are based upon the record and upon observation of the demeanor of the various witnesses. Preponderance of the evidence is the standard of proof applied.

FINDINGS OF FACT AND LAW

The Respondents[4/]

Respondent Waddell & Reed, Inc. ("W&R" or "Waddell & Reed") is a Massachusetts corporation with its principal office in Kansas City, Missouri,that has been registered as a broker-dealer with the Commission under Section 15(b) of the Exchange Act since November 21, 1969. Its predecessor of the same name was a New York Corporation registered with the Commission as a broker-dealer from September 20, 1937 until it withdrew its registration on March 10, 1970. Both the existing and the predecessor corporation are referred to herein as "W&R" or "Waddell & Reed", and the reference is to one or the other depending upon the respective time span within which the reference is made. W&R is a member of the National Association of Securities Dealers ("NASD"). From at least December, 1967, to about December 10, 1969, W&R maintained an office in New York, New York, at 40 Wall

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4/ As already indicated at p. 2 above, this decision has application only to Respondent Lynch, the other respondents having settled the charges against them, but certain findings respecting the other respondents, based on the record herein, are essential in order to place the findings and conclusions respecting Respondent Lynch in proper factual and legal perspective.

Street, where they rented the 58th floor for their use and the use of various subsidiaries and affiliates involved in this proceeding. During most of this period, i.e. until about September 1, 1969, the Chairman of W&R's Board of Directors, Chauncey M. Waddell, maintained his offices at this New York office.[5/]

Waddell & Reed International, Ltd ("WRI") is a subsidiary[6/] of W&R that was incorporated as an international marketing company in 1963 in Bermuda with its principal place of business in Hamilton, Bermuda. It has been registered with the Commission as a broker-dealer since early in 1964 and is a member of the NASD. From the time of its organization until the early part of 1968 WRI, with various subsidiaries, was the overseas distributor and manager for the United Funds Group of mutual funds in the U. S. as well as several Canadian funds. However, after W&R, through WRI, in late 1967 sponsored creation of a new "overseas" mutual fund named United Capital Investment Fund, Ltd ("Fund")[7/], at the suggestion of Respondents Oppenheimer and Lynch, the principal activity of WRI for the years 1968 and 1969 came to be its acting as sponsor and underwriter for the Fund. From at least December 1967 to about

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5/ Waddell was president and chairman of the Board of Waddell & Reed International, Ltd ("WRI"), and vice president and a director of United Capital Management, Inc. ("UCM").

6/ At all material times W&R owned at least 92% of WRI.

7/ The Fund was incorporated in Nassau, the Bahamas, on October 20, 1967 as a leveraged,hedge fund. It is not registered with the Commission as an investment company under the Investment Company Act of 1940.

December 21, 1969, WRI maintained an office within the suite of offices rented by W&R at 40 Wall Street in New York City.

Contemporaneously with the establishment of the Fund, W&R caused its Canadian subsidiary, United Funds Management, Ltd. ("UFM"),[8/] to set up a wholly-owned New York subsidiary, United Capital Management, Inc. ("UCM"), whose sole function was to manage the Fund, including the determination of the Fund's portfolio securities. From at least January, 1968, until about December 10, 1969, UCM maintained its principal (and evidently its only) offices within the suite of offices rented by W&R at 40 Wall Street in New York, and its management of the Fund was carried on there.[9/]

Respondent Frederick M. Oppenheimer ("Oppenheimer") was executive vice president and a director of WRI and vice president and a director of UCM from at least December 1967 to about September 1, 1969, during which period he maintained his principal office within the suite of offices rented by W&R on the 58th floor at 40 Wall Street in New York City.

Respondent Robert F. Lynch ("Lynch") was associated with W&R from 1961 until about the end of 1969 and at various times within such period was an officer and director of some five investment companies and an officer or director, or officer, of

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8/ W&R owned 74% of the issued and outstanding capital shares of UFM.

9/ UCM was not registered with the Commission and is not a respondent in this proceeding.

some five companies involved in fund management and/or underwriting.[10] Between December 1967 and December 31, 1969 he was president and a director of UCM and vice president and a director of WRI, with offices in the suite of offices held by W&R at 40 Wall Street in New York City. During this period by far the greater part of Lynch's time and energy was directed to managing the Fund's portfolio in his capacity as president and fund manager at UCM.

During the relevant period Lynch drew an annual salary of $40,000. Of this, during the early part of the period, W&R paid $22,000, UCM $15,000, and WRI $3,000; subsequently W&R paid $22,000 and UCM $18,000 of the total.[11] From January 1964 until December 1969 Lynch carried the title of Assistant to the Chairman of the Board of W&R (Chauncey Waddell) for Foreign Operations.

An American citizen, Lynch resides in Long Island, New York.

10/ See, inter alia, Exhibit 17A. Except for a short period from February to December in 1963 when Lynch was in Bermuda as treasurer and director of United International Fund, he had no direct experience in personally selecting portfolio securities for a Fund prior to taking up that responsibility as president of UCM.

11/ The fact that W&R paid over half of Lynch's salary is a good indication of W&R's role in setting up and operating the Fund and its service entities (WRI and UCM) since the record shows that the services Lynch performed in New York on behalf of the W&R "home" office were sporadic, minimal, and in no way commensurate to the part of his salary paid by W&R. Lynch's time and energies were almost totally dedicated to UCM in its work for the Fund.

The Division's Charges

The Order as amended[12/] alleges in substance that during the charging period (approximately December 1, 1967, to about December 10, 1969) Lynch and the other respondents through use of jurisdictional means wilfully violated and wilfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act")[13/] in connection with the offer, purchase and sale of the Fund's shares by, inter alia: (1) substantial overvaluation of the Fund's portfolio securities

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12/ On August 22, 1972, The Division's motion to amend the Order to allege use of the mails, securities exchanges,and facilities of interstate commerce was granted during the course of the hearing.

13/ 15 USC 77q(a); 15 USC 78j(b); 17 CFR 240.10b-5; 15 USC §80b-6. Rule 10b-5 provides as follows:

> Rule 10b-5. Employment of Manipulative and Deceptive Devices.
>
> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

and other assets during a considerable portion of the relevant period; and (2) making false and misleading statements and omissions in the Fund's prospectuses.

In addition, Lynch and the other respondents are charged with having failed reasonably to supervise persons under their supervision with a view to preventing the violations of the Securities laws alleged in the Order.

Formation and Operation of the Fund

In the early part of 1967 Lynch and Oppenheimer formulated a proposal for forming an "offshore fund" with a portfolio of United States securities in order to take advantage of an apparent overseas demand for such an investment vehicle.[14/] Waddell and Reed studied and accepted the proposal; on October 20, 1967, the Fund was organized in Nassau, Bahamas (for tax purposes) as a leveraged, hedge fund. Through its Canadian subsidiary, UFM, Waddell & Reed formed, late in 1967, the New York Corporation, UCM, whose sole function was the management of the Fund's portfolio, including determinations as to when hedging and leveraging techniques were to be employed by the Fund.

Beginning in early 1968 WRI,[15/] the Fund's sponsor and underwriter,

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14/ See p. 33 below concerning tax advantages that inured to investors in such a fund.

15/ As noted above, WRI, incorporated in Bermuda, was at all times here relevant a subsidiary of W&R.

began offering and selling the Fund's shares abroad. The Fund's prospectus was prepared in New York, and both Lynch and Oppenheimer participated in its preparation or review. As already noted above, the principal activity of WRI from January 1968 to December 1969 was offering and selling the Fund's shares abroad.

Chase Manhattan Trust Company, Ltd. ("Trust Co.), a Bahamian subsidiary of Chase Manhattan Bank, N.A., in New York, was appointed trustee to act as custodian and shareholder servicing agent for the Fund. Trust Co. in turn designated its New York parent as sub-custodian. Thus, the Fund's portfolio securities, essentially all of which were issued by United States companies and included both exchange-listed securities and over-the-counter ("OTC") traded securities, were kept physically located in New York City.[16/] This was necessary from the standpoint of economy and efficiency of operation since virtually all of the Fund's portfolio transactions were placed with registered broker-dealers and executed on U. S. securities exchanges or in U. S. over-the-counter markets. Confirmations of the Fund's portfolio transactions were mailed both to the Fund's "offices"[17/] in Nassau in the Bahamas and to UCM, the Fund's portfolio manager, at 40 Wall Street.

16/ The Fund's portfolio securities (as well as its cash) were maintained either at Chase Manhattan Bank, N.A., the Fund's sub-custodian, or at Goldman, Sachs, New York, where the Fund maintained a substantial short-sale account.

17/ During much of the relevant period the Fund's "offices" were at Trust Co.

As part of its shareholder servicing functions, Trust Co. maintained the books and records of the Fund and confirmed the sale and redemption of Fund shares to its shareholders. But as far back as early 1969, Trust Co. failed to maintain the Fund's records on a current basis. Although responsibility for maintaining the Fund's books and records was shifted on April 1, 1969, to the Rawson Management Company, Ltd. ("Rawson"), in Nassau, Rawson likewise failed to keep such books and records on a current basis until at least December 10, 1969.

From the Fund's inception until about December 31, 1969, Lynch, president of UCM, personally managed and supervised the management of the Fund's portfolio. Lynch or someone under his supervision and direction selected each of the securities to be purchased or sold for the Fund's portfolio and selected the executing broker. Lynch decided when to use, and arranged for, leveraging and hedging techniques in managing the Fund's portfolio. During 1968 and 1969 the Fund's portfolio was leveraged at levels ranging from about $10 million to $20 million. From September 1968 to September 1969 the Fund, under Lynch's management, engaged in numerous short sale transactions.[18/]

18/ In connection with these transactions, Lynch utilized a New York broker, Goldman, Sachs, which retained custody of the cash and securities involved. The remaining cash and securities of the Fund were maintained in New York at Chase Manhattan Bank, N.A., as noted in footnote 16 above.

Under the Fund's Articles of Association, its net asset value per share was to have been determined once a week by the Fund's board of directors[19/] to establish the price for purposes of sales and redemptions. In practice, however, the net asset value was established by Lynch in New York on the basis of portfolio valuations he fixed or approved and on the basis of what he understood the Fund's other assets to be without the benefit of having available currently posted and maintained books and records of the Fund.[20/]

The Fund's shares were all sold abroad to persons who were neither citizens nor residents of the United States. At its peak on February 12, 1969, the Fund had assets of approximately $27,500,000. On December 10, 1969, the Fund's Board of Directors suspended sales and redemptions of its shares after having been advised that the net asset values at which the Fund's shares had been sold and redeemed for some time prior to that date were materially inflated as a result of overvaluation of portfolio

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19/ As of January, 1970, the Fund's listed board of directors included three members of Trust Co., a representative of Butler's Bank, and an officer of Rawson, all of Nassau, Bahamas. The record suggests that the Fund's board was relatively inactive; most of the functions necessary to the Fund's operations were "contracted out" to other entities, such as UCM, WRI, and Trust Co.

20/ Data on the Fund's sales and redemptions of its shares were phoned in from Nassau to New York for weekly valuation purposes since time did not allow written communication of these data.

securities and material accounting discrepancies.

After the Fund's books and accounts were reconstructed by internal auditors from August, 1968 [21] forward and after new, revised valuations of various securities had been established, it became apparent that throughout the period July 25, 1968 to December 10, 1969, the Fund's portfolio had been overvalued by amounts exceeding $3,000,000. [22] Further, the "audit" disclosed that as a result of substantial accounting errors between November 11, 1968 and December 10, 1969, the Fund's assets were additionally overstated. [23] The peak of overstatement of the Fund's assets occurred on July 30, 1969, when the combination of overvalued securities and accounting errors caused the net assets of the Fund to be overstated by $6,700,000, or 43%.

The results of these long-continuing overvaluations and accounting errors had the dual effects of having caused Fund purchasers to pay too much for their shares and of having caused the Fund to pay out too much to shareholders who redeemed Fund shares.

21/ This was the date of the last audited statement of the Fund.

22/ The revised valuations discussed herein of the Fund's portfolio securities were arrived at during the reconstruction of the Fund's books conducted by UFM under the supervision of Clarkson, Gordon & Co., chartered accountants in Canada. The statement of corrected valuations prepared by UFM was certified by Clarkson, Gordon & Co. See p. 19 et seq. below.

23/ As indicated in footnote 24 below, Clarkson, Gordon certified these audit corrections in the Fund's accounts.

Losses to the Fund as a result of overpayments for redemptions aggregated some $960,000.

Overvaluation of the Fund's Portfolio Securities and Other Assets

After July 25, 1968, and within the relevant period, Lynch purchased over $5 million worth of restricted securities for the Fund's portfolio. The purchases involved the securities of seven issuers. Since these securities could not be sold on the open market without registration, the Fund purchased them at substantial discounts from the value of the open-market or unrestricted shares of the same class or from the open-market values of the securities into which the restricted shares, if and when they became registered, were convertible.

Alphanumeric. During November and December, 1968, Lynch purchased 12,100 free-trading shares of Alphanumeric, Inc. ("Alphanumeric") in the OTC market at prices ranging from $69 to $79¼ the share. On January 3, 1969, he bought an additional 44,444 shares of Alphanumeric for the Fund at $45 a share in private placement. Upon acquiring these restricted shares, Lynch had them valued at a 10% discount from the market price and within six weeks time he valued them at the full bid price for the freely-traded shares. As of February 19, 1969, the overvaluation of the Alphanumeric shares rose to $722,000. After the market price of freely-traded shares of Alphanumeric dropped below the $45 cost price for the Fund's restricted shares, in late March, 1969, Lynch failed to lower his valuation of the restricted

44,444 shares or of the 12,100 registered shares below the $45 level, even when the market value of the stock dropped to $15. On January 8, 1969, the total overvaluation of the Fund's Alphanumeric shares aggregated $486,000 and reached a high point on December 10, 1969, of $1,950,000. In terms of percentages of overvaluation, the restricted shares of Alphanumeric were overvalued by 25% on January 8, 1969, and by 365% by December 10, 1969. The registered shares were overvalued by 25% on May 14, 1969, and by 230% on December 10, 1969.

Michigan General Corp. Lynch's first purchase of unregistered stock for the Fund occurred on July 25, 1968, when it bought a $500,000 "package" of securities from Michigan General Corp. ("Michigan"), consisting of debentures, convertible preferred stock, and common stock. The Fund acquired $300,000 worth of debentures at par and paid a total of $200,000 for 25,000 shares of convertible preferred and 20,000 shares of common, reflecting a price of $4.44 per share. The preferred shares were convertible into common on a one-to-one basis. At the time of these acquisitions, the market price of Michigan common was quoted at $10 bid-no ask, in the daily quotation sheets, and there was no quoted market for the preferred shares. Lynch initially valued both the common and preferred shares at twice their purchase price and thereafter at the prevailing price of the freely-traded common. In terms of percentage, the overvaluation fluctuated from 80% on August 8, 1968, to a high of over 320% on October 1, 1969, then down to 90% by December 10, 1969.

Sensormatic. On August 22, 1968, the Fund purchased 50,000 shares of Sensormatic Electronics Corp. ("Sensormatic") common stock for $250,000 or $5 per share. This stock was unregistered and was part of a private placement of 300,000 shares of the stock. Lynch valued the 50,000 Sensormatic shares at $500,000, i.e. at twice the Fund's cost price, at a time when no public market existed for any securities issued by Sensormatic. Thereafter the overvaluation of Sensormatic fluctuated during the relevant period from at least 55% to 170%; during most of the relevant period Lynch's valuation exceeded the adjusted valuation by over 100%.

Bell Television, Inc. On October 1, 1968, Lynch had the Fund buy 50,000 restricted shares of Bell Television, Inc. ("Bell") common stock at $15 a share. The purchase was part of a private placement of 739,000 shares sold at a discount of about 30% below the price of the freely traded Bell common stock on the commitment date. Lynch arbitrarily valued the Fund's restricted Bell shares at the market price for the unrestricted shares, thereby achieving instant appreciation of over 42%. On October 17, 1968, Lynch's valuation of the Bell shares exceeded the revised valuation by $768,000, or 60%. During the relevant period Lynch's valuations of the Fund's Bell stock exceeded the revised valuations by from about 30% to 60%, and during most of the period by 40% or more.

Harbor City National Bank. On December 30, 1968, Lynch purchased for the Fund's portfolio 12,450 unregistered shares of Harbor City National Bank ("Harbor"), a small, closely-held bank, for approximately

$373,127. Lynch valued the Harbor shares at cost from the time they were acquired until October 15, 1969. On the October 15th pricing sheet, after the Fund had purportedly exchanged its Harbor shares for 98,846 shares of Charter Bankshares Corporation ("Charter"), a bank holding company, Lynch valued the Charter shares at $593,076, representing an appreciation of $219,949, or almost 59%, over the cost of the Harbor shares. Thereafter Lynch valued the Charter shares at various smaller figures, closing with $494,230 on December 10, 1969. The trouble with Lynch's utilizing the Charter valuations was that the exchange of Harbor shares for Charter shares did not legally occur until after it was approved by the Federal Reserve Board on March 12, 1970. Moreover, there was no publicly quoted market for Charter shares during Oct.-Dec. 1969 since the FRB had temporarily prohibited trading in the stock. From October 15, 1969 to December 10, 1969, the Harbor shares were overvalued by from 58% to 32%.

B.T.B. Corporation. On February 11, 1969, the Fund purchased, at par, a $1,000,000 subordinated convertible note from B.T.B. Corporation ("B.T.B."). The note was part of a $22.5 million private placement by B.T.B. and was convertible into B.T.B. common stock at $14 per share. Neither the note nor the underlying shares were registered. Lynch valued the note at $1,230,000, at an appreciation of 23%, evidently based on the then market value of freely-trading B.T.B. common stock. From the time of its purchase until December 10, 1969, the B.T.B. note was overvalued by various percentages ranging from about 20% to about 120%. At its peak on July 23, 1969 the

overvaluation reached a sum of $715,000.

Systems Design Associates, Inc. The Fund bought 3,723 shares of unregistered common stock of Systems Design Associates, Inc. ("Systems") for $250,000 as part of a total private placement of 14,875 shares. On June 27, 1969, Systems split its common stock 10 for 1 and changed its name to Microdata Corporation ("Microdata"). From the time of its acquisition to December 10, 1969, no quoted market existed for the Systems/Microdata stock. Lynch first valued the stock at cost; but on October 15, 1969, he increased the valuation to $10 a share, the price at which a second private placement had been effected. This departure from cost valuation resulted in an overvaluation of the stock by $22,000, or 48%, which persisted throughout the remainder of the relevant period.

In addition to the foregoing very substantial overvaluations of restricted securities in the Fund's portfolio, which persisted in varying amounts over various portions of the relevant period, as found above, the record further discloses that Lynch also overvalued the registered securities of at least four issuers during various portions of the relevant period. These portfolio securities were those of: Benguet Consolidated, Inc.; Farrington Overseas Corp.; General Time Corp.; and Great American Holding Corporation. The peak overvaluations for these four portfolio securities were, respectively, approximately $63,000, $80,000, $212,000, and $335,000.

As a result of Lynch's overvaluations of both restricted and non-restricted securities of the Fund's portfolio, as found above, the value of the Fund's portfolio securities was very substantially

overstated at all times from July 25, 1968 to December 10, 1969. Thus, on October 31, 1968, the Fund's portfolio was overvalued by some $1.1 million and by July 30, 1969 such overvaluation reached $4 million. At the time sales and redemptions of the Fund's shares were suspended on December 10, 1969, the portfolio overvaluations stood at some $3.5 million.

In addition to the above-found overvaluations of the Fund's portfolio securities, the record establishes various discrepancies and anomalies in the Fund's books and records, the reasons for which have never been entirely explained, which also served to overstate the net-asset value per share of the Fund over a considerable period of time within the relevant period.

In October of 1969 Arthur Young & Company, an accounting firm, commenced the second annual audit of the Fund's books and records in Nassau. In reviewing the prior week's net-asset value calculations of the Fund, Arthur Young noted certain unexplained account differences and inconsistencies in the Fund's portfolio valuations, which they called to Lynch's attention. No one else seemed aware of these problems until by letter of December 1, 1969, the auditing firm advised the Fund's managing director that because of the substantial discrepancies in the Fund's records, they were unable to verify the Fund's net asset value. This caused the Fund's Board of Directors, as already noted, to suspend sales and redemptions of the Fund's shares on December 10, 1969.

At this point Waddell & Reed and UFM became greatly concerned about the situation. Steps were taken immediately after December 10, 1969, to have UFM personnel, with the aid and under the supervision of personnel from Clarkson Gordon & Co. ("CLarkson, Gordon"), (a Canadian chartered accounting firm located in Toronto, and an affiliate of Arthur Young) reconstruct the Fund's records, since the Fund's books and records were not in a condition that would allow a routine audit to be performed, and also to arrive at appropriate adjusted net asset values for the period during which they had been overstated.

On January 29, 1970, Clarkson, Gordon submitted a report to the directors of UFM concerning their review of the Fund's accounts. The report stated that the books in Nassau had not been maintained on a current basis and that when examined they were found to have been unposted since October 31, 1969. Thus, it was evident that the books and records in Nassau could not have been used in computing the weekly net asset value per share of the Fund. Instead, such weekly calculations had been made by Lynch in New York from at least August 1968 until December, 1969, or by persons subject to his supervision, based upon memoranda records in his office, which included officers certificates authorizing the purchase and sale of portfolio securities, officers expense certificates authorizing disbursements of the Fund's moneys for other expenses, and adding-machine tapes of the weekly transactions affecting net-asset values. Lynch did not maintain a double-entry bookkeeping system that would have enabled picking up errors, and, of course, the books in Nassau, not having been posted

currently, were not available as a cross check. Thus Lynch's errors in the accounts tended to remain undetected and to be carried forward from one week to the next.

The Clarkson, Gordon report 24/ indicated that the accounting discrepancies, which first became evident for the date October 17, 1968, did not materially affect the per share net asset value of the Fund until November 28, 1968, but from then on until December 10, 1969, material accounting discrepancies were found in every weekly computation. During the period from September 4, 1968 to December 3, 1969, the accounting discrepancies (the reasons for which the Clarkson, Gordon report was unable to identify, owing at least in part to a lack of some needed records) ran a range from an understatement of net assets by $53,000 on November 14, 1968, to an overstatement of net assets by some $2.8 million on October 8, 1969. This last discrepancy resulted in an overstatement of the Fund's assets by some 15%.

The record shows that the combined effect of Lynch's overvaluation of portfolio securities and his overvaluation of other assets of the Fund as a result of accounting errors was to create a peak overstatement of assets in July, 1969, of $6.7 million, or an overstatement of the net asset value per share by some 43.5%.

24/ Clarkson, Gordon reviewed the procedures under which UFM personnel reconstructed the Fund's records for the period from August 1968 forward, participated in such reconstruction, and certified the final results.

These continuing and substantial overvaluations of the Fund's assets constituted a grossly fraudulent scheme or device as against both actual and prospective purchasers of the Fund's shares, since it caused purchasers to pay more for the shares than they were in fact worth and induced purchasers to buy on the strength of a "performance" record that was illusory to the extent of the overstatement of assets. It was also a fraud as against the Fund's shareholders as a class because the overstated net asset values per share caused the Fund to pay out to redeeming shareholders more than their shares were worth, to the detriment of the remaining shareholders, whose assets were thus diminished.[24a/]

Lynch's participation in and his aiding and abetting of the fraudulent scheme was clearly willful,[25/] since he was obviously well aware of what he was doing, both in terms of the overvalued securities and of the fact that he was recklessly calculating other assets of the Fund on the basis of inadequate and inaccurate books and records.

24a/ The record shows that because of the way the Fund's shareholders were scattered about abroad it would have been impractical and uneconomic for the Fund to attempt to recover from most redeeming shareholders excess funds paid them for their shares.

25/ All that is required to support a finding of willfulness is proof that a respondent acted intentionally in the sense that he was aware of what he was doing and either consciously, or in careless disregard of his obligations, knowingly engaged in the activities which are found to be illegal. Hanley v. Securities and Exchange Commission, 415 F.2d 589, 595-6 (2d Cir. 1969); Nees v. Securities and Exchange Commission, 414 F.2d 211, 221 (9th Cir. 1969); Dlugash v. Securities and Exchange Commission, 373 F.2d 107, 109-10 (2d Cir. 1967); Tager v. Securities and Exchange Commission, 344 F.2d 5, 8 (2d Cir. 1965).

False and Misleading Statements and Omissions in the Fund's Prospectuses

Early in 1968 WRI prepared and printed a prospectus that was disseminated to its overseas offices and used in connection with the offer and sale of the Fund's shares. As already noted, Lynch participated in the preparation of this prospectus, as he concedes, along with Oppenheimer and the firm's attorneys and others. The next year, 1969, a similar 26/ prospectus was employed by WRI.

Under the heading "MANAGEMENT", the prospectuses emphasized that the success of a mutual fund is directly related to the ability and experience of its management team, and pointed out that management skill and judgment is of "paramount importance" to a fund employing such "sophisticated investment techniques" as hedging and leveraging. 27/

The prospectuses then went on to state that ". . . management of the Fund has been entrusted to [UFM], which specifically for the purpose of managing [the Fund], formed a new U.S. subsidiary management company, called [UFM]." The prospectuses then went on to set forth the extensive experience of UFM as investment manager for a variety of mutual funds.

Under the "MANAGEMENT" heading in the Fund prospectuses it was also pointed out that UFM is a subsidiary of W&R; and the extensive

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26/ Variations in the 1969 prospectus as compared with that used in 1968 are not material to the charges or findings herein.

27/ The techniques involved in hedging and leveraging were described earlier in the prospectuses.

and diverse experience of W&R as a mutual-fund manager was set forth, both for W&R individually and in combination with its subsidiaries.

This language in the prospectuses, which continued in use during the relevant period, was false and misleading in that its clear implication was that UFM's management experience (and, to a lesser degree, W&R's) would be employed for the benefit of the Fund, at the least in a supervisory or reviewing capacity, whereas in the actual event that was never done. In fact, the entire management discretion as to the Fund, both in terms of the selection of its portfolio securities and in terms of deciding when hedging and leveraging techniques were to be employed, was lodged in Lynch as president of UCM. UFM, the parent, never became actively concerned with UCM, the child, until that child had gotten the Fund into grave difficulties that forced it to suspend sales and redemptions of its shares. Only then did UFM come in and take the active hand in reconstructing the Fund's books and trying to pick up the pieces. W&R showed the same indifference until the disaster had already struck the Fund.

The failure of the prospectuses to disclose that in reality it was Lynch who would be or who was exercising essentially complete discretion and judgment in managing the Fund, as president of UCM, and the failure to disclose his relatively limited experience in fund management,[28/] constituted a fraud on actual and prospective shareholders of the Fund.

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28 / See footnote 10 above.

Under the heading "PERFORMANCE" the Fund's prospectuses set forth the "outstanding performance" results of two funds under the management of W&R and UFM, respectively, inasmuch as the Fund, as a new or relatively new fund, could not show a meaningful performance record.

The failure to disclose in the prospectuses that there would be, and that there was, no identity of management between the two funds whose experience was reported and that of the Fund constituted a fraudulent failure to disclose relevant facts in light of the statements that were made in the prospectuses of the Fund.

Moreover, in light particularly of the strong emphasis placed in the prospectuses upon the fund-management skills and experience of both W&R and UFM, the reader of those prospectuses had a right to infer that the net-asset value per share of the Fund would be calculated in accordance with commonly-accepted valuation procedures and on the basis of books and accounts that were correctly and currently posted. In these circumstances, it was a fraudulent failure to disclose material facts for the prospectuses to fail to disclose that Lynch was including substantial amounts of restricted securities in the Fund's portfolio that were not properly discounted in value to reflect their inability to be readily marketed. Likewise, it was fraudulent to fail to disclose that Lynch was making weekly computations of the net-asset value per share of the Fund without having available to him accurate and currently-posted books and records, without which such computations could not reliably be made.

Lastly, neither of the two prospectuses that were utilized during the relevant period contained the names or backgrounds of any of the Fund's directors.[29/]

Lynch was well aware of the contents of the prospectuses and was equally well aware that the false and misleading material statements or omissions found above did not accord with reality and were fraudulent, particularly inasmuch as the statements and omissions related primarily to his overvaluation of certain of the Fund's securities and to other aspects of his management of the Fund. His participation in these violations was therefore willful.[30/]

Lynch's Failure to Supervise

UCM had a small number of employees in the New York Offices of UCM, all of whom were subject to Lynch's supervision as president of UCM. Some of these at various times assisted Lynch in managing the Fund's portfolio or were responsible for managing particular segments of the portfolio, but always subject to Lynch's ultimate supervision. Some of the employees assisted Lynch in making net asset calculations, again, subject to his supervision. To the extent that any of the overvaluations of assets of the Fund were attributable to UCM personnel other than Lynch,[31/] he must be held to have failed

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29/ See footnote 19 above concerning the Board's composition.

30/ See footnote 25 above.

31/ The record establishes that the specific overvaluations of the unregistered portfolio securities of the fund were all or substantially all directly attributable to Lynch.

reasonably to supervise such personnel. Lynch established no procedures to ensure that the Fund's portfolio securities and other assets were valued correctly. Lynch made, and allowed personnel subject to his supervision to make, calculations of the Fund's net asset value on the basis of accounting records and data that he knew or should have known were incomplete and inaccurate. In these circumstances Lynch must be held under Section 15(b)(7) of the Exchange Act to have "failed reasonably to supervise" within the meaning of that term as used in Section 15(b)(5)(E) of that Act.[32/]

32/ The "omission" involved in failing reasonably to supervise that is set forth in Section 15(b)(5)(E) is incorporated by reference under Section 15(b)(7) as a basis for imposing sanctions under Section 15(b)(7) against "any person" whose acts or omissions bring him within the operation of Section 15(b)(7).

Respondent Lynch's Contentions.

1. Challenge to Commission's Jurisdiction. Respondent Lynch contends that the Commission lacks jurisdiction to bring and to adjudicate this proceeding against him and the other Respondents on the theory that the allegedly fraudulent conduct occurred entirely outside the United States.[33/] He argues that this supposed circumstance (1) renders the Exchange Act inapplicable in view of the exclusion from the provisions of that Act of ". . . any person insofar as he transacts a business in securities without the jurisdiction of the United States. . ." and (2) renders inapplicable all of the laws under which respondents are charged, under the general principle of international jurisprudence that the laws of any sovereign state are primarily territorial and do not apply to persons and activities outside the territorial jurisdiction of the sovereign except in special and very unusual circumstances. While conceding that the Commission would have jurisdiction under the statutes whose violation is charged if the record established that the foreign activities complained of produced substantial, detrimental effects within the United States, Respondent Lynch argues that the record herein contains no evidence to warrant such a finding of substantial and detrimental internal effect.

33/ In addition to the arguments on this point made in Respondent Lynch's pro se brief, he has incorporated therein by reference the jurisdictional arguments made earlier in this proceeding by other respondents in connection with motions to dismiss.

With the exception of the Exchange Act, none of the securities laws here involved contains any provision relating expressly to the extraterritorial scope of its application. Nevertheless, it would seem logical that judicial constructions of the exemption in Section 30(b) of the Exchange Act would be relevant by analogy in applying to the other acts the general principle against extraterritorial application of statutory enactments, particularly since each of the Acts involved had as its legislative purpose, broadly speaking, the protection of U. S. investors and the integrity, liquidity, and vitality of the U. S. securities markets. The Supreme Court has held consistently that U. S. Securities laws enacted for the purpose of avoiding frauds and to require full and fair disclosure to investors must be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes."[34/]

Judicial authorities establish that U. S. securities laws may be applied to transactions or acts whose situs is wholly or in part foreign either: (1) territorially, where a necessary and substantial act constituting the offense charged is performed within

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34/ Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); accord, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); Affiliated Ute Citizens v. United States, 40 U.S.L.W. 4448, 4455-56 (U.S. No. 70-78, April 24, 1972); Superintendent of Insurance of the State of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); see Securities and Exchange Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344, 353-355 (1943).

the United States, or (2) protectively, where the act, though performed entirely outside the United States, has a substantial impact on U. S. markets or investors.[35/] [36/]

Both the territorial and the protective concepts support the Commission's jurisdiction in this proceeding.

The exemption from the Exchange Act under Section 30(b)

35/ Kook v. Crang, 182 F. Supp. 388, (S.D.N.Y. 1960); S.E.C. v. United Financial Group, et al. __F.2d__, 41 L.W. 2415 (2-13-71)(C.A. 9, 1-17-73). In this last case the Court found jurisdiction on the dual grounds that substantial activities were carried on by the defendants within the United States in order to facilitate the sale of mutual fund securities abroad, and the fact (although it happened inadvertently, and not intentionally) that three American citizens were sold about $10,000 worth of stock. Since the case involved numerous mutual funds (UFG had some 80 subsidiaries) and the sales to Americans were insignificant both in number and quantity and occurred inadvertently, it would appear, analytically, that the primary ground for asserting jurisdiction had to be the "necessary and substantial acts" committed within the United States.

36/ Schoenbaum v. Firstbrook, 405 F. 2d 200, 206, 208 (C.A. 2d 1968), reversed on other grounds, 405 F. 2d 215 (C.A. 2d 1968) (en banc), cert. den. sub. nom Manley v. Schoenbaum, 395 U.S. 906 (1969). Accord: Roth v. Fund of Funds, Ltd., 405 F. 2d 422 (C.A. 2, 1968) cert. den. 394 U.S. 975 (1969); Wandschneider v. Industrial Incomes Inc. of North America, (S.D.N.Y., March 22, 1972) CCH Fed. Sec. L. Rep. ¶93,422 at p. 92,065; Investment Properties International, Ltd. v. I.O.S., Ltd., (S.D.N.Y. April 21, 1971) CCH Fed. Sec. L. Rep. ¶93,011 at pp. 90,734-90, 735; Finch v. Marathon Securities Corp., 316 F. Supp. 1345, 1349 (S.D.N.Y., 1970); Securities and Exchange Commission v. Gulf Intercontinental Finance Corp., Ltd., 223 F. Supp. 987, at 995 (1963). To the extent Kook v. Crang, 182 F. Supp. 388 (S.D.N.Y., 1960)--relied upon by Respondent and decided prior to the cases cited above--may be read as applying the presumption against extraterritoriality to the federal securities laws, it has been implicitly overruled by the Court of Appeals for the Second Circuit in Schoenbaum.

thereof of "any person" transacting "a business in securities" without the jurisdiction of the United States is now generally understood not to apply to a person making a single, isolated sale of securities, but to brokers, dealers, and banks.[37/]

As applied to the operation of a mutual fund, the term "a business in securities" as used in Section 30(b) must logically be deemed to embrace not only the "merchandising" of the fund, i.e. the activity and transactions involved in advertising the fund and in selling and redeeming its shares, but also the "management" of the fund, i.e. the decision - making aspects such as selection of the fund's portfolio securities and, in the contect of this proceeding, the determination of when "performance" techniques such as leveraging and hedging are to be employed.

As found above, the Respondents in this proceeding chose to locate the vital management (i.e. decision - making) aspects of their "business in securities" as it involved the Fund in New York, N. Y., rather than abroad; they therefore cannot claim exemption under Section 30(b) of the Exchange Act. For the same reasons, the Respondents cannot claim exemption from the Securities Act or the Investment Company or Investment Advisers Acts since, satisfying the territorial basis of jurisdiction, necessary and substantial acts consituting the offenses charged occurred in New York, N. Y. Not only did the[38/]

37/ Schoenbaum v. Firstbrook, supra, footnote 36, at p. 208.

38/ See footnote 35 above.

substantial and arbitrary or grossly negligent overvaluation of the Fund's portfolio securities and other assets occur within the United States, but the Fund's prospectuses, too, were drafted and reviewed in New York. Moreover, the failure of the corporate Respondents to furnish any supervision or guidance to Respondent Lynch may be said to have occurred within the United States since Lynch's regular duties respecting the Fund were performed within the United States.

While it may be true in one sense that the fraud alleged and established in this proceeding was not "consummated" until the fraudulent prospectuses and net asset per share valuations were communicated to the Fund and its shareholders overseas, it does not follow that the aspects of the fraud that did occur within the United States were not "necessary and substantial" elements of the fraud charged. Indeed, it is quite evident that the aspects of the fraud that occurred within the United States were indispensable elements of the fraud. Considering how the Fund was formed, controlled, and managed, the fraud found herein clearly bears a "made in U. S. A." label. 39/

39/ In addition, the Respondents chose in the prospectuses (falsely) to imply that the management experience of W&R in the U.S. would be employed for the benefit of the Fund, a fact that further served to give the entire operation an American flavor. As the U. S. Supreme Court has noted:

> "In the enforcement of an act [Securities Act] such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be."

S.E.C. v. C. M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943). Accord, S.E.C. v. United Benefit Life Inc., Co., 387 U.S. 202, 211 (1967).

In this connection, it is not without significance that the frauds here involved continued over substantial periods of time and thus represented continuing violations. Thus, the acts or omissions which occurred within the United States had a continuing operative effect and constituted indispensable elements of the fraud both before and after the prospectuses and net asset value times were communicated abroad or the Fund's shares were offered and sold abroad.[40/] Put another way, the acts and omissions that occurred in the United States were fraudulent in light of the representations that had already been made abroad just as much as the representations made abroad were fraudulent in light of the earlier acts and omissions that had occurred in the United States. Thus, it is as valid to consider that the frauds were "consummated" in the United States as it is to conclude that they were "consummated" abroad.[41/] In any event, integral and indispensable elements of the fraud occurred both at home and abroad.

The record further establishes that Lynch and the other Respondents made use of the mails and other means and instruments of transportation

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40/ It is abundantly clear that the fraudulent acts within the United States were committed in connection with the offer and sale of the Fund's shares since the entire purpose and effect of the fraudulent acts here were to create the impression of a prospering, successful Fund in order to attract and retain shareholders.

41/ The combined operations, representations, and transactions, at home and abroad, resembled more a continually rotating wheel than a finite series of events following sequentially in time.

and communication (notably, telephones) in interstate (including foreign) commerce in connection with the violations found above.[42/]

While the record thus clearly establishes a territorial basis for the Commission's jurisdiction over the violations here found, jurisdiction on a "protective" concept exists as well.

As Lynch himself testified, the Congress, in an effort to improve the United States' balance of payments situation, enacted the Foreign Investors Tax Act of 1966, 80 Stat. 1541 ("FITA"). FITA encouraged foreigners to invest in the United States by according them favorable tax treatment in various respects.[43/] Lynch testified that it was the enactment of FITA that made Respondents consider that establishment of the Fund involved in this proceeding was a viable proposition economically. FITA produced the expected and desired results within two years of its enactment.[44/]

42/ While use of the mails or other instrumentalities of interstate commerce is a required jurisdictional finding for application of the Securities laws here involved to Lynch, such a finding has not been held alone sufficient to confer jurisdiction where the activities complained of occurred overseas and did not have a substantial impact within the United States. See S.E.C. v. United Financial Group et al, cited supra in footnote 35 , where the Court of Appeals, having found jurisdiction on other bases, chose to express no opinion on the validity of the "interstate commerce facilities use" theory as a basis for U. S. jurisdiction.

43/ Note, United States Taxation and Regulation of Offshore Mutual Funds, 83 Harvard L. Rev. 404, 405 (1969-70) ("Offshore Fund Note").

44/ Offshore Fund Note (see footnote 43 above), at p. 406.

The significant impact of foreign investors on the American economy was recently reaffirmed and detailed by the findings of the Commission's Report on Institutional Investors. The report concluded that foreign investors were important to the balance of payments situation of the United States because the net purchases of American corporate stock by foreign investors "obviously permit larger net imports of commodities and services, larger net exportation of capital, or larger accumulation of monetary metals than would otherwise be possible, while protracted net sales have the opposite effect."45/ The Commission's Report further found that:

> ". . . to the extent that the recent, well-publicized difficulties of offshore funds have engendered net redemptions by shareholders and have led to the net sale of U.S. securities by the funds, the U.S. is detrimentally affected by an outflow of foreign capital in the balance of payments and by selling pressure on individual securities."46/

Even more recently, the Commission again emphasized the high importance of preserving foreing-investor confidence in connection with the sale of mutual fund shares to foreigners in terms of preserving the integrity of the United States securities markets and assisting the United States in its balance of payments posture by transmitting on

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45/ Supp. Vol. 1, Securities and Exchange Commission, Institutional Investor Study Report, H.R. Doc. No. 92-64, Part 6, 92nd Cong., 1st Sess. p. 152 (1971).

46/ Vol. 3 id. at p. 952.

April 3, 1973, to the Chairman of the House Committee on Interstate and Foreign Commerce, a legislative proposal that would enable creation of Foreign Portfolio Sales Corporations or Trusts to be organized in the United States for the sale of mutual fund shares to foreigners. This legislative proposal was developed by an inter-agency Offshore Fund Task Group assembled on the initiative of the Commission that included representatives of the Commission, the Treasury Department, the State Department, and the Federal Reserve Board. The proposal would permit the "domestication" (i.e. making subject to U. S. securities laws) of those offshore funds not now subject to U. S. laws (under traditional jurisdictional criteria) without changing the basic tax effects on the fund or its shareholders. Underlying this proposal is the obvious concern of its sponsors for the maintenance of investor confidence on the part of foreign mutual fund purchasers in order to improve the U. S.'s balance of payments position.

From the foregoing it is mainfest that the United States in fact has a strong national interest in the economic vitality and integrity of offshore mutual funds holding American portfolios. Where, as here, the Commission has in personam jurisdiction by virtue of registration or otherwise over the parties and can, as a practical matter, impose appropriate sanctions on such persons without getting involved in problems such as those that might be presented if foreign law had to be applied or if there were a practical impediment to applying effective sanctions, there is no reason why the Commission

should not exercise protective jurisdiction[47] in defense of the U. S.'s strong national interests.

Thus, while jurisdiction of the Commission in this proceeding can be sustained either under the territorial or the protective concept, the case for exercising jurisdiction becomes overwhelming when the two bases are taken in combination.[48] Were the Commission to fail to exercise jurisdiction in such a situation, the probability of loss of confidence by foreign investors in U. S. sponsored offshore funds specializing in U. S. issued portfolios securities would be high indeed.

2. Alleged Failure to Prove Overvaluations. In broad-brush fashion Respondent Lynch argues that the "corrected valuations' of securities utilized in finding the overvaluations of portfolio securities held by the Fund are not reliable because there was no satisfactory proof of the degree or extent to which Clarkson, Gordon supervised UFM

47/ In short, the situation here is one in which the activities complained of are well within the reach of the Commission's effective enforcement powers.

48/ The Division urges that the fact that the Fund's portfolio consisted almost entirely of the securities of U. S. issuers and that its portfolio securities were bought and sold in the U. S. is itself a sufficient basis for the Commission's jurisdiction. However, no authority is cited for this proposition, and none has been found. It seems doubtful that such circumstances alone would form a predicate for jurisdiction in the absence of a showing that fraud or other violations in connection with portfolio transactions, affecting the U. S. securities markets, were involved in the process.

personnel in their reconstruction of the Fund's books and in making revised valuations and that Clarkson, Gordon's certification of the revisions and adjustments cannot be relied upon because of certain alleged errors in the "corrected" valuations of certain securities.

As the Division's reply brief correctly points out, the apparent valuation errors pointed out by Lynch in toto amount to only about $50,000 and do not involve any of the securities whose valuations were revised by UFM and Clarkson, Gordon, or the accounting anomalies discovered by them, which in the aggregate, as found above, ran to overvaluations of as much as $6.7 million. Significantly, Lynch does not attack any particular revaluation of a portfolio security made by UFM and Clarkson Gordon nor does he attempt to justify either the propriety of his original valuations of the Fund's portfolio securities or of the Fund's other assets.

There is no support for the erratic and arbitrary way in which Lynch valued the Fund's restricted securities.

In Mates Financial Services,[49/] a case presenting facts analogous to those here involved, the Commission stated (p. 8):

> "The valuation of restricted securities at the market quotations for unrestricted securities of the same class, or at slight discounts from such quotations, is improper except in most unusual circumstances not present here. The valuation procedures followed by Mates. . .give the Fund, whose investment policy and attendant publicity

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49/ Securities Exchange Act Release No. 8836 (March 9, 1970).

> stressed performance, the appearance of a greater appreciation in value than was justified had proper valuation procedures been followed. . .There was thus created a distorted picture of the Fund's performance which affected investors' decisions to redeem or to continue to hold their shares. . . ."

Sections 2(a)(41) and 22 of the Investment Company Act and Rule 2a-4 thereunder, require that in determining net asset value, "securities for which market quotations are readily available" must be valued at current market value while other securities and assets must be valued at "fair value as determined in good faith by the board of directors."[50/] As the Commission stated in Winfield & Co., Inc.:

> "For valuation purposes, restricted securities constitute securities for which market quotations are not readily available and their value must therefore be determined by the directors."

The Commission has recognized that "there can be no automatic formula by which an investment company can value restricted securities in its portfolio. . .," but that "[I]t is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith. . . ."[51/]

Contrary to Lynch's contention, the record establishes abundantly that Clarkson, Gordon participated actively in the reconstruction of the Fund's records and the revaluation of its portfolio securities and in the correction of accounting anomalies. Even had they not done so,

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50/ Securities Exchange Act Release No. 9478, p. 6 (February 9, 1972).

51/ Investment Company Act Release No. 5847 (October 21, 1969).

their certification[52] of the revised valuations and accounts would serve to establish their validity in the absence of any contradictory evidence in the record.

3. Alleged Non-Applicability of §206(1) and 206(2) of the Investment Advisers Act. Respondent Lynch contends that Sections 206(1) and 206(2) of the Investment Advisers Act (15 U.S.C. §80b-6) are inapplicable to him because his employer, UCM, which acted as investment adviser to and manager of the Fund, was not registered under the Investment Advisers Act. To this argument the Division correctly responds that the antifraud provisions of Sections 206(1) and (2), since the 1960 amendments thereto,[53] apply to all investment advisers, whether registered or not.[54] There is thus no merit in

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52/ Clarkson, Gordon submitted its Auditors' Report to the Directors of Fund on April 14, 1970 (Exhibit 14), presenting the financial position of the Fund as at December 10, 1969, ". . .in accordance with generally accepted accounting principles."

53/ Section 8 of P.L. 86-750, 74 Stat. 885.

54/ The legislative history of the amendment, 1960 U.S. Code Cong. and Adm. News, p. 3502, states in part, at p. 3509, as follows:

> "Extension of antifraud provisions to unregistered advisers. Section 8 of the bill would amend the introductory paragraph of section 206 of the act so as to make the antifraud provisions applicable to all investment advisers whether or not registered.
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> * * * * *
>
> "Section 8 of the bill would make the fraud provisions applicable to all investment advisers, whether or not registered. This change follows the pattern now existing in the Securities Act of 1933 and the Securities Exchange Act of 1934. In both of these statutes there are securities or persons who are exempted, for reasons of policy, from registration, and thus from the regulatory jurisdiction of the Commission, but the fraud provisions of the Securities Act and the Securities Exchange Act are nevertheless applicable to them (sec. 17, Securities Act of 1933, secs. 10(b) and 15, Exchange Act of 1934)."

Respondent Lynch's contention.

Conclusions

In general summary of the foregoing, it is concluded that within the period from about December 1, 1967 to about December 10, 1969, Respondent Lynch, in connection with the offer, purchase and sale of the shares of the Fund, and by use of jursidictional means, all as more particularly found above: (1) wilfully violated and wilfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, thereby subjecting himself to sanctions under Section 15(b) of the Exchange Act, and (2) failed reasonably to supervise persons subject to his supervision with a view to preventing violations by such persons of the statutory provisions and Rules mentioned in paragraph (1) next above, thereby rendering himself subject to the imposition of sanctions under Section 15(b)(7) of the Exchange Act.

PUBLIC INTEREST

The kind of fraudulent overvaluation of the Fund's securities and other assets which Respondent Lynch committed, as disclosed by the record, is a threat to the integrity of the mutual-fund industry and to the integrity of the securities markets and to investors and other members of the public who have a right to count on the integrity of such funds

and such markets.[55] Lynch makes no serious effort to attempt to justify the erratic and arbitrary valuations of portfolio securities he made or to justify seriously his computation of net asset values on the basis of inadequate and unreliable books and accounting data. Nor does he explain why he allowed data he knew to be materially false and misleading to be circulated in the Fund's prospectuses.[56] It is quite apparent that Lynch committed, aided and abetted, and allowed these frauds to go on over an extended period of time[57] in order to give the false appearance that the Fund was performing well and in the mistaken belief that the antifraud provisions of the U. S. Securities laws were inapplicable.[58]

55/ The frauds here found are the more reprehensible in that they involved a breach of fiduciary duty on Lynch's part.

56/ Lynch's argument that the Division failed to prove the contents of any foreign-language prospectuses that may have been circulated is not entitled to any substantial weight since there is no proof that foreign-language prospectuses were circulated or that, if they were, they differed materially from the English-language prospectuses received in evidence.

57/ Significant overvaluations occurred for a period of at least 16 months.

58/ Erroneous reliance on advice of counsel to that effect does not excuse Lynch's acts and omissions, though it may be considered in assessing appropriate sanctions.

In mitigation of his conduct, Lynch urges inter alia that he was not directly involved in offering or selling the Fund's shares; that he made diligent efforts to require Chase Manhattan Trust and Rawson Trust to maintain proper and up-to-date records for the Fund and that in view of their failure to do so he made "every effort" to see that accurate "interim" records were maintained (presumably his reference here is to the "interim" records UCM maintained in New York for purposes of computing weekly net-asset values per share for the Fund); that no shareholder suffered any loss due to the overvaluations of the Fund's assets; that no profit accrued to him from the overvaluations; and that the "dilatory tactics of the Division over a 3 year period in failing to bring the Proceeding to a hearing" have caused him considerable hardship.

These contentions have little if any merit. While Lynch was involved in managing the Fund and not selling its shares, he did participate in reviewing the initial prospectus for the Fund and knew that the Fund's shares were being sold under prospectuses that were materially false and misleading. Moreover, these false and misleading aspects of the prospectuses related directly to Lynch's activities on behalf of the Fund.

The record does not support Lynch's claims to diligent concern about the Fund's records. To the contrary, as found above, the record shows that Lynch continued to make or cause to be made weekly calculations of the Fund's net asset value per share on the basis of records

that he knew or should have known to be both inaccurate and inadequate.

The circumstance that the Fund's losses were made good by payments by Chauncey Waddell (and others) and that Fund shareholders were thus spared ultimate financial loss is no credit to Lynch, since he made no contribution towards that end.

While Lynch did not directly "benefit" 59/ from the overvaluation of the Fund's assets in the sense that he was on straight salary and his compensation did not depend on the size of the Fund's assets, nevertheless it is clear, as found above, that Lynch's overvaluations of the Fund's portfolio securities were dictated by his desire to make his Fund's "performance" look better than it was. In short, his conduct makes it clear that he became beguiled and swept up by the cult of fund "performance."

The record does not support the charge that the Division engaged in dilatory tactics. The delay in bringing the proceeding to an early hearing is accounted for by the fact that extended discussions were held with numerous respondents in the proceeding, all of whom eventually settled the proceeding except for Lynch. In addition, a number of motions filed by various respondents challenging the Commission's jurisdiction delayed the setting of an earlier hearing date in this

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59/ The record contains some indication that W&R, UFM, WRI, Oppehneimer, and Lynch were entitled to receive "sponsors shares" in the Fund depending upon how well the Fund performed. However, the Division's briefs do not develop this matter and the record does not contain adequate evidence to warrant a finding on the point.

proceeding. Moreover, the record does not disclose that Respondent Lynch objected to the various postponements prompted by settlement discussions or that he ever moved to set the matter down for early hearing.

There are, however, certain factors which may properly be taken into account in mitigation. Firstly, it appears from the record that Lynch has not heretofore been sanctioned by the Commission or any other regulatory or self-regulatory body for any prior violations of the Securities laws or rules or regulations. Secondly, the record suggests that neither the other respondents named in this proceeding nor the Board of Directors of UCM exercised any effective or meaningful control or supervision over Lynch. While this does not excuse his transgressions, it helps explain why they continued over so long a period. Lastly, the belief, though erroneous, that U. S. securities laws were inapplicable has some value in mitigation.

Although the Division urges that the nature and duration of Lynch's violations are such that a permanent bar is required in the public interest, it is concluded, in light of all the mitigative factors, an assessment of the Respondent's demeanor at the hearing, and on the basis of the entire record herein, that the public interest will be adequately protected by bar orders with provisions that after one year the Respondent may apply to have the bars lifted subject to a showing that he will thereafter be subject to effective supervision or safeguards.

ORDER

Accordingly, IT IS ORDERED that Respondent Robert F. Lynch is hereby barred from association with a broker-dealer, except that after a period of one year from the effective date of this order he may become associated with a registered broker-dealer upon a satisfactory showing to the staff of the Commission that he will be adequately supervised.

IT IS FURTHER ORDERED that Respondent Robert F. Lynch is hereby 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, except that after a period of one year from the effective date of this order these prohibitions may be removed, in whole or in part, upon an adequate showing to the staff of the Commission that he will be adequately supervised or that such lifting of the prohibitions will otherwise be subject to adequate safeguards in the public interest.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice, 17 CFR 201.17(f).

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not within fifteen days after service of this initial decision upon him, filed a

petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party. 60/

David J. Markun
Administrative Law Judge

June 29, 1973
Washington, D. C.

60/ To the extent that the proposed findings and conclusions submitted by the parties, and the arguments made by them, are in accordance with the views herein they are accepted, and to the extent they are inconsistent therewith they are rejected. Certain proposed findings and conclusions have been omitted as not relevant or as not necessary to a proper determination of the issues presented.