

SECURITIES & EXCHANGE COMM.
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CFD NO.

ADMINISTRATIVE PROCEEDING
FILE NO. 3-6729

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

INVESTORS PORTFOLIO MANAGEMENT, :
INC. :

INITIAL DECISION

Washington, D.C.
March 31, 1988

Warren E. Blair
Chief Administrative Law Judge

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INVESTORS PORTFOLIO MANAGEMENT, : INITIAL
INC. : DECISION

APPEARANCES: Barbara Brooke Manning, Nanette A.
King, Bradley Takahashi, and
Kathryn A. Ashbaugh, of the New York
Regional Office of the Commission,
for the Division of Enforcement.

Donald T. Sheldon, for Investors
Portfolio Management, Inc.

Before: Warren E. Blair
Chief Administrative Law Judge.

These public proceedings were instituted pursuant to Section 9(b) of the Investment Company Act of 1940 ("IC Act"), Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") by order of the Commission dated September 26, 1986 ("Order"). The Order directed that a determination be made whether Investors Portfolio Management, Inc. ("IPM") had engaged in the misconduct alleged by the Division of Enforcement ("Division"), and what, if any, remedial action would be appropriate in the public interest.

In substance, the Division alleged that IPM wilfully violated various antifraud provisions of the Advisers Act, Exchange Act, and Securities Act of 1933 ("Securities Act") in connection with the offer and sale of securities of California Muni Fund ("Cal Muni") and California Tax-Free Money Fund ("Tax-Free"), both of which are municipal bond funds registered under the IC Act. The Division also alleged that IPM wilfully aided and abetted wilful violations of the IC Act by Cal Muni in causing Cal Muni (1) to borrow money and deviate from announced investment policies, (2) to sell, redeem, and repurchase its securities at improper prices, (3) to make fee payments to distributors of its securities without an approved distribution plan, and (4) to fail to maintain and keep current a record of each brokerage

order as required by the bookkeeping provisions of the IC Act.

Respondent failed to file an answer within the period specified in the Order, but upon application of Donald T. Sheldon ("Sheldon") on behalf of IPM, the default was set aside and IPM's answer dated December 4, 1986 denying the Division's allegations was accepted for the record. ^{1/}

During the course of the hearing, Sheldon appeared and represented IPM. As part of the post-hearing procedures, successive filings of proposed findings, conclusions, and supporting briefs were specified. Timely filings were made by the Division of its proposed findings of fact, conclusions of law, and brief in support thereof but a counterstatement of proposed findings and conclusions due on or before January 22, 1988 was not filed by IPM.

The findings and conclusions herein are based upon the preponderance of the evidence as determined from the record and upon observation of the witnesses.

^{1/} IPM's amended answer dated January 15, 1987 and received January 21, 1987 denied each and every allegation of the Division set forth in Section II of the Order.

RESPONDENT

IPM, an investment adviser registered pursuant to the Advisers Act since March 2, 1981, was the investment adviser to Cal Muni from on or about March 1, 1983 to on or about September 20, 1985, and was also Tax-Free's investment adviser during the same period.

IPM is the wholly-owned subsidiary of Donald Sheldon Group, a holding company controlled by Sheldon. During the relevant periods Lance Brofman ("Brofman") was president and a director of IPM, and president, treasurer, and portfolio manager of Cal Muni and of Tax-Free.

FRAUD VIOLATIONS

Misrepresentations of Yield on Cal Muni Shares

It appears from the record that from about August, 1984 through June, 1985 IPM, while acting as Cal Muni's investment adviser, wilfully violated the antifraud provisions of the Securities Act, Exchange Act, and Advisers Act by making misrepresentations and failing to disclose material facts relating to the high yields on Cal Muni capital shares and to the method used to obtain that result.

During the relevant period, IPM provided Cal Muni with advice and recommendations on the choice of

investments and execution of securities transactions and had discretionary authority to buy and sell on behalf of Cal Muni. IPM also had authority to determine which securities and the quantities to buy or sell for Cal Muni, the dealers with whom Cal Muni did business, and the terms on which transactions would be executed. Brofman exercised the discretionary authority granted to IPM by Cal Muni, limited only by advice of IPM's compliance director with respect to compliance problems.

Cal Muni's stated objective and purpose set forth in its prospectuses was "to provide investors with as high a level of income that is exempt from Federal and California income taxes as is consistent with the preservation of capital." ^{2/} IPM, which was named in the prospectuses as Cal Muni's investment adviser, was represented in each of the prospectuses as "responsible for maintaining the Fund's portfolio of investments in a manner consistent with the standards specified in this prospectus." ^{3/}

Ignoring the commitment by Cal Muni to provide as high a level of tax-exempt income "as is consistent with the preservation of capital" and in derogation of

2/ Division Exhibits 363, at 3, and 365, at 3.

3/ Id.

its fiduciary duty to Cal Muni and Cal Muni shareholders ^{4/} to act in accordance with its contract with Cal Muni, IPM adopted an investment strategy for Cal Muni that exposed the fund's capital to higher risks than authorized and led to borrowings that exceeded Cal Muni's legal limits. No disclosure of that strategy was made to the trustees of Cal Muni. IPM's strategy as implemented by Brofman sought to increase yields on Cal Muni's portfolio by purchasing a high percentage of bonds which Brofman knew or had reason to believe would not be delivered by settlement date.^{5/} The rationale behind this strategy was to take advantage of the fact that Cal Muni would earn interest on the failed bonds from the date of settlement but would not be obligated to pay for those bonds until actual delivery was made. Thus the delay in payment for failed bonds enabled IPM to use money to purchase additional bonds with funds that it would otherwise have been required to pay out if the failed bonds had been

^{4/} The Advisers Act reflects "a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship.'" S.E.C. v. Capital Gains Research Bureau, Inc. 375 U.S. 180, 191 (1963).

^{5/} Bonds purchased by but not delivered to Cal Muni by settlement date are referred to herein as "failed bonds":

delivered. 6/

IPM's strategy served to increase the amount of interest received by Cal Muni which in turn increased yield to investors in Cal Muni shares. By January 16, 1985 Cal Muni's average seven-day yield reached 15.22% and increased to 17.52% on January 21, 1985. In the same period that Cal Muni's shares were enjoying these yields, bonds in Cal Muni's portfolio were yielding only 9% to 12%, and comparable municipal bond funds were achieving no better than a 9% to 10% yield.

But while Brofman's portfolio strategy succeeded in raising the yield on Cal Muni's shares, it also materially increased risks which were inconsistent with Cal Muni's stated objectives and policies and which were not disclosed to Cal Muni nor to its trustees and shareholders. By using funds that would otherwise have paid for failed bonds to purchase additional bonds, IPM kept Cal Muni moneys more fully invested but increased

6/ As testified to by IPM's former compliance officer in response to a question regarding his discussion of fails with shareholders and potential shareholders who wanted to find out why Cal Muni's yields were higher than other funds:

"I would explain about fails and how in effect when a bond fails you accrue interest but you still have the money for it -- and in effect you're able to invest the same money twice so you can double your yields on that particular dollar." Tr. 103-04.

the risk that Cal Muni would have insufficient funds on hand to pay for the failed bonds when delivered. Also increased was the risk that the amount of borrowing required in order to pay for those delivered bonds would exceed Cal Muni's borrowing limitations. ^{7/} IPM also knew that Brofman's trading practices increased the risk that deliveries of failed bonds could force Cal Muni to liquidate a portion of its portfolio to pay for those deliveries, causing a disruption in Cal Muni's investment strategy and risking unfavorable prices due to market conditions. None of these risks were disclosed by IPM to Cal Muni or its stockholders. Neither was the fact that the extraordinarily high yields were temporary disclosed, nor was the need to exceed normal borrowings to carry out IPM's portfolio strategy revealed.

It is concluded that IPM knew and deliberately withheld from Cal Muni and its shareholders knowledge of the increased risks and of the departures from Cal Muni's objectives and policies which were entailed in the investment strategy pursued by Brofman. By so doing, IPM during the period from about August, 1984 to about June, 1985 wilfully violated Sections 206(1) and (2) of the Advisers Act.

^{7/} In fact, on at least three occasions in 1985 Cal Muni's borrowings exceeded the limitations set forth in Cal Muni's prospectuses. Division Exhibits 363 and 365.

Quite obviously IPM's scheme by which yields significantly higher than comparable municipal bond funds were realized by Cal Muni was devised for the purpose of attracting new investors or additional investments from existing shareholders. Cal Muni advertised high yields in newspapers and on the radio from August, 1984 through September, 1985 and IPM reviewed the advertisements for compliance.

During that same period, IPM received telephone calls daily in which shareholders and prospective shareholders asked the reason for Cal Muni's higher-yields. Those inquiries were answered by a reference to the impact that failed bonds had upon the yield, but the callers were not told of the materially greater risks involved in IPM's investment practices nor of the deviation from the prospectus disclosures.

Other than in response to telephone inquiries IPM made no disclosures to shareholders or prospective shareholders concerning the impact that failed deliveries had on Cal Muni yields.

By participating in the offer and sale of Cal Muni shares, IPM had the obligation to deal fairly with investors and prospective investors in Cal Muni. This it failed to do. Cal Muni shares were offered and sold by use of the mails and instruments of transportation and communication in interstate commerce

and by means of advertisements stressing high yields which did not disclose the temporary nature of those yields nor the risks involved in reaching yields significantly higher than those of competing bond funds.

It is clearly evident that the record sustains the conclusion that IPM, as alleged, wilfully violated Sections 206(1) and (2) of the Advisers Act, Sections 17(a)(1), (2) and (3) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10(b)(5) thereunder by making misrepresentations and by omitting material facts set forth in the above findings.

Misrepresentations as to Tax Exempt Status

From about August, 1984 until about June 1985, Cal Muni prospectuses represented that dividends paid by Cal Muni to its shareholders were potentially exempt from California income tax and that shareholders would be advised within 30 days after the end of a calendar year of the California tax status of the dividends paid during the year. From October 9, 1984 to May 7, 1985, IPM placed advertisements in various publications which stated that dividends paid by Cal Muni to California residents were exempt from California income tax.

In fact, exemption from California income tax was not available for Cal Muni dividends because that tax exemption was limited to dividends distributed by

management companies as defined by Section 17145 of the California Revenue and Tax Code. ^{3/} In turn, Section 17145 relies on Section 2370lm of the California Bank Incorporation Tax Law for a definition of "management company" and the latter section specifies that corporations are "classified as diversified management companies under Section 5 of the Federal Investment Company Act of 1940, and registered as provided in that act."^{9/} Inasmuch as Cal Muni was not a diversified management company but instead was a non-diversified fund within the meaning of Section 5 of the IC Act from on or about September 24, 1984 until November 19, 1985, Cal Muni dividends were not qualified for a tax-exempt status under California law.

The representations that Cal Muni's dividends were tax-exempt under California law are found to be materially false and misleading. It is concluded that by making those false representations in the offer and sale of Cal Muni shares IPM, as alleged, wilfully violated Sections 17(a)(1), (2), and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(4) of the Advisers Act and

8/ Division Exhibit 368.

9/ Division Exhibit 367.

Rule 206(4)-1 thereunder.

VIOLATIONS OF THE INVESTMENT COMPANY ACT OF 1940

Sections 13(a)(2) and (3)

The provisions of Section 13(a)(2) of the IC Act prohibit a registered investment company, unless authorized by the vote of a majority of its outstanding voting securities, from borrowing money "except in accordance with the recitals of policy contained in its registration statement in respect thereto." Section 13(a)(3) of the IC Act provides that no registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities:

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to Section 8(b)(3);

Cal Muni's prospectuses, respectively dated August 23, 1984 and April 29, 1985, represent that borrowing by Cal Muni cannot exceed 20% of its total assets. That limitation was adopted by Cal Muni as a fundamental policy changeable only by a majority vote of its shareholders. In derogation of that 20% limitation and of its existing fundamental policy with respect to borrowing, Cal Muni borrowed money in excess

of the limitation January, 1985 and again in July, 1985. A third excessive borrowing occurred in either April or July, 1985.

Since IPM, acting as Cal Muni's investment adviser and manager at the time of Cal Muni's excessive borrowing, was instrumental in causing Cal Muni's breaches of its borrowing policy, it is concluded that IPM wilfully aided and abetted wilful violations of Sections 13(a)(2) and (3) of the IC Act.

Section 22(c) of the Investment Company Act
and Rule 22c-1 Thereunder.

Under the provisions of Section 22(c) of the IC Act and Rule 22c-1 thereunder a registered investment company issuing a redeemable security must sell, redeem, or repurchase such security at a price "based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."

While IPM was acting as Cal Muni's investment adviser, it determined Cal Muni's net asset value ("NAV") on a daily basis using information provided by Inter-Active Data, an independent pricing service. IPM knew that Inter-Active data priced the bonds in Cal Muni's portfolio at round-lot prices regardless of whether

the bonds being priced were odd-lots or round-lots. The effect of that pricing method was to over-price odd-lots of less than 100 bonds by approximately 1 1/2% to 2% because an odd-lot commanded a market price that much lower than did a round-lot of 100 bonds. Consequently during the period October 9, 1984 to December 28, 1984 when odd-lots constituted nearly 100% of Cal Muni's portfolio, the NAV of that portfolio was consistently over-priced by 1 1/2% to 2%. The end result was that sales and redemptions of Cal Muni shares during that period were made at prices other than Cal Muni's NAV as required by Section 22(c) and Rule 22c-1.

Under the circumstances, it is found that Cal Muni wilfully violated and IPM, its investment adviser and manager during the period in question, wilfully aided and abetted violations of Section 22(c) of the IC Act and Rule 22c-1 thereunder.

Section 12(b) of the Investment Company Act
and Rule 12b-1 Thereunder.

Section 12(b) of the IC Act prohibits a registered investment company from acting as a distributor of securities of which it is the issuer in contravention of rules and regulations prescribed by the Commission. Rule 12b-1 promulgated thereunder provides, inter alia, that a registered, open-end, management company may

distribute its securities if in accordance with a written plan describing the financing of the distribution and if all agreements relating to that distribution are in writing.

Although a written Rule 12b-1 Distribution Plan was entered into by Cal Muni with IPM under which IPM as investment adviser acted in purchasing advertising of shares of Cal Muni and paying for sales literature and other promotional material, the record establishes that neither Cal Muni nor IPM had a written agreement with Donald Sheldon Marketing Services ("DSMS") to market Cal Muni's securities. Despite the absence of a written agreement, it appears that after January 1, 1985 IPM caused Cal Muni to make payments for advertisements to DSMS. Those payments constituted wilful violations by Cal Muni of Section 12(b) of the IC Act and Rule 12b-1 thereunder and it is found that IPM wilfully aided and abetted those wilful violations.

Section 31(a) of the Investment Company Act
and Rule 13a-1(b)(6) Thereunder.

Every registered investment company is required under Section 13(a) of the IC Act to maintain and preserve accounts, books, and other documents as prescribed

by the Commission. Rule 31a-1(b)(6) adopted pursuant to Section 31(a) imposes a duty upon a registered investment company to maintain and keep current a record of each brokerage order given by or on behalf of the investment company which record must, inter alia, include the time of entry of each order.

IPM managed Cal Muni's portfolio through Brofman, and it was he who placed the buy and sell orders for securities on Cal Muni's behalf. In discharging that function Brofman had the responsibility for filling out the order tickets which contained information on each of the orders.

Of the 178 order tickets admitted as exhibits in the record only 89, or 50%, bore sufficient indications of time of placing an order to be considered in compliance with Rule 13-1(b)(6). The other 89 order tickets were found inadequate because they either had no handwritten notation of the time of entry of an order or the time machine stamp imprinted on an order ticket was inconsistent with the date otherwise shown on the ticket.

The failure of Cal Muni to have the required time of order entered on its tickets was a wilful violation of Section 31(a) of the IC Act and Rule 31a-1(b)(6) thereunder. IPM's responsibilities for

advising Cal Muni and managing Cal Muni's portfolio extended to assuring that Cal Muni operated in compliance with applicable laws, rules, and regulations. Having failed to do so, it is concluded that under the circumstances IPM wilfully aided and abetted Cal Muni's wilful violations of Section 31(a) of the IC Act and Rule 13a-1(b)(6) thereunder.

PUBLIC INTEREST

Having found that IPM wilfully violated the anti-fraud provisions of the Securities Act, the Exchange Act, and the Advisers Act and wilfully aided and abetted wilful violations by Cal Muni of various regulatory provisions of the IC Act and rules thereunder, it is necessary to consider the remedial action appropriate in the public interest.

The Division recommends that revocation of the registration of IPM as an investment adviser is the necessary and appropriate sanction to be imposed in the public interest. In support of its recommendation, the Division not only points to the fraudulent activities and other misconduct of IPM charged and proved here, but also refers to the previous disciplinary action taken against IPM.

It appears that on June 4, 1984 the Commission

found that during various periods extending from May 1, 1981 through June 3, 1983, IPM committed wilful violations and wilfully aided and abetted wilful violations which arose from conduct substantially similar to that IPM has been found to have engaged in under charges in these proceedings. ^{10/} The sanction imposed upon IPM was a five-month suspension of its registration as an investment adviser and a five-month limitation with respect to its right to associate with a broker-dealer or act as an investment adviser to certain mutual funds.

Upon consideration of Division's recommendation, the previous disciplinary action against IPM, the facts adduced in this record which reflect disquietingly quick resumption by IPM of the type of misconduct for which it had been previously sanctioned, and the nature and extent of the misconduct here involved, it is concluded that the public interest demands the revocation of the registration of IPM as an investment adviser. It appears that nothing short of revocation will suffice to protect the investing public from further overreaching by

^{10/} Investors Portfolio Management, Inc., 30 SEC DOCKET 1010 (June 4, 1984).

respondent. 11/

ORDER

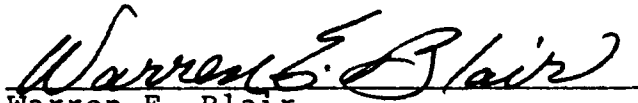
IT IS ORDERED that the the registration of Investors Portfolio Management, Inc., as an investment adviser is revoked.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Rules of Practice.

Pursuant to Rule 17(f) of the Rules of Practice, 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

11/ All proposed findings and conclusions submitted by the parties have been considered, as have their contentions. To the extent such proposals and contentions are consistent with this initial decision, they are accepted.

Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.

A handwritten signature in cursive script that reads "Warren E. Blair". The signature is written in black ink and is positioned above a horizontal line.

Warren E. Blair
Chief Administrative Law Judge

Washington, D.C.
March 31, 1988