

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. IA-1571 / July 16, 1996

ADMINISTRATIVE PROCEEDING
File No. 3-9043

In the Matter of McKenzie Walker Investment Management, Inc. and Richard C. McKenzie, Jr.

**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE- AND-DESIST PROCEEDINGS
PURSUANT TO SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF
1940 AND FINDINGS AND ORDER OF THE COMMISSION**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to institute public administrative and cease and desist proceedings against McKenzie Walker Investment Management, Inc. ("McKenzie Walker") pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and against Richard C. McKenzie, Jr. ("Richard McKenzie") (collectively, "Respondents") pursuant to Sections 203(f) and 203(k) of the Advisers Act.

In anticipation of the institution of these proceedings, McKenzie Walker and Richard McKenzie have submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, without admitting or denying the findings contained herein, except that Respondents admit the jurisdiction of the Commission over them and over the subject matter of these proceedings, McKenzie Walker and Richard McKenzie consent to the issuance of this Order Instituting Public Administrative and Cease and Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 and Findings and Order of the Commission ("Order").

Accordingly, IT IS ORDERED that administrative and cease and desist proceedings pursuant to Sections 203(e), 203(f) and 203(k) of the Advisers Act be, and hereby are, instituted.

II.

On the basis of this Order and the Respondents' Offer, the Commission makes the following findings.

A. FACTS

1. Respondents

McKenzie Walker is, and was at all relevant times, a Delaware corporation, whose principal place of business is in Greenbrae, California. McKenzie Walker has been registered with the Commission as an investment adviser since 1982.

Richard McKenzie, age 54, is a resident of Kentfield, California. He founded McKenzie Walker with a partner in 1982. Since 1990, and during the period of the conduct discussed below, Richard McKenzie has been associated with McKenzie Walker as its sole director, officer, shareholder and primary portfolio manager.

2. McKenzie Walker's Investment Advisory Business

During the relevant period, 1/ McKenzie Walker had approximately 33 accounts with over \$300 million in assets under its management. Richard McKenzie managed the assets of 29 accounts and supervised an assistant who managed the remaining four.

McKenzie Walker charged its clients one of two kinds of fees for its advisory services. Under a performance-based fee arrangement, McKenzie Walker charged a fee of 20% of the gain in the account. Under an asset-based fee arrangement, McKenzie Walker charged from 1% to 3% of the assets under management. During the relevant period, approximately 7 of McKenzie Walker's clients selected an asset-based fee arrangement and approximately 26 clients selected a performance-based fee arrangement. Richard McKenzie managed accounts for a former business partner of McKenzie Walker, one of McKenzie Walker's lawyers, and a former colleague from the mutual fund complex at which Richard McKenzie had been a portfolio manager, all of whom paid a fee based on the accounts' performance.

Richard McKenzie, as McKenzie Walker's primary portfolio manager, ultimately had discretionary trading authority over all client accounts. In allocating purchases and sales of equity securities, Richard McKenzie generally used profitable equity

trades to "smooth" or "boost" an account's performance. A profitable trade was one which resulted in a gain during the time interval between the execution of a trade before the end of a trading day and its allocation to an account at the end of the same trading day.

McKenzie Walker also used hot initial public offerings ("IPOs") to boost the performance of certain accounts.^{2/} McKenzie Walker frequently knew from the broker-dealers with whom it did business if investors had expressed interest in an IPO, and, if so, whether the IPO's share price was expected to rise in the immediate aftermarket. Upon allocation of a hot IPO, Richard McKenzie estimated the amount of profit a designated account could earn from buying and selling the IPO's shares in the aftermarket. In most cases, McKenzie Walker ordered shares of a hot IPO sold into the aftermarket within seven days.

3. McKenzie Walker's Allocation Practices

McKenzie Walker's portfolio managers allocated trades by considering each client's needs and investment objectives, including factors such as the account's cash position, industry weights and the particular securities already in each client's portfolio, and applying the portfolio managers' subjective judgment thereto. Other than the portfolio managers' discretion and application of the factors just mentioned, McKenzie Walker did not prescribe for its portfolio managers any objective procedures or formula for allocating trades among clients or maintain any internal control mechanism to monitor whether portfolio managers allocated trades fairly. McKenzie Walker's compliance officer was not required to review a portfolio manager's allocation practices and no one undertook to assess whether all accounts received an equitable allocation of trades consistent with their investment objectives.

McKenzie Walker's allocation practices resulted in a disparate allocation of profitable equity trades which significantly favored McKenzie Walker's 26 performance-based fee accounts and disfavored its 7 asset-based fee accounts. Similarly, Richard McKenzie's allocation practices as well as the practices of another portfolio manager whose trades Richard McKenzie reviewed and approved, resulted in the allocation of hot IPOs which significantly favored McKenzie Walker's performance-based fee accounts and disfavored its asset-based fee accounts. McKenzie Walker did not disclose these allocation practices to its clients.

As a result of its allocation practices, McKenzie Walker's fees were increased by at least \$224,683.00.

a. McKenzie Walker Failed to Disclose Its Practice of Favoring Its Performance-Based Fee Clients In the Allocation of Equity Trades

Richard McKenzie allocated specific equity trades to accounts after McKenzie Walker's trader had executed his order to buy or sell the securities. As a general practice, he used the time interval between the order execution (which occurred throughout the trading day) and the allocation of the equity trade (at the end of the same trading day) to assess whether the position had gained or lost in relation to the

intervening movement in the market. After observing the market's movement, he relegated the unfavorable purchases and sales to asset-based fee accounts at a far greater rate than to the performance-based fee accounts and, conversely, allocated the profitable trades to performance-based fee accounts at a far greater rate than to the asset-based fee accounts. With respect to securities actually traded in both types of accounts, Richard McKenzie allocated to the performance-based fee accounts approximately 3.7 profitable trades for every 3 unprofitable trades and allocated to the asset-based fee accounts approximately 2 profitable trades for every 3 unprofitable trades. In sum, the performance-based fee accounts received favorable trades at approximately twice the rate of the asset-based fee accounts.

Moreover, among the performance-based fee accounts, Richard McKenzie favored certain clients even more than other performance-based fee accounts. A former business partner of McKenzie Walker, one of McKenzie Walker's lawyers, and a former colleague from the mutual fund complex at which Richard McKenzie had been a portfolio manager, received 5.4 to 7.8 profitable trades for every 3 unprofitable trades. McKenzie Walker did not disclose to its clients either its practice of favoring the performance-based fee accounts generally or its practice of favoring certain performance-based clients specifically in the allocation of equity trades.

b. McKenzie Walker Failed to Disclose Its Practice of Favoring Its Performance-Based Fee Clients in the Allocation of Hot IPOs

Without disclosure to its clients eligible to trade in IPOs, or to any other clients, McKenzie Walker also allocated a substantially disproportionate share of hot IPOs to performance-based fee clients. As with ordinary equity trades, McKenzie Walker's portfolio managers allocated IPOs after their purchase orders for the IPO had been executed and after they had an opportunity to observe the IPO's price rise (or fall) in the aftermarket. Of the \$910,000 in gross trading profits that McKenzie Walker earned for its clients between January 1, 1992 and December 31, 1992 by selling IPOs within seven days, the 7 asset-based fee accounts received only \$18,240 or 2%. The asset-based fee accounts also received \$24,375 in trading losses from poor performing IPOs, for a net loss to that group of \$6,135. In contrast, the 26 performance-based fee accounts received the remaining \$892,095, or 98%, of the gross IPO trading profits and no trading losses.

B. LEGAL ANALYSIS

The Advisers Act imposes on investment advisers an affirmative duty to act in good faith for the benefit of their clients and to disclose fully and fairly all material facts. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

See also *In the Matter of Chancellor Capital Management, Inc.*, Advisers Act Release No. 1447 (October 18, 1994) citing *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Section 206(2) of the Advisers Act prohibits an investment adviser from engaging "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." A violation of Section 206(2) does not require a showing of scienter but may rest on a finding of negligence. *SEC v. Steadman*, 967 F.2d 636, 643, n.5 (D.C. Cir. 1992), citing *Capital Gains Research Bureau*, 375 U.S. at 191- 92.3/ McKenzie Walker willfully violated Section 206(2) of the Advisers Act by failing to disclose to its clients, current or prospective, that it engaged in a practice of generally favoring its performance-based fee clients in the allocation of equity trades and hot IPOs, and specifically favoring certain of its performance-based fee clients over such clients. The omitted facts were material. A reasonable investor, who was contemplating entering into or continuing an advisory arrangement with McKenzie Walker, would consider it important to know of those allocation practices. See also *In the Matter of Thomas H. Richards*, Investment Advisers Release No. 1495 (June 6, 1995); *In the Matter of Account Management Corporation*, Investment Advisers Release No. 1529 (September 29, 1995).

Richard McKenzie rendered "substantial assistance" to McKenzie Walker's violations of Section 206(2) and thereby willfully aided and abetted, and caused, McKenzie Walker's violations of Section 206(2). As the director, president and sole shareholder of McKenzie Walker, Richard McKenzie was responsible for McKenzie Walker's disclosure of material information to clients. As McKenzie Walker's principal portfolio manager, he implemented and sanctioned its allocation practice which resulted in favoritism of performance-based fee clients when allocating equity trades and hot IPOs. Richard McKenzie was also generally aware of an investment adviser's duty to act in good faith for the benefit of all clients.

Based on the foregoing, the Commission finds that:

1. McKenzie Walker willfully violated Section 206(2) of the Advisers Act;
2. Richard McKenzie willfully aided and abetted and caused McKenzie Walker's violations of Section 206(2) of the Advisers Act.

III.

On the basis of the foregoing, it is appropriate and in the public interest to impose the sanctions which are set forth in the Offer submitted by McKenzie Walker and Richard McKenzie.

Accordingly, IT IS ORDERED, that:

- A. McKenzie Walker Investment Management Inc. is censured;
- B. Richard C. McKenzie, Jr. is censured;
- C. Pursuant to Section 203(k) of the Advisers Act, McKenzie Walker shall cease and desist from committing or causing any violations of, and any future violations of, Section 206(2) of the Advisers Act;
- D. Pursuant to Section 203(k) of the Advisers Act, Richard McKenzie shall cease and desist from committing or causing any violation of, and any future violation of, Section 206(2) of the Advisers Act;
- E. McKenzie Walker shall, within thirty (30) days of the entry of the Order, pay disgorgement in the amount of \$224,683 plus \$35,974 in prejudgment interest. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) mailed by certified mail to the Comptroller, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549; and (D) submitted under cover letter which identifies McKenzie Walker as a Respondent in these proceedings, with a copy of said cover letter and money order or check sent to David B. Bayless, District Administrator, Securities and Exchange Commission, 44 Montgomery Street, Suite 1100, San Francisco, CA 94104;
- F. McKenzie Walker shall, within thirty (30) days of the entry of the Order, pay a civil money penalty in the amount of \$100,000. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) mailed by certified mail to the Comptroller, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549; and (D) submitted under cover letter which identifies McKenzie Walker as a Respondent in these proceedings, with a copy of said cover letter and money order or check sent to David B. Bayless, District Administrator, Securities and Exchange Commission, 44 Montgomery Street, Suite 1100, San Francisco, CA 94104.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1/ All findings in this Order relate to the period of August 1, 1992 through September 30, 1993, unless a different time period is specified.

2/ "Hot IPOs" as used in this Order means securities of a public offering that trade at a premium in the secondary market whenever such trading commences.

3/ "Willfully" as used in this Order means intentionally committing the act which constitutes the violation. There is no requirement that the actor also be aware that he is violating the Act. See *Tager v. SEC*, 344 F.2d 5 (2d Cir. 1965).