In the Matter of S SQUARED TECHNOLOGY CORPORATION, Respondent

ADMINISTRATIVE PROCEEDING File No. 3-9055

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940 Release No. 1575

August 7, 1996

ACTION: ORDER INSTITUTING PUBLIC PROCEEDINGS AND FINDINGS, CEASE AND DESIST ORDER, AND ORDER IMPOSING REMEDIAL SANCTIONS

TEXT:

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to institute public administrative proceedings pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), against S Squared Technology Corporation ("S Squared").

In anticipation of the institution of these proceedings, S Squared has submitted an Offer of Settlement ("Offer") to the Commission, 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, and without admitting or denying the findings contained herein, except as to Paragraph II.A., which is admitted, S Squared has consented to the entry of the findings and remedial sanctions set forth below.

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

II.

On the basis of this Order Instituting Public Proceedings, Making Findings, and Imposing Remedial Sanctions ("Order") and S Squared's Offer, the Commission makes the following findings:

RESPONDENT

A. S Squared has been registered with the Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act since October 10, 1986. S Squared has its principal place of business in New York City. Many of S Squared's clients are limited partners in limited partnerships of which S Squared is the general partner.

INTRODUCTION

B. This proceeding involves disclosure violations by S Squared concerning its soft dollar practices. The term "soft dollars" generally describes an arrangement whereby an investment adviser uses commission dollars generated by securities trades executed in advisory client accounts to pay for research, brokerage, or other products, services, or expenses.

THE SOFT DOLLAR ARRANGEMENT

C. In or about June 1989, S Squared entered into a soft dollar arrangement with a broker-dealer ("Broker"). n1 S Squared accrued soft dollar credits at a ratio of 1.7 to 1. Thus, for every $ 1.70 in Broker commissions generated by portfolio trades, S Squared accrued a soft dollar credit of $ 1.00.

n1 After S Squared's president obtained outside legal advice, S Squared established two separate soft dollar accounts with Broker: one for soft dollar credits generated by S Squared's client accounts subject to the Employee Retirement Income Security Act of 1974 ("ERISA") and certain not-for-profit entities whose accounts were treated as if they were ERISA accounts for soft dollar purposes; and one for soft dollar credits generated by S Squared's non-ERISA client accounts. S Squared used the soft dollar credits generated in the ERISA soft dollar account to pay research expenses. This proceeding involves S Squared's practices only with respect to the non-ERISA soft dollar account.

D. S Squared used these soft dollar credits to pay expenses such as its own rent, salaries of its own employees, legal fees, and accounting fees. In early 1990, a lawyer from S Squared's outside law firm advised an employee of S Squared that S Squared should cease using soft dollar credits to pay such expenses as rent and salaries. The employee did not act on this advice, and S Squared continued its soft dollar practices unchanged. From June 1989 through August 1993, S Squared paid a total of $ 867,623.51 in rent, salaries and legal and accounting fees with soft dollar credits. S Squared ceased paying these expenses with soft dollar credits only after Commission staff conducted a routine examination of S Squared in the summer of 1993.

S SQUARED'S SOFT DOLLAR DISCLOSURE

E. On March 30, 1990, S Squared filed the first amendment to its Form ADV after initiation of the soft dollar arrangement (the "1990 ADV").

F. The 1990 ADV included a "no" answer to Part II, Item 13.A., which asks: "Does the applicant . . . have any arrangements . . . where it . . . is paid cash by or receives some economic benefit (including commissions, equipment or non-research services) from a non-client in connection with giving advice to clients?" In light of the soft dollar arrangement, this answer was false.

G. Part II, Item 12. of Form ADV requires investment advisers to disclose the factors they employ in selecting brokers and determining the reasonableness of their commissions. If the value of products, research and services provided by a broker is a factor, then Item 12 requires a description of those products, research and services. S Squared's 1990 ADV contained the following disclosure in response to Part II, Items 12.A.(3) and (4):

The Applicant uses several different broker-dealers at any time in order to have access to research, other services and specific situations, such as underwritings, from different sources and to avoid having one firm know what the Applicant's accounts are invested in. The Applicant negotiates the commission arrangements with the broker-dealers, seeking the best combination of price and execution, as well as taking into account the quality of brokerage and other services. Because the selection of broker-dealers takes into consideration factors in addition to price, transactions will not always be executed at the lowest available commission.

(Emphasis added.) This disclosure failed to state that S Squared was using soft dollar credits generated by its non-ERISA client accounts to pay expenses such as its rent, salaries, legal and accounting fees.

H. S Squared filed the next amendment to its Form ADV on April 30, 1992 ("1992 ADV"). In response to Item 13.A. of its 1992 ADV, S Squared now answered "yes." In addition, S Squared modified the prior disclosure pursuant to Items 12.A.(3) and (4) concerning selection of broker-dealers, as follows (changes are underlined):
The Applicant uses several different broker-dealers at any time in order to have access to research, other services and specific situations, such as underwritings, from different sources and to avoid having one firm know what the Applicant's clients are invested in.

The Applicant negotiates the commission arrangements with the broker-dealers, seeking the best combination of price and execution, as well as taking into account the quality of brokerage and other products and services furnished by the broker-dealers.

* * *

Because the selection of broker-dealers takes into consideration factors in addition to price, transactions will not always be executed at the lowest available commission, although in most cases the commission charges would be the same.

I. S Squared also provided the following additional disclosure in the 1992 Form ADV:

> The Applicant directs a substantial amount of its brokerage business to one broker-dealer because of that firm's ability to execute large orders in a single transaction, willingness to commit capital and market-making activities. Such firm provides the Applicant with research material and other services used by the Applicant in its investment decision making process, such as quotation systems, exchange fees and access to wire services (with respect to ERISA and trust accounts), and, with respect to partnership and certain other accounts which by agreement specifically permit their assets to be used for the Applicant's direct administrative expenses, provides reimbursement of a portion of such administrative expenses.

J. The 1992 ADV disclosure still failed to disclose that S Squared was using soft dollar credits to pay expenses such as its rent, salaries, legal fees, and accounting fees. In addition, this disclosure was false and misleading insofar as it referred to administrative expenses being paid only by partnership and other accounts which "by agreement specifically permit their assets to be used" for S Squared's "direct administrative expenses." At the time, S Squared managed only one account that made such provision, but S Squared did not limit the payment of "administrative expenses" to soft dollar credits generated by that account. Rather, S Squared was continuing to pay its expenses with soft dollars generated by all of the non-ERISA accounts.

III.

INFORMATION CONCERNING AN INVESTMENT ADVISER'S SOFT DOLLAR ARRANGEMENTS IS MATERIAL

A. An investment adviser has a duty to disclose to clients all material information which might incline an investment adviser consciously or unconsciously to render advice which is not disinterested. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963). A fact is material if there is a substantial likelihood that a reasonable investor would consider it important. Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

B. Soft dollar arrangements are material because of the potential conflict of interest arising from an adviser's receipt of some benefit in exchange for directing brokerage on behalf of client accounts. See Kingsley, Jennison, McNulty & Morse, Inc., 55 SEC Docket 2434, 2441-42 (Dec. 23, 1993); Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 23170, 35 SEC Docket 905, 909 (Apr. 23, 1986) ("1986 Soft Dollar Release").

C. Moreover, disclosure of soft dollar arrangements is specifically required by Form ADV. n2 Form ADV embodies mandatory disclosure requirements to ensure that material information regarding brokerage placement practices and policies is disclosed to investors. See Investment Adviser Requirements Concerning Disclosure, Recordkeeping, Applications for Registration and Annual Filings, Advisers Act Rel. No. 664 (Jan. 30, 1979); Disclosure of Brokerage Placement Practices By Certain Regulated Investment Companies and Certain Other Issuers, Advisers Act Rel. No. 665 (Jan. 30, 1979) ("1979 Soft Dollar Release").

> n2 The "safe harbor" provided by Section 28(e) of the Securities Exchange Act of 1934 does not excuse an investment adviser from these disclosure obligations. The safe harbor only protects an investment adviser from charges of breach of fiduciary duty for failing to obtain the lowest available commission rate where the amount of commission is reasonable in relation to the value of brokerage and research services provided. 1986 Soft Dollar Release, 35 SEC Docket at 907 n.10.

D. Items 12 and 13, and Schedule F, of Part II of Form ADV require registrants to disclose soft dollar arrangements with broker-dealers. For investment advisers who have discretionary authority to select the broker-dealers to be used to execute trades in client accounts, Item 12.B. requires a description of the factors considered in selecting brokers and determining the reasonableness of their commissions. Further, Item 12.B. requires advisers to describe the "products, research and services" received from broker-dealers, if the value of such "products, research and services" is a factor in selecting broker-dealers. n3 Item 13 requires an investment adviser to disclose and describe any arrangement whereby it receives an economic benefit from a non-client in connection with giving advice to clients. These disclosure requirements are designed to "assist clients in determining whether to hire an adviser or continue a contract with an adviser, and permit them to evaluate any conflicts of interest inherent in the adviser's arrangements for allocating brokerage." Kingsley, 55 SEC Docket at 2441-42.

> n3 See 1986 Soft Dollar Release, 35 SEC Docket at 909. There is a presumption that receipt of non-research and non-brokerage products or services, except where nominally valued, is a factor in the selection of brokers. 1979 Soft Dollar Release at n.6.

E. S Squared's omissions and false and misleading disclosures regarding its soft dollar arrangement were material.

THE 1990 ADV

F. S Squared's "no" answer to Item 13.A., in the 1990 ADV was false. S Squared was in fact receiving an economic benefit from Broker, a non-client, in the form of soft dollar credits. n4

> n4 The 1986 Soft Dollar Release noted the relevance of Form ADV, Part II, Item 13 to soft dollar disclosure. 35 SEC Docket at 909 n.32.

G. The vague reference in the 1990 ADV to "research, other services and specific situations, such as underwritings" was not adequate disclosure. Overhead expenses are not "research." 1986 Soft Dollar Release, 35 SEC Docket at 907 n.10. Moreover, the 1986 Soft Dollar Release indicates that a greater degree of specificity is required. This Release states, with regard to research expenses:

An adviser need not list individually each product, item of research, or service received, but rather can state the types of products, research, or services obtained with enough specificity so that clients can understand what is being obtained. Disclosure to the effect that various research reports and products are obtained would not provide the specificity required.

Id. at 909 n.29 (emphasis added). The Release also emphasizes that "the disclosure made in response to Item 12 should provide sufficient information to enable a client or potential client to understand [brokerage] policies and practices." Id. at 909. See Kingsley, 55 SEC Docket at 2443. n5

> n5 Even apart from the vagueness of the phrase "other services," the payment of rent is not payment for a "service."

THE 1992 ADV

H. Although S Squared's 1992 ADV contained modifications of the disclosure contained in Item 12, Schedule F, it still failed to disclose that S Squared was using soft dollar credits to pay rent, salaries, legal fees, and accounting fees. The insertion of the phrase "direct administrative expenses" provided little additional meaningful information to investors. See Kingsley, 55 SEC Docket at 2443. Moreover, the statement in Item 12, Schedule F, of S Squared's 1992 ADV that certain administrative expenses were being reimbursed by partnership and other accounts, which "by agreement specifically permit their assets to be used" for S Squared's "direct administrative expenses" was untrue because only one of the partnership agreements provided that partnership assets could be used in this way.

VIOLATIONS OF SECTION 207 OF THE ADVISERS ACT

I. Section 207 of the Advisers Act provides that it shall be unlawful for any person willfully to make any untrue statement of material fact in any registration application or report filed with the Commission or willfully to omit to state in any such application or report any material fact required to be stated therein. n6

> n6 Section 204 of the Advisers Act and Rule 204-1 thereunder require periodic filing and amendment of Forms ADV by investment advisers. Pursuant to Rule 204-1(d), a Form ADV or an amendment thereto is a "report" within the meaning of Section 207.

J. A finding that a respondent acted "willfully" does not require a finding of specific intention to violate the law or awareness that the law is being violated, or proof of scienter. See Kingsley, Jennison, McNulty & Morse, Inc., Admin. Proc. File No. 3-7446, 50 SEC Docket 383, 415-16 (Nov. 14, 1991), aff'd, 55 SEC Docket 2434 (Dec. 23, 1993). It is enough that the respondent intended to perform the acts that constitute the violation or, if charged with a duty to act, failed to meet his responsibility. Tager v. SEC, 344 F.2d 5 (2d Cir. 1965). Here, under the "mandatory disclosure standards" embodied in Form ADV, S Squared had a duty to file Forms ADV that were not false or misleading and that did not omit to state material facts required to be stated therein.

VIOLATIONS OF SECTION 206(2) OF THE ADVISERS ACT

K. Section 206 of the Advisers Act makes it unlawful, inter alia, for an investment adviser to make materially false or misleading statements or omissions to any client or prospective client. An investment adviser's failure to disclose a material conflict of interest violates Section 206. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

L. Section 206(2) establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); Chancellor Capital Management, Inc., Investment Advisers Act Rel. No. 1447, 57 SEC Docket 2489, 2500 (Oct. 18, 1994). This fiduciary duty includes the duty to exercise the utmost good faith in dealings with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients. Capital Gains, 375 U.S. at 194; Chancellor Capital, 57 SEC Docket at 2500. Proof of scienter is not required to establish a violation of Section 206(2). Capital Gains, 375 U.S. at 195.

M. In view of restrictions in certain of the partnership agreements concerning payment of expenses incurred by S Squared, S Squared breached its duty to exercise the utmost good faith in its dealings with clients. In addition, the representations in the 1992 ADV would reasonably lead investors in all but one of the partnerships to believe -- incorrectly -- that commissions generated by their accounts were not being used to pay S Squared's own expenses. In fact, S Squared was using soft dollar credits generated by certain of its non-ERISA accounts to reimburse its administrative expenses, regardless of the terms of the client agreements.

IV.

As a result of the foregoing, in or about June 1989 through in or about August 1993, S Squared willfully violated Sections 207 and 206(2) of the Advisers Act.

V.

Respondent has represented in its Offer of Settlement that, prior to the commencement of this proceeding, Respondent has terminated all soft dollar arrangements and currently has no such arrangements.

VI.

In view of the foregoing, it is in the public interest to impose the sanctions specified in the Offer of Settlement.

Accordingly, IT IS HEREBY ORDERED that S Squared:

A. shall cease and desist from committing or causing any violation and any future violation of Sections 207 and 206(2) of the Advisers Act;

B. shall, within ten (10) days of the date of this Order, disgorge the sum of $ 878,250.31 to the appropriate advisory clients, representing the amount of expenses paid with soft dollar credits, plus the sum of $ 275,175.00, representing prejudgment interest thereon; n7

> n7 The Commission notes that, subsequent to the commencement of the Commission's investigation, but prior to the entry of this Order, S Squared paid the sum of $ 878,250.31 plus $ 275,175.00 to advisory clients, in satisfaction of the requirement that S Squared pay disgorgement and interest.

C. shall, within ten (10) days of the date of this Order, pay a civil money penalty in the amount of $ 50,000 to the United States Treasury. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the Securities and Exchange Commission; (3) delivered to the Comptroller, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549; and (4) submitted under cover letter which identifies S Squared as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Wayne M. Carlin, Assistant Regional Director, Northeast Regional Office, Securities and Exchange Commission, 7 World Trade Center, 13th Floor, New York, NY 10048;

D. shall comply with its undertakings, in the event that S Squared determines to enter into any new soft dollar arrangement, promptly to notify the Commission by letter to the Commission's Northeast Regional Office, 13th Floor, New York, New York 10048, to the attention of the Regional Director. In that event, S Squared shall also retain, at its own expense, a consultant not unacceptable to the Commission's staff, who shall review S Squared's policies and procedures with respect to direction of brokerage and who shall make such recommendations as are necessary with respect to S Squared's policies and procedures so that they may be reasonably designed to ensure that S Squared's soft dollar practices will comply with the federal securities laws. Within 30 days after S Squared's notification to the Commission, the consultant shall issue a report setting forth its findings and recommendations and shall forward the same to the Commission's New York Regional Office, 13th Floor, New York, New York 10048, to the attention of the Regional Director. S Squared shall implement the consultant's recommendations before implementing the soft dollar arrangement, provided, however, that as to any of the consultant's recommendations that S Squared determines is unduly burdensome or impractical, S Squared may suggest an alternative procedure designed to obtain the same objective, submitted in writing to the consultant and to the staff of the Commission. The consultant shall reasonably evaluate S Squared's alternative procedure and approve the alternative if it is not unreasonable. S Squared will abide by the consultant's determination with regard thereto and adopt those recommendations deemed appropriate by the consultant. The Commission's staff shall notify S Squared of any objection to the consultant's recommendations within 15 days of the staff's receipt of the consultant's report.

By the Commission.