

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Investment Advisers Act of 1940
Release No. 1765 / September 29, 1998

Administrative Proceeding
File No. 3-9744

In the Matter of RHUMBLINE ADVISERS and JOHN D. NELSON, Respondents

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTIONS 203(e) AND 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against RhumbLine Advisers ("RhumbLine"), and John D. Nelson, ("Nelson") (collectively, the "Respondents").

II.

In anticipation of the institution of these administrative proceedings, the Respondents have submitted Offers of Settlement ("Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings, and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings contained herein, except those findings pertaining to the jurisdiction of the Commission over them and over the subject matter of these proceedings, which they admit, the Respondents each consent to the entry of the findings and the Order set forth herein.

III.

On the basis of this Order and the Offers submitted by the Respondents, the Commission finds that: [1]

A. Respondents

1. RhumbLine is located in Boston, Massachusetts and is registered with the Commission as an investment adviser. (File No. 801-37845). The firm has approximately nine employees, 50 clients and \$3.7 billion of assets under management. RhumbLine's business consists primarily of managing equity index funds for public and private pension plans.

2. Nelson is the founder and was at all relevant times the chief executive officer ("CEO") of RhumbLine. During the times relevant herein, Nelson was responsible for all of RhumbLine's operations and investment management activities.

B. Other Relevant Person and Entities

1. From 1991 through October 1996, RhumbLine employed a chief investment officer ("CIO") who was responsible for developing and implementing an options trading program to complement RhumbLine's management of equity index funds.

2. AT&T Corp., a New York corporation engaged in the telecommunications business, administered during the relevant time employee benefit and pension plan assets through its subsidiary, AT&T Investment Management Corporation ("AT&T"). From 1992 through September 1996, AT&T was a client of RhumbLine's options trading program. AT&T also was a client of another RhumbLine investment program not involved in this matter.

3. Massachusetts Pension Reserves Investment Trust ("PRIT") contains the assets of the Massachusetts state employee and teachers retirement system. From 1992 through September 1996, PRIT was a client of RhumbLine's options trading program. PRIT also was a client of other RhumbLine investment programs not involved in this matter.

C. Findings

1. Summary

This matter involves RhumbLine's and Nelson's failure adequately to supervise the CIO. From January 1995 through September 1996, the CIO engaged in certain unauthorized trading and concealed and misrepresented losses in the AT&T options account, and engaged in certain unauthorized trading in the PRIT account in violation of the antifraud provisions of the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), and the Advisers Act. As a result, the AT&T options account, sustained losses through September 23, 1996 of approximately \$150 million.[2] The PRIT options account sustained losses of approximately \$12 million. The CIO was able to place unauthorized trades and misrepresent losses in part because RhumbLine and Nelson failed to respond to certain red flags, which should have alerted them to the CIO's activities. Further, RhumbLine did not have procedures to monitor the CIO's trading or his reporting of performance. Consequently, RhumbLine and Nelson failed reasonably to supervise the CIO with a view to detecting and preventing his securities law violations.

2. Unauthorized Trading and Misstatements of Losses in the AT&T Options Account

In 1991, RhumbLine hired the CIO, who had presented to RhumbLine a plan to develop the options trading program. RhumbLine eventually obtained four clients for the options program, including AT&T and PRIT. Prior to retaining the CIO and after his departure, RhumbLine did not engage in options trading on behalf of its clients.

The investment objective for the AT&T options account was to earn consistent, incremental premium income by writing: (1) call options on stocks and sector indices contained in a \$165 million Standard & Poor's ("S&P") portfolio; and (2) put and call option spreads on the S&P 100 and S&P 500 indices. AT&T and RhumbLine executed written account guidelines, which prohibited certain trades, including in-the-money options; naked, short S&P 100 and S&P 500 options; S&P 100 and S&P 500 options that exposed the account to a risk of loss greater than \$6 million; and options written against greater than approximately \$25 million in technology sector assets.

From January 1995 through September 1996, the CIO engaged in unauthorized trading in the AT&T account by placing options trades that represented attempts to profit on the future direction of the market. When his strategy was not successful, the CIO rolled positions forward and thereby avoided having to realize losses. Such trading was inconsistent with AT&T's investment objective of seeking only premium income. Some of the CIO's trading also violated the written guidelines governing the account. He wrote naked, short S&P 100 and S&P 500 index options, and he exposed the account to a risk of loss greater than its \$6 million loss constraint. The CIO wrote options against hundreds of millions of dollars of technology sector assets, instead of the approximately \$25 million permitted by the guidelines.

During the third quarter of 1996, the CIO concealed his unauthorized trading by misrepresenting and failing to disclose losses in the AT&T options account. On July 19, 1996; August 6, 1996; and August 29, 1996, in written and oral performance reports to representatives of AT&T, the CIO falsely understated losses by approximately \$26 million to \$43 million. The CIO did not disclose the account's mounting losses to representatives of AT&T. Upon learning of the losses, Nelson informed AT&T on September 19,

1996. AT&T thereafter suspended trading in the account. Total losses in the AT&T options account from January 1996 through September 23, 1996 were approximately \$150 million. [3]

3. Unauthorized Trading in the PRIT Account

The investment objective for the PRIT options account was to earn incremental premiums by writing S&P 100 and S&P 500 index option spreads. PRIT and RhumbLine executed written guidelines, which prohibited, among other things, writing options that exposed the account to a risk of loss greater than four percent of the value of PRIT's underlying stock portfolio, as of the beginning of the year.

In the PRIT account, as in the AT&T account, beginning in April 1995, instead of following the investment objective of earning incremental premium income, the CIO attempted to profit on the future direction of the market. He wrote in-the-money and at-the-money options, and he rolled positions forward to avoid realizing losses. On at least three occasions, the CIO violated PRIT's written guidelines by exceeding the account's four percent loss constraint. On September 18, 1996, Nelson, who had not previously known that the CIO had exceeded PRIT's loss constraint, informed PRIT of the losses. Total 1996 losses in the PRIT options account were approximately \$12 million. [4]

By the conduct described above, the CIO violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and he aided and abetted violations of Sections 206(1) and 206(2) of the Advisers Act.

4. Nelson Failed to Detect the CIO's Unauthorized Trading

Certain red flags should have alerted Nelson to the CIO's activities. During the spring of 1995, Nelson reviewed the positions in the clients' accounts and determined that the CIO had written uneven numbers of put and call option spreads on the S&P 100 and S&P 500 indices. Although this was an indication that the CIO was trading in a manner that was inconsistent with the accounts' investment objectives, Nelson took no additional steps to detect or prevent unauthorized trading by the CIO. During the summer of 1996, Nelson noticed options written against technology sector assets in the AT&T account in an amount in excess of the \$25 million limit contained in AT&T's written guidelines. He questioned the CIO, who asserted that AT&T had authorized him to write the positions. Despite knowing that the written guidelines prohibited positions of the size written, Nelson failed unreasonably to verify the CIO's assertion. Finally, Nelson knew that, in early 1996, the AT&T account had sustained large losses, and that AT&T had expressed concern about those losses. Despite this knowledge, he did not institute additional procedures to monitor the CIO's trading.

Nelson allowed the CIO to exercise complete control over all aspects of the options trading program, and no one regularly checked his trades to ensure that they complied with client guidelines. In addition, the CIO had complete control over calculating and reporting performance for the options accounts.

5. RhumbLine Lacked Controls and Procedures Relating to Options

RhumbLine had no policies or procedures designed to detect or prevent unauthorized trading in the options clients' accounts. The firm had no system for risk management or for monitoring the CIO's trading. Nelson relied exclusively on unverified oral reports from the CIO to monitor the options trading program. There was no segregation of responsibility for placing and valuing trades. Moreover, there was no procedure to ensure that the CIO correctly calculated or adhered to client loss constraints.

D. Failure Reasonably to Supervise

1. Standards of Supervision

Under Sections 203(e)(6) and 203(f) of the Advisers Act, the Commission may seek sanctions where an investment adviser or an associated person has failed reasonably to supervise, with a view to preventing violations of the federal securities laws and rules thereunder, another person subject to the investment

adviser's or associated person's supervision who commits such violations. See Van Kampen American Capital Asset Mgmt., Advisers Act Rel. No. 1525 (Sept. 29, 1995), 60 SEC Docket 1284; Kemper Fin. Serv., Inc., Advisers Act Rel. No. 1494 (June 6, 1995), (settlement). The Commission has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme. See John H. Gutfreund, Exchange Act Rel. No. 31554 (Dec. 3, 1992), 52 SEC Docket 4370, 4386. Management bears responsibility for ensuring that procedures reasonably designed to prevent and detect wrongdoing are adopted, and to take appropriate steps if it receives indications that such procedures are not working. First Capital Strategists, Advisers Act Rel. No. 1648 (Aug. 13, 1997), (investment adviser and its partners failed to supervise trader who engaged in unauthorized trading; noting that it was insufficient to rely on trustworthiness of trader without independently reviewing positions); Van Kampen American Capital Asset Mgmt., 60 SEC Docket at 1284 (finding that investment adviser failed to supervise because it gave complete control over pricing procedures to portfolio manager).

Supervisors must respond vigorously to indications of possible wrongdoing. See Kemper Fin. Serv., Inc.; see also Gutfreund, 52 SEC Docket at 4386-87; Wedbush Sec., Inc., 48 S.E.C. 963, 967 (1988) (especially imperative that those in authority exercise particular vigilance when indications of irregularity reach their attention). Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the federal securities laws. Kemper Fin. Serv., Inc., (quoting Edwin Kantor, Exchange Act Rel. No. 32341 (May 20, 1993), 54 SEC Docket 293, 301); see also Michael H. Hume, Exchange Act Rel. No. 35608 (Apr. 17, 1995), (a failure to supervise can arise where a supervisor was aware only of red flags or suggestions of irregularity); Frederick H. Joseph, Exchange Act Rel. No. 32340 (May 20, 1993), 54 SEC Docket 283, 291. The Commission has consistently stressed the importance of vigilant supervision. See, e.g., Smith Barney, Harris Upham & Co., Exchange Act Rel. No. 21813 (March 5, 1985), 32 SEC Docket 999, 1010.

2. RhumbLine And Nelson Failed Reasonably to Supervise the CIO

As a result of the conduct described above, RhumbLine and Nelson failed reasonably to supervise the CIO, who was subject to their supervision within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing his violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and his aiding and abetting of violations of Sections 206(1) and 206(2) of the Advisers Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offers of Settlement submitted by RhumbLine and Nelson and to impose the sanctions agreed to in the Offers.

V.

Accordingly, IT IS HEREBY ORDERED, pursuant to Sections 203(e), 203(f) and 203(i) of the Advisers Act, that:

- A. Nelson be, and hereby is, suspended from association with any investment adviser for a period of three months, effective on the second Monday following the entry of this Order;
- B. Nelson be, and hereby is, suspended from acting in any supervisory or proprietary capacity with any investment adviser for a period of nine months immediately following the period of his suspension from association;
- C. Nelson shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$10,000 to the United States Treasury. Such payment shall be: (a) made by United States postal money order, certified check, bank cashier's check or bank money order; (b) made payable to the Securities and Exchange Commission; (c) hand-delivered or mailed to the Office of the Comptroller, U.S. Securities

and Exchange Commission, 6432 General Green Way, Stop 0-3, Alexandria, Virginia; and (d) submitted under cover of a letter which identifies Nelson as a Respondent in these proceedings, the file number of these proceedings and the Commission's case number. A copy of the cover letter and money order or check shall be sent to Juan Marcel Marcelino, District Administrator, Securities and Exchange Commission, Boston District Office, 73 Tremont Street, Suite 600, Boston, Massachusetts, 02108;

D. RhumbLine be, and hereby is, censured;

E. RhumbLine shall, within 45 days of the entry of this Order, pay a civil monetary penalty in the amount of \$50,000 to the United States Treasury. Such payment shall be: (a) made by United States postal money order, certified check, bank cashier's check or bank money order; (b) made payable to the Securities and Exchange Commission; (c) hand-delivered or mailed to the Office of the Comptroller, U.S. Securities and Exchange Commission, 6432 General Green Way, Stop 0-3, Alexandria, Virginia; and (d) submitted under cover of a letter which identifies RhumbLine as a Respondent in these proceedings, the file number of these proceedings and the Commission's case number. A copy of the cover letter and money order or check shall be sent to Juan Marcel Marcelino, District Administrator, Securities and Exchange Commission, Boston District Office, 73 Tremont Street, Suite 600, Boston, Massachusetts, 02108;

F. RhumbLine shall comply with its undertakings to:

1. retain, at its own expense, within 30 days of the entry of this Order, the services of an independent consultant (the "consultant") who is not unacceptable to the Commission staff and who shall review RhumbLine's supervisory, compliance and other policies and procedures designed to prevent and detect federal securities law violations of the nature and type involved in this matter and recommend policies and procedures designed reasonably to prevent and detect such violations.
2. provide to the Commission staff, within 10 days from the date of engagement, a copy of an engagement letter detailing the consultant's responsibilities pursuant to subparagraph 1., above;
3. require the consultant to make his or her conclusions and recommendations within three months from the date of the engagement in the form of a report, which shall set forth in detail the nature and scope of the review conducted, as well as the conclusions and recommendations of the consultant. RhumbLine shall cooperate fully with the consultant and provide such person with access to its files, books, records and personnel as reasonably requested for such person's review;
4. require the consultant promptly to provide copies of its report, referenced above, to the Commission staff, and to discuss the findings therein with the Commission staff;
5. take all necessary and appropriate steps to adopt and to implement all recommendations of the consultant, provided, however, that as to any of the consultant's recommendations that RhumbLine determines is unduly burdensome or impractical, RhumbLine may suggest an alternative procedure designed to achieve the same objective, by submitting it in writing to the consultant and the Commission staff. The consultant shall reasonably evaluate RhumbLine's alternative procedure. RhumbLine shall abide by the consultant's determination with regard thereto and shall adopt those recommendations deemed appropriate by the consultant: and
6. ensure that for the period of engagement and for a period of two years from completion of the engagement, the consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with RhumbLine, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. Any firm with which the consultant is affiliated or of which he/she is a member, and any person engaged to assist the consultant in performance of his/her duties under this Order shall not, without prior written consent of the Boston District Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with RhumbLine, or any or its present or former

affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of engagement and for a period of two years after the engagement; and

G. RhumbLine shall comply with its undertaking to appoint a director of compliance, whose employment shall be pursuant to a written contract approved by RhumbLine's Advisory Board, and whose compensation shall be set by the Board; shall define the duties of such officer, including the development of a written manual of firm compliance procedures for approval by the CEO and the Board; and shall ensure that such officer is subject to the direct supervision of, and reports to, RhumbLine's CEO.

IT IS FURTHER ORDERED that, within nine months from the entry of this Order, RhumbLine shall provide an affidavit via certified mail to Juan Marcel Marcelino, District Administrator, Securities and Exchange Commission, Boston District Office, 73 Tremont Street, Suite 600, Boston, Massachusetts 02108, that it has complied with its undertakings set forth in paragraphs F. and G., above. Such affidavit shall contain a statement describing the procedures adopted and implemented in compliance with paragraph (4) above.

IT IS FURTHER ORDERED that, within 30 days after the expiration of the suspensions described in paragraphs B. and C., above, Nelson shall provide an affidavit via certified mail to Juan Marcel Marcelino, District Administrator, Securities and Exchange Commission, Boston District Office, 73 Tremont Street, Suite 600, Boston, Massachusetts 02108, setting forth with particularity the details of his compliance with the suspensions. Respondent Nelson shall not act in a supervisory or proprietary capacity until he delivers such affidavit.

By the Commission.

Jonathan G. Katz
Secretary

FOOTNOTES

[1]: The findings herein are not binding on anyone other than the Respondents.

[2]: Total pension assets held by AT&T during the relevant time were approximately \$47 billion.

[3]: The other AT&T account at RhumbLine was not affected by the matters discussed in this paragraph.

[4]: The other PRIT accounts at RhumbLine were not affected by the matters discussed in this paragraph.