

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**INVESTMENT ADVISERS ACT OF 1940**  
**RELEASE NO. 2153 / July 31, 2003**

**INVESTMENT COMPANY ACT OF 1940**  
**RELEASE NO. 26142 / July 31, 2003**

**ADMINISTRATIVE PROCEEDING**  
**FILE NO. 3-11197**

**In the Matter of JOHN McSTAY INVESTMENT COUNSEL L.P., Respondent.**

**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940**

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against John McStay Investment Counsel L.P. ("JMIC" or "Respondent").

**II.**

In anticipation of the institution of these proceedings, JMIC has 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 to which the Commission is a party, the Respondent, by its Offer, admits the jurisdiction of the Commission over it and over the subject matter of these proceedings, and consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), without admitting or denying the Commission's findings contained in this Order.

**III.**

On the basis of this Order and Respondent's Offer, the Commission makes the following findings<sup>1</sup>:

**Respondent**

1. John McStay Investment Counsel L.P. has been registered with the Commission as an investment adviser since December 14, 1983. JMIC serves as investment adviser for the Brazos Small Cap Portfolio ("Brazos Small Cap"), Brazos Micro Cap Portfolio ("Brazos Micro Cap"), and Brazos Multi Cap Portfolio ("Brazos Multi Cap") (collectively, the "Brazos Portfolios"), and the other series within the Brazos Mutual Funds, a registered investment company. JMIC also serves as investment adviser to private institutional clients.

## **Related Entity**

2. The Brazos Mutual Funds ("Brazos") has been registered with the Commission as an open-end investment company since December 1996. Brazos issues multiple series of shares; each series is identified as a particular "Portfolio." Included among the Portfolios issued by Brazos are the Brazos Small Cap, created on December 31, 1996, the Brazos Micro Cap, created on December 31, 1997, and the Brazos Multi Cap, created on December 31, 1998.

## **Summary**

3. From January 1, 1997 through December 31, 1999, JMIC implemented a new Initial Public Offering ("IPO") stock allocation procedure which provided that IPO shares would be allocated to the Brazos Portfolios unless JMIC received a sufficient quantity of IPO shares to allocate them among all its managed accounts consistent with the investment strategy for those accounts. The allocation of IPO shares to its advisory client, Brazos, under this procedure helped Brazos generate rates of return in its first year which placed Brazos at or near the top percentile in independent performance evaluations of comparable mutual funds.<sup>2</sup> Despite the large impact that IPO shares had on its Portfolios' return, Brazos failed to disclose in its Commission filings the fact that it had acquired a substantial amount of IPO stock or the significant effect the IPO shares had on Brazos' first year performance. Additionally, Brazos failed to disclose that given the growth in total assets, it was questionable whether Brazos could continue to experience, by investing in IPOs, substantially similar performance as it had previously experienced.

4. JMIC's new IPO allocation procedure, by resulting in the distribution of IPO shares to the Brazos Portfolios when there was an insufficient quantity to allocate shares to all of JMIC's managed accounts, effectively favored the Brazos Portfolios over JMIC's other advisory clients. JMIC failed to disclose adequately to some of its clients the change in IPO allocation procedure. Additionally, JMIC failed to disclose to its clients a potential conflict of interest that arose when JMIC's managers made personal investments in the Brazos Portfolios after the change in JMIC's IPO allocation procedure.

## **JMIC's Allocation of IPO Shares**

5. Prior to instituting the new IPO allocation procedure, JMIC's clients received in their accounts IPO shares on a rotational basis in those instances where the quantity of shares available to JMIC was insufficient to allocate IPO shares to all clients. After the institution of the new procedure in January 1997, JMIC allocated the available IPO shares to Brazos if the total value of shares available to JMIC from a given IPO was insufficient to enable JMIC to distribute to each and every JMIC client a portion of those shares equal in value to a pre-determined percentage of the current value of each JMIC client account (e.g., from .3% to .5%). In other words, only Brazos continued to receive those IPO shares that could not be broadly allocated. The percentage was a minimum purchase threshold applied uniformly to all JMIC clients. The new IPO allocation procedure differed from JMIC's prior IPO allocation procedure, whereby all JMIC advisory clients were afforded an opportunity to acquire IPO shares on a rotation basis regardless of the quantity available to JMIC.

## **Brazos Failed to Disclose in its Commission Filings the Large Impact of IPO Stock on Brazos' Performance**

6. JMIC's IPO allocations enhanced the performance of the Brazos Portfolios, enabling them to achieve exceptional returns during their first year - a tendency typical of IPOs generally. On December 31 of 1996, 1997 and 1998, JMIC created, respectively, the Brazos Small Cap, Brazos Micro Cap and Brazos Multi Cap Portfolios. During the first year of each Portfolio's operation, IPO allocations contributed approximately 20.9, 19.6 and 55 percentage points, respectively, toward the Portfolios' annual returns, which were 54.5%, 32.8%, and 92%, respectively. JMIC was aware of the possibility that Brazos would not repeat its exceptional performance due to the substantial uncertainty regarding the future availability of IPO stock, and the gradual decrease, as the Brazos Portfolios' value continued to grow, in the percentage of Brazos' aggregate Portfolio value attributable to IPO shares - diluting, thereby, the effect of the IPO share prices on Brazos' prospective performance.

7. JMIC did not analyze the contributions of the IPO shares to Brazos' overall performance, and thus did not disclose this information to Brazos or its board of directors. Consequently, in shareholder reports and prospectuses filed with the Commission, Brazos failed to disclose adequately the large impact on its first year performance of IPO stock, and failed to disclose adequately the possibility that it would be unable to achieve this performance level in the future as asset size increased.<sup>3</sup> This was material because it was questionable whether the Portfolios could continue to experience, by investing in the IPOs, substantially similar performance as they had previously experienced, given the growth in the Portfolios' total assets.

### **JMIC Failed to Disclose Adequately the New IPO Allocation Procedure to its Private Clients**

8. JMIC failed to provide actual notice of the change in the IPO allocation procedure at least to some of JMIC's pre-existing private clients. In Part II of JMIC's amended Form ADV filed with the Commission on January 31, 1997, JMIC disclosed the implementation of the new scarce IPO allocation procedure. JMIC sent a letter to each client offering to provide a copy of the Form ADV as required by Rule 204-3(c)(1). However, JMIC did not forward the amended ADV to its existing clients unless specifically requested to do so by the client, or otherwise provide actual notice to existing clients of the new IPO procedure. As a result, many of JMIC's pre-existing private clients may never have learned of this material change.

### **JMIC Failed to Disclose to its Advisory Clients a Potential Conflict of Interest**

9. JMIC failed to disclose a potential conflict of interest that arose when some JMIC managers, at various points in time, made significant personal investments in the Brazos Portfolios after the change in IPO allocation procedure. By investing in Brazos after the change in IPO allocation procedure, the managers were indirectly benefiting from Brazos' access to IPO shares. The managers' investment in Brazos posed a potential conflict of interest. Although JMIC disclosed the fact that its managers invested in Brazos to Brazos shareholders and JMIC's private clients, JMIC did not specifically disclose the potential conflict of interest created by the Brazos-favoring change in IPO allocation procedure and the managers' investment in Brazos.<sup>4</sup>

### **Legal Analysis**

10. An investment adviser such as JMIC has "an affirmative duty of `utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation `to employ reasonable care to avoid misleading' [its] clients." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (citation omitted). A fact is material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available." Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

11. Reasonable investors would view as material the change in the IPO allocation practices that favored Brazos over the other JMIC clients, because it would be important in making an investment decision. See McKenzie Walker Investment Management, Inc., Advisers Act Release No. 1571 (July 16, 1996). Reasonable investors would also view as material the fact that some JMIC managers, at various points in time, made significant personal investments in the Brazos Portfolios after the change in JMIC's IPO allocation procedure. See Capital Gains Research Bureau, Inc., 375 U.S. at 188. Moreover, under the facts and circumstance of this case, disclosure of an allocation procedure that had the effect of favoring one client to the potential financial detriment of other clients, and disclosure of a potential conflict of interest between JMIC's managers and JMIC's private advisory clients, would have been material to an advisory client's decision to continue an advisory relationship with JMIC. Thus, JMIC's failure to disclose adequately the new IPO allocation procedure and failure to disclose the potential conflict of interest were material omissions.

12. Similarly, reasonable investors would consider the fact that Brazos' performance in the first year of each Portfolio was substantially attributable to IPO shares as significantly altering the total mix of available information. This is of particular importance given the growth in total assets of the Brazos Portfolios, which places in doubt the ability of the Portfolios to continue to experience, by investing in

IPOs, substantially similar performance. See The Dreyfus Corporation and Michael L. Schonberg, Advisers Act Release No. 1870, (May 10, 2000); Van Kampen Investment Advisory Corp., Advisers Act Release No. 1819 (September 8, 1999). Thus, JMIC's failure to disclose the impact on the Brazos Portfolios' performance of IPO shares was a material omission. As a result of this omission, Brazos omitted the material information in its Commission filings.

## Violations

13. As a result of the conduct described above, JMIC willfully violated Section 206(2) of the Advisers Act.5

14. As a result of the conduct described above, Brazos violated Section 34(b) of the Investment Company Act and JMIC caused and willfully aided and abetted Brazos' violation.

## Undertakings

Respondent undertakes:

15. to retain, within 30 days of the date of the Order, at JMIC's own expense, an independent consultant, not unacceptable to the Commission's staff, to review: i) JMIC's methodology for calculating and disclosing the impact of IPO securities on JMIC's investment company clients; and ii) JMIC's procedures for implementing the consultant's recommendation regarding the calculations and disclosures referenced in Subsection III.15.i), above;

16. to require the consultant to prepare, within 150 days of the entry of the Order, a written recommendation of policies, practices, and procedures, or amendments thereto, designed reasonably to prevent and detect, insofar as practicable and deemed necessary, future violations of the federal securities laws relating to matters within the prescribed scope of the consultant's review, with a copy of such recommendation to be given simultaneously to the Commission's Fort Worth District Office (the "FWDO") and JMIC;

17. to adopt, implement, and maintain all policies, practices and procedures recommended by the consultant within 30 days of the receipt of the recommendation; provided, however, that as to any recommendation of the consultant which JMIC determines is, in whole or in part, unduly burdensome, JMIC may suggest an alternative procedure designed to achieve the same objective or purpose as that of the recommendation of the consultant. JMIC shall set forth in an affidavit to be submitted to the consultant and the FWDO such alternative procedure, and a description of how such alternative procedure achieves the same objective or purpose as the consultant's original recommendation. JMIC will require the consultant to evaluate the alternative procedure proposed by JMIC. However, JMIC will abide by the consultant's final determination with regard thereto and adopt those recommendations which the consultant ultimately determines are appropriate;

18. within 180 days of the issuance of the Order, to file an affidavit with the FWDO setting forth the details of JMIC's compliance with these undertakings and implementation of the consultant's recommendations pursuant to Sections III.16. and III.17., above;

19. to apply to the Commission's staff for any extension of the deadlines set forth in Sections III.15. through III.18., above, before their expiration, and upon a showing of good cause by JMIC, the Commission's staff may, in its sole discretion, grant such extensions for whatever time period it deems appropriate;

20. to ensure the independence of the independent consultant, by agreeing that Respondent:

- shall not have the authority to terminate the independent consultant without prior written approval of the Commission's staff;

- shall compensate the independent consultant and persons engaged to assist the independent consultant for services rendered pursuant to this Order at their reasonable and customary rates; and
- shall require the independent consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the independent consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with JMIC, or any of JMIC's present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the independent consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the independent consultant in performance of his/her duties under the Order shall not, without prior written consent of the FWDO, enter into any employment, consultant, attorney-client, auditing or other professional relationship with JMIC, or any of JMIC's present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement; and

21. within 30 days of the date of the Order, to disseminate, at its own expense, a copy of the Order to all JMIC advisory clients as of the date of the Order.

#### **IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions specified in Respondent JMIC's Offer.

ACCORDINGLY, IT IS HEREBY ORDERED:

A. That JMIC is censured;

B. Pursuant to Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act, that Respondent JMIC cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act and Section 34(b) of the Investment Company Act; and

C. IT IS FURTHER ORDERED that Respondent JMIC shall pay a civil money penalty in the amount of \$200,000 within 10 days of the entry of the Order 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 Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312; and (d) submitted under cover letter which identifies JMIC 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 Spencer C. Barasch, Associate District Administrator, Securities and Exchange Commission, Burnett Plaza, 801 Cherry Street, Suite 1900, Fort Worth, Texas 76102;

D. IT IS FURTHER ORDERED that Respondent shall comply with the undertakings enumerated in Sections III.15. through III.21., above.

By the Commission.

Jonathan G. Katz  
Secretary

#### **Footnotes**

1 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

2 As a result of their high market demand, a substantial percentage of IPO shares traded, during the relevant period, at a premium to their initial offering price.

3 Specifically, in Brazos' annual reports filed with the Commission on February 10, 1998 and February 3, 1999, its semi-annual reports filed with the Commission on August 4, 1997, July 30, 1998 and August 5, 1999, and in two prospectuses filed for the Micro Cap and Multi Cap Portfolios in December 1997 and December 1998, respectively.

4 Arguably, the potential conflict of interest was apparent to JMIC's new clients and those private clients who requested and received JMIC's amended Form ADV, because these clients would have had information about both the change in IPO allocation procedure, which favored Brazos and its shareholders, and the fact that, by investing in the Brazos Portfolios, the JMIC managers had become Brazos shareholders.

5 Section 206(2) of the Advisers Act does not require a showing of scienter. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 192.