

In the Matter of MICHAEL L. SMIRLOCK, Respondent

Admin. Proc. File No. 3-8243

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940, Release No. 1393

November 29, 1993

TEXT:

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

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") to determine whether Michael L. Smirlock ("Respondent") caused and aided and abetted violations of Sections 204 and 206(2) of the Advisers Act and Rules 204-2(a) (3), 204-2(c)(1), and 204-2(c)(2) thereunder.

II.

In anticipation of the institution of these administrative proceedings, Respondent has submitted an Offer of Settlement which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or to which the Commission is a party, Respondent consents to the issuance of this Order Instituting Proceedings Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 and Findings and Order of the Commission, and Cease and Desist Order ("Order"), without admitting or denying the findings set forth herein, and to the entry of the findings and the imposition of the cease and desist order and the remedial sanctions set forth in Section VI. below.

III.

The Commission finds the following:

A. SUMMARY

Respondent, who at all relevant times was Chief Investment Officer and head of the fixed-income desk of an asset management division of an investment advisory firm registered with the Commission ("Adviser"), caused to be executed purchase transactions in mortgage-backed securities which he failed to allocate to particular client accounts for periods of two to nine business days. These transactions involving late allocations occurred from December 1992 through February 1993. Respondent's failure to timely write trade tickets allocating such transactions caused the Adviser's books and records to be inaccurate and not current. n1

In addition, on February 24, 1993, Respondent caused two securities transactions to be executed between client accounts managed by the Adviser without taking the necessary and proper steps to ensure that best price and execution were obtained for the clients. In causing these transactions to be executed, Respondent failed to follow the Adviser's internal procedures regarding the execution of the cross transactions, to take adequate steps to obtain the best price and execution for the clients involved in the cross transactions, and to disclose these matters to the clients.

B. FACTS

1. Respondent

The Respondent is 37 years old. In May 1990, Respondent joined the asset management division of the Adviser as a vice president and mortgage portfolio manager responsible for two offshore funds. In August 1991, Respondent became the Chief Investment Officer of the Adviser's asset management division with responsibility for the fixed-income portfolios. In November 1992 he was elected to the partnership of the Adviser.

2. Allocation of Trades

During the period from December 1992 through February 1993, Respondent caused to be executed a series of purchase transactions in mortgage-backed securities for which Respondent failed to promptly prepare order tickets allocating the securities to specific managed accounts. Instead, Respondent waited until such time as he sold the positions to write both the tickets evidencing the earlier purchases and the tickets evidencing the sales of the positions. Respondent dated both the purchase and sale tickets as of the day of the sale of each position. The allocation of the securities to particular managed accounts was delayed until the positions were sold. Respondent delayed allocating the securities transactions for periods of between two and nine business days after the purchase of the securities. n2

3. Agency Cross Transactions

Early on the morning of February 24, 1993, Respondent caused two agency cross transactions ("cross trades") to be executed, selling securities from various advisory clients to other advisory clients. The cross trades were executed by an unaffiliated broker at prices set by Respondent.

One of the cross trades involved interest-only strips n3 which had been purchased and allocated into seven advisory accounts on January 20, 1993, at a price of \$ 47.94 per strip. On February 24, 1993, Respondent sold the strips out of three of those accounts into two other accounts managed by the Adviser at a price of \$ 41.00. The other cross trade involved another series of interest-only strips which had been purchased on October 2, 1991, at a price of \$ 5443.25 per strip. On February 24, 1993, Respondent transferred the strips from one advisory client account to four other advisory clients at a price of \$ 1750.00 per strip. The total market value of the two cross trades was approximately \$ 5 million.

Respondent himself set the prices at which he instructed the broker to execute the cross trades. Respondent failed to ask the broker for an independent evaluation of the price, or to ask the broker to confirm with his trading desk that the prices set by Respondent were accurate market prices. Further, Respondent failed to follow the Adviser's practice, when ordering a cross trade between or among investment advisory accounts managed by it, to obtain price information on the security involved from more than one dealer in order to obtain an accurate and independent evaluation of the market price. Thus, Respondent did not take the necessary and proper steps to ensure that he obtained the best price and execution on behalf of his advisory clients who purchased the securities in the cross trades.

C. LEGAL ANALYSIS

1. Section 206(2) of the Advisers Act

The Investment Advisers Act imposes on investment advisers an affirmative duty to their clients of utmost good faith, full and fair disclosure of all material facts, and an obligation to employ reasonable care to avoid misleading their clients. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). An adviser's fiduciary obligation also includes the duty to obtain the best price and execution of client transactions. An adviser must "execute securities transactions for

clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances." Securities Exchange Act of 1934 Release No. 23170 (April 23, 1986); Advisers Act Release No. 318 (May 9, 1972); In the Matter of Kidder, Peabody & Co., Incorporated, Advisers Act Release No. 232 (October 16, 1968). See also Advisers Act Rule 206(3)-2(c). Failure to do so constitutes a violation of Section 206(2) of the Advisers Act. In the Matter of Edgemont Asset Management Corp. and Bowling Green Securities, Inc., Advisers Act Release No. 1280 (June 18, 1991).ⁿ⁴ Moreover, during the time period relevant to this action, the Adviser disclosed in various amendments to its Form ADV - Uniform Application for Investment Adviser Registration, filed with the Commission, that its policy was to seek the net best price and execution for brokerage orders.

Respondent ordered execution of the cross trades on behalf of his advisory clients in reckless disregard of his duty to obtain the best price and execution. Respondent's conduct breached the Adviser's stated policy as well as its fiduciary duty. This was not disclosed to the clients. As a result, Respondent caused and willfully aided and abettedⁿ⁵ violations of Section 206(2) of the Advisers Act.

2. Section 204 of the Advisers Act and Rules 204-2(a)(3), 204-2(c)(1) and 204-2(c)(2) thereunder

The Advisers Act imposes extensive recordkeeping requirements on registered investment advisers. The records must be "true, accurate and current." Advisers Act Rule 204-2(a). The required books and records include "[a] memorandum of each order given by the investment adviser for the purchase or sale of any security. . . . Such memorandum shall show the terms and conditions of the order . . . and shall show the account for which entered, [and] the date of entry." Advisers Act Rule 204-2(a)(3).

The Advisers Act rules further provide that investment advisers who render any investment supervisory or management service to any client shall make and keep true, accurate and current the following records:

- (1) Records showing separately for each such client the securities purchased and sold, and the date, amount and price of each such purchase and sale [Advisers Act Rule 204-2(c)(1)]; and
- (2) For each security in which any such client has a current position, information from which the investment adviser can promptly furnish the name of each such client, and the current amount or interest of such client [Advisers Act Rule 204-2(c)(2)].

Respondent caused and aided and abetted violations of these recordkeeping provisions by failing to write trade tickets promptly after trades were executed. Respondent's actions caused the Adviser's records to fail to reflect the true and accurate date of entry of trades, resulting in violations of Rule 204-2(a)(3).

Furthermore, during the period between the date on which Respondent placed an order and the date on which Respondent wrote the ticket for such purchase, the Adviser's records were not current with respect to the terms and conditions of the orders for the purchase of securities ordered by Respondent as required by Section 204 of the Advisers Act and Rule 204-2(a)(3), and were not current as to the identification of securities purchased by each client, and the date, amount and price of each purchase as required by Rule 204-2(c)(1). Until the trade tickets for such securities were written and the allocations entered in the Adviser's books and records some days later, the Adviser's records failed to reflect the true position of any client in the unallocated securities as required by Section 204 of the Advisers Act and Rule 204-2(c)(2) thereunder. Respondent caused and willfully aided and abetted these violations by failing to promptly write tickets allocating trades on the days that the trades were executed.

IV.

FINDINGS

Based on the above, the Commission finds that Respondent caused and willfully aided and abetted violations of Sections 204 and 206(2) of the Advisers Act and Rules 204-2(a)(3), 204-2(c)(1), and 204-2(c)(2) thereunder.

V.

OFFER OF SETTLEMENT

Respondent has submitted an Offer of Settlement in which he consents to the Commission's issuance of this Order which makes findings, as set forth above; orders him, pursuant to Section 203(k) of the Advisers Act, to cease and desist from committing or causing any violation, and any future violation, of the provisions set forth above; suspends him from association with any broker, dealer, investment adviser, investment company, or municipal securities dealer for three months pursuant to Section 203(f) of the Advisers Act; and requires him to pay a penalty of \$ 50,000 pursuant to Section 203(i) of the Advisers Act.

VI.

ORDER

Accordingly, IT IS HEREBY ORDERED that Respondent:

(A) cease and desist from committing or causing any violation, and any future violation, of Sections 204 and 206(2) of the Advisers Act and Rules 204-2(a)(3), 204-2(c)(1), and 204-2(c)(2) thereunder;

(B) be suspended from association with any broker, dealer, investment adviser, investment company, or municipal securities dealer for three months beginning on the date of the entry of this Order;

(C) prior to the close of business on the fifth business day after 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) hand-delivered to the Comptroller, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549; and

(4) submitted under cover letter which identifies Michael Smirlock as a Respondent in these proceedings, and the Commission's case number, a copy of which cover letter and money order or check shall be sent to counsel for the Commission, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549; and

(D) comply with his undertaking to submit an affidavit to the Commission stating that he has complied with the sanctions set forth herein.

By the Commission.

Footnotes

n1 When the Adviser discovered Respondent's conduct in March of 1993, it brought the matter to the Commission's attention and has cooperated with the Commission's investigation.

n2 None of these trades appears to have involved any losses.

n3 Strips are mortgage pass-through securities created by separating and reassembling the principal and interest payments on a pool of long-term mortgages. Stripped mortgage pass-through securities are of two types: one that pays interest only (IO) and one that pays principal only (PO).

n4 A violation of this section does not require that the Respondent acted with scienter. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). See also *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992).

n5 This conduct satisfies the standard for aiding and abetting liability. See *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 72 (D.C. Cir.), cert. denied, 449 U.S. 1012 (1980); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980).

n6 "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 one of the Rules or Acts. See *Tager v. SEC*, 344 F.2d 5 (2d Cir. 1965).