

PUBLICATION

RIA Fined \$500,000 For Not Following Its Own Investment Guidelines

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The United States Securities and Exchange Commission (SEC) has determined that an investment adviser's failure to follow its own stock selection procedures and investment guidelines were willful violations of Section 206(2) of the Investment Advisers Act of 1940 (1940 Act). In *Pax World Management Corp.*, IA Release No. 2761/IC Release No. 28344 (July 30, 2008), the SEC fined the investment adviser \$500,000 for a failure to follow its own stock selection procedures.

By way of background, Pax World Management (PWM) served as the investment adviser to several "socially responsible" mutual funds. The investment guidelines for these mutual funds prohibited PWM from selecting for purchase stocks whose companies derived revenue from gambling, liquor sales and weapons manufacture, among other sources. The SEC's examination of PWM and its funds revealed that, in violation of its own guidelines, PWM's portfolios contained 5% - 18% of holdings whose revenue was in part derived from U.S. defense contracts, gambling and the manufacture of liquor. The SEC found that over a period of several years PWM (a) failed to implement systems and procedures to detect revenue streams from prohibited sources in the stocks it purchased, (b) failed to implement divestiture procedures to dispose of once compliant holdings that violated its investment guidelines, (c) generally failed to monitor the portfolios for compliance with the investment guidelines and (d) failed to inform the investing public that it did not monitor the portfolios for compliance with its investment guidelines. The SEC deemed this conduct to constitute willful violations of Section 206(2) of the 1940 Act.

This recent decision should serve as a reminder to all investment advisers and fund managers to take steps to avoid "violating their own rules" with respect to investment guidelines of any kind:

- Review all definitions and descriptions of portfolios used throughout the firm, including those in marketing materials, GIPS composite definitions and Form ADV to ensure consistency in the characteristics of their holdings, trading styles and risk profiles.
- Adopt a "zero tolerance" rule with respect to the disregard of investment guidelines by any employee. As evidenced in this recent decision, even 95% compliance with investment guidelines that are in effect can serve as the factual and legal basis for SEC enforcement proceedings.
- Check operational policies and procedures to ensure that investment guidelines, whether client specific or portfolio specific, are capable being routinely followed by portfolio managers, investment analysts and traders.
- Confirm with operations and risk management personnel that the firm's trading and portfolio accounting systems are providing (and able to provide) necessary information to supervisory personnel to detect violations of investment policies.