Paul | Weiss

January 9, 2004

Important SEC Settlement Concerning the Independent Directors of the Heartland Group

On December 11, 2003, the Securities and Exchange Commission (the "SEC") settled its civil charges against the independent directors of the Heartland Group in an administrative proceeding (the "Order").[1] This Order is significant because the SEC has very rarely taken enforcement action against the independent directors of a mutual fund. In this case, while the SEC determined that the independent directors had engaged in fraud, they were neither fined nor barred from acting as independent directors for other mutual funds in the future.[2]

Specifically, the SEC determined that four independent Heartland Group directors:

- violated the antifraud provisions of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, as amended (the "Securities Act");
- were a cause of Heartland Advisors, Inc.'s ("Heartland Advisors") violation of Rule 22c-1, promulgated under the Investment Company Act of 1940, as amended (the "1940 Act")[3], which concerns the calculations of the Funds' net asset values ("NAVs");
- negligently failed to monitor adequately the liquidity of the Funds; and
- failed to take adequate steps to address the Funds' pricing deficiencies.

---

1 SEC Administrative Proceeding File No. 3-11351; Securities Act of 1933 Release No. 8346, December 11, 2003; Investment Company Act of 1940 Release No. 26290 (December 11, 2003).

2 On December 11, 2003, the SEC filed civil fraud charges against Heartland Advisors, its C.E.O., C.O.O., General Counsel, Senior Vice President of Trading, Treasurer, two former portfolio managers, an associated director and a client of the C.E.O. The SEC also settled its charges against FT Interactive Data, a pricing service used by Heartland Advisors, Inc.

3 *Id.* at Sections III.D.1-5.

A. Background

The Heartland Group is a Maryland corporation, registered with the SEC since 1987 as a open-end management investment company. The Heartland Group offered seven series of mutual funds until March 21, 2001, when the SEC obtained a permanent injunction that froze the assets of three Heartland Group mutual funds: the High Yield Municipal Bond Fund, the Short Duration High Yield Municipal Fund and the Taxable Short Duration Municipal Bond Fund (collectively, the "Funds").[4] John Hammes, Dr. Gary Shilling, Allen Stefl and Linda Stephenson were all independent directors and members of the Audit Committee of the Heartland Group.[5]

Heartland Advisors is registered with the SEC as an investment adviser and broker-dealer, and until March 2001 when the SEC placed the Heartland Group mutual funds into receivership, it managed the Heartland Group mutual fund portfolios and served as its principal underwriter.[6]

B. The Facts

The controversy at Heartland Group arose from Heartland Advisors' alleged fraudulent mispricing of bond securities held by the Funds. The Heartland Group Board of Directors (the "Board") had delegated bond pricing responsibility to the Heartland Advisors Pricing Committee (the "Pricing Committee").[7] After determining that market quotations for the Funds' portfolio bonds were not readily available, the Board required the Pricing Committee to utilize the services of FT Interactive Data ("Interactive"), a valuation and pricing company, in determining how to calculate the Funds' daily net asset values ("NAVs").[8]

---

[4] SEC Administrative Proceeding File No. 3-11351 at Section III.B.1.

[5] *Id.* at Section III.A.

[6] *Id.* at Section III.B.2.

[7] *Id.* at Section III.C.1.

[8] Under Rule 22c-1, funds must calculate NAVs on a daily basis.

Throughout the year in 2000, several problems indicated serious issues in the liquidity and pricing of the Funds' portfolio bonds. The Order found the following indications as crucial:[9]

- the deteriorating credit quality and liquidity of the Funds' portfolio bonds;
- the Funds' growing borrowing and cash-flow problems; and
- Heartland Advisors failure to sell sufficient bonds to meet redemptions at prices based on valuations provided by Interactive.

At a board meeting in April 2000, Heartland Advisors informed the independent directors that many of the bonds held by the Funds were illiquid and that the Funds were experiencing net redemptions. Thomas Conlin, the Funds' co-portfolio manager, misrepresented to the independent directors that the portfolio bonds were being priced very conservatively by Interactive, however, because Heartland Advisors did not accurately value the portfolio bonds, the Funds borrowed on a credit line to satisfy investor redemptions.[10]

At the August 2000 meeting, the independent directors were told that the Funds had not sold sufficient amounts of the portfolio bonds to meet redemptions but, rather, had been borrowing heavily to satisfy the obligations. Prior to the meeting, the Board's counsel had informed the Board that interest on the funds borrowed to satisfy redemptions was materially damaging the Funds' returns. Moreover, the Board was informed by Heartland Advisors that the list of defaulted portfolio bonds was increasing and that the Fund had to sell portfolio bonds to reduce the borrowings. Conlin stated that a liquidity risk was present but also misrepresented to the Board that he could sell the portfolio bonds in one week, albeit at a discount.[11]

---

[9] SEC Administrative Proceeding File No. 3-11351 at Section III.C.3.

[10] *Id.* at Section III.C.4.

[11] *Id.* at Sections III.C.5-7.

In response, at the August 2000 meeting, the independent directors requested Heartland Advisors to prepare reports 1) on how to resolve the problems with the distressed portfolio bonds, 2) on how to reduce the Fund's credit line and 3) to verify that the portfolio bonds were being accurately priced. The independent directors also requested Conlin sell Fund portfolio bonds to reduce the borrowings. The independent directors never received the reports, and Conlin resigned from Heartland Advisors one week later after not selling any portfolio bonds. The Order notes that the independent directors did not take adequate actions to ensure that the requests for information and reports were satisfied.[12]

At the September 2000 Board meeting, the Board was told that Conlin had resigned after failing to resolve the Funds' liquidity problems. The Board was also told that the Funds' borrowings continued to increase and the number of defaulted and distressed portfolio bonds was also increasing. At the meeting, Heartland Advisors misrepresented to the independent directors that portfolio bonds had been sold above carrying value and pricing had been very close to Interactive's information. Heartland Advisors also informed the Board of its sale of the worst portfolio bonds at a steep discount and that it might consider suspending redemptions. The Order concludes that receiving this information should have notified the independent directors of fundamental liquidity risks, portfolio mispricing and an increased likelihood of future shareholder redemptions.[13]

At an October 12, 2000 special Board meeting, Heartland Advisors informed the independent directors that between 60% and 70% of the Funds' portfolio bonds were illiquid. The Funds new portfolio manager told the Board that the Funds' fair value was probably 70% of the then-current NAVs. The pricing information for the NAVs at that time had been provided by Interactive. The Board's counsel then discussed with the Board its obligations with respect to pricing and suggested to the Board that the Pricing Committee should

---

[12] *Id.* at Section III.C.6-8.

[13] *Id.* at Sections III.C.9-13.

reconsider using Interactive's prices. When the Board met with the Chairperson of the Pricing Committee, the independent directors did not direct the Pricing Committee to no longer use Interactive's prices. The independent directors instructed the Chairperson to follow the Board's pricing procedures, which included fair valuing portfolio bonds based on consideration of all relevant factors and available information. Later that day, the Pricing Committee again used Interactive's prices.[14]

On October 13, 2000, when informed that the Pricing Committee had continued to use Interactive's prices, the Board directed Heartland Advisors to fair value the portfolio bonds. The Order notes that the Board failed to override the Pricing Committee or retroactively correct the October 12, 2003 NAVs.[15]

In response, the Pricing Committee uniformly applied reductions ("haircuts") of 50% and 33% to the Funds' portfolio bonds on top of the fair values proposed by the Funds' portfolio managers. The Pricing Committee did not document the basis for the new values nor did it consider whether the haircuts were appropriate for each portfolio bond. The independent directors were told of the arbitrary haircuts in addition to the fair values proposed by the Funds' portfolio managers. The Order notes that the haircuts were in direct violation of the Board's pricing policies, which required the Pricing Committee to fair value all portfolio bonds. The independent directors did not take any steps to remedy the arbitrary actions of the Pricing Committee.[16] As a result, the Order concludes that millions of shares in the Funds were redeemed at incorrect NAVs.[17]

---

[14] *Id.* at Sections III.C.14-16.

[15] *Id.* at Section III.C.17.

[16] *Id.* at Sections III.C.17-18.

[17] *Id.* at Section III.C.19.

C. <u>The SEC's Findings</u>

According to the Order, the Heartland Group independent directors assumed the responsibility to monitor the liquidity of the Funds' portfolio bonds so that the Funds could meet shareholder redemption requests.[18] The independent directors were also charged with the duty to contribute meaningfully to the valuation of the Funds.[19] While directors may delegate pricing responsibility to a committee, the Order states that directors must still actively participate in the valuation process.[20]

The Order found that the independent directors did not adequately monitor the liquidity of the Funds' portfolio bonds or participate meaningfully in the valuation process of the Funds. As a result, the SEC found that the independent directors violated the general fraud proscriptions of Sections 17(a)(2) and 17(a)(3) of the Securities Act. Moreover, because the independent directors did not pursue their requests for further information from Heartland Advisors or repair the inaccurate haircuts Heartland Advisors applied to the Funds, the independent directors again violated Sections 17(a)(2) and 17(a)(3).[21]

Finally, because the independent directors did not correct the prices of the Funds' portfolio bonds or request that Heartland Advisors ignore the Interactive price information, the independent directors were a cause of Heartland Advisors violation of Rule 22c-1 under the 1940 Act, which requires accurate calculation of Fund NAVs.[22]

---

18 The SEC states that the independent directors assumed these responsibilities in the Funds' Statement of Additional Information and prospectus.

19 SEC Administrative Proceeding File No. 3-11351 at Sections III.D.1-2.

20 See *In the Matter of Hartl and Lipman*, Release No. IC-19840, 1993 WL 468571, at *4-5 (Nov. 8, 1993).

21 SEC Administrative Proceeding File No. 3-11351 at Sections III.D.1-2.

22 *Id.* at Sections III.D.3-5.

D. <u>Conclusions</u>

This Order raises very important and difficult issues for independent directors because it acknowledges that although Heartland Advisors lied to the independent directors, and despite the fact that the independent directors hired experts to assist them in performing their duties and attempted to implement remedial actions, "they did not go far enough in following through and resolving those issues as required by their duties arising under the [1940 Act]."[23] The Order gives no indication whatsoever as to what additional steps the independent directors should have taken and raises serious questions about whether independent directors can reasonably rely on the information and analyses of advisers and pricing services.

It is interesting to note that three years after the events described in this Order, the SEC appointed receiver, Philip Stern, has still not resolved the liquidity issues for about one-third of the Funds' remaining bonds.

* * *

Any questions concerning the foregoing should be addressed to any of the following. This memorandum is not intended to provide legal advice, and no legal or business decisions should be based on its contents.

Mark S. Bergman	212-373-3258	Steven R. Howard	212-373-3508
Raphael M. Russo	212-373-3309		

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

---

[23] SEC Press Release, 2003-171, at 4 (December 11, 2003).