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MUTUAL FUND INVESTMENT ADVISER SETTLES SEC AND NEW YORK ENFORCEMENT ACTIONS RELATING TO MARKET TIMING

[16903] December 22, 2003 TO: BOARD OF GOVERNORS No. 77-03 COMPLIANCE ADVISORY COMMITTEE No. 114-03 INVESTMENT COMPANY DIRECTORS No. 29-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 117-03 SEC RULES MEMBERS No. 196-03 SMALL FUNDS MEMBERS No. 92-03 RE: MUTUAL FUND INVESTMENT ADVISER SETTLES SEC AND NEW YORK ENFORCEMENT ACTIONS RELATING TO MARKET TIMING The Securities and Exchange Commission has issued an order making findings and imposing a censure, remedial undertakings, and a cease and desist order in an enforcement proceeding against a registered investment adviser to a group of mutual funds.1 The adviser consented to the entry of the SEC Order without admitting or denying the SEC's findings. In addition, the Attorney General of New York announced the settlement of related state charges against the same adviser.2 Both actions involved allegations that the adviser permitted market timing in certain mutual funds that violated the funds' prospectus disclosures, in exchange for fee-generating investments in other mutual funds and hedge funds managed by the adviser. The SEC Order and the Attorney General's announcement are summarized below. I. SEC Order A. Alleged Violations The SEC Order finds that, from early 2001 until July 2003, the adviser negotiated various arrangements with market timers or brokers seeking timing capacity for their clients that permitted timing of certain mutual funds managed by the adviser. According to the SEC Order, the arrangements were contrary to the funds' prospectus disclosures, were not disclosed to the funds' directors or shareholders, and were permitted despite the adviser's awareness of the harmful effects timing can have on mutual funds. The SEC Order further finds that the adviser 1 See In the Matter of Alliance Capital Management, L.P., SEC Release Nos. IA-2205 and IC-26312, Admin. Proc. File No. 3-11359 (Dec. 18, 2003) ("SEC Order"). A copy of the SEC Order is available on the SEC's website at http://www.sec.gov/litigation/admin/ia-2205.htm. 2 See Alliance Agreement Includes New Form of Relief for Shareholders (press release issued by Office of New York State Attorney General Eliot Spitzer, Dec. 18, 2003) ("Press Release"). A copy of the Press Release is available on the Attorney General's website at http://www.oag.state.ny.us/press/2003/dec/dec18c_03.html. 2 obtained shareholder approval to lift a fund's restriction on futures trading, without disclosing in the proxy statement that the change was sought in part to help the fund manage better the cash flows resulting from market timers. Finally, the SEC Order finds that the adviser provided confidential information about the portfolio holdings of certain funds to one of the market timers. The SEC Order states that the adviser willfully violated: • Sections 206(1) and

206(2) of the Investment Advisers Act of 1940 by knowingly, recklessly and/or negligently: (1) entering into the arrangements in exchange for fees on “sticky assets” in other investment vehicles managed by the adviser, including hedge funds run by the same portfolio managers as the mutual funds being timed; and (2) failing to disclose the arrangements to the funds’ directors and shareholders. • Section 204A of the Advisers Act by releasing material, nonpublic information concerning the weighted portfolio holdings of certain funds. • Section 20(a) of the Investment Company Act of 1940 and Rule 20a-1 under that Act by soliciting a proxy with respect to a security issued by a registered fund through use of a proxy statement that omitted material information; • Section 17(d) of the Investment Company Act and Rule 17d-1 under that Act by participating, as principal, in transactions in connection with joint arrangements in which the funds were participants without an SEC order approving the transactions; and • Section 34(b) of the Investment Company Act by making material misstatements or omissions in a registration statement, application, report, account, record or other document filed or transmitted pursuant to the Investment Company Act. B. Voluntary Undertakings In determining to accept the adviser’s settlement offer, the SEC considered the cooperation afforded the SEC staff by the adviser during the investigation. The SEC Order states that the cooperation included: (1) prompt reporting to the SEC of its discovery of possible misconduct; (2) conducting a thorough and independent internal investigation and sharing the results with the SEC staff; and (3) obtaining the resignations of certain supervisory personnel and others. According to the SEC order, the SEC further considered the following efforts voluntarily undertaken by the adviser, some of which are currently in effect: • At least 75% of the directors of each fund will be independent. • Any chairman of the board of directors of any fund will be independent. • Any counsel to the independent directors will be an “independent legal counsel” as defined under the Investment Company Act and will not have any employment, consultant, attorney-client, auditing, or other professional relationship with the adviser. 3 • No board action will be taken without approval by a majority of the independent directors, and any action approved by a majority of the independent directors but not by the full board will be disclosed in fund shareholder reports. • Commencing in 2005, each fund will hold a shareholder meeting to elect its board of directors at least once every five years. • Each fund will designate an independent compliance officer reporting to its board as responsible for assisting the directors in monitoring the adviser’s compliance with the federal securities laws, its fiduciary duties to fund shareholders, and its code of ethics in all matters relevant to the funds. C. Required Undertakings The SEC Order also sets forth the following required undertakings by the adviser: General Compliance • The adviser will maintain a Code of Ethics Oversight Committee responsible for all matters relating to issues under the adviser’s code of ethics. The committee will report to the funds’ Audit Committee at least quarterly on issues arising under the adviser’s code of ethics (to the extent related to fund business), including all violations of the code. Any material violations of the code will be reported promptly to the Audit Committee of the adviser. • The adviser will establish an Internal Compliance Controls Committee. Independent staff of the funds’ directors will be invited to participate in all meetings of the committee, provided that their involvement is limited to compliance issues relating to the funds. The committee will report to the funds’ Audit Committee at least quarterly on internal compliance matters. • The adviser also will provide the reports of the two committees described above to the Audit Committee of the adviser’s parent company. • The adviser will establish a full-time senior-level position with responsibilities for compliance matters relating to conflicts of interest. The officer will report directly to the adviser’s Chief Compliance Officer (“CCO”). • The adviser’s CCO or a member of his/her staff will: (1) review compliance with the policies and procedures that address compliance issues under the Investment Company Act and Advisers Act; and (2) report any violations to the Internal Compliance Controls Committee. • The adviser’s CCO

will report to the funds' independent directors at least quarterly any breach of fiduciary duty and/or the federal securities laws (to the extent related to fund business) of which the officer becomes aware. Any material breach will be reported promptly. 4 • The adviser will establish a corporate ombudsman to whom its employees may convey concerns about ethics matters or questionable practices. The adviser must review any matters brought to the ombudsman's attention (to the extent relating to fund business), along with any resolution of such matters, with the funds' independent directors with such frequency as they may instruct. Distribution of Disgorgement and Civil Penalty • The adviser will pay $150 million in disgorgement and a civil money penalty of $100 million. • Within 30 days of the SEC Order, the adviser must retain an Independent Distribution Consultant acceptable to the SEC staff and the funds' independent directors. The consultant will develop a plan to distribute the $250 million to compensate the funds' shareholders for losses attributable to the market timing trading activity by persons with whom the adviser entered into timing arrangements between January 1, 2001 and September 30, 2003. The Independent Distribution Consultant must submit the distribution plan to the SEC within 195 days of the SEC Order. Following a public comment period and issuance of an SEC order approving a final plan of disgorgement, the Independent Distribution Consultant and the adviser must take all necessary and appropriate steps to administer the final plan. Independent Compliance Consultant • Within 30 days of the SEC Order, the adviser must retain an Independent Compliance Consultant to conduct a comprehensive review of its supervisory, compliance, and other policies and procedures designed to prevent and detect conflicts of interest, breaches of fiduciary duty, breaches of the code of ethics, and federal securities law violations by the adviser and its employees. The review must include, but not be limited to, a review of the adviser's market timing controls, pricing practices that may make its funds vulnerable to market timing, utilization of short-term trading fees and other controls for deterring excessive short term trading, possible fund governance changes to improve compliance, and policies and procedures concerning conflicts of interest. The Independent Compliance Consultant must complete its review and provide its recommendations in a report to the adviser, the funds' directors, and the SEC staff no more than 120 days after the entry of the SEC Order. Periodic Compliance Review • At least once every two years, commencing in 2005, the adviser must undergo a compliance review by a third party who is not an interested person of the adviser. The third party must issue a report of its findings and recommendations to the Internal Compliance Controls Committee and the funds' audit committees. Certification • No later than 24 months after the entry of the SEC Order, the adviser's chief executive officer must certify to the SEC in writing that the adviser has fully adopted and 5 complied in all material respects with the foregoing undertakings and the recommendations of the Independent Compliance Consultant, or must describe any material non-adoption or non-compliance. Recordkeeping • Any record of the adviser's compliance with the foregoing required undertakings must be preserved for at least six years from the end of the fiscal year last used, the first two years in an easily accessible place. II. Settlement of Charges by Attorney General According to the Press Release, joint investigations by the Attorney General's office and the SEC revealed that senior executives of the adviser authorized complex timing arrangements with 18 broker-dealers and hedge fund operators in return for infusions of assets that generated management fees. The Press Release states that the secret timing arrangements were in contrast to publicly stated policies discouraging rapid trading of the adviser's mutual funds. The Press Release describes the settlement agreement as follows: • The adviser will reduce by 20% the management fees that it charges the funds and will maintain fees at that level for at least a five-year period.3 The Press Release states that the fee reduction is valued at $70 million per year. • The adviser will pay restitution of $250 million, which payment was negotiated jointly by the Attorney General's office and the SEC. • The adviser will take steps to halt

market timing and bolster corporate governance. • The adviser will hire a full-time senior officer to help ensure that fees charged by the funds are negotiated at arm's length and are reasonable. The officer will do this through either competitive bidding or an annual independent evaluation that considers factors including: (1) the level of fees charged to institutional investors; (2) the costs of providing services; and (3) the adviser's overall profit margins. He or she also will take steps to ensure that information on the calculation of fees is fully disclosed to the public. • The chairman of the funds' board of directors will be independent, with no prior connection to the adviser. • The agreement provides new requirements for disclosure of expenses and fees. Rachel H. Graham Assistant Counsel 3 In a statement announcing its settlement with the adviser, the SEC explained its rationale for not requiring the adviser to offer fee discounts to its mutual fund customers. A copy of the SEC's press release is available on the SEC's website at http://www.sec.gov/news/press/2003-176.htm.
