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December 16, 2003

SEC ACTION AGAINST ADVISER, ITS OFFICERS AND DIRECTORS, A PRICING VENDOR AND OTHERS FOR MISREPRESENTATIONS, MISPRICING AND INSIDER TRADING IN TWO HIGH YIELD BOND FUNDS

[16878] December 16, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 59-03 COMPLIANCE ADVISORY COMMITTEE No. 111-03 INVESTMENT COMPANY DIRECTORS No. 26-03 SEC RULES MEMBERS No. 188-03 SMALL FUNDS MEMBERS No. 86-03 RE: SEC ACTION AGAINST ADVISER, ITS OFFICERS AND DIRECTORS, A PRICING VENDOR AND OTHERS FOR MISREPRESENTATIONS, MISPRICING AND INSIDER TRADING IN TWO HIGH YIELD BOND FUNDS Last week, the Securities and Exchange Commission filed a civil complaint in the United States District Court for the Eastern District of Wisconsin alleging misrepresentations, mispricing and insider trading in two high yield municipal bond funds.1 The Commission is seeking permanent injunctions against the defendants as well as disgorgement, pre-judgment interest and civil penalties. In addition to the civil action, the Commission accepted settlements from and instituted cease-and-desist proceedings against four independent directors and an independent pricing service based upon the same facts.2 The complaint and administrative orders are briefly summarized below. Parties Involved The action involved an investment adviser, its CEO, two former portfolio managers, four officers (including the COO, former treasurer and former general counsel), five directors (four of which were independent directors), an independent pricing service and one other individual (a friend of the CEO). Each of the independent directors was a member of the audit committee, and one of the independent directors was the audit committee's chairman. The four independent directors and the independent pricing service settled the charges against them without admitting or denying those charges. The remainder of the parties involved are defendants in the civil action. 1 SEC v. Heartland Advisors, Inc., et al. The complaint is available at http://graphics.jsonline.com/graphics/news/img/dec03/secfiling.pdf. 2 In the matter of John D. Hammes, Albert Gary Shilling, Allan H. Stefl, and Linda F. Stephenson, Release No. 33-8346 (December 11, 2003) (available at http://www.sec.gov/litigation/admin/33-8346.htm) and In the matter of FT Interactive Data, f/k/a Interactive Data Corporation, Release No. IA-2201 (December 11, 2003) (available at http://www.sec.gov/litigation/admin/ia-2201.htm). 2 Administrative Findings and Alleged Facts The Commission's civil action arose from the sudden devaluation of two high-yield

municipal bond funds between September 28 and October 13, 2000 and the facts leading up to that devaluation. The orders and the complaint allege the following facts (among others). During 2000, the two funds at issue were in net redemption during a period when the bonds in their portfolios were deteriorating in credit quality and liquidity. During this period, the funds valued those bonds in their net asset value (NAV) calculations at or near the values provided by a single independent pricing vendor. Some of these values were allegedly fraudulent, in that the adviser and the pricing vendor knowingly agreed to take certain bad news into account in incremental amounts over time, improperly "smoothing out" the negative impact of that news on the value of the bonds being used for the funds' NAVs. In late September, in response to increasing liquidity problems, the adviser arranged for some of the bonds in the funds' portfolios to be sold in a transaction that involved the adviser's parent corporation and a personal guarantee by the adviser's CEO. As a result of this transaction, the NAVs for the two funds dropped on September 28, 2000 by 8.2% and 2.1%, respectively. The complaint alleges that the adviser then misrepresented the reasons for the devaluation in a letter to shareholders in October 2003. On October 13, 2000, when the full extent of the mispricing became clear, the adviser fair valued more of the funds' portfolio securities, resulting in a one-day reduction of 69.4% in one fund and 44% in the other fund. According to the administrative order relating to the independent directors, the fair valuation that resulted in this reduction was accomplished using a combination of values recommended by the funds' portfolio manager and across-the-board "haircuts," which was a method of fair valuation that was in direct violation of the funds' board-approved pricing procedures. In addition, the adviser failed to document the basis for these fair values as required by the funds' pricing procedures. As a result, the Commission has alleged that both before and after October 13, 2000, the funds redeemed millions of shares at incorrect NAVs. The administrative order relating to the independent directors also describes various misrepresentations to the board during this period relating to the valuation of the funds' portfolio securities by the funds' former portfolio manager and the adviser's CEO and COO. Alleged Violations Adviser and its Officers. The complaint charges the adviser, its CEO, COO, former general counsel, senior vice president of trading, former treasurer, and two former portfolio managers with violating or aiding and abetting violations of the following: • Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 (the antifraud provisions); 3 • Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the antifraud provisions); • Section 36(a) of the Investment Company Act of 1940 (imposing fiduciary duties); and • With respect to all but the former treasurer, Section 34(b) of the Investment Company Act (for misrepresentations or omissions in the registration statement and for certain recordkeeping requirements). The adviser also is charged with violations of Rule 22c-1(a) under the Investment Company Act for the mispricing of the funds' NAVs and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (the antifraud provisions). The adviser's CEO, COO, former general counsel, senior vice president of trading, former treasurer, and two former portfolio managers are charged with aiding and abetting the Advisers Act violations. In addition, the complaint alleges insider trading violations by the adviser's CEO, three of its former employees (the treasurer, general counsel, and one of the portfolio managers), and one individual alleged to have been tipped by the adviser's CEO. The allegations all involve trading in the affected funds shortly before the October 13 repricing. Independent Directors. The order relating to the independent directors states that they violated the antifraud provisions of the Securities Act by: (1) failing to adequately monitor the liquidity of the bonds in the funds' portfolios and to assure the continued liquidity of those bonds so the funds could meet shareholder redemption requests; (2) failing to adequately discharge their responsibility to participate meaningfully in the valuation of funds; and (3) permitting and not rectifying the haircut the adviser applied to the funds on October 13, which the directors knew or should have known resulted in prices that did not represent the fair values of the bonds affected. The order notes that “while mutual fund directors are permitted to delegate some responsibility for pricing a fund's securities to a separate committee, each director retains responsibility to be involved in the valuation process and may not passively rely on securities valuations provided by such a committee.”3 The order also states that the directors’ personal liability stemmed from their failure to take adequate steps to follow up on their requests for information from the adviser, when they were on notice of the problems with the prices of the funds' securities, in order to assure that the funds' securities were priced at fair value. The order further states that the directors were a cause of the adviser’s violation of Rule 22c-1(a) under the Investment Company Act, since they failed to expressly instruct the adviser to disregard the pricing vendor’s prices, or to correct the prices of the funds' bonds, when they knew or should have known that those prices did not reflect the bonds' fair value, and consequently knew or should have known that the adviser was selling, redeeming and repurchasing shares of the funds at prices that were not based on the funds' current NAVs. Interested Director. The complaint charges the interested director with violations of the antifraud provisions of the Securities Act and for breaching his fiduciary duties under Section 3 Citing In the Matter of Hartl and Lipman, Release No. IC-19840, 1993 WL 468571, at *4-5 (Nov. 8, 1993). 4 36(a) of the Investment Company Act for failing to adequately monitor the liquidity of the funds and to take adequate steps to address the funds’ pricing deficiencies. Pricing Vendor. The order relating to the pricing vendor states that it caused and willfully aided and abetted the adviser’s violations of Sections 206(1) and 206(2) of the Advisers Act and Rule 22c-1(a) under the Investment Company Act by knowingly providing substantial assistance to the fund’s portfolio managers in gradually decreasing the prices assigned to bonds held in the funds, even though it knew or was reckless in not knowing that these daily gradual price decreases did not reflect the fair value of the bonds and were not tied to any daily market or credit-related events that would have affected the value of the individual bonds by the same amount each day. Settlements The four independent directors settled the charges against them by consenting to the entry of an order to cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Rule 22c-1(a) under the Investment Company Act. The independent directors neither admitted nor denied the findings in the order. The pricing vendor settled the charges against it by consenting to the entry of an order that censured it, required it to cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the Advisers Act and Rule 22c-1(a) under the Investment Company Act, and pay a civil money penalty of $125,000. In addition, the order requires the pricing vendor to comply with the following four specific undertakings: 1. To provide its customers with valuations for high yield municipal bonds that are not based solely on information received from a single investment company or investment adviser customer and that have been verified by information from a third party other than that customer; 2. To assign valuations each day to such securities based solely on objectively verifiable information derived from or clearly relevant to the market for such securities, and not to assign valuations to such securities based on the special circumstances or needs of one or any group of its customers; 3. To comply with the Commission's guidelines governing the fair valuation of securities for which market quotations are not readily available; and 4. To keep written records in the format and for the period provided in Advisers Act Rule 204-2 reflecting the basis for each of its valuations, in sufficient detail to permit the Commission to evaluate its compliance with these undertakings. Robert C. Grohowski Associate Counsel