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MUTUAL FUND ADVISER AND AFFILIATED DISTRIBUTOR SETTLE SEC ENFORCEMENT ACTION RELATING TO DIRECTED BROKERAGE

[18340] December 16, 2004 TO: BOARD OF GOVERNORS No. 87-04 CHIEF COMPLIANCE OFFICER COMMITTEE No. 34-04 COMPLIANCE ADVISORY COMMITTEE No. 120-04 SEC RULES MEMBERS No. 176-04 SMALL FUNDS MEMBERS No. 130-04 RE: MUTUAL FUND ADVISER AND AFFILIATED DISTRIBUTOR SETTLE SEC ENFORCEMENT ACTION RELATING TO DIRECTED BROKERAGE The Securities and Exchange Commission has issued an order making findings and imposing disgorgement, civil money penalties, and disclosure and compliance reforms in an administrative proceeding against a registered investment adviser to a group of mutual funds ("Funds") and the Funds' distributor (collectively, "Respondents").* The Respondents consented to the entry of the SEC Order without admitting or denying the SEC's findings. The action involved allegations that the Respondents' shelf space arrangements with various broker-dealers, which were paid for in part through the direction of Fund brokerage, were not adequately disclosed. Findings According to the SEC Order, between 2001 and 2003, the distributor had shelf-space agreements with banks and broker-dealers for which the distributor agreed to pay the broker- dealers for heightened access to the broker-dealers' distributor or sales systems, such as placement of certain Funds on the brokers' websites and lists of preferred mutual funds, access to brokers, and participation in broker conferences. The SEC Order states that the distributor sent 39 broker-dealers a total of $52 million in brokerage commissions related to trades of fund shares (which were fund assets) in exchange for shelf space. The SEC Order finds that the use of Fund assets in lieu of cash payments by the distributor for these marketing arrangements created potential conflicts of interests that should have been, but were not, adequately disclosed to the Funds' Board of Directors and shareholders. It also finds that the use of brokerage commissions to compensate brokerage firms for marketing created a conflict of interest between * See In the Matter of Franklin Advisers, Inc. and Franklin/Templeton Distributors, Inc., SEC Release Nos. 34-50841, IA-2337, and IC-26692, Admin. Proc. File No. 3-11769 (Dec. 13, 2004) ("SEC Order"). The SEC Order also censures the Respondents and imposes a cease and desist order. Copies of the SEC Order and accompanying press release are available at http://www.sec.gov/litigation/admin/34-50841.htm and http://www.sec.gov/news/press/2004- 168.htm, respectively. 2 the adviser and the Funds because the adviser benefited from the increased management fees resulting from increased Fund sales. The SEC Order further finds that the adviser did not adequately disclose to the Funds' Boards and shareholders that brokerage commissions were being

used as a credit for shelf space. Finally, the SEC Order finds that, by using brokerage commissions of certain Funds to support shelf space arrangements that benefited other Funds, the Respondents created a joint distribution arrangement that had not been approved by the SEC. As a result of the conduct generally described above, the SEC Order finds that: • The adviser willfully violated (and the distributor willfully aided and abetted such violations of) Section 206(2) of the Investment Advisers Act of 1940, which makes it unlawful for an investment adviser to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon a client or prospective client; • The adviser willfully violated Section 34(b) of the Investment Company Act of 1940, which prohibits the making of material misstatements or omissions in a registration statement or other document filed with the SEC; and • The Respondents willfully violated Section 17(d) of the Investment Company Act and Rule 17d-1 under that Act, which prohibits a Fund affiliate from participating, as principal, in any transaction in connection with joint arrangements in which the Funds are participants without an SEC order approving the transactions. Voluntary Undertakings In determining to accept the settlement offer, the SEC considered the following efforts to be voluntarily undertaken by the Respondents: • Cooperation – The Respondents will use their best efforts to cause other affiliated investment adviser subsidiaries to perform the undertakings set forth in the SEC Order. • Registration Statement Disclosures – Subject to approval by the Funds' Boards, the Respondents will cause the Funds to include disclosure in their prospectuses or Statements of Additional Information: (1) about any payments by Respondents that are in addition to dealer concessions, shareholder servicing payments, and payments for services that Respondents would otherwise provide; and (2) where applicable, that such payments are intended to compensate broker-dealers for various services provided in exchange for such payments, including, without limitation: placement on the broker's preferred or recommended fund list, access to the broker's registered representatives, assistance in training and education of personnel, and marketing support. Required Undertakings • Senior-Level Person – The Respondents will appoint a senior level employee who will be responsible for developing and implementing within 90 days of the SEC Order and thereafter maintaining the following written compliance policies and procedures: 3 o Trade Execution Through Selling Brokers – Procedures designed to ensure that when the Funds' traders place trades with a broker-dealer that also sells Fund shares, the person responsible for selecting that broker is not informed by the Respondents of, and does not take into account, the broker-dealer's promotion or sale of Fund shares. o Written Contracts – Procedures requiring the distributor to use its best efforts to enter into written contracts memorializing all future shelf space arrangements. The documentation must set forth, among other things, the payment arrangement and the services that the broker-dealer or other intermediary will provide. o Approvals – Procedures for obtaining the approval in writing by the General Counsel of the Respondents' parent company ("General Counsel") (or his delegate) of all shelf space arrangements and presentation of such arrangements to the Funds' Boards for approval prior to implementation. • Compliance Guidelines – The distributor will include in its compliance manual guidelines for entering into shelf space arrangements, which must be consistent with the SEC Order. The guidelines must be reviewed by the Funds' Boards and approved by the General Counsel. • Periodic Reporting – At least annually, the distributor will present to each of the Funds' Boards an overview of the distributor's shelf space arrangements, including: the number and types of such arrangements, the types of services received, the identity of participating broker-dealers, and the total amounts paid. The overview will also cover the distributor's policies regarding shelf space arrangements and any material changes to the policies. On a quarterly basis, the distributor will provide the Boards with a report setting forth the amounts paid by the distributor for shelf space arrangements and the broker-dealers that received the

payments. • Best Execution Analysis – At least annually for each of the next five years, the Respondents will provide to the Funds' Boards a best execution analysis performed by a recognized independent portfolio trading analytical firm. • Independent Distribution Consultant – Within 30 days of the SEC Order, the Respondents will retain an independent distribution consultant acceptable to the SEC staff and to the Funds' Boards. The consultant will develop a plan to distribute the total disgorgement and penalties ordered in the SEC Order to compensate the Funds. The Respondents will require that the independent distribution consultant submit the distribution plan to the Respondents and the SEC staff within 60 days of the SEC Order. Following the issuance of an SEC Order approving a final plan of disgorgement, the independent distribution consultant and the Respondents will take all necessary and appropriate steps to administer the final plan. • Certification – No later than 24 months after the entry of the SEC Order, the presidents of the Respondents will certify to the SEC in writing that the Respondents have fully 4 adopted and complied in all material respects with the undertakings or will describe any material non-adoption or non-compliance. • Recordkeeping – Any record of the Respondents' compliance with the undertakings will 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. Disgorgement and Civil Penalties • The distributor will pay $1 in disgorgement and a civil money penalty of $ 10 million. • The adviser will pay a civil money penalty of $10 million. Jane G. Heinrichs Assistant Counsel

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