MEMO# 17857

August 5, 2004

MUTUAL FUND INVESTMENT ADVISER SETTLES SEC ENFORCEMENT ACTION RELATING TO MARKET TIMING

[17857] August 5, 2004 TO: BOARD OF GOVERNORS No. 52-04 COMPLIANCE ADVISORY COMMITTEE No. 77-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 76-04 SEC RULES MEMBERS No. 109-04 SMALL FUNDS MEMBERS No. 83-04 RE: MUTUAL FUND INVESTMENT ADVISER SETTLES SEC ENFORCEMENT ACTION RELATING TO MARKET TIMING The Securities and Exchange Commission has issued an order making findings and imposing disgorgement, penalties, and compliance reforms in an enforcement proceeding against a registered investment Adviser ("Adviser") to a group of mutual funds ("Funds").1 The Adviser consented to the entry of the SEC Order without admitting or denying the SEC's findings. The action involved allegations that the Adviser permitted market timing trading in the Funds, contrary to prospectus disclosures. The settlement is summarized below. I. Findings The SEC Order finds that, from at least 1996-2001, the Adviser followed a practice, undisclosed to the Funds' boards and shareholders, under which the Adviser approved requests to conduct market timing activity based solely upon whether the portfolio managers thought the proposed trading would be disruptive to the Fund involved. It finds that the practice conflicted with language in the Funds' prospectuses, which created the clear impression that market timing in the Funds was discouraged and would be closely monitored and restricted. According to the SEC Order, from late 1999 through September 2000, the Adviser's parent company and its subsidiaries (collectively, the "Company") generally made efforts to better detect and stop unauthorized market timing in the Funds. The SEC Order states that information was collected on the timers' activities and that, by early 2000, 36 unauthorized timers had been identified. The SEC Order further states that instead of immediately rejecting 1 See In the Matter of Franklin Advisers, Inc., SEC Release Nos. IA-2271 and IC-26523, Admin. Proc. File No. 3-11572 (Aug. 2, 2004) ("SEC Order"). The SEC Order also censures the Adviser 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/ia- 2271.pdf and http://www.sec.gov/news/press/2004-102.htm, respectively. 2 further trades by the identified timers, the Company allowed the timing activity to continue for several months, subject to certain limited conditions. According to the SEC Order, the Company planned to study the timers' activities during the period required for the Funds to adopt and implement revised prospectus language that would enable the Company to more effectively restrict market timing at a later date. The SEC Order finds that the Adviser failed to disclose to the boards of the affected Funds or to investors that the identified timers were being allowed to continue to time the Funds, and that the Funds' prospectuses were thereby rendered misleading during this period of time. The SEC Order states that in September 2000, once

the prospectus revisions were in place, the Company informed the timers that they could no longer market time the Funds and imposed stop codes on certain accounts or trades to prevent timing activity. According to the SEC Order, the Adviser engaged in the following additional misconduct: (1) from July 1998 through September 2000, the Adviser permitted two partnerships to market time a Fund whose prospectus stated that trading by market timers was prohibited; (2) after other identified market timers were told in September 2000 to stop their timing activity, the Adviser permitted an investment management firm to continue timing certain Funds through the end of that year; and (3) in August 2001, the Adviser permitted a known market timer to time a Fund whose prospectus prohibited investments by market timers, and "at about the same time," the market timer invested $10 million in a new hedge fund managed by the Company.2 The SEC Order states that, despite the Adviser allowing some market timing in violation of fund disclosures and its fiduciary duties, the Company as a whole "has generally sought to detect, discourage, and prevent market timing" in the Funds. It further states that the Company "began to increase its efforts to control market timing in 1999, at a time when other mutual fund complexes were encouraging timers." As a result of the conduct generally described above, the SEC Order finds that the Adviser willfully violated: • the antifraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, by: (1) following a practice, not disclosed to the Funds' boards or to investors, under which the Adviser considered market timing requests without considering the relevant prospectus language; and (2) failing to disclose to the Funds' boards or to investors that, for a certain period of time, identified market timers were allowed to continue their extensive timing activities; and • Section 34(b) of the Investment Company Act of 1940, by making material misstatements and omissions in the Funds' prospectuses. 2 The SEC Order states that the Adviser granted the request to market time the Fund based on the condition that the mutual fund trading and hedge fund investment could not be linked. It further states that, contrary to the Adviser's directive and without its knowledge, an employee of a subsidiary of the Adviser struck an arrangement with the timer under which the timer's investment in the hedge fund was linked to his being able to conduct the timing activity in the mutual fund. 3 II. Voluntary Undertakings In determining to accept the settlement offer, the SEC considered that the Adviser has voluntary undertaken to use its best efforts to cause: (1) all other registered investment adviser subsidiaries of the Adviser's parent company to perform the undertakings in the SEC Order relating to general compliance, periodic compliance review, certification and recordkeeping; (2) the Company to comply with the undertaking in the SEC Order relating to excess recovery; and (3) the Company to provide such cooperation as may be needed to facilitate the performance of the undertakings in the SEC Order. III. Required Undertakings The SEC Order sets forth the following required undertakings: General Compliance • The Adviser will establish and staff a full-time senior-level position whose responsibilities will include compliance matters related to conflicts of interest. This officer will report directly to the Adviser's Chief Compliance Officer ("CCO"). • The Adviser will require that: (1) its CCO or a member of his/her staff review compliance with the policies and procedures established to address compliance issues under the Investment Company Act or Investment Advisers Act; and (2) any violations will be reported to the Adviser's President and the independent trustees and directors of the Funds. • The Adviser will require its CCO to report to the independent trustees and directors of the Funds any breach of fiduciary duty or the federal securities laws to the extent related to fund business of which the CCO becomes aware, with such frequency as the independent trustees and directors of the Funds may instruct, and in any event at least quarterly. Any material breach, however, must be reported promptly. • 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 to the extent related to fund business brought to the ombudsman's attention, along with any resolution of such matters, with the independent trustees and directors of the Funds, with such frequency as the independent trustees and directors of the Funds may instruct. Disgorgement and Civil Penalty • The Adviser will pay $30 million in disgorgement and a civil money penalty of $20 million. • Independent Distribution Consultant – Within 30 days of the SEC Order, the Adviser must retain an Independent Distribution Consultant acceptable to the SEC staff and to the majority of the independent trustees and directors of the Funds. The consultant will develop a plan to distribute the total disgorgement and penalty ordered to the 4 shareholders of Funds managed by the Adviser or its affiliates to compensate for market timing trading activity during the relevant period. The Independent Distribution Consultant must submit the distribution plan to the Adviser and the SEC staff within 195 days of the SEC Order. Following the 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. • Excess Recovery – The Adviser will pay to the SEC all amounts in excess of $30 million that it obtains, through settlement, final judgment or otherwise, from individuals or entities alleged to have engaged in market timing in any of the Funds. Such amounts will be distributed pursuant to the distribution plan described above. Other Undertakings • Periodic Compliance Review – At least once every other year, commencing in 2005, the Adviser must undergo a compliance review by a third party that is not an interested person of the Adviser. The third party must issue a report of its findings and recommendations to the Adviser's Chief Compliance Officer, the independent trustees and directors of the Funds, and to the Compliance or Audit Committee of each Fund board. • Certification – No later than 24 months after the entry of the SEC Order, the Adviser's President must certify to the SEC in writing that the Adviser has fully adopted and complied in all material respects with the required undertakings, or must describe any material non-adoption or non-compliance. • Recordkeeping – Any record of the Adviser's compliance with the 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. Rachel H. Graham Assistant Counsel

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