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INVESTMENT ADVISER AND TWO EXECUTIVES SETTLE SEC, NEW YORK, AND NEW HAMPSHIRE ACTIONS RELATING TO MARKET TIMING

[17091] February 11, 2004 TO: BOARD OF GOVERNORS No. 12-04 COMPLIANCE ADVISORY COMMITTEE No. 20-04 INVESTMENT COMPANY DIRECTORS No. 7-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 15-04 SEC RULES MEMBERS No. 24-04 SMALL FUNDS MEMBERS No. 18-04 RE: INVESTMENT ADVISER AND TWO EXECUTIVES SETTLE SEC, NEW YORK, AND NEW HAMPSHIRE ACTIONS RELATING TO MARKET TIMING The Securities and Exchange Commission has issued an order making findings and imposing remedial undertakings, disgorgement, penalties, and suspensions in an enforcement proceeding against a registered investment adviser to a group of mutual funds, the adviser's chief executive officer, and its president and chief investment officer.1 The adviser and the two executives consented to the entry of the SEC Order without admitting or denying the SEC's findings.2 In addition, the Attorney General of New York and the New Hampshire Bureau of Securities Regulation announced the settlement of related state charges.3 All three actions involved allegations that the adviser knowingly permitted widespread market timing in certain mutual funds, in contravention of the funds' prospectus disclosures. The SEC Order and the announcements by the Attorney General and the Bureau are summarized below. 1 See In the Matter of Massachusetts Financial Services Co., John W. Ballen, and Kevin R. Parke, SEC Release Nos. IA- 2213 and IC-26347, Admin. Proc. File No. 3-11393 (Feb. 5, 2004) ("SEC Order"). The SEC Order also censures the adviser and imposes a cease and desist order on the adviser and the executives. A copy of the SEC Order is available on the SEC's website at http://www.sec.gov/litigation/admin/ia-2213.htm. The press release announcing the SEC Order states that the SEC's investigation is continuing. 2 Commissioner Glassman concurred in the SEC's settlement with the adviser but dissented from the settlements with the two executives. In a written dissent, available on the SEC's website at http://www.sec.gov/litigation/admin/ia- 2213a.htm, Commissioner Glassman states that the terms of those settlements were not strong enough. In an interview, she said the executives should have been subject to an industry "time out" of at least a year. See, e.g., Charles Forelle, SEC Commissioner Criticizes Terms of Settlement with MFS, Wall St. J., Feb. 9, 2004, at C5. 3 See MFS Settles Market Timing Issues (press release issued by Office of New York State Attorney General Eliot Spitzer, Feb. 5, 2004), available at http://www.oag.state.ny.us/press/2004/feb/feb05a_04.html; New Hampshire Securities Regulators Join SEC and New York Attorney General's Office in $225 Million Settlement with Massachusetts Financial Services (press release issued by New Hampshire Bureau of Securities Regulation, Feb. 5, 2004), available at

http://www.sos.nh.gov/securities/MFS%20SETTLEMENT.pdf. 2 I. SEC Order A. Alleged Violations The SEC Order finds that, from at least late 1999 through October 2003, the adviser and the executives allowed widespread market timing trading in 11 of the 104 retail mutual funds advised by the adviser. It further finds that the adviser and the executives did not disclose in the funds' prospectuses, and did not effectively communicate to the funds' boards, the adviser's internal policy of allowing market timing trading in the "unrestricted" funds. According to the SEC Order, the funds' prospectuses first stated that the funds do not permit market timing or other excessive trading practices; later, they were modified to state that the funds do not permit market timing or other excessive trading practices that might disrupt portfolio management and harm fund performance. The SEC Order states that the adviser and the executives believed that the unrestricted funds were not susceptible to successful exploitation of inefficiencies in mutual fund pricing. It finds that they failed, however, to determine whether market timing was causing harm to the unrestricted funds and that the adviser further failed to detect what appears to have been a significant amount of illegal late trading in the unrestricted funds. Finally, the SEC Order finds that the executives played a significant role in establishing and applying the internal policy, despite indications during the relevant period that market timing trading was causing potential and actual harm and disruption to the unrestricted funds. The SEC Order states that the adviser and the executives willfully violated the antifraud provisions of: • Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 by permitting widespread market timing trading in the unrestricted funds, in contravention of those funds' prospectus disclosures and with knowledge or reckless disregard of the fact that the internal policy was harmful or potentially harmful to the funds' long-term shareholders; and • Section 34(b) of the Investment Company Act of 1940 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 settlement offers, the SEC considered the cooperation afforded the SEC staff during the investigation by the adviser, the two executives, and a special committee of the adviser's board of directors. According to the SEC Order, the SEC further considered certain voluntarily undertakings by the adviser, which generally include the following: • At least 75% of the trustees of any retail fund will be independent. • Any chairman of the board of trustees of any retail fund will be independent. 3 • Any counsel to the independent trustees of any retail fund 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. • No action by the board of any retail fund will be taken without approval by a majority of the independent trustees, and any action approved by a majority of the independent trustees but not by the full board will be disclosed in fund shareholder reports. • Commencing in 2005, each retail fund will hold a shareholder meeting to elect its board of trustees at least once every five years. • Each retail fund will designate an independent compliance officer who will report to its board and be responsible for assisting the trustees 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 retail funds. • The adviser will cooperate fully with the SEC in any investigations, litigation, or other proceedings relating to or arising from the matters described in the SEC Order. 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 Compliance or Audit Committee of the trustees of the retail funds 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 Compliance or Audit Committee of the adviser. • The adviser will establish an Internal Compliance Controls Committee. The independent compliance officer of the trustees of the retail funds will be invited to participate in all meetings of the committee, provided that the officer's involvement is limited to compliance issues relating to the retail funds. The committee will report to the Compliance or Audit Committee of the trustees of the retail funds at least quarterly on internal compliance matters. • The adviser also will provide the reports of the Code of Ethics Oversight Committee and the Internal Compliance Controls Committee to the Risk Review or Audit Committee of the adviser's parent company. • The adviser will establish, at its own expense, 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"). 4 • The adviser's CCO will review compliance with the policies and procedures that address compliance issues under the Investment Company Act and Advisers Act and will report any violations to the Internal Compliance Controls Committee. • The adviser's CCO will report to the independent trustees of the retail funds at least quarterly any breach of fiduciary duty or the federal securities laws (to the extent related to fund business) of which the CCO becomes aware. Any material breach will 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 brought to the ombudsman's attention (to the extent relating to fund business), along with any resolution of such matters, with the independent trustees of the retail funds with such frequency as the independent trustees may instruct. Disgorgement, Civil Penalties, and Other Sanctions • The adviser will pay $175 million in disgorgement and a civil money penalty of $50 million. In addition, the adviser will disgorge all funds in excess of $175 million that it obtains through settlements with, or final judgments against, persons alleged to have engaged in late trading or market timing in any retail fund. • Each of the executives will pay approximately $65,000 in disgorgement and prejudgment interest, as well as a civil money penalty of $250,000. • Independent Distribution Consultant – Within 30 days of the SEC Order, the adviser must retain an Independent Distribution Consultant acceptable to the SEC staff and the independent trustees of the retail funds. The consultant will develop a plan to distribute the total disgorgement and penalties ordered to compensate the funds' shareholders for losses attributable to late trading and other market timing trading activity during the relevant period. The Independent Distribution Consultant must submit the distribution plan to the SEC 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. • 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: (1) the adviser's market timing and late trading controls across all areas of its business; (2) pricing practices that may make the retail funds vulnerable to market timing; (3) utilization by the retail funds of short-term trading fees and other controls for deterring excessive short term trading; (4) possible governance changes to the retail funds' boards to improve compliance; and (5) the adviser's policies and procedures concerning conflicts of interest. The Independent Compliance Consultant must complete its review and provide its recommendations in a report to the 5 adviser, the trustees of the retail funds, 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 2006, 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 Internal Compliance Controls Committee and the Compliance or Audit Committee of each retail fund's board of trustees. • 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 complied in all material respects with the required 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 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. D. Suspensions and Prohibitions • Each of the two executives named in the SEC Order is prohibited from serving as an officer or director of any investment adviser or as an employee, officer, or director of any registered investment company for a period of three years. • The chief executive officer and the president are prohibited from serving or acting as a member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, for periods of nine months and six months, respectively. • The chief executive officer and the president are suspended from association with any investment adviser for periods of nine months and six months, respectively. For 27 months following the suspension (30 months in the case of the president), the executives may not perform any duties for an investment adviser relating to prospectus or other public disclosures, distribution, institutional or retail sales of the shares of any registered investment company, compliance matters, internal audit functions, or shareholder trading activities.4 4 Each of the executives may, to the extent such duties are not prohibited during the 27 month period or 30 month period, as applicable: (1) perform duties involving strategic planning, business analysis, and business planning; (2) be employed by and act as a portfolio manager of a registered investment company and/or manage other investment personnel with respect to investment and personnel decisions; and (3) participate in the marketing of any non-mutual fund business of the investment adviser that employs the executive. 6 II. Settlement of State Charges A. New York According to the press release issued by the Office of the New York Attorney General, the adviser violated New York's Martin Act by stating in its prospectuses and other materials that its mutual funds do not permit market timing when, in fact, ten of those funds were open to market timers and were being heavily timed. The release states that the settlement agreement with the Attorney General requires the adviser to: • Pay $175 million in restitution to injured investors, as well as a $50 million penalty;5 • Reduce management fees by an estimated $125 million over the next five years; and • Hire a senior executive who will be responsible for ensuring that management fees charged to the funds are reasonable and are negotiated at arm's length. B. New Hampshire The press release issued by the New Hampshire Bureau of Securities Regulation describes the adviser's payment of $225 million in penalties and disgorgement and the suspensions of the two executives as part of a single settlement with the SEC, the Attorney General of New York, and the Bureau. According to the press release, the Bureau requested an additional $1 million for investor education efforts as part of its settlement with the adviser. In addition, the adviser agreed to reimburse certain costs associated with the settlement. Rachel H. Graham Assistant Counsel 5 These terms are incorporated in the SEC Order and do not represent additional penalties. The press release does not mention the settlement of charges against the two executives.

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