

**MEMO# 16771**

November 17, 2003

# **STRUCTURAL REFORMS TO PARTIALLY SETTLE SEC ENFORCEMENT ACTION AGAINST A MUTUAL FUND INVESTMENT ADVISER**

[16771] November 17, 2003 TO: BOARD OF GOVERNORS No. 61-03 COMPLIANCE ADVISORY COMMITTEE No. 97-03 INVESTMENT COMPANY DIRECTORS No. 17-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 99-03 SEC RULES MEMBERS No. 156-03 SMALL FUNDS MEMBERS No. 66-03 RE: STRUCTURAL REFORMS TO PARTIALLY SETTLE SEC ENFORCEMENT ACTION AGAINST A MUTUAL FUND INVESTMENT ADVISER 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 relating to alleged market timing activities in the funds by employees of the adviser.<sup>1</sup> The adviser consented to the entry of the Order without admitting or denying most of the Commission's findings.<sup>2</sup> The Order is summarized below. The Order notes that in determining to accept the adviser's settlement offer, the Commission considered cooperation afforded the Commission's staff by the adviser during the investigation. In addition, the Commission considered the fact that the funds' independent trustees have undertaken a special investigation related to late trading and market timing. Finally, as further discussed below, the Commission considered various other voluntary undertakings of the funds. Background and Alleged Violations The Order discusses alleged short-term trading activities by six employees of the adviser in the adviser's funds. The Order states that four of these employees engaged in short-term trading in their personal accounts in funds over which they had decision-making responsibility 1 See In the Matter of Putnam Investment Management, LLC, Investment Advisers Act Release No. 2192, Admin. Proc. File No. 3-11317 (Nov. 13, 2003) ("Order"). A copy of the Order is available on the Commission's website at [www.sec.gov/litigation/admin/ia-2192.htm](http://www.sec.gov/litigation/admin/ia-2192.htm). A related press release is available at [www.sec.gov/news/press/2003-156.htm](http://www.sec.gov/news/press/2003-156.htm). 2 The adviser admitted certain findings as to the Commission's jurisdiction and as to short-term trading by several investment management employees in funds managed by the adviser (and, in some cases, by those employees) in their personal accounts. 2 and about which they had access to non-public information such as current portfolio holdings, valuations and transactions. According to the Order, between 1998 and 2003, short-term trading by the six employees generated over \$1 million in gross personal gains. The 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 failing to disclose to the boards of mutual funds it managed that certain investment management professionals were engaging in potentially self-dealing short-term securities

trading. In addition, according to the Order, the adviser willfully violated Section 204A of the Advisers Act by failing to take adequate steps to detect and deter short-term trading of its funds by portfolio managers and other investment professionals who had access to non-public information regarding, among other things, current portfolio holdings, valuations and transactions not readily available to all fund shareholders. The Order further finds that the adviser willfully violated Section 17(j) of the Investment Company Act of 1940 and Rule 17j-1 thereunder by failing to use reasonable controls to monitor and detect market timing activity by its employees after it amended its code of ethics to prohibit such activity. Finally, the Order states that the adviser failed reasonably to supervise, within the meaning of Section 203(e)(6) of the Advisers Act, certain of its employees.

**Voluntary Undertakings**

The Order lists a series of voluntary efforts undertaken by the adviser's funds, some of which are currently in place, that the Commission considered in determining to accept the adviser's offer of settlement. These include the following:

- At least 75% of the trustees of each fund will be independent.
- Any chairman of the board of trustees of any fund will be independent.
- Any counsel to the independent trustees 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.
- The board will continue to maintain separate committees to oversee the investment operations of particular categories of funds. These committees will consist of at least a majority of independent trustees and will have independent chairs. They will identify any compliance issues unique to the particular category of fund and work with appropriate board committees to ensure that any such issues are properly addressed.
- No board action 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 2004, each fund will hold a shareholder meeting to elect the board of trustees at least once every five years.
- Each fund will designate a member of the independent administrative staff reporting to its board as 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 funds.

**3 Required Undertakings**

The Order also sets forth the following required undertakings by the adviser (some of which also apply to any broker-dealer affiliate that acts as principal underwriter for the adviser's mutual funds):

**Employee Trading Restrictions and Compliance**

- Beginning January 1, 2004, the adviser must require its employees to place purchase, redemption or exchange orders for the mutual funds it advises through the adviser.
- The adviser must add to its Rule 17j-1 code of ethics a 90-day holding period (one year for investment employees) applicable to employee investments in the adviser's mutual funds, other than money market funds and certain other funds designed to permit short-term investment.
- If any exceptions to the holding period requirements are granted by the Code of Ethics Oversight Committee, they must be reported to the independent trustees. In addition, if an exception from the holding periods is granted to an employee, the adviser must take all actions necessary to permit the application of a redemption fee on any exchange within 90 days by such employee in an amount equal to that imposed on any similarly situated investors and in no event less than 1% of the total redemption amount.
- The adviser's chief compliance officer or a member of his or her staff must review employee trading compliance and report violations to the Code of Ethics Oversight Committee for the imposition of an appropriate sanction. The minimum sanction for an initial violation will be disgorgement of any profit on a redemption made prior to the expiration of the applicable holding period.
- The adviser must use its reasonable best efforts to build within a reasonable time an automated system to prevent, on a pre-trade basis, redemptions by employees before the expiration of the applicable holding period, in funds advised by the adviser that are maintained on its recordkeeping

systems. • By December 31, 2003, responsibility for employee trading compliance must be transferred from the human resources department to the legal and compliance department under the supervision of the adviser's chief compliance officer. • The adviser must establish and staff a full-time, senior-level position whose responsibilities will principally concern compliance matters related to personal trading by the adviser's employees and who will report to the adviser's chief compliance officer. • The adviser's chief compliance officer must report to the funds' trustees any breach of fiduciary duty and/or of the federal securities laws of which he or she becomes aware in the course of carrying out his or her duties, at least quarterly, provided that any material breach must be reported promptly. • The adviser must maintain a Code of Ethics Oversight Committee, comprised of senior executives of its operating businesses, that will meet at least quarterly to review violations of the code of ethics and consider code of ethics policy matters. The adviser must report to the funds' audit committees on issues arising under the code of ethics, including violations, at least quarterly, provided that any material violation must be reported promptly. • The adviser must establish an Internal Compliance Controls Committee, chaired by the chief compliance officer and having as its members senior executives of the adviser's operating businesses. The fund trustees' independent staff must be invited to attend 4 and participate in all meetings of this committee, which will review compliance issues and endeavor to develop solutions. The committee must report to the funds' audit committees at least quarterly. • The adviser must establish a corporate ombudsman to whom its employees may convey concerns about ethics matters or questionable practices, and must establish procedures, approved by the funds' independent trustees, to investigate such matters. The adviser must review any matters brought to the ombudsman's attention, along with any resolution of such matters, with the independent trustees with such frequency as they may instruct. Restitution • Within 30 days of the Order, the adviser must retain an Independent Assessment Consultant acceptable to the Commission's staff and the funds' independent trustees to calculate the monetary amounts necessary to fairly compensate fund shareholders for losses attributable to excessive short-term trading and market timing trading activity by the adviser's employees. The Independent Assessment Consultant must conclude its review and submit a report to the adviser and the Commission's staff no more than 120 days after the date of the Order, and within 195 days after entry of the Order, the adviser must take all necessary and appropriate steps to compensate the funds' shareholders. Independent Compliance Consultant • Within 30 days of the 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 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. The Independent Compliance Consultant must complete its review and provide its recommendations in a report to the adviser, the funds' trustees and the Commission's staff no more than 120 days after the date of the 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 investment 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 date of the Order, the adviser's chief executive officer must certify to the Commission in writing that the adviser has fully adopted and complied in all material respects with the foregoing undertakings and the recommendations of the Independent Compliance Consultant, or must describe any 5 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. Civil Money Penalties and Other Monetary Relief The Order provides that, in addition to making restitution to investors, the adviser must pay a civil money penalty and possibly other monetary relief in an amount to be determined in a settlement or, if no settlement is reached, after a hearing. In the event of a hearing, the adviser will be precluded from arguing that it did not violate the federal securities laws in the manner described in the Order, and the findings in the Order will be accepted as and deemed true by the hearing officer. Frances M. Stadler Deputy Senior Counsel

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