

MEMO# 19213

October 5, 2005

FUND ADVISER AND DISTRIBUTOR SETTLE SEC CHARGES RELATING TO REVENUE SHARING

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [19213] October 5, 2005 TO: BOARD OF GOVERNORS No. 48-05 CLOSED-END INVESTMENT COMPANY MEMBERS No. 52-05 COMPLIANCE MEMBERS No. 19-05 SEC RULES MEMBERS No. 108-05 SMALL FUNDS MEMBERS No. 83-05 RE: FUND ADVISER AND DISTRIBUTOR SETTLE SEC CHARGES RELATING TO REVENUE SHARING The Securities and Exchange Commission has issued an order making findings and imposing compliance reforms in an enforcement action against a registered investment adviser to a group of mutual funds ("Funds") and the Funds' distributor, a wholly-owned subsidiary of the adviser.¹ The action involved allegations that the Respondents unlawfully used brokerage commissions on trades executed for some of the Funds to reduce the distributor's revenue sharing obligations with certain broker-dealers. The Respondents consented to the Order without admitting or denying the Commission's findings. Findings According to the Order, from at least January 2000 through June 2003, the distributor entered into arrangements with certain broker-dealers in order to gain access to their distribution systems. Under these arrangements, the distributor generally made cash payments to the broker-dealers from its own resources. In the case of approximately 25 broker-dealers, however, the distributor reduced its cash payments by directing brokerage commissions from some of the Funds to those broker-dealers ("revenue sharing directed brokerage"). The Order finds that the adviser failed to disclose this use of Fund assets to either the Funds' boards of directors ("Boards") or shareholders. In particular, it finds that the adviser's annual brokerage reports to the Boards mistakenly treated revenue sharing directed brokerage as "sales-recognition directed brokerage" (i.e., brokerage commissions awarded to broker- ¹ See In the Matter of OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc., SEC Release Nos. 34-52420, IA-2427 and IC-27065, Admin. Proc. File No. 3-12038 (Sept. 14, 2005) ("Order"). The Order, which also censures the Respondents and imposes cease and desist orders, is available on the Commission's website at <http://www.sec.gov/litigation/admin/34-52420.pdf>. ² dealers in consideration of their fund sales, in accordance with NASD rules in effect at that time). It also finds that the adviser failed to alert the Boards to the actual and potential conflicts of interest that the adviser faced in using Fund assets in connection with the revenue sharing arrangements. Finally, the Order finds that the Respondents did not ensure that the commissions paid to broker-dealers as revenue sharing directed brokerage came from the particular Funds being promoted by the broker-dealers, nor did they seek an exemption from the statutory provisions prohibiting such joint arrangements. Based on this conduct,

the Commission found that: • the adviser willfully violated Section 206(2) of the Investment Advisers Act of 1940 and Sections 15(c) and 34(b) of the Investment Company Act of 1940; • the distributor willfully aided and abetted and caused the adviser's violations of the Advisers Act; and • the Respondents willfully violated Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder. Remedial Actions by Respondents; Required Undertakings In determining to accept the settlement offer, the Commission considered remedial actions that were promptly and voluntarily undertaken by Respondents, as well as Respondents' cooperation with the Commission staff. In particular, the Commission considered that the adviser: • discontinued the use of directed brokerage, including revenue sharing directed brokerage; • retained an outside law firm to review the distributor's revenue sharing practices and make a report to the Boards; • directed its Internal Audit Department to determine the financial impact of the revenue sharing directed brokerage; and • voluntarily paid to the Funds approximately \$15.8 million, which represented the gross amount of brokerage commissions that had been used to reduce the distributor's revenue sharing cash payments. For these reasons, the Commission did not require the adviser to pay disgorgement, prejudgment interest, or a civil penalty. The Order does, however, impose the following undertakings: • The adviser will implement and maintain written procedures to ensure that when its trading desk places trades with a broker-dealer that also sells fund shares, the person responsible for selecting the broker-dealer does not take into account the broker-dealer's promotion or sale of Fund shares. 3 • The adviser will establish guidelines, as outlined in the Order, for entering into revenue sharing agreements with broker-dealers and other intermediaries concerning the sale of fund shares. The language of the guidelines must be presented to the Boards and approved by the adviser's Chief Legal Officer. • The adviser's Chief Legal Officer (or his/her delegate) must approve in writing all revenue sharing arrangements concerning the sale of fund shares. The form of such arrangements must be presented to the Boards prior to implementation. • Subject to the approval of the Boards, the adviser will prepare disclosures for the Funds' prospectuses or Statements of Additional Information concerning payments by either Respondent to broker-dealers or other intermediaries in respect of the sale of fund shares that are in addition to dealer concessions, shareholder servicing payments, and payments for services that the adviser or an affiliate would otherwise provide (e.g., sub-accounting). The disclosures must state that such payments are intended to compensate broker-dealers for various services, including without limitation: placement on a broker-dealer's preferred or recommended fund list, access to its registered representatives, assistance in training and educating personnel, marketing support, and other specified services. • At least once per year, the adviser will make presentations to the Boards concerning the Respondents' revenue sharing arrangements and policies, as outlined in the Order. The adviser also will provide the Boards with a quarterly report setting forth the amounts paid by Respondents for such arrangements and the recipients of those payments. • At least once per year, for at least five years, the adviser will continue to provide the Boards with a best execution analysis, including lists of (i) the top ten executing broker-dealers used by the adviser and (ii) the top ten selling broker-dealers conducting business with the distributor. • The adviser will develop policies and procedures to ensure that fund administrative expenses are not used to finance the distribution of Fund shares.

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