INVESTMENT COMPANY INSTITUTE

MEMO# 11885

May 15, 2000

SEC ADMINISTRATIVE PROCEEDING AND NEW YORK STATE STIPULATION REGARDING IPO ALLOCATIONS TO MUTUAL FUNDS

1 In the Matter of The Dreyfus Corp. and Michael L. Schonberg, Admin. Proc. File No. 3-10201 (May 10, 2000). 2 In the Matter of The Dreyfus Corp., Dreyfus Service Corp. and Michael L. Schonberg (Stipulation, dated April 18, 2000). 1 [11885] May 15, 2000 TO: ADVERTISING COMPLIANCE ADVISORY COMMITTEE No. 16-00 COMPLIANCE ADVISORY COMMITTEE No. 19-00 SEC RULES MEMBERS No. 32-00 RE: SEC ADMINISTRATIVE PROCEEDING AND NEW YORK STATE STIPULATION REGARDING IPO ALLOCATIONS TO MUTUAL FUNDS ____ The Securities and Exchange Commission recently accepted an offer of settlement and imposed sanctions in an administrative proceeding involving an investment adviser and a portfolio manager in connection with the portfolio manager's allocation of shares in initial public offerings among the mutual funds under his management.1 The adviser and the portfolio manager each consented to the entry of an order, without admitting or denying the Commission’s findings. The adviser, the portfolio manager and the funds' current distributor also entered into a related stipulation with the Attorney General of New York, in which each denied the Attorney General's contentions.2 Copies of the order and the stipulation are attached and are summarized below. The order states that the portfolio manager became responsible for a new fund in September 1995. At that time, he also managed two other funds and added a fourth fund in February 1996. Although their net asset sizes differed significantly, all four funds had the same stated investment objective -- capital appreciation -- and all four did and could invest in IPOs. In addition, the prospectus for the new fund stated that if "other investment companies [advised by the adviser] desire to invest in, or dispose of, the same securities as [the new fund], available investments or opportunities for sales will be allocated equitably to each investment company." The order further states, however, that during the new fund's first fiscal year, IPO shares were not allocated equitably. Instead, the portfolio manager's IPO allocations had the effect of favoring the new fund over the other funds in the allocation of IPOs in general and "hot" IPOs in particular. According to the order, the adviser published an advertisement in May 1996 that prominently displayed the new fund’s 84.16% return since inception and 40.97% return for the first quarter of 1996. This ad stated that the fund's "relatively small asset size combined with a period of high stock market performance may have contributed to the Fund's success and may not be replicated over the long term." Similar advertisements

appeared during the fall of 1996. The order notes, however, that the advertisements did not mention the large impact that IPOs had on the new 2fund's performance. The order further states that the adviser did not measure the impact of IPOs on the fund's performance and did not review the effect, over time, of the portfolio manager's allocation practices to assure equitable results. The order also indicates that the portfolio manager engaged in transactions on behalf of the funds involving the securities of seven companies in which he held a position acquired prior to his employment with the adviser. In addition, in two instances, he precleared and entered into personal securities transactions and later engaged in transactions in those securities on behalf of funds under his management. The adviser's code of ethics prohibited a manager from participating "in any activity that causes a conflict of interest or gives the appearance of a conflict of interest." The order did not identify any actual conflict of interest; however, according to the order, the adviser did not take appropriate steps, and had not instituted adequate procedures reasonably necessary, to prevent violations of its code of ethics relating to the portfolio manager's potential conflicts of interest. The order states that the failure to disclose the preferential allocation of IPOs was a material omission, and that the fund's prospectus disclosure regarding equitable allocation of investment opportunities was false and misleading. The Commission also concluded that disclosure that a large portion of the fund’s return during its first fiscal year was attributable to its investments in IPOs would have been material to an investor’s decision whether to invest in the fund. Accordingly, the Commission found that the adviser willfully violated, and the portfolio manager caused and willfully aided and abetted the adviser’s violation of, Section 206(2) of the Investment Advisers Act. In addition, the Commission found that the adviser willfully violated, and the portfolio manager willfully violated and caused and willfully aided and abetted the adviser's violation of, Section 17(a)(3) of the Securities Act of 1933. The Commission also found that the adviser failed reasonably to supervise the portfolio manager in connection with his IPO allocations, with a view to preventing his violations, and did not establish procedures, and a system for applying such procedures, reasonably expected to prevent and detect such violations. Finally, the Commission concluded that the adviser willfully violated Section 17(j) of the Investment Company Act and former Rule 17j-1(b)(1). The adviser and the portfolio manager were each censured and ordered to cease and desist from committing or causing any violation and any future violation of Section 206(2) of the Advisers Act and Section 17(a)(3) of the Securities Act. The adviser was also ordered to cease and desist from committing or causing any violation and any future violation of Section 17(j) of the Investment Company Act and Rule 17j-1(c) thereunder, and to pay a civil penalty of $950,000. In addition, the adviser agreed to retain an independent consultant to conduct a comprehensive review of its policies, procedures and practices relating to the allocation of IPO shares among mutual funds and portfolio managers, its policies, procedures and practices relating to performance advertising, its disclosure of policies and procedures relating to the allocation of IPO shares, its code of ethics and procedures for the prevention and detection of actual or apparent conflicts of interest in its portfolio managers' personal investing, and the supervision of such activities. The portfolio manager was suspended from association with any investment adviser and prohibited from serving or acting as an employee, officer, director, 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 nine months. He was also ordered to pay a civil penalty of $50,000. According to the related stipulation, the New York Attorney General caused an inquiry to be made into sales of the new fund pursuant to Section 352-c(1) of the New York General Business Law. 3The Attorney General agreed to accept the stipulation and close its investigation in light of the resolution of the SEC proceeding, the lack of evidence establishing any intentional wrongdoing, and the adviser's voluntary contribution of $1.6 million to a state university and payment of $400,000 to the Attorney General for the costs of investigation. The adviser, the portfolio manager and the funds' current distributor entered into the stipulation, but contested and denied the Attorney General's contentions of any wrongdoing. Kathy D. Ireland Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. 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