

MEMO# 18526

February 18, 2005

MUTUAL FUND INVESTMENT ADVISER AND AFFILIATED ENTITIES SETTLE SEC ENFORCEMENT ACTION RELATING TO MARKET TIMING, LATE TRADING

[18526] February 18, 2005 TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 17-05 COMPLIANCE ADVISORY COMMITTEE No. 16-05 SEC RULES MEMBERS No. 31-05 SMALL FUNDS MEMBERS No. 18-05 RE: MUTUAL FUND INVESTMENT ADVISER AND AFFILIATED ENTITIES SETTLE SEC ENFORCEMENT ACTION RELATING TO MARKET TIMING, LATE TRADING

The Securities and Exchange Commission has issued an order making findings and imposing disgorgement, civil money penalties, and disclosure and compliance reforms in an administrative proceeding against a registered investment adviser to a group of mutual funds ("Funds"), the Funds' distributor and an affiliated broker-dealer (collectively, "Respondents").* The Respondents consented to the entry of the SEC Order without admitting or denying the SEC's findings. The action involved allegations that the Respondents facilitated market timing and late trading in the Funds as well as unaffiliated mutual funds. The SEC Order is summarized below. * See In the Matter of Banc of America Capital Management, LLC, BACAP Distributors, LLC, and Banc of America Securities, LLC, SEC Release Nos. 33-8538, 34-51167, IA-2355, and IC-26756, Admin. Proc. File No. 3-11818 (Feb. 9, 2005) ("SEC Order"). The SEC Order also censures the Respondents 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/33-8538.htm> and <http://www.sec.gov/news/press/2005-16.htm>, respectively. In addition, the Attorney General of New York announced a settlement with the Respondents of related state charges. See Spitzer, S.E.C. Reach Largest Mutual Fund Settlement Ever (press release issued by Office of NY State Attorney General Eliot Spitzer, March 15, 2004), which is available at http://www.oag.state.ny.us/press/2004/mar/mar15c_04.html. For a summary of this press release, see Memorandum to Board of Governors No. 27-04, Compliance Advisory Committee No. 40-04, Investment Company Directors No. 18-04, Primary Contacts - Member Complex No. 35-04, SEC Rules Members No. 50-04, and Small Funds Members No. 38-04, Apr. 2, 2004 [17347]. The settlement document with the Attorney General of New York has not been publicly released as of the date of this Memorandum. In separate, coordinated agreements with the Office of the Comptroller of the Currency and the Federal Reserve Bank of Richmond, Bank of America has agreed to develop corporate governance and internal control policies and procedures relating to mutual fund trading and regulation. Copies of the agreements with the Office of the Comptroller of the Currency and the Federal Reserve Bank of Richmond, are available at <http://www.occ.gov/ftp/eas/ea2005-10.pdf> and <http://www.federalreserve.gov/boarddocs/press/enforcement/2005/20050209/attachment.p>

df, respectively. The agreements, which are not summarized in this Memorandum, do not involve fines or penalties. 2 Findings According to the SEC Order, from as early as July 2000 to July 2003, the adviser and the Funds' distributor entered into arrangements with two entities that allowed them to engage in frequent short-term trading in at least 13 Funds. In connection with one of these arrangements, the SEC Order states that the adviser and distributor received "sticky assets" – long-term investments that were to remain in place in return for allowing the entity to market time the Funds. The SEC Order further states that in 2002 the Board of Trustees of the Funds approved a redemption fee on short-term trades in certain Funds susceptible to timing, but simultaneously approved an exemption for one of these entities from the redemption fee. According to the SEC Order, the adviser and the distributor did not disclose to the Funds' shareholders and potential shareholders these two market-timing arrangements or the fact that one of these entities was being exempted from the redemption fee. During the same time period, the SEC Order finds that the affiliated broker-dealer facilitated market timing and late trading by some introducing broker-dealers and a hedge fund at the expense of shareholders of the Funds and other mutual funds. The SEC Order further finds that these entities effected their late trading through the affiliated broker-dealer's order entry system. Once granted access to the system, the introducing broker-dealers and hedge fund entered mutual fund trade orders as late as 7:00 p.m. Eastern Time. According to the SEC Order, the affiliated broker-dealer also provided the introducing broker-dealers with account management tools and other assistance that enabled the introducing broker-dealers to conceal the market timing activities of their clients from unsuspecting mutual funds. The SEC Order states that the affiliated broker-dealer facilitated the submission of hundreds of market timing trades by the introducing broker-dealers after the mutual funds in question had acted to block these entities from further trading. As a result of the conduct generally described above, the SEC Order finds that:

- the adviser willfully violated (and the distributor and broker-dealer willfully aided and abetted such violations of) Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 by entering into arrangements with two entities that created a conflict of interest, which the adviser knowingly or recklessly failed to disclose to the Funds' shareholders;
- the adviser and the distributor willfully violated Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 under that Act by participating in and effecting transactions in connection with joint arrangements in which the Funds were participants without an SEC order approving the transactions;
- the adviser willfully violated Section 20(a) of the Investment Company Act and Rule 20a-1 under that Act in connection with a proxy solicitation that contained material misstatements or omissions;
- the adviser willfully violated (and the distributor and the broker-dealer willfully aided and abetted such violations of) Section 34(b) of the Investment Company Act by filing with the SEC prospectuses that contained material misstatements or omissions;

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- the distributor willfully violated Section 17(a) of the Securities Act of 1933 by engaging in fraudulent conduct in the offer and sale of securities;
- the distributor willfully violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 under that Act by engaging in fraudulent conduct in connection with the purchase and sale of securities;
- the distributor and the broker-dealer willfully violated Section 15(c) of the Securities Exchange Act and Rule 15c1-2 under that Act by effecting transactions in the purchase or sale of securities by means of a manipulative, deceptive, or other fraudulent device or contrivance;
- the broker-dealer willfully violated, and willfully aided and abetted and caused violations of, Section 17(a) of the Securities Act by engaging in fraudulent conduct in the offer and sale of securities;
- the broker-dealer willfully violated, and willfully aided and abetted and caused violations of, Section 10(b) of the Securities Exchange Act and Rule 10b-5 under that Act by engaging in fraudulent conduct in connection with the purchase and sale of securities;
- the broker-dealer willfully violated Section 17(a) of the Securities Exchange Act

and Rules 17a-3 and 17a-4 under that Act for preparing inaccurate records and by destroying certain order tickets and other communications; and • the broker-dealer willfully violated Rule 22c-1(a) under the Investment Company Act, which requires orders for mutual fund shares placed after the market close to receive the next day's fund price.

Voluntary Undertakings In determining to accept the offers of settlement, the SEC considered the following efforts voluntarily undertaken by the Funds:

- Prior to May 1, 2005, each of the Funds will hold a meeting of shareholders at which all persons expected to serve on the Funds' Board of Trustees as of May 1, 2005, will stand for election.
- The seven trustees of the Funds with the longest tenure as of the date of the SEC Order, will not stand for election to the Funds' Board of Trustees.
- At least 75 percent of the trustees of the Board of Trustees of any of the Funds will be independent as described in the SEC Order.
- The chairman of the Board of Trustees of any of the Funds will be independent as described in the SEC Order.
- 4 • Any person who acts as counsel to the independent trustees of the Funds will be independent as described in the SEC Order.
- No action will be taken by the Funds' Board of Trustees or by any committee thereof unless such action is approved by a majority of the independent trustees (as described in the SEC Order) of the Board of Trustees or of such committee.
- Every five years, commencing in 2005, each of the Funds will hold a meeting of shareholders at which the Board of Trustees will be elected.
- Each of the Funds will designate an independent compliance officer reporting to its Board of Trustees as being responsible for assisting the Board of Trustees and any of its committees in monitoring compliance by the adviser and the distributor with the federal securities laws, the adviser's fiduciary duties to fund shareholders, and their code of ethics in all matters relevant to the operation of the Funds.
- The Governance Committee of the Board of Trustees of the Funds will be responsible for, among other things, making recommendations to the Board on issues related to the composition and operation of the Board. The Governance Committee will be composed entirely of trustees who are not interested persons as described in the SEC Order.
- The broker-dealer will exit the unaffiliated introducing broker-dealer mutual fund clearing business by December 31, 2004.

Required Undertakings

- **Ongoing Cooperation:** Respondents will cooperate fully with the SEC in any and all investigations, litigations or other proceedings relating to or arising from the matters described in the SEC Order.
- **Compliance and Oversight Structure:** The Respondents have agreed to the following:
 - o **Adviser and Distributor:** Code of Ethics Oversight Committee: The adviser and the distributor will maintain a Code of Ethics Oversight Committee, comprised of senior executives of the adviser's and distributor's operating businesses, that will be responsible for all matters relating to issues arising under the adviser's and the distributor's codes of ethics. The adviser and the distributor will report to the Audit Committee of the Funds' Board of Trustees at least quarterly on issues arising under the codes of ethics, including violations of the codes. Any material violations of the codes will be reported promptly.
 - o **Internal Compliance Controls Committee:** The adviser and the distributor will establish an Internal Compliance Controls Committee. The Committee will review compliance issues throughout the business of the adviser and the distributor, endeavor to develop solutions to those issues as they may arise from time to time, and oversee implementation of those solutions. Quarterly reports 5 on the activities of the Committee will be provided to the Audit Committee of the Funds' Board of Trustees.
 - o **Reports:** The adviser and the distributor will provide to their Board of Managers the same reports of the Code of Ethics Oversight Committee and the Internal Compliance Controls Committee that they provide to the Audit Committee of the Funds' Board of Trustees.
 - o **Senior Employee:** The adviser and the distributor will establish and staff a full-time senior-level position whose responsibilities will include compliance matters related to the conflicts of interest. He or she will report directly to the chief compliance officer ("CCO") of the adviser and/or the distributor.
 - o **Adviser's CCO:** The adviser and the distributor will require

that the adviser's CCO or a member of his or her staff review compliance with the policies and procedures established to address compliance issues under the Investment Advisers Act and the Investment Company Act and that any violations be reported to the Internal Compliance Controls Committee.

- o Quarterly Compliance Reporting: The adviser's CCO will report to the independent trustees of the Funds at least quarterly any breach of fiduciary duty or the federal securities laws of which the CCO becomes aware. Any material breach will be reported promptly to the independent trustees of the Funds.
- o Ombudsman: The adviser and the distributor will establish a corporate ombudsman to whom its employees may convey concerns about ethics matters or questionable practices. The adviser and the distributor will review any matters brought to the ombudsman's attention relating to fund business, along with any resolution of such matters, with the independent trustees of the Funds with such frequency as the independent trustees may instruct.

Broker-Dealer

- o Code of Ethics Oversight Committee: The broker-dealer will maintain a Code of Ethics Oversight Committee, comprised of senior executives of the broker-dealer's operating business, that will be responsible for all matters relating to issues arising under the broker-dealer's code of ethics. The broker-dealer will hold at least quarterly meetings of the Code of Ethics Oversight Committee to review violations of the code of ethics, as well as to consider policy matters relating to the code of ethics. Any material issues arising under the code of ethics, including violations, will be reported promptly to the broker-dealer's Board of Managers.
- o Internal Compliance Controls Committee: The broker-dealer will establish an Internal Compliance Controls Committee, chaired by the broker-dealer's CCO and comprised of senior executives of the broker-dealer's operating businesses. The Committee will review compliance issues throughout the business of the broker-dealer, endeavor to develop solutions to those issues as they may arise from time to time, and oversee implementation of those solutions. Quarterly reports on the activities of the Committee will be provided to the broker-dealer's Board of Managers.
- o Reporting: The broker-dealer will require its CCO to report promptly to the broker-dealer's Board of Managers any material violation of the federal securities laws of which he or she becomes aware in the course of carrying out his or her duties.
- o Ombudsman: The broker-dealer will establish a corporate ombudsman to whom its employees may convey concerns about ethics matters or questionable practices. The broker-dealer will establish procedures to investigate matters brought to the attention of the ombudsman, and these procedures will be presented for review and approval by the Board of Managers of the broker-dealer.

• Independent Distribution Consultant – Within 10 days of the SEC Order, the Respondents will retain an Independent Distribution Consultant not unacceptable to the SEC staff and to the majority of the Funds' independent trustees. The consultant will develop a plan to distribute the total disgorgement and penalties ordered under the SEC Order. The Respondents will require that the Independent Distribution Consultant submit the distribution plan to the Respondents and the SEC staff within 100 days of the SEC Order. Following the issuance of an SEC Order approving a final plan of disgorgement, the Independent Distribution Consultant and the Respondents will take all necessary and appropriate steps to administer the final plan.

Adviser and Distributor

- Independent Compliance Consultant: Within 30 days of the SEC Order, the adviser and the distributor will retain an Independent Compliance Consultant not unacceptable to the SEC staff and to the majority of the Funds' independent trustees 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 codes of ethics, and federal securities law violations by the adviser and the distributor and their employees. The review will include, but not be limited to: (1) the adviser's and the distributor's market timing controls across all areas of its business; (2) pricing practices that may make the Funds vulnerable to market timing; (3) use by the Funds of short-term trading fees and other controls for

detering excessive short term trading; (4) possible governance changes in the Funds' Boards to include committees organized by market sector or other criteria so as to improve compliance; and (5) the adviser's and distributor's policies and procedures concerning conflicts of interest, including conflicts arising from advisory services to multiple clients. The adviser and the distributor will require that the Independent Compliance Consultant complete its review and provide its recommendations in a report to the adviser and the distributor, the Board of Trustees, and the SEC staff no more than 120 days after the SEC Order.

- **Periodic Compliance Review:** At least once every other year, commencing in 2006, the adviser and the distributor will undergo a compliance review by a third party that is not an interested person of the adviser and/or the distributor. The third party will issue a report of its findings and recommendations to the Internal Controls Committee and the Audit Committee of the Funds' Board of Trustees.
- **Certification:** No later than 24 months after the SEC Order, the chief executive officer of the adviser and the distributor will certify to the SEC in writing that the adviser and the distributor have fully adopted and complied in all material respects with the undertakings and the recommendations of the Independent Compliance Consultant, or will describe any material non-adoption or non-compliance.
- **Recordkeeping:** Any record, except electronic mail, of the adviser's or the distributor's compliance with the undertakings will 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. Any electronic mail of the adviser's or the distributor's compliance with the undertakings will be preserved for at least three years from the end of the fiscal year last used, the first two years in an easily accessible place.

Broker-Dealer

- **Independent Compliance Consultant:** Within 30 days of the SEC Order, the broker-dealer will retain an Independent Compliance Consultant not unacceptable to the SEC staff 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 broker-dealer and its employees related to the retail sale and retail brokerage order processing of mutual funds. The broker-dealer will require that the Independent Compliance Consultant complete its review and provide its recommendations in a report to the broker-dealer and the SEC staff no more than 120 days after the SEC Order.
- **Periodic Compliance Review:** At least once every other year, commencing in 2006, the broker-dealer will undergo a compliance review by a third party that is not an interested person of the broker-dealer. The third party will issue a report of its findings and recommendations to the broker-dealer's Board of Managers.
- **Certification:** No later than 24 months after the SEC Order, the chief executive officer of the broker-dealer will certify to the SEC in writing that the broker-dealer has fully adopted and complied in all material respects with the undertakings and the recommendations of the Independent Compliance Consultant, or will describe any material non-adoption or non-compliance.
- **Recordkeeping:** Any record, except electronic mail, of the broker-dealer's compliance with the undertakings will 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. Any electronic mail of the broker-dealer's compliance with the undertakings will be preserved for at least three years from the end of the fiscal year last used, the first two years in an easily accessible place.

8 • **Obligations of Successor:** In the event that responsibility for the retail sales and retail brokerage order processing of mutual funds is transferred from the broker-dealer to a successor affiliated entity, the successor will comply with the undertakings in the SEC Order.

Disgorgement and Civil Penalties

- **The Respondents** will together pay \$250,000,000 in disgorgement and a civil money penalty of \$125,000,000.

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