

**MEMO# 18710**

March 31, 2005

## **MUTUAL FUND INVESTMENT ADVISER SETTLES WITH SEC RELATING TO DIRECTED BROKERAGE**

©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. [18710] March 31, 2005 TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 31-05 COMPLIANCE ADVISORY COMMITTEE No. 27-05 SEC RULES MEMBERS No. 44-05 SMALL FUNDS MEMBERS No. 28-05 RE: MUTUAL FUND INVESTMENT ADVISER SETTLES WITH SEC RELATING TO DIRECTED BROKERAGE The Securities and Exchange Commission issued an order making findings and imposing civil money penalties and compliance reforms in an administrative proceeding against a registered investment adviser to a group of mutual funds ("Funds").<sup>1</sup> The adviser consented to the entry of the SEC Order without admitting or denying the SEC's findings. The action involved allegations that the adviser's shelf space arrangements with various broker-dealers, which were paid for through the direction of Fund brokerage, were not adequately disclosed. Findings According to the SEC Order, from at least January 2000 through December 2003, the adviser's affiliated distributor entered into arrangements with over 80 broker-dealers whereby the broker-dealers provided services designed to promote the sale of the Funds. The SEC Order finds that more than 60 broker-dealers received directed brokerage commissions from the Funds' portfolio transactions. The arrangements were based primarily upon negotiated formulas relating to gross or net fund sales and/or the retention of fund assets. The SEC Order further finds that the affiliated distributor did not use its own assets to pay for the services obtained under these arrangements. The SEC Order states that the adviser, the distributor and other affiliated entities benefited from the use of fund assets to defray such expenses. Finally, according to the SEC Order, the adviser did not adequately disclose this potential conflict of interest to the Funds' Board of Trustees or its shareholders. As a result of the conduct generally described above, the SEC Order finds that: 1 See In the Matter of Putnam Investment Management, LLC, SEC Release Nos. IA-2370 and IC-26788, Admin. Proc. File No. 3-11868 (March 23, 2005) ("SEC Order"). The SEC Order also censures the adviser 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/ia-2370.pdf> and <http://www.sec.gov/news/press/2005-40.htm>. 2 • The adviser willfully violated Section 206(2) of the Investment Advisers Act of 1940, which makes it unlawful for an investment adviser to engage in any transaction, practice, or course of business that operates as a fraud or deceit upon a client or prospective client; and • The adviser willfully violated Section 34(b) of the Investment Company Act of 1940, which prohibits the making of material misstatements or omissions in a registration statement or other document filed

with the SEC. Undertakings • Senior-Level Person – The adviser will appoint a senior level employee who will be responsible for implementing within 90 days of the SEC Order and thereafter maintaining the following written compliance policies and procedures: o Trade Execution Through Selling Brokers – Procedures designed to ensure that when the Funds’ traders place trades with a broker-dealer that also sells Fund shares, the person responsible for selecting that broker does not take into account the broker-dealer’s promotion or sale of Fund shares. The procedures can be modified if the independent members of the Funds’ Board determine that modification is in the best interests of the Funds; o Written Contracts – Procedures requiring the distributor to use its best efforts to enter into written contracts memorializing all future revenue sharing arrangements. The documentation must set forth, among other things, the payment arrangement and the services that the broker-dealer or other intermediary will provide. o Approvals – Procedures for obtaining the approval in writing by the adviser’s chief legal officer (or his delegate) of all revenue sharing arrangements and presentation of such arrangements to the Funds’ Board for approval prior to implementation. o Prospectus Disclosure – Procedures for preparing disclosures for the Funds to include in their prospectuses or statements of additional information regarding information about payments made by the adviser or the distributor to broker-dealers or other intermediaries in respect of the sale of fund shares in addition to dealer concessions, shareholders servicing payments, and payments for services that the adviser or an affiliate otherwise would provide. o Board Presentations – Procedures for making yearly presentations (and quarterly updates) to the Communication, Service and Marketing Committee of the Funds’ Board (or other committee performing similar functions) including an overview of the adviser’s revenue sharing arrangements and policies, any material changes to such policies, the number and types of such arrangements, the types of services received, the identity of participating 3 broker-dealers or other intermediaries and the total dollar amounts paid to such broker-dealers and intermediaries. o Best Execution Analysis – Procedures for providing, at least annually for each of the next five years, to the Brokerage and Custody Committee of the Funds’ Board (or other committee performing similar functions) a best execution analysis. • Distribution Plan – Within 10 days of the entry of the SEC Order, the adviser will develop a distribution plan to distribute fairly and proportionately to the Funds the total disgorgement and penalties ordered in the SEC Order. Within 20 days of the date of entry of the SEC Order, the adviser will submit the distribution plan to the Funds’ Board and the SEC staff. Following the issuance of an SEC Order approving the final distribution plan, the adviser will take all necessary and appropriate steps to administer the final plan. • Previous SEC Order – In a November 2003 SEC order relating to market timing,<sup>2</sup> the adviser agreed to various undertakings, including those requiring it to retain an Independent Compliance Consultant to conduct a comprehensive review of the adviser’s supervisory, compliance, and other 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 adviser further agreed to direct the Consultant to review the completeness of the adviser’s then- current disclosures concerning revenue sharing arrangements to the Funds’ Board and its shareholders. Sanctions • The adviser will pay a civil money penalty of \$40 million. Jane G. Heinrichs Assistant Counsel 2 See In the Matter of Putnam Investment Management, LLC, SEC Release Nos. IA-2192 and IC-26255, Admin. Proc. File No. 3-11317 (Nov. 13, 2003). A copy of the order is available on the SEC’s website at <http://www.sec.gov/litigation/admin/ia-2192.htm>.

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