The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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NEW JERSEY ATTORNEY GENERAL ANNOUNCES SETTLEMENT WITH FUND ADVISERS AND DISTRUBUTORS RELATING TO MARKET TIMING

[17626] June 8, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 59-04 SEC RULES MEMBERS No. 85-04 SMALL FUNDS MEMBERS No. 64-04 RE: NEW JERSEY ATTORNEY GENERAL REACHES SETTLEMENT WITH FUND ADVISER RELATING TO MARKET TIMING, SELECTIVE DISCLOSURE The Attorney General of New Jersey has issued an order making findings and imposing corporate governance changes, penalties, and costs against a registered investment adviser, an affiliated distributor, and a parent company of the two entities for fraudulently permitting a hedge fund and its affiliates to engage in market timing activity in mutual funds managed by the adviser.* The defendants consented to the entry of the Attorney General's Order without admitting or denying the Attorney General's findings. The Order found that from 2001 until 2003, the adviser entered into an undisclosed arrangement with the hedge fund's introducing broker-dealer, which permitted the hedge fund and its affiliates to engage in market timing activity in certain mutual funds in return for long- term investments (referred to as "sticky assets") in a separate fund and a hedge fund. According to the Order, the arrangement allegedly allowed the hedge fund to engage in numerous round-trip transactions per year, even though the funds' prospectuses: (1) created the misleading impression that the adviser was protecting investors against the negative effects of market timing, including by limiting the round trips that investors could make; and (2) did not disclose to investors that an arrangement had been made to permit timing in the funds in exchange for sticky assets. The Order found that, during the same time period, rather than stopping the transactions, the distributor arranged for its market-timing police to make an exception for the hedge fund's trading in the funds. The Order also found that the adviser regularly provided material nonpublic information about the funds' portfolio holdings to the broker-dealer. * See Attorney Gen. ex rel. NJ Bureau of Securities v. Allianz Dresdner Asset Management of America L.P.; PA Distributors LLC; PEA Capital LLC; and Pacific Investment Management Company LLC, Civil Action No. C-54-04 (N.J. Super. Ct. Ch. Div. June 1, 2004). A copy of the Order is available on the Attorney General's website at http://www.state.nj.us/lps/newsreleases04/pr20040601a.html. Charges against Pacific Investment Management Company LLC were dismissed. 2 The Order states that the defendants' conduct was in violation of the antifraud provisions of the New Jersey Uniform Securities Law. The Order requires the defendants to pay a civil monetary penalty of $15 million, as well as $3 million for investigative costs and further enforcement initiatives. The Order notes that the adviser had previously reimbursed certain funds $1.6

million in connection with the hedge fund's market timing activity. The Order requires the defendants to fully cooperate in any investigation by the Attorney General of related third parties and further requires the defendants to implement the following corporate governance changes: • Separate the adviser's business management from the portfolio management function (e.g., chief executive officer to have no role in managing fund assets). • Reorganize the defendants' legal and compliance structures, including market timing review, to further separate them from the sales and management functions. • Classify the shareholder trading review for market timing activities as a compliance duty rather than a business function. • Require the current chief executive officer of the distributor to cease serving as the chairman of the board of certain funds. • Require the distributor and an affiliated adviser not a party to the Order (the "affiliated adviser") to maintain separate and distinct chief executive officers. • Require the parent company to hire an independent counsel, approved by the Attorney General, to conduct an internal annual audit for five successive years beginning in December 2004. Each audit must review the implementation of redemption fees, fair valuation procedures, and market timing surveillance with respect to the funds. • Require any special future arrangements not performed in the ordinary course of business with clients of the defendants and the affiliated adviser to be in writing and approved by the parent company's general counsel. • Prohibit disclosure to third parties of the portfolio holdings of the funds unless the disclosure is in accordance with the parent company's written procedures, as approved by its general counsel, or is required by law or regulation. • Appoint an ombudsman to receive "whistleblower" complaints relating to the funds. Jane G. Heinrichs Assistant Counsel

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