The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 17591

May 27, 2004

INVESTMENT ADVISER AND ITS FOUNDER SETTLE SEC, NEW YORK, AND WISCONSIN ENFORCEMENT ACTIONS ON MARKET TIMING

[17591] May 27, 2004 TO: BOARD OF GOVERNORS No. 40-04 COMPLIANCE ADVISORY COMMITTEE No. 54-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 50-04 SEC RULES MEMBERS No. 80-04 SMALL FUNDS MEMBERS No. 61-04 RE: INVESTMENT ADVISER AND ITS FOUNDER SETTLE SEC, NEW YORK, AND WISCONSIN ENFORCEMENT ACTIONS RELATING TO MARKET TIMING The Securities and Exchange Commission has issued an order making findings and imposing disgorgement, penalties, and bars from association in an enforcement proceeding against a registered investment adviser to a group of mutual funds ("Funds"), its founder and former chairman (who also served as chairman of the Funds' board of directors), an executive vice president of the adviser, the adviser's former chief compliance officer ("former CCO"), and the adviser's transfer agent and broker-dealer affiliates (collectively, "Respondents").1 The Respondents consented to the entry of the SEC Order without admitting or denying the SEC's findings. In addition, the Attorney General of New York and the Wisconsin Department of Financial Institutions announced the settlement of related state charges.2 All three actions involved allegations that the former chairman frequently traded shares of several Funds, in violation of the Funds' prospectus disclosures, and that other Respondents facilitated or failed to prevent his misconduct. The SEC and New York actions also involved allegations that 1 See In the Matter of Strong Capital Management, Inc., Strong Investor Services, Inc., Strong Investments, Inc., Richard S. Strong, Thomas A. Hooker, Jr., and Anthony J. D'Amato, SEC Release Nos. 34-49741, IA-2239 and IC-26448, Admin. Proc. File No. 3-11498 (May 20, 2004) ("SEC Order"). The SEC Order also censures the adviser and its affiliated entities and imposes a cease and desist order on the Respondents. A copy of the SEC Order is available on the SEC's website at http://www.sec.gov/litigation/admin/34-49741.htm. 2 See New York, Wisconsin Settle "Market Timing" Allegations with Strong Capital Management and its Founder (press release issued by Office of New York State Attorney General Eliot Spitzer, May 20, 2004), available at http://www.oag.state.ny.us/press/2004/may/may20a_04.html, and Wisconsin Dept. of Financial Institutions Reaches Settlement with Richard S. Strong (press release issued by WI Dept. of Fin. Institutions, May 20, 2004), available at http://www.wdfi.org/newsroom/press/2004/DFIReachesSettlementwithRichardStrong.htm. Copies of the New York complaint and judgment on consent are available on the Attorney General's website at http://www.oag.state.ny.us/press/2004/may/may20a_04_attach2.pdf and http://www.oag.state.ny.us/press/2004/may/may20a_04_attach1.pdf, respectively. Copies of the petition and order for revocation in the Wisconsin action are available on the

Department's website at http://www.wdfi.org/_resources/indexed/site/newsroom/admin_orders/2004/ma_strong_pet.pdf and http://www.wdfi.org/_resources/indexed/site/newsroom/admin_orders/2004/ma_strong_ord.pdf, respectively. 2 certain Respondents permitted select hedge funds to engage in market timing of certain Funds, in violation of the Funds' prospectus disclosures, in order to obtain non-mutual fund business from the hedge fund manager. The settlements in the three actions are summarized below. I. SEC Order A. Findings The SEC Order finds that, through the efforts of the executive vice president, the adviser entered into a written agreement permitting certain hedge funds to frequently trade shares of four Funds, with the expectation that the hedge fund manager would make additional investments with the adviser and the affiliated entities in non-mutual fund business. It finds that, during the period from December 2002 to May 2003, the hedge funds engaged in approximately 135 roundtrip trades in these Funds and, in return, the hedge fund manager invested $500,000 in a hedge fund affiliated with the adviser. The SEC Order finds that the adviser, contrary to its policy, provided the hedge fund manager on seven occasions with month-end portfolio holdings information for the four Funds. The SEC Order further finds that, from 1998 through 2003, the former chairman frequently traded shares of ten Funds (including one for which he served as portfolio manager), making approximately 660 redemptions in 40 accounts under his control. According to the SEC Order, the chairman continued to engage in such trading despite the fact that: (1) at least as early as 1999, counsel for the adviser and the affiliated entities told all employees, including the former chairman, that frequent trading in the Funds was inappropriate and that limitations could be placed on their trading as a result of such conduct; and (2) upon receiving advice from counsel in 2000, the former chairman agreed that he would stop his frequent trading in Fund shares. The SEC Order finds that the adviser's former CCO failed to monitor, as directed by counsel, the former chairman's trading activity. Finally, the SEC Order finds that the former CCO, together with the adviser and the affiliated entities, delayed for several weeks providing information about the former chairman's frequent trading to the SEC staff during its fall 2003 examination of market timing activity in the Funds. The SEC Order finds that the adviser failed to disclose the trading agreement with the hedge fund manager, and both the adviser and the former chairman failed to disclose the latter's frequent trading, to the Funds' boards of directors and to the shareholders of the frequently traded Funds. According to the SEC Order, these failures to disclose caused the adviser and broker-dealer's statements discouraging market timing (both in the Funds' prospectuses and in connection with enforcement of market timing policing procedures) to be materially misleading. As a result of the conduct generally described above, the SEC Order finds that the Respondents willfully violated, or willfully aided and abetted and caused violations of, the antifraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940. The SEC Order also finds that the adviser willfully violated: (1) Section 204A of the Advisers Act by failing to control the release of, and by actively releasing, material, nonpublic information concerning the portfolio holdings of certain Funds; and (2) Section 34(b) of the Investment Company Act of 1940 by making material misstatements in the Funds' prospectuses, which are filed with the SEC. 3 B. Undertakings In determining to accept the Respondents' settlement offer, the SEC considered certain voluntary undertakings by the Funds, which generally include the following: • At least 75% of the directors of each Fund will be independent. • The chairman of the board of directors of each Fund will be independent. • Any counsel to the independent directors of a Fund will be an "independent legal counsel," as defined under the Investment Company Act. • The boards of the Funds will maintain separate committees to oversee the investment operations of particular categories of funds. These committees will consist of at least a majority of

independent directors and will have independent chairs. They will identify any compliance issues unique to the particular category of funds and work with appropriate board committees to ensure that any such issues are properly addressed. • No action by a Fund board will be taken without the approval of a majority of the independent directors, and any action approved by a majority of the independent directors but not by the full board will be disclosed in Fund shareholder reports. • Commencing in 2005, each Fund will hold a shareholder meeting to elect its board of directors at least once every five years. • Each Fund will designate a member of the independent administrative staff reporting to its board as responsible for assisting the directors in monitoring the adviser's compliance with the federal securities laws, its fiduciary duties to Fund shareholders, and its code of ethics in all matters relevant to the Funds. The SEC Order also sets forth the following undertakings by the adviser and the affiliated entities: • Independent Compliance Consultant – The adviser and the broker-dealer must retain an Independent Compliance Consultant to conduct a comprehensive review of their supervisory, compliance, and other policies and procedures designed to prevent and detect breaches of fiduciary duty, breaches of the code of ethics, and federal securities law violations by each entity and its employees. The review must include, but not be limited to: (1) each entity's market timing and late trading controls across all areas of its business; (2) pricing practices that may make the Funds vulnerable to market timing; and (3) utilization by the Funds of short-term trading fees and other controls for deterring excessive short term trading. The Independent Compliance Consultant must complete its review and provide its recommendations in a report to the adviser, the directors of the Funds, and the SEC staff no more than 120 days after the entry of the SEC Order. 4 • Periodic Compliance Review – At least once every two years, commencing in 2005, the adviser and the broker-dealer must undergo a compliance review by a third party that is not an interested person of either entity. The third party must issue a report of its findings and recommendations to the Internal Compliance Controls Committee and the Audit Committee of each Fund's board of directors. • Independent Distribution Consultant – The adviser must retain an Independent Distribution Consultant to develop a plan to distribute the total disgorgement and penalties provided for in the SEC Order. The Independent Distribution Consultant must submit the distribution plan to the SEC staff within 100 days after entry of the SEC Order. Following the issuance of an SEC order approving a final plan of disgorgement, the Independent Distribution Consultant and the adviser must take all necessary and appropriate steps to administer the final plan. • Withdrawal from Registration – Within 365 days of issuance of the SEC Order, the transfer agent must file with the SEC a notice of withdrawal from registration. • Certification; Extension of Procedural Dates – No later than 24 months after the entry of the SEC Order, the chief executive officers of the adviser, broker-dealer, and transfer agent must certify to the SEC in writing that each entity has fully adopted and complied in all material respects with the required undertakings or must describe any material non- adoption or non-compliance. For good cause shown, the SEC staff may extend any of the procedural dates with respect to the undertakings. • Recordkeeping – Any record of the adviser's or broker-dealer's compliance with the required undertakings must 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. C. Disgorgement, Civil Penalties, Bars from Association, and Other Prohibitions • The SEC Order requires the payment of disgorgement as follows: $40 million by the adviser; $30 million by the former chairman; and $375,000 by the executive vice president. • The SEC Order requires the payment of civil money penalties as follows: $40 million by the adviser; $30 million by the former chairman; $375,000 by the executive vice president; and $50,000 by the former CCO. • Each of the individual Respondents is 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. • The former chairman is barred from association with any broker, dealer, municipal securities dealer, transfer agent, or investment adviser. He is, however, permitted to retain his ownership interest in the adviser and the affiliated entities until March 1, 2005. 5 • The executive vice president is barred from association with any broker, dealer, or investment adviser. • The former CCO is barred from association with any investment adviser. II. Settlement of State Charges A. New York The New York Attorney General's complaint named as defendants each of the Respondents and the parent company of the adviser and the affiliated entities. The factual allegations in the complaint generally mirror those in the SEC Order, except that the complaint does not allege that the adviser provided the hedge fund manager with nonpublic portfolio holdings information. The complaint charged Respondents and the parent company with fraudulent and deceptive conduct in violation of New York's Martin Act and other statutes and also charged the former chairman with committing common law fraud. The judgment on consent3 generally requires the following: • Injunctions Imposed on the Former Chairman – The former chairman is permanently enjoined from, among other things: (1) directly or indirectly engaging in any business relating to the purchase or sale of securities or commodities or the rendering of investment advice, with the exception of managing personal or family investments in securities; (2) investing or trading in mutual funds (except money market funds), unless the shares are purchased on his own behalf and held for at least one year; and (3) receiving any monetary benefit from the Respondent entities and their parent company, except for proceeds from their sale and benefits previously vested. • Injunctions Imposed on the Adviser, its Affiliated Entities, and its Parent Company – The Respondent entities and their parent company are permanently enjoined from, among other things: o having any employment, operational or other business association with the former chairman and the two other individual Respondents; o providing advisory services to any Fund whose board of directors does not maintain a full-time senior officer, reporting exclusively to the board, to monitor compliance and ensure that, at the time of each annual advisory contract renewal, the fees charged to the Fund are negotiated at arm's length and are reasonable. Reasonableness of fees will be determined through either competitive bidding (which must include at least three sealed bids) or an annual independent evaluation that considers factors including: (1) the level of fees 3 The executive vice president and the former CCO were not parties to the judgment on consent. 6 charged to institutional investors; (2) the level of fees charged by other mutual funds for like services; (3) the costs of providing services; and (4) the profit margins of the adviser and its affiliates; o providing advisory services to any Fund whose board of directors does not have at least 75% independent directors and an independent chair;4 and o allowing any investor to purchase, exchange or redeem Fund shares more frequently, or on terms more favorable, than those available to any other investor except as disclosed in the Fund's registration statement. • Reduction in Advisory Fees – The adviser will reduce the advisory fees charged to the Funds (except any money market fund) by $7 million per year for five years. According to the Attorney General's press release, this will constitute a 6% reduction. • Disclosure Regarding Independent Evaluation of Advisory Fees – If an independent evaluation is conducted in connection with the renewal of a Fund's advisory contract, the adviser must publicly disclose a reasonable summary of the evaluation within 15 days of its completion. The summary must contain data regarding the factors considered in the evaluation and sufficient specifics so that a reasonable investor can make an informed decision regarding the reasonableness of the fees evaluated, but the summary does not have to include confidential, competitively sensitive data. Public disclosure must include at least: (1) continuous, prominent posting on the adviser's website of the two most recent summaries; (2) inclusion of the most recent summary in the Fund's prospectus; and (3) prominent notice in shareholder account statements of the summary's availability. •

Actual Cost Disclosure on Quarterly Basis – Beginning with the third quarter of 2004, the adviser and the affiliated entities must disclose on a quarterly basis all fees and costs in actual dollar amounts charged to each investor based upon (1) the investor's most recent quarterly closing balance and (2) a hypothetical $10,000 investment held for 10 years, such disclosures to show the cumulative effect of fees on returns. • Disgorgement and Penalties – The adviser and the former chairman will pay disgorgement and penalties in the amounts and manner set forth in the SEC Order. • Recordkeeping – All documents and records of the adviser and the affiliated entities related to this matter must be maintained for at least ten years. According to the Attorney General's press release, the former chairman issued a statement in connection with the settlement, in which he admitted to frequent trading of Fund shares and stated that this behavior was "wrong and at odds with the obligations I owed my shareholders." 4 This requirement is similar to an undertaking set forth in the SEC Order. 7 B. Wisconsin The Division of Securities of the Wisconsin Department of Financial Institutions issued an order revoking the securities agent licenses of the three individual Respondents, as well as the investment adviser license of the former chairman. According to the petition for order, the revocations generally were sought on the basis of the former chairman's frequent trading in the Funds and the failure of the remaining Respondents to prevent such trading. The order of revocation contains the same undertakings as set forth in the SEC Order, and it likewise states that the adviser and the former chairman will pay the disgorgement and penalties required by the SEC Order. Rachel H. Graham Assistant Counsel

---