

A Summary of
Current Investment
Management Regulatory
Developments

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SEC Enforcement Actions

Asset Management Subsidiaries of Citigroup Settle Advisers Act Violations

On May 31, 2005, the SEC announced that two asset management subsidiaries of Citigroup, Inc. (“Citigroup”), Smith Barney Fund Management LLC (“Adviser”) and Citigroup Global Markets, Inc. (“Global Markets”) settled violations of the Advisers Act arising from (i) a failure to make appropriate disclosures to the boards of directors of certain Citigroup-sponsored funds and (ii) transactions that constituted fraud on clients. The Adviser and Global Markets have agreed to pay a total of \$208 million in disgorgement, hire an independent monitor to oversee a competitive bidding process among one or more unaffiliated vendors of transfer agency services and submit a distribution plan for payment of disgorgement within 90 days.

Fund advisors set up thinly-staffed affiliate entity to perform limited transfer agent services and sub-contracted bulk of such services to previous transfer agent without passing benefits from renegotiation of the transfer agent agreement to funds and without making fair disclosure

The Adviser serves as investment adviser to the Smith Barney Family of Funds (the “Funds”). The asset management operations of Global Markets

and the Adviser are part of Citigroup Asset Management (“CAM”). In 1997, CAM commenced a review of the Funds’ agreement for transfer agency services with First Data Investor Services Group (“First Data”). Transfer agents, such as First Data, generally maintain shareholder records for mutual funds, including tracking purchases, sales, dividend transactions, sales charges and asset balances, and also provide valuation services for calculation of a fund’s net asset value. First Data had served as the Funds’ transfer agent since 1994 and the agreement between the Funds and First Data was set to expire in 1997. First Data earned high profit margins on the agreement, primarily because it had moved during its term from a per-account fee to a fee based on the percentage of assets under management. CAM personnel sought to share in the high margins and explored establishing a CAM-affiliated transfer agency busi-

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ness to take over as the Funds' transfer agent upon expiration of the agreement with First Data and moving the transfer agency work to a third party. Once First Data discovered that CAM was considering replacing First Data, First Data proposed offering large fee discounts in an effort to keep CAM's business.

Despite the steep discounts, CAM concluded that an arrangement with one of First Data's competitors, DST, would be the best option. However, CAM continued to negotiate with First Data and First Data continued to sweeten the offer with even greater fee discounts and improved technology, and CAM was ultimately considering an arrangement whereby CAM would establish an affiliate staffed with 15 employees to handle customer service calls and sub-contract the bulk of the transfer agency services to First Data. While CAM's advisers counseled against this arrangement, noting that any discounts should be passed on to the Funds, CAM ultimately presented the CAM affiliate/First Data arrangement to the boards of directors without explaining that First Data would essentially provide the same services and that the CAM affiliate, reaping large profits, would only provide limited additional oversight and call center functions. The board was also not informed that CAM had initially believed the DST arrangement to be the best option for the Funds. The boards ultimately approved the proposal to establish a CAM affiliate and enter into the sub-contracting arrangement with First Data.

Although the Funds received some benefit from lower fees, the SEC noted that the CAM-affiliated transfer agent retained most of the benefit for itself, earning approximately \$100 million in profit at the Funds' expense over a five-year period. Such arrangements, the SEC continued, were not appropriately disclosed to the Funds' directors or investors. The SEC settlement notes that the foregoing conduct constituted fraud in violation of Sections 206(1) and 206(2) of the Advisers Act. A copy of the settlement is available at: <http://www.sec.gov/litigation/admin/34-51761.pdf>.

Hedge Fund Manager to Pay \$1.45 Million to Settle SEC and NASD Charges Related to Purchase and Sale of PIPE Shares

NASD continuing investigation of other individuals and entities involved in CompuDyne PIPE

On May 18, 2005, the SEC charged former hedge fund manager Hilary Shane with insider trading and illegal sales of unregistered securities in connection with a Private Investment in a Public Equity (“PIPE”) offering in violation of Section 10(b) of the Exchange Act, Rule 10b-5 promulgated thereunder and Sections 5 and 17(a) of the Securities Act. The complaint, filed in the United States District Court for the Southern District of New York, alleged that Shane sold short securities of CompuDyne Corporation (“CompuDyne”) prior to the effective date of the resale registration statement for the PIPE shares, and covered those short positions with shares received in the PIPE transaction. The SEC coordinated its investigation with the NASD, which reached a separate settlement with Shane of its enforcement proceeding, pursuant to which Shane was permanently barred from associating with any NASD-registered firm and ordered to pay a fine.

The SEC complaint alleges that in September 2001, Shane was asked to participate in CompuDyne’s PIPE offering. In October 2001, Shane agreed to purchase shares in the PIPE offering for one of the hedge funds that she managed as well as for her own account. Although Shane agreed both orally and in writing to keep the information about the offering confidential, the SEC alleges that before the public announcement of the PIPE offering, Shane began short selling CompuDyne stock in both her personal account and the hedge fund’s account. After the public announcement of the PIPE offering was made, Shane continued short selling CompuDyne stock for both accounts until she had sold all of the shares that had been allocated to her in the PIPE offering.

The complaint further alleges that Shane violated Section 5 of the Securities Act by executing the short sales without an effective resale registration statement for the PIPE shares and failing to deliver a prospectus. The complaint alleges that Shane executed the short sales with the intention of covering them using shares received in the PIPE offering, and that Shane did in fact do so, without ever selling those shares pursuant to the registration statement.

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Without admitting or denying the allegations in the complaints, Shane consented to the entry of a final judgment, subject to the court's approval, in which she is permanently enjoined from further violations of the antifraud and registration provisions of the federal securities laws. Shane also agreed to pay more than \$1 million to settle the charges. A copy of the SEC's complaint is available at: <http://www.sec.gov/litigation/complaints/comp19227.pdf>. A copy of the NASD's related press release is available at: http://www.nasd.com/web/idc-plg?IdcService=SS_GET_PAGE&ssDocName=NASDW_014158.

Waddell & Reed to Pay Up to \$11 Million to Clients Whose Annuities Were Exchanged and Another \$5 Million to Regulators

Waddell & Reed settles charges relating to variable annuity switching

On April 29, 2005, the NASD announced that in a settlement, Waddell & Reed Inc. ("Waddell") agreed to pay approximately \$11 million to more than 5,000 customers arising from charges that Waddell's sales force aggressively encouraged clients to switch from one type of variable annuity to another without regard to suitability and whether clients would incur "substantial unnecessary expenses." Waddell will also pay fines of \$2 million and \$5 million to the NASD and state regulators, respectively.

In its January 2004 complaint, the NASD charged Waddell with violating NASD Conduct Rule 2310, which requires that a member, in recommending to a customer the purchase, sale or exchange of any security, have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his or her other security holdings, financial situation and needs. The complaint alleged that between January 2001 and August 2002, Waddell engaged in an aggressive campaign to switch customers from variable annuity contracts issued by United Investors Life Insurance Co. ("UILIC") to similar annuities provided by Nationwide Insurance Co. ("Nationwide"). The NASD alleged that the switching campaign was implemented after Waddell failed to secure an agreement from UILIC to obtain a share of certain fees collected by UILIC from Waddell's customers, at which point Waddell and Nationwide agreed to a fee-sharing arrangement. The NASD claimed that following that agreement,

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Waddell's then president and other senior managers engaged in activities designed to "prod and scare" Waddell's sales force into pushing customers to switch annuities without regard to the suitability of the exchanges.

As a result, customers incurred approximately \$10 million in surrender charges, while Waddell made money through commissions charged on each exchange as well as through the fee-sharing arrangement with Nationwide. Additionally, more than 700 customers were switched into one Nationwide annuity product that produced greater compensation for Waddell's sales force than another Nationwide annuity being sold by Waddell, but the terms of which were less beneficial to customers.

Under the terms of the settlement agreement, Waddell will repay its customers all of the surrender charges incurred in the exchange and will compensate the purchasers of the more expensive annuity by reimbursing the cost differential between the two products. A copy of the NASD press release is available at: http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013886.

EGM Capital and Former CEO Settle SEC Charges Over Trading Error

Investment adviser and former CEO charged with violations of Sections 206(1) and 206(2) of Advisers Act

On April 6, 2005, investment adviser EGM Capital ("EGM") and its former chief executive officer, Michael T. Jackson ("Jackson"), settled SEC charges that they improperly made hedge fund clients pay for the firm's stock trading error, violating Sections 206(1) and 206(2) of the Advisers Act. In November 2000, EGM inadvertently oversold 100,000 shares of a company's stock, resulting in an unintended short position and a loss of approximately \$404,000. EGM did not have a compliance policy or procedure in place regarding trade errors. Instead of having the firm absorb the losses on the trade error, then chief executive officer and chairman of the board, Jackson, took improper steps leading to the allocation of the loss to several client hedge fund accounts. In addition, EGM personnel falsified records by, among other things, backdating trade tickets to give the impression that the firm had intentionally shorted the stock. The net loss to clients was \$326,000, and those clients affected were

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reimbursed, plus interest, once the SEC investigation revealed the error. In their settlement with the SEC, both parties agreed, without admitting or denying misconduct, to cease and desist from future violations. Additionally, Jackson agreed to a \$75,000 fine and a nine-month industry suspension. A copy of the settlement order is available at: <http://www.sec.gov/litigation/admin/ia-2374.pdf>.

Speech by SEC Staff

SEC Official Illustrates CCO Functions Under the New Regulatory Framework

Gohlke provides practical guidance for hedge fund CCOs

On May 5, 2005, at a Managed Funds Association educational seminar, Gene Gohlke, associate director of the SEC's Office of Compliance Inspections and Investigations, discussed his view of the responsibilities of Chief Compliance Officers ("CCOs") under the Advisers Act and listed 24 specific compliance objectives for CCOs. Gohlke specifically noted that compliance programs and the activities of CCOs are a "major issue" in light of the approaching February 1, 2006 registration deadline for investment advisers to private investment funds. Gohlke provided some general thoughts as to the CCO's position in a fund's organizational hierarchy and urged the industry to consider whether the CCO will be perceived as having the requisite authority if he or she has reporting obligations that differ from other "C" officers (such as the CFO or COO), as other chief officers typically report directly to the CEO. The specific CCO responsibilities and functions that Gohlke highlighted include, among other things:

- » *Advice.* The CCO should be involved in advice to senior management on compliance matters, including being the "go to person" that is "sought out on a consulting basis," in order to establish and maintain an effective culture of compliance;
- » *Monitoring and guidance.* The CCO should perform quality control and timely and appropriate review of both policies and procedures, undertaking to detect practical departures from such policies and procedures. In

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addition, the CCO should establish a compliance calendar to assist in securing adherence to regulatory deadlines.

- » *Training, awareness and advocacy.* The CCO should (i) be aware of regulatory developments and the requirements of the Advisers Act, including the adviser's code of ethics, (ii) train the firm's staff in such matters, (iii) be the firm's liaison to the SEC and active in industry efforts to design best practices and (iv) be active within the firm to ensure that the firm's compliance programs receive appropriate resources.

Gohlke urged advisers to consider the need for interim reviews to respond to regulatory developments, significant compliance events and changes in business arrangements. Gohlke reinforced that CCOs assist advisers in fulfilling their fiduciary obligations to clients and protecting investors. He also clarified that each CCO's specific responsibilities should be determined in light of his or her particular circumstances and that certain of the specific functions described above are beyond the measures required by the Advisers Act. A copy of Gohlke's speech is available at: <http://www.sec.gov/news/speech/spch050505gg.htm>.

Industry Updates

Donaldson to Step Down; President Nominates Cox as SEC Chairman

SEC Chairman leaving office on June 30

On June 1, 2005, William H. Donaldson announced that he is resigning from his position as the 27th Chairman of the SEC, effective June 30. Donaldson was appointed by President Bush in 2003 for a term that was to expire on June 5, 2007. Before joining the SEC, Donaldson worked in an executive capacity on Wall Street and served as NYSE Chairman and CEO. On June 2, 2005, President Bush nominated Christopher Cox, a Republican Congressman from California, to replace Donaldson. The press release announcing Donaldson's resignation is available at: <http://www.sec.gov/news/press/2005-82.htm>.

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Thomsen to succeed Cutler

Thomsen Named Enforcement Director

On May 12, 2005, the SEC announced that Deputy Enforcement Director Linda Chatman Thomsen would succeed Stephen Cutler as Enforcement Director. Thomsen joined the SEC in 1995 as assistant chief litigation counsel and was later named assistant director. In 2000, she was named associate director of the division. Prior to working at the SEC, Thomsen was an associate at Davis Polk & Wardwell and had previously served as an Assistant U.S. Attorney for the District of Maryland. A copy of the SEC press release is available at: <http://www.sec.gov/news/press/2005-73.htm>.

Eisenberg submits testimony regarding mutual fund rulemaking

SEC to Conduct Thorough Assessment of Fund Disclosure Regulation

On May 10, 2005, in written testimony before the House Subcommittee on Capital Markets, Meyer Eisenberg, acting director of the Division of Investment Management, provided an overview of mutual fund reform regulation to date and stated that the SEC is currently evaluating and will continue to explore certain mutual fund reform initiatives targeting portfolio transaction costs disclosure, “soft dollar” arrangements and Rule 12b-1 fees. Highlighting the SEC’s December 2003 concept release regarding fund transaction costs and the formation of a new SEC task force (the “Task Force”) to review “soft dollar” practices, Eisenberg described the SEC’s continued efforts to reform the mutual fund industry by improving disclosure and ensuring that investors understand how fund costs impact the value of their investments.

Eisenberg noted that Chairman Donaldson considers the examination of soft dollar arrangements (i.e., a fund’s payment of commissions for brokerage firm services to purchase research and other miscellaneous services) to be a “high priority.” The Task Force will place particular emphasis on exploring possible conflicts of interest arising from soft dollar practices, as well as whether disclosure can be improved to heighten investor understanding of the use of soft dollars and whether “enhanced disclosures” to fund directors will allow for better evaluation of a fund’s soft dollar transactions. The Task Force is also reviewing the definition of “research” as it pertains to the provisions of Section 28(e) of the Securities Exchange Act of 1934, which is, in part, the basis of the exemption that permits soft dollar payments.

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Eisenberg also said that the SEC will consider, in connection with its proposal to ban directed brokerage for distribution under Rule 12b-1 of the Investment Company Act (which sets forth the criteria pursuant to which a mutual fund may charge a fee related to promotion, distribution and marketing of the fund's shares), the broader question of whether Rule 12b-1 should be revised extensively or eliminated altogether. The SEC, Eisenberg noted, has considered whether such fees may have become, in certain circumstances, a non-transparent "substitute for a sales load." A copy of Eisenberg's written testimony is available at: <http://www.sec.gov/news/testimony/ts051005me.htm>.

SEC to Publicly Release Staff Comment Letters and Filer Responses on Disclosure Filings

On May 12, 2005, the SEC began releasing staff comment letters and filer responses relating to disclosure filings made after August 1, 2004 and reviewed by the Division of Corporation Finance and the Division of Investment Management. Such comment and response letters will be released individually on a filing-by-filing basis on EDGAR. Letters are to be released no earlier than 45 days after the review of the disclosure filing is complete. A copy of the SEC announcement is available at: <http://www.sec.gov/news/press/2005-72.htm>.

SEC to expand transparency of comment process

Industry Task Force Endorses Independent Director Oversight of Multiple Mutual Funds

On May 6, 2005, the Independent Directors Counsel (the "IDC"), a group representing independent directors of mutual funds, published a report by its Task Force on Director Oversight of Multiple Funds (the "Task Force") supporting independent director oversight of multiple mutual funds within a single family of funds. The Task Force concluded that the unitary or cluster board structure, in which directors oversee many, if not all, of the funds in a complex, is both customary in the industry and consistent with good governance. The Task Force noted, among other things, that oversight of "significant assets" improves knowledge and expertise of board members and provides influence over fund management and service providers. The Task Force concluded that shareholders benefit from efficiency and effectiveness when qualified inde-

IDC task force concludes that oversight of multiple funds enhances independent directors' expertise, knowledge and efficiency

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pendent directors oversee multiple funds in a family of funds. In its report, the Task Force identified measures that mutual fund boards have developed to deal with oversight of multiple funds, including the use of committees, professional assistance from outside advisers and others and improved technology that permits directors to be better prepared and conduct more productive board meetings. A copy of the IDC's report is available at: <http://www.idc1.org/getPublicPDF.do?file=18833>.

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