

**UNITED STATES OF AMERICA**

**Before the**

**SECURITIES AND EXCHANGE COMMISSION**

Administrative Proceedings

File No. 3-11696

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**In the Matter of**

**RS Investment Management, Inc., RS  
Investment Management, L.P.,  
G. Randall Hecht and Steven M. Cohen,**

**Respondents.**

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**PLAN OF DISTRIBUTION**

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# DISTRIBUTION PLAN FOR RS FUNDS

## Section 1 Introduction and Background

1.1 This Plan of Distribution (the "Plan") has been developed pursuant to an Order of the Securities and Exchange Commission (the "Commission") instituting administrative cease-and-desist proceedings, making findings, and imposing remedial sanctions and a cease-and-desist order in the matter of RS Investment Management, Inc., RS Investment Management, L.P. (collectively, "RS"), G. Randall Hecht and Steven M. Cohen, dated October 6, 2004 (the "Order").

1.2 Section IV.G.1 of the Order orders that RS shall pay disgorgement in the total amount of \$11.5 million and a civil money penalty in the total amount of \$13.5 million, for a total amount of \$25,000,000. Section IV.G.2 provides that a Fair Fund be established for the funds described in Section IV.G.1. The Fair Fund constitutes a Qualified Settlement Fund ("QSF") under Section 468B(g) of the Internal Revenue Code, 26 U.S.C. §468B(g), and related regulations, 26 C.F.R. §§1.468B-1 through 1.468B-5. On or before November 5, 2004, RS deposited \$13 million into an escrow account at Union Bank of California ("UBOC"). On or about December 29, 2004, RS (a) caused the assets in the UBOC account (with accrued interest) to be transferred to an escrow account at Deutsche Bank Trust Company Americas (the "DB account") and (b) deposited an additional \$6 million into the DB account. On May 24, 2005, RS deposited an additional \$6 million (the final payment) into the DB account. On or about October 5, 2005, per the instructions of Commission staff, the assets in the DB account (\$25 million, plus interest, minus taxes and fees) were transferred to the Commission's Office of Financial Management. The Fair Fund has since been deposited at the Bureau of Public Debt of the United States Treasury for investment in government obligations. Other than interest from these investments, it is not anticipated that the Fair Fund will receive additional funds, except that, as detailed in paragraph 7.1, money from other proceedings may be distributed along with the Fair Fund money.

1.3 Paragraph 29(a) of the Order stipulates that RS shall retain the services of an Independent Distribution Consultant ("IDC") acceptable to the staff of the Commission and the independent Trustees of the RS Funds, and that RS shall require the IDC to develop a Distribution Plan for the distribution of the total disgorgement and penalty ordered in paragraph IV.G of the Order, and any interest or earnings thereon (collectively, the "Fair Fund" or the "Funds Available"), according to a methodology developed in consultation with RS and acceptable to the staff of the Commission and the independent Trustees of the RS Funds. The methods of calculation of each eligible investor's share of the Fair Fund are intended by the Commission to result in a fairly estimated payment to each eligible investor that restores the impaired value of the investor's investment in the RS Funds. Some of this impaired value is susceptible to calculation, while some of this impaired value is not.

1.4 The Order stipulates (paragraph 29(a)) that the Plan shall provide for fund investors to receive, in order of priority, (i) their proportionate share of losses suffered by the fund(s) due to market timing trading activity as calculated by the IDC, and (ii) a proportionate share of advisory fees paid by the fund(s) that suffered such losses in connection with the violative trading activity. The method for determining the proportionate shareholder distribution amounts was based upon an assessment of dilution and brokerage costs.

1.5 Pursuant to the Commission Order, RS has retained Dr. Alan C. Shapiro to act as the Independent Distribution Consultant. Dr. Shapiro is the Ivadelle and Theodore Johnson Professor of Banking and Finance, Marshall School of Business, University of Southern California. Dr. Shapiro received a B.A. in Mathematics from Rice University (1967) and a Ph.D. in Economics from Carnegie Mellon University (1971). Prior to joining USC in 1978, he was an Assistant Professor at the Wharton School of the University of Pennsylvania (1971-1978). His publication credits include over 50 articles in leading academic and professional journals, several textbooks, and two monographs. Dr. Shapiro has been determined to be acceptable as the IDC by the staff of the Commission and the independent Trustees of the RS Funds. RS has agreed to pay all costs associated with the engagement of the IDC. In conjunction with Trident Consulting Group, LLC ("Trident"), Dr. Shapiro has developed a Distribution Plan. This Plan provides for the distribution of the Fair Fund among investors who held shares in ten RS mutual funds (Emerging Growth, Value + Growth, Contrarian Value, Partners, MidCap Opportunities, Internet Age, Information Age, Global Natural Resources, Diversified Growth, and Smaller Company Growth—collectively, the "ten RS Funds") between January 1, 2000, and December 31, 2003 except those investors who engaged in non-compliant trading, as defined in paragraph 2.1.1.

1.6 Dr. Shapiro has received full cooperation from the Management of RS, including access to data and individuals as requested. Dr. Shapiro is solely responsible for all work in this report. He has been assisted by Trident, which performed certain calculations and analyses under his direction. Dr. Shapiro has carried out his responsibilities using the best available data in conjunction with quantitative modeling and analysis that are based on the principles and methods of modern financial economics. Judgments regarding methodology and implementation are grounded in empirical evidence and conform to practicality constraints. Dr. Shapiro has never been employed by RS.

1.7 The IDC and the Fund Administrator (as defined in paragraph 3.1), and each of their designees, agents and assistants, shall be entitled to rely on any Orders issued in this proceeding by the Commission, the Commission Secretary by delegated authority, or an Administrative Law Judge, and may not be held liable to any person other than the Commission and the Fair Fund for any act or omission in the course of administering the Fair Fund, except upon a finding in this proceeding that such act or omission is caused by such party's gross negligence, bad faith or willful misconduct, reckless disregard of duty, or reckless failure to comply with the terms of the Plan. This limitation

on liability also applies to any order(s) to distribute additional funds in accordance with Section 8 of the Plan. Nothing in this paragraph is intended to create or restrict rights of private action and/or standing as found under the current law. This paragraph is an expression of the IDC's and the Fund Administrator's standard of care and is not intended, nor should it be deemed to be, a representation to or an indemnification of the IDC or the Fund Administrator or their designees, agents and assistants by the Commission or the Fair Fund, nor should this paragraph preclude the Commission or the Fair Fund from seeking redress from the IDC or the Fund Administrator in accordance with the rules and regulations of the Commission and the Fair Fund.

1.8 The Plan is subject to approval of the Commission and the Commission retains jurisdiction with respect to its implementation.

## **Section 2 Method for Determining Shareholder Distributions**

### 2.1 Identification of Non-Compliant Transactions

2.1.1 The IDC defined non-compliant trades as those that violated the ten RS Funds' exchange policy, as disclosed in the RS Funds' prospectus:<sup>1</sup>

Shares of one Fund may be exchanged for shares of another Fund.... However, you may not exchange your investment more than four times in any 12-month period (including the initial exchange of your investment from that Fund during the period, and subsequent exchanges of that investment from other Funds or the RS Money Market Fund during the same 12-month period).

2.1.2 The IDC identified non-compliant trades by examining the transaction history of all accounts in the ten RS Funds from 2000 through 2003. For every RS mutual fund account, the IDC constructed a time series of all exchanges between funds by matching shares in buy transactions with shares in subsequent sell transactions using the last-in-first-out (LIFO) method.<sup>2</sup> This method matched shares from the most immediate buy to shares from the most immediate sell. If the number of shares in the buy and sell transactions differed, the IDC used the minimum of the two to determine the size of the roundtrip trade. Non-compliant accounts were defined as those for which there were four or more exchanges in any calendar year between 2000 and 2003. In all accounts in which more than four exchanges took place during a 12-month period, all exchanges subsequent to the fourth exchange were considered non-compliant trades.<sup>3</sup>

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<sup>1</sup> From 2000 to mid-2003, the ten RS Funds issued a single prospectus.

<sup>2</sup> Only exchanges between RS funds were considered. Exchanges from the RS money market fund to another RS fund were considered, but purchases made from cash were not. Similarly, exchanges from an RS fund to the RS money market fund were counted, but redemptions to cash were not.

<sup>3</sup> Exchanges that were made as part of a systemic trading program (a pre-set program to invest a certain amount of money in a fund every month, for example) were not counted as exchanges for the purpose of

2.1.3 The IDC also identified a subset of non-compliant trades – those in which there was a purchase of units of a fund followed by a sale of units of the same fund within five days of the purchase. These non-compliant trades are referred to as short-term roundtrip trades. The IDC limited his estimate of dilution losses to short-term roundtrip transactions for practical reasons - expanding the damages estimate model to capture longer-term roundtrip trades would have increased the complexity of the calculations significantly. Also, the five-day window used captured more than 80 percent of all non-compliant activity in the RS Funds.<sup>4</sup> If the number of shares sold was not identical to the number bought, only the matched shares constituted the short-term roundtrip transaction. Unmatched shares may have been part of other short-term roundtrip transactions. For example, if an account purchased 500 shares of a fund on Day 1, sold 200 shares of the fund on Day 3, sold 250 shares of the fund on Day 5, and sold 50 shares of the fund on Day 7, there would be two short-term roundtrip transactions – one of 200 shares and the other of 250 shares.

## 2.2 Measurement of Dilution Losses

2.2.1 The IDC believes that the method for allocating the Fair Fund is fair and reasonable. The proportion of the Fair Fund allocated to each eligible investor is equal to that investor's proportionate share of the losses from market timing that are susceptible to calculation. The IDC calculated two types of losses – dilution costs and brokerage costs.

2.2.2 The IDC limited his estimate of dilution losses to short-term roundtrip transactions because, as discussed above, this methodology captured more than 80 percent of all non-compliant trades, and it would not have been practical to adjust the model to capture more non-compliant trades.

2.2.3 When new money comes into a fund via a short-term roundtrip transaction, it can either be invested by the fund manager, or it can remain in cash. The dilution to the fund is different under each scenario. If the money remains in cash, the value of the fund's underlying securities (and the gain or loss thereon) is the same as it would have been absent the purchase in question, but the number of units has increased. Any gain by the short-term trader is a gain that otherwise would have gone to other unit holders, and represents the dilution loss they suffered. For money that has been invested by the fund, the situation is more complicated, and it is necessary to separately examine the buy and sell sides of the short-term roundtrip trades, as explained in more detail below. Due to the different methodologies, the IDC calculated the dilution under each scenario,

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identifying non-compliant trades since they were not based on current information. The IDC also removed all exchanges that were cancelled and exchanges for less than \$100.

<sup>4</sup> For all accounts with more than four exchanges in any year between 2000 and 2003, 81 percent of purchases (weighted by dollars) and 81 percent of sales were part of short-term roundtrip transactions. Similarly, for all accounts with more than eight exchanges in any year, 81 percent of both purchases and sales were part of short-term roundtrip transactions. The percentages were also 81 percent for purchases and sales for accounts with more than 12 exchanges.

and estimated the proportion of new money that was invested on a particular day, and the proportion that remained in cash.

#### *Calculating the Day Ratio*

2.2.4 The day ratio is the percentage of cash in a fund that is invested by the fund in its securities portfolio on a particular day. The IDC estimated the day ratio by determining the cash balance at the beginning of the day, which involved adding the cash balance of the fund at the end of the previous day to the net cash flow into the fund on the previous day (since transactions are not recorded until after the end of the day). The IDC then calculated the cash investment by a fund on a given day by subtracting the cash balance at the end of that day from the cash balance at the beginning of the day. For example, if the fund had a cash balance of \$10 million at the end of day 1, net contributions of \$5 million on day 1 (which get recorded after the end of day 1), and a cash balance of \$9 million at the end of day 2, then \$6 million was invested by the fund on day 2 ( $\$10 \text{ million} + \$5 \text{ million} - \$9 \text{ million} = \$6 \text{ million}$ ). A total of \$15 million was available for investment (the original \$10 million plus the net infusion of \$5 million), so the day ratio (or percentage of available funds invested) for day 2 is 40 percent ( $\$6 \text{ million} / \$15 \text{ million}$ ). If another \$4.5 million was invested on day 3, with no net contributions on day 2, the day ratio for day 3 is 50 percent ( $\$4.5 \text{ million}$  invested out of the \$9 million available).

2.2.5 The IDC assumed that the day ratio for inflows from short-term roundtrip transactions was the same as for the fund in general. So in the example above, if a short-term roundtrip transaction resulted in \$100,000 being invested in the fund on day 1, 40 percent of this amount, or \$40,000, was assumed to have been invested the following day, 50 percent of the remaining \$60,000 was assumed invested on day 3, and so on. The fund will have available cash from the short-term trade until all of the cash has been invested, or until the short-term roundtrip transaction is completed with a sale of the fund shares.

#### *The Profit Estimate (Dilution from Infusions that Remain in Cash)*

2.2.6 For funds that remain in cash, the dilution is the profit made on the short-term roundtrip trading transaction. If the short-term roundtrip trade results in a loss, the fund benefited from the transaction, and the dilution gain to the other shareholders equals the loss to the short-term roundtrip trader.

2.2.7 To illustrate the calculation of dilution on funds that remained in cash, assume that at the end of day 0, a mutual fund had net assets of \$1,000,000, composed entirely of 50,000 shares of a stock that closes at \$20 on day 0. The fund had 100,000 units, and an NAV of \$10.00. Assume also that 10,000 units of the fund were purchased on day 0 (at the NAV of \$10.00). The next day, the sole stock owned by the fund closed at \$22. The total assets of the fund were then \$1,200,000, composed of \$1,100,000 of the stock and \$100,000 in cash. The number of units of the fund was 110,000, and the NAV

was therefore \$10.9091. The profit to the short-term roundtrip trader (assuming he sold on day 1) was \$9,091. If the short-term roundtrip transaction had not taken place, the total assets of the fund would have been \$1,100,000 (50,000 shares of the stock valued at \$22, with no cash), and the NAV of the fund would have been \$11.00 (the fund would have had 100,000 units). The dilution loss to the original fund holders was \$0.09091/unit, times 100,000 units, or \$9,091 – the exact amount of the short-term roundtrip profit.

2.2.8 The calculation of this component of dilution losses – the profit estimate on funds that remain in cash – is relatively straightforward. The IDC calculated the profit estimate as the portion of the short-term roundtrip infusion that remained in cash (which was obtained by multiplying the available funds by (1 – the day ratio)) multiplied by the one-day NAV return for the fund. This was done for each day that any cash from a short-term roundtrip infusion remained in cash. For example, if an account purchased 1,000 units of a fund on day 1 at an NAV of \$10.00, there was an infusion of \$10,000 into the fund. If the day ratio on day 2 was 0.4, \$4,000 was invested on day 2, leaving \$6,000 in cash. This amount was multiplied by the NAV return on day 2 to obtain the profit estimate for day 2. If the fund closed at an NAV of \$10.50 on day 2, the fund's NAV return would be 5.0 percent  $((10.50-10.00)/10.00)$ , and the profit estimate for day 2 would be \$300 (uninvested cash of \$6,000 times the day-2 NAV return of 5.0 percent equals \$300). If the day ratio on day 3 was 0.5, and the fund closed at an NAV of 10.605 (resulting in a next-day NAV return of 1.0 percent), the day-3 profit estimate would be \$30. The profit estimate of \$30 was computed by multiplying the available cash of \$3,000 (50% of \$6,000 remains uninvested) by the day-3 NAV return of 1.0 percent. The process was repeated for each day that any cash from a short-term roundtrip infusion remained uninvested.

#### *Buy-Side Dilution from Infusions that Are Invested*

2.2.9 To calculate the buy-side dilution for funds that were invested, the IDC multiplied the incremental amount invested that day (which equals the day ratio for that day multiplied by the remaining available funds) by the daily return to the short-term trader. For example, if the day ratio for a day was 0.5, and \$10,000 remained in a fund from the purchase portion of a prior short-term roundtrip, the incremental investment that day would be \$5,000. If the daily return of the fund on the next day was 2 percent, the buy-side dilution was \$100 (2 percent return times the incremental investment amount of \$5,000).

#### *Sell-Side Dilution from Infusions that Are Invested*

2.2.10 To calculate the sell-side dilution for funds that are invested, the IDC first determined the cumulative invested amount by summing the incremental investments made by the fund from the cash infusion by the short-term trader. If a short-term roundtrip transaction resulted in \$100,000 being invested in the fund on a day, and 40 percent of this amount, or \$40,000 was invested by the fund the following day, and 50

