The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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California Appellate Court Holds Federal Law Does Not Preempt State Action Alleging Fraud Based on Revenue Sharing

[20842]

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TO: COMPLIANCE MEMBERS No. 6-07
SEC RULES MEMBERS No. 14-07
SMALL FUNDS MEMBERS No. 13-07
BROKER/DEALER ADVISORY COMMITTEE No. 7-07
BROKER/DEALER ASSOCIATE MEMBERS No. 2-07 RE: CALIFORNIA APPELLATE COURT HOLDS FEDERAL LAW DOES NOT PREEMPT STATE ACTION ALLEGING FRAUD BASED ON REVENUE SHARING

In 2005, the California Superior Court held that the California Attorney General's claims against a fund's adviser and primary distributor alleging failure to adequately disclose revenue sharing arrangements with broker-dealers were preempted by the National Securities Markets Improvement Act of 1996 (NSMIA). [1] The Attorney General appealed this ruling to the California Court of Appeals. The appellate court reversed the Superior Court's judgment, finding that NSMIA did not preempt the Attorney General's action. [2] The appellate court's decision is attached and summarized below.

In the view of the court, in enacting NSMIA Congress had two objectives in mind. The first objective was to promote national uniformity in the registration of securities by preempting state Blue Sky Laws. The second, "but equally important," objective was "to encourage the continued participation of the states in preventing fraud in securities transactions,

particularly with regard to broker-dealers." Viewed from this perspective, the court found that the Attorney General's action was within his authority under NSMIA.

In particular, after reviewing the history and language of NSMIA, the court held that the Attorney General's action did not violate California's authority under NSMIA because it was brought against the fund's adviser and distributor rather than against the fund. As stated by the court:

Although the preemption provision [of NSMIA] expressly prohibits any state from imposing conditions on the use of a covered security's offering documents, the savings clause [3] gives the Attorney General authority to 'bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.' What this means is that the Attorney General cannot sue [the mutual fund] to force it to change its disclosure documents, but it can sue [the fund's distributor and adviser] to force them to disclose their oral agreements with the shelf-space brokers. The savings clause [in NSMIA] is sufficiently broad to permit this action and as applied to this case is entirely consistent with the purpose of NSMIA. (Emphasis in original.)

Based upon this holding, the court reversed the judgment of the Superior Court and remanded the case to the trial court for further proceedings, including "setting the case on track for trial."

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Attachment

endnotes

[1] See Institute Memorandum to Broker/Dealer Advisory Committee No. 35-05, Broker/Dealer Associate Members No. 13-05, SEC Rules Members No. 125-05, and Small Funds Members No. 98-05 [No. 19461], dated Dec. 7, 2005, summarizing the ruling of the Los Angeles Superior Court in Capital Research and Management Company and American Funds Distributors, Inc. v. Bill Lockyer, Attorney General of the State of California (Cal. Super. Ct. Nov. 22, 2005).

[2] Capital Research and Management Company v. Edmund G. Brown, Jr., as Attorney General, -- Cal.Rptr.3d --, 2007 WL 195785 (Cal. App. 2 Dist.) (Jan. 26, 2007).

[3] The "savings clause" refers to the provision in NSMIA that preserves to the states certain powers notwithstanding NSMIA's preemptive provisions.
