MEMO# 21569

September 7, 2007

California Appellate Court Rules That State Action Involving Revenue Sharing Not Preempted BY NSMIA

[21569]

September 7, 2007

TO: COMPLIANCE MEMBERS No. 53-07
SEC RULES MEMBERS No. 118-07
SMALL FUNDS MEMBERS No. 79-07
BROKER/DEALER ADVISORY COMMITTEE No. 54-07
BROKER/DEALER ASSOCIATE MEMBERS No. 3-07 RE: CALIFORNIA APPELLATE COURT RULES THAT STATE ACTION INVOLVING REVENUE SHARING NOT PREEMPTED BY NSMIA

In December 2004, the California Attorney General filed a civil action against a broker-dealer alleging two counts of fraud for failing to disclose to its customers information about the broker-dealer's revenue sharing (shelf-space) arrangements with mutual funds on the broker-dealer's "Preferred Funds" list. In May 2006, the Superior Court of California for the County of Sacramento dismissed the Attorney General's action on the ground that it was preempted by the National Securities Markets Improvement Act of 1996 (NSMIA) because "[t]he assertion of California's authority in [the case] conflicts with the federal regulation of information provided in mutual fund prospectuses." [1] This decision was appealed by the Attorney General to the California Court of Appeal, which has ruled that the Attorney General's action is not preempted under NSMIA or by Rule 10b-10 under the Securities Exchange Act of 1934. [2] The appellate court thus reversed the lower court's ruling and remanded the case for further proceedings. The appellate court's decision is briefly summarized below.

The Appellate Court's Decision

The court first considered the Attorney General's arguments that the lower court's decision should be reversed based on procedural errors. It concluded that, even if there were procedural errors, the lower court's judgment could not be reversed unless the Attorney General's arguments relating to the preemptive impact of NSMIA were correct.

With respect to the NSMIA arguments, the broker-dealer argued that "[i]f California and other states are able to dictate and control the content of prospectuses, then prospectus disclosure would be subject to potentially conflicting or inconsistent regulation in more than fifty different jurisdictions," which is a result NSMIA sought to prohibit. The court, however, disagreed because of the provision in NSMIA that expressly preserved to the states the ability to investigate and bring enforcement actions with respect to fraud or deceit. Based on this provision, the court found that the Attorney General's action "is a type of action expressly permitted by the NSMIA. That which is expressly permitted cannot be implicitly prohibited." Moreover, the court found that because of this preservation provision, a state's "enforcement action with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions may limit the use of a mutual fund prospectus, notwithstanding the prohibition against effecting a limitation by other methods."

The broker-dealer also argued that the savings clause in NSMIA only preserved state authority under common law notions of fraud or deceit. According to the court, however, "nothing in the NSMIA limits the savings clause to actions based on 'common law fraud or deceit.' Rather, the savings clause applies much more broadly to 'enforcement actions with respect to fraud or deceit or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.'" Because the Attorney General's action falls within the scope of this language in NSMIA, the court found this action to be "the type of enforcement action the NSMIA expressly excepts from its prohibitions." The court noted that, because it was able to reach this conclusion based on the unambiguous language of the statute, it did not need to consider the statute's legislative history.

The court next considered the broker-dealer's contention that the Attorney General's action was preempted by SEC Rule 10b-10. According to the court, the issue presented was whether, by requiring the disclosure of certain information in Rule 10b-10, the SEC intended to foreclose states from bringing enforcement actions against broker-dealers for not disclosing additional information the states deem material. The court was able to answer this question by reading a preliminary note to Rule 10b-10, which explained that the rule's requirements "that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision." In the court's view, this note "does not preclude a broker-dealer from being charged with violating its obligation under the general antifraud provisions of federal securities laws based on its failure to disclose additional information not required by the rule."   As such, the court found no conflict between Rule 10b-10 and the Attorney General's action.

Tamara K. Salmon

Senior Associate Counsel

endnotes

[1] See Institute Memorandum to Compliance Members No. 28-06 , SEC Rules Members No. 50-06, Small Funds Members No. 42-06, Broker-Dealer Advisory Committee No. 20-06, and Broker-Dealer Associate Members No. 2-06, [20100], dated June 9, 2006.

[2] The People of the State of California v. Edward D. Jones & Co., No. C053407 (Cal. Ct. App. Aug. 24, 2007). Rule 10b-10 is the federal rule that governs the contents of the confirmation sent to an investor upon the completion of a securities transactions.

Source URL: *https://icinew-stage.ici.org/memo-21569*