

MEMO# 18216

November 18, 2004

FUND DISTRIBUTOR SETTLES CALIFORNIA ENFORCEMENT ACTION RELATING TO DIRECTED BROKERAGE

[18216] November 18, 2004 TO: BOARD OF GOVERNORS No. 77-04 CHIEF COMPLIANCE OFFICER COMMITTEE No. 27-04 COMPLIANCE ADVISORY COMMITTEE No. 112-04 SEC RULES MEMBERS No. 165-04 SMALL FUNDS MEMBERS No. 122-04 RE: FUND DISTRIBUTOR SETTLES CALIFORNIA ENFORCEMENT ACTION RELATING TO DIRECTED BROKERAGE The Attorney General of California has announced the settlement of a civil proceeding against a distributor to a group of mutual funds ("Funds") relating to the distributor's shelf space arrangements with various broker-dealers. The civil proceeding alleges that these arrangements, which were paid for in part through the direction of Fund brokerage, were not adequately disclosed.* The complaint filed in this proceeding alleges that, from January 2000 through the present, the distributor entered into at least 100 shelf space arrangements with various broker-dealers, under which the distributor agreed to make cash payments and direct Fund brokerage transactions to the broker-dealers in return for: (i) heightened visibility for the Funds in the broker-dealer's distribution systems or sales systems, such as through placement on preferred lists; and (ii) privileged access to broker-dealer's distribution or sales systems. It also alleges that the distributor and the Funds' disclosure documents failed adequately to disclose the shelf space arrangements to Fund shareholders and prospective shareholders. According to the complaint, disclosure of these material facts was necessary to avoid statements in the Funds' registration statements relating to dealer compensation and portfolio transactions from being misleading. Accordingly, omission of these material facts was alleged to be a violation of two of the antifraud provisions of California's Corporate Securities Law of 1968. The distributor agreed to settle the action without admitting or denying the allegations in the complaint. The settlement agreement - which contains no findings of fact or conclusions of law - noted the efforts voluntarily implemented by the distributor, including: ensuring * See Attorney General Lockyer Announces \$18 Million Settlement with Franklin Templeton Fund Distributor (press release issued by Office of California Attorney General Bill Lockyer, Nov. 17, 2004), available at <http://ag.ca.gov/newsalerts/2004/04-133.htm>. Copies of the complaint and settlement agreement are available at <http://ag.ca.gov/newsalerts/2004/04-133b.pdf> and <http://ag.ca.gov/newsalerts/2004/04-133a.pdf>, respectively. 2 registration statement disclosures of all shelf space arrangements; memorializing future shelf space arrangements in written contracts; and implementing policies that preclude it from directing any brokerage transactions to any broker-dealer where the allocation is based, directly or indirectly, on sales of mutual fund shares. Pursuant to the settlement agreement, the distributor will pay a total of \$18 million to settle the proceeding. Of this, \$2 million will go

to pay the Attorney General's fees and costs, \$2 million will go to the State of California as civil penalties, and \$14 million will be paid to the Funds. Jane G. Heinrichs Assistant Counsel

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.