INVESTMENT COMPANY INSTITUTE

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Federal District Court Grants Motion to Dismiss "Shelf Space" Cases Against Financial Services Firm and Subsidiaries

 [20124] June 21, 2006 TO: BROKER/DEALER ADVISORY COMMITTEE No. 22-06 COMPLIANCE MEMBERS No. 29-06 SEC RULES MEMBERS No. 56-06 SMALL FUNDS MEMBERS No. 45-06 RE: FEDERAL DISTRICT COURT GRANTS MOTION TO DISMISS “SHELF SPACE” CASES AGAINST FINANCIAL SERVICES FIRM AND SUBSIDIARIES On June 12, 2006, the U.S. District Court for the Southern District of New York dismissed a shareholder suit against a financial services firm and several of its subsidiaries that are engaged, directly or indirectly, in the sale of mutual funds.1 The plaintiffs alleged that the defendants failed to properly disclose an incentive structure that caused retail brokers to improperly “steer” or “push” plaintiffs into certain mutual funds (the “Shelf Space Funds”), and that once invested in those funds, the plaintiffs were charged “undisclosed” and “excessive” fees, which in turn were used to “steer” additional investors into the Shelf Space Funds. The plaintiffs alleged that these acts violated the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and state common law. The court dismissed the allegations of violations under the Securities Act and the Exchange Act, which were based on misleading statements or omissions regarding the “shelf space” arrangements, for several reasons. First, the court held that for an omission to be actionable it must involve information that the defendant had a duty to disclose. In this case, the defendants disclosed the fees and commissions charged to shareholders; they had no duty to disclose the precise allocation of those fees. Additionally, the court found that the plaintiffs had not properly pleaded that they suffered a loss as a result of the alleged misstatements or omissions, and that they had not met the heightened pleading standards for fraud required by the Private Securities Litigation Reform Act. The court also dismissed claims of control person liability based on these underlying claims. 1 See In re Merrill Lynch Investment Management Funds Securities Litigation, 2006 U.S. Dist. LEXIS 38978 (S.D.N.Y. June 12, 2006). 2 As to the claims made under the Investment Company Act, the court held that no private right of action exists under Sections 34(a), 36(a), and 48(a). With respect to the Section 36(b) claim, the court held that the plaintiffs did not allege facts sufficient to demonstrate that the advisory fees received by the investment adviser and distributor defendants were so disproportionately large that they bore no reasonable relationship to the services rendered.2 The Investment Advisers Act claim, which the plaintiffs brought derivatively on behalf of the funds they owned, was dismissed because the plaintiffs did not

make a demand on the boards of the funds or allege that demand would be futile, as required by the laws of all of the states in which the funds were incorporated. Finally, the court declined to exercise supplemental jurisdiction over the remaining state law claim for breach of fiduciary duty. Mara Shreck Assistant Counsel 2 This standard is set forth in Gartenberg v. Merrill Lynch Asset Mgmt, Inc., 694 F.2d 923, 928 (2d. Cir. 1982).
