

MEMO# 18732

April 8, 2005

COMPLAINTS FILED BY FUND COMPANY AND CALIFORNIA ATTORNEY GENERAL

©2005 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. [18732] April 8, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 16-05 BROKER/DEALER ASSOCIATE MEMBERS No. 6-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 33-05 COMPLIANCE ADVISORY COMMITTEE No. 29-05 SEC RULES MEMBERS No. 48-05 SMALL FUNDS MEMBERS No. 31-05 RE: COMPLAINTS FILED BY FUND COMPANY AND CALIFORNIA ATTORNEY GENERAL A registered investment adviser to a group of mutual funds ("Funds") and the Funds' distributor (collectively, "Fund Company") recently filed a complaint for injunctive and declaratory relief against the California Attorney General. 1 The complaint was filed in response to an investigation conducted by the California Attorney General regarding so-called "revenue sharing" payments made by the distributor to certain broker-dealers. On the same day, the California Attorney General also filed a complaint against the Fund Company relating to these issues.² Both complaints are summarized below. Fund Company's Complaint The Fund Company's complaint alleges that the distributor compensates broker-dealers selling the Funds' shares principally through receipt of dealer commissions and 12b-1 service fees. The distributor provides additional compensation to 50 of the Funds' top-selling dealers to defray the substantial direct and indirect costs of training the dealer's registered representatives to help them match appropriate investments to their clients' long-term investment needs. The complaint also alleges that in full compliance with all applicable federal disclosure 1 See *Capital Research and Management Company and American Funds Distributors, Inc. v. Bill Lockyer, Attorney General of the State of California* (Cal. Super. Ct., March 24, 2005). A copy of the complaint is attached and a copy of the accompanying press release is available at <http://www.americanfunds.com/planning/news/funds-in-the-news.htm>. 2 See *The People of the State of California v. American Funds Distributors, Inc. and Capital Research and Management Company* (Cal. Super Ct., March 24, 2005). Copies of the Attorney General's complaint and accompanying press release are available at http://www.ag.ca.gov/newsalerts/2005/05-021_lawsuit.pdf and <http://www.ag.ca.gov/newsalerts/2005/05-021.htm>, respectively. 2 requirements, the Funds have adequately disclosed in their registration statements that the distributor makes these payments to broker-dealers. According to the complaint, the California Attorney General has advised the Fund Company that he intends to commence an enforcement action against it for alleged violations of the California Corporations Code. In particular, his action would allege that the Fund Company purportedly failed to adequately disclose the terms of its additional dealer compensation arrangements, which the Attorney General pejoratively calls payments for "shelf space," because the Funds' prospectuses did not include certain details regarding the arrangements, even though no statute or rule has ever required such

disclosure. The Fund Company's complaint alleges that the Attorney General's threatened action is expressly preempted under the National Securities Market Improvements Act of 1996 and is without merit as a matter of law in all events. The complaint requests that the court (i) declare that the Funds' disclosure of additional compensation was accurate and not misleading under applicable law and (ii) prevent the California Attorney General from bringing any enforcement action against the Fund Company concerning these matters. California Attorney General's Complaint According to the California Attorney General's complaint, the Fund Company violated the anti-fraud provisions of the California Corporations Code because the Funds' prospectuses did not adequately describe the terms and alleged purpose of "shelf space" payments made to broker-dealers to sell and recommend the Funds. Specifically, the complaint alleges that, from 2000 through the end of 2004, the Fund Company's shelf space payments totaled at least \$426 million, including \$294 million in cash and \$132 million in commissions generated by the Funds' portfolio trades. In exchange for these payments, the complaint alleges that the Fund Company received from the broker-dealers various exclusive marketing benefits, including, (i) privileged and guaranteed access to the broker-dealers' distribution or sales systems, (ii) heightened visibility of the Funds' within the broker-dealers' distribution or sales systems; and (iii) participation in programs in which transaction fees associated with sales are waived. The complaint notes that such payments - made in cash or "directed brokerage" commissions on mutual funds' portfolio transactions - create conflicts of interest, increase mutual funds' expenses, and decrease consumers' investment choices. The complaint seeks disgorgement of all profits the Fund Company purportedly obtained as a result of the alleged violations of the Corporations Code, restitution for investors, civil penalties of up to \$25,000 per violation, and an injunction prohibiting future violations. Jane G. Heinrichs Assistant Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 18732, or call the ICI Library at (202) 326-8304 and request the attachment for memo 18732.