

MEMO# 18878

May 24, 2005

FEDERAL DISTRICT COURT GRANTS MOTION TO DISMISS CLAIMS THAT CLOSED FUNDS PAID EXCESSIVE 12B-1 FEES

©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. [18878] May 24, 2005 TO: BOARD OF GOVERNORS No. 25-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 43-05 COMPLIANCE ADVISORY COMMITTEE No. 40-05 SEC RULES MEMBERS No. 70-05 SMALL FUNDS MEMBERS No. 50-05 RE: FEDERAL DISTRICT COURT GRANTS MOTION TO DISMISS CLAIMS THAT CLOSED FUNDS PAID EXCESSIVE 12B-1 FEES The U.S. District Court for the District of Massachusetts has dismissed derivative claims against the investment advisers, distributor, and trustees¹ of a group of mutual funds ("Funds") in a shareholder suit under Section 36(b) of the Investment Company Act of 1940 alleging a breach of fiduciary duty for continuing to charge 12b-1 fees on funds that are closed to new investors.² The court also dismissed the plaintiffs' state law claims. The court did not, however, dismiss the plaintiffs' claim that the defendants breached their fiduciary duties in authorizing and receiving excessive advisory fees. Breach of Fiduciary Duty Claims According to the Memorandum, the Funds offer several classes of shares. Two classes pay the distributor an annual "distribution fee" equal to .75 percent of the net asset value of the Funds for expenses incurred in connection with the distribution and marketing of the Funds' shares. All of the classes pay an annual "service fee" equal to .25 percent of the net asset value of the Funds to compensate broker-dealers for their ongoing personal services, such as providing information and assistance to shareholders and for maintaining shareholder accounts. In addition, all classes of shares pay yearly "advisory fees" to the investment advisers equal to .80% of the net asset value of the Funds to cover investment advisory and portfolio management services. In discussing the applicable law, the court explained that mutual funds may not charge fees that are so disproportionately large that they bear no reasonable relationship to the services ¹ Seven members of the Funds' eleven member Board of Trustees are named as defendants. ² See ING Principal Protection Funds Derivative Litigation, Civil Action No. 03-12198-JLT (Dist. Mass. May 9, 2005) ("Memorandum"). A copy of the Memorandum is attached. ² actually provided. The court also explained that to state a claim that a fee violates the fiduciary duties imposed by Section 36(b), a complaint must contain a "short and plain statement" showing that the fee charged is so large that it bears no reasonable relationship to the relevant services actually provided. The court observed that the plaintiffs make no comparison between the sales-related services actually provided when shares of the Funds were offered and sold to the

public and the .75 percent distribution fees at issue. Instead, the plaintiffs simply allege that the distribution fees exceed the de minimis sales-related expenses incurred when the Funds were closed to new investors. The court found that, because the plaintiffs' claims regarding distribution services are expressly limited to when the Funds were closed, their allegations are impermissively selective. At a minimum, the court stated, the plaintiffs must also allege that the distribution fees are disproportionate and unrelated to the sales-related services actually provided when shares of the Funds were marketed and sold to the public. Without this fundamental claim, the court found that the plaintiffs have failed to state a claim for breach of fiduciary duty in connection with the payment and receipt of distribution fees. Similarly, the court found that the plaintiffs have failed to state a claim with respect to the .25 percent service fees. According to the Memorandum, the plaintiffs do not allege that the service fees exceed the ongoing expenses associated with maintaining shareholder accounts. Nor do they allege any facts that, if true, would indicate that the service fees are unrelated to the shareholder services provided by broker-dealers. With respect to the advisory fees, the court found that the plaintiffs have adequately alleged that the defendants breached their fiduciary duties in authorizing and receiving excessive compensation. The Memorandum states that the plaintiffs' complaint alleges sufficient facts to state a claim that these fees are so disproportionately large that they bear no reasonable relationship to the advisory services actually rendered on behalf of the Funds. State Law Claims The court also dismissed the plaintiffs' derivative state law claims because the plaintiffs failed to make pre-suit demands on the Funds' trustees. Under a Massachusetts "universal demand" statute that took effect on July 1, 2004, "demand must be made prior to the commencement of every derivative case, whether or not the directors are independent with respect to the matter subject to the demand." The court observed that on July 30, 2004, without making pre-suit demand, plaintiffs amended the complaint, adding seven of the Funds' independent trustees as defendants. The plaintiffs brought a claim against the trustees for breach of fiduciary duty under Massachusetts law. The court explained that the primary purpose of the universal demand statute is to protect the authority of the board of directors to decide whether to pursue a lawsuit on behalf of the corporation. The court determined that the amendment adding the independent trustees did not relate back to the original 2003 complaint, notwithstanding the plaintiffs' argument to the contrary. The court also rejected the plaintiffs' argument that the universal demand requirement only applies to derivative suits brought on behalf of corporations. Instead, the court stated its belief that Massachusetts courts will apply the requirement of universal, pre-suit demand to derivative actions brought on behalf of business trusts. Jane G. Heinrichs Assistant Counsel 3 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 18878, or call the ICI Library at (202) 326-8304 and request the attachment for memo 18878.