

MEMO# 19461

December 7, 2005

CALIFORNIA COURT RULES THAT FEDERAL LAW BARS STATES FROM IMPOSING DISCLOSURE REQUIREMENTS ON MUTUAL FUND PROSPECTUSES

©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. [19461] December 7, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 35-05 BROKER/DEALER ASSOCIATE MEMBERS No. 13-05 BOARD OF GOVERNORS No. 63-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 66-05 COMPLIANCE MEMBERS No. 26-05 SEC RULES MEMBERS No. 125-05 SMALL FUNDS MEMBERS No. 98-05 RE: CALIFORNIA COURT RULES THAT FEDERAL LAW BARS STATES FROM IMPOSING DISCLOSURE REQUIREMENTS ON MUTUAL FUND PROSPECTUSES As we previously informed you, in March, an investment adviser to a group of mutual funds and the funds' distributor (collectively referred to here as "Defendants") filed a complaint for injunctive and declaratory relief against California's Attorney General.¹ The complaint was filed in response to an investigation conducted by the Attorney General regarding the Defendants' revenue sharing arrangements with broker-dealers. On the same day the Defendants filed their action, the Attorney General filed a complaint alleging that the Defendants violated the antifraud provisions of California law by not adequately disclosing in their prospectuses their shelf-space (i.e., revenue sharing) arrangements with broker-dealers. These two actions were consolidated in California Superior Court. In this proceeding, the Defendants argued that the claims against them in the Attorney's General's complaint are without merit because the National Securities Markets Improvement Act of 1996 ("NSMIA") expressly and impliedly preempts states from taking action against funds based upon insufficient prospectus disclosure. According to the Defendants, NSMIA vested the federal government with exclusive authority to regulate national securities offerings and, consequently, prohibits the states from taking any action that would directly or indirectly regulate the contents of any offering document disseminated by or on behalf of any mutual fund. On November 22nd, the Court ruled on the Defendants' NSMIA arguments.² 1 See Institute Memorandum to Broker/Dealer Advisory Committee No. 16-05, Broker/Dealer Associate Members No. 6-05, Chief Compliance Officer Committee No. 33-05, SEC Rules Members No. 48-05, and Small Funds Members No. 31-05 [18732], dated April 8, 2005. 2 See Court's Ruling and Order Re: Defendants' Demurrer to Complaint of State of California, Capital Research and Management Company and American Funds Distributors, Inc. v. Bill Lockyer, Attorney General of the State of California (Cal. Super Ct. Nov. 22, 2005) (the "Court's Ruling"), a copy of which is attached. 2 After noting that the Defendants bore the burden of proving

that NSMIA preempted the Attorney General's action, the court considered the Defendants' express and implied preemption arguments. It began by analyzing the language of the relevant provisions of NSMIA to determine whether they expressly preempted the Attorney General's action. Based on this analysis, the court concluded that NSMIA's language was ambiguous and therefore NSMIA did not expressly preempt the Attorney General's action. The court next considered whether NSMIA impliedly preempted the action. After reviewing NSMIA's structure, purpose, and the report of the Commerce Committee of the U.S. House of Representatives on NSMIA, the court concluded that, pursuant to the House Committee report and the intent of Congress, "state-mandated [prospectus] disclosures . . . are directly barred by NSMIA." According to the court: In other words, the Attorney General's claims and the injunctive relief sought in the [Attorney General's compliant] impermissibly seek to require or otherwise impose conditions on the disclosure of information for covered securities. As Congress has made clear, a state cannot, consistent with NSMIA, impose conditions on the disclosure of any information in an offering document for covered securities. The notion that a California court or jury may determine the materiality or adequacy of disclosures (or non-disclosures) is inconsistent with, and would undermine, NSMIA. It would place Investment Company Act Funds in the untenable position of having to seek review of their offering statements by regulators in all states in which their shares are sold. Such would be the antithesis of the national regulation of securities offerings contemplated by NSMIA.³ The court went on to note that . . . a finding that the [Attorney General's] claims are not impliedly preempted would reduce nationwide uniformity and consistency. This would directly conflict with Congress' intent to designate the federal government as the exclusive regulator [of] national offerings of securities. . . . Consequently, the Attorney General's state action here 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'⁴ ³ Court's Ruling at pp. 16-17 (Emphasis in original). ⁴ Court's Ruling at p. 18. The Court's Ruling also notes, "Significantly, the Attorney General does not allege that the Defendants failed to make required disclosures under federal law, or that Form N-1A was improperly or fraudulently completed." (Emphasis in original.) Court's Ruling at p. 19. ³ Based upon the above, the court concluded that the Defendants satisfied their burden of proving that California's action was impliedly preempted by NSMIA and directed the parties to submit a proposed judgment consistent with the court's order. Tamara K. Salmon Senior Associate 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 19461, or call the ICI Library at (202) 326-8304 and request the attachment for memo 19461.