The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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FEDERAL DISTRICT COURT GRANTS MOTION TO DISMISS FEE LITIGATION SUIT AGAINST FUND COMPANY

 [19064] August 8, 2005 TO: BOARD OF GOVERNORS No. 35-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 54-05 COMPLIANCE MEMBERS No. 8-05 SEC RULES MEMBERS No. 88-05 SMALL FUNDS MEMBERS No. 67-05 RE: FEDERAL DISTRICT COURT GRANTS MOTION TO DISMISS FEE LITIGATION SUIT AGAINST FUND COMPANY The U.S. District Court for the Southern District of New York has dismissed a shareholder suit against a group of mutual funds ("Funds") and their investment advisers, distributor, directors, trustees, and officers claiming that the defendants used improper means to acquire "shelf space" at brokerage firms.1 Specifically, in a ten count complaint, the plaintiffs alleged that the defendants used the Funds' assets to pay excessive commissions to brokers to induce the brokers to market aggressively the Funds to new investors in violation of the Investment Company Act of 1940, the Investment Advisers Act of 1940, New York General Business Law, and state common law. According to the court's opinion, the plaintiffs brought all but one of their ten claims against the defendants as class actions. Count One of the action was brought against the investment advisers and the Funds' officers, directors and trustees, alleging that these defendants made material misrepresentations and omissions in registration statements and reports filed with the Securities and Exchange Commission in violation of Section 34(b) of the Investment Company Act. Counts Two and Three were brought against the investment advisers, the distributor, and the Funds' officers, directors and trustees for violation of Sections 36(a) and 36(b) of the Investment Company Act, alleging a breach of fiduciary duty for improperly charging investors in the Funds 12b-1 fees and by drawing on the Funds' assets to make undisclosed payments of soft dollars and excessive commissions. Count Four was brought against the distributor and affiliates of the investment advisers for violation of Section 48(a) of the Investment Company Act for allegedly causing the investment advisers to violate Sections 34(b), 36(a), and 36(b). Count Five is a derivative action brought on behalf of the Funds against the investment advisers for violation of Section 206 of the Investment Advisers Act for allegedly knowingly and/or recklessly engaging in actions alleged in Counts One through Three. Count Six was brought against all defendants for violation of New York 1 See In re Eaton Vance Mutual Funds Fee Litigation, 04 Civ.1144 (JGK) (S.D.N.Y. July 29, 2005). 2 General Business Law. Counts Seven through Nine were brought for breach of fiduciary duties under common law. Specifically, Count Seven was brought against the investment advisers, Count Eight was brought against the Funds' officers, directors and trustees, and Count Nine against all defendants for aiding and abetting breaches of

fiduciary duties. Count Ten was brought against all defendants alleging unjust enrichment under common law. The defendants sought to dismiss all claims pursuant to Federal Rules of Civil Procedure. Relying on the reasoning in Supreme Court and Second Circuit opinions, the court dismissed Counts One, Two, and Four, holding that there are no private rights of action under Sections 34(b), 36(a), or 48(a) of the Investment Company Act.2 The court also dismissed Counts One, Two, Four, and Seven through Ten because the claims should have been brought as derivative actions. The court explained that, under Massachusetts' law,3 to determine whether a claim should be brought through a derivative suit, a court must determine whether the plaintiff has alleged an injury or contractual wrong distinct from that suffered by other shareholders. Here, the court noted that the injury asserted – the misuse of the Funds' assets to provide excessive compensation to brokers, improper 12b-1 plans, and soft dollar compensation to brokers – is an injury to the Funds that adversely affects the plaintiffs only indirectly through their status as investors in the Funds. As such, any claim resulting from these alleged actions belongs to the Funds and must be brought through a derivative action. The court dismissed Count Three because the plaintiff failed to allege that the defendants charged excessive fees. The court explained that in order to state a claim under Section 36(b), the plaintiffs must allege that the defendants violated their fiduciary duty under Section 36(b) by receiving fees that were so disproportionately large that they bore no reasonable relationship to the services rendered. In this case, the plaintiffs do not allege any facts that would demonstrate that the compensation paid to the defendants was disproportionate to the services rendered. The court also found that, as to the investment advisers and the Funds' officers, directors, and trustees, Count Three failed under Section 36(b)(3) because that provision expressly precludes an action under Section 36(b) against any person other than the recipient of compensation or payments. The court noted that the plaintiffs did not allege that these defendants had received the disputed payments. The court dismissed Count Five because the plaintiffs failed to make pre-suit demands on the Funds' trustees. The court rejected the plaintiffs' arguments that demand would have been futile because the trustees were 'beholden' to the investment advisers for their position and compensation as trustees. Finally, Count Six was dismissed on the grounds that New York General Business Law does not apply to securities transactions. The court also noted that federal law preempted 2 The District Court considered four factors in determining whether a private right of action exists under Sections 34(b), 36(a), or 48(a). These four factors were based in particular on the holdings in Alexander v. Sandoval, 532 U.S. 275 (2001) and Olmstead v. Pruco Life Ins. Co. of New Jersey, 283 F.3d 429 (2d Cir. 2002). For a discussion of these factors, see Investment Company Institute Memorandum to Board of Governors No. 8-05, Chief Compliance Officer Committee No. 14-05, Compliance Advisory Committee No. 13-05, SEC Rules Members No. 28-05, and Small Funds Members No. 15-05, dated February 16, 2005 [18549]. 3 In determining whether claims are properly brought as derivative or direct, the court looks to the law of the state in which the investment company is incorporated. In this case, the Funds are organized under Massachusetts' law. 3 Counts Seven through Ten. The court concluded by dismissing the plaintiffs' complaint in its entirety and rejecting the plaintiffs' request to amend their complaint. Jane G. Heinrichs Assistant Counsel