

MEMO# 20100

June 9, 2006

California Court Holds Federal Law Preempts State Action Alleging Fraud Based on Revenue Sharing Arrangements

©2006 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. [20100] June 9, 2006 TO: COMPLIANCE MEMBERS No. 28-06 SEC RULES MEMBERS No. 50-06 SMALL FUNDS MEMBERS No. 42-06 BROKER/DEALER ADVISORY COMMITTEE No. 20-06 BROKER/DEALER ASSOCIATE MEMBERS No. 2-06 RE: CALIFORNIA COURT HOLDS FEDERAL LAW PREEMPTS STATE ACTION ALLEGING FRAUD BASED ON REVENUE SHARING ARRANGEMENTS In December 2004, the California Attorney General filed a civil action against a broker-dealer alleging two counts of fraud for failing to disclose to its customers information about the broker-dealer's revenue sharing (shelf-space) arrangements with mutual funds on the broker-dealer's "Preferred Funds" list.¹ The broker-dealer sought to have the action dismissed arguing that the provisions of the National Securities Markets Improvement Act of 1996 (NSMIA) preempts states from regulating disclosure regarding mutual fund revenue sharing arrangements, either in prospectuses or at the point of sale. In support of its view, the broker-dealer cited a November 2005 decision by the Los Angeles Superior Court that dismissed a similar revenue sharing action by the Attorney General. In that case, the court held that the Attorney General's action was preempted by provisions in NSMIA that vested the federal government with exclusive authority to regulate national offerings of securities.² In May 2006, the Superior Court of California for the County of Sacramento ruled against the Attorney General stating: The Court is of the view that NSMIA prohibits states such as California from enforcing state laws that directly or indirectly prohibits, limits, or imposes conditions (sic) on 1 The People of the State of California v. Edward D. Jones & Co., L.P., No. 04AS05097 (Cal. Super. Ct. Dec. 20, 2004). 2 See Institute Memorandum to Broker/Dealer Advisory Committee No. 35-05, Broker/Dealer Associate Members No. 13-05, SEC Rules Members No. 125-05, and Small Funds Members no. 98-05 [No. 19461], dated Dec. 7, 2005 summarizing the ruling of the Los Angeles Superior Court in 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). This case is currently on appeal. 2 any security offering, including mutual funds. 15 U.S. Code 77(r). The Court is of the view that the Attorney General's action here seeks to impose the State of California's view of what a prospective (sic) should say on mutual funds that have a 'shelf agreement' with broker-dealer. The assertion of California's authority in this manner conflicts with the

federal regulation of information provided in mutual fund prospectuses and hence is pre-empted by such. This is clearly an area that requires nationwide uniformity and consistency and not be subject to the differing rules of 50 states. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith v. Dabit* (2006) __ U.S. __, 2006 U.S. Lexis 2497, decided March 31, 2006.³ The court added that it was not restricting the enforcement by the Attorney General of California's antifraud laws, though such laws may only be enforced in areas not subject to federal preemption. The Attorney General has not yet decided whether to appeal the court's decision. 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 20100, or call the ICI Library at (202) 326-8304 and request the attachment for memo 20100. ³ See Court's Ruling on Matter Taken Under Submission on 5/23/2006, *The People of the State of California v. Edward D. Jones & Co., L.P.*, No. 04AS05097 (Cal. Super. Ct. May 25, 2006), which is attached. In the *Merrill Lynch* case cited, the Supreme Court held that the Securities Litigation Uniform Standards Act, which preempts state class actions alleging fraud, extends to "holders" of securities. (The Court's holding was consistent with the views expressed in an amicus brief the Institute filed in the case.) According to the Supreme Court, "The magnitude of the federal interest in protect the integrity and efficient operation of the market for nationally traded securities cannot be overstated." See Institute Memorandum to SEC Rules Members No. 32-06 and Small Funds Members No. 25-06 [No. 19884], dated March 24, 2006 for a summary of the Supreme Court's holding.

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