DechertOnPoint

January 2006 / Special Alert

A legal update from Dechert's Financial Services and Securities Litigation and Financial Services Groups

State Court Upholds Preemptive Reach of NSMIA in Rejecting Action by California Attorney General

In March 2005, Capital Research and Management Company ("CRMC") and American Funds Distributors, Inc. ("AFD") sued California Attorney General Bill Lockyer ("Lockyer") in Los Angeles Superior Court over Lockyer's investigation regarding CRMC/AFD prospectus disclosure of compensation agreements (so-called "shelf-space agreements") between CRMC, AFD, and unaffiliated broker-dealers which sell shares of the American Funds (the "Funds").[1]

CRMC and AFD are, respectively, the investment adviser and principal underwriter of the Funds. CRMC and AFD requested a judgment declaring Lockyer's investigation preempted by federal law. The following day, in a separate action, Lockyer sued CRMC and AFD in the same court, alleging that the Funds' prospectuses did not adequately disclose the compensation agreements with broker-dealers in violation of the California Corporations Code.[2] In April, the two suits were consolidated.

In briefing, as well as in oral arguments on November 15, 2005, CRMC and AFD contended that Lockyer's suit was preempted by the National Securities Markets Improvements Act of 1996 ("NSMIA"),[3] arguing that regulation of prospectus disclosures is, by virtue of NSMIA, the sole province of the Securities and Exchange Commission ("SEC"). The court agreed with CRMC and AFD, holding that Lockyer's claims stood "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress under NSMIA."[4]

Lockyer's Complaint

"Shelf-space agreement" typically refers to an agreement between a mutual fund distributor and a broker-dealer to exchange dollars and/or directed brokerage in return for preferred or exclusive access to the broker-dealer's sales force and heightened visibility within a broker-dealer's distribution or sales system.[5]

Lockyer took issue with the shelf-space agreements that CRMC and AFD had entered into with unaffiliated broker-dealers because those agreements apparently involved the use of "brokerage commissions, a fund asset belonging to the shareholders" to obtain preferential sales treatment by outside broker-dealers.[6] The result, according to Lockyer, was "a potential conflict of interest with respect to which funds to recommend to meet the customer's personal investment needs."[7]

Lockyer's core complaint was that the funds' disclosure documents—prospectuses and statements of additional information ("SAIs")—omitted several material facts that made statements about other compensation to

1 *Capital Research and Management Co. and American Funds Distributors, Inc. v. Lockyer*, LASC Case No. BC330770 (filed Mar. 24, 2005).

2 *People of the State of California v. American Funds Distributors, Inc. and Capital Research Management Co.*, LASC Case No. BC330774 (filed Mar. 25, 2005).

3 Pub. L. No. 104-290, 110 Stat. 3416.

4 *Capital Research and Mgmt. Co. v. Lockyer*, LASC Case No. BC330770 at 20 (Nov. 22, 2005) (consolidated with *California v. American Funds Distributors, Inc.*, LASC Case No. BC330774).

5 *Id.* at 8-9.

6 *Id.* (citing Lockyer Complaint ¶19).

7 *Id.* (citing Lockyer Complaint ¶19).

dealers and execution of portfolio transactions misleading;[8] that is, the prospectuses and SAIs did not, according to Lockyer, adequately disclose the shelf-space agreements. This omission, he argued, violated the California Corporations Code.

Lockyer sought, among other things, a preliminary and permanent injunction enjoining CRMC and AFD from violating the California Corporations Code, civil penalties (fines), disgorgement of profits, and restitution to the purchasers of the Funds' shares with interest.[9] The court, however, observed that practically speaking, Lockyer was requesting a court order directing that CRMC and AFD cease using the prospectuses and SAIs in their present form and/or that they change the disclosures contained in those documents to eliminate the alleged "omissions."[10]

The Court's Analysis

Among the different ways in which state law may be preempted by federal law, courts have "found preemption where it is impossible for a private party to comply with both state and federal requirements, or where state law 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"[11] Thus, the court determined that, broadly speaking, the question before it was whether Lockyer's complaint stood as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress in enacting NSMIA.[12]

NSMIA provides in relevant part:

> Except as otherwise provided in this section, no law, rule, regulation or order, or other administrative action of any State or any political subdivision thereof –
>
> (1) requiring, or with respect to, registration or qualification of securities, or registration of qualification of securities transactions, shall directly or indirectly apply to [covered securities[13] or securities that will be covered securities];
>
> (2) shall directly or indirectly prohibit, limit or impose any conditions upon the use of –
>
> (A) with respect to a covered security ... , any offering document that is prepared by or on behalf of the issuer; or
>
> (B) any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof that is required to be and is filed with the Commission or any national securities organization registered under section 780-3 of this title, ...; or
>
> (3) shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer, upon the offer or sale of any security described in paragraph (1).[14]

To determine Congress's objectives in enacting NSMIA, the court turned to legislative history. In explaining Congress's purpose in passing NSMIA, the Joint Explanatory Statement of the Committee of Conference stated that:

> [NSMIA] does not preserve the authority of state securities regulators to regulate the securities regulation and offering process through commenting on and/or imposing requirements on the contents of prospectuses or other offering documents whether prior to their use in a state or after such use.[15]

While Congress intended to "preserve the ability of the States to investigate and bring enforcement actions under the laws of their own State with respect to fraud and

---

8 *Id.* (citing Lockyer Complaint ¶34).

9 *Id.* at 10 (citing Lockyer Complaint, Prayer for Relief at 16:3-13).

10 *Id.*

11 *Id.* at 14 (citing *Dowhal v. Smithkline Beecham Consumer Healthcare*, 32 Cal. 4th 910, 923-924 (2004) (citations omitted)).

12 *Id.*

13 NSMIA provides that "covered securities" include, *inter alia*, securities listed on the New York Stock Exchange, the American Stock Exchange, the National Market System of the Nasdaq Stock Market, or on a national securities exchange that has listing standards that the SEC determines by rule are substantially similar to the listing standards of the three aforementioned exchanges; also included within the definition of "covered securities" are securities issued by an investment company that is registered (or that has filed a registration statement) under the Investment Company Act of 1940. 15 U.S.C. § 77r(b) (2005).

14 15 U.S.C. § 77r(a) (2005).

15 *Lockyer,* LASC Case No. BC330770 at 14-15 (quoting H.R. Conf. Rep. 104-864, 104th Cong., 2nd Sess. 1996 at *40).

deceit," the House Commerce Committee noted that it nonetheless intended that NSMIA would:

> [P]reclude State regulators from, among other things, citing a State law against fraud or deceit ... as its justification for prohibiting the circulation of a prospectus or other offering document ... that does not include ... a disclosure that the State believes is necessary or that includes information that a State regulator criticizes based on the ... content thereof.[16]

The legislative history also makes clear that, "The [House Commerce] Committee intend[ed] to eliminate States' authority to require or otherwise impose conditions on the disclosure of any information for covered securities."[17]

As suggested above, however, Congress also built into NSMIA a "savings clause," reserving to the states the authority "to investigate and bring enforcement actions under the laws of their own State with respect to fraud and deceit (including broker-dealer sales practices) in connection with any securities or securities transactions."[18] The House Commerce Committee explained that this "savings clause" was intended to capture circumstances where, for instance, a prospectus contained fraudulent financial data.[19] Predictably, Lockyer argued that his complaint fell squarely within the NSMIA "savings clause."

Given the fairly explicit preemptive language in the legislative history, together with the "savings clause," the court identified as the issue to be determined:

> [W]hether the allegations in [Lockyer's] complaint would operate either: (1) in the nature of a prohibition on the circulation of an offering document that does not include a disclosure that the State believes is necessary; or (2) in the nature of a prohibition on prospectuses containing "fraudulent financial data" and/or a prohibition on common law or deceit.[20]

In the case of the former, NSMIA would preempt Lockyer's suit; in the case of the latter, the suit would fall within NSMIA's "savings clause."

The court concluded that the omissions about which Lockyer complained were not in the nature of "fraudulent financial data," nor were they otherwise indicative of common law fraud or deceit by a broker or dealer.[21] Instead, the complaint pursued statutory claims under the California Corporations Code[22] and, according to the court, sought exclusively to enforce a prohibition on the circulation of an offering document that did not contain a disclosure that the state believed was necessary.[23] This, the court held, constituted a state-mandated disclosure which, pursuant to Congress's stated purposes and objectives, was "directly barred by NSMIA."[24] In rejecting Lockyer's lawsuit, the court expounded:

> 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 . . . .

16 *Id.* at 15 (quoting H.R. Rep. 104-622, 104th Cong., 2nd Sess. 1996 at *34).

17 *Id.*

18 *Id.* at 15 (quoting H.R. Rep. 104-622, 104th Cong., 2nd Sess. 1996 at *34).

19 *Id.*

20 *Id.* at 15-16.

21 *Id.* at 16.

22 The court noted a number of differences between the alleged statutory violations and common law fraud actions. Among those differences cited are that the penalties available under the Corporate Securities Law include civil remedies, criminal sanctions, and administrative enforcement actions. Furthermore, such penalties are cumulative, so that a single violation may result in a variety of enforcement actions, and any civil remedies are *in addition* to whatever other remedies or causes of action may be available under the common law. *Id.* at 16, n. 10.

Also, the elements that need to be proven in a statutory Corporate Securities Law claim differ from those that must be proven in an action predicated on common law fraud and deceit, *e.g.*, in the former, reliance on the deception need not be shown. *Id.*

23 *Id.* at 16.

24 *Id.*

> The Attorney General's action stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress under NSMIA.[25]

Prospective Impact

This case is a victory for an industry that has of late been subjected to ever-increasing scrutiny from regulators at all levels of government, often leading to a confusing and contradictory set of mandates. The business section of the Los Angeles County Superior Court enjoys a reputation for sophistication and a keen business acumen. This does not render its opinions binding on the courts of other jurisdictions, but assuming the decision is affirmed on appeal, it may in fact carry a good deal of weight in those courts' consideration of similar issues.

■ ■ ■

This update was authored by Catherine Botticelli (+1 202 261 3368; catherine.botticelli@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), and Adam Schoeberlein (+1 202 261 3337; adam.schoeberlein@dechert.com).

[25] *Id.* at 17, 20 (emphasis in original). A final order has not been issued in the case, though it is reasonable to assume that when issued, the order will dismiss Lockyer's suit with prejudice.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financialserviceslit or www.dechert.com/financialservices.

Vincent J. Badolato
Washington
+1 202 261 3389
vincent.badolato@dechert.com

Sander M. Bieber
Washington
+1 202 261 3308
sander.bieber@dechert.com

Catherine Botticelli
Washington
+1 202 261 3368
catherine.botticelli@dechert.com

Timothy M. Clark
New York
+1 212 698 3652
timothy.clark@dechert.com

Douglas P. Dick
Newport Beach
+1 949 442 6060
douglas.dick@dechert.com

William K. Dodds
New York
+1 212 698 3557
william.dodds@dechert.com

Ruth S. Epstein
Washington
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington
+1 202 261 3381
brendan.fox@dechert.com

David J. Harris
Washington
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm
Washington
+1 202 261 3356
robert.helm@dechert.com

David M. Howard
Philadelphia
+1 215 994 2218
david.howard@dechert.com

Paul Huey-Burns
Washington
+1 202 261 3433
paul.huey-burns@dechert.com

Jane A. Kanter
Washington
+1 202 261 3302
jane.kanter@dechert.com

Stuart Kaswell
Washington
+1 202 261 3314
stuart.kaswell@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Jeffrey S. Puretz
Washington
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Keith T. Robinson
Washington
+1 202 261 3386
keith.robinson@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington
+1 202 261 3355
david.vaughan@dechert.com

Dechert LLP

www.dechert.com

U.S.

Boston
Charlotte
Harrisburg
Hartford
New York
Newport Beach
Palo Alto
Philadelphia
Princeton
San Francisco
Washington, D.C.

U.K./Europe

Brussels
Frankfurt
London
Luxembourg
Munich
Paris