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April 2011 / Special Alert

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

Another Section 47(b) Claim Dismissed Against a Mutual Fund's Distributor and Trustees for the Alleged Failure of Broker-Dealers that Receive Rule 12b-1 Fees to Register as Investment Advisers

Following a series of much-publicized demand letters served upon the trustees of three mutual fund complexes (Franklin Templeton, Eaton Vance and OppenheimerFunds), derivative lawsuits were filed last year by the Milberg firm against the funds' trustees and distributors. Each complaint alleges nearly identical facts and asserts the same causes of action under the Investment Company Act of 1940 ("1940 Act") and purported underlying violations of the Investment Advisers Act of 1940 ("Advisers Act"). In June of last year, the court presiding over the *Franklin/Templeton* action granted the defendants' motion to dismiss on the ground that plaintiff had not stated a viable claim for "contract voiding" under Section 47(b) of the 1940 Act.[1]

A second court granted a motion to dismiss the same claim on March 30, 2011. In *Weiner v. Eaton Vance Distributors, Inc.*, Judge Woodlock of the District of Massachusetts issued an opinion in which he (1) rejected the plaintiff's Section 47(b) claim, and (2) rejected the plaintiff's underlying premise that the alleged failure of a broker-dealer that has received Rule 12b-1 Fees to register under the Advisers Act gives rise to a Section 47(b) claim against a fund's distributor and trustees.[2]

This update provides the background of these lawsuits and analyzes the *Eaton Vance* court's decision in dismissing that complaint.

Background of the Lawsuits

Rule 12b-1 under the 1940 Act permits a fund to use its assets to support fund distribution provided that such payments are made in accordance with a written plan (a "Rule 12b-1 Plan"). Pursuant to a fund's Rule 12b-1 Plan, a fund generally makes these payments in support of distribution and certain specified shareholder services, known as Rule 12-1 Fees, to its distributor, and the distributor pays these Rule 12b-1 Fees to broker-dealers that sell fund shares. NASD Rule 2830(d)[3] limits the amount of Rule 12b-1 Fees that may be paid to broker-dealers to a certain percentage of the annual

1 *Smith v. Franklin/Templeton Distributors, Inc.*, 2010 WL 2348644 (N.D. Cal. June 8, 2010). The court subsequently dismissed plaintiff's amended complaint on the same basis. *Smith v. Franklin/Templeton Distributors, Inc.*, 2010 WL 4286326 (N.D. Cal. Oct. 22, 2010). The dismissal of the lawsuit is currently on appeal to the Ninth Circuit Court of Appeals.

2 2011 WL 1233131 (D. Mass. March 30, 2011).

3 The Financial Industry Regulatory Authority ("FINRA") is in the process of consolidating the rules of its predecessor organizations, NASD, Inc. and NYSE Regulation, Inc. NASD Rule 2830 has not yet been formally incorporated into the rules of FINRA and is referred to as an NASD Rule by the convention established by FINRA. *See* December 8, 2008 FINRA Information Notice at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117506.pdf.

net assets of the fund. Thus, Rule 12b-1, in conjunction with NASD Rule 2830, contemplates Rule 12b-1 Fees as being "asset-based," i.e., based on a percentage of assets.

However, according to plaintiffs in these derivative actions, because Rule 12b-1 Fees are asset-based compensation paid to broker-dealers, the broker-dealers that receive them must register as investment advisers under the Advisers Act. While the Advisers Act regulates persons that give investment advice, a broker-dealer is exempt from Advisers Act registration if the investment advice it provides "is solely incidental to the conduct of his business as a broker or dealer and receives no special compensation therefor . . . "[4] Through their lawsuits, plaintiffs allege that Rule 12b-1 Fees are *de facto* "special compensation" because they are "asset-based" rather than transactional commissions, meaning that the broker-dealers that received them could not qualify for the Advisers Act broker-dealer exemption. Thus, according to plaintiffs, any broker-dealer not registered as an investment adviser under the Advisers Act that received Rule 12b-1 Fees was (and still is) in violation of the Advisers Act.

Plaintiffs further claim that by paying Rule 12b-1 Fees to broker-dealers that are not registered under the Advisers Act, the funds and their distributors were in violation of the 1940 Act. In particular, plaintiffs allege that the payment of Rule 12b-1 Fees to these broker-dealers violates Section 36(a) of the 1940 Act and Rule 38a-1 thereunder. Plaintiffs—acting derivatively on behalf of the funds—contend that, because of the alleged violation of Section 36(a) and Rule 38a-1, they can obtain contract rescission under Section 47(b) of the 1940 Act, which permits either party to seek rescission of a contract "that is made, or whose performance involves, a violation of [the 1940 Act], or of any rule, regulation, or order thereunder . . . "

The *Eaton Vance* Decision

The recent *Eaton Vance* decision refuted the premise that plaintiffs in each of the derivative actions allege as a basis to hold the funds' trustees and distributors responsible under the 1940 Act for a purported violation of the Advisers Act by broker-dealers. Specifically, the *Eaton Vance* court reached the following important conclusions:

- First, Rule 12b-1 Fees, although asset-based rather than transactional commissions, were found not to constitute "special compensation."[5] As such, the broker-dealers in receipt of Rule 12b-1 Fees were not disqualified from the broker-dealer exemption from the Advisers Act registration requirement merely by their receipt of that compensation.[6] In reaching this conclusion, the *Eaton Vance* court reviewed the Advisers Act legislative history, judicial interpretation of the "special compensation" provision of the broker-dealer exemption, and the SEC's rulemaking. The court found that determining whether compensation paid to broker-dealers constitutes "special compensation" requires an inquiry into whether the compensation was paid *for investment advice*, and does not turn on the form in which the compensation was paid, i.e., transactional commissions or asset-based.[7] Indeed, as the court reasoned, Rule 12-1 Fees "are, by definition, paid by investment companies to effect the distribution of their shares," and not explicitly payments for investment advice.[8]

- Second, the *Eaton Vance* court concluded that *even if* the plaintiff's Advisers Act arguments were correct, the plaintiff still had not stated a claim under Section 47(b) of the 1940 Act.[9] As the court recognized, to state a Section 47(b) claim, a plaintiff must allege that the contract at issue violates the 1940 Act or a rule issued under the 1940 Act that itself provides for a private right of action.[10] The statue and rule on which the plaintiff relied—Section 36(a) of the 1940 Act and Rule 38a-1 thereunder—cannot supply the required predicate because neither permits private actors to pursue a cause of action for their breach; only the SEC may seek to enforce Section 36(a) and Rule 38a-1. In reaching its conclusion, the

4 15 U.S.C. § 80b-2(a)(11)(c).

5 *Eaton Vance Distributors, Inc.*, 2011 WL 1233131, at *10-11.

6 *Id.*

7 *Id.* at *7-10.

8 *Id.* at *10 (citing Rule 12b-1 and *Franklin/Templeton Distributors, Inc.*, 2010 WL 2348644, at *8).

9 *Id.* at *11.

10 *See id.* at *12. *Accord Franklin/Templeton Distributors, Inc.*, 2010 WL 2348644, at *7; *Franklin/Templeton Distributors, Inc.*, 2010 WL 4286326, at *2-3.

Eaton Vance court followed the line of precedent since the U.S. Supreme Court's 2001 decision in *Alexander v. Sandoval* rejecting attempts by plaintiffs to imply private rights of action under the 1940 Act.[11]

- Third, the *Eaton Vance* court concluded that neither Section 36(a) nor Rule 38a-1 encompasses the wrongdoing that the plaintiff alleged.[12] Indeed, the court concluded that, even if it were to accept the plaintiff's allegations as true, the agreement between the fund and its distributor, which included the provision regarding the payment of Rule 12b-1 Fees, could be performed without violating the Advisers Act because nothing in the contract prohibited broker-dealers from registering. Accordingly, the contract on its face did not violate the Advisers Act—meaning that Section 47(b) relief would not be available.[13]

[11] *Eaton Vance Distributors, Inc.*, 2011 WL 1233131, at *12.

[12] *Id.* at *12-13.

[13] *Id.* at *13.

Conclusion

The *Eaton Vance* decision, like the *Franklin/Templeton* decisions of last year, is another rejection of the transparent attempt by the plaintiffs' bar to upset the settled practice of payment of Rule 12b-1 Fees for distribution-related activities. We will continue to report on developments in this important series of cases.

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