THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 39 No. 20 November 15, 2006

STATE REGULATORS AND THE MUTUAL FUND INDUSTRY

Recent Assertions of Authority by New York and California Regulators in Parallel Cases of Misconduct by Mutual Funds Have Conflicted with the Federal Claim to Preemptive Power Over the Subject. The Resolution of Several Pending Cases in the Two States May Moderate the Conflict.

By Lori A. Martin and Cristina Alger *

Although state and federal regulators share concurrent jurisdiction to investigate and prosecute securities fraud, state regulators only recently began to exercise their authority with respect to the mutual fund industry. In September 2003, when New York Attorney General Eliot Spitzer sued a hedge fund that allegedly engaged in market timing and late trading of leading mutual fund families, state regulators became much more prominent in the investigation and prosecution of fraud involving investment advisers and mutual fund distributors.[1]

Shortly thereafter, many state-initiated investigations of the mutual fund industry followed. Spitzer, for example, launched investigations of investment advisers who allegedly permitted preferred investors to engage in short-term trading in their mutual funds. William Galvin, Secretary of the Commonwealth of Massachusetts, and Bill Lockyer, the California Attorney General, similarly pursued regulatory actions against fund advisers, alleging that their distribution practices, or their selective enforcement of mutual fund market-timing policies, constituted a deceit on investors.

The recent increase in the number of state regulatory proceedings against the mutual fund industry has presented some new enforcement challenges, particularly with respect to the scope of relief that state regulators have demanded from investment advisers. In the past year, for example, an investment adviser and a broker-dealer successfully and separately challenged the California Attorney General's authority to impose relief relating to mutual fund prospectus disclosures. In addition, another investment adviser is litigating with the New York Attorney General over the state's authority to mandate lower advisory fees in connection with a market- timing settlement.

[1] *See State of New York v. Canary Capital Partners, LLC*, Index No. 402830/2003 (Supreme Court New York County, Sept. 3, 2003).

* *LORI A. MARTIN is a partner in the Securities and Litigation Departments at Wilmer Cutler Pickering Hale and Dorr LLP, resident in the firm's New York Office. Prior to joining the firm, she was First Vice President and Assistant General Counsel at Merrill Lynch Investment Managers, L.P. and was responsible for litigation and regulatory proceedings at the company. Her e-mail address is Lori.Martin@wilmerhale.com. CRISTINA ALGER was a member of the firm's 2006 Summer Associate Program.*

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RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 299 Park Avenue, 16th floor, New York, NY 10171-3898. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1711 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-319-6706; e-mail mofinkelstein@hotmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

This article reviews challenges to state regulatory authority and examines whether federal law preempts state regulators from imposing certain settlement terms on mutual fund distributors and investment advisers. We consider, in turn, the history of concurrent jurisdiction of federal and state regulation of the securities industry, legislative restrictions on state regulatory authority, particularly with respect to mutual fund disclosure requirements, state enforcement actions against mutual fund advisers and distributors, and challenges by mutual fund advisers and broker-dealers to particular remedial measures sought by state regulators.

DUAL REGULATION OF THE SECURITIES INDUSTRY: BLUE SKY LAWS

Although the Securities and Exchange Commission (SEC) is the dominant regulator of the mutual fund industry, the states historically have had an important role in prosecuting securities fraud within their jurisdictions. Indeed, states enacted investor protection statutes long before the federal government passed any securities legislation. When the federal government turned to the subject, Congress sought to retain a system of dual securities regulation, with federal legislation supplementing state efforts, without replacing state authority. The savings clauses in both the Securities Act of 1933 and the Securities Exchange Act of 1934 preserved the power of state regulators to regulate the securities industry for local conduct. Section 18 of the Securities Act provides that "nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person." The congressional report accompanying the Act further explained that the bill "carefully preserves the jurisdiction of state security commissions to regulate transactions within their borders."[2] Section 28(e) of the Securities Exchange Act of 1934 also contains a savings clause: it states that "nothing in this title shall affect the securities commission (or any agency or officer performing like functions) of any State over any security or person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder." The Senate Report accompanying the Act confirmed "that rights and remedies under the act shall be in addition to those already existing" and that the "jurisdiction of State securities commissions remains unaffected insofar as it does not conflict" with federal law.[3] The Investment Company Act of 1940, by contrast, does not have an express savings clause, and one adviser is currently litigating whether the 1940 Act preserves any state authority to regulate, for example, mutual fund advisory fees.[4]

MODERN RESTRICTIONS ON STATE REGULATORY POWER

In more recent years, Congress has reexamined the jurisdiction of state securities regulators and further strengthened the dominance of the SEC as the principal regulator of the nation's securities markets. The first of these measures occurred in 1996, following the election of Republican majorities in the House and the Senate, and resulted in the enactment of the National Securities Markets Improvements Act of 1996 ("NSMIA").[5] The second was a bill, originally proposed in 2003, whose purpose was to augment the powers of the SEC and to preempt expressly state remedial measures that were different from, or in addition to, the requirements promulgated by the SEC. The bill, known as the Securities Fraud Deterrence and Investor Restitution Act of 2003 (sometimes called "H.R. 2179"), was a reaction to Spitzer's settlement of a research conflicts-of-interest action against a prominent investment bank in which he unabashedly sought to change business practices in the broker-dealer industry. Both statutory measures are discussed below, and provide a framework for the mutual fund actions that followed.

[2] H.R. Rep. No. 73-85, at 10 (1933).

[3] S. Rep. No. 73-792, at 23 (1934).

[4] *J.&W. Seligman & Co., Inc. v. Spitzer*, United States District Court for the Southern District of New York, No. 05 Civ. 7781 (Complaint, dated Sept. 6, 2005).

[5] 15 U.S.C. § 78a.

National Securities Markets Improvements Act of 1996

In 1996, Congress enacted NSMIA to "further advance the development of national securities markets and eliminate the costs and burdens of duplicative and unnecessary regulation by, as a general rule, designating the Federal government as the *exclusive* regulator of national offerings of securities."[6] The House Commerce Committee's Report on NSMIA criticized the "substantial degree of duplication between Federal and State securities regulation," and criticized regulatory duplication for "the cost of capital to American issuers of securities without providing commensurate protection to investors or our markets."[7] The Conference Committee Report for the Act described duplicative securities regulation as "redundant, costly, and ineffective"[8] and expressed the need to "reallocat[e] responsibility over the regulation of the nation's securities markets in a more logical fashion between the Federal government and the states."[9]

To accomplish this goal, NSMIA expressly exempted from state regulation categories of "covered securities" (or securities that will become "covered securities" upon completion of a transaction). Covered securities include: (1) nationally traded securities,[10] (2) securities sold to qualified purchasers,[11] (3) securities issued in certain exempt offerings,[12] and (4) federally registered investment companies (or mutual funds).[13] As with the original federal securities laws, Congress included savings clauses with respect to state authority to prosecute securities fraud by investment advisers and broker-dealers. The clause regarding investment advisers appears in the Investment Advisers Supervision Coordination Act and states: "Nothing in this subsection shall prohibit the securities commission (or any agency or office performing like functions) of any State from investigating and bringing enforcement actions with respect to fraud or deceit against an *investment adviser* or person associated with an investment adviser."[14] NSMIA also includes a savings clause for regulatory action involving broker-dealers.[15] Thus, while the Conference Committee expressed continued congressional support for the state prosecution of securities fraud, the report stated that NSMIA "does not preserve the authority of state securities regulators to regulate the securities registration and offering process through commenting on and/or imposing requirements on contents of the prospectuses or other offering documents, whether prior to their use in a state or after such use."[16]

The restriction extended to indirect as well as direct conditions of disclosure for covered securities. In this regard, the House Committee observed:

> Section 18 precludes State regulators from, among other things, citing a State law against fraud or deceit or regarding broker-dealer sales practices as its justification for prohibiting the circulation of a prospectus or other offering document or advertisement for a covered security that does not include a legend or disclosure that the State believes is necessary or that includes information that a State regulator criticizes based on the format or content thereof. The Committee intends to eliminate States' authority to require or otherwise impose conditions on the disclosure of any information for covered securities.[17]

SEC Staff members have looked to this, and similar language in the legislative history of the federal securities laws, as support for the conclusion that Congress intended that "those areas of regulation reserved to the federal system should be immune not just

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[6] H.R. Rep. No. 104-622, 104th Cong., 2nd Sess. 1996 at 16 (emphasis supplied).

[7] *Id.*

[8] Joint Explanatory Statement of the Committee of Conference, Conference Report, National Securities Markets Improvement Act of 1996, H.R. 3005, H.R. Conf. Rep. No. 104-864 (1996) at 39, *reprinted in* 1996 U.S.C.C.A.N. 3920.

[9] *Id.*

[10] 15 U.S.C. § 77r(b)(1).

[11] 15 U.S.C. § 77r(b)(3).

[12] 15 U.S.C. § 77r(b)(4).

[13] 15 U.S.C. § 77r(b)(2).

[14] 15 U.S.C. § 80b-3a(b)(2) (emphasis supplied).

[15] 15 U.S.C. § 77r(c)(1) ("Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by *a broker or dealer*, in connection with securities or securities transactions") (emphasis supplied).

[16] H.R. Conf. Rep. 104-864, 104th Cong., 2nd Sess. 1996 at 40 (Joint Explanatory Statement of the Committee of Conference).

[17] H.R. Conf. Rep. 104-622, 104th Cong., 2nd Sess. 1996 at 34 (Report of the House Committee on Commerce).

from the direct exercise of state authority, but also from the indirect exercise of such authority."[18]

Securities Fraud Deterrence and Investor Restitution Act of 2003 (H.R. 2179)

More recently, claims that state regulators intended to restructure the manner in which securities firms conducted business have prompted Congress to consider further limits on the scope of state regulatory authority over the securities industry. The case that appears to be the impetus for renewed federal legislation was an action brought by New York Attorney General Spitzer against a prominent New York investment bank regarding its practices with respect to analyst research.[19] Spitzer asserted that the firm had violated New York's Martin Act by issuing stock ratings that allegedly "were biased and distorted in an attempt to secure and maintain lucrative contracts for investment banking services. As a result, the firm often disseminated misleading information that helped its corporate clients but harmed individual investors."[20]

When the investment bank agreed to settle the dispute, Spitzer announced an "*unprecedented agreement to reform investment practices*" at the investment bank.[21] In addition to a $100 million penalty, the settlement agreement included provisions governing the manner in which the investment bank paid for and provided analyst research, which Spitzer boasted "substantially outstrips any current requirements or mandated reforms."[22] Among other provisions, Spitzer demanded that the investment bank prohibit investment banking input into the content of opinions by research analysts and their compensation, create an investment review committee responsible for approving research recommendations independent of investment banking, and disclose in research reports whether the investment bank has received or was entitled to receive any compensation from a covered company over the past 12 months.[23]

Spitzer described the case as the harbinger of "reform throughout the entire industry."[24] Days after settling with the investment bank, Spitzer announced that he was expanding his investigation to review the research practices of every major Wall Street firm. The North American Securities Administrators Association ("NASAA"), an association of state securities regulators, formed a task force headed by representatives of New York, New Jersey, and California. The SEC, belatedly, launched its own investigation into research analyst conflicts of interest.

Notwithstanding the potential for competing investigations, federal and state regulators appeared to work cooperatively to obtain a global settlement of the action. On April 28, 2003, the SEC, NASD, NYSE, and state regulators, for example, settled enforcement actions against ten Wall Street firms in a "Global Analyst Research Settlement," which included the same structural provisions that had been included in Spitzer's first action.[25] The firms were required to pay $875 million in disgorgement and civil penalties, half of which went to the SEC and self-regulatory organizations, for distribution to investors by a Distribution Fund Administrator. The other half of the settlement funds was distributed to the states, with many states choosing to allocate the funds to their state treasuries.

Although the Global Analyst Research Settlement could be viewed as a model of state and federal cooperation, some members of Congress were critical that a New York regulator purported to regulate and reform the national securities markets. These concerns reflected the view that separate state enforcement actions could lead to the balkanization of the securities laws, which was all the more likely because a single state regulator did not necessarily have a national perspective

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[18] Stephen M. Cutler, Director, SEC Division of Enforcement, Remarks at the F. Hodge O'Neal Corporate and Securities Law Symposium, 81 Wash. U. L. Q. 545, 552 (Summer 2003).

[19] State News Enforcement: NASAA Chief to Fight Congressional Plan for Federal Preemption, 35 Sec. Reg. & L. Rep. (BNA) 1562 (September 22, 2003) (attributing federal preemption discussion to "states' enforcement success targeting the conflict of interest between brokerage's investment research departments and investment banking operations").

[20] Press Release of New York Attorney General, dated April 8, 2002, *available at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html.

[21] Press Released, dated May 21, 2002, *available at* http://www.oag.state/ny/us/press/2002/may/may21a_02.html (emphasis supplied).

[22] *Id.*

[23] Settlement Agreement between the Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith Incorporated, dated May 21, 2002, *available at* http://www.oag.state.ny.us/investors/merrill_agreement.pdf.

[24] *Id.*

[25] SEC Fact Sheet on Global Analyst Research Settlements, *available at* http://www.sec.gov/news/speech/factsheet.htm.

on the securities markets.[26] Representative Richard Baker, a proponent of a dominant, national regulator for the securities markets, expressed "grave concerns" about New York's "unprecedented efforts to propose and impose its own rules on the marketplace."[27] He further criticized the Global Analyst Research Settlement on the grounds that only "a very small portion of the Global Settlement . . . went to investor restitution."[28]

In June 2003, Representative Baker held hearings on H.R. 2179, a bill that would have bolstered SEC enforcement activities through enhanced fines and subpoena power, as well as recognition of a selective privilege waiver for materials provided to the SEC while, at the same time, restricting certain state enforcement powers.[29] The initial version of the bill included a provision that would have amended Section 308 of the Sarbanes-Oxley Act (in particular, the provision relating to distribution of funds from SEC enforcement actions to investors) to require states to turn over to the SEC the proceeds of any state settlement that included remedial provisions seeking to alter market structure.[30] Some members of the Committee, however, were concerned that Congress lacked constitutional authority to require states to turn over regulatory fines to the SEC.

On July 10, 2003, the Subcommittee chaired by Representative Baker passed a revised version of H.R. 2179 that dropped the requirement that states remit settlement funds to the SEC, but included instead an amendment barring states from imposing standards against financial services companies regarding disclosure or conflicts of interest "that differ from or are in addition to the requirements in those areas established . . . by the Commission or by any national securities exchanges or self-regulatory organization."[31] State regulators complained that the bill would impair their efforts to combat fraud. Spitzer "called the change an 'outrageous' proposal that [would] benefit only investment banks."[32] NASAA opposed the bill, claiming that "commonly used and effective remedies at the state level such as requiring wrongdoers to submit to special supervision, re-education, monitoring, special audits, and increased disclosures to investors would be disallowed under the bill."[33]

Against the backdrop of a congressional battle over the role of the state regulators in policing the securities industry, William Galvin, Secretary of Massachusetts, accompanied by Spitzer, announced that he was filing a civil administrative complaint against Morgan Stanley for its alleged failure to disclose special compensation to its brokers for selling proprietary mutual funds.[34] Spitzer used the occasion to criticize the preemption provision in H.R. 2179: "In dark of night, the securities industry is trying to take away crucial protection for investors . . . They're trying to remove the cop from the beat."[35] He then called upon William H. Donaldson, the newly confirmed Chairman of the SEC, to "stand up and loudly reject" the bill that would limit the role of state regulators. "If you do not do that I'll have to say you haven't learned the lessons of the last five years."[36]

Chairman Donaldson did not accede to pressure from the states, noting: "What's at issue is the remedy, and the remedy, I believe is the responsibility of the Securities and Exchange Commission . . . and I do not believe that we can have [fifty] state regulators coming up with remedies."[37] Spitzer took issue with Donaldson's apparent support of the bill, stating, "[t]he SEC, once again, unfortunately, is failing the investors. I see them kowtowing to Capitol Hill, instead of

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[26] *See, e.g.*, SEC Enforcement: Panel Postpones Action on Bill Panned By States for Stripping Power, 35 Sec. Reg. & L. Rep. (BNA) 1243 (July 28, 2003).

[27] Christopher R. Lane, Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators, 39 New Eng. L. Rev. 317, 319 (Winter 2005), quoting Dan Ackman, Everyone Wants a Shot at the Analysts (May 1, 2002) *available at* http://www.forbesimg.com/2002/05/01/0501analysts.html.

[28] The Securities Fraud Deterrence and Investor Restitution Act of 2003: Hearing on H.R. 2179 before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, 108th Cong. 18 (2003).

[29] The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179, 108th Cong. (2003).

[30] H.R. 2179, 108th Cong. §8(b) (2003).

[31] *Id.*

[32] Judith Burns, Deals & Deal Makers: States, Consumers Protest Measure to Bolster SEC, Wall St. J. C5 (July 11, 2003).

[33] SEC Enforcement: Panel Postpones Action on Bill Panned by States for Stripping Power, 35 Sec. Reg. & L. Rep. (BNA) 1243, 1244 (July 28, 2003).

[34] State News: Mass., N.Y. Regulators Announce Probe of Morgan Stanley Sales Practices, 35 Sec. Reg. & L. Rep. (BNA) 1215 (July 21, 2003).

[35] Jeffrey Krasner, State Files Morgan Stanley Complaint; Galvin Charges Company With Hiding Truth About Fund-Sale Fees For Brokers, The Boston Globe D1 (July 15, 2003).

[36] *Id.*

[37] Alan Murray, For the SEC Chief, Feud with Spitzer is No-Win Situation, Wall St. J. A4 (July 22, 2003).

standing up. They don't have the guts to be independent."[38]

In September 2003, after Spitzer announced the settlement of a fraud claim against Canary Capital Partners, a hedge fund that had engaged in problematic trading with a number of mutual funds (discussed below), Baker agreed to postpone consideration of the preemption measure while the Committee assessed alternative measures to support the SEC as the primary regulator of the national securities markets.[39]

On February 25, 2004, several months into the mutual fund scandal, the House Financial Services Committee deleted the preemption provision from H.R. 2179. NASAA applauded the action, stating, "The Committee has taken a significant step toward restoring investor confidence. State and federal regulators will continue to work together to investigate and prosecute unethical, inequitable, and illegal practices in the securities business."[40]

ACTIONS AGAINST INVESTMENT ADVISERS AND MUTUAL FUND DISTRIBUTORS

During the period when the House Financial Services Committee was proposing legislation to preempt state enforcement remedies, state regulatory investigations proceeded. On September 4, 2003, Spitzer announced the first of many enforcement actions involving the mutual fund industry. The allegations in the complaint were startling, partly because the mutual fund industry had been largely scandal free since the adoption of the Investment Company Act of 1940, and partly because the SEC was made to appear asleep at the switch with respect to the protection of mutual fund investors.[41]

Spitzer's announcement of a regulatory settlement with Canary Capital Partners prompted significant state regulatory activity against the mutual fund industry. In that case, Spitzer alleged that the hedge fund had engaged in market timing and late trading of leading mutual fund families. Even more disturbing was the Attorney General's allegation that many fund families had consented to the practice. Spitzer asserted that Canary Capital Partners had "obtained special trading opportunities with leading mutual fund families – including Bank of America's Nations Funds, Banc One, Janus, and Strong – pursuant to undisclosed agreements that involved substantial benefits for the fund management companies."[42] The Attorney General reported that his investigation was ongoing and he vowed to seek investor restitution and "appropriate reforms."[43] The ongoing investigations focused on, *inter alia*, Alliance, Invesco, Nations Funds, Massachusetts Financial Services Company, Banc One, Janus, and Strong.

Within months, Spitzer and the SEC jointly announced the first market-timing settlement with a fund company -- Alliance Capital Management. The terms of the two settlements, however, were not identical.[44] As with the research conflict-of-interest settlement, Spitzer claimed that the Alliance "settlement will fundamentally alter the way this company is run."[45] The agreement required Alliance to pay significant disgorgement and civil penalties; it also included other provisions affecting corporate governance and the adviser's future fee levels. In particular, the agreement required Alliance to cut fees by twenty percent over a period of five years, implement corporate governance reforms (including the installation of an independent chairman of the fund boards and reconstituting the fund boards so that 75% of the directors were independent), and also required Alliance not to seek indemnification pursuant to any insurance

[38] *Id.*

[39] SEC Enforcement: Controversial Preemption Provision Dropped from SEC Enforcement Bill, 36 Sec. Reg. & L. Rep. (BNA) 384 (March 1, 2004).

[40] *Id.*

[41] *See* Statement of John T. Freeman, Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors, Hearing Before the Subcomm. on Fin. Mgmt., the Budget and Int'l Sec. of the S. Govt'l Affairs Comm., 108th Cong. at 268 (Jan. 27, 2004) ("The SEC's Division of Investment Management ("DIM") presents a classic case of 'regulatory capture.' It is conflicted as well. Bluntly stated, over time, DIM has become far too deferential to the industry. The SEC's Division of Investment Management represents a Chihuahua watchdog, not the Doberman shareholders need").

[42] Press Release, dated September 4, 2003, *available at* http://oag.state.ny.us/press/2003/Sep/Sep03a_03.html.

[43] *Id.*

[44] *See, e.g., In the Matter of Alliance Capital Mgmt., L.P.*, Assurance of Discontinuance, dated September 1, 2004, *available at* http://www.oag.state.ny.us/investors/alliance_cap_mgmt_aod.pdf. *See also In the Matter of Alliance Capital Mgmt.*, SEC Release No. 26312 (Dec. 18, 2003).

[45] Press Release, dated December 18, 2003, *available at* http://www.oag.state.ny.us/press/2003/dec/dec18c_03.html.

policies that might apply to the action.[46] New York's agreement with Alliance Capital Management became the template for all future New York settlements with fund families.[47]

The SEC settlement with Alliance also provided for a significant $250 million penalty. By contrast with the New York settlement, however, the SEC settlement did not require that Alliance reduce its advisory fees. The SEC issued an unusual but compelling statement on the Commission's rationale for not requiring a fee reduction:

> We determined – unanimously - that such relief would not serve our law-enforcement objectives in this case. There were no allegations that Alliance Capital's mutual fund fees were illegally high. This is a case about illegal market timing, not fees. Therefore, we see no legitimate basis for the Commission to act as a 'rate-setter' and determine how much mutual fund customers should pay for the services they receive in the future from Alliance Capital. This decision is better left to informed consumers, independent and vigorous mutual fund boards, and the free market. Mandatory fee discounts would (i) require that customers do business with Alliance in order to receive the benefits of the discounts, and (ii) provide monetary relief to customers who were not harmed by the violations set forth in the order. That is why our efforts focused on providing full compensation to harmed investors and a significant upfront penalty.[48]

In conclusion, the Commission affirmed its historical preference for "rules uniformly applicable to the entire industry" over "a piecemeal approach that fragments the marketplace."[49] Spitzer publicly rebuked the SEC settlement, contending "the SEC settlement with Alliance sells investors short because it does not provide any compensation to investors for that harm. A $250 million settlement – which is all the SEC negotiated for – is simply inadequate to address all of the harms uncovered in our investigation."[50]

The philosophical differences between the state regulators and the SEC played out throughout 2004 and into 2005. Both the SEC and the states initiated concurrent investigations against a number of mutual fund families and broker-dealers. Massachusetts pursued enforcement actions against, among other firms, Putnam Investment Management and Franklin Advisers, Inc. California initiated actions against PA Distributors (formerly known as PIMCO Advisors Distributors), Franklin Templeton Funds Distributor, Edward D. Jones & Co., American Funds Distributors, Inc., and Capital Research and Management Company. Like Spitzer's settlement with Alliance, Massachusetts and California demanded "voluntary reforms" in addition to civil penalties.[51]

In some of these cases, and to the public, federal and state regulators appeared to work at cross-purposes. The federal and state investigations of Putnam Investment Management are illustrative. In October 2003, Secretary Galvin of Massachusetts filed an administrative complaint against Putnam, asserting that it had failed to enforce fund market-timing restrictions against an employee retirement plan. Press coverage reported that the SEC refused to investigate the charges after a whistleblower notified the agency of potential securities law violations.[52] A month after Galvin filed his

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[46] *See, e.g., In the Matter of Alliance Capital Mgmt., L.P.*, Assurance of Discontinuance, dated September 1, 2004, *available at* http://www.oag.state.ny.us/investors/alliance_cap_mgmt_aod.pdf.

[47] The fee reduction and other governance provisions included in the Alliance settlement were included in subsequent settlements between New York and investment advisers, including, *e.g., In the Matter of Banc of America Capital Management, LLC,* Assurance of Discontinuance, dated January 31, 2005, *available at* http://www.oag.state.ny.us/press/2005/fed/bac.pdf; *In the Matter of Columbia Management Advisors, Inc. and Columbia Funds Dist., Inc.*, Assurance of Discontinuance, dated February 9, 2005, *available at* http://www.oag.state.ny.us/press/2005/feb/Columbia.pdf.

[48] Statement of the Commission Regarding the Enforcement Action Against Alliance Capital Management, L.P., dated December 18, 2003, *available at* http://www.sec.gov/news/press/2003-176.htm.

[49] *Id.*

[50] Christopher R. Lane, "Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators," 39 New Eng. L. Rev. 317, 337 (Winter 2005) (quoting Tim Reason, Cheese It, THE STATES! Corporate Wrong-doers are Finding State Cops More Aggressive than the Feds, CFO Mag. (Feb. 2004) at 57).

[51] *E.g.,* Press Release by California Office of the Attorney General, dated September 15, 2004, *available at* http://ag.ca.gov/newslaerts/2004/04-105.htm.

[52] Deborah Solomon & John Hechinger, SEC Takes Heat for Quick Deal with Putnam, Wall St. J. C1 (Nov. 17, 2003) ("The SEC already has taken heat for failing to act on a tip from a Putnam call-center employee, who said he told the Boston office about rapid trading among several employee retirement

complaint, the SEC announced that it had settled the federal enforcement action against Putnam.[53] The agreement between Putnam and the SEC provided for significant corporate governance reforms, including the requirement it had reached in the Alliance settlement that 75% of the funds' board members be independent and that the chair of the boards also be independent. The agreement also included a restitution provision, with the amount of the restitution to be determined at a later date by an Independent Assessment Consultant. The SEC again declined to pursue advisory fee reductions.

Galvin immediately attacked the SEC settlement as inadequate: "The significance of this haste to enter into an agreement with Putnam is to set the standards so low as to put a lid on the whole issue . . . They're not interested in exposing wrongdoing, they're interested in giving comfort to the industry."[54] In other statements Galvin declared: "This settlement sends a message to the mutual fund industry: Relax, don't worry, the SEC isn't going to bother you . . . Well, they shouldn't relax. Mr. Spitzer and I are still there."[55] Spitzer joined Galvin's criticism of the SEC. In a *New York Times* editorial, Spitzer maintained that the SEC's settlement with Putnam "ignores consumers and is unsatisfactory to state regulators."[56]

Several months later, Galvin and the SEC jointly announced a settlement with Putnam in which the adviser agreed to pay $5 million in restitution to funds that it allegedly failed to protect from market timing.[57] On the basis of damage analysis conducted by the Independent Assessment Consultant, the SEC fined Putnam $50 million and ordered $5 million in restitution to the funds.[58]

Congressional hearings further spotlighted the divergent views between the SEC and state regulators on the issue of mutual fund fee reductions. The SEC Director of Enforcement, Stephen M. Cutler, testified: "We did not, as I know Mr. Spitzer would have liked, require Putnam to revamp its disclosure of fees or the way in which fees are negotiated. We thought that was a subject better left to a case that involved violations relating to fees or to regulation of the industry as a whole, rather than the resolution of a case about fund trading by portfolio managers."[59]

In response, Spitzer accused "the industry and many of its apologists" for "still opposing true reform in the area that most directly impacts investors: advisory fees."[60] He rejected criticisms that the fee reduction measures in the cases brought by his office amounted to rate setting: "These actions have lead my critics to accuse me of engaging in 'rate setting.' That charge is false. Requiring mutual funds to return to investors money that should never have been taken from them is not 'rate setting.' It is what regulators across the country do every day when they uncover evidence that consumers have been ripped off, and it is what I will continue to do as I uncover more evidence that mutual fund investors have been cheated."[61]

Spitzer's criticisms of federal regulatory efforts captured media attention and provided incendiary public rhetoric. In one interview, Spitzer remarked: "Every time we turn over a rock in the mutual fund industry these days, we are seeing vermin crawl out that are appalling. Late trading, timing by those in the executive boardroom, billions of dollars every year being scraped off that should be going into the pockets of investors. Instead, ending up in the hands of the executives. It's

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plans overseen by Putnam"); Hannah Glover, SEC's New Boston Chief Eyes Conflicts, Money Management Executive (April 17, 2006).

[53] *In the Matter of Putnam Investment Management LLC*, Investment Advisers Act of 1940 Rel. No. 2192 (Nov. 13, 2003), *available at* http://www.sec.gov/litigation/admin-2192.htm.

[54] Gretchen Morgenson, Market Watch: Slapping Wrists as the Fund Scandal Spreads, New York Times 3-1 (Nov. 16, 2003).

[55] Deborah Solomon & John Hechinger, SEC Takes Heat for Quick Deal with Putnam, Wall St. J. C1 (Nov. 17, 2003).

[56] Eliot Spitzer, *Regulation Begins at Home*, N.Y. TIMES A21 (Nov. 17, 2003).

[57] Press Release, dated April 8, 2004, *available at* http://www.sec.state.ma.us/sct/sctpdf/putnampressrelease.pdf; *In the Matter of Putnam Investment Management, LLC*, Docket No. E-2003-061 (Commonwealth of Mass., Office of the Secretary of the Commonwealth) (Consent Order April 8, 2004), *available at* http://www.sec.state.ma.us/sct/sctpdf/ptnconsent.pdf.

[58] *In the Matter of Putnam Investment Management, LLC*, Investment Advisers Act of 1940, Release No. 2226 (April 8, 2004), *available at* http://www.sec.gov/litigation/admin/ia-2226.htm.

[59] Testimony of Stephen Cutler, Review of the Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Hearing before S. Banking, Housing and Urban Affairs Comm., 108th Cong. at 21-22 (2003).

[60] Testimony of Eliot Spitzer, Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors, Hearing Before the Subcomm. on Fin. Mgmt., the Budget and Int'l Sec. of the S. Govt'l Affairs Comm., 108th Cong. at 103-04 (Jan. 27, 2004).

[61] *Id.*

crazy and it's wrong."[62] His conclusion was clear: federal regulators should have done more to police the mutual funds industry. He pointedly demanded, "heads should roll" at the SEC.[63]

The antagonism between federal and state regulators prompted Arthur Levitt, a former Chairman of the SEC, to encourage greater cooperation and less public bickering among securities regulators. While praising Spitzer and Galvin for "a substantial public service," he noted: "I firmly believe in local regulators working with federal regulators . . . But the 'with' is very important. I think the public bickering between regulators damages investor interests. The SEC has the law and it has resources . . . It's hard for average investors to imagine where or when the escalating mutual fund crisis will finally end. But when that time comes, the SEC will be the government agency most responsible to those investors."[64]

State and federal regulators appeared to reach this same conclusion and their public statements became more conciliatory. In testimony before a Senate subcommittee, Spitzer stated: "We have absolutely no difficulty cooperating in entirety with the SEC. We will work hand-in-glove with them as we go forward. They are, must be, and will continue to be the primary regulator of the securities markets."[65] At another hearing, SEC's Cutler similarly praised the collaborative federal and state effort: "I know Mr. Spitzer would agree that our staffs have worked very well together and that our collaboration has resulted in stronger enforcement cases and has certainly allowed us to cover more territory than each of us could cover singly."[66] And even with respect to their pointed disagreement on the legitimacy of advisory fee reductions, the harsh public rhetoric seemed to fade. On this issue, Spitzer reported that he and the SEC had "agreed to disagree on this particular issue, while continuing to jointly investigate and resolve these cases."[67]

Putnam, of course, was merely exemplary of the actions pursued against the mutual fund industry in 2004 and 2005. During this period, state regulators initiated and settled some of the most aggressive enforcement actions against any industry. In September 2004, for example, California Attorney General Lockyer announced a $9 million settlement of a lawsuit against PA Distributors that alleged the firm had violated state securities laws by not disclosing adequately the directing of commission payments for portfolio transactions to broker-dealers in return for sales of PIMCO mutual funds.[68] Lockyer highlighted the case as notable because it was the first enforcement action that California had taken against a mutual fund adviser pursuant to a newly enacted California statute that expanded the Attorney General's authority in securities fraud cases.[69]

Lockyer announced additional actions against the mutual fund industry in the months that followed. In November 2004, for example, he announced an $18 million settlement with the distributor of Franklin Templeton Investments over claims that the distributor had not adequately informed investors about its "shelf space" agreements to pay broker-dealers to recommend and sell Franklin Templeton funds.[70] In December 2004 and March 2005, respectively, Lockyer also announced that he had filed "major securities fraud lawsuit[s]" against Edward D. Jones & Co. and the American Funds Distributors, Inc. regarding their disclosures of broker-dealer compensation relating to mutual fund sales.[71] During this same period, in Massachusetts, Secretary

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[62] *Lou Dobbs Tonight* (CNN television broadcast, Nov. 5, 2003), *available at* http://transcripts.cnn.com/TRANSCRIPTS/0311/05/ldt.00.html.

[63] Eliot Spitzer, *Regulation Begins at Home*, N.Y. Times (Nov. 17, 2003).

[64] Steven Syre, *Boston Capital; Piling on the SEC*, The Boston Globe E1 (Nov. 18, 2003).

[65] Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before Subcomm. On Fin. Mgmt., the Budget, and Int'l Sec. of the S. Governmental Affairs Comm., 108th Cong. 13 (2003).

[66] Review of the Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Hearing before S. Banking, Housing and Urban Affairs Comm., 108th Cong. 21-22 (2003).

[67] Strategic Planning, Resource Allocation and Crisis Management -- Is the SEC Ready?: Hearing Before the Subcomm. On Gov't Efficiency and Fin. Mgmt. 108th Cong. 8 (2004) (statement of Eliot Spitzer, Attorney General, State of New York).

[68] Press Release, dated September 15, 2004, *available at* http://www.ag.ca.gov/newslaerts/2004/04-105.htm.

[69] *Id.*

[70] Press Release, dated November 17, 2004, *available at* http://www.ag.ca.gov/newslaerts/2004/04-133.htm; *People v. Franklin/Templeton Dist., Inc.* (Superior Court Sacramento County 2004), *available at* http://ag.ca.gov/newsalerts/2004/04-133b.pdf; *People v. PA Dist., LLC* (Superior Court Sacramento County 2004), *available at* http://ag.ca.gov/newsalerts/2004/04-105_complaint.pdf.

[71] Press Release, dated December 20, 2004, *available at* http://www.ag.ca.gov/newslaerts/2004/04-146.htm; Press Release, dated March 23, 2005, *available at* http://www.ag.ca.gov/newsalerts/2005/05-021-htm.

Galvin pursued fraud actions against Franklin Advisers, Inc. and Franklin Templeton Alternative Strategies, Inc., alleging that the firms had permitted a "market timer to invest in mutual funds in exchange for an investment in a Franklin hedge fund."[72] The Massachusetts action resulted in a $5 million fine.[73]

EFFORTS TO AMEND MUTUAL FUND DISCLOSURES

Although state regulatory activity against the mutual fund industry has been intense, the mutual fund families targeted by those actions did not dispute that state regulators shared concurrent jurisdiction with the SEC to prosecute violations of state securities laws, or to impose significant fines for violations of law. Some state efforts to "reform" the mutual fund business, however, have resulted in litigation over the scope of state authority to impose certain remedial measures as settlement conditions. In California, an investment adviser and a distributor, Capital Research and Management Company, and Edward D. Jones & Co., separately and successfully challenged California's authority to impose remedial disclosures in mutual fund offering documents.[74] In both cases, two California Superior Court judges concluded that NSMIA directly bars such action by the State Attorney General.[75] These decisions are discussed in further detail below.

Capital Research and Management Co. v. Lockyer (the "American Funds Litigation")

In the *American Funds* litigation, Lockyer averred that the American Funds' prospectuses did not disclose adequately the principal underwriter's distribution arrangements with broker-dealers, in violation of the California Corporations Code. Lockyer alleged that the American Funds paid approximately $426 million in shelf space payments to brokers who sold and recommended the American Funds. The Complaint asserted that the shelf space agreements "are, in fact, negotiated arrangements in which brokerage commissions, a fund asset belonging to the shareholders, is traded to obtain preferential sales by outside broker-dealers."[76] In the prayer for relief, California sought to enjoin American Funds from using allegedly misleading prospectuses and "Statements of Additional Information" that did not disclose the funds' distribution arrangements with broker-dealers.

American Funds challenged California's authority to seek such remedial relief with respect to its prospectus disclosures. In particular, American Funds argued that California was preempted by NSMIA from imposing any conditions on the terms of offering documents for "covered securities" such as registered investment companies. American Funds argued further that they complied fully with federal disclosure requirements.[77] In this regard, California did not allege that American Funds had failed to make required disclosures under federal law or that the funds' registration forms filed with the SEC had been improperly or fraudulently completed. American Funds consequently argued that California's proposed disclosure requirements exceeded those required by the SEC.

The Superior Court found in favor of American Funds and concluded that NSMIA impliedly preempts states from regulating the content of mutual fund prospectus disclosures.[78] Although the court acknowledged that Congress did not *expressly* preempt state authority with respect to investment advisers' prospectus disclosures in the text of NSMIA, the court nonetheless found that the California action was *impliedly* preempted by federal law because it "st[ood] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress in enacting NSMIA."[79]

The court looked to the legislative history of NSMIA for evidence of Congressional intent to preempt state authority to regulate the content of offering documents. In particular, the court reasoned that the House Commerce Committee's Report and the Conference Committee's Explanatory Statement confirmed Congressional intent to designate "the Federal government as the exclusive regulator of national

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[72] Press Release, dated September 20, 2004, *available at* http://www.sec.state.ma.us/sct/sctpdf/ftpressrelease2.pdf.

[73] *Id.*

[74] *See Capital Research and Management Co. and American Funds Distributors, Inc. v. Lockyer*, LASC Case No. BC330770 (November 22, 2005); *People v. Edward Jones*, Sacramento Superior Court Case No. 04AS05097 (May 25, 2006).

[75] *Id.*

[76] *People v. American Funds Distributors*, Case No. BC330770, Superior Court of Los Angeles County, Complaint ¶ 9, dated March 24, 2005, *available at* http://ag.ca.gov/newsalerts/2005/05-021_lawsuit.pdf.

[77] *Capital Research and Management Co. and American Funds Distributors, Inc. v. Lockyer*, LASC Case No. BC330770 (March 24, 2005) ("Slip Op.") at 14, 19.

[78] *Id.* at 21.

[79] *Id.* at 14.

offerings of securities"[80] and to preclude states from "regulat[ing] the securities registration 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."[81]

The court considered, but rejected, California's argument that the NSMIA savings clause permitted California to request injunctive relief as a remedy for a fraud conducted within the state.[82] On this claim, the court considered whether the California Attorney General's action was either: "1) in the nature of the 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 fraud or deceit."[83] The court concluded that the allegedly omitted facts were not "in the nature of fraudulent financial data."[84] The court also found that the complaint did not include common law fraud and deceit claims. The Attorney General, instead, had asserted that the shelf payments were violations of the California Corporation Code. Thus, the court reasoned, any savings clause was inapplicable to common law fraud or deceit claims.

Having addressed these savings-clause arguments, the court concluded that California was seeking to prohibit circulation of an offering document that did not include a disclosure that the State believed was necessary:

> In other words, the Attorney General's claims and the injunctive relief sought in the prayer 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.[85]

The court further found that the California Attorney General's action presented two specific obstacles to Congressional purpose in enacting NSMIA. First, the California action would reduce nationwide uniformity and consistency in mutual fund offering documents.[86] Second, the court concluded that the California action would impose disclosure requirements beyond those deemed necessary by the SEC in the current mutual fund registration form.[87]

The California Attorney General has announced that he intends to appeal the decision. On September 13, 2006, the NASAA filed an amicus brief in support of the California Attorney General, arguing that NSMIA preserves California's authority to bring the enforcement action.

People v. Edward D. Jones & Co., L.P.

In May 2006, a second California state court judge concluded that NSMIA preempted Attorney General Lockyer from imposing supplemental disclosure requirements in a mutual fund prospectus.[88] The ruling came in the *Edward D. Jones* litigation, a companion case to *American Funds* in that California had asserted that Edward D. Jones & Co. was the largest shelf-space partner for American Funds.[89] Lockyer alleged that Edward D. Jones received cash payments from investment advisers, or directed brokerage from mutual funds, in exchange for placing the funds on lists of recommended buys or providing other preferential treatment, without informing investors of the arrangements. Upon filing the action, Lockyer stated: "The documents we have obtained show Jones blatantly disregarded investors' interests as it collected some $300

[80] *Id.* at 14 (quoting H.R. Rep. No. 104-622, 104th Cong., 2nd Sess. 1996 at 16).

[81] *Id.* at 14-15 (quoting H.R. Conf. Rep. 104-864, 104th Cong., 2nd Sess. 1996 at 40).

[82] *Id.* at 34.

[83] *Id.* at 15-16.

[84] *Id.* at 15.

[85] *Id.* at 16-17 (emphasis in original).

[86] *Id.* at 18.

[87] *Id.* at 19.

[88] *People v. Edward Jones & Co.*, Sacramento Superior Court, Case No. 04AS05097 (May 25, 2006) (Court Ruling on Demurrer "Slip Op.")

[89] *People v. Edward Jones & Co.*, Sacramento Superior Court, Case No. 04AS05097, Complaint, dated December 20, 2004, *available at* http://ag.ca.gov/newsalerts/2004/04-146a.pdf.

million in secret payments from mutual funds."[90] He asserted that the broker-dealer's failure to disclose these agreements violated California corporations law.

The Superior Court granted defendants' demurrer and dismissed the action:

> The Court is of the view that NSMIA prohibits states such as California from enforcing state laws that directly or indirectly prohibit, limit, or impose conditions on any security offering, including mutual funds. 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 prospectus should say on mutual funds that have a 'shelf agreement' with a 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.[91]

Lockyer disputes the court's conclusion that he was seeking to regulate prospectus disclosures. In particular, he stated: "we are not in any way trying to regulate what goes into a prospectus. What we're saying is that you can't defraud investors. You can't omit facts about what investors need to know."[92]

Lockyer has announced that he intends to appeal the order.[93]

EFFORTS TO COMPEL REDUCTIONS IN ADVISORY FEES

Another recent challenge to the authority of state regulators to the management of investment advisers has arisen out of Attorney General Spitzer's effort to compel advisory fee reductions in the settlement of a market-timing enforcement action against J.& W. Seligman & Co., Inc.[94] The case relates to an investigation that Spitzer commenced in February 2004 after Seligman disclosed that it had entered into an agreement permitting a brokerage firm to conduct frequent trading in certain mutual funds advised by Seligman.[95] Seligman and the Attorney General's office entered into settlement discussions and tentatively agreed on a financial penalty.[96]

Seligman avers, however, that Spitzer sought to impose additional advisory fee reductions.[97] Seligman resisted the reductions, arguing (as did the SEC with respect to the Alliance settlement) that any harmed investors were past investors, not future ones. Therefore, fee cuts would not provide restitution to injured investors, and were an inappropriate remedial measure for a market-timing action.[98] When Seligman refused to agree to future fee reductions, Spitzer allegedly retaliated by expanding his investigation to consider whether the Seligman funds paid "excessive" advisory fees. Spitzer issued subpoenas to the Seligman Funds, the investment adviser, and the Funds' independent directors.[99] Seligman contends that the subpoenas were a "pressure tactic" by the Attorney General, issued to compel the adviser to yield to the conditions of settlement.[100]

At an impasse with the state regulator, Seligman sought a federal court injunction against Spitzer, seeking to enjoin him from investigating or issuing subpoenas for information concerning Seligman's investment advisory fees. Weeks later, Spitzer asked a *state* court to compel Seligman to provide documents and testimony.[101] Seligman maintains that the Investment Company Act of 1940 delegates the regulation of mutual fund advisory fees to the SEC and not to the states. The

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[90] Press Release, dated December 20, 2004, *available at* http://ag.ca.gov/newsalerts/2004/04-146.htm.

[91] Slip Op. at 2 (typographical and grammatical errors corrected).

[92] *Id.*

[93] State News Broker Dealers: AG's Suit Over Shelf-Space Deals With Funds Preempted, Calif. Court Rules, 38 Sec. Reg. & L. Rep. (BNA) 1029 (June 12, 2006).

[94] *J. & W. Seligman & Co., Inc. v. Spitzer*, United States District Court for the Southern District of New York, No. 05 Civ. 7781 (Complaint, dated Sept. 6, 2005).

[95] *Id.*

[96] *Id.*

[97] *Id.*

[98] The Seligman complaint "publicly aired what many in the industry had railed about behind closed doors regarding what they saw as aggressive negotiation tactics and Spitzer's leverage of the market-timing and late-trading abuses to influence advisory fees." Amanda Gerut, Scandal Legacy: Spitzer v. Seligman, BoardIQ (August 29, 2006).

[99] *Id.* at ¶ 14.

[100] *Id.*

[101] Amanda Gerut, Scandal Legacy: Spitzer v. Seligman, BoardIQ (Aug. 29, 2006).

limiting language regarding mutual fund advisory fees, Seligman avers, appears in Section 36(b) the 1940 Act, which states in relevant part:

> For purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission [*i.e.,* the SEC], or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person . . . for breach of fiduciary duty in respect of such compensation.[102]

Because Section 36(b) creates only two express rights of action – one by the SEC and the other by a mutual fund investor – Seligman contends that the 1940 Act impliedly preempts all other actions, including state regulatory challenges to advisory fees. Moreover, as discussed above, the 1940 Act contains no savings clause for state regulatory actions.

Spitzer's motion to dismiss the action is pending before the federal district court in Manhattan. In that motion, New York argues that the federal court should abstain from ruling on the action under the *Younger* abstention doctrine, which generally requires federal courts to abstain from taking jurisdiction over federal claims that involve or call into question ongoing state proceedings. The issue before the federal district court is whether the *Younger* doctrine is applicable to a preemption case or whether the mere assertion of preemption is sufficient to permit a federal court to rule on the motion for injunctive relief.[103]

Spitzer also argues that the Investment Company Act does not preempt states from investigating persons who may be engaging in fraud with respect to the setting of investment advisory fees. This is an unsettled area of law. There is conflicting authority as to whether the Investment Company Act preempts state common law actions. The United States Court of Appeals for the Third Circuit has held that Section 36(b) did not preempt state common law or breach of fiduciary duty claims.[104] There are *dicta* in other district court decisions, however, stating "that §36(b) preempts state law claims relating to breach of fiduciary duty with respect to excessive management fees."[105] It is an issue of first impression as to whether the statute preempts state regulatory actions regarding advisory fee levels.

Seligman's challenge seeks to demonstrate that the creation of express actions in Section 36(b) implies that Congress intended to preempt all other actions, including actions by state regulators. Seligman's argument is a difficult one, in part because "[c]onsideration of issues arising under the Supremacy Clause 'starts with the assumption that the historic police powers of the States [are] not to be superceded by [a] Federal Act unless that [is] the clear and manifest purpose of Congress.'"[106] To meet this standard, Seligman contends that New York's effort to impose rate reductions is contrary to the scheme that Congress created whereby mutual fund directors and advisers engage in arm's length bargaining to set mutual fund advisory fees.[107] Seligman maintains that rate setting efforts by state regulators "usurp the SEC's core regulatory function: dictating general regulatory policy for the capital markets."[108] The district court's decision may provide much needed clarity on whether the reduction of advisory fees is yet another remedial provision preempted by federal law.

The New York state courts may also weigh in on this issue. On September 22, 2006, Spitzer filed a complaint against J. & W. Seligman, alleging that the company had entered into preferential market-timing arrangements with some investors, and that Seligman charged

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[102] Seligman Compl. at ¶ 2.

[103] *See In re Pan American Corp.*, 950 F.2d 839, 847 (2d Cir. 1991) ("These concerns, however, are not implicated when federal questions are presented since supremacy clause questions are 'essentially ones of federal policy.' We therefore have observed that 'abstention . . . is not appropriately invoked in a preemption case'") (citations omitted); *see also De Cisneros v. Younger,* 871 F.2d 305, 308 (2d Cir. 1989) ("when the applicable substantive law is federal, abstention is disfavored").

[104] *Green v. Fund Asset Management L.P.*, 245 F.3d 214 (3d Cir. 2001).

[105] *Batra v. Investors Research Corp.*, 1992 W.L. 280790 at *6 n.3 (W.D. Mo. April 2, 1992). *See also Tarlov v. Paine Webber Cashfund, Inc.*, 559 F. Supp. 429, 441 (D. Ct. 1983) ("To the extent a pendant state claim does exist . . . [i]t may be that any such parallel common law action has been preempted by Section 36(b)").

[106] *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992) (citations omitted).

[107] See Seligman's Memorandum in Opposition to Motion to Dismiss, dated October 28, 2005 at 7.

[108] *Id.*

excessive management fees, in violation of the Martin Act.

CONCLUSION

Although cases challenging the scope of state enforcement authority are few in number – and none has been reviewed by an appellate court – they merit serious attention: they will inform debate over the circumstances in which state regulators can impose industry changes in individual enforcement actions against investment advisers and mutual fund distributors. It is important to understand these challenges in context.

Fairly understood, none of the pending challenges attacks the importance of state regulators in protecting investors from fraud, or threatens to erode the ability of state securities regulators to pursue fraudulent conduct within their jurisdictions. The pending cases, however, raise serious challenges to the ability of state regulators to influence prospectus disclosures for mutual funds, or to change the method by which investment advisers and independent directors negotiate advisory agreements. The California and New York litigations are premised on the view that Congress intended that the federal government – and not the states – establish the rules and policies governing mutual fund disclosures and the approval of mutual fund advisory fees. They express a preference for national reforms, rather than piecemeal state reforms. The implied preemption arguments advanced in the cases reflect the view that states should not rely on their residual power to set regulatory standards for the national markets. To the extent the state courts, or the federal district courts, reject the remedial measures imposed by state regulators, there may be no appetite for further congressional action, such as that initially proposed in H.R. 2179.■

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