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Comments: The National Securities Markets Improvement Act (NSMIA) Savings Clause: A New Challenge to Regulatory Uniformity

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THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT (NSMIA) SAVINGS CLAUSE: A NEW CHALLENGE TO REGULATORY UNIFORMITY

I. INTRODUCTION

The tension between state and federal regulation of the securities industry continues to exist despite the 1996 passage of the National Securities Markets Improvement Act (NSMIA).¹ Congress enacted NSMIA to resolve decades of inefficiency and conflict in the federal-state regulatory framework.² This inefficiency and conflict harmed mutual fund investors by “frustrat[ing] national policies designed to benefit fund shareholders, hinder[ing] innovative and beneficial products and services, impos[ing] needless compliance burdens, and divert[ing] state oversight resources away from critical consumer protection efforts.”³ NSMIA attempted to address these problems by giving certain types of securities,⁴ including nationally distributed mutual funds,⁵ a federally imposed exemption from state securities registration regulations.⁶ Although NSMIA preempts state

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1. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C. (2006)).
 2. See *infra* Part II.A.
 3. Matthew Fink, *Mutual Fund Regulation: Forging a New Federal and State Partnership*, 2 INVESTMENT CO. INST. PERSPECTIVE 1 (Jan. 1996), available at <http://www.ici.org/pdf/per02-01.pdf>.
 4. A security is:
[A]ny note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof)
Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(a)(1) (2006).
 5. “A mutual fund is a distinct legal entity that raises money by selling shares and then invests in securities for the benefit of its shareholders.” *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770, 772 n.1 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).
 6. See 15 U.S.C. § 77r(a). This section exempts “covered securities” from state regulation of “registration or qualification of securities, or registration or qualification

involvement in these matters, it contains a savings clause that preserves the states' power to investigate and prosecute fraud.⁷

Recent action by the California Attorney General attempted to widen this savings clause into a loophole.⁸ In *Capital Research & Management Co. v. Brown*,⁹ the state brought an antifraud enforcement action against a mutual fund company's investment adviser¹⁰ and distributor¹¹ for failure to adequately disclose revenue-sharing agreements.¹² The suit focused on the lack of adequate disclosure in the mutual fund prospectuses.¹³ Under NSMIA, states are preempted from regulating such disclosure.¹⁴ However, in *Capital Research*, the court found that the savings clause gave the state the authority to enforce disclosure requirements, in effect, permitting the state to regulate activity that would otherwise be preempted under NSMIA.¹⁵

of securities transactions. . . ." *Id.* § 77r(a)(1). States are also preempted from "directly or indirectly prohibit[ing], limit[ing], or impos[ing] any conditions" on the offering documents (such as prospectuses) of covered securities. *Id.* § 77r(a)(2). *See also infra* Part II.B.1.

7. The savings clause authorizes a state's securities commission to "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." 15 U.S.C. § 77r(c)(1).
8. *See infra* Part II.D.
9. 53 Cal. Rptr. 3d 770.
10. *Id.* at 772. Capital Research and Management Company (CRMC) is the investment adviser for American Funds (AF). *Id.* AF is currently among the largest mutual fund companies in the United States. Americanfunds.com, About Us, http://www.americanfunds.com/about/index.htm?r=t_h (last visited Oct. 30, 2008). "Each [mutual] fund contracts with an investment adviser who provides management, portfolio selection, and administrative services to the fund, for which the adviser is usually compensated based on a percentage of the fund's total assets." *Capital Research*, 53 Cal. Rptr. 3d at 772 n.1.
11. *See Capital Research*, 53 Cal. Rptr. 3d at 772. American Funds Distributor (AFD) distributes AF mutual fund shares to various retail broker-dealers who then sell the funds directly to investors. *See id.*
12. *See id.* at 772-73. "'Revenue sharing' usually refers to payments made by fund advisers or their affiliated underwriters (and not by the funds themselves) to sellers of fund shares to compensate them for distribution and shareholder services." Mark Perlow, *Mutual Fund Directors' Oversight of Distribution Relationships: Emerging Best Practices*, 11 INVESTMENT LAW. 1, 10 (2004).
13. *See Capital Research*, 53 Cal. Rptr. 3d at 772 n.2.
14. *See infra* Part II.B.1.
15. *See infra* Part II.D.2. State Attorney General Jerry Brown dropped the suit in early February 2008, indicating that he was satisfied with AF's efforts to amend disclosure concerning the revenue-sharing agreements. Press Release, Office of Cal. Attorney Gen., Brown and American Funds End Litigation (Feb. 15, 2008), <http://ag.ca.gov/newsalerts/release.php?id=1524&year=2008&month=2>. As part of

The newly broadened interpretation of the antifraud savings clause defeats the purpose of NSMIA by allowing indirect regulation of federally preempted securities.¹⁶ As noted by Paul Atkins, U.S. Securities and Exchange (SEC) Commissioner at the time, “attempts to augment SEC disclosure requirements through state enforcement actions . . . can create regulatory uncertainty and undermine the common federal disclosure scheme that was Congress’s clear purpose in the [NSMIA].”¹⁷ Courts must determine which part of NSMIA controls prospectus disclosure of revenue-sharing agreements. If the savings clause controls, then states would be permitted to compel additional prospectus disclosure not required under federal law.¹⁸ This type of state authority would undermine NSMIA’s goal of national uniformity.¹⁹

This Comment will examine the developments in the securities industry that led to the enactment of NSMIA,²⁰ as well as the legislation’s resulting effects.²¹ An analysis of *Capital Research*²² will cover the purposes of NSMIA as contrasted with the state attorney general’s purpose in bringing the case.²³ Finally, the Comment will discuss the underlying problems associated with mutual fund prospectus disclosure²⁴ and scrutinize possible solutions that would better address the problem while maintaining the uniformity of securities regulation.²⁵

the settlement, Case Research & Management Co. and American Funds Distributors also agreed to pay the State’s legal costs, totaling \$2.5 million. See Tom Petrino, *State Drops Broker Fee Case*, L.A. TIMES, Feb. 15, 2008, at C1.

16. See *infra* Part III.A.

17. Paul S. Atkins, Comm’r, SEC, Remarks Before the Investment Company Institute’s 2008 Mutual Funds and Investment Management Conference ¶ 13 (Mar. 17, 2008) (transcript available at <http://www.sec.gov/news/speech/2008/spch031708psa.htm>).

18. See *infra* Part III.A.2.

19. See *infra* Part III.A.2.

20. See *infra* Part II.A.1.

21. See *infra* Part II.C.

22. 53 Cal. Rptr. 3d 770 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).

23. See *infra* Part II.D–III.A.

24. See *infra* Part III.B.

25. See *infra* Part III.C.

II. BACKGROUND

A. Securities Regulation Pre-NSMIA

1. State of the Mutual Fund Industry

The mutual fund industry had already ballooned from a small-scale, localized business to a large-scale, national juggernaut by the time of NSMIA's enactment in 1996.²⁶ Not only did assets under management skyrocket, but the number of funds available to investors increased, as did the complexity of products offered.²⁷ Moreover, 37% of U.S. households owned investments in mutual funds by this time.²⁸ Accordingly, the number of investment advisers registered with the SEC also increased from 5,400 in 1986 to over 22,000 in 1996.²⁹ This expansion necessitated corresponding expansion in the regulatory bodies responsible for the oversight of the mutual fund industry.³⁰

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26. Mutual fund industry assets under management grew from approximately \$48 billion in 1970, INVESTMENT CO. INST., 1971 MUTUAL FUND FACT BOOK 16 (1971), to \$2.3 trillion in 1996. BD. OF GOVERNORS OF FED. RESERVE SYS., STATISTICAL RELEASE, FLOW OF FUNDS ACCOUNTS OF THE U.S.: FLOWS AND OUTSTANDINGS FOURTH QUARTER 1996, at 76 (Mar. 14, 1997), available at <http://www.federalreserve.gov/releases/z1/>.
 27. *Securities Promotion Act of 1996: Hearing on S. 1815 Before the S. Comm. on Banking, Hous., and Urban Affairs*, 104th Cong. 3-4, 6 (1996) [hereinafter *Securities Promotion Act Hearings*] (testimony of Arthur Levitt, Chairman, SEC), available at <http://www.sec.gov/news/testimony/testarchive/1996/spch107.txt>.
 28. INVESTMENT CO. INST., FUNDAMENTALS 1 (Dec. 1996), available at <http://members.ici.org/getPublicPDF.do?file=fun1296>. By comparison, 4.6 million households (6% of all U.S. households) owned mutual fund investments in 1980. INVESTMENT CO. INST., 1993 MUTUAL FUND FACT BOOK 89 (1993).
 29. Norman Johnson, Comm'r, SEC, Speech at Investment Company Institute ¶ 5 (Dec. 3, 1996) (transcript available at <http://www.sec.gov/news/speech/speecharchive/1996/spch138.txt>).
 30. See *id.* ¶¶ 5-6.

2. Conflict Between State and Federal Regulation³¹

The states and the SEC have jointly regulated the securities industry since the Securities Exchange Act of 1934.³² By the 1980s, the rapid growth of the U.S. financial industry began to pose challenges³³ to the effectiveness of the existing regulatory system.³⁴ Parallel enforcement of federal securities regulations and state blue sky laws³⁵ increasingly resulted in duplication and conflict.³⁶

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31. “The debate over the respective roles of Washington and the States in securities regulation has been proceeding for three-quarters of a century. In 1920, Congressman Edward Dennison proposed a bill under which the federal government would have enforced state securities laws.” Arthur Levitt, Chairman, SEC, Remarks at the North American Securities Administrators Association Conference, *The SEC and the States: Toward a More Perfect Union* ¶ 10 (Oct. 23, 1995) (transcript available at <http://www.sec.gov/news/speech/speecharchive/1995/spch058.txt>).
 32. The Securities Exchange Act of 1934 established the SEC. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation* ¶ 16, <http://www.sec.gov/about/whatwede.shtml#create> (last visited Sept. 26, 2008); *see also* Securities Exchange Act, 15 U.S.C. §§ 78d-d2 (1934). Concurrent state jurisdiction was expressly preserved by the Securities Act, 15 U.S.C. §§ 77a, 77v (1933), and the Investment Company Act of 1940, 15 U.S.C §§ 80a-43, 80a-51 (1940).
 33. In 1983, the SEC held its first annual conference with the North American Securities Administrators Association (NASAA) which represents state securities regulators. SEC, 49th ANNUAL REPORT, at 12 (1983), *available at* <http://www.sec.gov/about/annualreport/1983.pdf>; *see also* SEC & NASAA, INC., CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION, SUMMARY REPORT (Apr. 1984). The goal was to determine how to better prevent conflict and promote uniformity between federal and state regulation of investment companies. SEC, 49th ANNUAL REPORT, *supra*. The NASAA committee formed at the conference issued a final post-conference report, recognizing the problems resulting from the lack of uniformity in states’ regulation of investment companies and calling for the states to take various steps in the direction of uniformity on several different subjects such as registration exemptions, merit standards, and sales literature requirements. NASAA, INC., REPORT OF THE INVESTMENT COMPANIES COMMITTEE TO THE FALL 1984 MEMBERSHIP MEETING (1984). Not a single one of the resolutions listed in the report were adopted by all of the states. *Id.*
 34. *See supra* note 32 and accompanying text.
 35. State securities laws are often referred to as “blue sky” laws, in reference to their purpose—to regulate “speculative schemes which have no more basis than so many feet of ‘blue sky.’” *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917) (finding that state police power extended to regulation of securities); *see also* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 7 (1958) (examining the creation of state securities law).
 36. In 1984, the SEC noted the “need to increase uniformity between federal and state regulatory systems . . . so that capital formation can be made easier while appropriate investor protections are retained.” Annual Conference on Uniformity of State Securities Laws, Securities Act Release No. 6561, [1984-1985] Fed. Sec. L. Rep.

The proliferation of conflicting regulation had a particularly negative impact on the mutual fund industry.³⁷ Wide-ranging state regulations forced fund companies to maintain complex and expensive compliance operations³⁸ to ensure continuing conformity with differing requirements that were “full of complexities, surprises, unsuspected liabilities for transactions normal and usual—in short, a crazy-quilt of state regulations no longer significant or meaningful in purpose, and usually stultifying in effect, or just plain useless.”³⁹ The broker-dealers distributing fund shares were also subject to an intricate web of regulation involving the SEC, self-regulatory organizations such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD),⁴⁰ as well as state blue sky laws.⁴¹ Predictably, the burdensome costs of regulatory compliance resulted in higher expenses for investors.⁴²

The system of parallel state and federal regulation allowed regulation by one state to frustrate the SEC’s efforts to create a consistent national policy.⁴³ This occurred in the area of prospectus

(CCH) ¶ 83,717, at 87,193 (Dec. 6, 1984). See generally Rutheford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985) (discussing difficulties associated with the complexity and nonuniformity of state securities laws).

37. *Securities Promotion Act Hearings*, *supra* note 27, at 8 (“The current scheme of federal-state regulation is particularly onerous for investment companies, which are extensively regulated by the [SEC], and whose business is fundamentally national in nature.”).
38. Fink, *supra* note 3, at 12–13.
39. J. Sinclair Armstrong, *The Blue Sky Laws*, 44 VA. L. REV. 713, 714-15 (1958). J. Sinclair Armstrong was SEC Chairman from 1953 to 1957. SEC Historical Summary of Chairmen and Commissioners, <http://www.sec.gov/about/sechistoricalsummary.htm> (last visited Mar. 10, 2008).
40. The NASD and certain operations of the NYSE consolidated on July 30, 2007 to become the Financial Regulatory Authority (FINRA). FINRA is now the securities industry’s “largest non-governmental regulatory organization.” Press Release, FINRA, NASD & NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority (July 30, 2007), <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P036329>.
41. Howard M. Friedman, *The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers*, 53 BUS. LAW. 511, 512 (1997-1998). This regulation from different sources encompassed broker-dealer business practices from registration to sales. *Id.*
42. Atkins, *supra* note 17, ¶ 11. As is still the case, “[l]ack of [regulatory] consistency increases costs, which are ultimately paid by investors.” *Id.*
43. See, e.g., Paul S. Stevens & Craig S. Tyle, *Mutual Funds, Investment Advisers, and the National Securities Markets Improvement Act*, 52 BUS. LAW. 419, 431 n.62 (1996-1997) (summarizing Ohio’s frustration with SEC attempts to implement uniform treatment of illiquid securities within mutual fund investment portfolios); see also

disclosure, where regulatory requirements were all over the map.⁴⁴ Concurrent regulation forced mutual fund companies to comply not only with individual state regulations, but with SEC regulations as well.⁴⁵ As a result, funds offering their shares for sale on a national basis had to conform their prospectuses to the most restrictive disclosure comments issued by state examiners, while at the same time adhering to SEC requirements.⁴⁶ In effect, the state with the most stringent requirements acted as the lowest common denominator, forcing nationally distributed mutual funds to comply with the state regulations and thwarting SEC efforts to benefit investors by creating a simplified, uniform approach to prospectus disclosure.⁴⁷

State regulatory disparities were still causing problems even into the early 1990s.⁴⁸ The states attempted to address some of these problems with little success. For example, the North American Securities Administrators Association (NASAA) Investment Companies Committee created state guidelines for mutual fund prospectus disclosure; however, the guidelines differed from a similar policy already set in place by the SEC.⁴⁹ In addition, many states then added extra requirements of their own to the NASAA prospectus disclosure guidelines.⁵⁰ The stated purpose of the guidelines—to promote uniformity—was not achieved, either between federal-state regulations, or even from state to state.⁵¹ SEC Chairman Arthur Levitt discussed the ramifications of the failure to achieve uniformity

Fink, *supra* note 3, at 5, 8–9 (“Accordingly, if even one state insists upon restricting a portfolio manager’s ability to invest in a manner consistent with federal law, *investors in all states will be adversely affected.*”).

44. See Fink, *supra* note 3, at 9–10.

45. *Id.* at 4.

46. See Stevens & Tyle, *supra* note 43, at 431. In the late 1980s, the SEC attempted to simplify prospectus disclosure by amending the requirements of Form N-1A to standardize the disclosure of mutual fund fees and expenses. *Id.* However, Missouri required the mutual fund prospectus fee table disclosure to conform to a different format than the one set out by the SEC. *Id.* at 431 n.64. As a result, nationally distributed mutual funds were forced to conform prospectuses distributed in Missouri to the Missouri format. See *id.* Other states also “required fee table disclosure beyond that required by the SEC.” *Id.* These types of changes “often result[] in overcrowded prospectus cover pages with inappropriate emphasis given to selected information.” Fink, *supra* note 3, at 10.

47. See Stevens & Tyle, *supra* note 43, at 430.

48. *Id.* at 435–36.

49. *Id.*

50. *Id.* at 436.

51. *Id.* at 435–36.

in a 1996 Senate hearing before the Committee on Banking, Housing, and Urban Affairs:

The current system of dual federal-state regulation is not the system that Congress—or the [SEC]—would create today if we were designing a new system. While securities markets today are global, issuers and securities firms still must register many securities offerings in 52 separate jurisdictions; satisfy a multitude of separate books and records requirements; and bear the substantial costs of compliance with the overlapping requirements.⁵²

Levitt's summary illustrates the frustrations associated with the lack of uniformity and the impetus behind the implementation of NSMIA.

3. Legislative Response

The introduction of legislation in the early 1990s laid the groundwork for making the growing problem a congressional priority.⁵³ In early 1995, legislation was proposed to exempt certain small investment advisers from SEC regulation.⁵⁴ This legislation would also preempt states from regulating larger advisers, who would then fall under the exclusive jurisdiction of the SEC.⁵⁵ Over the next year, this piece of legislation evolved into the National Securities Markets Improvement Act.⁵⁶ President Clinton signed the final version of NSMIA into law on October 11, 1996.⁵⁷

52. *Securities Promotion Act Hearings*, *supra* note 27, at 8.

53. *See* Stevens & Tyle, *supra* note 43, at 439–40.

54. Investment Advisers Integrity Act, S. 148, 104th Cong. (1995). Senator Phil Gramm introduced legislation that would exempt certain small investment advisers from federal regulation, particularly advisers with less than \$5 million assets under management. *Id.*

55. Other Senators then suggested that the legislation should shift the regulation of large investment advisers from the states to the federal government. Keith Bradsher, *New Finance Decontrol Bill from G.O.P.*, N.Y. TIMES, July 28, 1995, at D5.

56. *See* Assoc. Press, *Securities Regulation Bill Advances*, N.Y. TIMES, June 19, 1996, at D3; *see also* Leslie Eaton, *Bill to Revise Securities Regulations Ready for Clinton*, N.Y. TIMES, Oct. 2, 1996, at D4.

57. Press Release, White House, Statement by President William J. Clinton (Oct. 11, 1996), 1996 WL 584922. President Clinton's press release described NSMIA as "the most significant overhaul of the securities regulatory structure in decades." *Id.*

B. *The National Securities Markets Improvement Act (NSMIA)*⁵⁸

1. Preemption Provisions

NSMIA preempted state regulation of certain “covered securities,” including nationally distributed mutual funds.⁵⁹ Prior to NSMIA, these covered securities were subject to concurrent regulation.⁶⁰ NSMIA accomplished this change by amending several provisions of existing federal law: the Securities Act of 1933,⁶¹ the Securities Exchange Act of 1934,⁶² the Investment Company Act of 1940,⁶³ and the Investment Advisers Act of 1940.⁶⁴ These amendments created federal preemption in areas such as registration of securities offerings,⁶⁵ regulation of offering or various other documents of an issuer,⁶⁶ and merit or substantive regulation.⁶⁷

Regulation of an issuer’s offering documents includes the regulation of mutual fund prospectuses as defined under section 2(10) of the Securities Act.⁶⁸ States are preempted from taking actions that “directly or indirectly prohibit, limit, or impose any conditions” on mutual fund prospectus disclosure.⁶⁹ This broad language prevents states from taking even indirect action to influence the language of mutual fund prospectuses.⁷⁰ However, as illustrated by *Capital Research & Management Co. v. Brown*,⁷¹ this preemption is not necessarily absolute.

58. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C. (2006)).

59. 15 U.S.C. § 77r(b). The definition of “covered securities” encompasses securities issued by investment companies that are registered under the Investment Company Act of 1940. *Id.* § 77r(b)(2). “Covered securities” also refer to securities that are listed on a national securities exchange, as well as transactions involving securities that have been otherwise exempted from registration. *Id.* 77(r)(b)(1).

60. *See supra* note 32 and accompanying text.

61. Codified at 15 U.S.C. §§ 77a-77aa (2006).

62. Codified at 15 U.S.C. §§ 78a-78mm.

63. Codified at 15 U.S.C. §§ 80a-1 to 80a-64.

64. Codified at 15 U.S.C. §§ 80b-1 to 80b-21.

65. 15 U.S.C. § 77r(a)(1).

66. *Id.* § 77r(a)(2).

67. *Id.* § 77r(a)(3).

68. *Id.* § 77r(d)(1)(A).

69. *Id.* § 77r(a)(2).

70. *See id.*

71. 53 Cal. Rptr. 3d 770, 776 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).

2. State Antifraud Enforcement Savings Clause⁷²

Although NSMIA preempts state regulation in many areas,⁷³ it preserves state authority in limited situations, most notably the state's authority to bring antifraud enforcement actions.⁷⁴ This savings clause retains state jurisdiction as follows:

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.⁷⁵

There are no further references to this preservation of state regulatory power within the text of the Act. The savings clause does not limit state authority to fraud, but also extends it to "unlawful conduct by a broker or dealer."⁷⁶ This ambiguous language leaves open an unresolved question: where did the legislature intend to draw the line? It is unclear whether states can implement broad legislation prohibiting conduct that is nevertheless permitted under federal securities law.⁷⁷

C. *The Securities Regulation Landscape Post-NSMIA*

1. Division of Authority

One of NSMIA's main objectives was to alleviate the duplication of state and federal regulatory efforts.⁷⁸ Decreasing regulatory overlap between the SEC and the states was intended to allow the concentration of regulatory resources where most effective.⁷⁹ This

72. 15 U.S.C. § 77r(c)(1) (Supp. II 1996).

73. See *supra* notes 57–67 and accompanying text.

74. 15 U.S.C. § 77r(c)(1) (Supp. II 1996).

75. *Id.*

76. *Id.*

77. As one commentator noted, the generalized language of the savings clause "raises the question of when regulation of broker-dealer business practices in selling covered securities really amounts to one of the types of indirect regulation prohibited by NSMIA so that enforcement of the provisions are inconsistent with NSMIA." Friedman, *supra* note 41, at 530.

78. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, prefatory note (1996) (codified as amended in scattered sections of 15 U.S.C. (2006)).

79. S. REP. NO. 104-293, at 3–4 (1996).

would, in turn, increase the consistency and effectiveness of the efforts of both state and federal regulatory bodies.⁸⁰ To this end, the Senate Banking Committee Report indicated that “[t]he states should play an important and logical role in regulating small investment advisers whose activities are likely to be concentrated in their home state.”⁸¹ On the other hand, “[l]arger advisers, with national business, should be registered with the [SEC] and be subject to national rules.”⁸²

The SEC and the state regulators have each interpreted this division of authority according to their own enforcement agenda. NASAA weighed in shortly after the passage of NSMIA, arguing that, “other regulations of business practices, even when they do not amount to prohibitions of fraud, should remain enforceable against large advisers.”⁸³ In contrast, the SEC took the position “that a state should not be able to indirectly regulate the activities of SEC-registered advisers by enforcing requirements that are defined as ‘dishonest’ or ‘unethical’ business practices—unless the activities rise to the level of being ‘fraudulent.’”⁸⁴ NASAA created a task force immediately following the enactment of NSMIA to focus on promoting and coordinating the adoption of model state legislation

80. *See id.* Shortly before the passage of NSMIA, the SEC Associate Director of Compliance, Inspections, and Examinations estimated that SEC staffing levels would only allow for examination of the average investment adviser once every 22 years. *SEC's New Approach to Examinations of Advisers Focuses on Risk to Clients*, 27 Sec. Reg. & L. Rep. (BNA) 1704, 1704-05 (Oct. 27, 1995) (statements of Eugene Gohlke, Assoc. Dir., SEC Office of Compliance, Inspections, & Examinations).

81. S. REP. NO. 104-293, at 4.

82. *Id.* Estimates from 1992 indicated that 70% of mutual fund industry assets were managed by only 5% of the investment advisers. *Roberts Calls for SEC and States to Split Investment Adviser Oversight*, 24 Sec. Reg. & L. Rep. (BNA) 1801, 1801 (Dec. 4, 1992). Therefore, by limiting SEC responsibility to only the larger advisers, the SEC would be able to more readily focus its attention on that 5% of investment advisers, where arguably the greatest amount of risk is located.

83. Letter to Jonathan G. Katz, Secretary, SEC, *Regarding Rules Implementing Amendments to the Investment Advisers Act of 1940*, N. Am. Sec. Admins. Ass'n Rep. (CCH) ¶ 13,039, at 13,080-13,082 (Feb. 13, 1997); *see also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Release No. 1633, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,940, at 89,611-89,612 (May 15, 1997).

84. Isaac Hunt, Comm'r, SEC, Remarks at the National Regulatory Services Annual Compliance Conference for Investment Advisers and Broker-Dealers: Implementing the National Securities Markets Improvement Act (Apr. 10, 1997) (transcript available at <http://www.sec.gov/news/speech/speecharchive/1997/spch153.txt>).

and rules.⁸⁵ The NASAA members specifically indicated their intention to “err on the side of the perceived congressional intent where the statutory language in NSMIA was ambiguous”⁸⁶ It is unclear from the task force records how NASAA perceived the congressional intent behind the NSMIA savings clause. However, the SEC indicated its understanding of NSMIA as congressional recognition “that overlapping state and [SEC] regulation adds little investor protection, is a waste of limited regulatory resources, and imposes considerable burdens on the larger advisers who tend to be subject to the laws of multiple jurisdictions.”⁸⁷ This view appears to line up more closely with the new regulatory roles envisioned in the Committee record.⁸⁸

2. State Fraud Statutes

“[T]he most concerted attempt by state securities administrators to achieve uniformity” was the creation of the Uniform Securities Act (USA),⁸⁹ which was approved in 1956 by the National Conference of Commissioners on Uniform State Laws (NCCUSL).⁹⁰ The USA defines securities fraud to include “mak[ing] an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading.”⁹¹ A substantial number of states, including Maryland, have adopted the USA.⁹² As a result, the language of many state antifraud statutes continues to model that of the USA.⁹³

85. G. Philip Rutledge, *NSMIA . . . One Year Later: The States' Response*, 53 *BUS. LAW.* 563, 568 (1997) (citing memorandum from the NASAA Bd. of Dirs. et al. to the U.S. NASAA Member Representatives (Mar. 7, 1998)).

86. *Id.*

87. Johnson, *supra* note 29.

88. H.R. REP. NO. 104-622, at 16 (1996). See *infra* Part III.A.2 for further discussion.

89. Kenneth I. Denos, *Blue and Gray Skies: The National Securities Markets Improvement Act of 1996 Makes the Case for Uniformity in State Securities Law*, 1997 *UTAH L. REV.* 101, 125.

90. UNIF. SEC. ACT (amended 1958), 7C *U.L.A.* 1 (2002). “To the extent practicable, the Uniform Securities Act (1985) encourages both greater coordination between federal and state securities law regulation and greater cooperation among states.” UNIF. SEC. ACT prefatory note 1985 (amended 1988).

91. UNIF. SEC. ACT § 501, 7C *U.L.A.* 150. Section 501 “was modeled on Rule 10b-5 adopted under the Securities Exchange Act of 1934 and on Section 17(a) of the Securities Act of 1933.” *Id.* at cmt. 1.

92. Uniform Business & Financial Laws Locator, Cornell University, <http://www.law.cornell.edu/uniform/vol7.html#secur> (last visited Sept. 25, 2008).

93. See, e.g., MD. CODE ANN., CORPS. & ASS'NS § 11-301 (LexisNexis 2007). The language of Maryland's antifraud statute tracks the language of the Uniform

*D. Capital Research & Management Company v. Brown*⁹⁴

The ambiguous scope of state authority under the NSMIA savings clause inevitably created a conflict with its federal preemption provisions.⁹⁵ This conflict surfaced in the *Capital Research* case, where the court was given the opportunity to address the reach of the NSMIA savings clause with respect to prospectus disclosure.⁹⁶ This suit was one of several actions⁹⁷ brought by the California Attorney General, Bill Lockyer, immediately following the passage of a California law that gave the state attorney general unusually broad latitude to prosecute corporate conduct.⁹⁸ These suits focused on the mutual fund industry practice of revenue-sharing,⁹⁹ with Lockyer alleging inadequate disclosure of shelf-space agreements.¹⁰⁰ Lockyer's other enforcement actions focused on broker-dealers,¹⁰¹ including Edward Jones, a broker-dealer that distributed American Funds (Capital Research and Management Co. (CRMC) is the parent company of American Funds (AF)).¹⁰²

Securities Act Section 501 exactly. Compare *id.* with UNIF. SEC. ACT § 501, 7C U.L.A. 150.

94. 53 Cal. Rptr. 3d 770 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).
95. See *id.* at 775.
96. See *id.*
97. See *id.* at 773.
98. See Press Release, Office of the Cal. Attorney Gen., Attorney General Lockyer Launches Investigation of Fraudulent Sales Practices by Mutual Funds (Jan. 2, 2004), <http://ag.ca.gov/newsalerts/release.php?id=567&year=2004>.
99. Perlow, *supra* note 12.
100. *Capital Research*, 53 Cal. Rptr. 3d at 773. "A 'shelf-space' or 'revenue-sharing' agreement is one where a mutual fund complex (such as American Funds) agrees to pay broker-dealers something extra (in addition to loads and other fees) for shelf space (heightened visibility, access to the 'broker-dealers' registered sales representatives, and placement on preferred or recommended lists)." *Id.* at 773 n.4.
101. *Id.* at 773. A broker-dealer is defined as "a person engaged in the business of effecting transactions in securities for the account of others or for his own account." MD. CODE ANN., CORPS. & ASS'NS § 11-101(c)(1) (LexisNexis 2007).
102. State Attorney General Bill Lockyer had already filed suit against Edward Jones, a broker-dealer that distributed American Funds, by the time of the action against CRMC and American Funds Distributors, Inc. (AFD). See Press Release, Office of the Cal. Attorney Gen., Attorney General Lockyer Sues American Funds for Not Telling Investors Truth About Broker Payments (Mar. 23, 2005), <http://ag.ca.gov/newsalerts/release.php?id=586>. The suit against Edward Jones alleged inadequate disclosure of shelf-space payments received from seven mutual fund companies, including American Funds. *People v. Edward D. Jones & Co.*, 65 Cal. Rptr. 3d 130, 133 (2007), *cert. denied*, 2007 Cal. LEXIS 13605 (Nov. 28, 2007).

The *Capital Research* case marked the first time that a state brought an enforcement action against an investment adviser based on a theory of inadequate prospectus disclosure.¹⁰³ The relationship between the mutual fund and investment adviser is such that allowing the state regulator to bring an action against the fund's investment adviser almost guarantees a substantial effect on the fund as well.¹⁰⁴ In effect, the state would arguably be permitted to "creat[e] a new disclosure requirement for mutual funds, above and beyond what the SEC requires."¹⁰⁵

1. Trial Court

In 2004, California state regulators began an investigation into the revenue-sharing¹⁰⁶ practices of CRMC,¹⁰⁷ the parent company of and investment adviser to AF.¹⁰⁸ After months of state investigation without any official action, CRMC filed a declaratory action against the state attorney general.¹⁰⁹ The suit alleged that Attorney General Bill Lockyer's investigations infringed on the SEC's jurisdiction over regulation of prospectus disclosure.¹¹⁰ Lockyer responded by filing an enforcement action against CRMC and American Funds

103. See Resp't Br., at 18–20, *Capital Research & Mgmt. Co. v. Lockyer*, (Cal. Super. 2006), *rev'd sub nom.* *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007) (No. B189249), 2006 WL 3242946; see also Press Release, Office of Cal. Attorney Gen., *supra* note 98, ¶¶ 1, 3.

104. A mutual fund's investment adviser essentially runs the mutual fund, "provid[ing] management, portfolio selection, and administrative services to the fund, for which the adviser is usually compensated based on a percentage of the fund's total assets." *Capital Research*, 53 Cal. Rptr. 3d at 772 n.1.

105. Tom Lauricella, *American Funds Sues Regulator: Company Argues California Is Infringing on SEC's Turf; State Files a Countersuit*, WALL ST. J., Mar. 25, 2005, at C13.

106. Perlow, *supra* note 12.

107. See Lauricella, *supra* note 105, at C13. "CRMC manages AF Fund's 29 mutual funds (with combined assets of about \$600 billion) . . ." *Capital Research*, 53 Cal. Rptr. 3d at 772. American Funds currently has \$900 billion in assets under management. Americanfunds.com, About Us, http://www.americanfunds.com/about/index.htm?r=t_h (last visited Sept. 17, 2008).

108. See Lauricella, *supra* note 105, at C13. The California Attorney General investigated disclosure of revenue-sharing arrangements at other mutual fund companies during that same approximate time period, including Pimco Funds and Franklin Templeton Investments. *Id.*

109. See Joe Morris, *American Goes on the Offensive*, IGNITES, Mar. 28, 2005, http://www.ignites.com/articles/20050328/american_goes_offensive; see also Lauricella, *supra* note 105, at C13. It is "highly unusual" for a mutual fund company to bring a legal action against a regulator. *Id.*

110. Lauricella, *supra* note 105, at C13.

Distributors (AFD),¹¹¹ the “wholesale” broker-dealer distributor arm of AF.¹¹²

The state alleged that CRMC’s and AFD’s participation in undisclosed shelf-space agreements violated California statutes¹¹³ prohibiting misleading statements or omissions of material facts in connection with the sale of securities.¹¹⁴ The trial court characterized the state’s argument as follows: “The gravamen of the Complaint is that the required Disclosure Documents (i.e., the prospectus and SAIs) omitted several material facts that made the statements about other compensation to dealers and execution of portfolio transactions misleading.”¹¹⁵ The California Superior Court ultimately found that CRMC and AFD had “satisfied their burden of proving that Congress, in enacting the NSMIA, intended to preempt state law purporting to govern disclosure requirements in offering

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111. *Capital Research*, 53 Cal. Rptr. 3d at 773. The suit was filed on March 24, 2005, the same day the CRMC and AFD suit was filed. *See id*; *see also* Complaint for Injunctive and Declaratory Relief, *Capital Research & Mgmt. Co. v. Lockyer* (Cal. Super., 2006), *rev'd sub nom.* *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d at 770 (2007) (No. BC 330770), 2006 WL 3242946. The suits were consolidated in April 2005 in the California Superior Court. *See Capital Research*, 53 Cal. Rptr. 3d at 774; *see also* *Capital Research & Mgmt. Co. v. Lockyer*, Nos. BC 330770, BC 330774, 2005 WL 4717680 (Cal. Super. Nov. 22, 2005), *rev'd sub nom.* *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770 (2007).
 112. *Capital Research*, 53 Cal. Rptr. 3d at 772. “AFD distributes AF Fund’s shares through ‘selling group agreements’ with more than 2,000 unaffiliated broker-dealers.” *Id.* “A mutual fund’s shares are sold through various channels, one of which is through third party broker-dealers and their sales representatives.” *Id.* at 772 n.1.
 113. CAL. CORP. CODE §§ 25401, 25216(a) (West 2006). The relevant statutory language states: “It is unlawful for any person to offer or sell a security in this state or buy or offer to buy a security in this state by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” *Id.* § 25401. This is the exact language from the Uniform Securities Act antifraud provision. UNIF. SEC. ACT § 501 (amended 1958), 7B U.L.A. 510 (1985).
 114. *See* Complaint for Injunctive and Declaratory Relief at 3–4, *Capital Research & Mgmt. Co. v. Lockyer* (Cal. Super, Mar. 24, 2005), *rev'd sub nom.* *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770 (2007) (No. BC 330770), 2005 WL 4983333.
 115. Court’s Ruling and Order Re: Defendants’ Demurrer to Complaint of State of California at 9, *Capital Research & Mgmt. Co. v. Lockyer* (Cal. Super. 2006), *rev'd sub nom.* *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770 (2007) (Nos. BC 330770, BC 330774), 2005 WL 4717680.

documents.”¹¹⁶ Therefore, the state did not have the authority to regulate the disclosure of the shelf-space agreements.¹¹⁷

2. Court of Appeals

On appeal, the 2nd Appellate District of the California Court of Appeal overturned the trial court’s decision.¹¹⁸ The court upheld state authority to “impose conditions on the use of AF Fund’s offering documents by its investment adviser [CRMC] and broker-dealers [AFD],” finding that the state’s actions were covered by the express preemption provision in the NSMIA savings clause.¹¹⁹ The court framed the issue as whether the savings clause was able to act as an umbrella, permitting an action “against a covered security’s investment advisor and wholesale broker-dealer who allegedly made inaccurate or inadequate representations to purchasers.”¹²⁰ Congress’s intent in enacting NSMIA, as well as the language, structure, and purpose of the act itself, were therefore the key to establishing the scope of the savings clause.¹²¹

The court determined that “[t]he primary purpose of NSMIA was to preempt state ‘Blue Sky’ laws which required *issuers* to register many securities with state authorities prior to marketing in the state.”¹²² The court continued to place a special emphasis on the usage of the word “issuers,” noting that, “Congress recognized the redundancy and inefficiencies inherent in such a system and passed NSMIA to preclude states from requiring *issuers* to register or qualify certain securities with state authorities.”¹²³ Therefore, the court concluded that NSMIA preempted action against the issuer (American Funds).¹²⁴ At the same time, the court found that NSMIA did not intend to preempt the state from bringing this type of action against American Funds’ investment adviser (CRMC) and distributor (AFD).¹²⁵

From the court’s perspective, Congress had two objectives in enacting NSMIA—“the primary intent to promote national

116. *Id.* at 20.

117. *See Capital Research*, 53 Cal. Rptr. 3d at 771–73.

118. *See id.* at 774.

119. *Id.* at 775.

120. *Id.* at 771–72.

121. *Id.* at 774–75.

122. *Id.* at 775 (emphasis added) (quoting *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 108 (2d Cir. 2001)).

123. *Id.* (emphasis added).

124. *Id.*

125. *See id.* at 778.

uniformity in the securities registration process by preempting state blue sky laws, and the secondary but equally important intent to encourage the continued participation of the states in preventing fraud in securities transactions, particularly with regard to broker-dealers.”¹²⁶ First, the court determined that the state’s actions against CRMC and AFD did not conflict with the primary intent of NSMIA.¹²⁷ Moreover, the state attorney general’s exercise of state police power fulfilled the secondary purpose of NSMIA with respect to preventing broker-dealer fraud.¹²⁸ The court therefore concluded that the action was covered by the express language of the savings clause and thus not preempted.¹²⁹

III. ANALYSIS & IMPLICATIONS

A. *The Purpose of the Savings Clause*

Although NSMIA was “the most significant overhaul of the securities regulatory structure in decades,”¹³⁰ it left ambiguities in many areas.¹³¹ In particular, the precise reach of the antifraud provision remains unclear.¹³² The language of the savings clause preserves state antifraud jurisdiction over not only fraud and deceit, but also over “unlawful conduct by a broker or a dealer.”¹³³ The Act does not define fraud and deceit, nor does it define the standard that should be used to determine what constitutes unlawful conduct.¹³⁴

1. Preemption

The *Capital Research* court did not address the issue of fraud,¹³⁵ but instead analyzed the threshold issue of whether federal law preempted the state attorney general’s action.¹³⁶ As the court noted,

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 775.

130. Press Release, White House, *supra* note 57.

131. See Robert G. Bagnall & Kimble Cannon, *The National Securities Markets Improvement Act of 1996: Summary and Discussion*, 25 SEC. REG. L.J. 3, 4 n.6 (1997); see also Hunt, *supra* note 84.

132. Hunt, *supra* note 84.

133. 15 U.S.C. § 77r(c)(1) (2006).

134. See generally National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C. (2006)).

135. See *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770, 773 n.4 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007). The court specifically

Preemption occurs [in] three ways: (1) where federal law states expressly that state law is preempted; (2) where federal law is so comprehensive that it leaves no room in the covered field for supplementary state regulation; and (3) where there is an actual conflict between state and federal law.¹³⁷

CRMC argued that the state was expressly preempted from bringing the suit,¹³⁸ because NSMIA expressly preempts state regulation of covered securities and the issuers of those securities.¹³⁹ This includes disclosure documents, such as prospectuses, that are distributed by the issuers of covered securities.¹⁴⁰ However, the State Attorney General Lockyer sued CRMC, the investment adviser, and AFD, the distributor, as opposed to American Funds, the *issuer* of the covered securities.¹⁴¹ Further, Lockyer argued that the state's complaint only alleged fraud on the part of CRMC and AFD, the investment adviser and broker-dealer, without directly challenging the adequacy of American Funds' disclosure documents.¹⁴²

The court determined that NSMIA expressly preempted Lockyer's enforcement action, recognizing that "the Attorney General's enforcement action seeks relief that would impose conditions on the use of AF Fund's offering documents by its investment adviser and broker-dealers—and it is thus indisputably covered by this express preemption provision."¹⁴³ The court's analysis compared *Capital Research* to a previous New York case in which the court found that state common law fraud claims were covered by the express

noted, "[t]he legality of the shelf-space agreements is not before us on this appeal."
Id.

136. *See id.* at 774–75.

137. *Id.* (citing Cal. Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272, 280–81 (1987)).

138. Capital Research & Mgmt. Co. v. Lockyer, Nos. BC 330770, BC 330774, 2005 WL 4717680 (Cal. Super. Nov. 22, 2005). The trial court rejected the express preemption argument, but accepted CRMC's alternative theory of implied preemption. *See id.* Lockyer argued that a "presumption against preemption" exists where the state's enforcement action stems from its police powers. *Capital Research*, 53 Cal. Rptr. 3d at 775. However, CRMC contended that the "significant history of federal presence in the field of securities regulation" prevented any such presumption from existing. *Id.*

139. *See* 15 U.S.C. § 77r (2006).

140. *See id.*

141. *Capital Research*, 53 Cal. Rptr. 3d at 774.

142. *Id.*

143. *Id.* at 775.

preemption provision in the savings clause.¹⁴⁴ Congress clearly intended the savings clause to cover state common law fraud claims.¹⁴⁵ However, *Capital Research* did not involve a question of common law fraud, but rather a question of state enforcement action against investment adviser conduct that is federally regulated and historically acceptable under such regulation.¹⁴⁶ The court admitted that the state's action would impact the disclosure documents of a covered security.¹⁴⁷ However, following this admission, the court went on to declare that a preemption analysis was not even necessary.¹⁴⁸ Rather, the pivotal issue in the case was "whether the savings clause applies, not whether we are dealing with express or implied preemption."¹⁴⁹

The court used the language of the NSMIA savings clause to avoid a preemption analysis.¹⁵⁰ Regardless of whether the state's actions were expressly preempted by the main preemption provision of NSMIA, the court concluded that the state attorney general's action included all of the necessary factors for enforcement under the savings clause.¹⁵¹ Namely, the action was "(1) an enforcement action[,] (2) brought by a state officer performing the functions of a securities commission, (3) under [state] law[,] (4) with regard to fraud and deceit[,] (5) in connection with covered securities transactions."¹⁵² Therefore, the Attorney General had the authority under the savings clause to bring actions against the investment adviser and distributor "to force them to disclose their oral agreements with the shelf-space brokers" even though "the Attorney General cannot sue AF Fund to force it to change its disclosure documents."¹⁵³ The court reached this conclusion by declining to find an ambiguity in either the preemption provision of NSMIA or in its savings clause.¹⁵⁴ In analyzing the legislative intent behind

144. *Id.* at 775 n.6 (citing *Zuri-Invest AG v. Natwest Fin. Inc.*, 177 F. Supp. 2d 189, 194 (S.D.N.Y. 2001)).

145. *See infra* Part III.A.2.

146. *See Capital Research & Mgmt. Co. v. Lockyer*, Nos. BC 330770, BC 330774, 2005 WL 4717680 (Cal. Super. Nov. 22, 2005).

147. *See Capital Research*, 53 Cal. Rptr. 3d at 775.

148. *See id.* at 775 n.6.

149. *Id.*

150. *Id.* at 775–76.

151. *See id.* at 776.

152. *Id.*

153. *Id.* (emphasis from original omitted).

154. *Id.*

NSMIA,¹⁵⁵ the court further determined that the application of the savings clause to the state's action in this case was "entirely consistent with the purpose of NSMIA."¹⁵⁶

2. Legislative History

Several aspects of NSMIA's legislative history contradict the court's finding of consistency between the state's action and the purpose of NSMIA. Rather, NSMIA's legislative history supports the assertion that Congress intended NSMIA to *preclude* this type of state action. According to the Senate Committee record, the savings clause was intended to preserve the states' ability "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 any securities transactions."¹⁵⁷ This would include covered securities that Section 18 would normally preempt from state regulation.¹⁵⁸

However, the Committee specifically contemplated and discussed the possibility that states would attempt to reassert regulatory jurisdiction over covered securities disclosure (such as prospectuses).¹⁵⁹ The Committee Report notes that "[t]he Committee intends to eliminate States' authority to require or otherwise impose conditions on the disclosure of any information for covered securities."¹⁶⁰ The Committee foresaw the possibility of a state regulator

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 States believes is necessary or that includes information that a State regulator criticizes based on the format or content thereof,¹⁶¹

155. "The issue [of federal preemption] is one of Congressional intent, and our task is to divine that intent by examining NSMIA's language as well as its structure and purpose." *Id.* at 774 (citations omitted).

156. *Id.* at 776.

157. H.R. REP. NO. 104-622, at 33-34 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3896.

158. *See id.* at 34, *reprinted in* 1996 U.S.C.C.A.N. 3877, 3896.

159. *See id.*, *reprinted in* 1996 U.S.C.C.A.N. 3877, 3896-97.

160. *Id.*

161. *Id.*, *reprinted in* 1996 U.S.C.C.A.N. 3877, 3896.

and indicated that the savings clause “precludes State regulators” from taking such action.¹⁶²

The Committee Report goes on to offer examples of the limited circumstances related to prospectus disclosure within which the states would have the power to exercise their antifraud enforcement authority.¹⁶³ For instance, states would be permitted to pursue action alleging that a prospectus of a covered security “contained fraudulent financial data or failed to disclose that principals in the offering had previously been convicted of securities fraud.”¹⁶⁴ The examples given are also considered “fraud and deceit” under existing federal regulations.¹⁶⁵ The Committee could have easily cited a violation of a state statute that was not also a federal violation. This would have clarified how the legislature intended the “fraud or deceit, or unlawful conduct” portion of the savings clause to be administered.¹⁶⁶ In fact, given that the entire purpose of NSMIA was to promote uniformity of securities regulation,¹⁶⁷ it seems reasonable to assume the Committee would have specifically addressed this potential conflict.

The Committee Report notes that “it is conceivable that State laws regarding fraud and deceit could serve as the basis of a judgment.”¹⁶⁸ Even so, this language does not unequivocally grant states the authority to regulate simply because they determine there is evidence of fraud or deceit under state law. The phrase “it is conceivable” highlights the Committee’s hesitancy to provide a determinate foundation for the states to define fraud and deceit.¹⁶⁹ The Committee record speaks to the existence of a balancing act that seeks to preserve state power to police against fraud, while preventing possible future attempts to defeat the purpose of NSMIA.¹⁷⁰

Most importantly, the Committee takes great care to note that Section 18 precludes state use of the savings clause as a loophole to

162. *Id.*

163. *See id.*, reprinted in 1996 U.S.C.C.A.N. 3877, 3897.

164. *See id.*

165. *See id.* at 33, reprinted in 1996 U.S.C.C.A.N. 3877, 3895.

166. *See supra* note 7 and accompanying text.

167. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102(b), 110 Stat. 3416, 3420 (codified as amended in scattered sections of 15 U.S.C. (2006)).

168. H.R. REP. NO. 104-622, at 34, reprinted in 1996 U.S.C.C.A.N. 3877, 3897.

169. *See id.*

170. *See id.* at 30, reprinted in 1996 U.S.C.C.A.N. 3877, 3892.

force covered securities to comply with state disclosure laws.¹⁷¹ The Committee indicates that it intended “to prevent the States from indirectly doing what they have been prohibited from doing directly.”¹⁷² There is no point to NSMIA’s federal preemption provision if states are permitted to use the savings clause as a backdoor.¹⁷³ The Committee’s notes illustrate that the members foresaw this possibility of the savings clause as a catchall vehicle for states to reassert regulatory authority preempted by NSMIA.¹⁷⁴ This is why they took care to specifically indicate in the record that this interpretation would be contrary to the legislative intent behind the passage of the Act.

3. Implications of the Failure to Define Fraud

One of the major weaknesses of the savings clause is Congress’s failure to define fraud, while extending state authority over “fraud or deceit, [and] unlawful conduct.”¹⁷⁵ This phrase essentially gives each state the ability to define the scope of its authority. By creating a law that makes certain conduct unlawful, the state thereby also creates jurisdiction over that conduct through the “unlawful conduct” portion of the savings clause.¹⁷⁶ This creates an extremely broad umbrella for state enforcement actions.

Attorney General Lockyer took advantage of this umbrella, bringing the *Capital Research* suit under a 2004 California statute.¹⁷⁷ In determining the scope of the state’s authority, the *Capital Research* court noted that NSMIA’s express preemption provision

171. See *id.* at 34, reprinted in 1996 U.S.C.C.A.N. 3877, 3896 (“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 States [sic] believes is necessary or that includes information that a State regulator criticizes based on the format or content thereof.”).

172. *Id.*

173. A prominent securities law attorney later commented regarding the *Capital Research v. Brown* case that, “[t]he end result is to achieve in the industry what the NSMIA says you can’t do directly.” Tom Leswing, *Calif. Overstepping in American Funds Case*, IGNITES, Apr. 25, 2007, http://www.ignites.com/articles/print/20070425/calif_overstepping_american_funds_case. This appears to be exactly what the Committee intended to avoid. See also H.R. REP. NO. 104-622, at 34, reprinted in 1996 U.S.C.C.A.N. 3877, 3896.

174. H.R. REP. NO. 104-622, at 34, reprinted in 1996 U.S.C.C.A.N. 3877, 3896–97.

175. 15 U.S.C. § 77r(c)(1) (2006).

176. See *id.*

177. CAL. CORP. CODE §§ 25401, 25216(a) (West 2006).

prohibits state action that even indirectly limits the use of a mutual fund prospectus.¹⁷⁸ However, the state's enforcement action fell under the express exception provided by the savings clause.¹⁷⁹ The court, in part, based this determination on analysis of the following savings clause language: "[e]xcept as otherwise provided in this section . . ." ¹⁸⁰ The court interpreted this statement to mean that the savings clause should be looked at "to determine the true scope of the prohibition."¹⁸¹ However, the court did not similarly examine the introductory phrase of the savings clause.¹⁸²

The language of the savings clause does not explicitly define "fraud or deceit,"¹⁸³ but the clause's introductory phrase sheds some light on how the legislature intended "fraud" to apply.¹⁸⁴ The clause begins, "[c]onsistent with this section, the securities commission . . . shall retain jurisdiction."¹⁸⁵ The wording "[c]onsistent with this section"¹⁸⁶ indicates that, in order for conduct to fall within the category of "fraud," which states are permitted to regulate, the regulated activity must be "grounded in conduct other than that which states are expressly preempted from regulating more generally."¹⁸⁷ For the most part, states are expressly preempted from regulating a broker-dealer's offer or sale of securities "based upon a merits standard relating to terms and issuer characteristics."¹⁸⁸ However, the state antifraud jurisdiction would still cover broker-dealers who "are acting unlawfully if they do not observe a suitability standard, which focuses on the fitness of securities for a particular purchaser."¹⁸⁹ There is a key differentiation between regulation of broker-dealer conduct at the point of sale as opposed to disclosure language in a

178. *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770, 775 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).

179. *People v. Edward P. Jones & Co.*, 65 Cal. Rptr. 3d 130, 139 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 13605 (Nov. 28, 2007).

180. National Securities Markets Improvement Act of 1996, 15 U.S.C. § 77r(a) (2006).

181. *Edward Jones*, 65 Cal. Rptr. 3d at 139.

182. *See id.* at 138–40.

183. *See* 15 U.S.C. § 77r(c)(1).

184. *See id.*

185. *Id.*

186. *Id.*

187. RONALD J. COFFEY, REFORM FOLLOWS FUNCTION: EFFICIENT FEDERALISM? 28 (1997), <http://www.law.case.edu/faculty/documents/coffey/top.html#DIPLIC> (discussing the legislative intent behind interpretation of the NSMIA antifraud savings clause).

188. *Id.*; *see also* 15 U.S.C. § 77r(a).

189. COFFEY, *supra* note 187, at 28.

mutual fund prospectus; the broker-dealer has no control over the prospectus language.¹⁹⁰

If the language of the savings clause remains as is, states will be able to effectively regulate disclosure in mutual fund prospectuses as occurred in *Capital Research*.¹⁹¹ Legal action against an investment adviser or broker-dealer for distributing a fund prospectus that the state determines does not contain adequate disclosure language has the indirect, but substantial, effect of regulating the contents of that prospectus. The majority of mutual funds are distributed through broker-dealers.¹⁹² The California decision essentially determined that shares of AF could not be distributed in California until the disclosure language was changed to comply with California state law.¹⁹³ In effect, *Capital Research* allows the state regulator to indirectly force mutual funds listed as “covered securities” under NSMIA to comply with state disclosure requirements.¹⁹⁴

Capital Research turned on whether the broker-dealer and investment adviser could be held liable for the disclosure in a mutual fund prospectus or lack thereof.¹⁹⁵ The extent of either party’s disclosure obligation can be interpreted as either independent of or dependent on the mutual fund prospectus disclosure. If independent, then this obligation would exist regardless of how comprehensively the prospectus disclosed the shelf-space agreements. However, if their disclosure obligations are dependent, then adequate disclosure in the prospectus would seem to relieve the investment adviser and broker-dealer of any respective duty to disclose.

Since the *Capital Research* court spent a substantial part of the opinion discussing the lack of mutual fund prospectus disclosure,¹⁹⁶ it

190. See Robert A. Robertson, *In Search of the Perfect Mutual Fund Prospectus*, 54 BUS. LAW. 461, 471–75 (1999).

191. 53 Cal. Rptr. 3d 770, 776–78 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).

192. See generally Victoria Leonard-Chambers & Michael Bogdan, Investment Co. Inst., *Why Do Mutual Fund Investors Use Professional Financial Advisers?*, 16 RESEARCH FUNDAMENTALS 1, 2 (Apr. 2007), available at <http://members.ici.org/getPublicPDF.do?file=fun1601>.

193. See Brief of Respondent at n.2, *Edward Jones & Co. v. Sup. Ct. of Cal.*, No. C053407 (Ct. App. Jan. 29, 2007), 2007 WL 623751; see also *Capital Research*, 53 Cal. Rptr. 3d at 777–78.

194. See 15 U.S.C. § 77 r(a)-(b) (2006). Attorneys interviewed by the *Wall Street Journal* regarding Lockyer’s pursuit of mutual fund revenue-sharing disclosure indicated that, “Mr. Lockyer was essentially creating a new disclosure requirement for mutual funds, above and beyond what the SEC requires.” Lauricella, *supra* note 105, ¶ 16.

195. See generally *Capital Research*, 53 Cal. Rptr. 3d 770.

196. See generally *id.*

is clear that the court perceives the two sets of obligations as interrelated. If the investment adviser's and broker-dealer's obligations were not tied to the mutual fund's obligation, then the disclosure in the prospectus would be a non-issue. By taking advantage of this interdependent relationship, the court's expansion of the state's authority under the antifraud savings clause effectively enables the state to regulate the mutual fund prospectus disclosure through regulation of the investment adviser or broker-dealer.

The *Capital Research* case is particularly disturbing because it is the first time since the enactment of NSMIA that a state has successfully brought an enforcement action against a "covered" investment adviser.¹⁹⁷ The court clearly stated that its holding did not apply to the fund company directly, indicating that "[i]t is the wholesale distributor's conduct that is at issue in this case (and the enabling conduct of the adviser), not the sufficiency of the disclosures made by AF."¹⁹⁸ However, the court did recognize that "this action, if successful, might indirectly encourage AF Fund to alter its disclosure documents."¹⁹⁹ The court uses the word "might,"²⁰⁰ but the words "almost certainly" would be more accurate. Although the state was unable to bring an action directly against AF, the court acknowledged that they would effectively be forced to alter their prospectus language.²⁰¹ The court's decision accomplished an admirable end: increasing the transparency of prospectus disclosure. However, the means that the court used to reach its decision not only defeats the primary purpose of NSMIA, but also exacerbates the underlying problem of how best to encourage meaningful disclosure of conflicts of interest.

B. *Mutual Fund Prospectus Disclosure*

1. Disclosure of Revenue-Sharing Conflicts of Interest

The controversy surrounding the state's authority to compel investment adviser disclosure of revenue-sharing agreements stems from the basic conflicts of interest associated with such agreements.

197. See Josh Friedman, *Court Backs American Funds in Suit*, L.A. TIMES, Nov. 16, 2005, at C4 ("[A] win for Lockyer could mean new regulatory standards for an industry historically governed by federal rules.").

198. *Capital Research*, 53 Cal. Rptr. 3d at 776.

199. *Id.*

200. *Id.*

201. See *id.*

In *Capital Research*,²⁰² the California Attorney General described the relevant revenue-sharing agreements as “a potential conflict of interest because they raised the risk that brokers would push the funds that paid their firms the most, rather than those most appropriate for their clients.”²⁰³ In general, state securities regulations are targeted at preventing investor fraud.²⁰⁴ As a result, these conflicts of interest invariably attract the attention of state securities regulators because of the potential for abuse in the investment sales and distribution process.²⁰⁵

The average mutual fund investor heavily relies on a financial professional’s advice for help choosing his or her mutual fund investments.²⁰⁶ According to a 2006 Investment Company Institute (ICI) survey, many investors have a difficult time understanding the information in typically lengthy and complicated mutual fund prospectuses.²⁰⁷ In particular, 59% of recent fund investors “describe[d] mutual fund prospectuses as very or somewhat difficult to understand.”²⁰⁸ Roughly 65% indicated that “prospectuses contain too much information.”²⁰⁹ Given that only 8% of investors in the survey read the entire prospectus for each of the mutual funds they purchased,²¹⁰ it is not surprising that many investors rely on advice from financial professionals when choosing a new investment. In fact, 73% of recent fund investors consulted a professional financial adviser before their most recent mutual fund purchase, with 60%

202. *Id.*

203. Friedman, *supra* note 197, ¶ 5.

204. The regulatory group that represents state securities administrators, NASAA, describes its primary mission as “investor protection.” About NASAA, http://www.nasaa.org/About_NASAA/ (last visited Sept. 23, 2008) (“Organized in 1919, the North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection.”).

205. *Cf. Perlow, supra* note 12.

206. *See generally* Leonard-Chambers & Bogdan, *supra* note 192 (discussing the rationale behind mutual fund investors’ use of professional advisers).

207. SANDRA WEST & VICTORIA LEONARD-CHAMBERS, INVESTMENT CO. INST., UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 23 (2006), available at http://members.ici.org/getPublicPDF.do?file=investor_prefs0806.

208. *Id.*

209. *Id.*; see also Diya Gullapalli, *In the Top Cop’s Office in Washington, The Search for More Fund Skeletons*, WALL ST. J., Feb. 5, 2007, at R1, R5 (interview with SEC Chairman Andrew Donohoe). Donohoe described printing out “some of the documents that we would expect an investor might be interested in when making an investment decision, including the prospectus, statement of additional information, annual report and semi-annual reports. For one fund it was over 500 pages” *Id.*

210. WEST & LEONARD-CHAMBERS, *supra* note 207, at 25.

indicating that their adviser was the most important source of information in the decision to purchase.²¹¹

This relationship between investor and financial professional can create a conflict of interest. The investor trusts the financial professional to act in the investor's best interest. However, the existence of a shelf-space agreement can produce a situation where the investor's personal interest may conflict with that of the financial professional.²¹² Some revenue-sharing agreements give the financial professional a higher commission for investor purchases of certain preferred mutual funds.²¹³ The average investor would not recognize that this conflict of interest exists. This arrangement may be disclosed in the fund's statement of additional information (SAI), as in *Capital Research*,²¹⁴ however, most investors relying on a financial professional do not read the lengthy, complex disclosure document.²¹⁵ Even if the investor did read the SAI disclosure, he or she would still be unlikely to understand the mechanics of a shelf-space agreement and the conflicts of interest that may arise. From this perspective, state regulators have a valid justification for viewing a financial adviser's failure to inform a potential investor of a shelf-space agreement as a form of fraud.

A SEC examination sweep in 2003 found that shelf-space agreements were a widely used form of revenue-sharing agreements.²¹⁶ Fourteen out of fifteen broker-dealers examined were receiving monetary compensation for participation in some form of

211. *Id.* at 17.

212. See Perlow, *supra* note 12.

213. See, e.g., *People v. Edward D. Jones & Co.*, 65 Cal. Rptr. 3d 130, 132–33 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 13605 (Nov. 28, 2007).

214. *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770, 772 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).

215. WEST & LEONARD-CHAMBERS, *supra* note 207, at 25. In addition, the SAI is only required to be provided to an investor on request. SEC, Information Available to Investment Company Shareholders, <http://www.sec.gov/answers/mfinfo.htm> (last visited Oct. 31, 2008).

216. *Oversight Hearing on Regulatory Reforms to Protect Our Nation's Mutual Fund Investors: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 28029 (2003) (statement of William H. Donaldson, SEC Chairman); see also *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing Before the Subcomm. on Financial Management, the Budget & International Security of the S. Comm. on Governmental Affairs*, 108th Cong. 6–7 (2004) [hereinafter *Mutual Fund Oversight Hearing*] (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

shelf-space agreement.²¹⁷ The compensation from these agreements ranged from 5 to 40 basis points at the time that the investor purchased the mutual fund shares and ongoing compensation of 0 to 25 basis points based on the amount of the investor's mutual fund assets that continued to be invested through the broker-dealer.²¹⁸ Thirteen out of the fifteen brokers "appear to have favored the sale of the revenue sharing funds by providing increased access and visibility in the broker-dealer's sales networks (e.g., listings on firms' websites, access to sales staff, promotional material sent to customers, inclusion on firms' recommended lists)."²¹⁹ In addition to providing these supplementary services, approximately half of the broker-dealers gave extra compensation to registered representatives for sales of these preferred mutual funds—more compensation than was normally received for sales of other nonpreferred mutual funds.²²⁰ This second form of remuneration is much more troublesome. It gives the individual registered representative a direct financial incentive to sell a particular mutual fund, for reasons beyond suitability for the investor who is relying on the representative for sound, objective financial advice. Moreover, the mutual funds involved in the shelf-space arrangements generally provided only broad disclosure of the existence of possible broker-dealer compensation related to sales and distribution.²²¹

In *Capital Research*, AFD asserted that this additional shelf-space compensation was disclosed in the prospectus.²²² The prospectus language stated that AFD "may pay[] or sponsor informational meetings for [] dealers as described in the [SAI]."²²³ In addition, the SAI disclosed that AFD

at its expense (from a designated percentage of its income), currently provides additional compensation to dealers. Currently these payments are limited to the top 100 dealers who have sold shares of [AF Fund] These payments are based principally on a pro rata share of a qualifying

217. *Mutual Fund Oversight Hearing*, *supra* note 216 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

218. *Id.* at 6.

219. *Id.* at 7.

220. *Id.*

221. *See, e.g.*, *People v. Edward D. Jones & Co.*, 65 Cal. Rptr. 3d 130, 133 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 13605 (Nov. 28, 2007).

222. *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770, 772 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).

223. *Id.*

dealer's sales. [AFD] will, on an annual basis, determine the advisability of continuing these payments.²²⁴

AFD explained the shelf-space arrangement as merely additional compensation "to defray the costs of training the dealers' registered representatives . . . who help dealers match appropriate investments to their clients' long term investment needs."²²⁵ In contrast, the California Attorney General characterized the arrangements as "kickbacks"²²⁶ that "adversely affect[ed] the relationship between broker-dealers and mutual funds on the one hand, and their customers on the other."²²⁷

2. SEC Enforcement Actions

Proponents of increased state regulatory power often portray state encroachment on SEC regulatory territory as a justified response to the SEC's ineffective monitoring of the financial services industry.²²⁸ However, the SEC has been very active in addressing the issue of revenue-sharing disclosure.²²⁹ SEC enforcement actions have generally focused on violations of Rule 10b-10 of the Securities Exchange Act of 1934.²³⁰ Under this rule, any third party compensation received by a broker-dealer for a client's mutual fund purchase must be disclosed in writing.²³¹ The SEC requirements differ from the *Capital Research* approach in that the broker-dealer's

224. *Id.*

225. *Id.*

226. "[W]hen you look beneath the cloak of legitimacy, the payments are little more than kickbacks to buy preferential treatment." Press Release, Office of the Cal. Attorney Gen., Attorney General Lockyer Sues American Funds For Not Telling Investors Truth About Broker Payments, at 1 (Mar. 3, 2005), <http://ag.ca.gov/newsalerts/release.php?id=586>.

227. *Capital Research*, 53 Cal. Rptr. 3d at 773.

228. Cf. Christopher R. Lane, *Halting the March Toward Preemption: Resolving Conflicts Between State & Federal Securities Regulators*, 39 NEW ENG. L. REV. 317, 329 (2004).

229. The North American Securities Administrators Association (NASAA) described nine different successful enforcement actions filed by the SEC during a three-year period from 2003 to 2006 in their *amicus curiae* brief in support of the California Attorney General. Brief for NASAA, Inc. as Amicus Curiae Supporting Appellants at 9-10 & n.10, *Capital Research & Mgmt. Co. v. Lockyer*, 53 Cal. Rptr. 3d 770 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007) (No. B189249), 2006 WL 3446894.

230. See, e.g., Perlow, *supra* note 12.

231. 17 C.F.R. § 240.10b-10(a) (2008). This compensation includes revenue-sharing payments. Perlow, *supra* note 12.

obligation to disclose is satisfied by delivery of a prospectus containing adequate disclosure.²³²

a. American Funds & Edward Jones

The SEC investigations of American Funds and Edward Jones occurred during the same timeframe as the suits brought by the California Attorney General.²³³ The SEC's three-year scrutiny of American Funds centered on allegations of directed brokerage,²³⁴ rather than improperly disclosed shelf-space agreements. The SEC maintained that American Funds "had for years paid brokerages inflated trading commissions as a reward for pushing their brokers to sell the company's funds."²³⁵ The SEC finally abandoned the investigation in October 2007, without filing a case against the mutual fund complex.²³⁶

In contrast, the SEC's investigation of Edward Jones for improper disclosure of revenue-sharing agreements resulted in a \$75 million settlement.²³⁷ The SEC ultimately found that Edward Jones had failed to disclose the payments that it was receiving from seven preferred mutual fund families, including American Funds, in exchange for promoting those funds to Edward Jones's clients.²³⁸ California Attorney General Locker referred to the settlement as "inadequate"²³⁹ in spite of the \$75 million payment and Edward Jones's creation of a disclosure document detailing compensation from the seven preferred mutual fund families.²⁴⁰

232. Delivery and Disclosure Requirements, Exchange Act Release No. 13,508, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143, at 87,931 n.41 (May 5, 1977).

233. Tom Petrino, *SEC Eyes Fund Firm's Trade Costs*, L.A. TIMES, Mar. 31, 2005, at C1.

234. See Press Release, SEC, Edward Jones to Pay \$75 Million to Settle Revenue Sharing Charges (Dec. 22, 2004), <http://www.sec.gov/news/press/2004-177.htm>. Directed brokerage refers to arrangements where "a fund directs the execution of a portion of the fund's trades through a particular broker-dealer. In exchange for those brokerage commissions, the broker-dealer agrees to pay certain fund expenses, provide services to the fund, or provide a cash rebate to the fund through a commission recapture program." *Mutual Fund Oversight Hearing*, *supra* note 216, at 12 (statement of Marc E. Lackritz, President, Securities Industry Association).

235. Petrino, *supra* note 233.

236. *Id.*

237. See Press Release, SEC, *supra* note 234. The settlement was a joint settlement agreed to by the SEC, NASD, and the NYSE. *Id.*

238. *Id.*

239. Laura Johannes, John Hechinger & Deborah Solomon, *Edward Jones Agrees to Settle Host of Charges*, WALL ST. J., Dec. 21, 2004, at C1.

240. Chris Frankie, *Edward Jones Reveals Revenue-Sharing Details*, IGNITES, Jan. 14, 2005, ¶¶ 1-2, <http://www.ignites.com/articles/print/20050114/>

b. *Other SEC enforcement actions*

i. Hartford Funds

The SEC brought a successful enforcement action against Hartford Funds in late 2006 for misleading disclosure of shelf-space agreements in fund prospectuses.²⁴¹ This differed from the Edward Jones investigation in that the SEC did not allege improper disclosure on the part of the broker-dealer.²⁴² Rather, the issue was that the prospectus language contained statements that were false and misleading.²⁴³ The prospectus represented that shelf-space compensation to broker-dealers was paid out of the revenue of the mutual fund company and the distributor, as opposed to coming from the fund's assets.²⁴⁴ The SEC found that the disclosure statements were misleading because Hartford Investment and Hartford Distribution sometimes used brokerage commissions from transactions within the fund portfolio of investments as compensation to shelf-space partners.²⁴⁵ Revenue from portfolio transactions belongs to the fund, and investors own the mutual fund shares; therefore, the SEC determined that the additional compensation was, in fact, paid by Hartford Fund investors.²⁴⁶

ii. Franklin Templeton

The SEC also successfully pursued the investment adviser and distributor for Franklin Templeton mutual funds with regard to their practice of using fund assets to compensate broker-dealers for shelf space.²⁴⁷ From 2001 to 2003, Franklin Templeton maintained shelf-

edward_jones_reveals_revenue_sharing_details; *see also* Edward Jones, Preferred Fund Families, Fee Disclosures and Revenue Sharing, http://www.edwardjones.com/en_US/products/investments/mutual_funds/preferred/index.html (last visited Oct. 31, 2008).

241. *In re* Hartford Inv. Fin. Servs., LLC, Exchange Act Release No. 54,720, [2006-2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,712, ¶¶ 83,766–83,767 (Nov. 8, 2006).

242. *Compare id. with* Press Release, SEC, *supra* note 234.

243. *In re* Hartford Inv. Fin. Servs., LLC, Exchange Act Release No. 54,720, [2006-2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,712, ¶¶ 83,766–83,767 (Nov. 8, 2006).

244. *Id.* ¶ 83,768. The prospectus language disclosed that additional compensation was paid to broker-dealers but then specifically stated that “[t]his additional compensation is not paid by you.” *Id.* ¶¶ 83,767–83,768.

245. *Id.* ¶¶ 83,767–83,768.

246. *See id.* ¶ 83,768.

247. Press Release, SEC, Franklin Advisers and Franklin Templeton Distributors to Pay \$20 Million to Settle Charges Related to Use of Brokerage Commissions to Pay for Shelf Space (Dec. 13, 2004) [hereinafter Franklin Templeton Press Release],

space agreements with 39 broker-dealers.²⁴⁸ Although the shelf-space agreements themselves were permitted, Franklin Templeton used fund assets, in the form of brokerage commissions, to compensate those broker-dealers.²⁴⁹ The SEC action centered on Franklin Templeton's failure to disclose this use of fund assets.²⁵⁰ The *Capital Research* case differs from the Franklin Templeton situation in that American Funds used its own assets, rather than the assets of the funds, as compensation for shelf-space agreements with Edward Jones and other broker-dealers.²⁵¹

C. Possible Disclosure Solutions

The continuing overlap between state and federal regulation of revenue-sharing agreements is symptomatic of an underlying problem in the financial industry. Regulation of disclosure will continue to be an issue until the industry as a whole improves its methods of communicating information about conflicts of interest in the sales and distribution process. The use of visible, plain English disclosure would resolve the controversy surrounding disclosure of revenue-sharing agreements and reduce the need for regulatory enforcement.

Several different forms of disclosure have been proposed in the past five years, including disclosure on mutual fund purchase confirmations,²⁵² enhanced disclosure in a more user-friendly Form ADV,²⁵³ and disclosure in a summary prospectus.²⁵⁴ As SEC Director Andrew Donohoe commented in a 2007 *Wall Street Journal* interview, "[w]e can't mandate that people read disclosures. What we can do is to require that the disclosures are more meaningful to them."²⁵⁵ The three forms of disclosure listed above take different approaches, but they all share the same goal of making disclosure

<http://www.sec.gov/news/press/2004-168.htm>. Franklin Templeton agreed to pay a \$20 million penalty as part of a settlement with the SEC in December 2004. *Id.* California Attorney General Lockyer had also brought an action against Franklin Templeton, resulting in an \$18 million settlement the month before Lockyer filed the suit against Edward Jones. Gillian Flaccus, *Attorney General Files Fourth Suit Against Calif. Brokers*, ASSOCIATED PRESS, (L.A.), Mar. 25, 2005, ¶ 11.

248. Franklin Templeton Press Release, *supra* note 247.

249. *See id.*

250. *Id.*

251. *See* *Capital Research & Mgmt. Co. v. Brown*, 53 Cal. Rptr. 3d 770, 772 (Ct. App. 2007), *cert. denied*, 2007 Cal. LEXIS 5149 (May 16, 2007).

252. *See infra* Part III.C.1.

253. *See infra* Part III.C.2.

254. *See infra* Part III.C.3.

255. Gullapalli, *supra* note 209, at R1, ¶ 34.

more meaningful to investors. Each form, however, has different advantages and drawbacks associated with its implementation.

1. Disclosure on Mutual Fund Purchase Confirmations

In 2005, the SEC proposed a rule that would have mandated the inclusion of substantial disclosure on each mutual fund trade confirmation.²⁵⁶ Brokers are normally required to disclose the source and amount of compensation they receive from a sale of a security to an investor—this is not the case with the sale of mutual fund shares.²⁵⁷ The proposed disclosure would have required confirmations to contain detailed language discussing, for example, the amount of any front-end sales loads, estimates of contingent deferred sales loads, 12b-1s, commissions received by the broker, as well as disclosure of revenue-sharing agreements between the broker-dealer and the mutual fund company.²⁵⁸ Disclosure of revenue-sharing agreements, such as shelf-space agreements, would be expressed “on the basis of the firm’s sales on behalf of the fund complex, as a percentage of the total net asset value represented by the broker-dealer’s total sales of mutual funds within the complex over the four most recent calendar quarters, updated each calendar quarter.”²⁵⁹ The broker-dealer would also have to disclose “the total dollar amount of revenue sharing or portfolio brokerage commissions that the firm may expect to receive in connection with the transaction, calculated by multiplying that percentage by the net amount of the transaction.”²⁶⁰

Disclosure located on a confirmation is arguably more easily and more frequently seen by the investor. This is in contrast to disclosure

256. See Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Certain Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, 70 Fed. Reg. 10,521 (proposed Mar. 4, 2005) (codified at 17 C.F.R. pts. 239, 240 & 274) [hereinafter Proposed Confirmation Disclosure Rule].

257. See *Mutual Fund Oversight Hearing*, *supra* note 216 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

258. See Letter from George R. Kramer, Sec. Indus. Ass’n, to Jonathan G. Katz, SEC Sec’y, Re: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, File No. S7-06-04, at 4–5 (Apr. 12, 2004), available at <http://www.sec.gov/rules/proposed/s70604/sia041204.pdf>. The SIA’s comment letter suggested layered disclosure similar to that of the newly proposed summary prospectus; see *infra* Part III.C.3.

259. Kramer, *supra* note 258, at 6.

260. *Id.* Broker-dealers would be required to update this information each quarter within a 30-day window. *Id.*

located in the prospectus, which most investors do not read in full,²⁶¹ or the SAI, which does not need to be given to an investor unless specifically requested.²⁶² However, this approach is problematic in that the cost to implement personalized disclosure, both initially and on an ongoing basis, may be prohibitive.²⁶³ There are also competitive issues with listing the specific amount of revenue-sharing.²⁶⁴ Equally important, this type of disclosure is not conducive to allowing investors to easily make comparisons between various funds or investment scenarios.²⁶⁵ Disclosure of different fees and expenses, when placed on a mutual fund confirmation, is transaction-specific, meaning that it only applies to the particular transaction in question.²⁶⁶

2. Enhanced Form ADV II Disclosure

Another proposed rule involves the implementation of a plain English, narrative Form ADV.²⁶⁷ Mutual fund investors would receive the “narrative brochures” at the time of their first purchase of that mutual fund, and then annually on an ongoing basis.²⁶⁸ The new disclosure would include any violation of securities laws, as well as the advisers’ conflicts of interest with clients.²⁶⁹ One advantage to this form of disclosure is the anticipated low cost of implementation.²⁷⁰ Other than costs associated with the initial drafting, the new Form ADV disclosure is not expected to require significant expenditures.²⁷¹ However, this form of disclosure would primarily focus on fees and conflicts of interest associated with the investment adviser.²⁷² It is unlikely that there would be meaningful

261. See WEST & LEONARD-CHAMBERS, *supra* note 207, at 25.

262. See SEC, Information Available to Investment Company Shareholders, *supra* note 215.

263. See Proposed Confirmation Disclosure Rule, *supra* note 256, at 10,522.

264. See *id.* at 10,537 n.68.

265. See *id.* at 10,526.

266. See Kramer, *supra* note 258, at 5, 17.

267. See Amendments to Form ADV, 73 Fed. Reg. 13,958 (proposed Mar. 14, 2008) (to be codified at 17 C.F.R. pts. 275 & 279). The SEC requires SEC-registered investment advisers “to provide clients and prospective clients with a disclosure statement [the Form ADV] providing information about the adviser, its business practices, the fees it charges, and its conflicts of interest.” *Id.*

268. See *id.* at 13,959.

269. See *id.* at 13,959, 13,964.

270. See *id.* at 13,982.

271. *Id.*

272. See *id.* at 13,959.

disclosure indicating to an investor whether his or her financial representative has a financial incentive to sell certain mutual funds.²⁷³

3. The Summary Prospectus

The SEC recently implemented an overhaul of the current prospectus delivery requirements with the introduction of the summary prospectus.²⁷⁴ The new rule “require[s] key information to appear in plain English in a standardized order at the front of the mutual fund statutory prospectus.”²⁷⁵ The summary section contains information such as the fund’s investment objectives and strategies, risks, costs, and performance.²⁷⁶ This summary information can also be made available in a stand-alone summary prospectus that would likely be three to four pages in length.²⁷⁷ Previously, an investor had to receive a full-length statutory prospectus prior to making a mutual fund purchase.²⁷⁸ Under the new rule, receipt of the summary prospectus alone satisfies the delivery requirement, as long as the statutory prospectus is available both on the Internet and by investor request.²⁷⁹

Both investors and the mutual fund industry appear to agree that the implementation of the summary prospectus will result in more meaningful disclosure and enable investors to make more informed investment decisions.²⁸⁰ Although there is a general consensus

273. *See id.* at 13,963.

274. *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546 (Jan. 26, 2009) (to be codified at 17 C.F.R. pts. 230, 232, 239 & 274) [hereinafter Summary Prospectus Rule]. The Director of the SEC’s Division of Investment Management explained that, “[m]any investors often find current fund prospectuses to be lengthy, legalistic and confusing. This mutual fund disclosure framework will provide information that is easier to use and more readily accessible, while retaining the comprehensive quality of the mutual fund information available today.” Press Release, SEC, SEC Improves Disclosure for Mutual Fund Investors (Nov. 19, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-275.htm>.

275. Summary Prospectus Rule, *supra* note 274.

276. *Id.* at 4548.

277. *See id.*

278. *See id.*

279. *Id.* The summary prospectus would therefore involve layered disclosure – simplified disclosure in a prominent position, combined with more detailed disclosure available online or in a print statutory prospectus. *See id.*

280. *See generally* Comments on Proposed Rule: Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, <http://www.sec.gov/comments/s7-28-07/s72807.shtml> (last visited Apr.

surrounding the advantages of the summary prospectus, there are also a few concerns.²⁸¹ Mutual fund companies are apprehensive about potential liability associated with such a dramatically shortened prospectus, as well as the reliance on technology for the Internet-based disclosure.²⁸² In addition, the rule does not allow for integrated prospectuses.²⁸³ Many mutual fund companies use integrated prospectuses to simplify the comparison process for investors.²⁸⁴ The new rule requires fund companies to create separate summary prospectuses for all of their mutual funds, even related funds, making it more time-consuming for investors to compare those funds.²⁸⁵ Lastly, the summary prospectus proposal requires boilerplate intermediary compensation disclosure indicating that, “the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment.”²⁸⁶ The general disclosure does not “quantif[y] the financial incentives that conventional distribution arrangements create for brokers to recommend the highest-paying fund, regardless of the best fit for the client.”²⁸⁷ The SEC noted that a previously

13, 2009) [hereinafter Comments on Proposed Summary Prospectus Rule]; see also Summary Prospectus Rule, *supra* note 274, at 4548.

281. See Gary O. Cohen, *Summary Versus Profile Prospectus Liability*, INVESTMENT LAW., Feb. 2008, at 3.
282. See *id.* at 3–4.
283. Summary Prospectus Rule, *supra* note 274, at 4549. “An integrated prospectus organizes the information by topic or subject-matter for similar funds, eliminating redundancies and using charts to compare information across the funds.” Darrell N. Braman & Brian R. Poole, *In Search of the Holy Grail: Has the SEC Found It with Prospectus Disclosure Reform?*, INVESTMENT LAW., Feb. 2008, at 10. The SEC’s discussion of the rule expresses concern regarding the potential length and complexity of an integrated summary prospectus. Summary Prospectus Rule, *supra* note 274, at 4549. It would defeat the purpose of the rule to allow a fund company to integrate all of its funds into one summary prospectus. See *id.*
284. See Letter from Darrell N. Braman, Assoc. Legal Counsel, T. Rowe Price et al., to Nancy M. Morris, SEC Sec’y 3–5 (Feb. 28, 2008), available at <http://www.sec.gov/comments/s7-28-07/s72807-118.pdf>. The integrated approach offers significant benefits to investors looking to compare similar products, such as target-date retirement funds. *Id.* at 3.
285. See Braman & Poole, *supra* note 283, at 10.
286. Summary Prospectus Rule, *supra* note 274, at 4557. The required disclosure will also direct a fund investor to ask his or her salesperson or to visit the applicable financial intermediary website for more information. *Id.*
287. Letter from Mercer Bullard, Fund Democracy, Barbara Roper, Consumer Fed’n of Am. & Ken McEldowney, Consumer Action, to Nancy M. Morris, SEC Sec’y, at 13 (Feb. 28, 2008), available at <http://www.sec.gov/comments/s7-28-07/s72807.shtml>.

proposed rule specifically addressed point-of-sale disclosures of conflicts of interest, but that initiative was proposed in early 2005, and it seems unlikely that it will soon become a priority.²⁸⁸

Overall, the summary prospectus seems to be an effective, popular solution to improving prospectus disclosure.²⁸⁹ Although it will not contain personalized disclosure of fees and conflicts of interest, it will allow investors to begin using the prospectus as a primary source of information, rather than solely as a legally required document.

D. *Balkanization*²⁹⁰

The California Attorney General's use of the NSMIA savings clause may turn out to be an anomaly rather than the beginning of a trend. The previous New York Attorney General, Eliot Spitzer, was similarly aggressive in expanding state jurisdiction over securities regulation.²⁹¹ His focus on the financial sector in 2002 through 2005 created apprehension about a further shift towards state regulation of the financial services industry.²⁹² However, the political makeup of the state attorney general offices increases the likelihood that attorney generals will "focus scarce resources on a more traditional consumer protection and health and safety agenda."²⁹³ Spitzer and Lockyer were the state attorney generals most focused on the financial

288. Summary Prospectus Rule, *supra* note 274, at 4557 n.155.

289. *See generally* Comments on Proposed Summary Prospectus Rule, *supra* note 280.

290. The term "balkanization" refers to the theory that "the creation and enforcement of securities market reforms devised by individual states will destroy the integrity of a single, efficient national market system." Johnathan Mathiesen, *Dr. Spitzlove Or: How I Learned to Stop Worrying and Love "Balkanization,"* 2006 COLUM. BUS. L. REV. 311, 313 (2006).

291. Aaron Lucchetti & Joann S. Lublin, *Debate Continues on Whether Wall Street Changes Have Aided Investors*, WALL ST. J., Mar. 12, 2008, at A18. Eliot Spitzer used New York's Martin Act, "a uniquely harsh law allowing prosecutors to declare almost anything a 'fraud,' and no requirement on their part to prove criminal intent," to exert prosecutorial pressure on Wall Street firms. John Fund, Editorial, *Eliot the 'Enforcer,'* WALL ST. J., Mar. 12, 2008, at A21. Similar to Lockyer's expansive use of the NSMIA savings clause, the legislative intent behind the 1921 Martin Act arguably did not extend to the types of actions brought by Spitzer. *See* Editorial, *Of Martin and Mann*, WALL ST. J., Mar. 12, 2008, at A20.

292. *See* Mathiesen, *supra* note 292, at 323–26.

293. *United States: Legal Climate Brightens for Wall Street*, OXFORD ANALYTICA, May 29, 2007, at ¶ 2, <http://www.oxan.com/display.aspx?ItemID=DB134649> (subscription only). Thirty-one out of the current fifty state attorney generals are Democrats. *Id.* ¶ 3. *See also* *Democrat AGs Back Off Wall Street*, FORBES.COM, May 30, 2007, http://www.forbes.com/2007/05/29/attorney-general-democrats-biz-cx_0530oxford.html (summarizing *Oxford Analytica* article).

services sector; both have been replaced by individuals who emphasize a more populist approach centered around consensus-building.²⁹⁴ The environmental factors that contributed to their prominence as regulatory enforcers no longer exist.²⁹⁵ In particular, there is no longer a federal regulatory vacuum as Congress has taken an increased interest in oversight of the securities industry, particularly in areas involving investor protection.²⁹⁶ The regulatory climate that allowed state attorney generals to play such an aggressive role has shifted in light of federal concerns about the effects of overregulation on the competitiveness of domestic capital markets.²⁹⁷ Subsequently, the phenomenon referred to as “balkanization” has not occurred as predicted.²⁹⁸ Regardless, the issue of mutual fund prospectus disclosure remains an important one.

IV. CONCLUSION

Problems with the current regulatory framework cannot be ignored. Congress did not intend for the regulation of revenue-sharing agreement disclosure involving mutual fund investment advisers and distributors to fall under state purview, even under the limited umbrella of NSMIA’s savings clause.²⁹⁹ There is merit to the contention that additional disclosure of revenue-sharing agreements

294. See *United States: Legal Climate Brightens for Wall Street*, *supra* note 295, ¶¶ 3, 4, 7, 12, 13. State Attorney General Jerry Brown, Bill Lockyer’s successor, settled the *Capital Research v. Brown* case in February 2008 after American Funds made changes to its prospectus and SAI to better disclose its revenue-sharing agreements. Press Release, Office of Cal. Attorney Gen., *supra* note 15. Capital Research agreed to pay \$2.5 million to cover the State’s legal costs. *Id.* Brown also settled an earlier suit against Edward Jones for \$7.5 million after the firm made substantial changes in disclosure. Press Release, Office of Cal. Attorney Gen., Attorney General Brown Settles Edward Jones Lawsuit (Sept. 10, 2008), <http://ag.ca.gov/newsalerts/release.php?id=1607&>.

295. See *United States: Legal Climate Brightens for Wall Street*, *supra* note 295, ¶¶ 5, 6, 10, 11.

296. See, e.g., Robert K. Steel, Under Sec’y for Domestic Finance, Remarks Before the Council on Competitiveness: Strengthening our Capital Markets Competitiveness (May 17, 2007) (transcript available at <http://www.ustreas.gov/press/releases/hp409.htm>). Steel noted, “regulation at the retail level will require some focus on rules, particularly to protect less sophisticated market participants, where investor protection must be a paramount focus.” *Id.* ¶ 29.

297. See Jeremy Grant, *Paulson Vows to Bolster US Competitiveness*, FIN. TIMES, Mar. 13, 2007, <http://www.ft.com/cms/s/0/eb34ca58-d19f-11db-b921-000b5df10621.html>.

298. See Arden Dale, *Spitzer Effect: Not Quite Devastating*, WALL ST. J., Sept. 21, 2005, at C13.

299. See *supra* Part III.A.

is needed.³⁰⁰ However, enabling state regulation of nationally distributed mutual fund prospectuses risks a return to the duplication and conflict of the pre-NSMIA regulatory landscape,³⁰¹ especially when the SEC is already taking an active role in this area.³⁰²

The *Capital Research* case is indicative of a larger issue that needs to be addressed: how to make disclosure more meaningful to investors.³⁰³ The promotion of visible, plain English disclosure will enable investors to make more informed decisions and take a more active role in the investment process.³⁰⁴ Ideally, the increased emphasis on investor-friendly disclosure in the summary prospectus will be a strong step towards curbing the need for state intervention to protect investors.³⁰⁵ Our current regulatory system is far from perfect,³⁰⁶ but regulators must continue the search for approaches that will “appropriately balance issues of investor protection, market integrity and systemic risk, as well as the historic tension between state and federal boundaries.”³⁰⁷

Linda M. Stevens

300. See *supra* Part III.B.1.

301. See *supra* Part III.A.

302. See *supra* Part III.B.2.

303. See *supra* Part III.C.

304. See *supra* Part III.C.

305. See *supra* Part III.C.

306. Steel, *supra* note 296, ¶ 28 (“If we were starting fresh and had a blank page, no one would choose to draw a regulatory structure that resembles our current picture.”).

307. *Id.* ¶ 26.