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HEADLINE: American Funds Wins Fees Case

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BODY:

A federal judge reluctantly handed the fund industry another courtroom victory last week in a ruling that some say has cemented the need for the Securities and Exchange Commission to take a fresh look at fees.

In the case, which had dragged on since 2004, shareholders in eight mutual funds alleged that Capital Research and Management Company (CRMC) and American Funds charged them excessive investment advisory, 12b-1, and administrative services fees. CRMC is the investment adviser for the American Funds family.

While sympathetic to the investors' case, Judge Gary Feess said they did not meet their high burden of proof, which was to show that any given fee was "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." Feess's ruling comes at a complicated time for fee disputes. The "arm's-length bargaining" burden, for example, is the same standard that the Supreme Court is evaluating in *Jones v. Harris Associates*. As a result, until the Supreme Court releases its ruling, decisions like Feess's will be met with a degree of uncertainty.

[See How the Supreme Court May Make Mutual Funds More Expensive.]

More important, the recent ruling adds fuel to a heated debate over 12b-1 fees, which are nominally used to allow funds to advertise but often end up financing commissions handed out to brokers. In 2008 alone, shareholders paid more than \$13 billion in 12b-1 fees.

In their filings, the American Funds shareholders pointed to a rapid escalation over the years in the amount American has collected in 12b-1 fees. Still, since the eight funds' 12b-1 fees have in the past several years almost always been at or below their peer group averages, the plaintiffs' claim held little water in a strictly numerical sense. But the plaintiffs contextualized their argument by contending that the fees were being used to encourage brokers to sell American Funds products at a time when the company was already experiencing significant inflows. As a result, the

shareholders say, their funds' assets grew too quickly, and performance suffered.

In ruling in favor of the defendants, Feess added to the string of victories that the fund industry has enjoyed in recent years. Over time, this pattern has left reformists convinced that the courts (barring a surprise ruling in *Jones v. Harris Associates*) are no longer a viable option and that their only real hope is an overhaul by the SEC. "I think everybody's now going to look to the SEC to take a hard look at 12b-1 fees," says Niels Holch, the executive director of the Coalition of Mutual Fund Investors, a nonprofit advocacy group.

For her part, SEC Chair Mary Schapiro recently indicated that the commission will re-evaluate 12b-1 fees this year. While this is a perennial promise, Holch remains hopeful. "I think we're going to see action this time," he says. "Reading the tea leaves, that's my conclusion."

[See SEC Promises to Rethink 12b-1 Fees.]

Even as Feess sided with American Funds and Capital Research Management, he still devoted a chunk of his ruling to chastising the defendants for their claims that their independent directors effectively represent shareholders' interests. "There is not a shred of evidence that any director asked management to identify who CRMC perceived as its competition, to provide information regarding compensation levels at those competing firms, to compare those compensation levels to compensation paid to CRMC and [American Funds Distributors] employees, or to explain why those compensation levels were necessary to attract and retain personnel or to provide services at a specified level of quality," Feess writes. "Thus, although the directors were represented by counsel and were provided with detailed materials to which they and defendants can point to [*sic*] and say, 'see how thorough and careful we were,' the entire process seems less a true negotiation and more an elaborate exercise in checking off boxes and papering the file."

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