



All that's hot in the mutual fund industry

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American Funds Hit With 12b-1 Lawsuit

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An investor in the \$122 billion American Funds EuroPacific Growth Fund¹ is suing the fund family and its parent for alleged misuse of 12b-1 fees.

The suit challenges a longstanding industry compensation structure crucial to fund companies' getting their funds distributed through different broker-dealers and ensuring that brokers who sell the funds get paid.

Rachelle Korland of Ohio filed a complaint in the Central District Court of California against **Capital Research and Management Company** and **American Funds Distributor** on behalf of all shareholders of the fund.

The complaint accuses **American Funds** of violating its fiduciary duty under Section 36(b) of the Investment Company Act of 1940 by unlawfully financing activities that were not "primarily intended" to result in the sale of fund shares.

A spokeswoman for American Funds did not return phone calls seeking comment as of press time.

Attorneys for the plaintiff argue that American Funds' 12b-1 fees were used to pay for ongoing shareholder services after the initial sale of fund shares, thereby making them "excessive and disproportionate." In 2007, over \$2 billion in 12b-1 fees were paid by American Funds' shareholders alone, according to the complaint.

The suit is seeking, among other things, a declaration that American Funds' 12b-1 fees are "unreasonable, excessive and unlawful," a removal of the 12b-1 fee adopted by the fund, removal of the fund's independent trustees, undetermined compensatory damages in favor of the fund, and removal of American Funds Distributor and Capital Research as the fund's distributor and advisor.

"The mutual fund industry ignored the rule and went about getting away with whatever it could get away with," says Daniel Krasner, Korland's attorney and a partner at **Wolf Haldenstein Adler Freeman & Herz**. "The amount of fees being collected to pay for services outside of their originally designated use is astronomical. American Funds should reimburse all improperly paid 12b-1 fees."

Further, the complaint argues that breakpoint discounts offered to fund shareholders were not commensurate to the huge increase in size the fund has experienced in recent years.

In a recent *Ignites* question-and-answer forum addressing 12b-1 fees, Paul Haaga, executive VP and director with Capital Research, shared his thoughts on critics' call for an unbundling of the distribution portion of 12b-1 fees.

"Unfortunately, there's an 'Old Time Religion' that still considers distribution/sales a bad thing and believes we need to isolate these components so we can attach warning labels and disfavor them," he wrote in his post. "It's time to move on, simplify our disclosure and regulation, and stop assuming that all a broker/adviser does is 'sell.'"

In 1980, the **SEC** adopted 12b-1 fees as a way for funds to use a small portion of their assets to boost marketing efforts, helping to offset redemptions. The fees, which generally range from 25 to 50 basis points, ostensibly translate into an increase in assets, driving economies of scale, which push down costs for fund shareholders.

However, the rule was drawn up in such a way that left it open for interpretation, and it has since been stretched well beyond its original intent, analysts say. An Investment Company Institute study released in 2006 found that 92% of 12b-1 fee income is used to compensate financial advisors and other intermediaries for providing shareholder advice and ongoing account servicing.

The debate has raged for years with no concrete fix. The SEC is said to be weighing a proposal that would overhaul the fees. Meanwhile, some fund executives have been adamant that the fees are crucial to the

success of smaller fund complexes aiming to grow their assets. However, others blast 12b-1 for eating away at investor returns.

Either way, mutual fund consultants are skeptical of the lawsuit because it lacks specific instances of fraud. "The lawyers for the plaintiffs don't have a detailed understanding of 12b-1 to go forward with this suit," says Jeff Keil, principal at **Keil Fiduciary Strategies** and an expert on 12b-1 fees. "I can't see the suit being even remotely successful."

Keil argues that in order to counteract redemptions, fund companies need to be able to sell new shares. Otherwise, shareholders will suffer weaker performance as the portfolio manager is forced to sell out of positions to offset outflows. Portfolio managers often cite redemptions as the biggest enemy of performance, he says.

Attorneys that represent mutual fund companies scoff at the notion that there is something inherently rotten with 12b-1 fees. "Large fund companies are repeated targets of frivolous lawsuits because of their deep pockets and large number of shareholders," says Robert Skinner, litigation partner at **Ropes & Gray**. "The notion that 12b-1 is a broad conspiracy to rip off shareholders is contrary to the statute and the business realities of the industry."

"The lawsuit is based on a fallacy that providing good services to existing shareholders does not sell new shares," Skinner says. "The reality is that new assets increase the prospect of economies of scale and selling through intermediaries is how many mutual fund firms get access to retail investors."

American Funds has 30 days from the date the complaint was filed, June 18, to issue a rebuttal. Skinner estimates that if the suit doesn't get dismissed, American Funds will incur millions of dollars in legal expenses. "Discovery is very expensive," he says.

Still, attorneys for the plaintiff better be prepared for a dogfight. American Funds is currently appealing a three-year-old **Finra** charge that it made nearly \$100 million in improper payments to roughly 50 brokerages as an incentive to get them to sell its funds. The fund giant fought vigorously to preserve its pristine image against similar charges brought by the California attorney general's office. Those charges were dropped in March after a three-year legal bout.

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