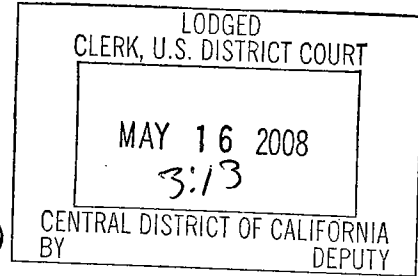


1 MILBERG LLP
JEFF S. WESTERMAN (SBN 94559)
2 E-mail: jwesterman@milberg.com
SABRINA S. KIM (SBN 186242)
3 E-mail: skim@milberg.com
One California Plaza
4 300 South Grand Ave., Suite 3900
Los Angeles, CA 90071
5 Telephone: (213) 617-1200
Facsimile: (213) 617-1975



6 MILBERG LLP
7 JEROME M. CONGRESS (admitted *pro hac vice*)
E-mail: jcongress@milberg.com
8 JANINE L. POLLACK (admitted *pro hac vice*)
E-mail: jpollack@milberg.com
9 ANNA C. DOVER (SBN 217100)
E-mail: adover@milberg.com
10 One Pennsylvania Plaza
New York, NY 10119
11 Telephone: (212) 594-5300
Facsimile: (212) 868-1229

12 WEISS & LURIE
13 JOSEPH H. WEISS
RICHARD A. ACOCELLI (admitted *pro hac vice*)
14 JULIA J. SUN
551 Fifth Avenue, Suite 1600
15 New York, NY 10176
Telephone: (212) 682-3025
16 Facsimile: (212) 682-3010

17 Co-Lead Counsel for Plaintiffs

18 UNITED STATES DISTRICT COURT
19 CENTRAL DISTRICT OF CALIFORNIA
20 WESTERN DIVISION

21 In Re American Mutual Funds Fee
Litigation

Master File: CV 04-5593 GAF (RNBx)
FOURTH AMENDED COMPLAINT

24 THIS DOCUMENT RELATES TO:

25 All Actions

Assigned to: Hon. Gary A. Feess

1 Plaintiffs, by and through their counsel, allege the following based upon the
2 investigation of counsel, which included interviews with persons with knowledge of
3 the conduct complained of herein and a review of United States Securities and
4 Exchange Commission (“SEC”) filings, as well as other regulatory filings, reports,
5 advisories, press releases, media reports, conversations with former employees, news
6 articles, academic literature, and academic studies. Plaintiffs believe that substantial
7 additional evidentiary support will exist for the allegations set forth herein after a
8 reasonable opportunity for discovery.

9 **NATURE OF THE ACTION**

10 1. This is an action brought by Plaintiffs on behalf of the American mutual
11 funds in which the Plaintiffs are shareholders as alleged below (“the Funds”) arising
12 from the payment of excessive compensation and fees to Defendants. Defendants are
13 liable under Section 36(b) of the Investment Company Act of 1940 (the “ICA”)
14 because, during the relevant timeframe of July 15, 2003 to July 15, 2004 and to the
15 present, the 12b-1 and advisory fees received by Defendants were disproportionate to
16 the value of the services provided and not within the bounds of what would have been
17 negotiated at arm’s-length.

18 2. American Funds is the second largest mutual fund company in the United
19 States with current assets under management in excess of \$813 billion. To achieve
20 this gargantuan asset size, the Investment Adviser and Distributor Defendants (as
21 defined below) have placed an enormous emphasis on sales of their funds. For
22 example, in 1974, the gross sales of American Funds were \$75 million. By 2002,
23 American Funds were sold at a rate of \$75 million every 2 to 3 days. These sales
24 resulted in growth from \$455 billion in 2003 to over \$813 billion at the present time.
25 In fact, by October 2004, American Funds had taken in 40 percent of all U.S. mutual
26 fund inflows, excluding money market funds. Although Vanguard Funds is currently
27 the largest mutual fund company with assets of approximately \$877 billion, if current
28 sales trends continue, American Funds will soon surpass Vanguard. In addition, *Time*

1 magazine reported in December of 2005 that more than \$1 of every \$3 currently
2 invested into a mutual fund goes into American Funds, while \$1 of every \$5 goes into
3 Vanguard Funds. Yet despite the American Funds' popularity, an analysis of
4 Defendants' fee structures reveals that Defendants operate the Funds largely to
5 enhance their own profits by enjoying the windfall associated with the asset-based
6 fees charged to the Funds and their investors. In fact, Defendants' fund growth has
7 resulted in the charging of excessive fees to investors when compared to similar funds
8 in the industry. In addition, unlike Vanguard, which has spread its vast wealth over
9 105 funds, Defendants have persisted in limiting their fund offerings to 29 funds. This
10 limitation has adversely affected the Funds' performance versus their peers.

11 3. The advisory and 12b-1 (or distribution) fees which Defendants received
12 from the Funds and their investors were excessive. The 12b-1 fees Defendants
13 charged were excessive because they were not used for services that benefited the
14 Funds and their investors. In theory, 12b-1 fees should be used to grow the funds'
15 size so that the expenses of operating such funds per share are reduced and economies
16 of scale are passed on to investors. In practice, however, Defendants' 12b-1 fees were
17 higher than those charged to comparable funds, did not result in economies of scale
18 being passed on to the Funds and did not cause any decrease the Funds' expenses per
19 share over time.

20 4. An analysis of the proportion of the Funds' expense ratio which was
21 devoted to 12b-1 fees reveals that Defendants' true aim was to grow, rather than
22 manage, the Funds. Defendants used 12b-1 fees to continue to grow the Funds at a
23 time when further growth was eroding their performance and was contrary to standard
24 industry practice. As a result, the 12b-1 fees Defendants received were
25 disproportionate to the services rendered because the nature of the services provided
26 (marketing and distribution activities for increasing the funds' size) did not benefit the
27 Funds and their investors.

28

1 5. The advisory fees charged by Defendants were also excessive because
2 they were disproportionate to the value of the services provided to the Funds and their
3 investors. The quality of the advisory services provided to the Funds and their
4 investors did not justify Defendants' advisory fees given that the Funds' performance
5 lagged behind the performance of comparable, less expensive Funds. Moreover, when
6 the Funds achieved their massive size, the vast proportion of their assets began to
7 function as an index fund, for which only passive management was required and
8 rendered. Since Defendants only actively managed, at best, a small portion of the
9 Funds' assets but continued to charge fees commensurate with active management of
10 all of the Funds' assets, Defendants were able to charge "something" (advisory fees)
11 for "nothing" (passive, not active, management). The advisory fees Defendants levied
12 also exceeded the standard fees charged to manage an index fund. Thus, the Funds'
13 advisory fees were excessive because they were disproportionate to the real services
14 provided by Defendants.

15 6. The overall fee structure Defendants imposed on the Funds and their
16 investors resulted in the charging of fees which exceeded those which would have
17 been paid as a result of arm's-length bargaining. This excessiveness is illustrated by
18 the fact that share classes of certain Funds in which the investors had bargaining
19 power enjoyed lower fees than those share classes available directly to the public. In
20 addition, the fees Defendants charged were excessive because they were higher than
21 fees levied by other benchmark funds of the same size.

22 7. Defendants also received excessive fees through revenue sharing directed
23 brokerage arrangements and benefits from Shelf-Space agreements with broker-
24 dealers. Revenue sharing occurs when the investment adviser or its affiliate makes
25 cash payments to a broker-dealer in exchange for the broker-dealer pushing shares of
26 that fund. Directed brokerage is the practice whereby investment advisers direct
27 underlying portfolio securities transactions to broker-dealers that sell shares of the
28 fund to remunerate those firms and their brokers for pushing the investment adviser's

1 funds instead of other fund companies' funds. Payments for Shelf-Space agreements
2 made pursuant to these programs supercharged the growth of the Funds, which
3 benefited Defendants because it allowed their asset-based fees to increase. Yet
4 Defendants' increased compensation based on these programs was not justified by any
5 increase in the quality or nature of the services which they provided to the Funds. As
6 such, Defendants received "something for nothing," demonstrating that their fees were
7 excessive. The monies for such side-payments were embedded in the fee structures
8 imposed on the Funds. Moreover, these programs allowed Defendants to receive the
9 "fall-out" benefits of using the Funds' assets to offset what should have been their out-
10 of-pocket expenses, while the advisory fees Defendants charged were excessive
11 because they were not reduced to reflect the fall-out benefits they received.

12 8. Furthermore, the Directors of the Funds failed to satisfy their duty to
13 independently and conscientiously evaluate the Funds' 12b-1 and advisory fee
14 arrangements, a factor which strongly supports a finding of fee excessiveness. That is,
15 the Directors failed to notice that the 12b-1 fees were higher than comparable funds
16 and were no longer justified given the Funds' already enormous size. The Directors
17 also failed to notice that the advisory fees were no longer justified due to the Funds'
18 functioning as index funds and that the advisory fees were not being reduced to reflect
19 growing *de facto* economies of scale. Moreover, the Directors failed to analyze
20 properly the perverse effects of the Funds' revenue sharing and directed brokerage on
21 the Funds and their investors. The Directors' failure to satisfy their duty resulted in
22 fees being charged to the Funds that were disproportionate to the services rendered
23 and that were not the product of arm's-length bargaining.

24 **JURISDICTION AND VENUE**

25 9. The claims asserted herein arise under and pursuant to ICA Section
26 36(b), 15 U.S.C. §§ 80a-35(b).

27
28

1 or units of the Capital Income Builder and Income Fund of America, and has been
2 damaged by the conduct alleged herein.¹

3 17. Plaintiff Gregory J. Baurnes held as of July 15, 2004 and continues to
4 hold Class A shares or units of the American Balanced Fund, Bond Fund of America,
5 Growth Fund of America, Capital Income Builder, and Capital World Growth &
6 Income Fund, and has been damaged by the conduct alleged herein.

7 18. Plaintiff Ernest Visalli held as of July 15, 2004 and continues to hold
8 Class A shares or units of the Bond Fund of America, and has been damaged by the
9 conduct alleged herein.

10 **Defendants**

11 **The Investment Adviser Defendant**

12 19. Defendant Capital Research and Management Company (the “Investment
13 Adviser Defendant”), is registered as an investment adviser under the Investment
14 Advisers Act. The Investment Adviser Defendant, a wholly-owned subsidiary of
15 Capital Group Companies, Inc. (“Capital Group”), is headquartered at 333 South
16 Hope Street, Los Angeles, California 90071. The Investment Adviser Defendant
17 manages the investment portfolio and business affairs of the American Funds. The
18 Investment Adviser Defendant has ultimate responsibility for overseeing the day-to-
19 day management of the American Funds. The Investment Adviser Defendant
20 principally derives its revenue from annual advisory fees paid on the assets of
21 American Funds and maintains a trading desk that places trades for American Funds’
22 portfolio managers with broker-dealers for execution.

23
24
25

26 ¹ The David L. Caplan Revocable Trust was created on June 22, 2005. Prior to that
27 date, David L. Caplan and Robert M. Macko held Capital Income Builder and Income
28 Fund of America as joint tenants.

1 **The Distributor Defendant**

2 20. Defendant American Funds Distributors, Inc. (“AFD” or “Distributor
3 Defendant”), a registered broker-dealer, NASD member and wholly-owned subsidiary
4 of the Investment Adviser Defendant, is the principal underwriter and distributor of
5 the American Funds. In this capacity, AFD was responsible for underwriting and
6 sponsoring the American Funds and selling shares of the American Funds to
7 consumers through financial intermediaries. AFD is located at 333 South Hope Street,
8 Los Angeles, CA 90071.

9 **The American Funds**

10 21. Nominal defendants the American Funds, as identified in the list annexed
11 hereto as Exhibit A, are open-ended management companies consisting of the capital
12 invested by mutual fund shareholders, each having a Board of Directors charged with
13 representing the interests of the shareholders in one or a series of the funds. The
14 American Funds are named as nominal defendants to the extent that they may be
15 deemed necessary and indispensable parties pursuant to Rule 19 of the Federal Rules
16 of Civil Procedure and to the extent necessary to ensure the availability of adequate
17 remedies.

18 22. The American Funds offer multiple classes of shares, with each class
19 representing a *pro rata* interest in each American Fund. American Funds’ shares are
20 issued to American Funds’ investors pursuant to prospectuses that must comply with
21 the federal securities laws, including the Investment Company Act. All of the
22 prospectuses are substantially the same on the matters relevant to this litigation.

23 **SUBSTANTIVE ALLEGATIONS**

24 23. The fees charged to mutual fund investors should be the equivalent of
25 fees that would have resulted from arm’s-length bargaining. Directors are required to
26 negotiate the fees charged to the fund on behalf of the investors (who, individually,
27 are unable to negotiate such fees), and on behalf of the fund, which is otherwise under
28 the control of the fund’s adviser or distributor. At the same time, investment advisers

1 and their affiliates have a fiduciary duty with respect to the fees that are charged to the
2 funds and their investors, in that the fees must be reasonably related to the services
3 provided.

4 24. Distributors, as affiliates of the investment adviser, are also fiduciaries to
5 the fund investors with respect to the fees that the fund and its investors pay.

6 **The Fees At Issue**

7 25. **Investment Advisory Fees:** Investment advisory fees are calculated as a
8 percentage of assets under management. Investment advisory fees are paid to
9 investment advisers for managing the underlying portfolio, *i.e.*, for choosing the
10 securities in which a mutual fund should invest and the operations required to support
11 the management of the portfolio. As the fund assets increase, the dollar amount of
12 such fees parallels this growth.

13 26. **Rule 12b-1 Fees:** SEC Rule 12b-1 permits a fund to pay “12b-1”
14 distribution fees out of fund and investor assets only if the fund has adopted a 12b-1
15 plan authorizing their payment, and only if the Directors properly find that there is a
16 reasonable likelihood that the plan will benefit the fund and its shareholders.
17 Distribution fees include fees paid for marketing and selling fund shares, such as
18 compensation for brokers and others who sell fund shares, and payments for
19 advertising, the printing and mailing of prospectuses and sales literature. Like the
20 investment advisory fees, the 12b-1 fees are calculated as a percentage of assets under
21 management and the dollar amount of such fees increases with the size of the fund.

22 27. **Transfer Agency Fees:** Transfer agency fees are paid to either an
23 affiliated or independent third party to handle sales and redemptions of fund shares, to
24 maintain shareholder records, to compute the net asset value (the “NAV”) of the fund
25 daily, and to pay out dividends and capital gains. Like the investment advisory fees
26 and 12b-1 fees, the transfer agency fees are calculated as a percentage of assets under
27 management and the dollar amount of such fees increases with the size of the fund.
28 These fees can constitute “fall-out” benefits to the Investment Adviser Defendant as a

1 result of its relationship with the Funds, and must be considered in evaluating whether
2 the fees paid were excessive.

3 28. These fees are the principal components of a fund expense ratio, which is
4 the ratio of total expenses to net assets. The expense ratio determines the fund's
5 efficiency and cost effectiveness, and consequently a lower number is desirable
6 because it reflects higher total returns.² The expense ratio of a fund is considered in
7 the industry to be a key indicator of a fund's performance.

8 **Factors That Show The Fees Charged To The American Funds And Their**
9 **Investors Were Not Reasonably Related To The Services Provided Them**

10 29. The mutual fund industry recognizes that certain factors indicate that fees
11 are excessive. In particular, the following factors, *inter alia*, illustrate whether a fund
12 is charging excessive fees to the funds and their investors:

- 13 • the quality of services provided to the fund and its investors;
- 14 • the nature of services being paid for by the fund and its investors;
- 15 • whether economies of scale were passed to the fund and its investors or
16 kept by the investment adviser;
- 17 • whether the investment advisory fees are reduced to reflect the “fall-out
18 benefits” the adviser receives, which are those benefits other than the
19 advisory fees that flow to the adviser and its affiliates as a result of the
20 adviser's relationship with the fund;
- 21 • what other fund families or funds within the same fund family charge for
22 similar mutual funds; and
- 23 • whether the trustees exercised a sufficient level of care and
24 conscientiousness in approving the investment advisory and distribution
25 agreements and the fees contained therein.

26
27 ² These fees are often measured in basis points. A basis point (“bp”) is one-hundredth
28 of a percentage point (0.01%). For example, 10bps of \$1 billion equals \$1 million.

1 30. When examining the American Funds, these factors show that
2 Defendants took advantage of the fees and charged excessive amounts to benefit
3 themselves. An investment adviser’s main sources of revenue are investment adviser,
4 distribution and transfer agency fees. In the absence of effective “watchdogs” (*i.e.*,
5 the Directors) and given the Funds’ opaque fee structures, the Investment Adviser and
6 Distributor Defendants were able to take advantage of the various forms of fees and
7 the Funds’ assets under their control to grant themselves a windfall of compensation.

8 **The 12b-1 Fees Were Paid To The Distributor Defendant To Cover Its Costs**
9 **As A Representative Of The Funds And To Allow It To Compensate Brokers**
10 **In Its Discretion**

11 31. Section 12(b) of the Investment Company Act prohibits mutual funds
12 from directly or indirectly distributing or marketing their own shares unless certain
13 enumerated conditions set forth in Rule 12b-1, promulgated by the SEC pursuant to
14 the Investment Company Act, are met. The conditions of Rule 12b-1 are, among
15 others, that payments for marketing must be made pursuant to a written plan
16 “describing all material aspects of the proposed financing of distribution;” all
17 agreements with any person relating to implementation of the plan must be in writing;
18 the plan must be approved by a vote of the majority of the board of Directors; and the
19 board of Directors must review, at least quarterly, “a written report of the amounts so
20 expended and the purposes for which such expenditures were made.” 17 C.F.R.
21 § 270.12b.1.

22 32. The Funds enter into distribution agreements with the Distributor
23 Defendant who receives fees to sell the Funds’ shares, usually called 12b-1 fees. The
24 Distributor Defendant, as an affiliate of the Investment Adviser Defendant, is under a
25 fiduciary duty to the Funds and their investors with respect to the 12b-1 fees it
26 receives, in that it must ensure that the 12b-1 fees are reasonably related to the
27 services provided (*i.e.*, are not excessive).

28 33. In adopting and renewing the distribution agreements with the distributor
on behalf of the Funds, the Directors “have a duty to request and evaluate, and any

1 person who is a party to any agreement with such company relating to such plan shall
2 have a duty to furnish, such information as may reasonably be necessary to an
3 informed determination of whether [the] plan should be implemented or continued.”
4 17 C.F.R. § 270.12b.1. The Directors may continue the plan “only if the board of
5 Directors who vote to approve such implementation or continuation conclude, in the
6 exercise of reasonable business judgment, and in light of their fiduciary duties under
7 state law and section 36(a) and (b) [15 U.S.C. § 80a-35(a) and (b)] of the Act that
8 *there is a reasonable likelihood that the plan will benefit the company and its*
9 *shareholders.” Id. (emphasis added).*

10 34. According to the American Balanced Fund’s prospectus effective March
11 1, 2005, which is similar in language to all American Funds’ prospectuses, the Fund’s
12 12b-1 distribution plans “finance activities primarily intended to sell [Fund] shares.”
13 The prospectus further states that the Distributor Defendant receives the 12b-1 fees,
14 has the right to sell future rights to its 12b-1 fees and has the discretion to compensate
15 brokers for the sale of Funds up to a certain limit. As a result of the American Funds’
16 12b-1 plans, which the Boards of Directors authorized, the Distributor Defendant
17 collected millions of dollars in purported Rule 12b-1 marketing and distribution fees.
18 These excessive fees were paid to the Distributor Defendant, and were used at the
19 Distributor Defendant’s discretion, for marketing and distribution activities, including,
20 payments to brokers in that regard.

21 35. As part of the normal course of its duties, the Distributor represents
22 mutual funds in their relationship with third parties that sell fund shares. A portion of
23 the 12b-1 fees is used to cover the Distributor Defendant’s costs as a representative of
24 the Funds and a portion is used to cover sales charges to brokers. A majority of the
25 mutual fund industry uses 66% percent of 12b-1 fees to reimburse underwriters or
26 distributors for upfront load payments to brokers. *How Mutual Funds Use 12b-1*
27 *Fees*, Fundamentals, Feb. 2005. Here, under the Funds’ distribution agreements, the
28 Funds use their 12b-1 fees to compensate the Distributor Defendant for acting as a

1 representative of the Funds and to pay securitization obligations. As is noted in the
2 Growth Fund of America’s amended and restated distribution plan effective
3 November 1, 2005, “the Distributor will be deemed to have performed all services
4 required to be performed in order to be entitled to received its Allocable Portion of the
5 Distribution Fee payable” and “[t]he Distributor may sell and assign its right to its
6 Allocable Portion of the Distribution fee to a third party.”³ As described more fully
7 below, the Distributor Defendant also negotiated revenue sharing arrangements with
8 over 100 brokerage firms, which provided that hundreds of millions of dollars in
9 additional compensation would be paid to broker-dealers as an incentive to steer their
10 clients into American Funds. The Distributor Defendant used its discretion to
11 determine how much each broker received from these revenue sharing arrangements,
12 which varied amongst the different brokerage firms.

13 36. The importance of 12b-1 fees to Defendants has been recognized by
14 industry analysts, who have noted that “American Funds relies heavily on wirehouses
15 and small broker-dealers who need to get paid. While a ban on 12b-1 fees is not very
16 likely, it could be catastrophic, at least in the short run, to American Funds.” Cerulli
17 Associates, *Mutual Fund Revenue Sharing: Current Practices and Projected*
18 *Implications* 127 (2005).

19 37. The reason 12b-1 fees are allowed to be used for distribution, however, is
20 because the Distributor and Investment Adviser Defendants are supposed to share
21 with investors the economies of scale resulting from the growth of the Fund. Here, as
22 explained below, the Defendants failed to share these benefits.

23

24

25

26

27 ³ Growth Fund of Am., prospectus effective Nov. 1, 2005 (Form N-1A) (Oct. 31,
2005).

28

1 **The 12b-1 Fees Were Excessive Because They Were Not Used For Services**
2 **That Benefited The Funds**

3 38. The exceptions to the Section 12(b) prohibition on mutual fund
4 marketing were enacted in 1980, principally on the ground that the marketing of
5 mutual funds, all things being equal, should be encouraged because increased
6 investment in mutual funds would presumably result in decreased costs, the benefits
7 of which would be returned by fund managers to investors. Here, the Funds grew to
8 gargantuan size but so did the expenses. As such, increased investment was not
9 resulting in decreased expense ratios. Instead, the excessive fees being charged to the
10 Funds and their investors were retained by the Investment Adviser and Distributor
11 Defendants as a windfall.

12 39. The use of 12b-1 fees resulted in the Defendants' intended purpose,
13 which was to increase the inflow of cash as investments. This is clearly illustrated by
14 the increase in sales over the last few years and last few decades. In 1974, the gross
15 sales of American Funds were \$75 million. Charles D. Ellis, *Capital* 116 fn.29 (John
16 Wiley & Sons 2004). By 2002, sales of American Funds were \$75 million every 2 to
17 3 days. *Id.* Since 2003, the amount of American assets has jumped from \$455 billion
18 to \$813 billion at present. Morningstar.com, American Family Funds Family
19 Snapshot, [http://quicktake.morningstar.com/FundFamily/Snapshot.asp?Country=](http://quicktake.morningstar.com/FundFamily/Snapshot.asp?Country=USA&Symbol=10139)
20 [USA&Symbol=10139](http://quicktake.morningstar.com/FundFamily/Snapshot.asp?Country=USA&Symbol=10139) (password required) (last visited Feb. 16, 2006).

21 40. When one examines American Funds' expense ratios, it is apparent that
22 the Fund and investor assets used to pay for 12b-1 plans were not offset by decreased
23 expense ratios in many cases. In fact, the proportionate increase in the expenses often
24 exceeds the proportionate growth in assets. For example:

- 25 • According to AMCAP Fund's Statement of Additional Information
26 ("SAI") to its prospectuses dated May 1, 1995 and May 1, 2005, between
27 the years ended Feb. 28, 1995 and Feb. 28, 2005, the Fund's assets under
28 management (including undistributed net investment income) grew from

1 \$2,970,115,000 to \$18,616,256,000, increasing by **527%**, while
2 expenses increased from \$20,786,000 to \$131,364,000, increasing by
3 **532%**.

- 4 • According to American Balanced Fund's SAI to its prospectuses dated
5 Mar. 1, 1995 and Mar. 1, 2005, between the years ended Dec. 31, 1994
6 and Dec. 31, 2004, the Fund's assets under management (including
7 undistributed net investment income) grew from \$2,081,886,000 to
8 \$44,974,013,000, increasing by **2,060%**, while expenses increased from
9 \$12,647,000 to \$305,072,000, increasing by **2,312%**.
- 10 • According to the Growth Fund of America's SAI to prospectuses dated
11 Nov. 1, 1995 and Nov. 1, 2005, between the years ended Aug. 31, 1995
12 and Aug. 31, 2005, the fund's assets under management (including
13 undistributed net investment income) grew from \$7,524,890,000 to
14 \$114,655,201,000, increasing by **1,424%**, while expenses increased
15 from \$45,302,000 to \$751,901,000, increasing by **1,560%**.
- 16 • According to the Income Fund of America's SAI to prospectuses dated
17 Oct. 1, 1995 and Oct. 1, 2005, between the years ended July 31, 1995
18 and July 31, 2005, the Fund's assets under management (including
19 undistributed net investment income) grew from \$12,290,157,000 to
20 \$60,151,568,000, increasing by **389%**, while expenses increased from
21 \$71,752,000 to \$363,903,000, increasing by **407%**.

22 41. According to a recent study by a financial economist in the Office of
23 Economic Analysis of the SEC, entitled, "The Costs and Benefits to Fund
24 Shareholders of 12b-1 Plans: An examination of Fund Flows, Expenses and Returns,"
25 fund shareholders pay the costs to increase assets under management, while the
26 adviser is the primary beneficiary of the fund's growth. Lori Walsh, Financial
27 Economist with the SEC's Office of Economic Analysis (Apr. 30, 2004), *available at*
28 <http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf>. The study concludes,

1 “12b-1 plans do seem to be successful in growing fund assets, but with no apparent
2 benefits accruing to the shareholders of the fund.” *Id.* at 18.

3 42. Under Rule 12b-1, Directors are supposed to consider the circumstances
4 that would make a 12b-1 plan necessary. They are also supposed to consider
5 “whether the plan has in fact produced the anticipated benefits for the company and its
6 shareholders.” *See* Bearing of Distribution Expenses by Mutual Funds, Investment
7 Company Act Release No. 11,414,45 Fed. Reg. 73, 898, 73, 904 (Oct. 28, 1980).
8 Here, as the numbers above illustrate, there was no “reasonable likelihood” that the
9 12b-1 plan was benefiting the Funds and their shareholders and the Directors should
10 not have continued to annually renew the 12b-1 plan.

11 **The 12b-1 Fees Were Excessive When Compared To What The Funds Were**
12 **Charging For Advisory Fees And The 12b-1 Fees Charged By Comparable**
13 **Funds**

14 43. The large portion of the expense ratio represented by 12b-1 fees
15 illustrates that Defendants’ primary focus was on continuing to grow the Funds, rather
16 than effectively managing them. In certain instances, the Funds were actually paying
17 significantly more in 12b-1 fees than in management fees. As a result, investors were
18 paying more to have their Funds sold than to be managed.

19 44. The Defendants’ focus on distribution and selling funds has resulted in
20 rapid growth, which has doubled the assets under management over three years.
21 According to Jim Rothenberg, President of Capital Research and Management:

22 The 12(b)-1 fee the fund pays out for investor service and retention can
23 be greater than our incremental management fee for continuously
24 managing these same assets.... These services fees can really add up for
25 a strong mutual fund salesman – as much as \$200,000 to \$250,000 a year
26 – and they’ll keep right on coming, year-after-year, if the broker has sold
27 good, persistent business. And that’s what we and our wholesalers
28 always emphasize with the stockbroker.

29 Ellis, *Capital* 121.

1 45. A review of the level of advisory versus distribution fees paid by the
2 Funds, and a comparison of similar data for funds of comparable size, shows that
3 American Funds' distribution fees were excessive. As demonstrated below, in many
4 instances the American Funds' distribution (12b-1) fees substantially exceeded
5 management fees.

- 6 • According to the 2004 annual report of the Growth Fund of America, the
7 Fund and its investors paid \$246,856,000 in distribution fees while
8 paying \$205,522,000 in management fees.⁴
- 9 • According to the Investment Company of America Fund's 2004 annual
10 report, the Fund and its investors paid \$203,917,000 in distribution fees
11 while paying \$165,092,000 in management fees.⁵
- 12 • According to the 2004 annual report of the American Balanced Fund, the
13 Fund and its investors paid \$160,465,000 for distribution fees, an amount
14 significantly larger than the \$89,237,000 paid for management fees.⁶
- 15 • According to the Income Fund of America's 2004 annual report, the
16 Fund and its investors paid \$134,930,000 in distribution fees and
17 \$97,491,000 in management fees.⁷

18 46. By contrast, funds of comparable size to the American Funds listed above
19 charged significantly *lower* distribution fees than management fees, demonstrating the
20 excessive nature of the 12b-1 fees Defendants charged and received. For instance:

21 _____
22 ⁴ Growth Fund of Am., annual report for the fiscal year ending Aug. 31, 2004 (Form
23 N-CSR) (Nov. 11, 2004).

24 ⁵ Inv. Co. of Am. Fund, annual report for the fiscal year ending Dec. 31, 2004 (Form
25 N-CSR) (Mar. 11, 2005).

26 ⁶ Am. Balanced Fund, annual report for the fiscal year ending Dec. 31, 2004 (Form
27 N-CSR) (Mar. 11, 2004).

28 ⁷ Income Fund of Am., annual report for the fiscal year ending July 31, 2004 (Form
N-CSR) (Oct. 12, 2005).

- 1 • The 2004 annual report for the comparably sized Vanguard 500 Index
2 Fund stated that the fund and its investors paid only \$13,596,000 in
3 distribution fees while paying \$140,836,000 in management fees.⁸
- 4 • The 2004 annual report for the comparably sized Vanguard Total Stock
5 Index Fund stated that the fund and its investors paid only \$7,094,000 in
6 distribution fees while paying \$62,820,000 in management fees.⁹
- 7 • The 2004 annual report of the comparably sized Vanguard Windsor II
8 Fund stated that the fund and its investors paid only \$3,362,000 in
9 distribution fees but \$95,644,000 in management fees.¹⁰
- 10 • The 2004 annual report for the comparably sized Vanguard Wellington
11 Fund stated that the fund and its investors paid \$3,753,000 in distribution
12 fees and \$81,310,000 in management fees.¹¹

13 47. In addition, when comparing the 12b-1 fees for Classes A, B and C of the
14 American Funds to the benchmark funds found in similar categories by the University
15 of Chicago’s Center for Research in Securities Prices (“CRSP”)¹², it is clear that
16 Defendants made a practice of charging excessive 12b-1 fees. As noted below, during
17
18
19

20 ⁸ Vanguard Index Fund, annual report for the fiscal year ending Dec. 31, 2004 (Form
21 N-CSR) (Feb. 25, 2005).

22 ⁹ *Id.*

23 ¹⁰ Vanguard Windsor Fund, annual report for the fiscal year ending Nov. 30, 2004
(Form N-CSR) (Dec. 17, 2004).

24 ¹¹ Vanguard Wellington Fund, annual report for the fiscal year ending Nov. 30, 2004
25 (Form N-CSR) (Jan. 19, 2005).

26 ¹² The CRSP benchmark is the value weighted (weights obtained using the monthly
27 asset valuation for each fund) average of all funds that had the same CRSP Strategic
Objective Designation. CRSP assigns each fund one of 187 Strategic Insight Fund
Objective Codes based on its investment strategy.

1 2003, Defendants charged 12b-1 fees that were anywhere from 50 bps to 76 bps
2 higher than those charged by the benchmark funds.¹³

3 **Comparison of the 2003 12b-1 Fees for American Funds To The CRSP**
4 **Benchmark of Comparable Funds¹⁴:**

American Fund Name	Strategic Objective	Amount by which American Fund's 12b-1 Fee Exceeded 12b-1 Fee for Benchmark Funds
American Balanced Fund	Balanced	64 bps
AMCAP Fund	Growth	51 bps
Bond Fund of America	Corporate High Quality	66 bps
Capital Income Builder	Growth and Income	76 bps
Capital World Growth & Income	Global Total return	53 bps
Growth Fund of America	Growth	50 bps
Income Fund of America	Balanced	54 bps
Investment Company of America	Growth & income	70 bps

5
6
7
8
9
10
11
12
13
14
15 48. In addition, when comparing the 12b-1 fees charged by large-size funds
16 that experienced the same costs and economies of scale, the 12b-1 fees charged by
17 Defendants were also excessive.

18
19
20
21
22
23
24 ¹³ The benchmark funds are comparable funds that shared the same strategic objective
25 as the American Funds.

26 ¹⁴ The results are for the A, B and C Classes only, and are presented in terms of
27 difference, defined as follows: American Funds Fee Levels Minus Benchmark Fee
28 Levels. Thus, a positive (negative) value denotes American Funds fees that are higher
(lower) than industry benchmark averages.

1 **Comparison of the 2003 12b-1 Fees for American Funds to CRSP**
 2 **Benchmark¹⁵ of Large Size Funds**

American Fund Name	Amount by which American Fund's 12b-1 Fee Exceeded 12b-1 Fee for Benchmark of Large Size Funds
AMCAP Fund	54 bps
American Balanced Fund	49 bps
Bond Fund of America	58 bps
Capital World Growth and Income Fund	38 bps
Growth Fund of America	54 bps
Income Fund of America	53 bps
Investment Company of America	61 bps
Capital Income Builder Fund	50 bps

13
 14 **The 12b-1 Fees Were Excessive Because the Primary Purpose to Which They**
 15 **Were Being Put – Growing the Funds – Actually Inhibited the Achievement of**
 16 **Superior Returns for Investors**

17 49. Rule 12b-1 was adopted to provide a way to increase assets that would
 18 create economies of scale, and therefore decrease costs for the investors. However, at
 19 a certain point the increase of fund assets is no longer a desirable option for investors
 20 because it impedes the management of the fund.

21 50. Plaintiffs have studied the performance of the American Funds and the
 22 benchmark funds over the period of 2000 to 2004. Such a review shows that the
 23 performance of the American Funds relative to the performance of the benchmark

24 _____
 25 ¹⁵ The benchmark funds are funds that are comparable in size and would therefore
 26 have similar costs and experience the same economies of scale. The results are for the
 27 A, B and C Classes only, and are presented in terms of difference, defined as follows:
 28 American Funds Fee Levels Minus Benchmark Fee Levels. Thus, a positive
 (negative) value denotes American Funds fees that are higher (lower) than industry
 benchmark averages.

1 funds deteriorated as the funds grew larger. Specifically, Plaintiffs found that for
2 every additional \$3 billion inflow of assets there was an approximately correlating
3 61 bp decline in performance. The data utilized by Plaintiffs for this study was
4 equally available to the American Funds directors, who either ignored such
5 information or never sought to determine the impact of massive asset inflows on
6 performance.

7 51. As described more fully below, the three major reasons why a fund's
8 large size inhibits the achievement of superior returns are: (1) the number of stocks
9 available for a fund's portfolio decreases; (2) transactions by the funds adversely
10 affect the market price of funds investments; and (3) portfolio management becomes
11 increasingly structured, group-oriented, and less reliant on savvy individuals. John C.
12 Bogle, *Common Sense On Mutual Funds* 265 (John Wiley & Sons 1999).

13 52. First, the number of stocks available to investors decreases for very large
14 funds because managers must keep their funds diverse and therefore rarely have more
15 than a 3% investment in a company. *Id.* Holding a big proportion of a certain stock
16 constrains a fund's market liquidity. Therefore, due to a fund's need to maintain its
17 diversity and liquidity, a fund's increase in size decreases the number of stocks in
18 which the fund can invest. As explained in a recent *Time* article:

19 The scale problem is this: as a stock fund swells with assets, the
20 manager, who usually operates with limits on how much of any one
21 stock can be in the fund, must find ever more winning stocks. And
22 managers of big funds tend to have fewer choices because they focus on
23 shares of big companies.

24 Daniel Kadlec, *Meet the No-Star Team*, *Time*, Dec. 19, 2005, at 58-59.

25 53. Second, an expansive increase in a fund's size adversely affects the funds
26 ability to profit from transactions. The fund becomes so bulky that it often must take
27 large positions in individual stocks, such that selling its holdings in a particular
28 investment affects that investment's market price, thus lowering profits. If the fund's

1 management then wants to buy, it will not get the best price because the stock price
2 rises due to the demand and the higher stock price lowers potential profits. Thus, a
3 fund's large size impairs the profitability of transactions by the fund and impedes the
4 money manager's ability to trade underlying securities of the fund. For example, with
5 respect to American Balanced Fund, Morningstar explains:

6 But good news for advisers and American funds might be mixed news
7 for shareholders. That's because bigger funds can have difficulty trading
8 shares without adversely impacting their share prices...

9 Fund companies have tools at their disposal to limit growth, such as
10 raising investment minimums and closing funds, but American hasn't
11 taken such steps.

12 Paul Herbert, Morningstar's Take: American Funds American Balanced's Asset
13 Growth Continues to Be Our Primary Concern About It, Feb. 5, 2005,
14 <http://quicktake.morningstar.com> (password required).

15 54. For example, in 2006, five American Funds (including four Funds in this
16 lawsuit) were General Motors' ("GM") biggest mutual fund investors and the
17 substantial amount that these Funds hold could influence the prices at which they are
18 able to sell their shares.

- 19 • Washington Mutual Investors Fund is the top GM holder, owning 4.34%
20 of the company at a value of \$743,470,985. Yahoo! Finance, General
21 Motors Corp., <http://finance.yahoo.com/q/mh?s=GM> (last visited Feb.
22 14, 2006).
- 23 • Investment Company of America owns 2.31% of GM at a value of
24 \$396,399,500. *Id.*
- 25 • The Income Fund of America Inc owns 2.04% of GM at a value of
26 \$349,253,978. *Id.*
- 27 • AMCAP Fund owns .80% of GM at a value of \$136,214,500. *Id.*

1 • Capital Income Builder, Inc. Fund owns .80% of GM at a value of
2 \$136,214,500. *Id.*

3 55. In early 2006, GM decided to cut its dividend from \$0.50 to \$.25. This
4 decrease injures what commentators have called American's "five dividend-hungry
5 portfolios" because each of these portfolios invests so heavily in GM. While the
6 Funds' stake in GM was down 18% from June 2005, their size adversely affects its
7 liquidity and makes it more difficult for the Funds to unload their shares.

8 56. Massive size also limits a fund's ability to invest in smaller companies.
9 As further explained in the *Time* article:

10 [S]hares of small companies, whose price moves quickly with big trades,
11 tend to quickly get too expensive. And since most funds have
12 restrictions on the percentage of any one company they can own, with a
13 small company even a smart pick has little impact.

14 Kadlec, *Meet the No-Star Team*, *Time*, Dec. 19, 2005, at 58-59.

15 57. Finally, the reliance on more advisers which usually accompanies a
16 fund's growth dilutes the impact of any individual adviser. As noted in a *Business*
17 *Week* article:

18 By continuing to add managers to a fund, it risks diluting the
19 performance of the other managers. "You do have to worry about the
20 asset growth," says Don Phillips, managing director at Morningstar.
21 "Their strategy assumes they can bring in new people who are just as
22 talented. Think about expansion teams in baseball. If you bring 10 more
23 teams, it waters down the talent."

24 Most of American's managers preside over pieces of two or three funds
25 and rely on the same pool of in-house analysts, who also manage parts of
26 each fund. The results: Many of the funds have similar stocks in their
27 portfolios. For example, the firm's two equity-income funds, Capital
28

1 Income Builder Fund... and the Income Fund of America...have 59 of
2 their top 100 stocks in common.

3 Christopher Palmeri & Adrienne Carter, American Fund's Dilemma: Will Too Much
4 Growth Make It A Victim Of Its Own Success, Business Week, Feb. 21, 2005.

5 58. Yet despite the fact that the ballooning of fund assets can be detrimental
6 to investors, Defendants still charged 12b-1 fees to further increase Fund assets. As
7 noted with respect to American Funds:

8 But the avalanche of new money potentially poses more problems for
9 American than the others. Its assets under management have nearly
10 doubled, to \$656 billion, over the past five years, a dizzying growth rate
11 far faster than those of its rivals. American operates 29 funds, vs. 360 at
12 Fidelity and 110 at Vanguard, so its individual funds tend to swell much
13 faster. Unlike many other fund families, American refuses to close its
14 funds to new investors to limit the amount of money it needs to deploy.

15 *Id.*

16 59. This problem has been noted with respect to specific American Funds.
17 For example, with respect to the American Balanced Fund, Morningstar noted that:
18 “[American Balanced is] bringing in money hand over fist, and a trio of funds has
19 topped the \$70-billion-in-assets mark recently...given the absolute sizes of some
20 portfolios, we think the firm owes shareholders this duty [to resolve problems
21 associated with the Fund's size].” American Funds American Balanced Stewardship
22 Grade, Aug. 9, 2004, [http://quicktake.morningstar.com/Fund/FidGrade.asp?Country=](http://quicktake.morningstar.com/Fund/FidGrade.asp?Country=USA&Symbol=ABALX&fdtab=fidgrade)
23 [USA&Symbol=ABALX&fdtab=fidgrade](http://quicktake.morningstar.com/Fund/FidGrade.asp?Country=USA&Symbol=ABALX&fdtab=fidgrade) (password required).

24 60. Another analyst similarly noted the precariousness of asset growth in the
25 American Balanced Fund, stating, “[i]n the past we have called for American Funds to
26 limit the growth of this fund and others, but we don't expect it will close funds. In our
27 opinion, it may be keeping funds open at shareholders' peril.” Paul Herbert,
28 *Morningstar's Take: Size May Be Playing More Of A Role In This Fund's Positioning*

1 *Than It Initially Seems*, July 5, 2005, <http://quicktake.morningstar.com> (password
2 required).

3 61. Similar comments have been made with respect to other American
4 Funds:

- 5 • “We’ve been worried about the large and growing asset bases of the
6 American Funds, including this one [the Investment Company of
7 America Fund], in recent years.” Paul Herbert, *Morningstar’s Take: We
8 Aren’t As High On Investment Company Of America As We Are On
9 Similar Offerings In The American Funds Stable*, Dec. 21, 2005,
10 <http://quicktake.morningstar.com> (password required);
- 11 • “Quick asset growth continues to be a wild-card issue for the [Income
12 Fund of America]. Its asset base has topped \$60 billion, or about \$40
13 billion more than its level at the end of 2002.” Paul Herbert,
14 *Morningstar’s Take: This Fund’s Recent Sluggishness Doesn’t Bother
15 Us, Its Size Remains Our Major Qualm*, Dec. 12, 2005,
16 <http://quicktake.morningstar.com> (password required);
- 17 • “We’ve spilled a lot of ink telling readers that [the Growth Fund of
18 America’s] size concerns us.” Paul Herbert, *Morningstar’s Take: Size
19 And Other Considerations Make Us Somewhat Cautious About Growth
20 Fund Of America*, Aug. 12, 2005, <http://quicktake.morningstar.com>
21 (password required).

22 62. Other investment companies have taken prudent steps to curb their funds’
23 growth, instead of charging additional money for 12b-1 fees that aggravate the
24 problem by encouraging more fund growth. From the end of 2002 to 2003, American
25 Funds’ total assets increased by \$120 billion, between 2003 and 2004 they increased
26 by \$184 billion, and from 2004 to 2005 they increased by another \$115 billion. When
27 funds rapidly increase in size, industry practice dictates that the prudent approach is to
28 either increase the minimum investment or close the fund to new investors. Here

1 Defendants failed to do either, instead choosing to use Fund and investor assets,
2 including 12b-1 fees, to further increase the size of American Funds and aggravate the
3 Funds' problems attributable to their gargantuan size.

4 63. In the first half of 2004, there were four mutual fund companies that saw
5 their funds balloon (Fidelity Investments, Vanguard, Dodge & Cox and American
6 Funds) with aggregate inflows of \$114 billion. Aside from Defendants, the three
7 other fund companies who also experienced significant inflows either closed their
8 funds or increased their minimum investments to curb the sales of their funds. In
9 January of 2004, Dodge & Cox closed its Dodge & Cox Stock Fund to new investors
10 "to slow the pace of cash flows to the fund." Ian McDonald, *Four Mutual-Fund*
11 *Firms See Cash Just Pouring In -- And That's Both Good and Bad: Portfolio*
12 *Managers Find It Hard To Maneuver When They're Giants*, Wall Street Journal,
13 Aug. 5, 2004.

14 64. In Vanguard's press release regarding why it has closed the Primecap
15 Fund and Capital Opportunity Fund, Vanguard Chairman, John C. Brennan, stated:

16 While the funds' asset levels and cash flows are currently manageable,
17 the likelihood of rising cash flows is clearly high, given the funds' strong
18 performance...Our responsibility lies with the funds' current clients, so
19 we are taking these steps to preserve PRIMECAP Management's ability
20 to employ its distinct investment strategy and pursue competitive long-
21 term returns going forward.

22 Press Release, Vanguard Group, Vanguard Closes Two Equity Funds (Mar. 4, 2004),
23 available at <http://onlinepressroom.net/vanguard/> (follow "Press Releases" hyperlink).

24 65. Furthermore, the press release noted:

25 Vanguard has a long history of acting preemptively to restrict cash
26 inflows and maintain fund assets at reasonable levels to protect existing
27 shareholders, employing measures such as closing funds, raising their
28 minimum initial investment amounts, and imposing redemption fees.

1 *Id.*

2 66. Other fund companies have also increased the minimum investments
3 required to invest as another way to curb the inflow of funds. In order to avoid
4 problems associated with massive inflows, Vanguard Health Care mutual fund has
5 raised its investment minimum twice since 1999 – first to \$10,000 and then to
6 \$25,000. According to Christine Benz, associate director of fund analysis at
7 investment-research firm Morningstar Inc., “[r]aising the bar at such a fund helps
8 protect the current shareholders.” Dawn Smith, *SmartMoney Fund Screen / High*
9 *Minimum Funds*, Wall Street Journal, Nov. 9, 2004. In 2004, as a result of assets
10 doubling in size to \$3.3 billion, Vanguard Energy Fund also raised its investment
11 minimum to curb new money coming into the fund. Allison Bisbey Colter, *Vanguard*
12 *Energy Raises Minimum -- Mutual Fund Aims to Curb Investors Looking to Oil for*
13 *Short-Term Payouts*, Wall Street Journal, June 1, 2004. Additionally, in January of
14 2004, Vanguard International Explorer Fund raised its minimum to \$25,000 from
15 \$10,000. *Id.*

16 67. Moreover, none of these funds was charging a 12b-1 fee. For example,
17 according to Vanguard’s website, the Vanguard Health Care Fund, Vanguard Energy
18 Fund, Vanguard International Explorer Fund, Vanguard Primecap Fund and Vanguard
19 Capital Opportunity Fund did not have any 12b-1 fees. In addition, according to the
20 Dodge & Cox public filings available on its website, the Dodge & Cox stock fund
21 does not charge any 12b-1 fees. In contrast, at the same time that the above-
22 mentioned funds took prudent steps by either closing the funds or increasing the
23 investment minimums, Defendants used more of investors’ money to increase sales
24 through 12b-1 fees and revenue sharing arrangements, thereby aggravating the
25 problems associated with huge funds.

26 68. Despite the industry’s repeated acknowledgements that the numerous
27 American Funds are becoming too big to serve the investors’ best interest and that
28 ballooning Fund size can impact the performance of the Funds, many of the largest

1 American Funds continued to charge distribution fees that were disproportionately
2 high to the services rendered. This disproportionate nature of the distribution fees is
3 demonstrated by the fact that Defendants continued to charge these fees to the Funds
4 and their investors even though such fees, which were used to finance the growth of
5 the Funds, no longer had a “reasonable likelihood” of benefiting the Funds and their
6 investors and therefore failed to satisfy the requirements of Rule 12b-1.

7 69. Furthermore, the fact that the distribution fees of some of the largest
8 American Funds were significantly higher than those Funds’ management fees, as
9 demonstrated above, while comparably sized funds charged much lower distribution
10 than management fees, was a red flag that the Directors ignored when approving the
11 Funds’ fee arrangements. The Directors’ approval of the Funds’ fee agreements
12 resulted in fees being charged to the Funds that were disproportionate to the services
13 rendered and would not have been the product of arm’s-length bargaining.

14 70. In fact, as described more fully below, Defendants continued to focus on
15 (and charge) huge 12b-1 fees for growing the Funds because their asset-based fees
16 grew with the size of the Funds.

17 **THE ADVISORY FEES WERE EXCESSIVE BECAUSE THEY WERE**
18 **DISPROPORTIONATE TO THE SERVICES BEING PROVIDED**
19 **The Advisory Fees Were Excessive Because The Size Of The Funds Resulted**
20 **In The Funds Performing Like Passively Managed Index Funds While Still**
21 **Charging For Active Management**

22 71. With the huge growth in the American Funds over the past several years,
23 they have functioned more like an index fund. Increased asset size causes the Funds
24 to act similarly to index funds because as the funds grow, managers must increase
25 their number of holdings so they do not have too much money in any one stock.
26 Among other things, they increase their number of holdings to avoid problems with
27 trading in and out of their positions. Most funds need no more than 50 stocks to be
28 well diversified, after which they begin behaving like an index fund. Lewis Braham,
How To Spot A Closet Index Fund, Business Week, Sept. 6, 2004.

1 72. The SEC has given the following explanation of what index funds are
2 and why they have lower fees:

3 The management of index funds is more “passive” than the management
4 of non-index funds, because an index fund manager only needs to track a
5 relatively fixed index of securities. This usually translates into less
6 trading of the fund’s portfolio, more favorable income tax consequences
7 (lower realized capital gains), and lower fees and expenses than more
8 actively managed funds.

9 Securities and Exchange Commissions, Index Funds, *available at*
10 <http://www.sec.gov/answers/indexf.htm>. (last visited February 16, 2006).

11 73. As noted in a *Business Week* article:

12 The risk is that American’s funds will get so big that they become little
13 more than index and can no longer justify charging investors steep initial
14 fees of up to 5.75%.... A similar problem crimped Fidelity’s Magellan
15 Fund in the 1990s. Such worries could encourage defections.

16 Palmeri & Carter, *American Funds’ Dilemma*, *Business Week*, Feb. 21, 2005.

17 74. The table below shows that American Funds’ return on investment
18 closely tracked the S&P index return over the period of January 2002 through
19 December 2003, and that American Funds’ movement significantly followed the S&P
20 500.

21 **Correlations Between Monthly Returns of American Funds and the**
22 **S&P 500 Period Between January 2002 and December 2003**

Name of American Fund, Class A Shares	Correlation with the S&P 500	Total Net Assets as of 12/20/2003
AMCAP	96.9 %	\$11.7 Billion
Capital World Growth & Income	93.1%	\$17.6 Billion
American Balanced	96.9 %	\$26.3 Billion
Investment Company of America	97.9%	\$63.3 Billion

1 75. American Funds' increasing similarity to index funds is also illustrated
2 by looking at the Funds' "R-squared" figures. The R-squared figure measures a
3 fund's movements against its particular benchmark index on a scale ranging from 1 to
4 100. An S&P 500 index fund will have an R-squared number very close to 100
5 because the fund mirrors the index. A fund with a low R-squared number is moving
6 out of sync with its index. "A number above 90 indicates that it's pretty close to the
7 S&P index [or the respective index tracked by the fund]." Russel Kinnel, *Fund Spy:*
8 *How to Diversify With Big Funds*, Sept. 9, 2002, <http://news.morningstar.com>
9 (password required).

10 76. As the Funds have grown, the R-squared figures have changed and
11 reflected a greater and greater similarity between American Funds and benchmark
12 index funds. The following American Funds have high R-squared numbers, which
13 indicate their similarity to particular indexes:

- 14 • The Growth Fund of America has an R-squared of 90 to the Russell 1000
15 Value Index. American Growth Fund of America Fund Family Data,
16 <http://quicktake.morningstar.com> (password required) (last visited
17 Feb. 16, 2006).
- 18 • The Bond Fund of America has an R-squared of 93 to the Lehman
19 Brother's Credit Index. American Bond Fund of America Fund Family
20 Data, <http://quicktake.morningstar.com> (password required) (last visited
21 Feb. 16, 2006).

22 77. Despite the American Funds' performing largely as index funds, which
23 traditionally charge a significantly lower management fee, American Funds' investors
24 were still paying a management fee which was no longer justified given the changing
25 character of the Funds. The following table shows that the American Funds had
26 significantly higher expense ratios than are charged by the benchmark index fund:

27
28

1 **Correlation of 2003 Fees of American Funds to CRSP Benchmark of**
 2 **Index Funds**

Name of the American Fund	Amount By Which Expense Ratio of American Funds Exceeded Benchmark of Index Funds
AMCAP Fund	50 bps
American Balanced Fund	53 bps
Bond Fund of America	31 bps
Capital World Growth and Income Fund	41 bps
Growth Fund of America	91 bps
Income Fund of America	89 bps
Investment Company of America	49 bps

8 78. According to a recent study by Ross Miller, a risk consultant and former
 9 finance professor at Boston University, big funds tend to have a portion of their funds
 10 passively managed, like an index fund. The percentage of a fund's assets that is being
 11 passively managed can indeed be determined. Miller's analysis demonstrates that this
 12 passively managed portion is analogous to an index fund, while the remainder of the
 13 fund's assets are aggressively managed by a manager trying to beat the market. His
 14 results raise the question of, "Why should an investor have to pay a full management
 15 fee on the portion of an investor's money that is not being actively managed?" Jason
 16 Zweig, *Funds: How Much You're Really Paying*, Money Magazine, Nov. 2005.¹⁶

17 79. Likewise, American Funds grew so large during the relevant timeframe
 18 that only a portion of the Funds was actively managed. However, the size of the
 19 management fee reflected an incorrect assertion that the funds should compensate the
 20 Investment Adviser Defendant as if the Funds were fully actively managed -- which
 21
 22

23
 24 ¹⁶ According to this article, Miller formulates the true expense ratio of a fund by
 25 taking the passively managed portion of it into consideration. For example, according
 26 to Miller, for the year ending in 2004, although Defendants stated that American
 27 Funds Investment Company of America Class A's expense ratio was 0.59%, when
 28 considering how much of the Fund is actively managed, its true expense ratio is
 2.81%. American Funds Capital Income Builder Class A, American Balanced Funds,
 Amcap Fund, and the Growth Fund of America all yielded similar numbers. Zweig,
Funds, Money Magazine, Nov. 2005.

1 they were not. Accordingly, the advisory fee was excessive because it was
2 disproportionate to the services rendered. *Id.*

3 80. As a *Wall Street Journal* article recently explained: “It’s just a reality that
4 as a fund gets bigger it gets tougher for it to beat its benchmark,” said Russ Wermer, a
5 finance professor and fund researcher at the University of Maryland’s Smith School of
6 Business. McDonald, *Four Mutual-Fund Firms See Cash Just Pouring In*, *Wall*
7 *Street Journal*, Aug. 5, 2004.

8 **The Advisory Fees Were Excessive Because The Massive Inflow Of Assets**
9 **Impeded the Quality Of Advisory Services Provided To The Funds**

10 81. The quality of advisory services eroded due to the dramatic inflow of
11 fund assets. As previously explained, the size of the Funds compromised the Funds’
12 ability to be managed. Warren Buffet, an industry leader, noted in a section titled, “A
13 Fat Wallet Is the Enemy of Superior Investment Results” that:

14 [A]bout 75 percent of the difference in our performance between now
15 and in the distant past is accounted for by size. We have always known
16 that huge increases in managed funds would dramatically diminish our
17 universe of investment choices.

18 * * *

19 For the entire 1950s, my personal returns using equities with a market
20 cap of less than \$10 million were better than 60 percent annually. At our
21 present size [\$64 billion], I dream at night about 300 basis points (i.e., 3
22 percentage points per year better than the market).

23 Bogle, *Common Sense On Mutual Funds* 268. As previously discussed, the assets of
24 the American Funds have ballooned during the last few years and the growth of the
25 Funds was so drastic that it adversely affected the liquidity of the positions held by the
26 Funds, thereby eroding the Funds’ performance.

27 82. The negative impact of the massive inflows on the quality of American
28 Funds’ services has influenced brokers’ and industry analysts’ views on American

1 Funds. According to Michael J. Francis, president of Francis Investment Counsel
2 LLC, a retirement consultant in Hartland Wisconsin, due to the growth in American
3 Funds he is “telling [his] clients to consider other funds.” Palmeri & Carter, *American*
4 *Fund’s Dilemma*, Business Week, Feb. 21, 2005. Furthermore, according to an article
5 in *Kiplinger*, “if you’ve invested in the bigger American Funds...it’s time ... to sell.”
6 Steve Goldberg, *Are American Funds Too Fat*, Sept. 21, 2004, available at
7 <http://www.Kiplinger.com/personalfinance/printstory.php?pid=3382>.

8 83. Morningstar, a popular information source for investors, also removed
9 American’s Growth Fund of America from its list of analyst picks in May 2004
10 because “[i]t’s eye-popping asset growth will likely lead to moderate returns in
11 coming years.” McDonald, *Four Mutual-Fund Firms See Cash Just Pouring In*, Wall
12 Street Journal, Aug. 5, 2004.

13 **The Quality of Defendants’ Services Did Not Justify**
14 **The Advisory Fees Charged Because The Funds**
15 **Underperformed When Compared To Less Expensive Funds**

16 84. While Defendants often tout their Funds’ performance, the Funds
17 underperformed relative to less expensive benchmark funds once expenses and sales
18 charges were taken into account. In the chart set forth below, the benchmark funds to
19 which the American Funds were compared consisted of no-load funds. The figures in
20 the columns in the chart below which address the “excess returns net of expenses and
21 maximum loads” are calculated by taking the value-weighted annual returns of the
22 American Funds and subtracting the annual return of a benchmark of no load funds.
23 The calculation is made net of expenses and maximum allowable front and back end
24 loads. A positive value in this column demonstrates that the American Fund
25 outperforms its benchmark, while a negative number demonstrates that the Fund has
26 underperformed the benchmark.
27
28

1 **Comparison Of American Funds' Excess Returns Over The Returns Of**
 2 **No Load Benchmark Funds In 2003 And 2004**

American Fund Name	2003 Difference Between the Funds' returns net of expenses and maximum loads and the returns of no-load benchmark funds	2004 Difference Between the Funds' return net of expenses and maximum loads and the returns of no-load benchmark funds
AMCAP Fund	-423 bps	-449 bps
American Balanced Fund	77 bps	-175 bps
Bond Fund of America	326 bps	-216bps
Capital Income Builder Fund	-1693 bps	424 bps
Capital World Growth and Income Fund	-101 bps	263 bps
Growth Fund of America	-69 bps	-181bps
Income Fund of America	-67 bps	-163 bps
Investment Company of America Fund	-280 bps	-260 bps

17 85. This chart demonstrates that when the Funds' performance is analyzed
 18 net of expenses and sales loads it is inferior to what investors would have received had
 19 they invested in comparable no-load benchmark funds. Since the quality of the
 20 services for which Defendants received their fees failed to result in superior Fund
 21 performance, the fees were disproportionate to the services rendered and were
 22 therefore excessive.

23 **The Advisory Fees Were Excessive Because The Investment Adviser**
 24 **Defendant Used Such Fees To Compensate For Its Revenue Sharing**
 24 **Arrangements Which Are Not Advisory In Nature**

25 86. Revenue sharing occurs when the investment adviser or its affiliate
 26 makes cash payments to a broker-dealer in exchange for the broker-dealer pushing
 27 shares of that fund. Directed brokerage is the practice whereby investment advisers
 28 direct underlying portfolio securities transactions to broker-dealers that sell shares of

1 the fund to remunerate brokers for pushing their funds instead of other fund
2 companies' funds.

3 87. The expenses associated with such revenue sharing should not be taken
4 into consideration in determining advisory fees because they do not relate to any
5 advisory services provided to the Funds or their investors. Investment advisory fees
6 are meant to cover management of investment funds and other costs that support the
7 management of the funds. *See* Report of the SEC on the Public Policy Implications of
8 Investment Company Growth, H.R. Rep. No. 89-2337 (1966). The investment
9 advisory fees used for revenue sharing do not fit either of these two categories.
10 Revenue sharing expenses are not supposed to be borne by investors and their funds,
11 as they are not management or traditional advisory expenses.

12 88. In fact, in actions to date involving Massachusetts Financial Services,
13 Co., Franklin Templeton Distributors, Inc., Putnam Investment Management, LLC,
14 American Funds Distributors, Inc., OppenheimerFunds, Inc. and OppenheimerFunds
15 Distributor, Inc., as well as PIMCO Funds' PA Fund Management LLC, PEA Capital
16 LLC and PA Distributors LLC, the SEC has made factual findings that the costs of
17 these revenue sharing arrangements should have been borne by the funds' investment
18 adviser as an out-of-pocket expense. As the SEC has stated, "[r]evenue sharing
19 arrangements not only pose potential conflicts of interest, but also may have the
20 indirect effect of reducing investors' returns by increasing the distribution-related
21 costs incurred by funds. Even though revenue sharing is paid to broker-dealers
22 directly by fund investment advisers, rather than out of fund assets, it is possible that
23 some advisers may seek to increase the advisory fees that they charge the fund to
24 finance those distribution activities.... Moreover, revenue sharing arrangements may
25 prevent some advisers from reducing their current advisory fees." 69 Fed. Reg. 6438,
26 6441 n.21 (Feb. 10, 2004).

27 89. Here, Defendants had revenue sharing agreements with over 100
28 brokerage firms, including Edward Jones (their top shelf space partner), Morgan

1 Stanley Dean Witter, Piper Jaffray, Salomon Smith Barney, Wachovia Securities and
2 UBS Financial Services. These *quid pro quo* arrangements called for hundreds of
3 millions of dollars in additional compensation to be paid from Defendants to broker-
4 dealers as incentives to steer unwitting investors into the American Funds. On
5 March 23, 2005, the California Attorney General's Office filed a securities fraud
6 lawsuit against the Investment Adviser and Distributor Defendants alleging that they
7 violated California's Corporate Securities Law by failing to inform investors that they
8 paid at least \$329 million in cash and directed brokerage in "Shelf-Space" payments
9 to numerous broker-dealers from 2000 to the end of 2003 to sell and recommend
10 American Funds to investors. Complaint, *State v. American Funds Distributors, Inc.*,
11 No. BC330774 (Cal. Super. Ct. Mar. 24, 2005). That is, between 2000 and 2003,
12 Defendants paid such broker-dealers over \$197 million in cash and, in 2004, \$97
13 million in cash. *Id.* According to the California Attorney General's complaint, the
14 Distributor Defendant created a "broker marketing pool" where it would direct five
15 basis points of cash to be paid to broker-dealers based on their previous year's sales.
16 *Id.* The Investment Adviser Defendant transferred monies to the Distributor
17 Defendant so that the Distributor Defendant could satisfy its revenue sharing
18 arrangements. *Id.* The Investment Adviser Defendant provided this funding to the
19 Distributor Defendant because the Distributor Defendant was the party actually
20 negotiating the revenue sharing arrangements which benefited the Investment Adviser
21 Defendant. *Id.*

22 90. According to the December 2, 2004 SEC Cease and Desist Order against
23 Edward Jones, Defendants:

24 agreed to make revenue sharing payments to Edward Jones in varying
25 amounts up to and in several cases meeting Edward Jones' target of 25%
26 of the advisory fees for assets purchased or held by Edward Jones'
27 customers.

28

1 SEC Order Instituting Administrative and Cease-and-Desist Proceeding, Making
2 Findings, an Imposing Restricted Sanctions, *In re Edward D. Jones & Co., L.P.*,
3 (Dec. 22, 2004).

4 91. Given the massive number of revenue sharing agreements Defendants
5 had with broker-dealers and the hundreds of millions of dollars they had to pay under
6 such agreements for Shelf-Space, on information and belief, to the extent that
7 Defendants made any of these payments purportedly from their own assets, they
8 reimbursed themselves through management and other fees charged to the Funds and
9 their investors. Instead of bearing the out-of-pocket costs of the revenue sharing
10 arrangements themselves, the Investment Adviser and Distributor Defendants took
11 such expenses into account when setting the fees they would levy upon the Funds and
12 their investors, so that Defendants would still make a profit after paying such expenses
13 – the precise concern expressed by the SEC, as quoted above. These revenue sharing
14 payments, covered by excessive fees to the Funds and their investors, benefited the
15 Investment Adviser and Distributor Defendants because they increased the size of the
16 Funds and, thus, their asset-based fees, but did not benefit the Funds or their investors.
17 Nor did Defendants perform any additional services for this increase in fees resulting
18 from the revenue sharing payments. Instead, the increase in fees was simply a
19 windfall for Defendants, or “something for nothing.” It did not reflect any legitimate
20 increase in the cost of the services being provided by Defendants, making such fees
21 disproportionately high relative to the services rendered.

22 92. As such, Defendants engaged in revenue sharing and charged the Funds
23 and their investors excessive fees to cover the costs of such arrangements to enhance
24 their own compensation, despite the fact that such programs were conducted in a
25 manner that violated SEC and NASD rules.

26
27
28

1 **Defendants Used Excessive Advisory Fees To Circumvent The Requirements**
2 **Of 12b-1 On Use Of Fund Assets For Distribution**

3 93. When an investment adviser has the intent of allocating a certain amount
4 of advisory fees towards distribution practices (such as revenue sharing), where the
5 investment adviser and its affiliates claim to make payments from their own profits,
6 such fees are regulated under Rule 12b-1 and Section 36(b). As the SEC explained,
7 “Rule 12b-1 could apply...in certain cases in which the adviser makes distribution
8 related payments out of its own resources...‘if *any allowance* were made in the
9 investment adviser’s fee to provide money to finance distribution.” Investment
10 Company Act of 1940 Rule 12b-1, 1998 SEC No-Act. Lexis 976, at *16 (Oct. 30,
11 1998) (citing Payment of Asset-Based Sales Loads By Registered Open-Ended
12 Management Investment Companies, Investment Company Act Release No. 16431,
13 1988 SEC LEXIS 1206 (June 13, 1988)) (emphasis added). As explained above,
14 Defendants paid for part of these revenue sharing arrangements through excessive
15 advisory fees to circumvent the limits placed on the use of Fund assets for distribution
16 under 12b-1.

17 **The Advisory Fees Were Excessive Because The Economies of Scale Were Not**
18 **Passed to Investors**

19 94. When examining the source of excessive advisory fees, the legislative
20 history of Section 36(b) states:

21 It is noted ... that problems arise due to the economies of scale
22 attributable to the dramatic growth of the mutual fund industry. In some
23 instances these economies of scale have not been shared with investors.

24 Recently there has been a desirable tendency on some fund managers to
25 reduce their effective charges as the fund grows in size. Accordingly,
26 the best industry practice will provide a guide.

27 S. Rep. No. 91-184, at 5-6 (1969), reprinted in 1970 U.S. Code Cong. & Ad. News, at
28 4901-02.

1 95. The profitability of an investment adviser is a function of revenue minus
2 the costs of providing services. Defendants' incremental costs of providing advisory
3 services to the Funds were nominal. The additional fees received by Defendants were
4 disproportionate given that the nature, quality and level of services remained the same.
5 On a per share basis, it does not cost more to manage additional assets in a growing
6 fund because economies of scale occur on both the fund complex and portfolio level
7 for various costs incurred. For example, many of the costs, such as the costs of
8 research for a particular investment, remain fixed regardless of the amount of assets in
9 a given fund devoted to that investment. As has been noted, the mutual fund industry
10 is a business in which economies of scale are present and are statistically significant.
11 *See* Jim Saxton, Chairman, Joint Economic Committee of the United States Congress,
12 *The Mutual Fund Industry: An Overview and Analysis* 19 (2002) (citing William
13 Baumol, *The Economics of Mutual Fund Markets: Competition Versus Regulation*
14 186, 190 (Kluwer Academic 1990)) *available at* [http://www.house.gov/jec/](http://www.house.gov/jec/mutual2.pdf)
15 [mutual2.pdf](http://www.house.gov/jec/mutual2.pdf).

16 96. Over the last five years, American Funds have experienced significant
17 growth and economies of scale as a result of 12b-1 fees and revenue sharing
18 arrangements. In fact, as previously noted, American Funds' assets under
19 management doubled between 2002 and 2005. For example, with respect to American
20 Balanced Fund, Morningstar explains that "[i]n the past, expenses have fallen as assets
21 have climbed. What we find a bit worrisome is that even as assets have ballooned in
22 the past two years, expenses have stayed at about the same levels." American Funds
23 American Balanced Stewardship Grade, Aug. 9, 2004, [http://quicktake.](http://quicktake.morningstar.com/Fund/FidGrade.asp?Country=USA&Symbol=ABALX&fdtab=fidgrade)
24 [morningstar.com/Fund/FidGrade.asp?Country=USA&Symbol=ABALX&fdtab=](http://quicktake.morningstar.com/Fund/FidGrade.asp?Country=USA&Symbol=ABALX&fdtab=fidgrade)
25 [fidgrade](http://quicktake.morningstar.com/Fund/FidGrade.asp?Country=USA&Symbol=ABALX&fdtab=fidgrade) (password required).

26 97. When examining the expense ratio over the last five years, similar to the
27 previous examples citing a 10-year period, it becomes clear that the economies of
28 scale created over the last five years were not passed to investors. For example,

1 despite the fact that net assets of the Investment Company of America's Class B
2 shares increased from \$439 million to \$3.7 billion, the expenses charged by
3 Defendants increased, with the ratio of expenses to net assets going from 1.34% in
4 2000 to 1.35% in 2004.¹⁷

5 98. Similarly, the Growth Fund of America's Class C shares increased in
6 assets from \$385 million in 2001 to \$4.8 billion in 2004. At the same time, the
7 expenses levied by Defendants increased, resulting in the increasing of the expense
8 ratio to net assets from .80% to 1.50%.¹⁸

9 99. The Capital World Growth & Income Fund's Class B shares increased in
10 assets from \$55 million in 2000 to \$1.2 billion in 2004. At the same time, the
11 expenses remained at 1.55%.¹⁹

12 100. The AMCAP Fund's Class A increased in assets from \$7.4 billion in
13 2001 to \$11 billion in 2004. At the same time, the ratio of expenses to net assets
14 increased from .67% to .73%.²⁰

15 101. The Investment Adviser Defendant enjoyed a windfall from the increase
16 in advisory fees, but did not substantially increase the services provided to investors as
17 the assets under management and its fees increased. Instead, rather than closing a
18 ballooning fund and creating new ones, the Investment Adviser Defendant added more
19 managers. For example, five years ago the Growth Fund of America had four main
20 managers, while today it has eight. Although its assets have tripled, the amount

22 ¹⁷ Inv. Co. of Am., annual report for the fiscal year ending Dec. 31, 2004 (Form N-
23 CSR) (Mar. 11, 2005).

24 ¹⁸ Growth Fund of Am., annual report for the fiscal year ending Aug. 31, 2004 (Form
N-CSR) (Nov. 9, 2004).

25 ¹⁹ Capital World Growth & Income Fund, annual report for the fiscal year ending
26 Nov. 11, 2004 (Form N-CSR) (Feb. 8, 2005).

27 ²⁰ AMCAP Fund, annual report for the fiscal year ending Feb. 29, 2004 (Form N-
CSR) (May 10, 2004).

28

1 supervised by each manager has not risen much. Palmeri & Carter, *American Funds'*
2 *Dilemma*, Business Week, Feb. 21, 2005.

3 102. The various funds' portfolios extensively overlapped and Defendants
4 kept their research costs down by sharing the same research across the Funds.
5 Therefore investors who purchased different American mutual funds received
6 relatively little diversity through these investments. As illustrated below, all the stock
7 funds performed in a highly correlated manner:

8 Correlations Across Selected American Funds By Investment Objective

9 American Stock Funds Name	AMCAP	Am. Balanced	Capital Income Builder	Growth Fund of Am.	Income Fund of Am.	Inv. Co. of Am.
11 AMCAP	1.000	0.824	0.599	0.931	0.778	0.937
12 Am. Balanced		1.000	0.804	0.630	0.938	0.924
13 Capital Income Builder			1.000	0.470	0.905	0.761
14 Growth Fund of Am.				1.000	0.616	0.830
15 Income Fund of Am.					1.000	0.900
16 Inv. Co. of Am.						1.000

19 Notes: All entries in boldface are statistically significant at the 5% level or better. Entries represent correlation coefficients between
20 monthly returns (net of expenses) for all share classes over the period 2000-2004.

21 103. These numbers show that there was little diversification across the
22 different American Funds. Defendants also did not open any more Funds, but kept
23 managing the 29 funds to keep their costs low.

24 104. It is also clear that the fees charged to American Funds and their
25 investors were excessive when looking at fees for funds of comparable sizes. As
26 evidenced above, the dramatic growth of American Funds has not benefited investors
27 in the form of lower fees, and this is further illustrated by the fact that American
28 Funds' expense ratios are significantly higher than those of large size benchmark

1 funds, thereby further demonstrating that economies of scale were not being passed to
 2 investors by Defendants. The chart below shows that for 2003, Defendants charged
 3 fees that were anywhere from 24 bps to 58 bps more than fees charged to comparable
 4 funds, which, due to their size should have similar costs and experience similar
 5 economies of scale:

6 **Comparison of 2003 American Funds Expense Ratios to CRSP**
 7 **Benchmark of Large Size Funds**

American Fund Name	Amount by Which American Funds' Expense Ratio Was Higher Than The Benchmark
AMCAP	27 bps
American Balanced Fund	50 bps
Bond Fund of America	58 bps
Capital World Growth and Income Fund	29 bps
Growth Fund of America	24 bps
Income Fund of America	43 bps
Investment Company of America	56 bps
Capital Income Builder Fund	31 bps

19 105. According to the website for American Funds, the Investment Adviser
 20 Defendant announced that it was waiving a portion of its advisory fees across the
 21 board for all of the American Funds as of September 2004: “The waiver has reduced
 22 fees by 5% since last September [2004], and the reduction will be 10% beginning
 23 April 1, 2005.” American Funds’ Investment Adviser Waives Part of Its Management
 24 Fees, <http://www.americanfunds.com/planning/news/reduce-management-fees.htm>
 25 (last visited Feb. 16, 2006). According to the Investment Adviser Defendant, this
 26 “waiver” was necessary to account for economies of scale achieved as a result of asset
 27 growth. *Id.* However, according to the Investment Adviser Defendant, the advisory
 28

1 fee waiver was not a permanent reduction but, rather, would “continue for an
2 indefinite period subject to a review of the funds’ boards of directors.” *Id.* Given the
3 substantial amounts by which the American Funds’ fees exceeded the fees for
4 comparable funds during 2003, as demonstrated on the chart above, it was not
5 surprising that, consistent with industry trends at that time, the Investment Adviser
6 Defendant was forced to institute a “waiver” on advisory fees late in 2004.
7 Nonetheless, even with the “waiver” in advisory fees, the overall fees charged to the
8 Funds and their investors remained higher than the benchmark funds, showing that
9 economies of scale windfalls continued to be enjoyed by Defendants.

10 **The Charging Of Lower Fees For Shares Only Available Through Special**
11 **Programs And The Lower Fees Charged to Retail Shares in Comparable**
12 **Funds Illustrate That The Fees At Issue Were Excessive**

12 106. Each American Fund is comprised of fourteen share classes. Class A, B
13 and C shares may be purchased directly by the public through a financial adviser. The
14 CollegeAmerica savings plan share classes (529-A through 529-F) are sponsored by
15 the Commonwealth of Virginia and can be purchased only through a
16 “CollegeAmerica” account by contacting an investment dealer authorized to sell such
17 an account.²¹ The five retirement plan share classes (R-1 through R-5) are sold
18 without any sales charge.²² The basis points on which the advisory fee is based,
19 unlike the 12b-1 fees, are identical for each share class within a Fund. The different
20 aspects of each class of shares is described below:

21 **Class A shares**

22 107. Class A shares are subject to an initial sales charge which declines as the
23 amount invested increases. Class A shares generally do not incur a contingent
24 _____

25 ²¹ Growth Fund of Am., prospectus effective Nov. 1, 2004 (Form N-1A) (Nov. 1,
26 2004).

27 ²² Am. Balanced Fund, annual report for the fiscal year ending Dec. 31, 2003 (Form
28 N-CSR) (Mar. 11, 2005).

1 deferred sales charge upon redemption and are subject to 12b-1 fees. Class 529-A
2 shares have a similar fee structure to Class A shares but are usually subject to higher
3 12b-1 plan limits.²³

4 **Class B shares**

5 108. Class B shares are not subject to an initial sales charge, but carry a
6 contingent deferred sales charge which declines over time. Class B shares are subject
7 to higher 12b-1 fees than Class A shares and convert to Class A shares after eight
8 years. Class 529-B shares have a similar fee structure to Class B shares.²⁴

9 **Class C shares**

10 109. Class C shares are not subject to an initial sales charge, but carry a
11 contingent deferred sales charge if the shares are sold within one year after purchase.
12 Class C shares are subject to 12b-1 fees similar to those charged to Class B shares.
13 Class 529-C shares have a similar fee structure to Class C shares.²⁵

14 **Class 529-E shares**

15 110. Class 529-E shares are not subject to an initial or a contingent deferred
16 sales charge but are subject to 12b-1 fees. Class 529-E shares may be purchased only
17 by employees participating in CollegeAmerica through an eligible employer plan.²⁶

18 **Class F shares**

19 111. Class F shares are not subject to an initial or a contingent deferred sales
20 charge but are subject to 12b-1 fees similar to Class A shares. Class F shares are
21 generally available only to fee based programs of investment dealers that have a
22

23
24 ²³ Growth Fund of Am., annual report for the fiscal year ending Aug. 31, 2005 (Form
N-CSR) (Nov. 9, 2005).

25 ²⁴ *Id.*

26 ²⁵ *Id.*

27 ²⁶ *Id.*

28

1 special agreement with the Funds' distributor and through certain registered
2 investment advisers. These same charges apply to Class 529-F shares.²⁷

3 **Class R Shares**

4 112. Class R shares are sold exclusively for retirement plans and are not
5 subject to an initial or a contingent deferred sales charge. Class R shares are also
6 generally only available to those retirement plans which satisfy certain requirements
7 and recordkeeping preferences.²⁸ In addition, Class R-5 shares are generally only
8 available to retirement plans with at least \$1 million or more in plan assets. Class R-5
9 shares are only available to certain clients of the Personal Investment Management
10 group of Capital Guardian Trust Company.²⁹ Class R-5 shares are not subject to any
11 12b-1 fees.³⁰

12 113. As described above, the A, B, and C share classes of the American Funds
13 are the only ones which the general public can directly purchase from a financial
14 adviser. By contrast, the purchase of F and R shares is restricted to investors in fee-
15 based programs and retirement programs, respectively. Unlike the fees charged to A,
16 B and C shares, the fees charged to F and R shares for the same services are the
17 product of arm's-length bargaining and are lower as a result. For example, in the
18 Growth Fund of America, the F and R-5 shares had lower expenses than the A, B, and
19 C share classes. One of the reasons that fees charged to share classes which are not
20 purchased directly by individual investors are lower than the A, B and C share classes
21 is because the third parties negotiating the fees, such as an employer negotiating fees

22 ²⁷ *Id.*

23
24 ²⁸ Growth Fund of Am., prospectus effective Nov. 1, 2004 (Form N-1A) (Nov. 1,
25 2004); *see also* American Funds Share Classes & Expenses,
<http://www.americanfunds.com/funds/classes/index.htm> (last visited Feb. 16, 2006).

26 ²⁹ Growth Fund of Am., prospectus effective Nov. 1, 2004 (Form N-1A) (Nov. 1,
2004).

27 ³⁰ *Id.*

1 for a retirement plan, are more sophisticated and are unwilling to absorb the cost of
2 high revenue sharing payments, and they demand positive performance.

3 114. The A, B and C share classes for the American Funds also have higher
4 expense ratios than the A, B and C share classes of comparable funds. This is clearly
5 illustrated by comparing the 2003 expense ratios for the A, B and C classes of
6 American Funds' shares against the CRSP Benchmark, which consists of the value-
7 weighted average of the A, B and C classes of all funds existing in 2003 with the same
8 CSRP objective as the American Funds. As illustrated below, when the F and R class
9 shares (those share classes that allowed for arm's-length bargaining of the fees) are
10 not considered, the expense ratios for the A, B, and C classes of American Funds are
11 significantly higher in virtually every case than the expense ratio Benchmark for
12 comparable funds:

13 **Comparison of American Funds' 2003 Expense Ratios for A, B and C**
14 **Share Classes³¹ to the CRSP Benchmark for A, B and C Share Classes**

American Fund Name	Strategic Objective Category	Amount by Which American Funds' Expense Ratio Exceeded the Benchmark
American Balanced Fund	Balanced	24 bps
AMCAP Fund	Growth	61 bps
Bond Fund of America	Corporate High Quality	69 bps
Capital Income Builder	Growth & Income	54 bps
Capital World Growth & Income	Global Total Return	57 bps
Growth Fund of America	Growth	20 bps
Income Fund of America	Balanced	46 bps
Investment Company of America	Growth & Income	72 bps

25
26
27 ³¹ The 529-A, 529-B and 529-C share classes are included in the comparison.
28

1 **Defendants Profited From Fall-Out Benefits As A Result of Their**
2 **Relationship With The Funds**

3 115. “Fall-out” benefits are those benefits other than the advisory fees that
4 flow to the adviser and its affiliates as a result of the adviser’s relationship with the
5 fund. The fall-out benefits from which Defendants benefited included the use of
6 directed brokerage, transfer agency fees and Rule 12b-1 payments. However, during
7 the relevant period, at least through September 2004, the Investment Adviser and
8 Distributor Defendants did not reduce their fees to reflect the fall-out benefits they
9 received from these various forms of payment.

10 **Defendants Failed To Reduce Their Fees To Reflect The Fall-Out Benefits**
11 **Received By Using Brokerage Commissions To Pay For Defendants’ Expenses**

12 116. Defendants benefited from the use of the Funds’ brokerage commissions,
13 which are Fund assets, because they avoided paying for revenue sharing out of their
14 own assets. Directed brokerage is an expense which is not reflected in the expense
15 ratio but impacts an investor’s returns. Directed brokerage is the practice whereby
16 investment advisers direct underlying portfolio securities transactions to broker-
17 dealers that sell shares of the fund to remunerate brokers for pushing their funds
18 instead of other fund companies’ funds. This practice directly harms investors,
19 especially where, as here, the fund is alleged to be “paying up,” or trading securities at
20 commission rates higher than the fund would otherwise pay were it not indirectly
21 paying for distribution by directing brokerage commissions. Directed brokerage gives
22 the investment adviser and its affiliates a strong incentive to use brokerage
23 commissions to increase the size of the funds (thereby increasing advisory and other
24 asset-based fees) because they can avoid paying brokers out of their own assets.

25 117. On February 16, 2005, the NASD brought a disciplinary proceeding
26 against the Distributor Defendant for engaging in “directed brokerage” with numerous
27 brokerages in exchange for those brokerages pushing the American Funds on their
28 clients. As reported by *Bloomberg News*:

1 American Funds, the biggest U.S. seller of mutual funds, violated
2 securities rules for three years by paying brokerages \$100 million in
3 commissions in exchange for promoting its products over other firms',
4 the NASD said...The kickbacks were made to about 50 brokerages by
5 American Funds Distributors Inc., a unit of Los Angeles-based Capital
6 Group Cos.,...Morgan Stanley, Edward Jones & Co. and Franklin
7 Resources Inc. are among brokerages and fund firms that paid at least
8 \$275 million in penalties since September 2003 for their roles in so-
9 called revenue-sharing programs...American Funds initiated the
10 commissions rather than consenting to brokers' demands, opening a new
11 chapter in regulators' probes of fund sales practices.

12 Amy Strahan Butler & Danielle Kost, *American Funds Accused of Paying Kickbacks*
13 *to Brokers*, Feb. 16, 2005, [http://www.bloomberg.com/apps/news?pid](http://www.bloomberg.com/apps/news?pid=10000103&sid=aN7hxVL6xCI8&refer=us)
14 [=10000103&sid=aN7hxVL6xCI8&refer=us](http://www.bloomberg.com/apps/news?pid=10000103&sid=aN7hxVL6xCI8&refer=us).

15 118. The NASD's action against the Distributor Defendant demonstrates that
16 the type of misconduct engaged in by Defendants – the same type as alleged in this
17 Complaint – violated regulatory standards in existence during the relevant time frame.
18 As stated in the NASD's action against the Distributor Defendant regarding the
19 kickback scheme at issue here, such conduct violates NASD Conduct Rules 2830(k)
20 and 2110:

21 *First*, ... AFD, directly or indirectly, offered or promised brokerage
22 commissions to other firms, as a condition to the sale or distribution of
23 shares of American Funds, in violation of NASD Conduct Rule 2830(k).
24 *Second*, AFD violated NASD Conduct Rule 2830(k) by, directly or
25 indirectly, arranging for [the Investment Adviser] to direct to the top-
26 selling retail firms a percentage of directed brokerage commissions
27 conditioned upon that firm's sales or promise of sales of shares of
28 American Funds.

1 Complaint at 4, *NASD Dep't of Enforcement v. American Funds Distributor, Inc.*, No.
2 CE3050003 (Feb. 16, 2005). Furthermore, as explained by NASD Vice Chairman
3 Mary L. Schapiro in announcing the action against the Distributor Defendant,
4 “[t]oday’s action makes clear that it is just as impermissible [for mutual fund
5 families] to offer and make [kickback] payments as it is [for brokers] to receive
6 them.” Press Release, NASD, NASD Charges American Funds Distributors, Inc.
7 With Arranging \$100 Million in Directed Brokerage Commissions For Top Sellers of
8 American Funds (Feb. 16, 2005), available at [http://www.nasd.com/web/idcplg?](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013358)
9 [IdcService=SS_GET_PAGE&ssDocName=NASDW_013358](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013358).

10 119. The Investment Adviser Defendant directed brokerage commissions to
11 the top-selling retail firms in two different ways, depending upon whether the firm
12 possessed the capacity to execute securities trades.

13 120. First, for the approximately 20 of the top-selling retailers with which the
14 Distributor Defendant had a sponsorship arrangement to provide execution services,
15 the Distributor Defendant calculated “target commissions” that it intended to direct to
16 each of the top-selling retail firms according to a formula based upon each of the
17 firms’ prior year’s sales of American Funds. Complaint at 9, *State v. American Funds*
18 *Distributors, Inc.*, No. BC330774 (Cal. Super. Ct. Mar. 24, 2005).

19 121. To provide these firms with target commissions, the Distributor
20 Defendant arranged for the Investment Adviser Defendant to direct American Funds
21 portfolio transactions directly to these firms. *Id.* These firms executed the trades and
22 received the directed brokerage commissions. *Id.*

23 122. According to the complaint filed by the California Attorney General,
24 Defendants created target commissions that were based on 10 or 15 basis points of the
25 prior year’s sale of American Funds. *Id.* These 10 or 15 basis points, paid through
26 brokerage commissions, were significant when looking at the amount of sales per
27 fund.

28

1 123. For example, according to its annual report for the year ending on
2 December 31, 2002, the Investment Company of America Fund sold \$9.3 billion
3 worth of shares. Considering that the Defendants placed the target at around 10 or 15
4 basis points for 2003, this translates into \$9.3 million or \$14 million of Fund and
5 investor assets being the target needed to pay for revenue sharing. For 2003, the
6 Investment Company of America sold \$10.3 billion worth of shares which translates
7 into \$10.3 million or \$15 million in brokerage commissions being used to pay for
8 revenue sharing arrangements.³²

9 124. For the fiscal year ending December 31, 2002, the American Balanced
10 Fund sold \$10.4 billion in shares, which translates into \$10 million or \$15 million for
11 the amount of brokerage commissions that needed to be paid in 2003.³³ Other funds
12 acted similarly and their sales were also used to create target commissions.

13 125. For the approximately 30 of the top-selling retailers who did not have the
14 ability to execute trades for the Investment Adviser Defendant, they entered into “step
15 out” arrangements with clearing firms. In a “step out” arrangement, the firm to which
16 the commissions were to be directed (*i.e.*, the “step out” firm) identified to the
17 Investment Adviser and Distributor Defendants the clearing firm to which the
18 Investment Adviser Defendant should direct trades for execution. These trades were
19 designated for the “step out” firm pursuant to the target commissions established by
20 the Distributor Defendant. The Investment Adviser Defendant then directed
21 American Fund portfolio transactions to the clearing firm for the benefit of the “step
22 out” firm.

23 126. The clearing firm, which executed the trade, shared the commission with
24 the “step out” firm, even though the “step out” firm provided no services in

25
26 ³² Inv. Co. of Am., prospectus effective Mar. 1, 2004 (Form N-1A) (Apr. 27, 2004).

27 ³³ Am. Balanced Fund, prospectus for the fiscal year ending Mar. 1, 2004 (Form N-
1A) (Apr. 27, 2004).

1 connection with the trade. The amount of commission that the “step out” firm
2 received depended upon the agreement between the “step out” firm and the clearing
3 firm. As a result of these agreements, the clearing firm generally credited or paid
4 approximately 70-90% percent of the commission to the “step out” firm.

5 127. The directed brokerage commissions paid as a result of these practices
6 totaled at least \$132 million for the years of 2000-2003, which were out-of-pocket
7 expenses that should have been covered by Defendants. Complaint at 9, *State v.*
8 *American Funds Distributors, Inc.*, No. BC330774 (Cal. Super. Ct. Mar. 24, 2005).

9 128. This practice belies the notion that the Investment Adviser and
10 Distributor Defendants merely considered the selling efforts of the brokers involved.
11 These practices were, in fact, negotiated arrangements in which brokerage
12 commissions were traded to obtain preferential sales efforts by outside broker-dealers.

13 129. The directed brokerage used by Defendants did not fund any services that
14 benefited the American Funds shareholders. Instead, these directed brokerage
15 payments were simply a vehicle for Defendants to shift the burden of their out-of-
16 pocket expenses onto the Funds and their investors. This practice materially harmed
17 Plaintiffs and the Funds and their investors, from whom the directed brokerage assets
18 were taken.

19 **Defendants Failed to Reduce Their Fees To Reflect The Fall-Out Benefits**
20 **They Received From The Use Of Transfer Agency Fees**

21 130. When a mutual fund is sold through an intermediary, such as a brokerage
22 firm, it is the intermediary who tracks all the shareholder transactions and balances.
23 Therefore, intermediaries will typically demand to recover a fee in addition to the 12b-
24 1 fees. This is referred to as a sub-transfer agency fee.

25 131. Defendants used sub-transfer agency fees to pay for their out-of-pocket
26 expenses and optimize their own profits. Inflated sub-transfer agency fees paid by the
27 Funds and their investors were really used to pay for revenue sharing arrangements.
28 For example, instead of charging \$5 per account for the year, the broker would charge

1 \$25 per account for the year. The inflated amount would be used to settle revenue
2 sharing agreements. According to the complaint filed by the California Attorney
3 General, “Sub-Transfer Agency or Networking Fees were also paid to some Shelf-
4 Space Brokers ostensibly for the cost of record-keeping but were, in part, actually a
5 disguised additional form of Shelf-Space Payments from fund assets.” Complaint at
6 9, *State v. American Funds Distributors, Inc.*, No. BC330774 (Cal. Super. Ct. Mar. 24,
7 2005).

8 132. The amount of transfer agency fees paid by the Funds and their investors
9 is significant. For example, according to its annual report for the fiscal year ending
10 December 31, 2004, the Investment Company of America Fund Class A paid over
11 \$44.8 million in transfer agency fees. Although the fees should have been lower to be
12 reasonably related to the services being provided to the investors, they were inflated
13 so that a portion would be reallocated to pay for the Defendants’ out-of-pocket
14 expenses for revenue sharing commitments. This was another form of fall-out benefit
15 to the Investment Adviser Defendant, for which, until at least September 2004, it
16 failed to reduce its fees.

17 **The Investment Adviser Defendant Failed To Reduce Its Fees To Reflect Fall-**
18 **Out Benefits From 12b-1 Fees**

19 133. The Investment Adviser Defendant also received a fall-out benefit from
20 the Distributor Defendant’s use of 12b-1 fees. 12b-1 fees are used to encourage the
21 sale of fund shares which, in turn, increases fund assets and advisory fees. Therefore,
22 in light of the Investment Adviser Defendant’s receipt of increased asset-based
23 advisory fees, coupled with its failure to pass on economies of scale to investors, as
24 described above, the Investment Adviser Defendant was the beneficiary of the 12b-1
25 fees.

26
27
28

1 **The Directors' Failure To Act Independently And Conscientiously Resulted In**
2 **Defendants Charging Excessive Fees To The Funds And Their Investors**

3 134. Mutual funds are typically created and managed by investment advisers
4 for a profit. Investment advisers usually supervise a mutual fund's daily operations,
5 and often select affiliated persons to serve on the Board of Directors. As former SEC
6 Commissioner Manuel Cohen remarked when referring to testimony by investment
7 advisers:

8 They also made the point that the investment advisor creates the fund,
9 and operates it in effect as a business. Many of them stated that "It is our
10 fund, we run it, we manage it, we control it," and I don't think there is
11 anything wrong with them saying it. They were just admitting what is a
12 fact of life. *The investment advisor does control the fund.*

13 John P. Freeman, Prof. of Law, Univ. of South Carolina Law School, Before the
14 United States Senate Governmental Affairs Comm., Subcomm. on Fin. Management
15 the Budget, and International Security (Jan. 27, 2004) (citing Statement of Manuel
16 Cohen, Commissioner, SEC, Investment Company Act Amendments of 1976:
17 Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Fin. of
18 the Comm. on Interstate and Foreign Commerce (1967) (emphasis added)) *available*
19 *at* <http://hsac/senate.gov/-files/012704freeman.pdf>.

20 135. As a result of the investment adviser's control of the fund, the
21 relationship between investment advisers and mutual funds contains many potential
22 conflicts of interest. This conflict arises because part of the fees the investment
23 advisers levy, which reduce investors' returns, represents revenue and a source of
24 profit to the investment adviser. *See* U.S. Government Accountability Office Report,
25 Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition ("GAO
26 Report"), at 14, 82 (2000), *available at* <http://www.gao.gov/new.items/gg00126.pdf>.

27 136. The ICA was enacted in response to concerns that mutual fund
28 shareholders were not being adequately protected as a result of these conflicts of

1 interest. As a result, the Directors were made responsible for overseeing the
2 investment advisers' activities. GAO Report at 14. More specifically, the ICA
3 requires the presence of independent Directors on the Board of Directors to review
4 and approve the fees the funds and their investors are charged. *See* 15 U.S.C. § 80a-
5 10(a). The Board of Directors is responsible for approving the investment advisory
6 agreements, 12b-1 plans, and fees paid to Defendants. In reviewing and approving the
7 foregoing, the Directors are required to act in the best interest of the investors.

8 137. Acting in the investors' best interests requires the Directors to exercise
9 due care in approving the fees charged to those funds that the Directors have the
10 responsibility to oversee. This is why the expertise of the independent Directors,
11 whether they are fully informed of all facts bearing on the adviser's fee, and the extent
12 of care and conscientiousness with which they perform their duties are ***among the***
13 ***most important factors*** to be examined in evaluating whether the compensation fund
14 advisers and distributors receive is reasonable under § 36(b) of the ICA. *See*
15 *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 930 (2d Cir. 1982).

16 138. One way to evaluate whether the Directors fulfilled their duties with
17 adequate care and conscientiousness is to determine whether they acted independently
18 in approving the Funds' fee arrangements or, conversely, whether the Directors'
19 actions were controlled by the Funds' investment advisers. In determining whether or
20 not a Director is considered an "interested person," the ICA states that "a natural
21 person shall be presumed not to be a controlled person." 15 U.S.C. § 80a-2(a)(9).
22 The term "interested person" is defined to include "any affiliated person" of an
23 investment company, investment adviser, or principal underwriter. *Id.* at § 80a-
24 2(a)(19)(A)(i), (B)(i). "Affiliated person" is further defined as "any person directly or
25 indirectly controlling, ***controlled by***, or under common control with, such other
26 person." *Id.* at § 80a-2(a)(3)(C) (emphasis added). Finally, the ICA defines "control"
27 as "***the power to exercise a controlling influence*** over the management or policies of
28 a company." *Id.* at § 80a-2(a)(9) (emphasis added).

1 139. The presumption that a Director is not a “controlled person” under the
2 ICA may be rebutted by “evidence.” 15 U.S.C. § 80a-2(a)(9). Such evidence may
3 include allegations that non-employee Directors followed a course of action suggested
4 by the investment adviser which prejudiced the funds’ shareholders. If the Directors
5 rubber stamp suggestions of the investment adviser, they cannot fulfill their statutory
6 duties to act as “watchdogs” for the funds.

7 140. Moreover, the investment advisers control:

- 8 • the information that flows to the independent Directors;
- 9 • the board meeting agenda;
- 10 • the materials prepared and presented at the board meetings,
11 therefore “framing the issues”;
- 12 • who presents items at the meetings; and
- 13 • who is involved in educating and advising the independent
14 Directors.

15 *Management Conflicts Dominate Boardroom*, Fund Directions, July 1, 2005. Thus, it
16 is clear that the investment adviser is in a position to control the information and
17 actions of the Directors.

18 141. “[D]espite th[e] congressionally mandated ‘watchdog’ role, trustees have
19 acquiesced too readily to the demands of fund management companies, failing to ...
20 [*inter alia*] question excessive fees...” Julie Hembrook Daum & Richard Lannamann,
21 *Rising Expectations: Mutual Fund Directors Called To Create a Culture of*
22 *Independence*, June 2004, available at [http://www.spencerstuart.com/](http://www.spencerstuart.com/research/boards/679/)
23 [research/boards/679/](http://www.spencerstuart.com/research/boards/679/).

24 142. A wealth of evidence demonstrates that the purportedly “non-interested”
25 Directors blindly followed the Investment Adviser Defendant’s suggested courses of
26 action by rubber stamping fees and arrangements which prejudiced the Funds’
27 investors. This evidence also firmly establishes that, even if the Directors were
28 considered “independent,” they failed to fulfill their duties with the care and

1 conscientiousness necessary to ensure that the fees paid to Defendants from Fund and
2 investor assets were reasonable and not excessive.

3 143. One of these such instances was the Directors' adoption and renewal of
4 distribution agreements which resulted in the charging of 12b-1 fees which did not
5 benefit the Funds or their investors. If the Directors had examined the publicly
6 available information regarding the amounts of 12b-1 fees being charged to
7 comparable funds and the deterioration in fund performance resulting from the use to
8 which the 12b-1 fees were put – *i.e.*, enlarging the funds – it would have been obvious
9 that the 12b-1 fees charged to the Funds were not justified. As described hereinabove,
10 when funds rapidly increase in size, industry practice dictates that the prudent
11 approach is to either increase the minimum investment or close the fund to new
12 investors. Yet despite the fact that the ballooning of Fund assets was a red flag that
13 further growth would be detrimental to investors, the Directors still approved 12b-1
14 fees which were higher relative to comparable funds, in order to further increase fund
15 assets. This prejudiced the Funds and their investors.

16 144. Another of these such instances is the Directors' approval of, or
17 acquiescence in, the directed brokerage and revenue sharing arrangements to grow the
18 Funds which benefited only Defendants through increased asset-based fees. During
19 the relevant time frame, the Directors approved of the Distributor Defendant's yearly
20 directed brokerage arrangements with approximately 50 brokerage firms, under which
21 more than \$100 million of brokerage commissions generated by American Funds'
22 portfolio trades were to be directed to the top-selling retailers to both reward past sales
23 and encourage future sales. These arrangements enabled Defendants to annually pay
24 10 or 15 basis points through brokerage commissions to cover their revenue sharing
25 and directed brokerage arrangements. These 10 or 15 basis points were significant
26 when looking at the amount of sales per fund. *See supra* ¶¶ 132-134. The fact that the
27 Directors did not even question the acts or recommendations of the Defendants with
28 respect to these programs which only benefited Defendants demonstrates the

1 Directors' failure to act as a "watchdog" of the Investment Adviser Defendant. *See*
2 *supra* ¶¶ 148-152. Moreover, the Directors failed to recognize that since brokerage
3 commissions are Fund assets, their use should have been reflected in a 12b-1 plan.
4 This failure to act prejudiced the Funds and their investors.

5 145. Another example of the Directors following a course of action set by the
6 Investment Adviser Defendant instead of acting in the investors' best interest is found
7 in the Directors' failure to ensure that economies of scale were passed on to the Funds
8 and their investors. The SEC has made clear that it is the duty of the Directors to
9 carefully scrutinize the advisory and other fees to ensure that economies of scale are
10 being passed to investors as fund assets grow, so that the increases in asset-based
11 advisory and other fees are not a windfall to the investment advisers and their
12 affiliates:

13 If the fund or fund family is experiencing economies of scale, fund
14 directors have an obligation to ensure that fund shareholders share in the
15 benefits of the reduced costs by, for example, requiring that the adviser's
16 fees be lowered, breakpoints be included in the adviser's fees, or that the
17 adviser provide additional services under the advisory contract. If the
18 fund or fund family is not experiencing economies of scale, then the
19 directors may seek to determine from the adviser how the adviser might
20 operate more efficiently in order to produce economies of scale as fund
21 assets grow.

22 SEC, Division of Investment Management: Report on Mutual Fund Fees and
23 Expenses (Dec. 2000), *available at* <http://www.sec.gov/news/studies/feestudy.htm>.
24 The increase in fund assets accompanied by an increase in the expense ratio, and the
25 failure to reduce the 12b-1 and advisory fees levied upon the Funds and their investors
26 were all red flags that the Directors disregarded. The Directors' failure to ensure the
27 implementation of economies of scale across all of the Funds prejudiced the Funds
28 and their investors during the relevant time period.

1 149. This Count is brought by Plaintiffs derivatively on behalf of the
2 American Funds held by Plaintiffs, against the Distributor and Investment Adviser
3 Defendants, for breach of their fiduciary duties with respect to compensation as
4 defined by Section 36(b) of the ICA. Section 36(b) does not require plaintiffs to make
5 a demand on the Funds' Directors before bringing a claim.

6 150. Defendants had a fiduciary duty to the American Funds and their
7 investors with respect to the receipt of compensation for services and payments of a
8 material nature made by and to such Defendants.

9 151. As alleged above, the fees received by the Distributor and Investment
10 Adviser Defendants were excessive, in that they were so disproportionately large that
11 they bore no reasonable relationship to the services rendered and would not have been
12 negotiated in an arm's-length relationship. Specifically, the fees were
13 disproportionately large when considering: (1) the nature and quality of the services
14 rendered did not justify the fees; (2) the profitability of the funds to the adviser; (3) the
15 fact that economies of scale were not passed to the Funds and their investors; (4) what
16 other fund families or within the same fund family charge for similar mutual funds;
17 (5) the fact that Defendants failed to reduce their fees to reflect the fall-out benefits
18 they received; and (6) the fact that the Directors failed to exercise a sufficient level of
19 care and conscientiousness in approving the fees charged pursuant to the investment
20 advisory and distribution agreements.

21 152. By reason of the conduct described above, the Distributor and Investment
22 Adviser Defendants violated Section 36(b) of the ICA. As a direct, proximate and
23 foreseeable result of these Defendants' breaches of fiduciary duties in their roles as
24 principal underwriter and investment adviser, respectively, to the American Funds and
25 their investors, the American Funds and their investors have sustained many millions
26 of dollars in damages.

27
28

1 153. Plaintiffs, in this count, seek to recover the excessive advisory, Rule 12b-
2 1, service, and other fees charged to the American Funds and their investors by
3 Defendants and their affiliates.

4 **PRAYER FOR RELIEF**

5 WHEREFORE, Plaintiffs pray for relief and judgment, as follows:

6 (a) Awarding Plaintiffs compensatory damages on behalf of the Funds
7 against all Defendants for all damages sustained as a result of Defendants'
8 wrongdoing, in an amount to be proven at trial, including interest thereon;

9 (b) Awarding the Funds and their investors injunctive relief ordering
10 Defendants to cease the charging of excessive fees;

11 (c) Ordering an accounting of all Fund-related fees and commissions;

12 (d) Ordering restitution of all excessive fees and charges;

13 (e) Awarding Plaintiffs their reasonable costs and expenses incurred in this
14 action, including counsel fees and expert fees; and

15 (f) Such other and further relief as the Court may deem just and proper.

16 DATED: May 16, 2008

MILBERG LLP
JEROME M. CONGRESS
JANINE L. POLLACK
ANNA C. DOVER

17
18
19 

JANINE L. POLLACK

20 One Pennsylvania Plaza
21 New York, NY 10119
22 Telephone: (212) 594-5300
Facsimile: (212) 868-1229

23 MILBERG LLP
24 JEFF S. WESTERMAN
25 SABRINA S. KIM
26 One California Plaza
27 300 South Grand Ave., Suite 3900
28 Los Angeles, CA 90071
Telephone: (213) 617-1200
Facsimile: (213) 617-1975

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

WEISS & LURIE
JOSEPH H. WEISS
RICHARD A. ACOCELLI
JULIA J. SUN
551 Fifth Avenue, Suite 1600
New York, NY 10176
Telephone: (212) 682-3025
Facsimile: (212) 682-3010

Co-Lead Counsel for Plaintiffs

BROWER PIVEN, A PROFESSIONAL
CORPORATION
CHARLES J. PIVEN
MARSHALL N. PERKINS
The World Trade Center – Baltimore
Suite 2525
401 East Pratt Street
Baltimore, MD 21202
Telephone: (410) 332-0030
Facsimile: (410) 685-1300

STULL, STULL & BRODY
JULES BRODY
AARON BRODY
MARK LEVINE
6 East 45th Street
New York, NY 10017
Telephone: (212) 687-7230
Facsimile: (212) 490-2022

GLANCY BINKOW & GOLDBERG
LIONEL Z. GLANCY
MICHAEL GOLDBERG
1801 Avenue of the Stars, Suite 311
Los Angeles, CA 90067
Telephone: (310) 201-9150
Facsimile: (310) 201-9160

MURRAY FRANK & SAILER LLP
ERIC BELFI
275 Madison Avenue, Suite 801
New York, NY 10016
Telephone: (212) 682-1818
Facsimile: (212) 682-1892

LIM, RUGER & KIM, LLP
CHRISTOPHER KIM
LISA J. YANG
1055 W. 7th Street, Suite 2800
Los Angeles, CA 90017
Telephone: (213) 955-9500
Facsimile: (213) 955-9511

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

SCHIFFRIN BARROWAY TOPAZ
& KESSLER, LLP
MARC TOPAZ
RICHARD A. MANISKAS
280 King of Prussia Road
Radnor, PA 19087
Telephone: (610) 667-7706
Facsimile: (610) 667-7056

LAW OFFICE OF ALFRED G.
YATES JR., PC
ALFRED G. YATES, JR.
GERALD L. RUTLEDGE
8519 Allegheny Building
429 Forbes Avenue
Pittsburgh, PA 15219
Telephone: (412) 391-5164
Facsimile: (412) 471-1033

Additional Counsel for Plaintiffs

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

EXHIBIT A

**AMERICAN FUNDS HELD BY PLAINTIFFS FOR SECTION 36(b)
CLAIM UNDER THE INVESTMENT COMPANY ACT OF 1940**

- AMCAP Fund
- American Balanced Fund
- The Bond Fund of America
- Capital Income Builder
- Capital World Growth and Income Fund
- The Growth Fund of America
- The Income Fund of America
- The Investment Company of America

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

DECLARATION OF SERVICE BY MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, employed in the County of Los Angeles, over the age of 18 years, and not a party to or interest in the within action; that declarant's business address is One California Plaza, 300 South Grand Avenue, Suite 3900, Los Angeles, California 90071-3149.

2. That on May 16, 2008, declarant served the FOURTH AMENDED COMPLAINT by depositing a true copy thereof in a United States mailbox at Los Angeles, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct.
Executed this 16th day of May, 2008, at Los Angeles, California.


ANN MARIE GENOVESE

AMERICAN FUNDS
Service List

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

<i>Counsel for Plaintiffs</i>	
JEFF S. WESTERMAN SABRINA S. KIM MILBERG LLP One California Plaza 300 S. Grand Avenue, Suite 3900 Los Angeles, CA 90071-3149 Telephone: (213) 617-1200 Facsimile: (213) 617-1975 E-mail: jwesterman@milberg.com skim@milberg.com	JOSEPH H. WEISS RICHARD A. ACOCELLI JULIA J. SUN WEISS & LURIE 551 Fifth Avenue, Suite 1600 New York, New York 10176 Telephone: (212) 682-3025 Facsimile: (212) 682-3010 E-mail: jweiss@weisslurie.com*** racocelli@weisslurie.com jsun@weisslurie.com
JEROME M. CONGRESS JANINE L. POLLACK ANNA C. DOVER MILBERG LLP One Pennsylvania Plaza New York, New York 10119 Telephone: (212) 594-5300 Facsimile: (212) 868-1229 E-mail: jcongress@milberg.com jpollack@milberg.com adover@milberg.com	JULES BRODY AARON BRODY MARK LEVINE STULL, STULL & BRODY 6 East 45th Street New York, NY 10017 Telephone: (212) 687-7230 Facsimile: (212) 490-2022
LIONEL Z. GLANCY MICHAEL GOLDBERG GLANCY BINKOW & GOLDBERG 1801 Avenue of the Stars, Suite 311 Los Angeles, CA 90067 Telephone: (310) 201-9150 Facsimile: (310) 201-9160	ERIC BELFI MURRAY FRANK & SAILER LLP 275 Madison Avenue, Suite 801 New York, NY 10016 Telephone: (212) 682-1818 Facsimile: (212) 682-1892

1	CHRISTOPHER KIM	MARC TOPAZ
2	LISA J. YANG	RICHARD A. MANISKAS
3	LIM, RUGER & KIM, LLP	SCHIFFRIN BARROWAY
4	1055 W. 7th Street, Suite 2800	TOPAZ & KESSLER, LLP
5	Los Angeles, CA 90017	280 King of Prussia Road
6	Telephone: (213) 955-9500	Radnor, PA 19087
	Facsimile: (213) 955-9511	Telephone: (610) 667-7706
		Facsimile: (610) 667-7056
	<i>Counsel for Defendants</i>	
7	Gareth T. Evans	James N. Benedict
8	Andrew Z. Edelstein	Andrew E. Tomback
9	GIBSON DUNN & CRUTCHER	Sean M. Murphy
10	333 S. Grand Avenue, 45th Floor	C. Neil Gray
11	Los Angeles, CA 90071-3197	MILBANK, TWEED, HADLEY
12	Telephone: (213) 229-7000	& McCLOY LLP
13	Facsimile: (213) 229-7520	One Chase Manhattan Plaza
14	E-mail: gevens@gibsondunn.com***	New York, NY 10005
15	aedelstein@gibsondunn.com	Telephone: (212) 530-5000
16		Facsimile: (212) 530-5219
		E-mail: jbenedict@milbank.com
		smurphy@milbank.com***
		cngrey@milbank.com
	*** Denotes service via e-mail.	

17
18
19
20
21
22
23
24
25
26
27
28