

**BEACON POINTE**

**A D V I S O R S**

**INVESTMENT MANAGER RESEARCH**

**MUTUAL FUNDS – SHELF SPACE  
JANUARY 2004**

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## BEACON POINTE INVESTMENT MANAGER RESEARCH

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### Introduction

- State Attorney General Bill Lockyer announced on January 2, 2004, that an investigation of fraudulent sales practices by mutual funds had been launched. Lockyer and his staff are evaluating whether mutual funds failed to disclose deals to California investors regarding broker-dealer mutual fund recommendations and compensation—also known in the industry as “selling shelf space.” Lockyer has started the investigation with three large mutual fund companies in California: PIMCO (Newport Beach, CA), Franklin Templeton Investments (San Mateo, CA), and Capital Research & Management Co. (Los Angeles, CA). Lockyer subpoenaed the three mutual fund companies January 2, 2004.
- The practice of “selling shelf-space” is not illegal—however, failing to disclose the practice to investors is illegal. Shelf space is the practice in which “fund companies pay brokerage firms to push their funds to individual investors. This is done either through outright cash payments, known as hard money payments, or by steering lucrative stock and bond trading business to the firms, which is known as directed brokerage.”<sup>11</sup> Broker-dealers can only sell a mutual fund that sends portfolio trades to the broker if the arrangement is properly disclosed in the mutual fund prospectus and if the broker is getting best execution for the trades. Mutual fund companies and broker-dealers can both be liable for violations of this state law.
- Lockyer’s investigations resemble the SEC probe last year with Morgan Stanley. Morgan Stanley and the SEC reached a settlement in November 2003 (\$50 million) after allegations that the firm made mutual fund recommendations to its clients without disclosing compensation arrangements it made with certain mutual fund companies.
- Lockyer’s investigation falls under SB 434, which gives the Attorney General with the Commissioner of Corporations the ability to “investigate violations of the state Corporate Securities Law and to bring civil enforcement actions for such violations.”<sup>2</sup> SB 434 took effect on New Year’s Day this year.
- Lockyer’s investigations are fairly recent and all three mutual fund companies, which have been subpoenaed, have stated that they intend and will cooperate with the investigations and have supplied the Attorney General with requested information.
- As stated earlier, both mutual fund companies *and* broker-dealers can both be liable for violations of state law. Beacon Pointe strongly agrees with the statement made by Mr. Wayne Wagner, Chairman of the Plexus Group (<http://www.plexusgroup.com>), a consulting firm that analyzes trading costs, that “the broker should be saying ‘What’s in the best interest of my client,’ not ‘Who’s paying me the most.’”<sup>3</sup>
- Beacon Pointe has contacted the mutual fund companies, which our clients have invested assets with, and is closely monitoring the events of the investigation. We will keep you posted on any new developments and the impact on our clients.

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<sup>1</sup> Josh Friedman. “State Investigates Fund Firms.” *Los Angeles Times*, January 2, 2004

<sup>2</sup> Office of the Attorney General. “Attorney General Lockyer Launches Investigation of Fraudulent Sales Practices by Mutual Funds, Probe Marks First Use of Expanded Authority Under New State Law.” <http://caag.state.ca.us/newsalerts/2004/04-001.htm>, January 2, 2004

<sup>3</sup> Josh Friedman. “State Investigates Fund Firms.” *Los Angeles Times*, January 2, 2004