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10 SUPERIOR COURT OF THE STATE OF CALIFORNIA

11 COUNTY OF SACRAMENTO

12
13 THE PEOPLE OF THE STATE OF
CALIFORNIA,

14 Plaintiff,

15 v.

16 EDWARD D. JONES & CO., L.P., a limited
17 partnership and DOES 1 through 1000,
inclusive,

18 Defendants.
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CASE NO:

COMPLAINT FOR CIVIL PENALTIES,
ANCILLARY RELIEF AND
PRELIMINARY AND PERMANENT
INJUNCTION BASED ON
VIOLATIONS OF THE CALIFORNIA
CORPORATE SECURITIES LAW OF
1968

[Corporations Code sections 25401 and
25216: Antifraud Provisions]

21 Plaintiff the People of the State of California ("plaintiff" or the "People"), by and through
22 Bill Lockyer, Attorney General of the State of California, allege as follows:

23 **PLAINTIFF AND JURISDICTION**

24 1. Bill Lockyer is the duly elected Attorney General of the State of California and is
25 the chief law officer of the State. The Attorney General is authorized by Government Code
26 sections 12658 and 12660 to bring actions in the name of the people of the State of California in
27 the superior court to enforce the Corporate Securities Law of 1968 ("CSL").

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DEFENDANT

2. Defendant Edward D. Jones & Co., L.P. ("Jones") is, and at all times mentioned herein was, a limited partnership, organized and existing under the laws of the State of Missouri. Jones is a national brokerage firm, headquartered in St. Louis, Missouri. Jones caters almost exclusively to individual investors and small businesses and, according to its public web site, has over 8,500 local branch offices throughout the United States. Jones maintains at least 450 of these branch offices in California. Each branch office is operated by brokers who are referred to by Jones as "investment representatives" ("IRs"). At all times mentioned herein, Jones was a licensed "broker-dealer" as defined pursuant to Corporations Code section 25004.

3. Whenever reference is made in this complaint to any act or transaction of a defendant such allegation shall be deemed to mean that said defendant and, if a business, its owners, officers, directors, agents, employees, or representatives, did or authorized such acts while engaged in the management, direction, or control of the affairs of the defendant and while acting within the scope and course of their duties.

4. Whenever reference is made in this complaint to any act of defendants, such allegation shall be deemed to mean the act of each defendant acting individually and jointly with the other defendants named in that cause of action.

5. At all times mentioned herein, each defendant knew that the other defendants were engaging in or planned to engage in the violations of law alleged in this complaint. Each defendant nevertheless intended to and did encourage, facilitate, or assist in the commission of the unlawful acts, and thereby aided and abetted the other defendants in the unlawful conduct.

6. The violations of law which are the subject of this action occurred throughout the State of California, including but not limited to, the County of Sacramento.

7. The true names and capacities, whether individual, corporate, or otherwise, of defendants sued herein under the fictitious names of DOES 1 through 1000, inclusive, are unknown to plaintiff who therefore sues these defendants by using fictitious names. Plaintiff will amend this complaint to show the true names of each when the name has been ascertained.

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SHELF-SPACE AGREEMENTS -- A MUTUAL FUND INDUSTRY-WIDE PRACTICE

8. Plaintiff brings this action in response to a mutual fund industry-wide mutual fund practice involving secret, and mostly oral, agreements between mutual fund complexes and certain securities broker-dealers ("broker-dealers") who sell the funds' shares to California investors. These secret agreements benefit the mutual fund complexes and these broker-dealers to the detriment of mutual fund investors.

Background

9. A mutual fund is a fund operated by an investment company that raises money from shareholders and invests it in securities. Mutual funds bring the benefits of professional management, portfolio diversification, and securities ownership to millions of individuals. Today, over 91 million individuals, comprising nearly half of all U.S. households, own shares in mutual funds. The majority of these individuals represent households with moderate annual incomes between \$25,000 and \$75,000. These individual mutual fund investors can choose from over 500 mutual fund complexes offering over 8,000 mutual funds to save for their future. Robust competition - on a level playing field - among mutual fund complexes benefits shareholders by providing investment choice, diversified investments, easier methods to invest and innovative customer services.

10. Mutual funds are distinct legal entities owned by the shareholders of the fund. Each fund contracts separately with an investment adviser who provides management, portfolio selection and administrative services to the fund. A mutual fund's accrued daily operating costs are periodically deducted from the fund's assets. These costs include such items as the fee paid to the fund's investment adviser for managing the fund, accounting expenses and the cost of preparing fund documents. A board of directors reviews each mutual fund's operations and represents fund shareholders' interests. This review includes monitoring for conflicts of interest between the fund and its adviser.

11. A mutual fund sells shares through a variety of distribution channels. For example, investors can buy shares directly by telephone or mail or they can be sold by a sales staff employed by the mutual fund complex's distributor. Mutual funds may also sell shares

1 through third parties broker-dealers or their account representatives. A mutual fund may
2 compensate these third party financial professionals by levying a sales charge based on a
3 percentage of the amount being invested - called a load - that the investor can either pay when
4 making the investment (a front-end load) or later when selling or redeeming the shares (a back-
5 end load). Mutual funds marketing shares through third party financial professionals may also
6 charge investors ongoing fees as compensation for costs expended in marketing the fund or for
7 servicing the investor's account. Third party and fund-affiliated broker-dealers may also offer
8 fund supermarkets. These allow investors to purchase and redeem shares of mutual funds from a
9 wide range of fund companies through the customers' accounts at the broker-dealer operating the
10 supermarket.

11 12. Mutual funds provide various disclosures to their shareholders about fees in a
12 written prospectus which includes a fee table that discloses the sales charges, operating expenses,
13 and other fees that investors pay as part of investing in the fund. Specifically, the fee table
14 discloses (1) charges paid directly by shareholders out of their investment such as front or back-
15 end sales loads and (2) recurring charges deducted from fund assets such as management fees,
16 distribution fees, and other expenses charged to shareholder accounts. The fees deducted from
17 the fund's assets on an ongoing basis are reported to investors as a percentage of fund assets and
18 are called the fund's operating expense ratio.

19 **Shelf-Space Agreements in the Mutual Fund Industry**

20 13. Retail broker-dealers have increasingly demanded compensation for selling
21 mutual fund shares that is over and above that received in the form of sales loads other fees
22 ("Additional Compensation"). A shelf-space agreement, more informally known as a "pay-to-
23 play" scheme, occurs when a mutual fund pays this Additional Compensation in exchange for the
24 broker-dealer preferentially marketing its shares ("Shelf-Space Agreement"). Mutual fund
25 complexes have made these Additional Compensation payments in two ways: (i) out of their
26 own resources ("Cash Payments"); and (ii) by brokerage commissions for fund portfolio
27 transactions directed to broker-dealers that sell the funds' shares to investors ("Directed
28 Brokerage").

1 14. Shelf-Space Agreements typically are created when a mutual fund complex
2 executive enters into an oral agreement with an executive of a broker-dealer to exchange Cash
3 Payments and/or Directed Brokerage for a precious commodity: privileged access to the broker-
4 dealer's sales force and heightened visibility within a broker-dealer's distribution or sales
5 systems. The amount of this Additional Compensation typically has been based upon
6 percentages of the mutual fund shares sold by the broker-dealers and/or held for certain periods
7 of time by the broker-dealer's customers.

8 15. Both the mutual funds and the broker-dealers, however, fail to fully disclose the
9 Additional Compensation or other incentives provided to the broker-dealers selling the mutual
10 fund shares. Specifically, the mutual funds fail to provide their prospective investors, and the
11 broker-dealers fail to provide their customers, a means to understand the broker-dealer is being
12 paid extra to sell a particular fund. The mutual funds additionally fail to disclose that, when
13 Directed Brokerage is utilized, fund assets are being used to pay for premium "shelf-space" at the
14 selling broker's office. These undisclosed payments may increase costs to investors as well as
15 create conflicts of interest between investors and the financial professionals with whom they
16 deal.

17 **Potential Increased Mutual Fund Costs**
18 **from Shelf-Space Agreements**

19 16. Broker-dealers demand that the mutual fund complexes participating in their
20 Shelf-Space Agreements either pay in cash or in a multiple of that cash amount in the form of
21 extra commission business on fund portfolio transactions. Faced with that choice, some mutual
22 fund complexes paid the multiple with Directed Brokerage commission dollars rather than
23 paying for shelf-space with their own hard dollars.

24 17. In order to pay for shelf-space with these Directed Brokerage commissions,
25 mutual funds frequently conduct their portfolio transactions using multiple broker-dealers for
26 execution, step-outs, and other arrangements. These complex practices belie the notion that
27 mutual fund advisers merely consider the selling efforts of the broker(s) involved. These
28 practices instead bear all the hallmarks of barter arrangements in which brokerage (a fund asset

1 belonging to the shareholders) is secretly traded to pay the mutual fund complex's costs for
2 preferential sales efforts by outside brokers. Depleting this brokerage commission asset as a *quid*
3 *pro quo* for shelf-space imposes additional costs on the fund because this asset is not available to
4 offset other fund costs. Put simply, this practice is a real and meaningful cost to mutual fund
5 shareholders because it consumes a fund asset that could otherwise be used to negotiate lower
6 commission rates, pay custodial, transfer agency and other fund expenses, or to obtain any
7 available cash rebates from third-party vendors.

8 18. Pressures to generate brokerage commissions may also increase a mutual fund's
9 portfolio turnover rates, which may drive up fund costs and harm fund performance. The mutual
10 fund complex's desire to generate brokerage commissions also disadvantages mutual funds that
11 do not normally actively trade their portfolios because of those funds' investment strategy
12 considerations.

13 **Potential Conflicts of Interest from Shelf-Space Agreements**

14 19. Undisclosed Shelf-Space Agreements adversely affect the relationship between
15 broker-dealers and their customers. Shelf-Space payments create an incentive for a broker-dealer
16 to highlight, feature or recommend funds that best compensate the broker-dealer or to meet other
17 secret promises rather than to recommend the best performing investments and/or investments
18 that meet the customer's personal investment needs. The secrecy of these agreements prevents
19 the prospective mutual fund investor from recognizing this potential and/or actual conflict of
20 interest.

21 20. Undisclosed Shelf-Space Agreements also adversely affect the relationship
22 between mutual funds and their shareholders. Mutual fund complexes typically employ wholly-
23 owned subsidiary entities to manage their mutual funds (fund advisors) and to coordinate
24 distribution and sales efforts (fund distributors). Fund distributors' and advisers' compensation
25 rates largely derive from mutual fund sales and the adviser's assets under management. Shelf-
26 Space Agreements may promote growth over quality, and accordingly threaten the financial
27 positions of existing shareholders. The secrecy of these agreements prevents the prospective
28 mutual fund investor from recognizing this potential and/or actual conflict of interest.

1 21. Mutual Fund complexes that use fund assets to promote the sale of fund shares
2 may also avoid paying fees out of their own pocket by using Directed Brokerage. Although
3 potential conflicts exist with respect to the use of other fund assets to pay for the marketing of
4 fund shares, the use of fund Directed Brokerage commissions exacerbates this conflict because
5 mutual fund directors cannot effectively ascertain a fund adviser's true motivations in selecting a
6 broker-dealer or a distributor's involvement in that selection. Mutual fund complexes further
7 impede the directors' ability to protect shareholders by not clearly disclosing the Shelf-Space
8 Agreements to them.

9 22. Undisclosed Shelf-Space Agreements, accordingly, create unmanageable conflicts
10 of interest that may harm funds and fund shareholders. The intense competition among fund
11 distributors to secure a prominent position in the selling brokers' distribution systems creates
12 powerful incentives for mutual fund complexes to direct brokerage based on distribution and
13 sales considerations rather than quality and price considerations. These incentives may adversely
14 affect decisions about how and where to effect portfolio securities transactions and impact the
15 quality of portfolio transactions.

16 **SPECIFIC FACTUAL ALLEGATIONS**

17 23. Jones' failures to disclose to investors and prospective investors the existence,
18 details and significance of defendants' Shelf-Space Agreements constitute violations of the CSL,
19 as more fully alleged below.

20 24. During the period since at least January 1, 2000 through the present ("Relevant
21 Period"), Jones offered for sale and sold shares in the following mutual fund complexes:
22 American Funds; Federated Investors; Goldman Sachs; Hartford; Lord Abbett; Putnam Funds;
23 and Van Kampen Investments (collectively "Preferred Funds"). While Jones had selling
24 agreements with at least 150 mutual fund complexes, Jones' sales of the Preferred Funds
25 constituted approximately ninety-eight percent (98%) of all of Jones' mutual fund sales for the
26 Relevant Period. More than fifty percent of all sales for the relevant Period were with respect to
27 one fund complex -- American Funds.

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1 25. Jones' domineering relationship with its Preferred Funds is illustrated by Jones'
2 letter of March 27, 2001 to each of the Preferred Funds scolding them for certain of their funds
3 which had not performed well over the last 12 months and, in concluding, threatening them that
4 as new fund ideas are considered, Jones "may wish to keep this recent performance in mind." A
5 copy of the Jones March 27, 2001 letter is filed herewith as Exhibit "A" and is incorporated
6 herein by reference.

7 26. Jones' offers for sale and sales of the Preferred Funds' shares, as alleged above,
8 were made by means of written communications in the form of mutual fund prospectuses and
9 statements of additional information prepared by the Preferred Funds ("Disclosure Documents").

10 27. During the Relevant Period, pursuant to Shelf-Space Agreements with the
11 Preferred Funds, the Preferred Funds agreed to make primarily Cash Payments and to furnish
12 some Directed Brokerage transactions to Jones in return for: (i) heightened visibility of the
13 Preferred Funds within Jones' distribution and/or sales systems, including being placed on Jones'
14 Preferred Funds list; and (ii) privileged access to Jones' distribution and/or sales systems.
15 During the Relevant Period, pursuant to Shelf-Space Agreements with the Preferred Funds, Jones
16 received Cash Payments and Directed Brokerage commissions in the combined amount of
17 approximately \$300 million from the Preferred Funds. (Hereinafter, the term "Shelf-Space
18 Agreements" shall refer to the agreements alleged in this paragraph.)

19 28. Pursuant to the Shelf-Space Agreements, Jones has provided to each of the
20 Preferred Funds some or all of the following consideration: participation in meetings with Jones'
21 representatives regarding the Preferred Funds, including the Paid Excursions where the Preferred
22 Funds had a captive audience of Jones brokers for making presentations concerning the Preferred
23 Funds; the opportunity for the Preferred Funds to be touted in communications with Jones'
24 customers such as on Jones' website or in customer newsletters; placement of the Preferred
25 Funds on a "preferred list," including on Jones' intranet website; limiting information during
26 training for Jones' brokers in mutual fund sales to almost exclusively the Preferred Funds;
27 discouraging Jones' brokers from contacting mutual funds other than the Preferred Funds; the
28 ability to reimburse Jones for certain expenses that made the sale of the Preferred Funds more

1 profitable than the sale of other fund shares; and the ability to compensate Jones' representatives
2 both at a higher commission rate for initial sales and for retaining Preferred Fund shares.

3 29. In fact, Jones' internal policies and procedures were specifically designed to
4 ensure that only Preferred Funds were sold to Jones' customers by Jones' IRs. For example, the
5 Jones IRs' incentive compensation consisting of bonuses and contest awards was based upon the
6 IRs' sales of Preferred Funds. IRs received monthly reports referred to by Jones as "Profit and
7 Loss Statements" which, among other things, detailed the IRs' sales of Preferred Funds for the
8 month and showed the IRs' respective proportionate shares of Shelf-Space Agreement
9 compensation the IRs were entitled to receive from such sales. Jones also compelled the sale of
10 Preferred Funds through its internal computer system used by the IRs to execute and record sales
11 of stocks and mutual funds. This system, by design, facilitated the sale of Preferred Funds and
12 discouraged the sale of non-Preferred Funds. As alleged above, Jones' sales of the Preferred
13 Funds constituted approximately ninety-eight percent (98%) of all of Jones' mutual fund sales for
14 the Relevant Period.

15 30. Not surprisingly, many of the IRs complained to Jones by anonymous e-mail
16 messages sent to an electronic suggestion box that Jones' Preferred Fund arrangements might
17 present a conflict of interest between the IR and the client and that perhaps the Preferred Fund
18 arrangements should be abandoned so that the best interests of the client would be of paramount
19 importance. Samples of these e-mail messages are filed herewith as Exhibit "B" and
20 incorporated herein by reference.

21 31. The Disclosure Documents, in sum and substance, disclosed in pertinent part that
22 from time to time additional cash bonuses or other incentives would be made to selected
23 participating brokers in connection with the sale or servicing of mutual fund shares and on
24 occasions such bonuses or incentives may be conditioned upon the sale of a specified minimum
25 amount of those shares.

26 32. However, the Disclosure Documents and Jones failed to disclose to investors
27 and/or prospective investors sufficient facts necessary to alert such persons to the following
28 matters:

1 the meaning of Corporations Code section 25008.

2 38. Jones' pattern of conduct demonstrates the necessity for: (i) granting injunctive
3 relief, restraining such and similar acts in violation of Corporations Code section 25401; (ii)
4 granting ancillary relief, including providing restitution or disgorgement to purchasers; and (iii)
5 imposing appropriate civil penalties.

6 SECOND CAUSE OF ACTION

7 (Violations of Corporations Code Section 25216(a))

8 39. Plaintiff refers to and realleges paragraphs 1 through 38, inclusive above, and
9 incorporates said paragraphs by reference as though fully set forth herein.

10 40. In offering for sale, and/or selling, the Preferred Funds' shares, and failing to
11 disclose to purchasers and prospective purchasers of the Preferred Funds' shares, the Undisclosed
12 Matters, Jones has violated Corporations Code section 25216(a), pursuant to the definition of the
13 phrase "manipulative, deceptive, or other fraudulent scheme, device, or contrivance," as set forth
14 in California Code of Regulations, title 10, section 260.216(b). That definition includes any
15 omission to state a material fact necessary in order to make the statements made, in the light of
16 the circumstances under which they are made, not misleading, if the person making the omission
17 knows or has reasonable grounds to believe that it is misleading.

18 41. The Undisclosed Matters are "material facts," necessary in order to make the
19 statements about broker compensation and directed brokerage as set forth in the Disclosure
20 Documents, in light of the circumstances under which they were made, not misleading and Jones
21 knew or had reasonable grounds to believe that failing to disclose to purchasers and prospective
22 purchasers of the Preferred Funds' shares the Undisclosed Matters, was misleading.

23 42. Jones' pattern of conduct demonstrates the necessity for: (i) granting injunctive
24 relief, restraining such and similar acts in violation of Corporations Code section 25216; (ii)
25 granting ancillary relief, including providing restitution or disgorgement to purchasers; and (iii)
26 imposing appropriate civil penalties.

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1 WHEREFORE, plaintiff prays for judgment against Jones as follows:

2 1. For a permanent and preliminary injunction, enjoining Jones and its agents,
3 servants, and employees, and all persons acting under, in concert with, or for it, from directly or
4 indirectly or in any other manner engaging in the conduct as above alleged in violation of
5 Corporations Code sections 25401 and/or 25216(a);

6 2. For an order that Jones pay to plaintiff, a civil penalty in the maximum sum of
7 \$25,000 for each violation of Corporations Code sections 25401 and/or 25216(a);

8 3. For an order disgorging all profits and compensation obtained by Jones as a result
9 of its violations of Corporations Code sections 25401 and/or 25216(a);

10 4. For an order requiring Jones to make restitution to the purchasers of the Preferred
11 Funds' shares in the principal amount paid by each purchaser by means of the unlawful conduct
12 alleged hereinabove, less the amount of any repayment of principal to any such purchaser by
13 Jones, with interest from the date of purchase of the fund shares on the amount of any such
14 principal amounts remaining unpaid;

15 5. For an order awarding damages to the purchasers of the Preferred Funds' shares in
16 an amount sufficient to compensate the purchasers for loss suffered as a result of Jones'
17 violations of Corporations Code sections 25401 and/or 25216(a);

18 6. For plaintiff's cost of suit incurred herein; and

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