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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 FRANKLIN/TEMPLETON
17 DISTRIBUTORS, INC., a corporation and
DOES 1 through 100, inclusive,

18 Defendants.
19

CASE NO.:

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

[Corporations Code sections 25401 and
25216: Antifraud Provisions]

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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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1 **DEFENDANTS**

2 2. Defendant Franklin/Templeton Distributors, Inc. (“FTDI”) is, and at all times
3 mentioned herein was, a corporation organized and existing under the laws of the State of New
4 York. At all times mentioned herein, FTDI: (i) was a wholly owned subsidiary of Franklin
5 Resources, Inc. (“FRI”), parent of the mutual fund complex known as Franklin Templeton
6 Investments (“FT”); (ii) provided, among other things, distribution services to the mutual funds
7 organized, managed, advised and distributed by affiliates of FT (“FT Funds”); and (iii) was a
8 “broker-dealer” and an “underwriter” as defined pursuant to Corporations Code sections 25004
9 and 25022, respectively.

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

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

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

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

24 7. The true names and capacities, whether individual, corporate, or otherwise, of
25 defendants sued herein under the fictitious names of DOES 1 through 100, inclusive, are
26 unknown to plaintiff who therefore sues these defendants by using fictitious names. Plaintiff
27 will amend this complaint to show the true names of each when the name has been ascertained.

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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
13 expenses, and other fees that investors pay as part of investing in the fund. Specifically, the fee
14 table discloses (1) charges paid directly by shareholders out of their investment such as front or
15 back-end sales loads and (2) recurring charges deducted from fund assets such as management
16 fees, distribution fees, and other expenses charged to shareholder accounts. The fees deducted
17 from the fund's assets on an ongoing basis are reported to investors as a percentage of fund assets
18 and 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 and other fees
22 ("Additional Compensation"). A shelf-space agreement occurs when a mutual fund pays this
23 Additional Compensation in exchange for the broker-dealer preferentially marketing its shares
24 ("Shelf-Space Agreement"). Mutual fund complexes have made these Additional Compensation
25 payments in two ways: (i) out of their own resources ("Additional Cash Compensation"); and
26 (ii) by brokerage commissions for fund portfolio transactions directed to broker-dealers that sell
27 the funds' shares to investors ("Directed Brokerage").

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

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

8 18. Undisclosed Shelf-Space Agreements may adversely affect the relationship
9 between broker-dealers and their customers. Shelf-space payments may create an incentive for a
10 broker-dealer to highlight, feature or recommend funds that best compensate the broker-dealer or
11 to meet other promises rather than to recommend investments that meet the customer's personal
12 investment needs. The failure to adequately disclose these agreements prevents the prospective
13 mutual fund investor from recognizing this potential and/or actual conflict of interest.

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

23 20. Mutual Fund complexes that use fund assets to promote the sale of fund shares
24 may also avoid paying fees out of their own pocket by using Directed Brokerage. Although
25 potential conflicts exist with respect to the use of other fund assets to pay for the marketing of
26 fund shares, the use of fund Directed Brokerage commissions exacerbates this conflict because
27 mutual fund directors cannot effectively ascertain a fund adviser's true motivations in selecting a
28 broker-dealer or a distributor's involvement in that selection. Mutual fund complexes may

1 further impede the directors' ability to protect shareholders by not clearly disclosing the Shelf-
2 Space Agreements to them.

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

10 **SPECIFIC FACTUAL ALLEGATIONS CONCERNING FTDI**

11 22. Defendants' failures to disclose to investors and prospective investors the
12 existence, details and significance of defendants' Shelf-Space Agreements constitute violations
13 of the CSL, as more fully alleged below.

14 23. During the period since at least January 1, 2000 through the present ("Relevant
15 Period"), FTDI offered for sale and sold shares in the FT Funds.

16 24. FTDI's offers for sale and sales of the FT Funds' shares, as alleged above, were
17 made by means of written communications in the form of mutual fund prospectuses and
18 statements of additional information ("Disclosure Documents").

19 25. During the Relevant Period, FTDI entered into at least 100 Shelf-Space
20 Agreements with various broker-dealers ("Shelf-Space Broker-Dealers").

21 26. During the Relevant Period, pursuant to FTDI's Shelf-Space Agreements, FTDI
22 agreed to provide Additional Cash Compensation and furnish Directed Brokerage transactions to
23 the Shelf-Space Broker-Dealers in return for: (i) heightened visibility of the FT Funds within the
24 Shelf-Space Broker-Dealers' distribution or sales systems; and (ii) privileged access to the Shelf-
25 Space Broker-Dealers' distribution or sales systems. (Hereinafter, the term "Shelf-Space
26 Agreements" shall refer to the agreements alleged in this paragraph.)

27 27. During the Relevant Period, pursuant to the Shelf-Space Agreements, FTDI
28 provided Additional Cash Compensation and caused Directed Brokerage commissions to be paid

1 in the combined amount of approximately \$147 million, including approximately \$63 million of
2 which was attributable to Directed Brokerage.

3 28. Pursuant to the Shelf-Space Agreements, FTDI has received from the Shelf-Space
4 Broker-Dealers the following consideration: participation in meetings with Shelf-Space Broker-
5 Dealer representatives regarding the FT Funds; the opportunity for the FT Funds to be featured
6 in communications with the Shelf-Space Broker-Dealers' customers such as on a broker-dealer's
7 website or in customer newsletters; placement of the FT Funds on a "preferred list," in a
8 "partners program," or in a similarly-named group of mutual fund complexes receiving
9 preferential treatment at the Shelf-Space Broker-Dealers' offices, including through the Broker-
10 Dealers' intranet websites; the ability to participate in certain programs, such as 529 plans or
11 retirement plans, exclusively available to mutual fund complexes paying for shelf-space; the
12 ability to reimburse Shelf-Space Broker-Dealers for certain expenses that made the sale of FT
13 Funds more profitable than the sale of other fund shares; and the ability to compensate Shelf-
14 Space Broker-Dealers' representatives both at a higher commission rate for initial sales and for
15 retaining FT Funds.

16 29. In late 2002, for example, one of FT's Shelf-Space Broker-Dealers sought to
17 modify its Shelf-Space Agreement for 2003; solicited shelf-space partners; and predicted the
18 results of its preferential marketing practices. This Shelf-Space Broker-Dealer advised FTDI
19 that it would reduce the number of its shelf-space partners from 22 to as few as 6. The Shelf-
20 Space Broker-Dealer predicted that the FT Funds would realize a 58% increase in mutual fund
21 sales through that Shelf-Space Broker-Dealer during the coming year and that mutual fund
22 complexes who remained in the shelf-space program would capture 80% of its non-proprietary
23 mutual fund sales. In other words, this Shelf-Space Broker-Dealer agreed to preferentially
24 market the mutual funds of as few as 6 mutual fund complexes out of over 500 mutual fund
25 complexes commercially available and, by limiting the number of shelf-space partners,
26 forecasted an immediate gain in FT Funds' market share without regard to the quality or
27 propriety of FT's Funds. FTDI paid this one Shelf-Space Broker-Dealer – in a combination of
28 Cash Payments and Directed Brokerage – nearly \$5 million in 2003 and nearly \$20 million over

1 the four-year Relevant Period.

2 30. The Disclosure Documents, under a heading entitled “Dealer compensation,”
3 disclosed in pertinent part that:

4 a. FTDI and/or its affiliates may provide financial support to broker-dealers that sell
5 FT Funds based primarily on the amount of such sales and/or total assets with FT;

6 b. The amount of such financial support may be affected by: total sales; net sales;
7 levels of redemption; the proportion of a broker-dealer’s sales and marketing efforts in FT; a
8 broker-dealer’s support of, and participation in, FTDI’s marketing programs; a broker-dealer’s
9 compensation for its registered representatives; and the extent of a broker-dealer’s marketing
10 programs relating to FT;

11 c. Such financial support to broker-dealers may be made: by payments from FTDI’s
12 resources; from FTDI’s retention of underwriting concessions; and, in the case of funds that have
13 Rule 12b-1 plans, from payments to FTDI under such plans; and

14 d. In addition, certain broker-dealers may receive brokerage commissions generated
15 by fund portfolio transactions in accordance with the rules of the National Association of
16 Securities Dealers, Inc.

17 31. The Disclosure Documents, under a heading entitled “Portfolio Transactions,”
18 disclosed in pertinent part that if the FT Funds’ officers are satisfied that the best execution is
19 obtained, the sale of FT Funds also may be considered a factor in the selection of broker-dealers
20 to execute the FT Funds’ portfolio transactions.

21 32. However, the Disclosure Documents and FTDI failed to adequately disclose to
22 the FT Funds’ shareholders and/or prospective shareholders that the Directed Brokerage and
23 payment of Additional Cash Compensation described in Paragraph 29 were intended to
24 compensate the Shelf-Space Broker-Dealers for various services that the broker-dealers
25 promised to provide in exchange for such payments, including: Shelf-Space Agreements;
26 placement on the Shelf-Space Broker-Dealers’ “preferred” or “recommended” fund lists,
27 including placement on Shelf-Space Broker-Dealers’ intranet websites; access to the Shelf Space
28 Broker-Dealers’ registered representatives, including attendance at conferences and other

1 meetings; assistance in training and education of personnel; marketing support; and/or other
2 specified services intended to assist FTDI in the distribution and marketing of the FT Funds.

3 **FIRST CAUSE OF ACTION**

4 (Violations of Corporations Code Section 25401)

5 33. Plaintiff refers to and realleges paragraphs 1 through 32, inclusive above, and
6 incorporates said paragraphs by reference as though fully set forth herein.

7 34. The FT Funds' shares offered for sale and sold by FTDI, as alleged hereinabove,
8 are "securities" as defined in Corporations Code section 25019.

9 35. In offering for sale, and/or selling, the FT Funds' shares, FTDI has violated
10 Corporations Code section 25401 by failing to disclose to purchasers and prospective purchasers
11 of the FTI Funds' shares the matters alleged in paragraph 32 above ("Undisclosed Matters"), as
12 the Undisclosed Matters are "material facts" necessary in order to make the statements about
13 "dealer compensation" and "portfolio transactions" as set forth in the Disclosure Documents, as
14 alleged in paragraphs 30 and 31 above, in light of the circumstances under which they were
15 made, not misleading. More precisely, the Undisclosed Matters are matters which a "reasonable
16 investor" would consider important in deciding whether to invest in the FT Fund shares.

17 36. FTDI's omissions of material facts were in connection with the offer and sale of
18 securities within the meaning of Corporations Code section 25017.

19 37. FTDI's omissions of material facts took place within the State of California
20 within the meaning of Corporations Code section 25008.

21 **SECOND CAUSE OF ACTION**

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

23 38. Plaintiff refers to and realleges paragraphs 1 through 37, inclusive above, and
24 incorporates said paragraphs by reference as though fully set forth herein.

25 39. In offering for sale, and/or selling, the FT Funds' shares, and failing to disclose to
26 purchasers and prospective purchasers of the FT Funds' shares the Undisclosed Matters, FTDI
27 has violated Corporations Code section 25216(a), pursuant to the definition of the phrase
28 "manipulative, deceptive, or other fraudulent scheme, device, or contrivance," as set forth in

1 California Code of Regulations, title 10, section 260.216(b). That definition includes any
2 omission to state a material fact necessary in order to make the statements made, in the light of
3 the circumstances under which they are made, not misleading, if the person making the omission
4 knows or has reasonable grounds to believe that it is misleading.

5 40. The Undisclosed Matters are: “material facts,” necessary in order to make the
6 statements about “dealer compensation” and “portfolio transactions” as set forth in the
7 Disclosure Documents, as alleged in paragraphs 30 and 31 above, in light of the circumstances
8 under which they were made, not misleading; and FTDI knew or had reasonable grounds to
9 believe that failing to disclose to purchasers and prospective purchasers of the FT Funds’ shares
10 the Undisclosed Matters, was misleading.

11 WHEREFORE, plaintiff prays for judgment against FTDI as follows:

12 1. For a permanent and preliminary injunction, enjoining FTDI, its agents, servants,
13 and employees, and all persons acting under, in concert with, or for them, from directly or
14 indirectly or in any other manner engaging in the conduct as above alleged in violation of
15 Corporations Code sections 25401 and/or 25216(a);

16 2. For an order that FTDI pay to plaintiff, a civil penalty in the maximum sum of
17 \$25,000 for each violation of Corporations Code sections 25401 and/or 25216(a);

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

20 4. For plaintiff’s cost of suit incurred herein; and

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5. For such other and further relief as this Court deems just and proper.

Dated: November 17, 2004

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