Client Alert.

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Derivative Action Challenging Rule 12b-1 Fees Dismissed Based on Lack of Private Right of Action

The U.S. District Court for the Southern District of New York dismissed a shareholder derivative lawsuit challenging distribution fees paid pursuant to Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act"). The plaintiff was a shareholder of two mutual funds (the "Funds") that paid Rule 12b-1 fees to the Funds' distributor ("Distributor"), which funneled the fees to broker-dealers who distributed the Fund shares. The plaintiff argued that the broker-dealers were required to register under the Investment Advisers Act of 1940, as amended (the "Advisers Act") because they provided investment advice in exchange for 12b-1 payments, which as asset-based fees constituted "special compensation" under Section 202(a)(11)(C) of the Advisers Act.

The plaintiff claimed that through the payment of 12b-1 fees to broker-dealers who failed to register as investment advisers, the Distributor and the Fund trustees (the "Trustees") breached their fiduciary duties owed to the Funds under Section 36(a) of the 1940 Act. The plaintiff also alleged that the Trustees breached an affirmative duty derived from Rule 38a-1 under the 1940 Act to ensure that the distribution fees were paid in accordance with the Advisers Act and other governing law. According to the plaintiff, these breaches rendered the agreement between the Funds and the Distributor unenforceable under Section 47(b) of the 1940 Act, which provides that contracts that violate provisions of the Act are void.

The Court rejected the plaintiff's view that Section 47(b) provides a distinct private right of action, regardless of whether the predicate violation of the 1940 Act provides its own private right of action. Indeed, the Court held that a plaintiff asserting claims under Section 47(b) must also allege the violation of a substantive provision of the 1940 Act that itself implies a private right of action. As a result, the Court concluded that the plaintiff could not assert liability under Section 36(a) of the 1940 Act or Rule 38a-1 thereunder as a predicate to liability under Section 47(b).

The Court did not rule on the plaintiff's assumption that the broker-dealers were required to register under the Advisers Act because any fees other than transactional fees constituted "special compensation" under Advisers Act Section 202(a)(11)(C). In fact, the Court noted that the plaintiff may sue the broker-dealers themselves alleging Advisers Act violations or seek to have the selling agreement between the Distributor and the broker-dealers voided pursuant to Advisers Act Section 215.

Should the plaintiff appeal the Court's decision and prevail, the case could have broad implications for mutual funds and broker-dealers alike. It could cause many broker-dealers already registered under the Securities Exchange Act of 1934 to register under the Advisers Act and provide mutual funds with a financial stake in monitoring the Advisers Act registration of broker-dealers to whom they pay 12b-1 fees.

> *Bradley C. Smith, derivatively on behalf of Oppenheimer Gold & Special Minerals Fund, v. OppenheimerFunds Distributor, Inc. et al.*, Civil Action 10-07387-LBS (S.D.N.Y.), 6 June 2011; *Bradley C. Smith, derivatively on behalf of Oppenheimer Quest for Value Funds, v. OppenheimerFunds Distributor, Inc. et al.*, Civil Action 10-07394-LBS (S.D.N.Y.), 6 June 2011.

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