ICI MUTUAL **RISK MANAGEMENT STUDY**

Mutual Fund Prospectus Liability

Understanding and Managing the Risk

ICIMutual
A Risk Retention Group

Mutual Fund Prospectus Liability

Introduction

Over the past decade, the fund industry has emerged as an attractive target for a sophisticated, aggressive, and entrepreneurial body of plaintiffs' securities lawyers known, in the vernacular, as "the plaintiffs bar." Even as court decisions have reduced the number of legal avenues by which it can attack the industry, the plaintiffs bar has vigorously pursued those avenues that remain.[1]

A major remaining avenue is the investor class action lawsuit alleging liability for mutual fund disclosure—that is, liability for inaccurate or incomplete disclosure in a fund's prospectus and/or statement of additional information. Such lawsuits are typically brought against one or more funds, fund advisers, and principal underwriters, and may also name individual fund directors and officers as additional defendants.

Given the high financial and reputational stakes that are usually involved, defending a disclosure class action lawsuit is typically a time-consuming and stressful experience. Regardless of the substantive merits of the underlying allegations, such lawsuits can generate substantial expense and reputational damage for affected entities and individuals.

Even a modest decline in the net asset value (NAV) of a sizeable fund may result in alleged investment losses to fund shareholders of tens or hundreds of millions of dollars. Thus, a disclosure lawsuit that survives pretrial legal challenges can present defendants with a difficult choice between (1) proceeding to trial and taking the risk, however low, of an adverse judgment awarding damages at or near the amount of alleged losses, and (2) settling the lawsuit before trial, for only a small fraction of that amount.

Faced with such a choice, fund groups that do not successfully dispose of the lawsuit before trial most often opt to settle. Even then, the settlement amount, while typically far less than the potential worst-case trial outcome, may still run into the millions or tens of millions of dollars. Moreover, along the way, it is not uncommon for fund group defendants to incur millions more in defense costs.

Accordingly, from both a business and financial perspective, it is appropriate for fund directors, senior management, and legal and compliance personnel to understand the nature of this liability risk, and to take appropriate steps to manage it. Towards that end, this study is structured as follows:

- **Part I** provides general background on the class action as a device for private enforcement of the federal securities laws (a distinctly American phenomenon) and, more specifically, on class actions that challenge mutual fund disclosure. It includes a sidebar outlining the various stages in the life of a class action lawsuit.

- **Part II** studies the industry's actual experience in class actions that challenge mutual fund disclosure. Exactly who is suing whom, and for what? What issues are commonly contested during the course of the litigation? How are the lawsuits ultimately resolved, and why? And at what cost? In considering these questions, ICI Mutual examined a wealth of data from a decade's worth of such litigation.

- **Part III** transitions to risk management. It reviews a number of factors that senior management, legal and compliance personnel, and fund directors may wish to consider when designing practices and procedures to reduce the risk of liability for disclosure violations. This part also discusses the potential availability of insurance and director indemnification for liability in this area.

- **Appendix I** provides, by way of general background, a brief overview of civil liability under the disclosure law that is most often implicated in the mutual fund context.

- **Appendix II** provides a list of mutual fund disclosure lawsuits over the past ten years—designed as a resource for readers wishing to review particular cases and/or conduct additional research.

The contents of this study reflect ICI Mutual's analysis of actual mutual fund litigation, consultations with multiple specialists, comprehensive research of the available law and commentary, and long claims experience as the industry's largest provider of professional liability insurance.

This study takes its place among a long line of risk management studies prepared by ICI Mutual.[2] As with those earlier publications, this study is not intended to, and does not, suggest any single approach or set of "best practices" for use by fund groups in addressing fund disclosure; one-size-fits-all standards are generally not practical or advisable, given the diversity of fund groups.

Moreover, while this study discusses applicable laws generally, readers should of course look to their counsel for specific legal advice.

Private Enforcement of Disclosure Laws

The U.S. Supreme Court has described the "fundamental purpose" of the federal securities laws as implementing a "philosophy of full disclosure" as a substitute for the "philosophy of caveat emptor" (let the buyer beware).[3] American securities regulation thus goes far beyond a simple prohibition against fraud, and instead establishes "a detailed and mandatory system of continuing, periodic disclosure."[4]

This system is enforced in part by government regulators, including primarily the U.S. Securities and Exchange Commission. This study, however, focuses on enforcement of the federal securities laws by *investors*—a "vigorous, arguably even hyperactive, system of *private* enforcement"[5] that itself imposes billions of dollars in annual costs on securities issuers and associated parties (including underwriters and broker-dealers, among others).[6]

Investors often have a choice of enforcement devices: investors may file individual lawsuits, initiate FINRA arbitrations, or may participate with other similarly situated investors in securities class actions. Indeed, the same defendants may be simultaneously targeted by many such proceedings—individual claims, arbitrations, *and* class actions.

While the collective impact of individual lawsuits and arbitrations can be very high, securities class actions are generally more severe in terms of reputational and financial damage. In any event, the securities class action appears to be the enforcement device most favored by leading plaintiff-side law firms and, accordingly, is the focus of this study.

Securities Class Actions

Basically, a "class action" is a "lawsuit in which the court authorizes a single person or a small group of people to represent the interests of a larger group."[7] It is intended to solve a problem inherent in types of wrongdoing that give rise to a widely dispersed harm: namely, the problem that any given individual will have insufficient incentive to seek redress in court, because the cost and effort to the individual of doing so (i.e., pursuing litigation) would far outweigh the value of that individual's small claim.

Originally devised in the eighteenth and nineteenth centuries,[8] the class action is now commonly used in a number of areas where small individual claims may be typical, such as securities, antitrust, and consumer litigation.

In the securities area, the filing of a class action lawsuit may be spurred by various events. A dramatic drop in the stock price of a publicly traded company is a common trigger.[9] By analogy, in the fund industry, a sharp decline in a fund's NAV may trigger a class action lawsuit.[10] Recent examples include class action lawsuits filed against fixed-income funds that, relative to their peers, underperformed during the credit crisis.[11]

Press reports of regulatory investigations and settlements, or of newly filed lawsuits, are another trigger of securities class actions (as occurred, for example, when hundreds of follow-on lawsuits were filed in the wake of the market-timing and revenue-sharing regulatory investigations of 2003 and 2004).[12]

Also, plaintiff law firms may conduct their own "investigations" of particular practices, while prospecting for potential plaintiffs.[13] In this sense, the plaintiffs bar is widely viewed as entrepreneurial. Indeed, securities class actions have been described as "enforcement by bounty hunter."[14]

Criticisms of the securities class action are commonplace,[15] and have had a substantial effect over the past several decades. During this time, Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA)—two measures designed to address concerns over abusive and frivolous cases.

To date, the Supreme Court's interpretation of both of these statutes has "generally been considered defendant-friendly,"[16] and a number of the Court's other decisions have further contained private litigation under the federal securities laws.[17]

Notwithstanding these measures, the securities class action remains a significant threat in today's environment. According to a recent survey, there were 169 securities class actions filed in 2009. While this number is modestly (14%) below the average number of annual filings for the twelve-year period of 1997 to 2008,[18] securities class actions continue to account for most class action filings, by far. As noted by one observer, "they are the 800-pound gorilla that dominates and overshadows other forms of class actions . . . ."[19]

Securities class actions are typically brought in federal trial courts (known as "district courts"), where the lawsuits are overseen by individual judges appointed to lifetime tenures.[20] Such lawsuits ordinarily follow a common procedural path, as described in the below sidebar.

Life Cycle of a Securities Class Action

- Complaint. The litigation begins with the filing in court of a "complaint," in which counsel for one or more named shareholders, purportedly acting on behalf of a designated group ("class") of investors, (1) identifies who is being sued (typically the securities issuer and a number of related individuals and/or entities), (2) alleges a violation of securities law, such as misrepresentations or omissions in the issuer's disclosure, and (3) requests "damages" (i.e., an award of money to be paid as compensation for the shareholders' investment losses).
- Follow-On Lawsuits. Over a period of weeks or months thereafter, substantially similar lawsuits are typically initiated by <u>other</u> plaintiff law firms representing <u>other</u> individual shareholders. While the same disclosure may be at issue, follow-on lawsuits may be filed in the same or different courts, advance the same or different legal theories, add or subtract defendants, and designate the same or different class of investors.
- Consolidation. The various lawsuits are then often combined into a single proceeding before one federal judge, such that only one "consolidated" lawsuit proceeds. Consolidation may be for pre-trial purposes only, or for all purposes (including trial). However, even where the consolidation is technically for pre-trial purposes only, the original component lawsuits rarely re-start because, as a practical matter, a consolidated securities class action is almost always resolved before trial (whether by a motion to dismiss, summary judgment or a settlement).
- Selection of Lead Plaintiff Counsel. The PSLRA established detailed and interrelated procedures for choosing a lead plaintiff and selecting lead plaintiff counsel. Competition among plaintiff attorneys is fierce, since the selected lead counsel will ultimately receive most if not all of any court award of plaintiff attorneys' fees. The lead counsel essentially controls the litigation on behalf of all potential class members, starting with the filing of a single "consolidated" complaint that replaces all previously filed complaints in the litigation.

- Motion to Dismiss. Defendants must then respond to the consolidated complaint. The response can be in the form an "answer" (where defendants either admit or deny each of the individual allegations made in the complaint), but most defendants instead opt for the "motion to dismiss." In such a motion, defendants request that the judge terminate the litigation on purely legal grounds. If successful, the motion can end the entire litigation at a relatively early stage, and spare defendants the very substantial cost of discovery. (See "Motions to Dismiss," page 17, for a more detailed discussion of this critical litigation stage.) The judge may decide to grant the motion in its entirety, to grant the motion only in part, or to deny the motion. If the motion to dismiss is granted, then the court may allow plaintiffs to file a new amended complaint that seeks to remedy the defects in the original complaint, in which case defendants may likewise file a new motion to dismiss.
- Class Certification. If defendants are not successful in obtaining a complete termination of the litigation on the motion to dismiss (i.e., if the motion is not granted in its entirety), then the litigation proceeds through additional pre-trial phases. These include "class certification," when the court determines (typically following an opportunity for related factual investigation by the parties) whether the litigation can properly be brought as a class action under federal rules of court procedure. If it can, then the class action is said to be "certified." (See "Class Certification Issues," page 16, for a description of the primary prerequisites for class action certification.) In certain circumstances, the court order granting or denying class-action certification may be appealed prior to the conclusion of the underlying litigation.
- Discovery. The fact-finding phase of litigation is known as "discovery," when each side is entitled to demand all relevant facts and documents that are possessed by the other, and to compel sworn testimony in depositions of the other side's witnesses and experts. Subjects of discovery include both liability (i.e., whether defendants have violated the law) and damages (i.e., the amount of compensation defendants would owe for any violation of law).
- Motion for Summary Judgment. Following discovery, plaintiffs or defendants or both may marshal their evidence in an effort to persuade the court that, with respect to all or only some issues, there are no material factual disputes requiring resolution via a trial. If the judge agrees, he or she grants "summary judgment" to one side or the other on such issues.
- Pretrial Motions. If a lawsuit endures this far, the parties have a final opportunity to position the remaining issues in their favor via pretrial motions. For example, in a "motion in limine," defendants can ask the judge to exclude all evidence regarding one or more issues, on the basis (for example) that such issues are not relevant to the defendants' liability. If the motion is successful, plaintiffs may not be allowed to refer to the excluded evidence at trial.
- Settlement. At anytime during the process, the parties may reach a "settlement" of the lawsuit by mutual agreement, in which defendants typically agree to make a payment to the plaintiff class, some portion of which will be paid to plaintiff attorneys for their fee. Where the class has been certified, the judge must approve the settlement amount and fee award. (See "Settlements," page 18, for a discussion of the parties' incentives to settle.)
- Trial. The trial, of course, is the formal and adversarial judicial proceeding at which the evidence is weighed and a determination is made regarding the plaintiffs' claims. In practice, however, virtually all securities class actions are resolved before trial, such that an actual trial is a rare event.
- Appeal. Once the judge ends the case, and assuming no settlement between the parties, the losing party can and frequently does appeal to a three-judge panel of a federal court of appeals. Where the district court has terminated a lawsuit on defendants' motion to dismiss or motion for summary judgment, the appellate panel often gives little deference to the lower court's decision, tending instead to conduct its own in-depth review of the evidentiary and legal basis for the decision.

Applicable Laws

Shareholders generally have two legal avenues to challenge mutual fund disclosure in a class action: the Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act). These two federal statutes "have long been mainstays for general claims based on issuer misrepresentations in the distribution of their shares and vehicles for class actions."[21]

Disclosure lawsuits under the '33 Act typically allege violations of sections 11 and/or 12(a)(2). Disclosure lawsuits under the '34 Act typically allege violations of rule 10b-5, one of the regulations issued by the SEC implementing section 10(b). (See the sidebar below.)

In addition, "controlling persons" of defendants sued under the foregoing provisions may themselves be sued under, respectively, section 15 ('33 Act) or section 20 ('34 Act). In the mutual fund context, alleged "controlling persons" may include, for example, the fund's adviser as well as any parent organization.

Sections 11 and 12(a)(2) of the '33 Act afford plaintiffs a number of practical and strategic advantages relative to a lawsuit brought pursuant to rule 10b-5 under the '34 Act. Indeed, the burden on plaintiffs of proving a violation of sections 11 and 12(a)(2) is, in the words of the Supreme Court, "relatively minimal."[22]

In particular, plaintiffs suing under rule 10b-5 are subject to a requirement that the facts underlying the complaint be alleged with substantial detail and specificity, while plaintiffs suing under the '33 Act ordinarily are not—meaning, as a practical matter, that it is usually easier for '33 Act plaintiffs to draft a complaint that can survive defendants' pre-trial challenge.

Also, and again unlike a rule 10b-5 claim, plaintiffs suing under sections 11 and 12(a)(2) have no obligation to prove that defendants engaged in intentional

Key Disclosure Laws

- Sections 11 and 12(a)(2) of the '33 Act. Section 11 applies to the "registration statement" (a statutory phrase that includes the prospectus, among other documents), and prohibits "an untrue statement of a material fact" or an omission of "a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 12(a)(2) prohibits essentially the same thing, but applies to prospectuses and certain types of oral statements. In either case, to establish a violation, it is not necessary for a plaintiff to prove "scienter" (see next bullet item); even innocent and unintended misrepresentations and omissions are actionable. Under the '33 Act, the plaintiff must be a purchaser of the security at issue. For a more detailed outline of civil liability under the '33 Act, see Appendix I.

- Section 10(b) of the '34 Act and Rule 10b-5. These provisions prohibit fraud "in connection with the purchase or sale of a security." A successful plaintiff must show that (1) the defendant made a false statement or omission of material fact (2) with "scienter" (3) upon which the plaintiff justifiably relied (4) that proximately caused the plaintiff's damages.[1] To prove the necessary mental state of "scienter," negligence is not enough. A plaintiff must show either intentional misconduct or such severe recklessness that the danger of misleading investors was either known to the defendant or so obvious that the defendant must have been aware of it. Under the '34 Act, the plaintiff must be a purchaser or seller of the security at issue.

[1] E.g., Cozzarelli v. Inspire Pharms., Inc., 549 F.3d 618, 623 (4th Cir. 2008).

or reckless misconduct (i.e., “scienter”). In many cases, even innocent or negligent misstatements or omissions can give rise to ’33 Act liability. (For an important exception, in which innocent or negligent misstatements may be protected, see the sidebar regarding the “bespeaks caution” doctrine, at right.)

For the foregoing reasons, among others, securities class actions in the mutual fund context tend to allege violations under sections 11 and/or 12(a)(2) of the ’33 Act, and rule 10b-5 lawsuits are relatively uncommon.

By contrast, securities class actions in the public company context more commonly allege violations of rule 10b-5,[23] notwithstanding the strategic and practical advantages of the ’33 Act. There are various reasons for this difference.

One relates to the effect of time limits (known as “statutes of limitations”) for initiating lawsuits. The statute of limitations applicable to ’33 Act claims is less frequently a bar to plaintiffs pursuing mutual funds (which issue their shares continuously) than to plaintiffs pursuing public companies (which typically issue their securities only periodically).[24]

A second possible reason relates to the “fraud-on-the-market principle”—a legal doctrine that is helpful to rule 10b-5 plaintiffs in the public company context but generally not applicable in the mutual fund context.[25]

Of course, the same lawsuit may assert violations of both the ’33 Act *and* ’34 Act; and mutual funds are not immune to liability under rule 10b-5. But the ’33 Act remains the focus of this study because, as between the two statutes, it is the ’33 Act that has proven to be the favorite of the plaintiffs bar for attacking mutual fund disclosure.

The “Bespeaks Caution” Doctrine

Under the “bespeaks caution” doctrine, an alleged misrepresentation or omission is not actionable when it is “sufficiently balanced by cautionary language within the same prospectus such that no reasonable investor would be misled about the nature and risk of the offered security.”[1] However, the doctrine protects only "forward-looking, prospective representations," and may not be used to caution against "[h]istorical or present fact—knowledge within the grasp of the offeror."[2]

1 P. Stolz Family P’ship L.P. v. Daum, 355 F.3d 92, 96 (2d Cir. 2004).

2 Id. at 97.

Disclosure Litigation in the Fund Industry

Appendix II lists a decade's worth of securities class actions filed against fund industry defendants in which the plaintiffs alleged disclosure violations under the '33 Act.

Collectively, these cases demonstrate that, in the fund industry, the '33 Act has proven to be a flexible hook on which to hang a class action. That is, plaintiffs have used *disclosure* (the statute's linchpin) to challenge a wide range of practices that plaintiffs allege to be unlawful and/or find objectionable, and also to seek recovery of investment losses following periods of especially poor fund performance.

Who Sues Whom?

Class action challenges to mutual fund disclosure under the '33 Act are initiated by individual investors who wish to represent the class of investors on whose behalf the litigation will be pursued. However, not every investor can serve as a class representative; multiple legal considerations bear on that question.[26] (For a key issue that arises in the fund arena, see the sidebar on next page.)

Moreover, as it happens, not every investor who can challenge disclosure does. Specifically, in mutual fund class action litigation, it is still individuals, and not institutional investors, who tend to serve as "named plaintiffs" (i.e., class representatives).

To date, the main (albeit not only) exception has been the multidistrict proceeding established for market-timing litigation, in which a number of public pension funds served as named plaintiffs. Even when not a named plaintiff, however, institutional investors will be bound by any settlement unless they choose to opt out of the class (in which case they may pursue an individual '33 Act claim through either the courts or arbitration proceedings) or persuade the court to reject the settlement.

In any event, where individual shareholders serve as class representatives, effective *control* of the litigation resides not with them, but rather with their litigation counsel. Reversing the usual litigation paradigm—in which plaintiffs are the "principals" who control their counsel (their "agent") and thus the litigation—generally it is the plaintiffs' *counsel* who, in a securities class action, is the principal that controls the litigation. In doing so, the counsel typically enjoys "broad and unconfined discretion."[27]

As a result, the role of plaintiffs' counsel in class action litigation has been compared to that of "an independent entrepreneur";[28] and indeed it is counsel (not the individual plaintiffs) who funds the ongoing expenses of prosecuting the lawsuit and stands to gain substantial benefit (in the form of attorney fee awards).

Today, as in the past, a relatively small number of these "entrepreneurs" dominate the "market" for securities class action plaintiff counsel. In fact, by ICI Mutual's count, just a half dozen plaintiff firms have spearheaded more than half of the '33 Act class action lawsuits filed in the mutual fund arena over the last decade.

Suing with Regard to Unowned Funds

In the mutual fund arena, a key "who can sue" issue has been whether the individual plaintiffs who filed the suit (the "named plaintiffs") may attack disclosure used by multiple funds in a complex, even though the named plaintiffs collectively acquired shares of only some such funds. The relevant legal issues,[1] and especially the interplay between them in the mutual fund area, can be complex. Some courts have held that litigation against funds never owned by any named plaintiff would fail to satisfy minimum requirements of the U.S. Constitution, whether or not those plaintiffs would otherwise be adequate class representatives under the court's class-action rules;[2] but the case law is not unanimous on this point.[3]

1 See infra endnote 26.

2 See, e.g., In re Salomon Smith Barney Mut. Fund Fees Litig., 441 F. Supp. 2d 579, 608 (S.D.N.Y. 2006) ("[T]he Court dismisses from the action those Defendant Proprietary Funds, as well as the Defendants (personal and corporate) whose only connection is to Funds in which the Plaintiffs own no shares."), appeal docketed, No. 08-38 (2d Cir. Jan. 2, 2008); In re Eaton Vance Corp. Secs. Litig., 219 F.R.D. 38, 41 (D. Mass. 2003) ("Yet the named plaintiffs never purchased shares in or conducted any other business with two of the four funds, namely, the Institutional and Advisers funds. The named plaintiffs have therefore not been injured by Institutional and Advisers funds.").

3 See, e.g., In re Mut. Funds Inv. Litig., 519 F. Supp. 2d 580, 587 (D. Md. 2007) ("[F]or purposes of Article III analysis there is no reason to limit artificially, as defendants attempt to do, the class of persons on whose behalf a plaintiff may assert claims to shareholders in the same fund.").

These plaintiff firms tend to be skilled and well financed. They are also aggressive, frequently conducting their own "investigations" of particular practices[29] and even placing newspaper ads[30] or sending direct mail[31] to prospect for shareholders willing to serve as plaintiffs. Several attorneys at one prominent plaintiff firm went so far as to arrange illegal kickback schemes with "professional" plaintiffs.[32] Also, it has long been argued that plaintiff attorneys routinely file speculative lawsuits.[33]

As for the defendant-side of the litigation, the '33 Act itself identifies which entities and individuals may be sued. In the fund context, '33 Act defendants may include the fund at issue, the fund's directors and officers, and the fund's distributor.

In addition, the fund's adviser, as well as the parent organization of the adviser or distributor, may be named as defendants under section 15 of the '33 Act which imposes potential liability on the "controlling persons" of defendants sued under sections 11 or 12(a)(2).[34]

While a fund's independent directors are not necessarily subject to potential liability under section 12(a)(2),[35] they *are* expressly subject to potential liability under section 11. Even though settlements of '33 Act claims are typically funded by entity defendants and/or insurers rather than by independent directors themselves,[36] independent directors nevertheless do experience the disruption and potential reputational harm associated with such litigation.

For What Are Defendants Sued?

Sections 11 and 12(a)(2) of the '33 Act both authorize shareholders to sue with respect to certain misstatements and omissions.[37] (See "Key Disclosure Laws," page 6.)

Potential liability under these sections thus reaches only *disclosure*, and not other matters, like mismanagement and breach of fiduciary duty. For this reason, courts may be reluctant to permit plaintiffs to "bootstrap" allegations of mismanagement or breach of duty into '33 Act claims simply by alleging that defendants failed to disclose the purported misconduct.[38]

On the other hand, "[t]he line between a material nondisclosure [which is actionable under the '33 Act] and the nondisclosure of mere mismanagement [which is not actionable under the '33 Act] is often difficult to draw,"[39] a fact the plaintiffs bar has attempted to exploit.

Thus, plaintiffs have frequently used '33 Act class actions, formally couched in terms of disclosure, to wage thinly veiled attacks on fund performance (i.e., on management of the fund), and/or on a variety of industry practices that the plaintiffs bar has viewed as unlawful or otherwise objectionable.

While these attacks generally have been unsuccessful, they nevertheless collectively demonstrate the plaintiffs' attempt to expand the '33 Act and the concept of fund disclosure to a broad range of subjects. By way of illustration, consider the following broad spectrum of factual contexts for actual mutual fund '33 Act class action litigation over the past decade.

- ***Risk Profile/Investment Policies.*** Starting in 2007, a number of underperforming fixed-income funds were targeted by class actions arising from the collapse of the subprime mortgage market and ensuing credit crisis.

  These cases (which include a few cases targeting, respectively, leveraged exchange-traded funds and closed-end funds) are the latest example of disclosure lawsuits filed in the aftermath of significant declines in fund share prices. Examples of "price drop" cases in prior years include litigation against funds that held, respectively, Enron stock, senior loans, and micro-cap securities.

  Plaintiffs in these cases have sought to link the price drop to (1) a particular investment risk or practice for which the fund's disclosure is alleged to be misleading or incomplete and/or (2) a failure to follow the investment policies or limitations described in the fund registration statement.

- ***Valuation.*** In a number of cases—including many of the current '33 Act class actions involving fixed-income funds, as well as several filed in 2001 and 2002—plaintiffs have focused heavily on issues relating to valuation of portfolio securities and disclosure of valuation policies and procedures.

  Some counsel suggest that this focus may partly reflect an attempt by plaintiffs to avoid "loss causation" problems that are inherent in proving defective mutual fund disclosure. (See "Loss Causation," page 15.)

- ***Transfer of Trust Assets into Proprietary Funds.*** In 2005 and 2006, several class action lawsuits alleged that, lacking proper disclosure, banks used trust-account assets to support the mutual funds offered by other business units within the same financial organizations (by investing the assets in those funds). While these lawsuits thus focused on defendants' practices with respect to bank trust accounts, fund group defendants and fund disclosure were also caught up in the litigation.

- ***Market Timing.*** As is well known, the market-timing scandal of 2003 and 2004 gave rise to widespread regulatory enforcement activity and litigation. Ultimately, a multidistrict litigation proceeding was established for the private civil litigation.

Consolidated class action complaints filed by fund investors in that proceeding included '33 Act claims, in which plaintiffs alleged misleading or incomplete fund disclosures regarding whether (and to what extent) favored investors were being allowed to market time in the funds at issue.

- ***Class B Shares.*** Several class action lawsuits filed in 2003 and 2004 challenged disclosures regarding Class B shares. In particular, plaintiffs alleged that they were induced by various misleading statements into purchasing Class B shares that had higher expenses and/or lower yields than available alternative share classes.

- ***Distribution-Related Payments.*** Also in 2003 and 2004, the fund industry saw a wave of class action lawsuits attacking widespread practices regarding distribution-related payments to broker-dealers, such as soft dollars and revenue sharing.

  Most of these lawsuits did not assert disclosure violations under the '33 Act; but several did, alleging that funds did not disclose these practices. In each of these lawsuits that included '33 Act claims, plaintiffs were targeting the proprietary funds affiliated with large securities brokerage firms.

- ***Investment Banking Conflicts.*** In 2002, several of the country's largest securities brokerage firms entered into regulatory settlements following investigations of conflicts of interest.[40] Specifically, regulators had investigated the firms' use of in-house securities research to benefit the firms' investment banking clients.

  In the fallout of these investigations, multiple class action lawsuits alleged that the firms likewise used their proprietary funds for the same purpose, by having the proprietary funds purchase shares in underperforming companies with whom the firms had investment banking relationships. Plaintiffs alleged that the funds did not disclose these practices.

- ***Other.*** Over the past decade, plaintiffs have also brought disclosure-based class action lawsuits with regard to the suitability of the funds at issue for use in retirement plans and "front running" by a portfolio manager.

See Appendix II for a case list that identifies these same subject matters by case.

What Issues Are Commonly Contested?

During the pretrial stages of the litigation process, lawyers representing plaintiffs and defendants contest various legal and factual issues. In some cases, these issues may be ripe for the court's consideration at the outset of the litigation process, and may provide grounds for an early termination of the litigation by the court and/or spur an early negotiated resolution by the parties.

Conversely, if lawsuits survive defendants' early challenges, then unresolved issues become the subject of factual discovery and expert disputes, and uncertainty regarding these issues can ultimately impact the amount of any settlements. Among the most commonly contested issues in '33 Act class actions are the following.

ADEQUACY OF DISCLOSURE

The crux of a '33 Act class action is, not surprisingly, the adequacy of the security issuer's disclosure. In this regard, plaintiffs' counsel in '33 Act class actions typically cast a wide net, alleging a litany of specific misrepresentations and/or omissions in support of one or more broad themes.

By way of illustration, a complaint's broad theme may be that a large securities brokerage firm steered plaintiffs into particular mutual funds for improper reasons. Then, in order to support a claim under the '33 Act, the complaint may contain a long bullet list or multiple paragraphs that more specifically identify particular misleading statements or omissions. For example, in one case having such a theme, the complaint alleged that the brokerage's proprietary funds failed to disclose:

- that the funds' investment adviser and distributor "used investor assets to satisfy bilateral arrangements with brokerage firms . . . [which] improperly steered unsuspecting clients into Proprietary Funds for personal financial gain,"

- that the funds' investment adviser "used brokerage commissions over and above those allowed by Rule 12b-1, and over and above those permitted under the shareholder approved Distribution Plans to pay for the 'shelf-space,'"

- that the funds' investment adviser "directed brokerage payments to brokerage firms that favored the Proprietary Funds to satisfy bilateral arrangements," and that "this directed brokerage was a form of marketing that was not . . . authorized by the Proprietary Funds Rule 12b-1 Plans,"

and so on.[41]

As a result, defendants in '33 Act class actions must likewise proceed on two levels: refute plaintiffs' specific disclosure-based allegations on an item-by-item basis *and* counter the plaintiffs' broader theme(s). If the litigation survives defendants' motion to dismiss and progresses through the fact-finding (or "discovery") phase, the specific statements and omissions under attack by the plaintiff attorneys, and even the nature of their overall theme(s), may change—further complicating the defense effort.

In practice, how have defendants fared? Where plaintiffs have argued that defendants omitted information specifically required by a certain statute or rule (e.g., by Form N1-A), defendants have successfully argued in motions to dismiss that disclosure of the information at issue was in fact not specifically mandated by that statute or rule.[42]

However, even where information is not *specifically* required, liability may yet arise from an "untrue statement of a material fact," or from an omission of "a material fact" that is "necessary to make the statements" not misleading.[43] In either case, the requisite "materiality" of the information at issue is evaluated under an objective "reasonable investor" standard (see the sidebar regarding materiality, next page).

Materiality is not always the sort of purely legal issue that is readily amenable to resolution on a pretrial motion to dismiss.[44] But where the alleged misrepresentations or omissions are *so* "obviously unimportant to a reasonable investor" that "reasonable minds could not differ on the question of their importance,"[45] courts can and do decide, on motions to dismiss, that the information at issue is not "material."[46]

Legal Standard: Materiality

The "materiality" of an alleged misrepresentation or omission is evaluated using the well-established standard articulated by the U.S. Supreme Court in Basic Inc. v. Levinson, which requires proof that there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[1]

Put another way, "[t]he materiality of a misstatement depends on whether there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to act."[2]

1 485 U.S. 224, 231-32 (1988).

2 ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 197 (2d Cir. 2009) (internal quotation marks and brackets omitted).

Courts have also dismissed lawsuits where a reasonable investor would already know (or at least have inquired about) allegedly omitted information—whether from public knowledge, other statements in the prospectus, or otherwise.[47]

In at least one of these cases, the fact that there is an "extensive regulatory regime governing mutual funds and what they must disclose"[48] appears to have played some role in defendants' success. That judge, making note of such a regime, viewed "the absence of a specific directive" in a statute or regulation requiring a particular disclosure as presenting "a serious obstacle" to plaintiffs.[49]

In summary, adequacy of mutual fund disclosure is one of the key issues generally contested by the parties throughout pretrial litigation, including defendants' motion to dismiss. As explained above, defendants have had some success with defending, on a motion to dismiss, the adequacy of disputed disclosure. In other cases, courts have either denied the motion to dismiss[50] or resolved the motion on a different basis.

TIMELINESS OF THE PLAINTIFF'S LAWSUIT

Federal law sets a time limit (known as a "statute of limitations") on when a plaintiff must initiate a lawsuit. The time limit varies, depending on the plaintiff's particular claim. In the case of the '33 Act, a plaintiff must file by the earlier of (1) one year after the plaintiff discovered or *should have* discovered the untrue statement or omission at issue, or (2) three years after the public offering (as regards section 11) or sale (as regards section 12(a)(2)) of the security at issue.[51]

Because shares of mutual funds are offered continuously (such that the three-year period rarely expires), it is the one-year limitation that typically controls in '33 Act class actions against fund group defendants. Thus, most often, the key question with regard to timeliness of the lawsuit is: using reasonable diligence, when *should* the plaintiffs have discovered the facts constituting the alleged disclosure violation?

If plaintiffs failed to initiate their lawsuit within one year of such discovery—i.e., the point by which they should have discovered the relevant facts, known as "inquiry notice"—then the plaintiffs acted too late, and the lawsuit should be dismissed.

On this basis, a number of courts have granted fund group defendants' motions to dismiss.[52] In these cases, courts have examined a wide range of sources of information—including news articles, press releases, previously filed lawsuits, and the prospectus itself—when considering the timeliness of a plaintiff's lawsuit. See the sidebar at right for an example of fund defendants achieving a dismissal on this issue.

Too Late to Sue

In Benak v. Alliance Capital Management, L.P.,[1] the plaintiffs argued that a fund's disclosures regarding the investment strategies employed and companies invested in were materially misleading in light of the fund's continued and increasing equity stake in Enron.

In affirming the lower court's dismissal, the appeals court cited a combination of facts—plaintiffs' knowledge that the fund group had Enron holdings, subsequent news reports regarding Enron, Enron's highly-publicized bankruptcy, the publicity in the immediate aftermath of the bankruptcy that referenced the fund group's Enron-related losses, and the filing of a similar complaint—that should have placed plaintiffs on notice more than one year before they first filed their complaint.

1 435 F.3d 396 (3d Cir. 2006).

LOSS CAUSATION

In rule 10b-5 claims, the concept of "loss causation" requires a plaintiff to prove that its alleged investment losses were in fact caused by the alleged misrepresentation or omission at issue, rather than other factors (e.g., changed macroeconomic circumstances).[53] Unlike plaintiffs alleging a rule 10b-5 violation, plaintiffs alleging a violation of '33 Act sections 11 or 12(a)(2) are not required to demonstrate loss causation as an affirmative element of their case.

Instead, it is up to defendants to prove (as an "affirmative defense") the *absence* of loss causation (sometimes referred to as "negative causation"). That is, to the extent that defendants can show that the plaintiffs' losses were caused by factors *other than* the alleged disclosure violation, defendants can reduce their liability under the '33 Act to that extent.[54]

The customary pattern of events that is used to show loss causation for stock issued by a public corporation—inflated price, corrective disclosure, price drop[55]—does not translate to the context of mutual funds. (See the sidebar, next page.) As a result, recent commentary has focused on whether, and how, "loss causation" applies in the context of mutual fund disclosure.[56]

It is too early to predict what consensus courts may ultimately reach on the fate of loss causation in the mutual fund context. Fund group defendants have indeed won motions to dismiss on loss-causation grounds by arguing that the disclosure at issue could have no possible effect on NAV.[57]

On the other hand, the two most recent courts to address loss causation on a motion to dismiss in the fund context ruled against defendants.[58] In one of these cases, the court worried that a "narrow" concept of loss causation "would effectively insulate mutual fund companies from claims for a wide range of material misrepresentations."[59]

Even where motions to dismiss do not succeed, defendants may yet use the expert discovery process to identify other causes of plaintiffs' investment losses (as discussed at "Settlement Payments," page 20), thereby reducing the settlement value of the case.

Public Company Share Price v. Mutual Fund NAV

Unlike the market price of stock in a public corporation, which is set by traders in a secondary market making judgments about the value of that corporation based on publicly available information, the price of a mutual fund share (the NAV) is not set by the market. Indeed, mutual fund shares (unlike shares of closed-end funds) do not trade on an exchange. Rather, their NAV is set according to a statutory formula: namely, the fund's total assets minus liabilities, divided by the number of outstanding fund shares.

As a result of this structure, it is rather unclear how a misrepresentation or omission in a fund's prospectus could possibly effect a fund's NAV: "The absence of a secondary market for a mutual fund's shares means that any misstatements in a fund's prospectus by themselves can neither inflate the shares' NAV (price) nor, when revealed, diminish the shares' NAV."[1] A prospectus can say what it will, but anything said is not reflected in the NAV. Rather, the fund's NAV will remain a function of the statutory formula.

1 David M. Geffen, A Shaky Future for Securities Act Claims Against Mutual Funds, Sec. Reg. L.J., Spring 2009, at 24.

CLASS CERTIFICATION ISSUES

Federal Rule of Civil Procedure 23 establishes several prerequisites to proceeding with a lawsuit on behalf of a large "class" of plaintiffs. The requirements of rule 23 touch on multiple factual and legal concepts, including primarily the following.

- ***Numerosity.*** The class must be so numerous that joinder of all members is impracticable.
- ***Commonality.*** There must be questions of law or fact common to the class.
- ***Typicality.*** The claims or defenses of the representative parties must be typical of the claims or defenses of the class.
- ***Adequacy of representation.*** The representative parties will fairly and adequately protect the interests of the class.

"Class certification" refers to a court's determination that the lawsuit satisfies each of these requirements, and so may proceed as a class action.[60]

In connection with certification, the court establishes a class definition which identifies all persons considered to be within the class of persons represented by the plaintiffs. Persons within the class, unless they choose to opt out, are bound by any resolution of the class action and entitled to a share in any settlement.

In theory, class certification, like the motion to dismiss, presents another pre-trial procedural hurdle for plaintiffs to clear. In practice, however, fund group defendants do not always oppose a motion for class certification.

For example, defendants may agree that *a* class should be certified, and dispute only one or more particulars of the class definition as proposed by plaintiffs. Also, when defendants agree to settle a class action lawsuit, they generally support certification of the class in order to bind all class members to the terms of the settlement.

Where fund group defendants do decide to oppose class certification, or at least the class definition as proposed by plaintiffs, contested issues commonly include the "class period" (i.e., the time period that defines which shareholders are entitled to potential damages).

Defendants may also raise challenges to the manageability of one or more claims on a class-wide basis (e.g., claims based on oral statements, or claims by shareholder clients of independent investment advisers not affiliated with any fund group defendant). Standards for certifying a class action "have been significantly tightened across the spectrum of federal court litigation over recent years."[61]

How Is Disclosure Litigation Ultimately Resolved?

In theory, a district court may resolve a '33 Act class action at any of various sequential stages in the litigation process. The court may (1) grant defendants' motion to dismiss, (2) deny plaintiffs' motion to certify a class, (3) grant defendants' motion for summary judgment, or (4) decide the case after a trial. Following the court's entry of a final judgment, the losing party may then decide to appeal, which further extends the life of the case.

Meanwhile, at any time in the litigation process, the parties themselves may mutually agree to end the litigation through a negotiated settlement. Of the foregoing possibilities, the vast majority of securities class actions are resolved in one of two ways: either in favor of defendants at the motion-to-dismiss stage, or through a subsequent negotiated settlement.

MOTIONS TO DISMISS

During congressional hearings on the Private Securities Litigation Reform Act of 1995 (PSLRA), it was estimated that "discovery costs comprised eighty percent of the expense of defending securities class actions."[62] One reform introduced by that statute was a presumptive bar against all discovery "during the pendency of any motion to dismiss."[63]

In light of the PSLRA discovery bar, it is difficult to overstate the importance to defendants of winning the motion to dismiss. If defendants are *not* successful in terminating a securities class action on a motion to dismiss, the PSLRA discovery bar will end, such that defendants will be required to incur the high cost of discovery. In addition, a failed motion to dismiss increases the settlement value of the case.

Its importance thus established, how can defendants win a motion to dismiss? Technically, the motion to dismiss is a procedural mechanism for deciding (as relevant to this discussion) a limited issue: whether the facts alleged in the plaintiffs' complaint, if true, would plausibly suggest the violations of law claimed by plaintiffs, such that plaintiffs should be allowed an opportunity to prove the alleged facts.

In other words, the issue to be decided by a judge on such a motion is *not* whether the allegations in the plaintiffs' complaint are factually correct or supported by adequate evidence, but rather whether those allegations, assuming that they are true, would allow the court "to draw the reasonable inference that the defendant is liable for the misconduct alleged."[64]

Over the past ten years, fund group defendants have had substantial success with obtaining dismissals of '33 Act claims. (See Appendix II.) However, one must be cautious in viewing all dismissals as necessarily constituting clear-cut "wins" for the fund group defendants.

For example, lawsuits commonly allege violations of multiple securities laws. Thus, even though defendants may obtain dismissal of the '33 Act claim, the same court may decide to allow a different claim to proceed (such as a section 36(b) claim under the Investment Company Act of 1940). In such a case, defendants still face the prospect of discovery and settlement notwithstanding their victory on the '33 Act claim.

In addition, even if defendants' motion to dismiss resolves the entire lawsuit, plaintiffs commonly appeal the dismissal to a U.S. court of appeals. In fact, several of the Appendix II cases are now pending on appeal.

Moreover, past success of course does not guarantee future success. In this regard, it is important to note that motions to dismiss have yet to be ruled upon by district court judges in most of the investment company class actions relating to the sub-prime and credit crisis events of 2007 and 2008. In fact, in the two motions to dismiss decided to date in these cases, the courts denied defendants' motions and have permitted the litigation to proceed.[65]

SETTLEMENTS

Securities class actions that survive motions to dismiss usually settle, sooner or later, by agreement of the parties, such that "almost none" go to trial.[66] Mutual fund cases follow this pattern.

While subsequent pretrial developments may impact the settlement *amount*—for example, discovery may yield evidence that cuts one way or the other, a plaintiff's proposed class definition may be narrowed significantly, and/or a motion for summary judgment may resolve some issues in defendants' favor—the lawsuit settles nonetheless. Indeed, of the fund lawsuits listed in Appendix II, none went to trial (although some of these cases still remain pending).

Why do securities class action lawsuits eventually settle if motions to dismiss are unsuccessful? As it happens, both plaintiffs and defendants face significant incentives and risks that cause them to prefer a negotiated resolution over a trial.

In understanding the plaintiffs' perspective, the key insight is that plaintiffs' strategic and economic decisions are often driven not by the plaintiffs themselves, but rather by their *lawyers*.[67] In this regard, consider the incentives and risks faced by plaintiffs' counsel in a securities class action:

> When one adds . . . the expenses that the [plaintiff] attorney must bear and the attorney's expected contingent fee[,] . . . the attorney has far more at stake than any individual class member. Second, time is money, and delay for class counsel means additional costs and expenses that the attorney alone bears; thus the attorney/entrepreneur has more reason to desire an early settlement than the client. . . . Finally, because plaintiff's [attorney] fee awards are typically a declining percentage of the recovery, the attorney benefits less from an increase in the recovery than does his or her clients. These factors . . . help explain why so few securities class actions ever go to trial. Risk aversion induces the plaintiff's attorney to settle at a discounted price . . . .[68]

In other words, plaintiffs' counsel have considerable financial incentives to settle a class action without risking the "all or nothing" outcome often inherent in a trial.

Defendants likewise may have substantial incentives and risks that promote settlements prior to trial, even as regards class action lawsuits that may have little or no substantive merit.

Indeed, it may be perfectly rational for a defendant to agree to a settlement payment for a variety of reasons entirely unrelated to the underlying merits of the plaintiffs' allegations—to avoid, for example, the high cost of defense, the all-or-nothing nature of a trial judgment, uncertainty regarding outcome probabilities, and/or the reputational harm of adverse publicity.[69]

Even if a defendant *wins* its motion to dismiss, it may still agree to a settlement (albeit in a smaller dollar amount) in order to avoid the risk of a court of appeals reversing the dismissal on appeal—a risk heightened by the fact that a U.S. court of appeals uses a non-deferential standard to review a district court's dismissal.

Defendants' incentives to settle prior to trial are further strengthened to the extent that plaintiffs claim "losses" in a very large dollar amount, as is often the case when the stock price of an issuer (or the NAV of a fund) has declined significantly.

Albeit not in a '33 Act case, an influential federal appellate judge aptly described the predicament faced by a defendant in such circumstances: "When the potential liability created by a lawsuit is very great, even though the probability the plaintiff will succeed in establishing liability is slight, the defendant will be under pressure to settle rather than to bet the company, even if the betting odds are good."[70]

Adding to this pressure is the fact that defendants' settlement payments in class action litigation have historically been just a small fraction of the total amount claimed by plaintiffs (and the fraction generally decreases as the estimated damages increase).[71] The ability of defendants to terminate their potential liability at such a large discount adds to their incentive to avoid the uncertainties inherent in trial.

The existence of defendants' liability insurance is yet another factor that may increase the incentives to settle even relatively weak '33 Act claims: "The limits of the D&O insurance policies are an obvious and widely noted structural factor affecting the value of securities class action settlements. Insurance . . . is seen as relatively easy money."[72] In particular, cases tend to settle within the amount of available insurance limits.[73]

In light of the foregoing, it is not surprising that insurance policies routinely require ongoing cooperation by insureds with their insurers during the pendency of any lawsuit that may implicate insurance coverage, and require insureds to receive their insurers' consent *before* making any settlements.

Finally, federal court rules require judicial approval of any settlement with a certified class, in order to ensure that any settlement is "fair, reasonable, and adequate."[74]

At What Cost?

Commentators have long observed that the cost of securities class actions falls largely on defendant companies rather than on plaintiffs or individual director-and-officer defendants.[75] Defendant companies incur not only their own substantial costs of defending such lawsuits (litigation counsel and experts), but may be responsible for the litigation expenses of the individual director-and-officer defendants.

In addition, and especially if motions to dismiss are denied, defendant companies may also agree to a substantial settlement payment. Any settlement payment typically includes not only a payment to members of the plaintiff class but also an award of plaintiff attorneys' fees and other litigation expenses.

DEFENSE COSTS

ICI Mutual has previously reported on the rising cost of defending lawsuits and regulatory investigations.[76] Even where their motion to dismiss is successful, fund group defendants in '33 Act class actions commonly incur defense costs in the range of seven figures. Where motions to dismiss are *not* successful, defense costs increase substantially (as does the overall "settlement value" of the lawsuit[77]).

The increase in defense costs following an unsuccessful motion to dismiss is largely attributable to the extraordinary costs normally associated with discovery—the lengthy fact-finding phase of litigation, in which each side may demand written answers, documents and expert and other witness testimony (i.e., depositions) from the other.

While the costs of discovery have tended to fall disproportionately on defendants (in that defendants are the ones who possess most of the information and who are associated with most of the witnesses relevant to the lawsuit),[78] advancements in technology have added substantially to discovery costs for both sides to the litigation.[79]

Among other things, such advancements have resulted in a dramatic increase in the sheer volume of corporations' electronically stored information, including e-mails and data. Defendants' retrieval and both parties' examination of such materials have added significantly to discovery costs.

The high cost of defending a securities class action (which cost is ultimately reflected in the cost of insurance) underscores the need, in the event of a lawsuit, for proactively managing the fund group's defense costs. ICI Mutual's prior risk management study on defense costs extensively reviewed multiple strategies and techniques for doing so.[80]

SETTLEMENT PAYMENTS

While securities class actions generally settle for only a fraction of the amount claimed by plaintiffs,[81] that fraction may still be large in absolute terms, running into the millions or tens of millions of dollars. These amounts are typically funded by entity defendants (such as the fund adviser and/or distributor), by liability insurance, or by some combination of the two.[82] As a result, fund independent directors remain at relatively low risk of personal liability in the event of a settlement.

In order to influence the ultimate *amount* of the settlement, plaintiffs and defendants marshal the discovery process and their respective experts in support of "dueling damages" theories. That is, plaintiffs seek to develop an argument and find support for a very large damage award, while defendants seek to limit the potential amount of damages that plaintiffs could conceivably recover.[83]

When engaged in this process, a key threshold question is: how are damages measured under the '33 Act? Generally, under section 11, damages are measured by "the difference between the amount paid for the security and either (1) the security's value at the time of suit (if it is still held at the time of suit) or (2) the price at which the security was sold (if it was sold before suit)."[84]

Under section 12(a)(2), damages are measured by the difference between (1) the amount paid for the security, plus prejudgment interest, and (2) the amount for which the plaintiff sold the security, together with any income the plaintiff received on the security; or, if the plaintiff still owns the security, the plaintiff may exchange the shares for the original purchase price plus interest, minus the amount of any income received on the security.[85]

In either case, the maximum amount recoverable by a plaintiff in the mutual fund context is "the depreciation in the mutual fund's per-share NAV (price), measured from the time the plaintiff purchased the shares from the fund."[86]

The foregoing formulas for damages are thus "based upon price differentials."[87] Calculating price differentials is easy enough outside the class action context, where there is but a single plaintiff. Taking a simple example, if an individual plaintiff bought the security at $18 per share and still owned the shares at the time suit was filed, at which point the stock's price had declined to $15 per share, then (of course assuming a violation) the plaintiff has potential maximum damages of $3 per share.

A class action, however, exceedingly complicates the damages issue,[88] as illustrated by both of the following key issues:

- ***Size of the Investment Loss.*** In a class action, perfect individualized data as to all class members is frequently unavailable, in part because individuals' trades are frequently aggregated in omnibus accounts or otherwise. In these cases, generating the price differentials underlying the damages calculation requires the use of a number of assumptions.

  Assumptions are also frequently necessary even where individualized data *is* available. For example, does the damages model assume that shares were redeemed on a "FIFO" or "LIFO" basis? Such assumptions can significantly impact the overall damages calculation.

- ***Causes of the Investment Loss.*** As previously discussed, defendants can defeat a '33 Act claim by demonstrating that plaintiffs' investment losses were caused by other factors unrelated to the alleged disclosure violation.[89]

  This issue thus presents a significant opportunity for defendants to reduce the settlement value of a case because, even where investment loss is undisputed and properly quantified, it may very well be that other factors unrelated to disclosure (e.g., changed macroeconomic circumstances) caused all or part of that loss.[90] In order to distinguish disclosure-related causes from such other causes, an event study or similar analysis is generally necessary.[91]

Plaintiff Attorneys' Fees

Federal court rules provide that, in a certified class action, a court may award "reasonable" attorneys' fees "that are authorized by law or by the parties' agreement";[1] and, in accord, some portion of the settling defendants' payment is typically awarded to the plaintiff attorneys.

In general, courts award plaintiff attorneys' fees in class actions under either the "percentage of the fund" method or the "lodestar" method.

Under the "percentage of the fund" method, the plaintiff attorneys are awarded some percentage of the settlement payment to the plaintiff class.

Under the lodestar method, the court "multiplies hours reasonably expended against a reasonable hourly rate" and, in its discretion, "may increase the lodestar by applying a multiplier based on factors such as the riskiness of the litigation and the quality of the attorneys."[2]

1 Fed. R. Civ. P. 23(h).

2 Wal-Mart Stores, Inc. v. Visa U.S.A. Inc., 396 F.3d 96, 122 (2d Cir. 2005) (citation omitted).

These damages issues have "generated extensive literature";[92] and multiple consulting firms offer relevant expertise to defendant fund groups (such as Compass Lexecon, Cornerstone Research, and NERA Economic Consulting, to name a few).

The complex mathematics and models of technical damages analysis are beyond the scope of this publication. Suffice it to say that, in the event of a securities class action, fund group defendants should be prepared to work closely with their counsel and experts to investigate all relevant damages issues: "[S]ince damages will be used by the plaintiffs . . . [and any] mediator . . . to argue for a larger settlement, a detailed understanding of the damages analysis . . . is critical."[93]

Managing the Risk

While the overall *frequency* of '33 Act securities class action lawsuits may not be high, the potential *severity* of such litigation certainly is. That severity—in terms of defense costs, potential damages exposure, business disruption, reputational harm, and impact on insurance premiums—highlights the importance to fund groups of implementing strong practices and procedures to promote complete and accurate fund disclosure.

As with many aspects of mutual fund management, practices for ensuring proper disclosure vary across the industry such that there is not any single approach or set of "best practices" for use by fund groups.

Given the wide diversity of fund groups—in terms of size, product line-up, and culture, among other things—it is not practical or advisable to seek a "one size fits all" standard. Rather, as with prior ICI Mutual studies, this part sets forth issues that fund groups may wish to consider, with a view to understanding whether and how their existing disclosure practices and procedures might be improved.

Finally, because disclosure-based securities litigation does threaten even the most careful fund groups, it is appropriate to prepare in advance for the prospect of litigation by appreciating the role of insurance coverage for exposure in this area.

Role of Adviser Personnel

Inasmuch as a fund typically has no employees of its own but rather is externally managed by its investment adviser, the adviser's personnel necessarily have a lead role in developing and reviewing the fund's disclosure. This role includes not only establishing practices and procedures for full and complete disclosure, but also making sure that portfolio managers fully understand the limits of their discretion under the fund's disclosures.

In this regard, fund groups may wish to consider the following issues.

- ***What departments are involved in the preparation of the fund's prospectus and statement of additional information?*** Fund groups may choose to involve any combination of various key personnel from various departments in the drafting, review and updating of a fund's disclosure—including legal, senior management, portfolio management, risk management, and the adviser's Chief Compliance Officer (CCO), among others.

  Given the number of potential personnel, it is important to clarify the role and expectations for each department and specifically identify individuals involved in the process.

- ***What is the role of in-house legal personnel?*** In-house legal personnel frequently bear primary responsibility for drafting disclosure and for overseeing its review and updating. In doing so, it is critical for them to work closely with portfolio managers, so that the disclosure reflects the reality of the fund's portfolio management.

  Such collaboration may be especially important with regard to complex strategies and securities, to better inform the drafters of the intricacies of the subject (including the risks involved) so that the disclosure accurately reflects how the portfolio managers intend to manage the fund. Finally, it is not uncommon for legal personnel to study disclosure used by similar funds at other fund groups.

- ***What is the role of outside counsel?*** Outside regulatory counsel are often involved in drafting or reviewing the registration statement, or specific portions thereof. Outside counsel frequently have broad experience in preparing fund disclosure for multiple fund groups, and/or may bring specific expertise to particular disclosure issues (e.g., complex derivatives).

  In addition, some fund groups find it helpful for securities litigators to also review the fund disclosure. Litigation specialists can bring a useful perspective to the review process. For example, they may be able to identify wording and concepts that appear vulnerable to attack by the plaintiffs bar, and/or to enhance the fund's risk disclosures.[94]

- ***What is the role of the CCO?*** CCOs (whether for the adviser, the fund, or both) appear to have different roles at different fund groups with regard to disclosure. It is clear, however, that the CCO "should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm."[95] Thus, the CCO should at least evaluate whether reasonable policies and procedures exist with respect to disclosure, and monitor compliance with those policies and procedures.

The Summary Prospectus

In January 2009, the SEC issued a release adopting long anticipated rule and form amendments in an effort to improve and simplify mutual fund disclosure and delivery.[1] New rule 498 under the '33 Act permits, but does not require, the delivery of a new stand-alone "summary prospectus" containing key fund information in "plain English" instead of a full statutory prospectus (provided that certain conditions are met). In addition, the amendments to Form N-1A (the registration form for mutual funds) require a summary section upfront in the full statutory prospectus containing the same information as the stand-alone summary prospectus.

With new rule 498, the SEC has taken important steps to address the concerns raised by fund industry representatives, including the Investment Company Institute, about potential civil liability for information omitted from the summary prospectus. To that end, new Rule 498 expressly provides for "incorporation by reference" into the summary prospectus of information from other fund documents (provided certain conditions are met).[2]

The SEC has advised that all information included in, or incorporated by reference into, a summary prospectus will remain subject to liability under sections 11 and 12(a)(2).[3] It also bears noting that the distribution of summary prospectuses does not lessen the need for full and accurate disclosure in statutory prospectuses and SAIs, which will remain widely available (e.g., on fund group websites), and which remain a source of potential liability.

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1 Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8998, 74 Fed. Reg. 4546 (Jan. 26, 2009).

2 Id. at 4571 ("Numerous commenters stated that, by permitting incorporation by reference, the proposal significantly addresses liability issues that resulted in funds' unwillingness to use the fund profile and will encourage wider use of the Summary Prospectus.").

3. Id. at 4571 (noting that "nothing in rule 498 removes, or diminishes" liability under section 12(a)(2)), 4574 ("[A]ll of the information in the Summary Prospectus will be subject to liability under section 11, either because the information is the same as information contained in the statutory prospectus or because the information is incorporated by reference from the registration statement.").

- ***What is the role of portfolio management personnel?*** Regardless of which other personnel may be involved in the drafting, review and update of fund disclosure, there seems to be general agreement that portfolio management personnel must be involved, in order to ensure that the disclosure is consistent with the portfolio manager's investment strategies and techniques.

  Particular processes for doing so vary from fund group to fund group but can include:

  (a) a mandatory face-to-face, interactive meeting between the portfolio manager and compliance and/or legal personnel, including especially the individual(s) drafting the disclosure,

  (b) requiring the portfolio team to read the disclosure, and to memorialize their understanding by having them complete relevant checklists, and

  (c) arranging for the continued participation of appropriate portfolio management personnel during any subsequent updating of the disclosure.

  In the case of sub-advised funds, it is necessary to additionally consider how to involve the sub-adviser's portfolio management personnel in these processes.

- ***What is the role of risk management personnel?*** The concept of "risk management" varies among fund groups. Personnel involved in management of *investment* risks can be a particularly important constituency to involve in preparation of fund disclosure. Such personnel may have a sense of the "worst case" scenario for any fund, among other insights.

  Highlighting the importance of disclosure regarding investment risks, outside counsel consulted for this study noted that sufficient cautionary language regarding such risks can protect a fund's disclosure under the "bespeaks caution" doctrine (see sidebar at page 7), and also influence a judge to view defendants as having acted responsibly in alerting investors to the principal risks associated with their investment.

- ***How is the adviser's process explained to the fund's directors?*** In fulfilling their responsibilities, fund directors want to understand the process by which the adviser and outside counsel create and assess the adequacy of disclosure.

  In this regard, an outside counsel consulted for this study has suggested that it may be helpful for advisory personnel to include in their presentations to fund boards an explanation of the process for preparing fund certifications regarding disclosure controls and procedures that are required by regulations promulgated under the Sarbanes-Oxley Act.[96]

- ***What is the process for updating the fund's disclosures?*** Emerging issues are a constant in the fund business. In the past, these have included portfolio strategies, trading costs, soft dollar relationships, and the structure of portfolio managers' compensation. More recently, disclosure regarding target-date funds has emerged as an issue of interest to a number of industry participants.[97] As such issues emerge, fund complexes consider whether it may be appropriate to provide additional or revised disclosure about them.[98]

Similarly, additional or revised disclosure may be warranted by new SEC requirements or by fund-specific actions and issues (such as a new type of investment, or a change in the fund's investment restrictions or techniques). Indeed, one counsel consulted for this study commented that one challenge in the prospectus disclosure process is "capturing changes" as portfolio management strategies and practices evolve over time.

It is thus important for fund groups to have procedures to monitor for such issues, to evaluate each fund's existing disclosures in light of new issues, to systematically compile such items throughout the year, and to involve portfolio management, operational, and trading personnel in the process for updating prospectuses. Enhancing disclosure may involve, depending on circumstances, "stickering" the prospectus.

- ***How does the fund group seek to ensure that the fund is managed in accord with its disclosure?*** In the wake of the 2008 credit crisis, multiple lawsuits filed against bond funds alleged, essentially, that the funds were managed in violation of the their stated parameters. Whatever their actual merits may be, these cases again highlight the importance that fund groups have in place a process by which the group seeks to ensure that funds are managed in full accordance with their stated disclosure.

  In this regard, fund groups have adopted a wide range of techniques—including written policies, compliance monitoring, prior approval for new instruments or strategies, interaction between portfolio management and compliance/legal personnel, training portfolio managers on compliance risks, and compensation policies for portfolio managers—that are designed to ensure disclosure is consistent with the fund's investment strategies and techniques.[99]

  In addition, many firms deploy automated compliance systems that screen for trades or other actions that may be inconsistent with fund disclosure. It is important that such systems be set up correctly in the first instance, and that portfolio managers do not substitute over-reliance on them for an independent and thorough understanding of the fund's disclosure.

- ***How does the fund group vet data published in the prospectus and statement of additional information?*** In recent years, several ICI Mutual insureds have reported errors in performance data. While none of these instances gave rise to a class action, the fund groups did incur costs to correct the situation (e.g., a supplement for each prospectus and/or a rescission offer). These situations highlight the importance for procedures to confirm the accuracy of published data.

Role of Independent Directors

In recent years, influence within U.S. corporations has "shifted from officers to the board," board responsibilities have increased, and "scrutiny is on the rise."[100] The same could be said about independent directors of U.S. mutual funds, who as independent "watchdogs" with fiduciary obligations to the funds they oversee,[101] have likewise assumed an increasingly active role in addressing risk management within their fund groups.

Of course, independent directors also have a personal interest in managing disclosure risk, inasmuch as material misstatements or omissions in a registration statement may trigger a section 11 class action that names directors among the defendants.

DUE DILIGENCE DEFENSE

Section 11(b) of the '33 Act provides that, in order to defeat an otherwise valid section 11 claim made against them, directors must demonstrate (subject to a limited exception regarding "expertised" portions of the registration statement[102]) that they exercised what is commonly known as "due diligence."[103] Generally, however, the due diligence defense will *not* support a motion to dismiss,[104] and so ordinarily would not come into play until that motion has already been lost.

Because most '33 Act cases in the fund industry are dismissed or settled before trial, the due diligence defense may thus seem to have relatively small relevance in comparison to the dispositive legal issues discussed at "What Issues Are Commonly Contested?," page 12. Yet a recognition and understanding of the defense can assist fund directors to carry out their responsibilities in such a way as to minimize their own risk for potential personal liability.

What, then, is meant by "due diligence"? Technically, due diligence refers to (as stated in section 11 itself) a "reasonable investigation" after which the director has a "reasonable" belief in the registration statement's accuracy.[105]

While there is relatively little case law (and virtually none in the mutual fund context) explaining what constitutes such a "reasonable investigation" or "reasonable" belief,[106] courts have held that independent directors may not place "blind faith" reliance on management-prepared documents.[107]

Rather, courts have generally permitted directors to rely on management representations regarding the registration statement only after some "reasonable effort to seek verification" of the statement's accuracy.[108]

SEC Rule 176

In 1982, the SEC adopted rule 176 in an attempt "to make explicit what circumstances may bear upon the determination of what constitutes a reasonable investigation and reasonable ground for belief as these terms are used in Section 11(b)."[1]

Although the rule identifies a number of such circumstances—e.g., the type of issuer, the type of security, the type of person whose due diligence is at issue—the SEC noted that "only a court can make the determination of whether a defendant's conduct was reasonable under all the circumstances of a particular offering."[2]

1 Circumstances Affecting the Determination of What Constitutes Reasonable investigation, Securities Act Release No. 6335, 1981 SEC LEXIS 946, at *2-*3 (proposed Aug. 6, 1981).

2 Id. at *41-*42.

ADDRESSING FUND DISCLOSURE

There are obviously different approaches by which directors can satisfy their responsibilities regarding disclosure. Regulators as well as other industry participants express their own views in this regard;[109] and, as might be expected, independent directors' approaches may vary depending on a number of factors, including the fund group's size, the nature of the funds, and the directors' particular backgrounds and expertise.

Fund counsel interviewed for this study advised that fund boards may wish to ensure that independent directors are afforded an opportunity to review and comment upon the overall process by which fund disclosure is prepared, reviewed, revised, and updated.

As regards the substance of a fund's disclosure, it is often impractical for the directors themselves to read in advance every line of every page of every disclosure for every supervised fund (and few would expect directors to do so). For this reason, among others, directors frequently engage outside counsel for assistance. (See "Role of Outside Counsel," below.)

In addition, directors can build general familiarity with the fund's disclosure documents—by sampling, browsing, reviewing key sections, or otherwise. This exercise can be a useful risk management effort, and can encourage appropriate discussion of disclosure issues between independent directors and management.

Other documents that may be of interest to independent directors in their consideration of disclosure include (1) the annual compliance report from the fund's Chief Compliance Officer (CCO), required by an Investment Company Act rule,[110] and (2) any "deficiency letter" issued to the fund group by the SEC staff. Either of these documents could conceivably identify a disclosure-related weakness or other issue.

Whatever approach a particular board may use, an important resource for its independent directors (in addition to outside counsel) is the fund CCO. The CCO has a unique relationship with the fund's board, and in fact may be the only officer who meets with the board during executive session. At a minimum, the fund CCO should be able to answer the board's questions regarding the adviser's processes and procedures regarding disclosure.

Finally, and as with directors' other duties, attention to the general principles of *preparation, process* and *documentation* remains a useful all-purpose approach to managing liability risk of all types.

Following these principles helps to (1) ensure that matters of importance are evaluated fully and in the best interest of the fund and (2) establish a contemporaneous, accurate and unambiguous record that can protect directors in the event that their deliberations, judgments or actions become subject to legal challenge. These principles are described in more detail in a prior ICI Mutual publication, *Independent Director Litigation Risk*.[111]

ROLE OF OUTSIDE COUNSEL

Funds and/or independent directors frequently engage outside counsel to review and comment upon a fund's draft disclosures in advance, to provide guidance on any disclosure issues raised by counsel's review, and to identify the more significant disclosures on which directors may wish to focus their attention. Counsel's work and advice on disclosure issues can generally be expected to strengthen directors' showing of due diligence in the event of subsequent litigation.

Insurance and Director Indemnification

In the general corporate arena, "[m]ost securities class-action settlements, other than the very large ones, are funded in total or in substantial part by proceeds from . . . insurance policies purchased by the issuer."[112] Settlements in mutual fund cases are no different in this regard.

Indeed, fund groups typically view coverage for disclosure liability claims as a core feature of mutual fund D&O/E&O insurance. In some policy forms, affirmative coverage for such claims is explicitly provided. In other policy forms, coverage is implicitly provided (either under the policy form's definition of "wrongful act" or otherwise[113]). Either way, policy forms rarely, if ever, expressly exclude disclosure liability coverage.

Counsel to fund boards should be alert to the fact that a few courts have considered whether section 11 liability is uninsurable as a matter of public policy, with mixed results;[114] and some academic commentary is critical of insurance in this area.[115]

It is important to recognize, however, that the case law is very thin, such that the question has not been decided (or even considered) by the great majority of courts; and even in those relatively few cases in which the issue has been addressed, the disclosures involved were issued by operating companies rather than by mutual funds.

Insurance aside, fund directors may wish to confirm that their fund's governing documents appropriately address director indemnification (i.e., use of fund assets to pay legal expenses and other amounts that may be incurred by directors in claims made against them), including the fund's ability to advance, during the pendency of a claim, its directors' legal expenses.

Fund indemnification is often a strong first line of protection for directors, though directors and their counsel should recognize that indemnification rights remain subject to certain restrictions under state and federal law,[116] and that the SEC and some courts have taken the position that indemnification for liability under the '33 Act is contrary to public policy and thus unenforceable.[117]

Conclusion

The fund industry remains an attractive potential target for an energetic, sophisticated and creative plaintiffs bar. Most recently, in connection with the 2007-08 credit crisis, a number of class actions were filed regarding bond funds whose performance had suffered significantly.

These lawsuits primarily assert disclosure violations, typically under sections 11 and/or 12(a)(2) of the Securities Act of 1933, in connection with various alleged misstatements or omissions (e.g., lack of "true diversification" of the funds' assets, their concentration in certain types of securities, and the illiquidity of such securities).

As the potential severity of a securities class action is extraordinarily high—in terms of defense costs, the potential amount of damages at issue, reputation, and business disruption—this newest round of lawsuits underscores the continuing imperative of seeking accurate and complete disclosure. Addressing the risk of liability for disclosure violations requires the ongoing attention of numerous individuals and departments within a fund group, including fund independent directors and their counsel.

Appendix I: Civil Liability Under the Securities Act of 1933

This brief overview of civil liability under sections 11, 12(a)(2), and 15 of the Securities Act of 1933 ('33 Act) is by way of background only. Nothing contained in this appendix should be considered legal advice. Instead, readers should look to their counsel for such advice.

Section 11

Section 11 imposes civil liability (on the fund, its directors, and its affiliated distributor, among others) if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[118]

While the registration statement of a mutual fund may be "evergreen" (in that fund shares are continuously offered pursuant to that statement), note that section 11 imposes liability only if the registration statement contains an untrue statement or omission *as of the "effective date"* of the registration statement.

As has been recognized by the Supreme Court itself, section 11 "places a relatively minimal burden on a plaintiff."[119] Generally, to make a case, a plaintiff need prove only "(1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment."[120]

It is generally *not* necessary for a plaintiff to prove that he or she relied on the misstatement or omission,[121] or even that the misstatement or omission caused his or her loss.[122] Moreover, it is likewise unnecessary for the plaintiff to prove the defendant's degree of knowledge regarding the misrepresentation, such that even innocent and unintended misrepresentations and omissions can give rise to section 11 liability.[123]

Assuming the plaintiff proves a section 11 violation, defendants may yet defeat the claim by proving any of several defenses. For example, a defendant can seek to prove that the plaintiffs' losses were caused by something other than the misrepresentations (a defense sometimes known as "negative causation," to signify the absence of causation).[124] Also, any defendant (other than the fund itself[125]) may seek to prove that—

> as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.[126]

This defense is commonly known as the "due diligence" defense.[127] See "Role of Independent Directors," page 26 (discussing the due diligence defense with respect to independent directors).

In addition, the Private Securities Litigation Reform Act of 1995 (PSLRA) protects "outside" directors[128] from "joint and several" liability under section 11 (i.e., shared liability with other defendants for the *entire* judgment) absent proof that the outside director had actual knowledge that the issuer had made a materially false or misleading statement to the investing public.[129]

Section 12(a)(2)

Whereas section 11 concerns misrepresentations and omissions in a registration statement, section 12(a)(2) concerns misrepresentations and omissions in "a prospectus or oral communication."[130] Also, the reach of section 12(a)(2) liability extends only to a person who "offers or sells" the security; and there are some differences in the measure of damages under each section.[131]

Otherwise, sections 11 and 12(a)(2) are largely the same:

- Both sections prohibit essentially the same thing.[132]
- The test for materiality is the same under both sections.[133]
- Neither section requires the plaintiff to prove reliance, scienter, or causation.[134]
- Both sections allow defendants to defeat the claim by proving negative causation and/or (for certain defendants) due diligence.[135]

As noted by one judge, "[t]hese provisions prohibit essentially the same conduct,"[136] except that § 12(a)(2) covers not only statements made in a prospectus but also oral statements.

Section 15

Section 15 imposes liability on "controlling persons" of any defendant liable under sections 11 or 12(a)(2).[137] By virtue of section 15, fund advisers, as well as the parent organizations of fund advisers and distributors, may be named as defendants in '33 Act litigation.[138]

If there is no violation of section 11 or 12(a)(2), then necessarily there can be no "controlling person" liability under section 15.[139] In addition, even where there has been a violation of section 11 or 12(a)(2), a "controlling person" may escape liability under section 15 by demonstrating that he or she "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[140]

Appendix II: Case List

This appendix lists every class action identified by ICI Mutual that included a section 11 claim regarding mutual fund disclosure and, during the ten-year period ending December 31, 2009, (1) was filed and/or (2) resulted in a judicial disposition of the section 11 claim.[141] While the far right column reports that defendants have had substantial success with obtaining dismissals of section 11 claims during this time period, it is important to keep in mind that a dismissal is not always or necessarily a clear-cut "win" for defendants (for reasons explained at "Motions to Dismiss," page 17).

Case Name	*Venue*	*Filed*	*Subject* [a]	*Motion to Dismiss § 11 Claim* [b]
In re Dreyfus Aggressive Growth Mut. Fund Litig.	S.D.N.Y.	1998	other risk profile/inv. policies (*micro-cap securities*)	motion to dismiss denied
Abrams v. Van Kampen Funds, Inc.	N.D. Ill.	2001	valuation risk profile/inv. policies (*senior loans*)	motion to dismiss denied
Benak v. Alliance Capital Mgmt. L.P.	D.N.J.	2001	risk profile/inv. policies (*Enron stock*)	dismissal affirmed on appeal
Hicks v. Morgan Stanley & Co.	S.D.N.Y.	2001	valuation	motion to dismiss denied
In re Eaton Vance Corp. Secs. Litig.	D. Mass.	2001	valuation	motion to dismiss denied
Johnson v. AEGON USA, Inc.	N.D. Ga.	2001	other	dismissal affirmed on appeal
Donovan v. Am. Skandia Life Assurance Corp.	S.D.N.Y.	2002	other	dismissal affirmed on appeal
In re Merrill Lynch & Co. Global Tech. Fund Secs. Litig.; In re Merrill Lynch & Co. Internet Strategies Fund . . .	S.D.N.Y.	2002	research analyst/inv. banking conflicts	dismissed [c]
In re Merrill Lynch Focus Twenty Fund, Inc. Secs. Litig.	S.D.N.Y.	2002	research analyst/inv. banking conflicts	dismissed
In re Morgan Stanley Tech. Fund Secs. Litig.; In re Morgan Stanley Info. Fund Secs. Litig.	S.D.N.Y.	2002	research analyst/inv. banking conflicts	dismissed [c, d]
In re Van Wagoner Funds, Inc. Secs. Litig.	N.D. Cal.	2002	valuation	dismissed
White v. Heartland High-Yield Mun. Bond Fund	E.D. Wis.	2002	valuation	settled before mot. to dismiss
Benzon v. Morgan Stanley Distribs., Inc.	M.D. Tenn.	2003	class B shares distribution-related payments	dismissal affirmed on appeal

Case Name	*Venue*	*Filed*	*Subject* [a]	*Motion to Dismiss § 11 Claim* [b]
Fitzgerald v. Citigroup Inc.	S.D.N.Y.	2003	class B shares	dismissed
In re Morgan Stanley & Van Kampen Mut. Fund Secs. . . .	S.D.N.Y.	2003	distribution-related payments	dismissed
DeBenedictis v. Merrill Lynch & Co.	D.N.J.	2004	class B shares	dismissal affirmed on appeal
In re Mut. Funds Inv. Litig. (Judge Blake)	D. Md.	2004	market timing	dismissed [c]
In re Mut. Funds Inv. Litig. (Judge Davis)	D. Md.	2004	market timing	dismissed [c]
In re Mut. Funds Inv. Litig. (Judge Motz)	D. Md.	2004	market timing	dismissed [c]
In re Salomon Smith Barney Mut. Fund Fees Litig.	S.D.N.Y.	2004	class B shares distribution-related payments research analyst/inv. banking conflicts	dismissed [d]
Siepel v. Bank of Am., N.A.	E.D. Mo.	2005	txfr of trust assets into proprietary funds	dismissal affirmed on appeal
Brooks v. Wachovia Bank, N.A.	E.D. Pa.	2006	txfr of trust assets into proprietary funds	dismissal affirmed on appeal
Rabin v. JP Morgan Chase Bank, N.A.	N.D. Ill.	2006	txfr of trust assets into proprietary funds	dismissed
In re Regions Morgan Keegan Open-End Mut. Fund Litig.	W.D. Tenn.	2007	valuation risk profile/inv. policies (*credit crisis*)	mot. to dismiss not yet filed
In re Regions Morgan Keegan Closed-End Fund Litig.[f]	W.D. Tenn.	2007	risk profile/inv. policies (*credit crisis*)	consol. compl. not yet filed[g]
Gosselin v. First Trust Advisors, L.P.[f]	N.D. Ill.	2008	valuation risk profile/inv. policies (*credit crisis*)	motion to dismiss denied
In re Charles Schwab Corp. Secs. Litig.	N.D. Cal.	2008	valuation risk profile/inv. policies (*credit crisis*)	motion to dismiss denied
In re Evergreen Ultra Short Opportunities Fund Secs. Litig.	D. Mass.	2008	valuation risk profile/inv. policies (*credit crisis*)	mot. to dismiss pending
In re Reserve Primary Fund Secs. & Derivative Class . . .	S.D.N.Y.	2008	valuation risk profile/inv. policies (*credit crisis*)	consol. compl. not yet filed[g]
Plumbers & Steamfitters Union v. State Street Corp.; Yu v. State Street Corp.	S.D.N.Y.	2008	valuation risk profile/inv. policies (*credit crisis*)	mots. to dismiss pending
Zametkin v. Fid. Mgmt. & Research Co.	D. Mass.	2008	valuation risk profile/inv. policies (*credit crisis*)	mot. to dismiss pending
Novick v. ProShares Trust and related cases[h]	S.D.N.Y.	2009	risk profile/inv. policies (*credit crisis*)	consol. compl. not yet filed[g]

Case Name	*Venue*	*Filed*	*Subject* [a]	*Motion to Dismiss § 11 Claim* [b]
In re Oppenheimer Champion Fund Secs. Fraud Class . . .	D. Colo.	2009	valuation risk profile/inv. policies (*credit crisis*)	mot. to dismiss pending
Ferguson v. OppenheimerFunds, Inc.	D. Colo.	2009	risk profile/inv. policies (*credit crisis*)	mot. to dismiss pending
In re Oppenheimer Rochester Funds Group Secs. Litig.	D. Colo.	2009	risk profile/inv. policies (*credit crisis*)	consol. compls. not yet filed[g]
Stoopler v. Direxion Shares ETF Trust and related cases[h]	S.D.N.Y.	2009	risk profile/inv. policies (*credit crisis*)	consol. compl. not yet filed[g]

[a] For a description of these subject categories, see "For What Are Defendants Sued?," page 10.

[b] This column reports results regarding only the section 11 claim (as of December 31, 2009). Note that lawsuits commonly allege violations of multiple securities laws. Thus, even though a defendant may obtain dismissal of the section 11 claim, the same court may decide to allow a different claim to proceed (such as a section 36(b) claim under the Investment Company Act of 1940).

[c] The same judge dismissed both cases on the same grounds.

[d] Currently pending on appeal.

[e] The three referenced judges presided over the multidistrict litigation proceeding established for the market-timing allegations of 2003 and 2004. They organized the proceeding by creating separate "subtracks" for each mutual fund family, with each judge presiding over multiple subtracks. Each judge's noted dismissal of the section 11 claim applied to each of the multiple subtracks assigned to that judge.

[f] Case concerns one or more closed-end funds.

[g] While a single consolidated complaint has not yet been filed, one or more of the originally filed complaints contains a section 11 claim.

[h] Case concerns one or more exchange-traded funds.

Endnotes

1 *See* Sean M. Murphy et al., Milbank, Tweed, Hadley & McCloy LLP, Recent Developments in Litigation Involving Mutual Funds and Investment Advisers 2 (March 22, 2009) (conference outline, on file with ICI Mutual) ("With claims under the [Investment Company] Act significantly restricted, private plaintiffs have begun to find other potential theories of recovery to attack the fund industry.").

2 Other recent publications by ICI Mutual include *Mutual Fund D&O/E&O Insurance* (2009), *Managing Risks in Trade Allocation* (2008), and *Outsourcing by Advisers and Affiliated Service Providers* (2008).

3 *E.g.*, Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 171 (1994) (internal quotation marks omitted).

4 JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 2 (11th ed. 2009).

5 John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 245 (2007) (emphasis added); *see also* Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 74 (2008) ("[P]rivate securities class actions are synonymous with private enforcement . . . ."); Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 331 ("In the case of securities disclosure regulation, the usual justification of civil liability is that allowing private plaintiffs to bring civil suits creates a body of private attorney generals who help society by supplementing the efforts of otherwise overstretched public enforcement officials.").

6 Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 281 (2007) ("Nearly $3.5 billion per year of private sanctions were . . . imposed on the U.S. securities markets in this period [2002-04] . . . ."); Lisa Rickard, *Another Threat to Average Investors: Securities Lawsuits*, THE CHAMBERPOST, July 31, 2008, http://www.chamberpost.com/2008/07/another-threat.html ("[P]laintiffs' lawyers have driven up settlement costs dramatically, generating approximately $51.8 billion in settlements over the past decade.").

7 BLACK'S LAW DICTIONARY 267 (8th ed. 2004).

8 DAVID W. LOUISELL ET AL., CASES AND MATERIALS ON PLEADING AND PROCEDURE 823 (6th ed. 1989).

9 *See, e.g.*, Robert Allen, Comment, *Securities Litigation as a Coordination Problem*, 11 U. PA. J. BUS. & EMP. L. 475, 501 (2009) ("Studies suggest that plaintiffs frequently file suits in response to large stock drops with the hopes to extract a settlement . . . ."); A.C. Pritchard, *The Political Economy of Securities Class Action Reform*, 2007-08 CATO SUP. CT. REV. 217, 247 ("[N]ot surprisingly, cases continue to be brought when the damages calculation is greatest, with large stock price drops and heavy trading. This means that the companies punished hardest by the market are also the ones that are most likely to face a class action.") (footnote omitted).

10 *See* David Hoffman, *Fund Industry Likely to Face Wave of Suits Over Risk Disclosure*, INV. NEWS, Apr. 12, 2009 ("The dismal performance of mutual funds could result in a wave of lawsuits . . . .").

11 See the lawsuits filed during 2007 to 2009, listed at Appendix II.

12 *See* In re Cendant Corp. Secs. Litig., 404 F.3d 173, 196 (3d Cir. 2005) ("Such complaints are as often spurred by news reports or press releases disclosing wrongdoing—or by reports that other firms have filed complaints—as by independent investigation."); In re Salomon Smith Barney Mut. Fund Fees Litig., 441 F. Supp. 2d 579, 582 n.1 (S.D.N.Y. 2006) ("The industry . . . practices which were the subject of the investigations and subsequent settlement became public in March, 2004. A wave of class action litigation immediately washed over the mutual fund industry."), *appeal docketed*, No. 08-38 (2d Cir. Jan. 2, 2008).

13 *See, e.g.*, Milberg LLP, Investigation of Improper Mutual Fund Sales Practices, http://www.milberg.com/page.aspx?pageid=5474 (last visited Jan. 4, 2010).

14 Coffee, *supra* note 5, at 245.

15 Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 333 ("Private securities litigation has become increasingly controversial.").

16 Pritchard, *supra* note 9, at 218; *see also* Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 235 (5th Cir. 2009) ("To be successful, a securities class-action plaintiff must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action."); Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 758 (2009) ("Studies since the PSLRA have found that securities lawsuits are now more often dismissed . . . .").

17 *See, e.g.*, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (holding that rule 10b-5 liability did not extend to the issuer's customers and suppliers who agreed to the arrangements that allegedly allowed the issuer to issue a misleading financial statement); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) (holding that a private plaintiff may not maintain a lawsuit for "aiding and abetting" a violation of rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding that a private plaintiff under rule 10b-5 must be an actual purchaser or seller of the security at issue).

18 CORNERSTONE RESEARCH, INC., 2009: A YEAR IN REVIEW 2 (2010).

19 John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006).

20 Technically, both federal and state courts have power to decide lawsuits alleging violations of the Securities Act of 1933. 15 U.S.C. § 77v(a) (2007). However, the Securities Litigation Uniform Standards Act of 1998 (SLUSA) authorizes removal to federal district court of "[a]ny covered class action brought in any State court involving a covered security, as set forth in subsection (b)." § 77p(c). "A 'covered class action' is a lawsuit in which damages are sought on behalf of more than 50 people. A 'covered security' is one traded nationally and listed on a regulated national exchange." Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 83 (2006). Most actions are in fact removed to federal court.

21 Mercer E. Bullard, Dura, *Loss Causation, and Mutual Funds: A Requiem for Private Claims?*, 76 U. CIN. L. REV. 559, 559 (2008).

22 Herman & Maclean v. Huddleston, 459 U.S. 375, 382 (1983).

23 *See* ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS 10 (2009) ("[O]nly a fraction of the cases in our sample did not involve Rule 10b-5 claims . . . ."); Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1804 n.34 (2007) ("In 2005, 93% of securities class actions alleged violations of Rule 10b-5.").

24 Defendants' use of the statute of limitations in defending against '33 Act liability is discussed at page 14.

25 The fraud-on-the-market principle assumes that the intrinsic "value" of a stock is reflected in its share price, such that a deceptive statement regarding the stock's value is reflected in the market price of the stock. But the price of a *mutual fund* share (i.e., its NAV) "reflects nothing about the fund's intrinsic value as an investment." Bullard, *supra* note 21, at 575-76. *See generally* Public Company Share Price v. Mutual Fund NAV, *supra* page 16.

26 First, most generally, the U.S. Constitution imposes certain minimum standards regarding who is entitled (has "standing") to file a claim in federal court. Second, sections 11 and 12(a)(2) likewise impose certain standing requirements for plaintiffs suing under those sections. Third, as among the potential universe of plaintiffs delineated by the foregoing, both the Private Securities Litigation Reform Act of 1995 (PSLRA) and the federal court rule regarding class actions (Rule 23) further specify which person or persons may represent the class in the litigation.

27 John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better than "Voice,"* 30 CARDOZO L. REV. 407, 411 (2008).

28 *Id.*

29 *See supra* note 13.

30 *E.g.*, Johnson, Pope, Bokor, Ruppel & Burns, LLP & Popham Law Firm, Advertisement, *Attention Mutual Fund Investors: Concerned About Excessive Fees and Other Abuses in the Mutual Fund Industry?*, POST-TRIB. (Jefferson City, Mo.), Feb. 24, 2004, at 6.

31 Beagan Wilcox Volz, *Oppenheimer Alleges Foul Play in Bond Litigation*, IGNITES, Sept. 3, 2009, http://www.ignites.com/articles/20090903 ("Oppenheimer says Cohen Milstein sent direct mail advertisements to fund shareholders in order to solicit plaintiffs before the firm filed a complaint, which Oppenheimer says is in violation of the Private Securities Litigation Reform Act of 1995.").

32 *See 2 Sentenced in Milberg Case*, L.A. TIMES, Nov. 4, 2008, at C2 ("Two more defendants in a secret lawsuit kick-back scheme involving the former Milberg Weiss law firm were sentenced by a federal judge who said he hoped future lawyers would learn a lesson from the careers ruined.").

33 *See, e.g.*, H.R. REP. NO. 104-369, at 31 (1995) (criticizing "abusive" practices including "the routine filing of lawsuits . . . with only [a] faint hope that the discovery process might lead eventually to some plausible cause of action").

34 *See generally infra* App. I at "Section 15."

35 A potential section 12(a)(2) defendant is any person who "offers or sells" the security at issue. In general, a person is considered a "seller" if he or she "either passed title to the securities or solicited the sale of the securities." In re Metro. Secs. Litig., 532 F. Supp. 2d 1260, 1295 (E.D. Wash. 2007). At least in theory, it appears that this concept of "seller" *could,* depending on the circumstances, include a fund's independent directors, *see* In re Charles Schwab Corp. Secs. Litig., 257 F.R.D. 534, 555 (N.D. Cal. 2009) (denying independent directors' motion to dismiss on this issue); but would not *necessarily* include them, *see, e.g.*, In re Metro., 532 F. Supp. at 1295 ("The Court determines that neither the signing of a prospectus, nor the unsupported assertion of solicitation is sufficient to qualify an individual as a 'seller' for the purposes of Section 12.").

36 *See infra* note 82 and accompanying text.

37 15 U.S.C. §§ 77k, 77*l*(a)(2) (2007).

38 The U.S. Supreme Court has held that acts of corporate mismanagement do not violate section 10(b) of the '34 Act or rule 10b-5. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977). Courts have extended this reasoning to claims brought under the '33 Act. *See, e.g.*, In re Craftmatic Secs. Litig., 890 F.2d 628, 638 n.14 (9th Cir. 1989).

39 In re Craftmatic, 890 F.2d at 639; *see, e.g.*, In re Tyco Int'l, Ltd. Multidistrict Litig., No. 02-1335-B, 2004 U.S. Dist. LEXIS 20733, at *11-*12 (D.N.H. Oct. 14, 2004) ("[C]ircuits have struggled in the wake of *Santa Fe Industries* to articulate a more nuanced standard to distinguish cases in which the failure to disclose mismanagement will support a § 10(b) claim from those in which it will not."); Abrams v. Van Kampen Funds, Inc., No. 01 C 7538, 2002 U.S. Dist. LEXIS 9814, at *36 (N.D. Ill. May 29, 2002) ("On the present pleadings, it cannot be determined that any of plaintiffs' allegations constitute mere corporate mismanagement.").

40 Press Release, N.Y. Office of Att'y Gen., SEC, NY Attorney General, NASD, NASSAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices, Dec. 20, 2002, http://www.oag.state.ny.us/media_center/2002/dec/dec20b_02.html.

41 The bulleted quotations are from the Consolidated Amended Class Action Complaint, *In re Salomon Smith Barney Mutual Fund Fees Litigation*, No. 1:04-cv-04055 (S.D.N.Y. June 1, 2005).

42 *E.g.*, Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598, 612 (6th Cir. 2005) ("SEC regulations, including Form N1-A, do not impose a disclosure obligation with respect to broker compensation."); Donovan v. Am. Skandia Life Assurance Corp., 96 F. App'x 779, 781 (2d Cir. 2004) ("[N]either NASD Notice 99-35 nor SEC Form N-4 imposes a duty on defendants to include in its prospectuses the warning sought by plaintiffs."); In re Morgan Stanley Tech. Fund Secs. Litig., No. 02-6153, 2008 U.S. Dist. LEXIS 106909, at *24 (S.D.N.Y. Feb. 2, 2009) ("Given the specificity of the requirements set forth in Form N-lA, Plaintiffs' argument that the alleged disclosures are required by the Form's *general* directive to disclose 'essential information' to assist an investor in comparing the fund with others, is unpersuasive."), *appeal docketed*, No. 09-837 (2d Cir. Mar. 3,

2009). In the *Morgan Stanley* appeal, the SEC has filed an amicus brief supporting Morgan Stanley's position. Brief of the SEC, *Amicus Curiae*, in Support of Appellees on Issue Addressed at 12, *In re Morgan Stanley Info. Fund Secs. Litig.*, No. 09-837 (2d Cir. Nov. 12, 2009) ("[T]he Commission believes that under the allegations in this case, Form N-1A did not require the funds to disclose that their affiliated broker-dealers had ceased to maintain an Information Barrier between their research and investment-banking departments or that the resulting organization structure may affect the investment strategy employed by the funds' managers.").

43 15 U.S.C. §§ 77k, 77*l*(a)(2) (2007).

44 *E.g.*, In re Britannia Bulk Holdings Inc. Secs. Litig., No. 08-9554, 2009 U.S. Dist. LEXIS 96468, at *23 (S.D.N.Y. Oct. 19, 2009) ("Materiality is essentially a 'mixed question of law and fact,' and as such, it is not ordinarily a question appropriate for resolution as a matter of law in a motion to dismiss.") (citation omitted).

45 ECA & Local 134 IBEW Joint Pension Trust of Chi. V. JP Morgan Chase Co., 553 F.3d 187, 197 (2d Cir. 2009) (internal quotation marks omitted).

46 *See, e.g.*, In re Morgan Stanley & Van Kampen Mut. Fund Secs. Litig., No. 03-cv-8208, 2006 U.S. Dist. LEXIS 20758, at *33 (S.D.N.Y. Apr. 18, 2006) ("Plaintiffs allege that managers' bonuses were linked to proprietary fund sales, and that the bonuses themselves could be substantial, but they do not allege—specifically or otherwise—that the proportion of sales of proprietary funds had a more than minimal impact on the amount of a bonus. Minimal payments such as these are not material under the securities laws.") (citation omitted).

47 *E.g.*, Benzon, 420 F.3d at 609 ("Given that all of the information necessary to compare the different class shares was in the prospectuses, the alleged omissions in this case are not material."); Donovan, 96 F. App'x at 781 ("An omission is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. . . . From this information [other prospectus statements], the reasonable investor would know [the allegedly omitted information] . . . . Adding a warning . . . thus would not have significantly altered the total mix of information in the prospectus.") (internal quotation marks omitted); In re Merrill Lynch & Co. Research Reports Secs. Litig., 289 F. Supp. 2d 429, 435 (S.D.N.Y. 2003) ("Plaintiffs claim that the Fund, and those associated with the Fund, had a duty to obtain and disclose the underlying conflicts of interest that allegedly made the reports of Merrill Lynch misleading on securities held by the Fund. This claim fails because the information regarding the alleged conflict of interest was public knowledge, and had been for years.").

48 Merrill Lynch, 289 F. Supp. 2d at 434.

49 *Id.*

50 *E.g.*, Gosselin v. First Trust Advisors L.P., No. 08 C 5213, 2009 U.S. Dist. LEXIS 117737, at *18 (N.D. Ill. Dec. 17, 2009) ("Plaintiffs have shown as this juncture that the allegations concerning the disclosures related to the Funds' investment strategies and risks may be actionable."); Abrams v. Van Kampen Funds, Inc., No. 01-7538, 2002 U.S. Dist. LEXIS 9814, at *35 (N.D. Ill. May 30, 2002) ("Plaintiffs have alleged false representations or omissions as to valuing the loans.").

51 15 U.S.C. § 77m (2007).

52 *E.g.*, DeBenedictis v. Merrill Lynch & Co., 492 F.3d 209 (3d Cir. 2007); Gerin v. Aegon USA, Inc., 242 F. App'x 631 (11th Cir. 2007) (per curiam).

53 *E.g.*, Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005) (defining "loss causation" as "a causal connection between the material misrepresentation and the loss"); Lentell v. Merrill Lynch & Co. Inc., 396 F.3d 161, 172 (2d Cir. 2005) ("Loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.") (internal quotation marks omitted).

54 15 U.S.C. §§ 77k(e), 77*l*(b). *See generally* Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 234 (5th Cir. 2009) (per curiam) ("Once a plaintiff establishes a prima facie case under the Securities Act, loss causation is presumed. Section 11(e) provides a means of rebutting that presumption. If a defendant can show that 'any portion or all of such damages represents other than the depreciation in value of [the] security resulting from [the material misstatement] of the registration statement,' the presumption is rebutted for so much of the loss as is not attributable to the misstatement.") (citations omitted) (brackets in original).

55 *See, e.g.*, In re Williams Secs. Litig., 558 F.3d 1130, 1137 (10th Cir. 2009) ("Loss causation is easiest to show when a corrective disclosure reveals the fraud to the public and the price subsequently drops . . . .").

56 *See, e.g.*, Bullard, *supra* note 21; David M. Geffen, *A Shaky Future for Securities Act Claims Against Mutual Funds*, SEC. REG. L.J., Spring 2009.

57 *E.g.*, In re Salomon Smith Barney Mut. Fund Fees Litig., 441 F. Supp. 2d 579, 590 (S.D.N.Y. 2006) (holding that plaintiffs had "not linked these [allegedly improper and undisclosed] fees in any way to a diminished value of the mutual fund shares"), *appeal docketed*, No. 08-38 (2d Cir. Jan. 2, 2008); In re Morgan Stanley & Van Kampen Mut. Fund Secs. Litig., No. 03-8208, 2006 U.S. Dist. LEXIS 20758, at *35-*36 (S.D.N.Y. Apr. 18, 2006) ("Unlike an ordinary share of stock traded on the open market, the value of a mutual fund share is calculated according to a statutory formula. . . . Plaintiffs explain no mechanism by which a mutual fund share's price could differ from its objective 'value.'"). While *In re Salomon Smith Barney* and *In re Morgan Stanley & Van Kampen* were both decided in the Southern District of New York, a different judge presided over each case.

58 Gosselin v. First Trust Advisors L.P., No. 08 C 5213, 2009 U.S. Dist. LEXIS 117737 (N.D. Ill. Dec. 17, 2009) (closed-end funds); In re Charles Schwab Corp. Secs. Litig., 257 F.R.D. 534 (N.D. Cal. 2009) (open-end funds).

59 Charles Schwab, 257 F.R.D. at 547.

60 *See* In re Initial Pub. Offering Secs. Litig., 471 F.3d 24, 41 (2d Cir. 2006) ("[A] district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met . . . .").

61 Coffee, *supra* note 27, at 431.

62 Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929, 945.

63 15 U.S.C. § 77z-1(b)(1) (2007).

64 Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (U.S. 2009). This "plausibility" standard for judging the adequacy of a plaintiff's complaint is very new, and widely viewed as raising the bar for plaintiffs to survive a motion to dismiss. *See, e.g.*, Erwin Chemerinsky, *The Supreme Court Moves to the Right, Perhaps Sharply to the Right*, CAL. BAR. J., Aug. 2009, at 6 ("It is difficult to overstate the importance of this case . . . . This would seem to give a great deal more discretion to district courts to decide whether to dismiss cases."); Iqbal *Decision Having Significant Impact on Federal Pleading Standards in Federal Courts*, Litig. Client Alert (Milbank, Tweed, Hadley & McCloy LLP, New York, N.Y.), Aug. 25, 2009, http://milbanklegalupdate.com/ve/ZZn807968W269127cPT96 ("*Iqbal*'s application to a broad array of civil actions, notably commercial litigation cases, will continue to be a source of strength for defendants seeking to ward off strike suits at an early stage.").

65 Gosselin v. First Trust Advisors L.P., No. 08 C 5213, 2009 U.S. Dist. LEXIS 117737 (N.D. Ill. Dec. 17, 2009) (closed-end funds); In re Charles Schwab Corp. Secs. Litig., 257 F.R.D. 534 (N.D. Cal. 2009) (open-end funds).

66 *In Credit Crisis, More Investors File Suit*, WASH. POST, May 3, 2009, at G3 (interview with Stephanie Plancich, NERA, Inc.); *see also* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 6 n.8 (2007) ("Of course, most SFCAs [securities fraud class actions] are settled if they are not dismissed. It is unusual for damages ever to be awarded by a court."); James D. Cox et al., *Do Differences in Pleading Standards Cause Forum Shopping in Securities Class Actions?: Doctrinal and Empirical Analyses*, 2009 WIS. L. REV. 421, 427 ("[N]early all securities class actions that survive motions to dismiss are settled . . . .").

67 *See supra* notes 27-28 and accompanying text.

68 Coffee, *supra* note 27, at 413-14 (footnote omitted).

69 *See, e.g.*, Pritchard, *supra* note 9, at 227 ("[T]he combination of the potential for enormous judgments and the cost of litigating securities class actions means that even weak cases may produce a settlement if they are not dismissed at the complaint stage."); Russell Kamerman, Note, *Securities Class Action Abuse: Protecting Small Plaintiffs' Big Money*, 29 CARDOZO L. REV. 853, 870 (2007) ("The potentially high cost of defending against even a weak securities class action suit makes settlement an attractive option."); Perry S. Granof & Gary L. Gassman,

Understanding Current Trends in U.S. Securities Class Actions, BRIEF, Winter 2009, at 56, 60 ("[A]s a practical matter, if the suit is not dismissed on the defendant's motion(s) to dismiss, and if the case is certified as a class action, a defendant will face pressure to settle even if the plaintiff has a relatively weak case.").

70 Kohen v. Pac. Inv. Mgmt. Co. LLC, 571 F.3d 672, 678 (7th Cir. 2009) (Posner, J.).

71 RYAN & SIMMONS, *supra* note 23, at 6 ("As we have described in previous reports, settlements as a percentage of estimated damages generally decrease as damages increase."); Coffee, *supra* note 27, at 414 ("According to one well-known study, the ratio of securities class action settlements to investors' economic losses has ranged over recent years between two and three percent.") (citing a 2005 study by NERA Economic Consulting).

72 Baker & Griffith, *supra* note 16, at 804.

73 James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOKLYN L. REV. 3, 25 (1999) ("Testimony that preceded the enactment of the Private Securities Litigation Reform Act estimated that 96 percent of securities class action settlements were for amounts within the limits of available insurance coverage.").

74 Fed. R. Civ. P. 23(e)(2).

75 *See* Coffee, *supra* note 19, at 1536 ("[T]he costs of securities class actions—both the settlement payments and the litigation expenses of both sides—fall largely on the defendant corporation . . . .").

76 ICI MUT. INS. CO., MANAGING DEFENSE COSTS 5-17 (2004).

77 Geffen, *supra* note 56, at 22 ("[T]he settlement value of the case to a plaintiff increases if the plaintiff can withstand defendant's motions for dismissal or summary judgment.").

78 *See* Patrick M. Garry et al., *The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform*, 49 S.D. L. Rev. 275, 282-83 (2004) ("Through discovery, plaintiffs are able to impose far greater litigation costs on defendants than defendants can impose on plaintiffs or plaintiffs' counsel. Trying to produce all documents pertaining to the knowledge of corporate management over a period of years can be a massive undertaking. . . . As costly as this discovery may be for defendants, the lost productivity and business disruption may be even more burdensome. The cost of lost productivity can dwarf the expense of attorneys' fees.") (footnotes and internal quotation marks omitted).

79 *See* ICI MUT. INS. CO., *supra* note 76, at 16-17 (discussing the impact of technology on defense costs).

80 *See id.* at 22-45.

81 *See supra* note 71.

82 Pritchard, *supra* note 9, at 239 ("The dirty secret of securities class actions is that companies and their insurers pay the costs of settlement . . . .").

83 *See* Booth, *supra* note 66, at 6 n.8 ("[T]he putative measure of damages will affect settlement negotiations.").

84 In re Countrywide Fin. Corp. Secs. Litig., 588 F. Supp. 2d 1132, 1167 (C.D. Cal. 2008); *see* 15 U.S.C. § 77k(e) (2007).

85 In re MetLife Demutualization Litig., 624 F. Supp. 2d 232, 271 (E.D.N.Y. 2009); *see* 15 U.S.C. § 77*l*(a)(2).

86 Geffen, *supra* note 56, at 24.

87 In re Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 867 (D. Md. 2005) ("[T]he only damages recoverable under Sections 11 and 12(a)(2) are based upon price differentials . . . .").

88 *See, e.g.*, COFFEE & SALE, *supra* note 4, at 1053 (noting, with respect to securities class actions, that "it is extremely difficult to develop an accurate measure of the losses that the defendants caused.").

89 *See supra* "Loss Causation," page 15.

90 *See, e.g.*, Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("[L]ower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price.").

[91] *See, e.g.*, In re Imperial Credit Indus., Inc. Secs. Litig., 252 F. Supp. 2d 1005, 1016 (C.D. Cal. 2003) ("[A]bsent an event study or similar analysis, Plaintiffs cannot eliminate that portion of the price decline of ICII's and/or SPFC's stock which is unrelated to the alleged wrong."); Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS. L. REV. 199, 228 ("The typical approach to estimating damages in a securities-fraud case involves performing an event study to determine . . . the magnitude of the losses caused by the alleged fraud.").

[92] John Finnerty & George Pushner, *An Improved Two-Trader Model for Measuring Damages in Securities Fraud Class Actions*, 8 STAN. J.L. BUS. & FIN. 213, 214 (2003) ("The measurement of damages in cases alleging violation of Rule 10b-5 under the Securities Exchange Act of 1934 has generated extensive literature."). Damages in securities *fraud* cases are also based on price differentials, such that literature regarding damages for securities fraud is generally also germane to the context of *non*-fraud disclosure lawsuits brought under the '33 Act. *See id.* at 248 ("The 10b-5 damages model described in this paper is easily modified to calculate Section 11 damages.").

[93] David H. Topol, *Attacking Plaintiffs-Style Damages During Mediation of Securities Cases*, PLUS J. (Prof'l Liab. Underwriting Soc'y, Minneapolis, Minn.), May-June 2004.

[94] *See* Julie Goodman, *Prospectus Review More In-Depth for Some Funds*, BOARD IQ, Nov. 24, 2009, http://www.boardiq.com/articles/20091124/ ("Prospectus reviews . . . have been supplemented in some cases by a litigator's input.").

[95] Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,720 (Dec. 24, 2003).

[96] 17 C.F.R. §§ 270.30a-2 (certification of Form N-CSR and Form N-Q), .30a-3 (disclosure controls and procedures related to preparation of required filings). *See* Management's Report on Internal Control, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 68 Fed. Reg. 36,636, 36,650 (June 18, 2003) ("The certification requirements implement Section 302 of the Sarbanes-Oxley Act, from which registered investment companies are not exempt.").

[97] *See, e.g.*, Josh Charlson, *Morningstar's To-Do List for Target-Date Regulators*, MORNINGSTAR, June 16, 2009, http://news.morningstar.com/articlenet/article.aspx?id=295438 ("Target-date funds are on the agenda in Washington, D.C., this week as the Securities and Exchange Commission and Department of Labor are holding hearings to investigate the investment strategies and disclosure practices of target-date funds."); Karrie McMillan, Gen. Counsel, Inv. Co. Inst., Testimony at SEC-DOL Target Date Funds Hearing (June 18, 2009), http://www.ici.org/pressroom/speeches/09_target_fund_tmny ("While target date mutual funds currently do a good job of describing their objectives, risks, and glide paths, we do see gaps in the public understanding of target date funds generally.").

[98] *See, e.g.*, Joe Morris, *ProFunds Sharpens Its Leverage Warning*, IGNITES, Oct. 5, 2009, http://www.ignites.com/articles/20091005 ("ProFunds has added emphasis to disclaimers about its leveraged and inverse funds, apparently in response to heightened regulatory scrutiny.").

[99] *See generally* ICI MUT. INS. CO., INVESTMENT MANAGEMENT COMPLIANCE RISKS 18-21 (2002) (discussing general risk management techniques in the selection of portfolio securities).

[100] Hillary A. Sale, *Monitoring* Caremark's *Good Faith*, 32 DEL. J. CORP. L. 719, 753 (2007).

[101] Burks v. Lasker, 441 U.S. 471, 484 (1979).

[102] Section 11 distinguishes between the parts of a registration statement prepared by an "expert" (such as financial statements certified by an independent accountant) and the statement's other parts. Section 11 generally permits directors to rely on portions prepared or certified by an expert.

[103] Section 12 affords a similar "reasonable care" defense, but courts have observed that it is *less* demanding on defendants than the section 11 "due diligence" defense. *See* In re Fuwei Secs. Litig., No. 07-9416, 2009 U.S. Dist. LEXIS 59658, at *31 n.10 (S.D.N.Y. July 10, 2009) ("Section 12(a)(2) provides for a 'defense of reasonable care,' which is 'less demanding than the duty of due diligence' under section 11 . . . .") (quoting *In re WorldCom, Inc. Secs. Litig.*, 346 F. Supp. 2d 628, 663 (S.D.N.Y. 2004)). And in any event, it is section 11 that remains the primary liability exposure for independent directors. *See supra* note 35 and accompanying text.

104 *E.g.*, In re Majesco Secs. Litig., No. 05-3557, 2006 U.S. Dist. LEXIS 73563, at *16-*17 (D.N.J. Sept. 29, 2006) ("[S]uch an inquiry is not one for a motion to dismiss. The . . . outside directors['] contention that [they] performed all necessary due diligence . . . is nothing more than an affirmative defense that defendants can assert and establish through discovery.").

105 15 U.S.C. § 77k(b)(3)(A) (2007); *see* In re Software Toolworks Inc. Secs. Litig., 50 F3d 615, 621 (9th Cir. 1994) ("[D]ue diligence is, "in effect, . . . a negligence standard."") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1975)).

106 *See* In re WorldCom, Inc. Secs. Litig., 346 F. Supp. 2d 628, 671 (S.D.N.Y. 2004) ("Neither the Supreme Court nor the Second Circuit has explored this area of law [how defendants can successfully establish their affirmative defenses under section 11] in any significant way."); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Scheme*, 79 WASH. U. L.Q. 491, 514 (2001) (noting that "there is little case law and only a few pointers from the SEC" regarding the due diligence defense).

107 *See, e.g.*, In re WorldCom, Inc. Secs. Litig., No. 02-3288, 2005 U.S. Dist. LEXIS 4193, at *25 (S.D.N.Y. Mar. 21, 2005) ("Whether a director is properly categorized as an inside or outside director, . . . the law . . . has not permitted them simply to accept at face value the representations of management . . . . After all, even honest . . . officers of a company may make mistakes."); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 688 (S.D.N.Y. 1968) ("In my opinion, a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers . . . ."). *BarChris* was a seminal case on director due diligence that remains influential today.

108 Laven v. Flanagan, 695 F. Supp. 800, 812 (D.N.J. 1988). In *Laven,* the court found that the outside directors' efforts were "a far cry from the passive and total reliance on company management that defeated the due diligence defense in *Escott v. BarChris*." *Id.*; *see also* Weinberger v. Jackson, No. 89-2301, 1990 U.S. Dist. LEXIS 18394, at *10 (N.D. Cal. Oct. 12, 1990) (holding that an outside director "could rely upon the reasonable representations of management, *if* his own conduct and level of inquiry were reasonable under the circumstances") (emphasis added).

109 For example, with regard to investments in derivatives, an SEC staff member described the approach that *he* would take as an independent director as follows:

> As a director, I would want to understand the process that is used to ensure that the ongoing level of risk to which the fund is exposed from its investments in derivatives is being fully and fairly described and illustrated in various disclosure documents provided to fund shareholders and that the language used to describe such risks is likely to be understood by the average investor in the fund.

Gene Gohlke, Assoc. Dir., Office of Compliance Inspections & Examinations, U.S. Secs. & Exch. Comm'n, Speech: If I Were a Director of a Fund Investing in Derivatives—Key Areas of Risk on Which I Would Focus (Nov. 8, 2007), http://www.sec.gov/news/speech/2007/spch110807gg.htm.

110 17 C.F.R. § 270.38a-1(a)(4)(iii) (2009).

111 ICI MUT. INS. CO., INDEPENDENT DIRECTOR LITIGATION RISK 12-19 (2006).

112 Fox, *supra* note 5, at 305; *see also supra* note 73.

113 Although the definition of "wrongful act" varies among policy forms, the term is often defined to include most or all of the following: errors, misstatements, misleading statements, neglect, negligent acts or omissions, and breaches of duty.

114 *Compare* Bank of Am. Corp. v. SR Int'l Bus. Ins. Co., No. 05-CVS-5564, 2007 NCBC LEXIS 36, at *39 (N.C. Super. Ct. Dec. 19, 2007) ("[T]here exists neither statutory authority nor judicial decision in North Carolina holding that claims under Section 11 are uninsurable.") *with* CNL Hotels & Resorts, Inc. v. Houston Cas. Co., 291 F. App'x 220, 223 (11th Cir. 2008) ("The return of money received through a violation of law, even if the actions of the recipient were innocent, constitutes a restitutionary payment, not a 'loss.' It is immaterial whether CNL committed fraud. CNL received money directly from the Purchaser Class through the sale of shares, and CNL returned some of the money after the Purchaser Class alleged that the sale of shares by CNL violated the law.") *and* Conseco, Inc. v. Nat'l Union Fire Ins. Co., No. 49D130202CP000348, 2002 WL

31961447, at *8 (Ind. Cir. Ct. Dec. 31, 2002) ("The Section 11 plaintiffs essentially sought back the amounts Conseco wrongfully obtained . . . .").

[115] Baker & Griffith, *supra* note 16, at 763 ("[A]bsent disclosure, D&O insurance significantly undermines the deterrence function of shareholder class actions.").

[116] *See generally* ICI MUT. INS. CO., *supra* note 111, at 20-21.

[117] The SEC requires a statement, "in substantially the following form," in certain investment company registration statements:

> Insofar as indemnification for liability arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. . . .

17 C.F.R. § 230.484(b) (2009); *see also* In re HealthSouth Corp. Secs. Litig., 572 F.3d 854, 862 (11th Cir. 2009) ("[P]recedent indicates that indemnification of participants in the context of securities violations is inconsistent with the policies underlying the securities laws. The cases have noted that such before-the-fact indemnification of participants would undermine a primary goal of securities legislation—i.e., to encourage diligence and discourage negligence in securities transactions.") (citations omitted).

[118] 15 U.S.C. § 77k(a) (2007).

[119] Herman & Maclean v. Huddleston, 459 U.S. 375, 382 (1983).

[120] Rubke v. Capitol Bancorp, Ltd., 551 F.3d 1156, 1161 (9th Cir. 2009).

[121] *See, e.g.*, In re Countrywide Fin. Corp. Secs. Litig., 588 F. Supp. 2d 1132, 1162 (C.D. Cal. 2008) ("Reliance is not an element.").

[122] *See, e.g.*, In re Merck & Co. Secs. Litig., 432 F.3d 261, 274 (3d Cir. 2005) ("Section 11 plaintiffs do not have to plead loss causation.").

[123] S*ee, e.g.*, Herman & MacLean, 459 U.S. at 381 ("Liability against the issuer of a security is virtually absolute, even for innocent misstatements.") (footnote omitted); APA Excelsior III L.P. v. Premiere Techs., Inc., 476 F.3d 1261, 1271 (11th Cir. 2007) ("Intentional or willful conduct is not required under Section 11 and liability will attach even for 'innocent misstatements.'") (quoting *Herman & MacLean*).

[124] *See, e.g.*, In re Merck, 432 F.3d at 274 ("Section 11 plaintiffs do not have to plead loss causation. Instead, it is an affirmative defense in section 11 cases; defendants can limit damages by showing that the plaintiffs' losses were caused by something other than their misrepresentations.") (citation omitted); In re Charles Schwab Corp. Secs. Litig., 257 F.R.D. 534, 544 (N.D. Cal. 2009) ("Although loss causation is not an element of the *prima facie* case under Section 11, that provision allows defendants to assert a lack of loss causation as an affirmative defense."); In re Salomon Smith Barney Mut. Funds Fee Litig., 441 F. Supp. 2d 579, 588 (S.D.N.Y. 2006) ("The absence of loss causation is . . . an affirmative defense to a § 11 claim . . . ."), *appeal docketed*, No. 08-38 (2d Cir. Jan. 2, 2008).

[125] As for a fund or other securities issuer, "liability under section 11 is absolute" except that an issuer can defeat a claim by proving that "the plaintiff knew of the untruth or omission at the time of his or her acquisition of the security." In re Initial Pub. Offering Secs. Litig., 483 F.3d 70, 73 n.1 (2d Cir. 2007).

[126] 15 U.S.C. § 77k(b)(3)(A) (2007).

[127] *See, e.g.*, In re Countrywide Fin. Corp. Secs. Litig., 588 F. Supp. 2d 1132, 1162 (C.D. Cal. 2008) ("The most notable affirmative defense is due diligence."); In re Prestige Brands Holding, Inc., No. 05-6924, 2006 U.S. Dist. LEXIS 46667, at *25 (S.D.N.Y. July 10, 2006) ("The Underwriter Defendants are free to attempt to avail themselves of the affirmative defense of 'due diligence,' under Section 11, which is available to defendants other than the issuer of the security.").

[128] The PSLRA provides that "the term 'outside director' shall have the meaning given such term by rule or regulation of the [SEC]." 15 U.S.C. § 78u-4(f)(10)(D). To date, the SEC has not promulgated any rule or regulation defining the term "outside director." However, it appears likely that directors who are considered to be independent under the stringent requirements of the Investment Company Act of 1940 would likewise be considered to be "outside directors" for purposes of the PSLRA.

[129] 15 U.S.C. § 78u-4(f)(2)(A).

[130] § 77*l*.

[131] *See supra* notes 84, 85, and accompanying text.

[132] Cozzarelli v. Inspire Pharms., Inc., 549 F.3d 618, 628 (4th Cir. 2008) ("Both provisions prohibit materially false statements or omissions . . . ."); J&R Mktg., SEP v. Gen. Motors Corp., 549 F.3d 384, 390 (6th Cir. 2008) ("Sections 11 and 12 both impose a duty to disclose additional facts when a statement of material fact made by the issuer is misleading, and they both impose liability for failing to fulfill that duty of disclosure as well as for misstating a material fact."); Backhaus v. Streamedia Commc'ns, Inc., No. 01-4889, 2002 U.S. Dist. LEXIS 14960, at *14 (S.D.N.Y. Aug. 14, 2002) ("To state a claim under § 12(a)(2), plaintiffs must satisfy the same requirements as under § 11.").

[133] Rombach v. Chang, 355 F.3d 164, 178 n.11 (2d Cir. 2003) ("The test for whether a statement is materially misleading under Section 12(a)(2) is identical to that under . . . Section 11: whether representations, viewed as a whole, would have misled a reasonable investor."); In re Cendant Corp., 109 F. Supp. 2d 225, 230 (D.N.J. 2000) ("The legal standard for materiality under this provision [§ 12(a)(2)] is the same as under Section 11."); COFFEE & SALE, *supra* note 4, at 846 ("[P]roof of materiality . . . is identical, or virtually so, under . . . §§ 11 and 12 of the 1933 Act . . . .").

[134] Friedman v. Rayovac Corp., 295 F. Supp. 2d 957, 981 (W.D. Wis. 2003) ("Under either §§ 11 or 12(a)(2), a plaintiff does not have to show reliance, causation or scienter."); *see also* In re Initial Pub. Offering Secs. Litig., 483 F.3d 70, 73 n.1 (2d Cir. 2007) ("Neither Section 11 nor Section 12(a)(2) requires that plaintiffs allege the scienter or reliance elements of a fraud cause of action.") (internal quotation marks omitted); Wagner v. First Horizon Pharm. Corp., 464 F.3d 1273, 1277 (11th Cir. 2006) ("It is clear that neither allegations of fraud nor scienter are necessarily part of either of these claims."); In re Suprema Specialties, Inc. Secs. Litig., 438 F.3d 256, 269 (3d Cir. 2006) ("Like Section 11, Section 12(a)(2) is a 'virtually absolute' liability provision that does not require an allegation that defendants possessed scienter.").

[135] In re Enron Corp. Secs. Derivative & ERISA Litig., 529 F. Supp. 2d 644, 721 n.97 (S.D. Tex. 2006) ("Section 11, like § 12(a)(2), provides two affirmative defenses: where the party can show that the depreciation in the value of the security was caused by something other than the misrepresentations in the registration statement or prospectus and where it can show due diligence."). Note, however, that some courts have suggested that it may be easier to establish the "due diligence" defense under section 12(a)(2) than section 11. *See supra* note 103.

[136] J&R Mktg., SEP v. Gen. Motors Corp., No. 06-10201, 2007 U.S. Dist. LEXIS 13227, at *18 n.12 (E.D. Mich. Feb. 27, 2007), *aff'd*, 549 F.3d 384 (6th Cir. 2008).

[137] 15 U.S.C. § 77o (2007).

[138] *See, e.g.*, In re Mut. Funds Inv. Litig., 566 F.3d 111, 130 (4th Cir. 2009) ("Plaintiffs' allegations adequately plead control of JCM [Janus Capital Management LLC] by JCG [Janus Capital Group, Inc.]. First, plaintiffs have alleged that JCG wholly owned JCM."), *petition for cert. filed* (U.S. Oct. 30, 2009) (No. 09-525). *See generally* Loftus C. Carson, II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 314 (1997) ("An enterprise may control another organization and, indirectly, that organization's agents and employees. An enterprise's section 15 . . . control of another organization may arise from virtually any source on which any other controlling person's status can be based. For example, a corporation may be a controlling person when it owns the majority of the shares of another corporation on the basis of its authority to control (legal control) the subsidiary.").

[139] *E.g.*, ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 207 (2d Cir. 2009) ("[H]aving found that Plaintiffs failed to state a claim under . . . section 11 of the Securities Act, their

control person liability claim pursuant to section 15 of the Securities Act . . . must also fail for want of a primary violation.").

140 15 U.S.C. § 77o.

141 While this data set thus focuses on section 11 litigation, analysis of the data is generally also applicable to claims brought under section 12(a)(2). This is because both sections prohibit essentially the same conduct (except that section 11 governs *registration statements*, while section 12(a)(2) covers statements made in a *prospectus* and certain oral statements). *See supra* notes 132-136 and accompanying text. Indeed, plaintiffs frequently allege violations of both sections based on identical facts, and courts frequently dispose of both claims based on identical grounds. For this reason, a second analysis of section 12(a)(2) cases would most likely be cumulative (i.e., would duplicate effort without producing different results or insights).

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