ICI MUTUAL **NEWSLETTER**

Claims Trends

Spring 2008

An Annual Review of Claims Activity in the Mutual Fund Industry

ICIMutual

Introduction

Despite severe disruptions in the credit markets, the claims environment for the mutual fund industry remains relatively benign. In 2007 and early 2008, both the frequency and severity of new claims reported to ICI Mutual (i.e., claims unrelated to matters previously reported) continued at levels well below those of claims reported during the period of the 2003-2004 mutual fund trading scandal.

Prior editions of *Claims Trends* have reported on favorable decisions by the courts over the past several years in the private civil lawsuits initiated during the scandal period. The fund industry had additional success in these lawsuits in 2007. Still, the plaintiffs' securities bar continues to pursue a number of pending scandal-period lawsuits, and has initiated new lawsuits against fund groups whose performance suffered in the wake of the 2007 collapse of the subprime mortgage market and ongoing disruption in the credit markets.

Whatever the eventual outcome of these various lawsuits may be, it seems clear that the fund industry has become, and will likely remain, an attractive potential target for an energetic and highly sophisticated plaintiffs' bar. Major litigation is enormously expensive, of course, and it is no longer uncommon for fund groups subject to such litigation to incur defense costs in the low-to-mid seven figures (and sometimes substantially more).

In 2007 and early 2008, ICI Mutual has also witnessed a resurgence in reported "costs of correction" claims, under which insured entities—in most cases, investment advisers—seek insurance recovery for payments made to correct operational errors for which they have actual legal liability. Losses associated with individual costs of correction claims can be substantial, with a number of such claims involving losses in the low-to-mid seven figures. The increased frequency of this type of claim highlights the importance to fund groups of close attention to (and periodic review and reconsideration of) policies, procedures and other measures designed to prevent and detect operational mistakes and oversights.

Subprime/Credit-Related Claims

There has been substantial speculation in recent months regarding the impact that the collapse of the subprime mortgage market and ongoing illiquidity in the credit markets may have on the litigation environment in the fund industry. Yet to date, "credit-related" lawsuits have been filed against relatively few funds and advisers.

In those suits that have been filed, shareholders have typically filed class action claims against advisers to bond funds holding subprime-related securities, fund officers and directors, the distributor of the funds' shares, and others. These lawsuits have asserted violations of federal securities laws for misrepresenting or failing to disclose, for example, the lack of "true diversification" of the funds' assets, their concentration in the subprime market of mortgage backed and related securities, and the illiquidity of such securities.[1]

In another instance, retirement plans have alleged violations of ERISA in connection with investment of plan assets in certain bond funds. Among other things, plaintiffs in that litigation alleged that "undisclosed, highly leveraged positions" in mortgage-related securities "radically altered the investment strategies" of the bond funds.[2]

In all these subprime-related cases, the investment performance of the funds at issue departed significantly

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1 *E.g.*, Labins v. Charles Schwab Corp., No. 3:08-cv-1510 (N.D. Cal. filed Mar. 18, 2008); Atkinson v. Morgan Asset Mgmt., Inc., No. 2:07-cv-2784 (W.D. Tenn. filed Dec. 6, 2007).

2 In re State Street Bank and Trust Co. ERISA Litig., No. 1:07-cv-8488 (S.D.N.Y. filed Oct. 1, 2007).

from those of their peers, suggesting that it is the "outlier" fund groups that may be most at risk for this type of litigation.

These lawsuits are only recently filed, and remain in preliminary stages. It is thus too soon to predict with certainty the impact that these lawsuits specifically (or ongoing disruptions in the credit markets more generally) may ultimately have on fund industry claims. Yet the fact that only a small number of claims traceable to these disruptions have so far been made against funds and advisers suggests that the fund industry may be positioned—by virtue of funds' diversification, lack of leverage, and transparent valuation—to weather current economic difficulties without incurring significant liability exposure.

As this publication goes to press, ICI Mutual is monitoring developments with respect to auction rate securities, including reported regulatory interest in the impact of recent auction failures on shareholders of closed-end funds.

Operational Errors

2007 and early 2008 saw an increase in portfolio management and other operational errors reported to ICI Mutual, particularly in connection with trades of portfolio securities for client accounts. Where such operational and compliance errors result in actual legal liability for an insured entity (typically, an insured investment adviser), insurance recovery may be available to the insured entity under "costs of correction" coverage in the ICI Mutual Directors and Officers/Errors and Omissions (D&O/E&O) Liability Insurance Policy (or under analogous coverage that may be available from other insurers).

A number of recently reported issues have involved failures to properly code trade restrictions and/or security descriptions in front-end compliance systems. For example, the following matter was recently reported to ICI Mutual:

- ***Error in Coding Front-End Compliance System.*** In reviewing a new account's governing documents, an employee failed to program one of the account's multiple investment restrictions into the adviser's front-end compliance system. The adviser lacked procedures for having the employee's coding work reviewed by a second employee or supervisor, and the error remained undiscovered until after several ineligible securities purchased for the account had declined significantly in value.

Such errors underscore the importance of ensuring that front-end compliance systems are set up correctly in the first instance, and ensuring that portfolio managers do not substitute over-reliance on such systems for an independent and thorough understanding of each account's applicable restrictions.

Other operational errors noticed to ICI Mutual in the post-scandal period have included the following:

- ***Oversale of Portfolio Securities.*** In advance of a regularly scheduled rebalancing of portfolio securities held by a client account, an adviser was notified that a net portfolio redemption would be required in the amount of approximately $77 *thousand*. The portfolio manager misread the notice, and sold almost $77 *million* of portfolio securities in order to meet the anticipated redemption request. The adviser's procedures did not require a second employee or supervisor to review large sale orders, and the adviser's pre-trade compliance system did not provide advance warnings of *sales* (as opposed to *purchases*) exceeding 5% of portfolio net assets.

- ***Failure to Monitor Deadlines for Liquidation of Portfolio Securities.*** An adviser's investment agreements with private accounts left discretion to the adviser to dispose of the accounts' large stock positions in an orderly manner, but specified maximum time periods for effecting such liquidations. The adviser had no formal process to monitor these deadlines or to seek client approval for any extensions that might be advisable. As a result, in certain instances, the adviser failed to liquidate the positions within the requisite time periods.

Operational and compliance mistakes highlight a constant of the mutual fund business: namely, the need (1) to identify the possibilities for human errors and oversights, (2) to develop policies and procedures designed to prevent them in the first instance and to detect promptly those that do nevertheless occur, and (3) to closely monitor compliance with those policies and procedures.

Legacy Scandal-Period Claims

As reported in prior editions of *Claims Trends*, the 2003-2004 scandal period generated unprecedented claims activity for the fund industry, primarily in four basic areas: regulatory actions and civil litigation over *market timing*, civil litigation over *fair valuation*, civil litigation over *fee levels*, and regulatory actions and civil litigation over revenue sharing and associated *distribution* issues. Although these scandal-period claims no longer command daily headlines, and while many have been concluded, others even now remain pending in the court system, and the industry continues to incur large sums in defending and resolving these matters.

1. Market Timing. Regulatory enforcement activity in this area continues to wane, with just one new scandal-period settlement involving a fund adviser announced in 2007 and early 2008.[3] As for the earlier regulatory settlements reached during the scandal period, distribution to investors of the "Fair Fund" money collected from respondents continued at a slow pace: of $3.3 billion collected from fund groups, broker-dealers and other respondents, the Securities and Exchange Commission (SEC) has authorized only $534 million for distribution.[4] Industry observers expect that the pace of distribution will accelerate over the next several years.[5]

Meanwhile, in associated civil lawsuits over market timing pending in the multidistrict litigation proceeding (MDL) in Maryland, federal judges have continued to issue decisions even as the parties progress through the lawsuits' discovery (fact finding) phase.[6] Most recently, the court resolved several important issues regarding *standing* (a party's right to make a legal claim), holding, among other things, that a plaintiff who invested in one or several mutual funds does not have standing under

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[3] Evergreen Inv. Mgmt. Co., Exchange Act Release No. 56,462, Investment Company Act Release No. 27,973 (Sept. 19, 2007). While regulatory authorities concluded additional market-timing settlements with other entities during the same period, those settlements involved broker-dealers, parent companies, or dual broker-dealer/advisers. *See, e.g.*, Morgan Stanley & Co., Exchange Act Release No. 56,980, Investment Company Act Release No. 28,078 (Dec. 18, 2007).

[4] Coal. of Mut. Fund Investors, Summary of Investor Distribution Plans (Mar. 17, 2008), http://www.investorscoalition.com/DistributionPlanSummary.pdf.

[5] Peter Ortiz, *Fair Funds Distributions Seen Improving in '08*, IGNITES, Nov. 26, 2007, http://www.ignites.com/articles/20071126.

[6] *E.g.*, In re Mut. Funds Inv. Litig., 487 F. Supp. 2d 618 (D. Md. 2007) (dismissing claims against certain fund group defendants in light of insufficient allegations that they made material misstatements or omissions); In re Mut. Funds Inv. Litig., 478 F. Supp. 2d 833 (D. Md. 2007) (denying in part and granting in part several motions to dismiss on a variety of grounds).

section 36(b) of the Investment Company Act of 1940 (ICA) to bring a suit on behalf of other, *unowned* funds.[7]

According to status reports filed by parties with the court, multiple fund group defendants have been involved in settlement discussions with the MDL plaintiffs during the past year. Some parties have reported that settlements have been agreed upon in principle, and it appears that some others have been finalized.

2. Fair Valuation. The scandal period saw a number of purported class-action lawsuits, filed in Illinois state courts and based on state law, in which plaintiffs claimed that fund group defendants facilitated market timing of international funds by failing to adopt appropriate "fair value" procedures. Defendants have argued that the Securities Litigation Uniform Standards Act of 1998 (SLUSA) precludes such state-law class actions.

Although a number of these lawsuits have been dismissed on that basis (with some dismissals pending on appeal) or have settled, a number of others have managed to survive years of purely procedural wrangling over which court system (federal or state) should decide the defendants' SLUSA defense.[8]

As 2007 ended, these remaining "survivors" had ultimately lodged in Illinois state court. To date, the Illinois state judges have declined to dismiss the suits, although some appear to have ended by agreement of the parties. Regardless, a 2006 decision by the U.S. Supreme Court has significantly diminished the threat of *future* securities class actions based on state law.[9]

3. Advisory Fees. The scandal period saw the plaintiffs' bar launch numerous challenges to the level of fees charged by investment advisers to their managed funds. Most of these cases have already ended, typically by agreement of the parties following unsuccessful motions to dismiss. Several others are proceeding through discovery toward trial.

In two other cases, however, 2007 brought significant court victories, with courts granting defendants' motions for summary judgment. While these decisions came only after the parties had engaged in discovery (the most expensive litigation phase), the decisions afforded defendants a complete victory without the need for a trial.[10] Should these decisions be upheld on appeal, they may provide useful precedents for the successful defense of future lawsuits alleging excessive fees.

4. Distribution Practices. The scandal period also generated numerous cases that challenged distribution-related practices—e.g., cash payments to brokers in return for the brokers' agreement to promote sales of fund shares, directed brokerage, and commission arrangements with brokers. Most of these cases have since ended, but they have left in their wake a number of favorable court precedents that should help inoculate the industry against certain lawsuits going forward.

Perhaps most significantly, in 2007, the U.S. Court of Appeals for the Second Circuit agreed with recent rulings by a number of lower courts in rejecting the existence of "private rights of action" under various sections of the ICA. In addition, the Second Circuit

[7] In re Mut. Funds Inv. Litig., 519 F. Supp. 2d 580 (D. Md. 2007).

[8] *See generally* In re Mut. Fund Market-Timing Litig., 495 F.3d 366, 367-68 (7th Cir. 2007) (per curiam) (reciting history of the litigation).

[9] Merrill Lynch, Pierce, Fenner & Smith v. Dabit, 547 U.S. 71 (2006) (holding that SLUSA precludes state-law securities class actions even where federal law provides no private remedy).

[10] Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974 (D. Minn. 2007), *appeal docketed*, No. 07-2945 (8th Cir. Aug. 22, 2007); Jones v. Harris Assocs. L.P., No. 04-C-8305, 2007 U.S. Dist. LEXIS 13352 (N.D. Ill. Feb. 27, 2007), *appeal docketed*, No. 07-1624 (7th Cir. Mar. 20, 2007).

held that, while shareholders have a right to challenge advisory fees under section 36(b) of the ICA, section 36(b) is concerned only with *excessive* fees (i.e., fees "so disproportionately large that they bore no relationship to the services rendered"), such that it does not suffice for a plaintiff to allege simply that the disputed fees were "improper."[11] In another significant victory, the SEC and California recently dropped their three-year-old directed-brokerage cases against American Funds.[12]

Of the civil lawsuits over distribution that remain active in the lower courts, two have advanced beyond the motion-to-dismiss stage, through discovery and toward trial. Courts have narrowed the scope of both lawsuits, however, essentially forcing plaintiffs to recast their distribution-related claims as challenges to advisory fee levels under ICA section 36(b). In each of the others, either the court has not yet ruled on a motion by defendants that would dispose of the case without a trial, or the plaintiffs' appeal of a dismissal order remains pending.

Other Post-Scandal Claims

Post-scandal claims of note, other than the subprime-related litigation and compliance errors already discussed, include the following.

1. 401(k) Litigation. The prior edition of *Claims Trends* reported that some investment advisers had been caught up in litigation between retirement plans (or plan participants) and the providers of retirement products and services to those plans. In particular, the plans (or plan participants) alleged liability under ERISA in light of various revenue-sharing agreements that the plan's service providers entered into with several mutual fund companies. While ICI Mutual has not observed new filings in this area, courts issued mixed opinions in 2007 regarding the viability of ERISA claims against investment advisers in these situations.[13]

2. Closed-End Fund Claims. Lawsuits against closed-end funds continue in the post-scandal environment, often involving dissident shareholders. For instance, citing persistent discounts to the fund's NAV, activist shareholders may seek to contest elections of the fund's directors; challenge fund bylaws, election procedures, or distribution policies; demand that funds implement certain measures that would supposedly diminish the discount; or even demand liquidation of funds. These matters underscore the unique risk profile of closed-end funds, and can raise the question of the proper role of insurance in what often appear to be essentially business disputes between closed-end fund and their activist shareholders over how best to promote shareholder value.

3. Bankruptcy Proceedings. A number of insureds have reported lawsuits brought by bankrupt companies that seek a return of pre-bankruptcy debt payments made to bond holders or other creditors. Typically, these lawsuits have included numerous mutual funds among the defendants, as passive holders of debt securities.[14] While these matters do not appear to directly implicate funds' risk management policies and procedures, and regardless of the potential for insurance coverage in such situations, these matters highlight a potential fall-out nuisance of credit risk.

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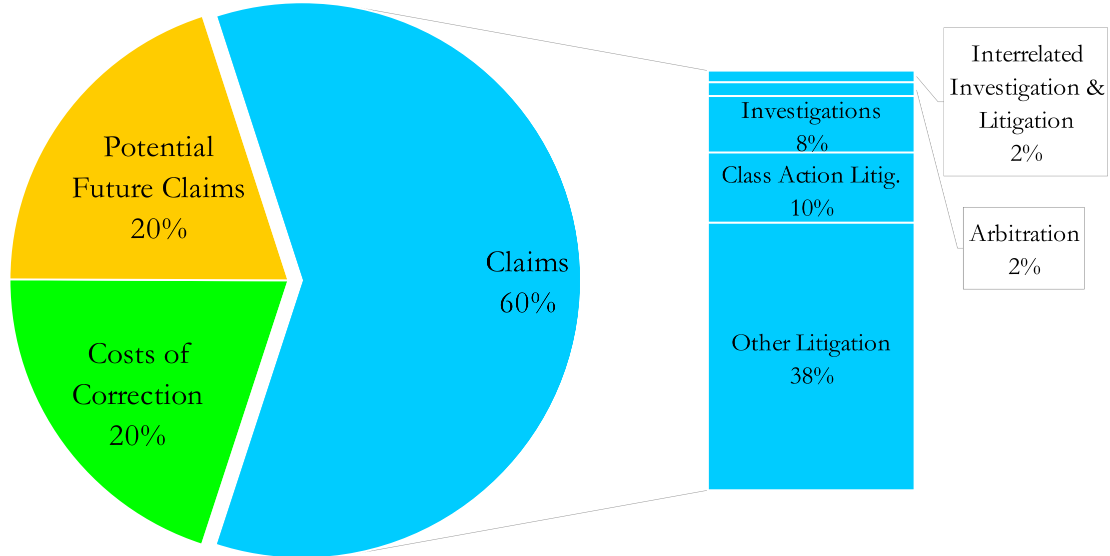
[11] Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007).

[12] Joe Morris, *American Funds Cleared in Broker-Pay Case*, IGNITES, Feb. 15, 2008, http://www.ignites.com/articles/20080215.

[13] *Compare* Hecker v. Deere & Co., 496 F. Supp. 2d 967 (W.D. Wis. 2007) (granting adviser's motion to dismiss), *appeal docketed*, No. 07-3605 (7th Cir. Oct. 26, 2007), *with* Phones Plus, Inc. v. Hartford Fin. Servs. Group, Inc., No. 3:06-cv-1835, 2007 U.S. Dist. LEXIS 78767 (D. Conn. Oct. 23, 2007) (denying adviser's motion to dismiss). The U.S. Department of Labor has intervened in the appeal of *Hecker*, filing a brief in support of the plaintiffs' appeal.

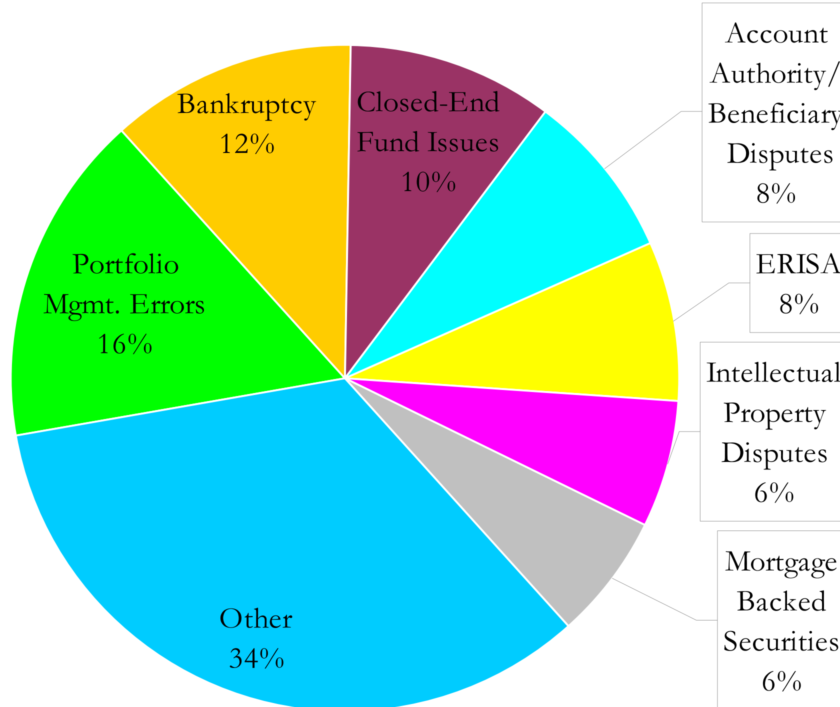
[14] *E.g.*, Adelphia Recovery Trust v. Bank of Am., N.A., No. 1:05-cv-9050 (S.D.N.Y. filed Oct. 24, 2005).

Table 1. Type of Underlying Matters Reported by ICI Mutual Insureds



Five Quarters Ending March 31, 2008

Table 2. Focus of Underlying Matters Reported by ICI Mutual Insureds



Five Quarters Ending March 31, 2008

Table 3. Cumulative Insurance Payments
Inception Through 12/31/03

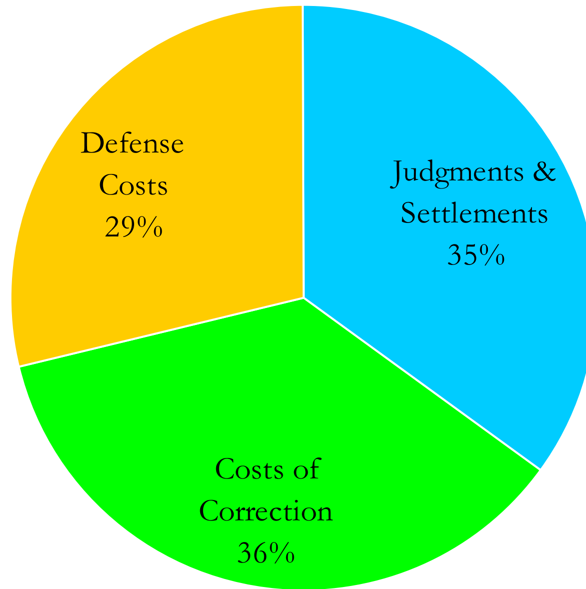
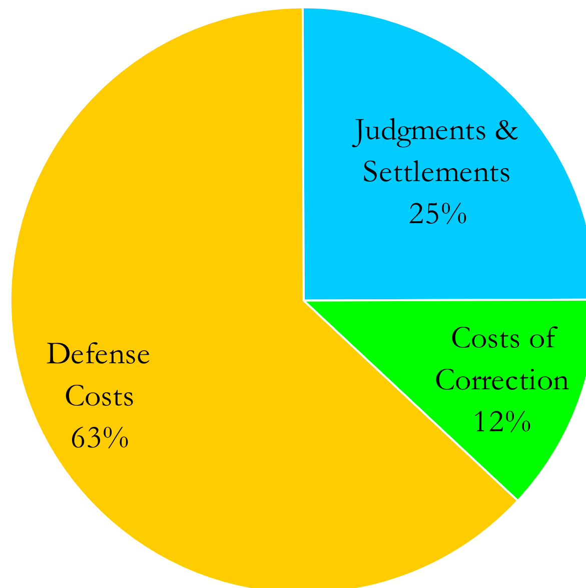


Chart 4. Cumulative Insurance Payments
Inception Through 12/31/07



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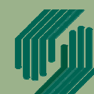

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