ICI MUTUAL **NEWSLETTER**

Claims Trends

Annual Review of Claims Activity in the Mutual Fund Industry *2008*

ICIMutual

Introduction

ICI Mutual has published *Claims Trends* annually since 1999, in order to provide insureds with information on significant claims within the fund industry. By highlighting the nature of these claims sustained by fund groups, this newsletter may assist insureds to better assess and manage their liability risks, thereby reducing the direct and indirect costs of claims.

The number of new claims reported to ICI Mutual in 2008 increased over the numbers reported in both 2006 and 2007, yet remained at a frequency far below that reported during the 2003-04 trading scandal.

Most notably, new civil lawsuits were filed in 2008 regarding funds whose performance suffered significantly in the wake of the subprime mortgage collapse and ongoing disruption in the credit markets. These lawsuits, which remain at an early stage, present potentially significant financial risks for the individual funds and advisers involved. Yet the litigation impact of subprime/credit-related issues on the fund industry as a whole has been limited. Thus, even as scores of subprime and credit-related securities lawsuits have been filed over the past two years, relatively few of them have focused on funds or fund advisers and distributors.

The fund industry remains an attractive potential target for an energetic, highly sophisticated and creative plaintiffs' bar, and this edition of *Claims Trends* describes several new categories of exploratory litigation in addition to the subprime/credit-related lawsuits. Separate and apart from the financial and reputational risk involved, major civil litigation remains enormously expensive to defend. Indeed, it is not uncommon for fund groups to incur legal fees and costs in the seven–figure range, and sometimes higher, in such matters.

In 2008, ICI Mutual also continued to receive a significant number of "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. These types of claims can often involve losses in the low-to-mid seven figures, illustrating the financial risk to fund groups presented by operational mistakes and oversights, particularly in uncertain economic times.

Finally, this edition reviews noteworthy litigation developments in 2008, relating to (1) the consolidated market-timing proceeding that remains pending in U.S. District Court, (2) a landmark decision regarding advisory fees that the U.S. Supreme Court has recently accepted for review (itself a significant development), and (3) continuing echoes of the death knell for state-law securities class actions.

Subprime/Credit-Related Claims

Last year saw a sharp increase in class action securities litigation brought against many types of financial institutions arising from the collapse of the subprime mortgage market and ensuing credit crisis.[1] The fund industry—while distinct in many respects from other types of financial institutions—was not immune from this development: eight fund groups had certain individual funds that were the focus of subprime/credit-related civil litigation during 2008 and early 2009.

In these lawsuits, the investment performance of the funds at issue have departed significantly from that of their peer groups, suggesting that "outlier" funds—and, most particularly, outlier *fixed-income* funds—are most at risk for this type of lawsuit.

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[1] *See generally* Nancy Trejos, *Livid Investors Launch a Volley of Lawsuits*, WASH. POST, Jan. 18, 2009, at F1 (reporting that 110 securities class actions filed in 2008 "were related to the credit crisis," compared with just 40 in 2007).

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

While most of these lawsuits remain in their preliminary pre-trial stages, two cases before federal lower court judges in the Northern District of California have so far been allowed to proceed past the initial stage of motions to dismiss.[2]

It remains too early to predict how these lawsuits may develop, or the impact they may ultimately have on applicable law regarding risk disclosure by funds and on the fund industry's loss experience. That being said, the existence of these lawsuits appears likely to add to concerns of the insurance and reinsurance markets over the nature and severity of the liability risks presented by the fund industry, and may influence the views of these markets on premium rates and coverage in 2009.

As a postscript, the broad category of subprime/credit-related claims is also sometimes viewed as encompassing disputes involving auction-rate preferred securities (ARPS). Although a number of regulatory settlements were reached in 2008 regarding the marketing of ARPS, the settlements generally involved broker-dealers, rather than funds themselves or fund directors or officers.[3] To ICI Mutual's knowledge, only a single ARPS lawsuit was filed against a fund in 2008; and this lawsuit was subsequently dismissed by the plaintiff after the fund group involved announced a refinancing of the ARPS at issue.

In early 2009, shortly before this edition of *Claims Trends* went to press, at least two new lawsuits were filed against directors of certain closed-end funds that had issued ARPS. Plaintiffs are demanding that the funds redeem at par or refinance all the ARPS held by them. Notwithstanding these latest lawsuits, it does not appear that claims over ARPS are likely to develop into a source of significant loss experience for the industry.

Portfolio Management Errors

Portfolio management and other operational errors continue to represent a significant portion of insurance payments made by ICI Mutual. This loss experience continues to highlight the importance to fund groups of close attention to policies, procedures and other measures designed to prevent and detect operational mistakes and oversights.

This experience also underscores the continuing value to the fund industry of the "costs of correction" coverage pioneered by ICI Mutual. Generally, under this coverage, an insured adviser or other service provider may be reimbursed for costs incurred to correct an operational error, so long as the adviser or other service provider has actual legal liability for the resulting loss.[4]

[2] Northstar Fin. Advisors, Inc. v. Schwab Invs., No. 08-4119, 2009 U.S. Dist. LEXIS 12763 (N.D. Cal. Feb. 19, 2009); In re Charles Schwab Corp. Secs. Litig., No. 08-1510, 2009 U.S. Dist. LEXIS 8125 (N.D. Cal. Feb. 4, 2009). Although the motion to dismiss in *Northstar* was formally granted on grounds related to the plaintiff's "standing," the court ruled that the plaintiff could cure the deficiency by amending its complaint. Most notably, the court then went on to rule that the plaintiff could pursue a claim that the fund at issue violated section 13(a) of the Investment Company Act of 1940 (ICA) by deviating from its investment objective to track a particular bond index. The *Northstar* decision runs contrary to a clear trend by courts in recent years against finding "implied" rights of action under provisions of the ICA.

[3] *See, e.g.*, SEC Finalizes Auction Rate Securities Settlements with Citigroup and UBS, Litig. Release No. 20,824 (Dec. 11, 2008).

[4] The coverage also requires the insured to obtain advance consent from ICI Mutual before incurring any costs for which the insured may seek reimbursement.

Examples of recently reported operational errors include the following, each of which resulted in individual losses ranging from $600,000 to over $5 million:

- ***Ambiguous Trading Instruction, and Failure to Notice a "Red Flag."*** A portfolio manager wished to sell enough shares of a stock to raise $475,000. However, based on a handwritten instruction to "sell 475,000," an employee arranged for the sale of 475,000 *shares* of the stock (instead of *dollars*)—not realizing that the fund in fact owned far fewer than 475,000 shares, such that the resulting trade violated a fund prohibition against short sales.

- ***Unilateral Attempt to Remedy a (Mistakenly) Suspected Trading Error.*** An adviser had a policy pursuant to which all suspected trading errors were to be reported to its compliance department without regard to dollar amount. However, based upon a *mistaken* belief that a particular security purchased for two private advisory accounts was prohibited by the accounts' investment guidelines, the portfolio manager sold the security. In fact, the security was *not* prohibited; and as a result of the portfolio manager's unilateral "fix," the fund deviated from an applicable investment model.

- ***Overreliance on Software.*** In the last two years, a number of cost of correction claims have had, as a common nexus, weak procedures related to automated systems. In one case, for example, an employee failed to properly code a new account's investment restriction. In another, a portfolio manager created an IPO indication in the order entry system using an incorrect price. A third case involved an adviser that processed fund trades of portfolio securities based on "signals" received electronically from a third-party's investment model. When two such signals arrived simultaneously, however, the adviser's server software "deadlocked," such that neither signal properly transferred to the adviser's trading application. With no redundancy or confirmation process in place between the adviser and the third party, and few human contacts between the two organizations, the adviser's discovery of the situation was substantially delayed. Such claims illustrate the perils of overreliance by portfolio managers and other personnel on automated software systems to prevent errors and oversights in the portfolio management process.

- ***Failure to Monitor Applicable Deadlines.*** In liquidating large security positions for certain private advisory clients, an adviser was required to accomplish the liquidation within certain time periods specified in the advisory agreements. The portfolio manager used his best judgment regarding timing of the liquidations, but without reference to the applicable deadlines. In two cases, the deadlines were missed, and the clients objected.

- ***Poor Communication to Fund Accounting.*** In separate communications regarding a single trade of a complex debt security—first by telephone, and then by e-mail—a portfolio manager provided conflicting information to the fund accounting department regarding the type of debt security purchased. As a result, a portion of the trade was recorded erroneously on the fund's books. When the portfolio manager subsequently ordered the sale of the

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See generally ICI MUT. INS. CO., MUTUAL FUND D&O/E&O INSURANCE 35-36 (2009) (discussing insurance for the costs of correcting operations-based errors).

security, the portion that had been erroneously recorded was not sold.

Operational losses such as those described above highlight a constant of the mutual fund business, a constant that is particularly important in uncertain economic times: 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.

Other Post-Scandal Matters

While the subjects already discussed comprise (by far) the majority of the industry's loss experience in the years since the 2003-04 trading scandal, four other subjects also gave rise to a number of notices to ICI Mutual in 2008 and early 2009.

1. Fund Investments in Gambling Industry Securities. Two plaintiffs' law firms joined forces last year, and filed at least three virtually identical complaints regarding fund investments in securities issued by gambling businesses. The plaintiffs' theory is novel: that defendants conspired to turn their managed funds into racketeering enterprises by causing the funds to invest in publicly traded companies in the gambling industry. The suits have been assigned to a single U.S. District Court judge in New York, and remain in very early stages, with defendants' legal challenges to the sufficiency of the lawsuits not yet having been decided by the court.

2. Disclosure Regarding Class A Shares. Also last year, plaintiffs filed two class action lawsuits that challenge disclosures regarding class A fund shares. Specifically, plaintiffs allege that fund prospectuses falsely presented class A shares as the best performing share class for the long-term for investments under a designated amount, when classes B and/or C would have been a better investment choice for any holding period. These lawsuits, which remain in very preliminary stages, appear to echo similar lawsuits from prior years (regarding class *B* shares) that were generally not successful for plaintiffs.[5]

3. Demand Letters Regarding Asset-Based Payments to Broker-Dealers. A prominent plaintiffs' firm has recently issued a number of demand letters to fund boards, demanding cessation of "non-transactional asset-based" payments to broker-dealers that have allegedly been made in connection with fund shares held in brokerage accounts.[6] ICI Mutual is unaware of any lawsuits filed to date, but is closely monitoring this situation.

4. Adversarial Bankruptcy Proceedings. In what could be viewed as a sign of the times, a number of bankrupt companies (or their creditors) have filed lawsuits in the past few years, seeking a return of pre-bankruptcy debt payments made to bond holders or other creditors. Mutual funds have been caught up in some of this litigation, named among many defendants as passive holders of the debt securities at issue. In one of these cases, the court last year dismissed the claims that had been made against such funds.[7]

2008 Court Decisions of Note

Federal courts issued a number of noteworthy decisions in 2008, including one (regarding advisory fee levels) that the U.S. Supreme Court has accepted for review.

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5 *See, e.g.*, Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598 (6th Cir. 2005) (affirming dismissal of plaintiffs' claims).

6 *See* Milberg LLP, Investigation of Improper Mutual Fund Sales Practices, http://www.milberg.com/page.aspx?pageid=5474 (last visited Feb. 19, 2009).

7 Adelphia Recovery Trust v. Bank of Am., N.A., 390 B.R. 80 (S.D.N.Y. 2008). This decision remains subject to possible appellate review.

1. Advisory Fees. Prior editions of *Claims Trends* have reported on numerous challenges to the level of fees charged by investment advisers to their managed funds. Most of these cases, launched by the plaintiffs' bar during the scandal period, have already ended; but a major decision last year by a federal appeals court created an apparent split in legal authority. In March 2009, the U.S. Supreme Court entered the fray, agreeing to review the case.

The split to be reviewed by the Court concerns the proper approach that judges should use in determining whether an adviser's fee violates section 36(b) of the ICA. For decades, the leading approach has required a fact-intensive determination as to whether the adviser's fee "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[8]

In May 2008, however, the U.S. Court of Appeals for the Seventh Circuit adopted a different approach, which instead seemingly requires a determination as to whether the fee was freely and honestly negotiated on the basis of adequate information.[9] As noted, the U.S. Supreme Court has agreed to review the Seventh Circuit's opinion. Any decision that the Court ultimately issues is likely to be a watershed event in mutual fund fee litigation.

2. Market Timing. Prior editions of *Claims Trends* also reported extensively on the regulatory enforcement activity and litigation arising out of the market timing and late trading scandals of 2003 and 2004. While these events may have long receded from the nation's headlines, and while a number of fund groups have already settled out, the multidistrict litigation proceeding established for the civil lawsuits (MDL) soldiers on.

Three U.S. District Court judges from the District of Maryland have presided over the MDL,[10] and their rulings continue to shape the remainder of the litigation. Most recently, one of the judges issued a mixed decision on defendants' motions for summary judgment.[11] Also last year, the U.S. Court of Appeals for the Fourth Circuit allowed ERISA claims, brought by former fund group employees, to proceed in the MDL.[12]

Separately, the U.S. Court of Appeals for the First Circuit held that, in an enforcement action brought by the SEC, two individual fund group executives could be held primarily liable (under the Securities Act of 1933 and the Securities Exchange Act of 1934) for using false or misleading fund prospectuses to sell mutual funds.[13]

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[8] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).

[9] Jones v. Harris Assocs. L.P., 527 F.3d 627, 632 (7th Cir.) ("A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."), *cert. granted* (U.S. Mar. 9, 2009) (No. 08-586).

[10] They organized the proceeding by creating separate "subtracks" for each mutual fund family. Generally, in each active subtrack, there remain two separate groups of claims: (1) claims asserted by mutual fund investors under section 10(b) of the Securities Exchange Act of 1934, and (2) claims brought on behalf of the mutual funds themselves under section 36(b) of the ICA.

[11] *See, e.g.*, In re Mut. Funds Inv. Litig., 590 F. Supp. 2d 741 (D. Md. 2008).

[12] In re Mut. Funds Inv. Litig., 529 F.3d 207 (4th Cir. 2008). Plaintiffs, who had 401(k) accounts in plans sponsored by their employers, allege ERISA violations against the plans' fiduciaries, based on the fiduciaries' purportedly knowing investments in mutual funds that allowed market timing. In its decision, the Fourth Circuit held that the former employees had a right to sue, even though they had already cashed out of their respective accounts.

[13] SEC v. Tambone, 550 F.3d 106 (1st Cir. 2008). The SEC alleges that the executives allowed market timing in particular mutual funds in violation of a strict prohibition contained in the funds' prospectuses.

3. SLUSA. The Securities Litigation Uniform Standards Act of 1998 (SLUSA) precludes class actions based on *state* law that allege a misrepresentation, omission, or manipulation in connection with the purchase or sale of a "covered security."[14] It is clear that mutual funds are "covered securities," such that SLUSA bars state-law class actions alleging untruth or manipulation in connection with the purchase or sale of fund shares.

In 2008, a federal appeals court extended SLUSA's reach to hybrid securities—"retirement trust accounts" comprised of both a life insurance component and a mutual fund component—even though life insurance is *not* a "covered security" under SLUSA. The securities' mutual fund component was sufficient to trigger SLUSA's preclusion of state-law class actions.[15]

As class action plaintiffs continue to strike out with claims brought under state law, the ultimate effect of SLUSA in the fund industry may be that *state-law* securities class actions will effectively cease to exist.

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[14] 15 U.S.C. § 77p(b) (2006).

[15] Instituto de Prevision Militar v. Merrill Lynch, 546 F.3d 1340 (11th Cir. 2008). Also in 2008, another federal appeals court twice held that SLUSA barred claims centered on a bank's alleged plan to funnel trust assets into propriety mutual funds, even though, in one case, the plaintiffs had attempted to withdraw all allegations of a misrepresentation. Kutten v. Bank of Am., N.A., 530 F.3d 669 (8th Cir.), *cert. denied*, 129 S. Ct. 598 (U.S. 2008); Siepel v. Bank of Am., N.A., 526 F.3d 1122 (8th Cir. 2008). The court reasoned:

> In determining whether SLUSA applies, we do not rely on the names of the causes of action that the plaintiff alleges. Instead we look at the substance of the allegations, based on a fair reading. SLUSA preemption is based on the conduct alleged, not the words used to describe the conduct.

Kutten, 530 F.3d at 670-71.

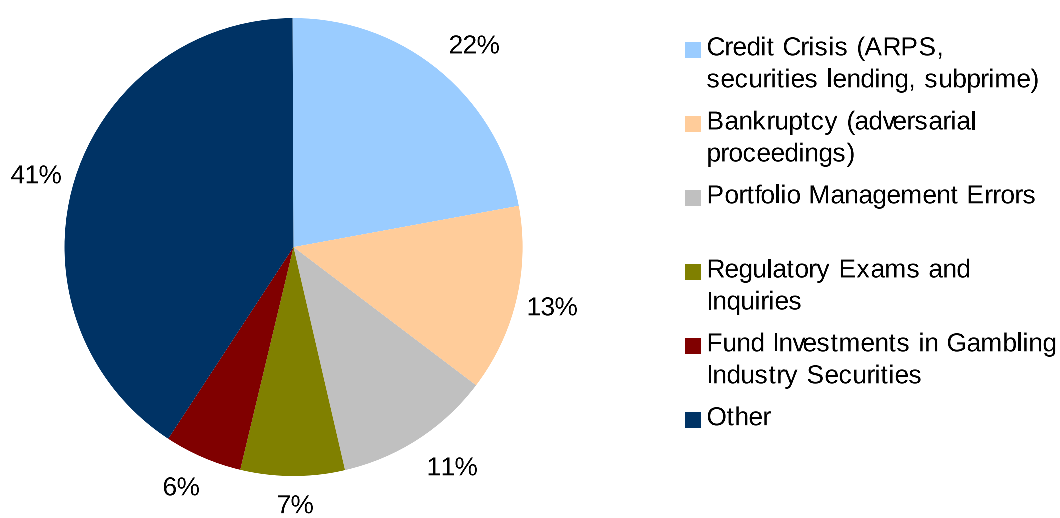
Outlook

While claim frequency in the current environment remains below the historical highs of five years ago, the potential for severe losses in individual cases remains. Claims activity in 2008 and early 2009 suggests that the most significant risks to the fund industry in the current environment are likely to arise in the following areas: (1) shareholder litigation challenging the accuracy or completeness of disclosure in fund prospectuses; (2) shareholder litigation challenging fees and/or charges paid by funds and/or fund shareholders; and (3) operational errors and oversights in the portfolio management process.

D&O/E&O Claims Data

- Chart No. 1 reports the top subject categories for new matters first noticed to ICI Mutual during calendar year 2008. The underlying data includes all D&O/E&O notices from ICI Mutual insureds, whether or not the notice has or is likely to result in any insurance payments. As such, the chart does not reflect potential claim severity for the indicated categories, but rather is a general indicator of the sorts of liability issues experienced by the industry in 2008. The large "other" piece indicates that the year included a fairly large mix of incongruous subjects, none of which accounted for more than 2%.

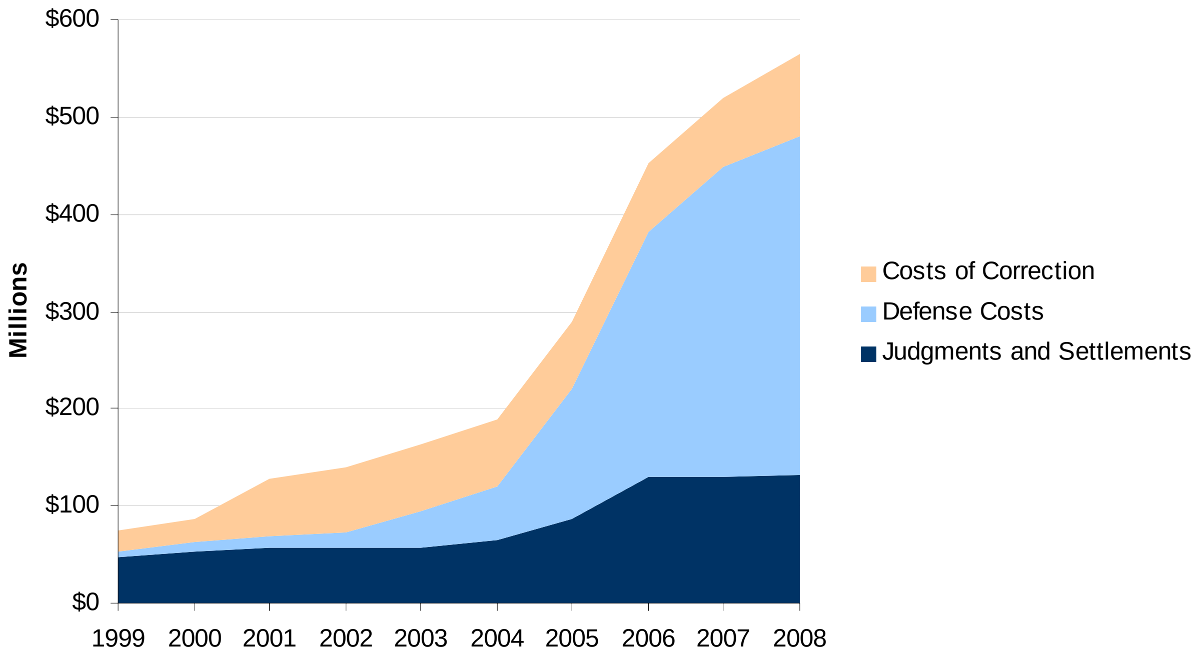
1. Subjects of Insureds' Notices (2008)



D&O/E&O Claims Data

- Chart No. 2 reports the cumulative total of ICI Mutual's D&O/E&O insurance payments over the past ten years (1999-2008), allocated among (1) costs of correction, (2) defense costs incurred in lawsuits and regulatory investigations, and (3) judgments and settlements. The chart highlights the extraordinary growth of defense costs over the past decade; such costs grew from just 6% of cumulative payments at year-end 1999 to 62% of cumulative payments by year-end 2008.

2. Cumulative Insurance Payments (1999-2008)



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ICI Mutual Insurance Company
A Risk Retention Group
1401 H Street NW
Washington, DC 20005

800.643.4246
info@icimutual.com