ICI MUTUAL **NEWSLETTER**

Claims Trends

Review of 2009 Claims Activity in the Mutual Fund Industry

ICI Mutual
A Risk Retention Group

Introduction

Since 1999, ICI Mutual's *Claims Trends* has reported on litigation, regulatory proceedings and operational errors affecting the fund industry. By doing so, the annual newsletter seeks to assist ICI Mutual's insureds to better assess and manage the risks associated with such matters, thereby reducing the potential for associated losses and reputational damage.

In 2009, the *frequency* of new claims reported to ICI Mutual remained within the historical norms that have prevailed following the more active period of the 2003-04 trading scandal.

These historical norms are nevertheless significant, and reflect the fact that the $11 trillion fund industry remains a key area of attention for regulators and for the plaintiffs' bar (i.e., that loose confederation of lawyers who specialize in pursuing large-scale recoveries in civil litigation brought on behalf of investors against financial institutions and other large corporations).

Indeed, in 2009 alone, more than one in five of ICI Mutual's D&O/E&O insured fund groups reported a potential insurance claim; and in the five-year period of 2005 to 2009, more than half of insured fund groups did so.

A second measure of claims activity, in addition to frequency, is *severity*—i.e., the magnitude of losses incurred by insureds in reported matters. Such losses may take the form of judgments or settlements in litigation, legal and associated costs incurred in defending against civil litigation or regulatory investigations and proceedings, and payments or other costs incurred to correct operational errors for which an insured is legally responsible.

Because many of the lawsuits and other claims reported in recent years remain at a relatively early stage of development, it is not yet possible to predict the overall level of exposure they may ultimately present to fund groups. That being said, in the post-trading scandal period, three perennial risks, in particular, have presented substantial potential severity exposure for fund groups:

- ***Prospectus Liability***—i.e., lawsuits alleging liability for inaccurate or incomplete disclosure in a fund's prospectus and/or statement of additional information,
- ***Fees***—i.e., lawsuits challenging fees received by investment advisers and other service providers, and
- ***Operational Errors***—i.e., errors committed by advisory personnel or other individuals or entities in the portfolio management process.

This edition of *Claims Trends* reports on recent activity with respect to each of these three risk areas. In addition, as in years past, this edition reviews noteworthy litigation developments in the past year.

Disclosure

A major source of potential liability for funds and their directors, officers, advisers, and principal underwriters is the investor class action lawsuit alleging liability for inaccurate or incomplete disclosure in a fund's prospectus and/or statement of additional information.

For a general introduction to securities class actions that challenge mutual fund disclosure, and for a review of the industry's actual experience in such litigation, see ICI Mutual's recent risk management study, *Mutual Fund Prospectus Liability* (available at www.icimutual.com). The study also outlines a number of considerations that fund groups may wish to take into account when designing and evaluating practices and procedures to reduce liability risk in this area.

Subprime/Credit Crisis Litigation

In 2007 and 2008, the collapse of the subprime mortgage market and the ensuing credit crisis spurred a sharp increase in securities litigation against many types of financial institutions, including fund groups. With the easing of the credit crisis in 2009, the pace of filings declined. Even so, a few new fund groups were targeted in such claims in 2009.

Depending on how broadly one chooses to define the terms "subprime" and "credit crisis," there are at least eight fund groups with individual funds that remain the subject of subprime/credit crisis-related litigation as this *Claims Trends* goes to press.

These lawsuits primarily assert *disclosure* violations under the federal securities laws—often under sections 11 and/or 12(a)(2) of the Securities Act of 1933, and sometimes under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. In their complaints, plaintiffs have alleged misrepresentations and omissions with respect to a number of subjects (e.g., lack of "true diversification" of the funds' assets, their concentration in certain types of securities, and the illiquidity of such securities).

Typically structured as class actions, these subprime/credit crisis-related lawsuits seek recovery for substantial investment losses incurred by fund shareholders. The targeted funds have tended to be *fixed-income* funds whose "outlier" investment performance departed significantly from that of their peer groups.

Even now, most of these lawsuits still remain in their early stages, and not all have reached the critical pre-trial stage of the *motion to dismiss*, where trial courts respond to the requests of defendants to terminate the litigation on purely legal grounds.

To date, trial courts have decided motions to dismiss in subprime/credit crisis-related lawsuits involving four fund groups. In one case, the court has granted the fund group's motion to dismiss, thereby terminating the litigation (although the time for plaintiffs to appeal has not yet run out).[1] In the other three cases, the courts have denied the defendants' motions, permitting the litigation to proceed to the fact-finding (and costly) stage of litigation known as "discovery."[2]

The subprime/credit crisis also gave rise to a number of regulatory matters, including multi-million dollar settlements with the SEC,[3] and with several states regarding 529 college savings plans.

Auction-Rate Preferred Securities

The broad category of subprime/credit crisis-related claims is sometimes viewed as encompassing disputes involving auction-rate preferred securities (ARPS). Regulatory settlements in this area in recent years have tended to involve the marketing of ARPS and have focused on broker-dealers, rather than funds themselves or fund directors and officers.[4]

To ICI Mutual's knowledge, only a handful of ARPS lawsuits were filed against funds, fund officers and directors, or fund advisers, and only one such lawsuit remains active at this time. That lawsuit, a purported class action, alleges that the defendants failed to properly disclose the risks posed by the funds' use of leverage through ARPS. Defendants' motion to dismiss has not yet been decided.

Exchange Traded Funds

2009 and early 2010 included several new filings targeting leveraged ETFs and inverse funds. These cases focus on the adequacy of disclosure relating to compounding, leverage, resets, and other attributes of the funds' investment strategies.

Funds from three fund groups are the subjects of this type of litigation. These lawsuits remain in early stages; motions to dismiss have not yet been filed.

Fees

Section 36(b) of the Investment Company Act of 1940 (ICA) provides that the investment adviser of a registered investment company "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services,"[5] and expressly affords shareholders the right to bring a lawsuit to enforce this duty.

In addition, advisory fee levels have also been at issue in litigation categories other than section 36(b), including litigation brought under the federal Employee Retirement Income Security Act of 1974 (ERISA) and derivative claims brought under state law for breach of fiduciary duty.

Section 36(b)

On March 30, 2010, the U.S. Supreme Court issued its highly anticipated decision in *Jones v. Harris Associates, L.P.*—a case regarding the scope of the fiduciary duty imposed on mutual fund advisers by section 36(b) of the ICA.[6]

The Supreme Court's examination of this issue followed dueling opinions issued by two different courts of appeal[7] as well as, in another case, a significant trial victory for defendants.[8]

In its decision, the Court affirmed the longtime "*Gartenberg* standard" as the appropriate measure of liability under section 36(b): "to face liability under § 36(b), an investment adviser must charge a fee that 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."[9]

> The *Gartenberg* standard . . . may lack sharp analytical clarity, but we believe that it accurately reflects the compromise that is embodied in § 36(b), and it has provided a workable standard for nearly three decades.
>
> —Justice Alito, Jones v. Harris Associates, L.P.

It remains to be seen whether and how the plaintiffs' bar may react to the Court's opinion in *Jones*. On the one hand, plaintiffs have historically had limited success in litigation brought under section 36(b). On the other hand, section 36(b) remains the only ICA section which expressly affords private parties the right to bring a lawsuit, and nothing in the Supreme Court's decision would appear to preclude plaintiffs from pursuing *Gartenberg*-based fee challenges in the future.

Courts in a number of pending fee cases had temporarily stopped the litigation, pending the outcome in *Jones v. Harris*. Now that *Jones* has been decided, lawyers for the plaintiffs are expected to assess the strength of their cases in light of the Supreme Court's decision and determine how to proceed.

ERISA

In recent years, the plaintiffs' bar has initiated numerous lawsuits under ERISA charging retirement plan sponsors and various plan service providers (including fund advisers and affiliates) with breaching their duties as ERISA "fiduciaries" by permitting plans to pay unreasonable (i.e., excessive) fees.

In one such case, for example, plan participants alleged that the plan's sponsor violated its fiduciary duty under ERISA by providing investment options that required the payment of excessive fees and costs and by failing adequately to disclose the fee structure to plan participants. This litigation also ensnared two sister companies within a fund group—one, the directed trustee and recordkeeper for the plans, and the other, an investment adviser for the mutual funds offered as investment options.

The plaintiffs alleged that these two fund group defendants were so-called "functional fiduciaries" for the plan participants and thus likewise liable under ERISA. In 2009, the U.S. Court of Appeals for the Seventh Circuit rejected this theory in an opinion that has been widely viewed as a significant legal victory for the fund industry.[10]

The same fund group defendants just completed a trial in a separate ERISA case in which the plaintiffs likewise made fee-based allegations. The court's trial judgment remains forthcoming.

Derivative Lawsuits

Although less common than section 36(b) suits and ERISA litigation, fees may also be attacked in *derivative* claims (i.e., claims filed ostensibly on behalf of the fund) for breach of fiduciary duty, as has happened in a pending lawsuit involving a financial institution's sale of its fund advisory business to another firm.

In that case, filed against the trustees of the affected funds, the plaintiff has argued (among other things) that the board "failed to avail itself of the opportunity presented to seek to negotiate lower fees" on behalf of the funds. The litigation is currently pending, awaiting a decision by the highest state court in Massachusetts on an unrelated procedural issue.[11]

Portfolio Management Errors

Portfolio management and other operational errors continue to represent a significant portion of insurance payments made by ICI Mutual.

Two errors reported in 2009 both involved violation of applicable investment guidelines in separately managed accounts. In one case, a debt-to-equity conversion of a portfolio security resulted in a violation of a prohibition against equity securities; and in the other case, the adviser continued to hedge foreign currency after the investment guidelines had been amended to prohibit such hedging.

Common denominators in both cases include the following factors:

- ***Change in key personnel.*** The departure of a portfolio manager (in one case) and the death of the chief compliance officer (in the other) appear to have blurred a sense of responsibility and/or awareness regarding the applicable restrictions.

- ***Inability of automated compliance system to detect the errors.*** As regards the convertible security, the adviser's compliance system did not track conversion events. As regards the currency hedging, advisory staff properly coded the *original* set of restrictions but failed to code the *amended* set of restrictions into the system. Both instances 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.

Including these losses (in the amounts of $600,000 and $3.5 million, respectively), ICI Mutual has paid nearly $90 million in costs of correction claims over its twenty-two year history. This loss history demonstrates 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.[12]

2009 Litigation Developments

In addition to the disclosure- and fee-based cases already discussed, last year also included these additional noteworthy developments.

Fund Investments in Gambling Industry Securities

Last year's edition of *Claims Trends* reported on several new cases advancing a novel theory of civil liability for racketeering, in which fund shareholders alleged that fund investments in online gambling companies constituted illegal racketeering.

In 2009, a federal appeals court affirmed the district court's dismissal of one of these lawsuits, holding that plaintiffs had failed to show (as required) that the fund group's alleged racketeering had itself *caused* the shareholders' alleged loss: "the complaint alleges that the decline in the funds' online gambling holdings was not the direct result of the RICO violation—the owning and/or financing of illegal gambling—but rather was the result of the subsequent 'government crackdown' on the illegal gambling."[13]

Market Timing

Prior editions of *Claims Trends* have reported extensively on the multidistrict litigation proceeding (MDL) established in 2004 for market timing claims. While multiple fund groups have reached settlements over the years, several litigation tracks in the

MDL remain active. As previously reported, MDL plaintiffs filed different types of lawsuits, including "fund class actions" filed by fund shareholders.

Another type is the "parent class action," in which shareholders of a fund adviser's parent company allege that they bought stock shares in the parent company at inflated prices, and thereafter lost money when previously undisclosed market timing practices became known to the public. In 2009, the U.S. Court of Appeals for the Fourth Circuit allowed one such "parent class action" to proceed.[14]

Separately, the U.S. Court of Appeals for the First Circuit revisited its prior decision (reported in last year's edition of *Claims Trends*) that individual fund group executives could be held primarily liable under rule 10b-5 for using false or misleading fund prospectuses to sell mutual funds. Sitting en banc this time,[15] the court reversed course: it *affirmed* the district court's dismissal of the SEC's rule 10b-5 claim.[16]

In the case, the SEC had alleged that the executives allowed market timing in particular mutual funds in violation of a strict prohibition contained in the funds' prospectuses. In its opinion, the First Circuit held that the executives did not "make" a statement (as required for liability under rule 10b-5) merely by using or disseminating a prospectus not authored by them.

Other Cases of Note

Prior editions of *Claims Trends* have reported on litigation regarding distribution-related payments, including "shelf space" payments to broker-dealers. By and large, plaintiffs have not succeeded in these cases. In 2009, a federal appeals court affirmed the dismissal of one such case filed against broker-dealer firms that had accepted such payments.

The court held that plaintiffs' claims were precluded by the firms' website disclosures that detailed the shelf-space arrangements—either because the *timing* of the disclosures triggered the applicable statute of limitations (such that plaintiffs waited too long before filing their suit), or because the *content* disclosed the existence of the very "conflict of interest" at the heart of the plaintiffs' complaint (thereby negating the firms' alleged misrepresentations and omissions).[17]

In an unrelated case, a federal appeals court recently reinstated a class action securities fraud claim filed against a fund adviser and affiliated defendants. According to plaintiffs, the adviser "negotiated a contract for transfer agent services that saddled the Funds with excessive, misleadingly disclosed fees, a significant portion of which were, in essence, kicked back" to the adviser's affiliate.[18]

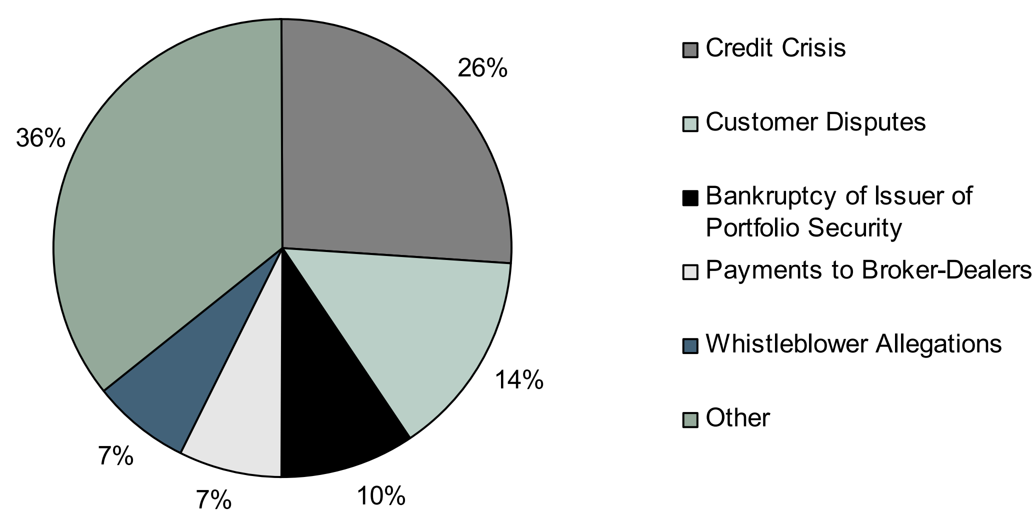
Finally, last year's edition of *Claims Trends* reported a decision in which a federal district court ruled that the plaintiff could pursue a claim that a fund violated ICA section 13(a). That decision, which runs contrary to a clear trend by courts in recent years against finding "implied" rights of action under provisions of the ICA, remains on appeal.[19]

D&O/E&O Claims Data

D&O/E&O Notices

The credit crisis constituted the most common subject of 2009 notices under ICI Mutual D&O/E&O policies. Noticed credit-crisis matters and circumstances involved fixed-income funds, 529 college savings plans, auction rate securities, and collateralized debt obligations. Customer disputes, the second most common subject of an insured's notice, concerned disputes with individual customers (including individual fund shareholders and separately managed accounts) regarding various investment management or account administration matters.

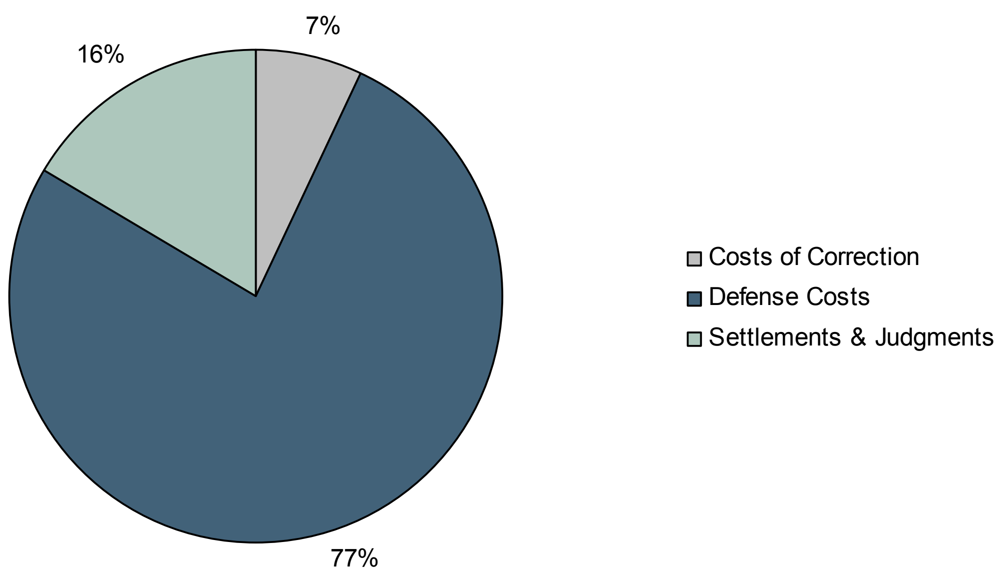
D&O/E&O Notices, by Subject (2009)



D&O/E&O Insurance Payments

This chart—covering a ten-year period that includes the scandal-era litigation regarding market timing, distribution-related payments, and fees—vividly illustrates that defense costs have historically represented the most severe loss exposure paid to ICI Mutual insureds during periods of heightened litigation.

D&O/E&O Insurance Payments, by Type (2000-09)



Endnotes

[1] Yu v. State Street Corp., No. 1:08-cv-8235, 2010 U.S. Dist. LEXIS 17147 (S.D.N.Y. Feb. 25, 2010).

[2] In re Evergreen Ultra Short Opportunities Fund Secs. Litig., No. 08-11064, 2010 U.S. Dist. LEXIS 31360 (D. Mass. Mar. 31, 2010); 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).

[3] Evergreen Inv. Mgmt. Co., No. 3-13507 (SEC filed June 8, 2009).

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

[5] 15 U.S.C. § 80a-35(b) (2007).

[6] Jones v. Harris Assocs. L.P., No. 08-586, 2010 U.S. LEXIS 2926 (Mar. 30, 2010).

[7] Gallus v. Ameriprise Fin., Inc., 561 F.3d 816 (8th Cir. 2009), *vacated*, No. 09-163, 2010 U.S. LEXIS 2999 (Apr. 5, 2010); Jones v. Harris Assocs., L.P., 527 F.3d 627 (7th Cir. 2008), *vacated*, No. 08-586, 2010 U.S. LEXIS 2926 (Mar. 30, 2010).

[8] In re Am. Funds Fee Litig., No. 2:04-cv-05593, 2009 U.S. Dist. LEXIS 98871 (C.D. Cal. Sept. 16, 2009), *appeal docketed*, No. 10-55221 (9th Cir. Feb. 12, 2010).

[9] Jones, 2010 U.S. LEXIS 2926, at *18-*19. This standard was first articulated by a federal appellate court in the case of *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982).

[10] Hecker v. Deere & Co., 556 F.3d 575 (7th Cir.), *reh'g denied*, 569 F.3d 708 (7th Cir. 2009), *cert. denied*, 130 S. Ct. 1141 (U.S. Jan. 19, 2010).

[11] Halebian v. Berv, 590 F.3d 195 (2d Cir. 2009), *certifying question to* No. 10641 (Mass. filed Jan. 8, 2010).

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

[13] McBrearty v. Vanguard Group, Inc., No. 09-1445, 2009 U.S. App. LEXIS 25675, at *3 (2d Cir. Nov. 20, 2009).

[14] In re Mut. Funds Inv. Litig., 566 F.3d 111 (4th Cir. 2009).

[15] In a rehearing en banc, *all* of the appellate court's judges participate (not just the three judges that originally decided the appeal).

[16] SEC v. Tambone, No. 07-1384, 2010 U.S. App. LEXIS 5031 (1st Cir. Mar. 10, 2010).

[17] In re AIG Advisor Group Secs. Litig., 309 F. App'x 495 (2d Cir. 2009).

[18] Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC, 595 F.3d 86 (2d Cir. 2010).

[19] Northstar Fin. Advisors, Inc. v. Schwab Invs., 609 F. Supp. 2d 938 (N.D. Cal. 2009), *appeal docketed*, No. 09-16347 (9th Cir. June 29, 2009).

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tailored, innovative coverage combined with expert claims handling

Stability and Financial Strength in All Markets:
consistent coverage and strong capital

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ICI Mutual also serves as a primary source of industry information regarding mutual fund insurance coverage, claims, risk management issues, and litigation developments. Publications include an extensive library of risk management studies addressing such topics as ERISA liability, prospectus liability, corporate action processing, investment management compliance, computer security, defense cost management, identity theft, and independent director litigation risk, among others, and the *Investment Management Litigation Notebook*, risk manager alerts, and the annual *Claims Trends* newsletter. Additional services include peer group profiles, coverage analyses, and assistance to insureds and their counsel in litigation defense.

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