ICI MUTUAL **NEWSLETTER**

Claims Trends

Review of Claims Activity in the Mutual Fund Industry (January 2011-March 2012)

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Abbreviations used in this *Claims Trends*:

'33 Act	Securities Act of 1933
'34 Act	Securities Exchange Act of 1934
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
ERISA	Employee Retirement Income Security Act of 1974
IAA	Investment Advisers Act of 1940
ICA	Investment Company Act of 1940
RICO	Racketeer Influenced and Corrupt Organizations Act
SEC	U.S. Securities and Exchange Commission
SLUSA	Securities Litigation Uniform Standards Act of 1998

In addition, U.S. Courts of Appeals are referred to by their circuit number (e.g., First Circuit, Second Circuit).

Introduction

Since 1999, ICI Mutual has provided annual *Claims Trends* reports on significant litigation, regulatory proceedings, and operational errors affecting the fund industry. These reports are designed to assist ICI Mutual's insureds in better assessing and managing the risks associated with such matters, thereby reducing the potential for associated losses and reputational damage.

ICI Mutual measures claims activity by both *frequency* and *severity*. With regard to *frequency,* nearly one-third of ICI Mutual's insured fund groups submitted at least one claim notice in 2011 under their directors and officers/errors and omissions (D&O/E&O) policies; approximately two-thirds of insured fund groups did so over the five-year period 2007-2011. These figures suggest that even now, with the mutual fund scandal period almost a decade in the past, claims frequency remains an issue for fund industry insureds.

In contrast to frequency, the *severity* of new claims can be more difficult to assess, particularly in the case of lawsuits and regulatory proceedings, where the magnitude of losses (whether in the form of judgments, settlements, and/or associated defense costs) may take years to establish. On a positive note, in 2011 and early 2012, there were relatively few *new* claims of the types that have traditionally given rise to substantial severity (e.g., prospectus disclosure claims, fee claims). Even so, this same period witnessed a series of multimillion dollar public settlements by fund groups of claims initiated prior to 2011, including two of the largest settlements of shareholder class action lawsuits in fund industry history (with each involving a payment in the nine figures). These settlements suggest that severity, too, remains an issue in the current claims environment.

As discussed in this *Claims Trends,* federal district and appellate courts have issued a number of noteworthy decisions in fund industry lawsuits over the past fifteen months. Many of these decisions were favorable to the fund industry. But even those that were not have helped to clarify the nature of liability risks faced by funds, fund directors, and fund advisers, particularly in civil litigation initiated by "the plaintiffs' bar"—i.e., those private lawyers who specialize in pursuing large-scale recoveries on behalf of investors against financial institutions.

On the regulatory front, last year's *Claims Trends* noted that various developments—including enactment of "whistleblower" provisions under Dodd-Frank and the creation of a new asset management unit in the SEC's Division of Enforcement—were leading some industry observers to predict an increase in SEC enforcement activity. Indeed, the agency did bring a record number of enforcement actions in its 2011 fiscal year, including a record number of actions in the asset management arena. Although the agency focused much of its enforcement attention in the asset management arena on hedge fund managers and other actors outside the registered investment company space, advisers and others involved with registered funds were not immune.

The cost to fund groups of defending claims remains high. Particularly in regulatory investigations and in shareholder litigation initiated by the plaintiffs' bar, ICI Mutual's claims experience evidences that defense costs for affected fund groups can quickly climb into seven figures, and sometimes reach eight figures.

As in past editions, this *Claims Trends* reports on developments in four traditional risk areas for fund groups: (1) *disclosure* claims, which challenge the accuracy or adequacy of disclosures made by funds and advisers; (2) *fee* claims, which challenge fees received by investment advisers and other service providers; (3) *regulatory* investigations, administrative proceedings, and/or litigation initiated by the SEC or other federal or state authorities; and (4) liabilities for *operational errors* committed by advisory personnel or other individuals or entities in the portfolio management process.

In addition, this *Claims Trends* also reports on continued efforts by the plaintiffs' bar to target fund advisers and fund directors in civil litigation alleging violations of state (rather than federal) law, and reviews certain other noteworthy litigation developments from 2011 and early 2012.

Disclosure

As described in prior *Claims Trends*, "prospectus liability" class action lawsuits brought under the '33 Act have proven in recent years to be a major source of potential liability for funds and their directors, officers, advisers, and principal underwriters. For a general introduction to '33 Act class action lawsuits (which allege inaccurate or incomplete disclosure in a fund's prospectus and/or statement of additional information), and for details regarding the fund industry's experience with such litigation, please refer to ICI Mutual's 2010 risk management study, *Mutual Fund Prospectus Liability* (available at http://www.icimutual.com).

No noteworthy new prospectus liability lawsuits were initiated against fund industry defendants in 2011 and early 2012. As discussed below, however, substantial developments occurred in prospectus liability lawsuits filed prior to 2011, developments that highlight the ongoing risks associated with this type of litigation.

Subprime/Credit Crisis Litigation

As reported in prior *Claims Trends*, the collapse of the subprime mortgage market and the credit crisis led to a sharp increase in litigation against fund groups and other financial institutions in 2007-2008, and continuing into 2009. Eight fund groups had one or more funds involved in major "prospectus liability" class action lawsuits alleging violations of the '33 Act (and, in some cases, other legal violations as well).

These lawsuits, spearheaded by the plaintiffs' bar and chiefly filed in federal court, challenged the adequacy of the disclosure provided by certain fixed-income funds that had significantly underperformed their peers during the subprime/credit crisis period. In particular, the plaintiffs, acting on behalf of larger "classes" of fund shareholders, sought to hold funds, their advisers, and, in some cases, other parties (including fund directors) liable for misrepresentations and omissions allegedly made with respect to the nature and types of securities that were held by the funds.

In most of these subprime/credit crisis lawsuits, the courts have now ruled on the defendants' efforts to terminate the lawsuits at the early, pre-trial stage of litigation known as the *motion to dismiss* (i.e., the stage at which defendants challenge the adequacy of plaintiffs' allegations on purely legal grounds). In the years prior to the subprime/credit crisis, fund group defendants enjoyed substantial success in their motions to dismiss '33 Act litigation. In contrast, in decisions since the subprime/credit crisis, the courts have generally ruled *against* fund group defendants on these early, pre-trial motions to dismiss.

More particularly, federal trial courts have now ruled on motions to dismiss with regard to seven of the eight fund groups charged in subprime/credit crisis ’33 Act lawsuits.[1] In only a single case has a court granted the defendants’ motion to dismiss. In that case, in a decision issued in early 2011, the court reasoned, in effect, that because mutual fund share prices are set according to a statutory formula and not in a secondary market, any misstatements or omissions in the fund’s disclosure could not themselves have *caused* the plaintiffs’ alleged losses.

The court’s rationale, if widely adopted by other federal courts, could significantly impair future efforts by the plaintiffs’ bar to pursue ’33 Act claims against mutual funds, fund directors, and fund advisers. The plaintiffs appealed the dismissal of the lawsuit to the Second Circuit, but in late 2011, before the appellate court ruled on this important “loss causation” issue, the parties reportedly reached a settlement of the litigation, such that the appeal is unlikely to go forward.[2]

Meanwhile, the courts have denied motions to dismiss (in whole or in part) in six other subprime/credit crisis ’33 Act lawsuits, thereby permitting the lawsuits to move ahead in the litigation process.[3] Notably, in several of these cases, the courts have explicitly rejected efforts by the defendants to use “loss causation” as a basis for dismissal.[4]

The fund industry’s claims experience suggests that ’33 Act shareholder class actions that survive motions to dismiss are likely to settle, sooner or later, by agreement of the parties, and that few, if any, are likely to reach a trial. To date, settlements (preliminary or final) have been announced in four of the above-referenced lawsuits. All four involve monetary payments by the defendants, with two involving payments in the nine figures.[5]

Exchange-Traded and Inverse Funds

Last year’s *Claims Trends* reported on ’33 Act class action litigation targeting leveraged ETFs and inverse funds. These lawsuits focus on the adequacy of prospectus disclosure relating to compounding, leverage, resets, and other attributes of the funds’ investment strategies.

As in the subprime/credit crisis litigation discussed above, fund industry defendants have had little success on their motions to dismiss these lawsuits. In early 2012, a federal district court denied defendants’ motion to dismiss one of the ETF lawsuits; the defendants’ motion to dismiss the other ETF lawsuit remains pending.[6] The defendants’ motion to dismiss the inverse fund lawsuit was also denied (in early 2011); since then, the parties reached a monetary settlement that was approved by the court in early 2012.[7]

Other Disclosure-Based Litigation

In addition to challenging mutual fund disclosure in ’33 Act class action lawsuits, shareholders sometimes seek to do so under the ’34 Act (more specifically, under section 10(b) of the ’34 Act and rule 10b-5 thereunder). Shareholders filing class action lawsuits under rule 10b-5 are subject to various legal requirements that can be difficult to satisfy in the mutual fund context, including the requirement to demonstrate that defendants engaged in intentional or reckless misconduct (i.e., “scienter”). As a result, fund industry defendants have historically enjoyed considerable—but by no means complete—success in defending against rule 10b-5 lawsuits initiated by the plaintiffs' bar.

The most noteworthy recent development in the rule 10b-5 area came in June 2011, with the U.S. Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*.[8] *Janus* involved a lawsuit that was brought *not* on behalf mutual fund shareholders, but rather on behalf of shareholders of the publicly traded parent company to the investment adviser for the Janus mutual funds. These public shareholders sought to hold the adviser and parent company liable for allegedly deceptive statements included in the Janus mutual fund prospectuses. In a 5-4 decision, the Court ruled in favor of the Janus defendants, holding that the adviser did not itself "make" any of the alleged prospectus misstatements at issue, and therefore could not be liable as a "primary" violator in shareholder litigation brought under rule 10b-5.

By establishing a relatively "bright line" test for primary liability, *Janus* brings more predictability and clarity to rule 10b-5 shareholder litigation in the broader public company area, which should prove beneficial to securities issuers and their associated service providers. As regards rule 10b-5 litigation brought by *mutual fund* shareholders, however, the impact of *Janus* may be relatively modest.[9] Nothing in the Court's decision removes the legal requirements (including scienter) that have been a disincentive to pursuing '34 Act lawsuits on behalf of fund shareholders against fund industry defendants. And given the realities of fund industry litigation, even when such lawsuits are pursued, *Janus* may prove to have little effect on the relative liability exposures faced by advisers, funds, and fund directors.

As with virtually any recent Supreme Court decision, interpretive questions remain, and the *Janus* decision is already being explored and interpreted by lower federal courts, including in rule 10b-5 lawsuits initiated by the SEC. Among the questions being considered by the courts is the extent to which the *Janus* test for liability should apply to securities fraud claims brought under certain other provisions of the federal securities laws.[10]

Fees

In lawsuits filed on behalf of mutual fund shareholders, the plaintiffs' bar has frequently sought to challenge fees charged to mutual funds by investment advisers and other service providers. Most commonly, these lawsuits allege violations of section 36(b) of the ICA, which 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," and expressly affords shareholders the right to bring a lawsuit to enforce this duty.[11] The plaintiffs' bar has also challenged fees in litigation brought under ERISA and, less commonly, in derivative claims brought under state law for breach of fiduciary duty.

Section 36(b)

In March 2010, the U.S. Supreme Court issued a decision in *Jones v. Harris Associates, L.P.*, in which the Court affirmed the longtime "*Gartenberg* standard" as the appropriate measure of liability under section 36(b).[12] At the time this *Claims Trends* went to press, *Jones* remained before the Seventh Circuit for further consideration in light of the Court's ruling.[13] But in decisions issued in 2011 and early 2012, a number of other courts ruled in section 36(b) lawsuits that were in progress (or on appeal) at the time that *Jones* was decided.

At the federal appellate level, three Circuits issued decisions affirming district court judgments in favor of fund advisers—judgments that had been granted either at the "summary judgment" stage of the litigation (two cases) or following a full trial (one case). In doing so, the Circuits offered views on certain issues that were arguably left unaddressed in *Jones,* including (i) whether a "process-based failure" in the establishment of fees can constitute an independent violation of section 36(b) (Eighth Circuit); (ii) the nature of "actual damages" for which defendants may be liable under section 36(b) (Fourth Circuit); and (iii) whether section 36(b) permits lawsuits "on a theory that fees were used for improper purposes" (Ninth Circuit).[14]

During this same period, another federal appellate court (Second Circuit), in a section 36(b) lawsuit involving an alleged overcharge for transfer agent services, affirmed in part and vacated in part the district court's grant of the defendants' motion to dismiss. Following the court's decision, the surviving portion of the lawsuit was dismissed with prejudice by agreement of the parties.[15]

At the federal trial court level, pre-*Jones* lawsuits continued through the litigation process in 2011 and early 2012. In May 2011 and January 2012, respectively, federal district courts terminated section 36(b) lawsuits by agreement of the parties.[16] In June 2011, another district court granted an adviser's motion to dismiss a section 36(b) lawsuit, though the plaintiff subsequently asked the court to reconsider its decision.[17] And in March 2011, a federal district court refused to reconsider a prior ruling that had denied shareholders in two "funds of funds" the right (i.e., "standing") to challenge the excessiveness of fees paid by the underlying funds; the plaintiffs in this lawsuit have since re-filed their complaint as a new lawsuit.[18]

Meanwhile, five *new* section 36(b) lawsuits have been filed since the Supreme Court's decision in *Jones,* suggesting that the plaintiffs' bar remains willing, in appropriate cases, to challenge fee arrangements involving registered funds. The first of these new lawsuits, filed the day after the Court's decision, targets a fund adviser, fund distributors, and certain affiliated insurance companies. The lawsuit is unusual in that it combines a section 36(b) claim with claims of ERISA violations. In May 2011, the trial court granted the defendants' motion to dismiss; the plaintiff appealed. In April 2012, the Third Circuit issued its decision in this case.[19]

In two companion post-*Jones* lawsuits filed in October 2010 and February 2011, respectively, plaintiffs sued the same defendant—the adviser/principal underwriter for a family of funds—and challenged as excessive the investment management and rule 12b-1 fees that it received. Among other things, the plaintiffs focused on alleged disparities between (1) the defendant's advisory fees and the fees paid to its "subcontractors" (i.e., subadvisers), and (2) the advisory fees paid to the defendant by managed funds and the fees paid by the defendant's institutional accounts. The defendant's motions to dismiss in both lawsuits were granted in part and denied in part in September 2011. One lawsuit has since been voluntarily dismissed; the other lawsuit continues.[20]

In mid-2011, two more post-*Jones* section 36(b) cases were filed.[21] The first of these—which involves a traditional challenge to advisory fees charged to certain mutual funds—survived a motion to dismiss in November 2011, and thereafter entered the discovery (or fact-finding) stage of the litigation process. The second lawsuit—which challenges fees paid to the investment advisers of certain funds offered in variable annuity products—alleges, among other things, that the fees retained by the investment advisers are excessive in light of the level of investment management services provided by the funds' sub-advisers. The defendants have filed a motion to dismiss, arguing that the plaintiff, as a variable annuity investor, lacks statutory "standing" to challenge fund fees under section 36(b). That motion remains pending.

Other Developments in Fee Litigation

Outside the context of section 36(b), fee payments have also been subject to challenge by the plaintiffs' bar under other legal theories involving different provisions of federal or state law.

Last year's edition of *Claims Trends* reported on one such challenge, in a lawsuit involving a financial institution's sale of its fund advisory business to another firm. The lawsuit charged the trustees of the affected funds with various violations of law in connection with their consideration of the sale and their approval of new advisory agreements, and asserted, in essence, that the trustees "failed to avail themselves of the opportunity to negotiate lower fees or seek competing bids from other qualified investment advisors."[22] In May 2011, the Second Circuit affirmed the district court's dismissal of two counts of the lawsuit, but vacated, on procedural grounds, the dismissal of a third "derivative" count, remanding it back to the district court for further consideration.[23]

2011 also saw the conclusion of three lawsuits filed in 2009 and 2010 that challenged rule 12b-1 distribution fee payments. More specifically, these lawsuits alleged that payments by mutual funds of "non-transactional asset-based compensation" to broker-dealers in connection with fund shares held in brokerage accounts violated provisions of the ICA and the IAA, so as to render the funds' distribution contracts unenforceable under ICA section 47(b). In 2010, a federal trial court dismissed one of these lawsuits for a second time; the appeal of this ruling to the Ninth Circuit was voluntarily dismissed in June 2011.[24] Another federal trial court dismissed a second of these lawsuits in March 2011; the appeal of this ruling to the First Circuit was voluntarily dismissed in June 2011.[25] A federal trial court dismissed the third lawsuit in June 2011, and no appeal was filed.[26]

Regulatory Claims

As discussed in the introduction to this *Claims Trends*, 2011 witnessed a record number of SEC enforcement actions in the asset management arena. These actions focused largely on hedge fund managers and other actors outside the registered investment company space. Even so, advisers and others involved with registered funds were by no means immune, as the SEC initiated or resolved proceedings involving such issues as valuation of portfolio securities;[27] misallocation of IPO shares;[28] marketing and disclosure of fixed-income funds;[29] improper payment of sub-advisory fees;[30] unlawful acceptance by advisory personnel of compensation;[31] and improper charges of "monitoring fees" on portfolio securities.[32]

More recently, public statements by SEC officials and observations by industry observers suggest that scrutiny by the SEC's Division of Enforcement of registered funds, fund advisers, and associated individuals (including advisory personnel, chief compliance officers, and fund directors) will likely continue in 2012. In particular, it appears that the Division may focus attention on valuation, compliance infrastructure and oversight, and fee arrangements. Indeed, as regards fund fees, the director of the Division stated in late 2011 that "[w]e want to take the advisory fee setting process out of the shadows by scrutinizing the role of investment advisers and fund board members in vetting fee arrangements with registered funds."[33]

Meanwhile, an SEC lawsuit outside the fund industry has also attracted significant attention by fund industry observers. In November 2011, a federal district court rejected a settlement reached by the SEC with a large financial institution, in which, as is customary in SEC settlements, the institution "neither admitted nor denied" the agency's allegations. The judge objected to this absence of an admission of wrongdoing by the institution, reasoning that it left the court without "a sufficient evidentiary basis to know whether the requested relief is justified …."[34]

The district court's reasoning, if widely adopted, could significantly disrupt SEC efforts to resolve enforcement proceedings short of trial. Following the district court's ruling, the SEC and the institution filed an interim (or "interlocutory") appeal. In March 2012, the Second Circuit stayed the underlying lawsuit, in an opinion that suggests that the Second Circuit is likely to support the SEC's use of "neither admit nor deny" settlements.[35] At the time this *Claims Trends* went to press, the interlocutory appeal remained pending.

Portfolio Management Errors

Portfolio management and other operational errors continue to represent a significant portion of insurance payments made by ICI Mutual. Since its formation in 1987, ICI Mutual has paid nearly $100 million in "costs of correction" insurance claims—i.e., insurance claims made by advisers who seek recovery for payments made by them, outside the litigation context, to remedy operational errors that have adversely affected their managed funds or private accounts. Generally, this coverage permits an insured adviser (or other insured service provider) to be reimbursed for costs incurred to correct an operational error, provided that the adviser or other service provider has actual legal liability for the resulting loss.[36]

As reported in last year's *Claims Trends,* whether measured in terms of frequency or severity, costs of correction claims reported to ICI Mutual have disproportionately involved private accounts. Costs of correction claims in 2011 and early 2012 followed this pattern, with three-quarters of them arising from errors or oversights affecting private accounts, either exclusively or in combination with registered funds. Several of these reported claims can be traced, directly or indirectly, to misclassifications by advisers of portfolio securities in compliance systems. Losses incurred by the affected complexes in these claims varied in amount, with some in the low- to mid-seven figures.

The ongoing risk of these claims highlights the importance to fund groups of close attention to policies, procedures, and the use of technology designed to prevent and detect operational mistakes and oversights.

State Law Actions and the Plaintiffs' Bar

Litigation challenges to fund groups sometimes take the form of (i) *state law class actions*—i.e., lawsuits filed ostensibly on behalf of groups (or "classes") of fund shareholders, that allege violations of state or common law by fund advisers, funds themselves, and/or fund directors and officers, or (ii) *state law derivative actions*—i.e., lawsuits filed ostensibly on behalf of funds themselves, that allege violations of state or common law by fund advisers and/or fund directors and officers.[37] As described below, the plaintiffs' bar had little success in either area in 2011 and early 2012.

Auction-Rate Preferred Securities

Past *Claims Trends* have reported on lawsuits involving closed-end funds that issued auction-rate preferred securities (ARPS), including lawsuits initiated in 2010 on behalf of common shareholders of ARPS funds. These lawsuits targeted at least nine fund groups, and alleged, in essence, breach of fiduciary duties to common shareholders through the defendants' authorizing or participating in the redemption of ARPS in favor of new, less favorable financing.[38]

In these ARPS cases, multiple *derivative actions* were filed in state courts against defendants in six fund groups. Defendants included fund advisers (and, in some cases, their parent companies), as well as interested directors and executive officers of the funds. (The ARPS funds were named as nominal defendants.) The lawsuits involving three of the fund groups were dismissed in 2011, either by order of the court or voluntarily.[39] Lawsuits involving the other three fund groups remain pending.[40]

Multiple ARPS lawsuits were also filed as *class actions* against defendants in three fund groups. Defendants in these class actions included the ARPS funds themselves, fund directors (including independent directors), and fund advisers (and in some cases, their parent companies). Most of these lawsuits were originally filed in federal courts, and then subsequently re-filed in *state* courts. In mid-2011, lawsuits involving two of these fund groups were dismissed by the state courts.[41]

Meanwhile, the class action lawsuits involving the third fund group were transferred (or "removed") from *state* court to *federal* court. There, the defendants argued that the lawsuits were barred by SLUSA, and in early 2011, the district court agreed, dismissing the first of these lawsuits.[42] The plaintiff appealed the dismissal.

In November 2011, the Seventh Circuit affirmed, and in doing so, staked out an expansive view of SLUSA preclusion, which, if widely adopted, would appear to leave little room for the plaintiffs' bar to pursue state law class actions against fund industry defendants.[43] The Seventh Circuit's opinion also arguably widens an existing split in federal appellate court approaches to the scope of SLUSA preclusion, and the plaintiff has petitioned the U.S. Supreme Court to review the decision.[44] At the time this *Claims Trends* went to press, the plaintiff's petition remained pending before the Court. (Since the date of the Seventh Circuit's decision, the other two class actions involving this fund group have likewise been dismissed.[45])

Fund Investments in Gambling Industry Securities

As reported in prior *Claims Trends*, beginning in 2008, the plaintiffs' bar filed a number of federal lawsuits alleging that fund investments in online gambling companies constituted illegal racketeering, in violation of RICO. Most of these federal lawsuits were dismissed in 2009 and 2010 (with the Second Circuit affirming the dismissals of two of these lawsuits in November 2009 and June 2011, respectively).[46]

Following the dismissals, the various plaintiffs re-filed their lawsuits in either federal or state courts. The new lawsuits, although based on essentially the same activities, were styled as derivative actions and alleged violations largely sounding in state law or common law (e.g., breach of fiduciary duty and waste). One of these lawsuits (re-filed in state court) was dismissed in June 2011, and the state supreme court affirmed this dismissal in January 2012.[47] Another (filed in federal court) was dismissed in February 2012.[48] At the time this *Claims Trends* went to press, it appears that two other lawsuits remain pending.[49]

Shareholder Derivative Demand Investigations

Derivative actions in the fund industry are often spearheaded by the plaintiffs' bar, and typically target fund advisers or their affiliates, and/or fund officers or directors, alleging that such entities or individuals have breached their fiduciary duties or otherwise engaged in violations of law with respect to their funds. As a prerequisite to bringing derivative actions, shareholders (or their attorneys) generally must first make "demands" on fund boards, in which they ask the boards to authorize and pursue litigation on behalf of the funds. In response to such demands, fund boards often appoint special committees of independent directors to conduct "shareholder derivative demand investigations" (SDDIs), so that the relevant facts and law can be examined and boards (or their special committees) can make informed decisions as to whether or not the pursuit of litigation is in the best interest of their funds.

In responding to SDDIs, fund boards may reject the demands and determine that litigation should *not* be pursued. It is not uncommon for such rejections to be challenged by the plaintiffs' bar in court. In evaluating these challenges, courts typically look to such factors as whether the boards' determinations were made in good faith, by independent decision makers, and following reasonable inquiry.

Two decisions in 2011 illustrate the close scrutiny that courts may afford to the process by which fund boards consider and respond to SDDIs. One of these decisions, issued by the Second Circuit, is discussed at p. 6 above, under "Other Developments in Fee Litigation." The other decision was issued by a federal district court, in a case involving a closed-end fund. Both decisions provide evidence that in appropriate cases, courts may grant derivative plaintiffs limited fact-finding (or "discovery") into the circumstances underlying board determinations rejecting shareholder derivative demands.[50]

In 2011, ICI Mutual introduced specialized coverage to defray the costs incurred by funds and other insureds in SDDIs. The coverage is provided automatically, at no additional premium, on all ICI Mutual D&O/E&O policies on which registered funds are named as insureds. See "D&O/E&O Insurance Coverage for Shareholder Derivative Demand Investigations – Frequently Asked Questions" (available at http://www.icimutual.com).

Other Litigation Developments

ERISA

The federal securities laws do not generally permit direct actions against advisers for alleged mismanagement of assets. In contrast, ERISA expressly contemplates that plan "fiduciaries" may be directly sued for mismanagement of assets under their control—i.e., for failure to adhere to their duty of "prudent management." While advisers to mutual funds are generally exempt from ERISA claims of imprudent management, no such protection is available to advisers to unregistered pooled investment vehicles that contain plan assets.

A recent court ruling illustrates the liability risks that may be faced by advisers under ERISA. In March 2012—in a lawsuit involving an investment adviser to certain unregistered funds that sustained significant losses during the subprime/credit crisis period—a federal district court ruled, following a bench trial, that the adviser violated its fiduciary duties under ERISA to invest prudently (or, more accurately, as a "prudent expert" would manage the assets) and to adequately diversify the funds' assets. The court ordered the adviser to pay damages in the eight figures.[51] Portions of the lawsuit remain ongoing.

Two years ago, *Claims Trends* reported on other lawsuits brought under ERISA, in which retirement plan sponsors and various plan service providers (including fund advisers and affiliates) were charged with breaching their duties as ERISA fiduciaries by permitting plans to pay unreasonable (i.e., excessive) fees. At that time, in a significant legal victory for the fund industry, the Seventh Circuit rejected the theory that two fund group defendants—one, the directed trustee and recordkeeper for the plans, and the other, an investment adviser for the mutual funds offered as investment options—were so-called "functional fiduciaries" to the plan participants and thus potentially liable under ERISA.[52]

The same fund group defendants, acting in the same capacities, were also involved in a separate ERISA lawsuit, in which the plaintiffs likewise made fee-based allegations. In March 2012, the trial court in that lawsuit issued an opinion finding, among other things, that the fund group defendants were ERISA "fiduciaries" (although not with respect to excessive fees) and that they breached their fiduciary duties to the plan with respect to the handling of "float income."[53] At the time this edition of *Claims Trends* went to press, it was not yet clear whether the defendants would appeal.

Bankruptcy Claims by Issuers of Portfolio Securities

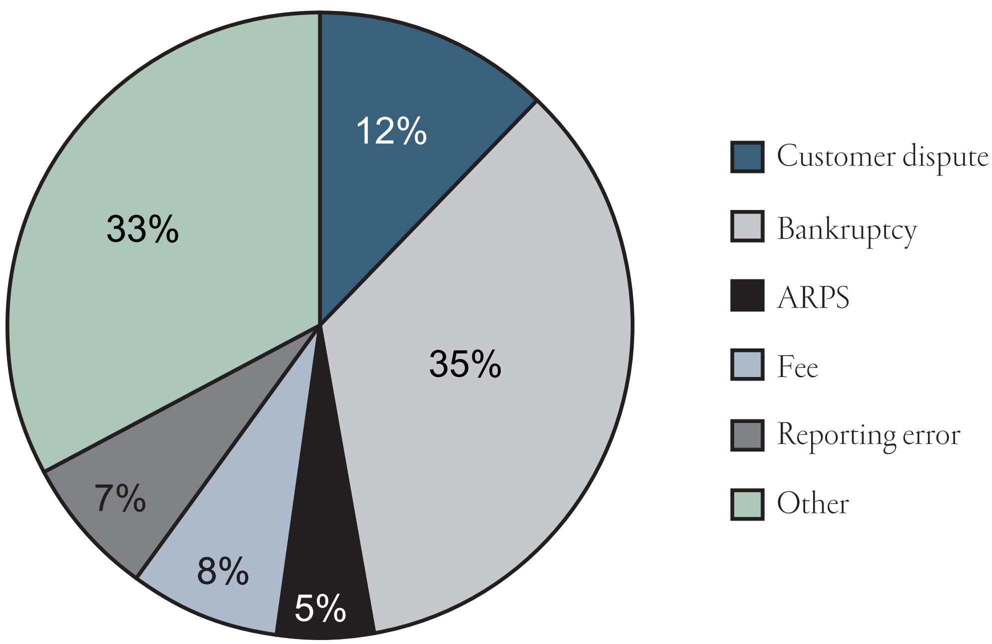
On occasion over the years, mutual funds have been involved in proceedings brought under federal bankruptcy laws, typically for no reason other than the funds' status as passive holders or former holders of securities of the bankrupt issuers. In these proceedings, bankrupt issuers and/or their creditors often seek a return of pre-bankruptcy payments made to security holders or other creditors, including funds. Recent bankruptcy proceedings (including proceedings for the Tribune Company and for Lyondell Chemical Company) have included a number of funds as parties.[54] The Tribune and Lyondell proceedings remain pending.

D&O/E&O Claims Data

D&O/E&O Notices – 2011

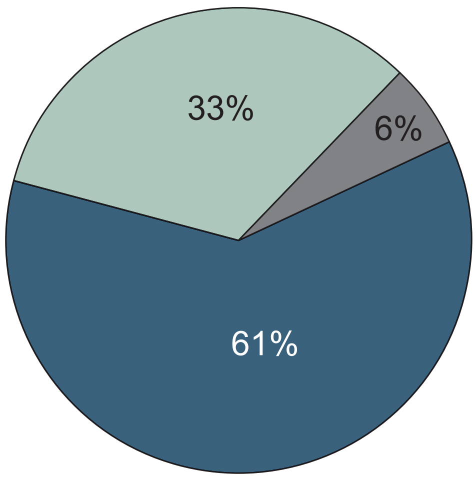
The most common subject matters in claims notices provided under ICI Mutual D&O/E&O policies in 2011 included (1) bankruptcy proceedings; (2) customer disputes (i.e., disputes between insureds and individual customers, including individual fund shareholders and separately managed accounts, regarding various investment management or account administration matters); and (3) lawsuits and regulatory proceedings relating to fees.

D&O/E&O Notices by Subject (2011)



D&O/E&O Insurance Payments by Category (2000-2011)

The first chart below shows the breakdown of payments (i.e., defense costs, settlements and judgments, and costs of correction) made by ICI Mutual on claims submitted from January 1, 2000 through December 31, 2011 under ICI Mutual D&O/E&O policies. The second chart shows the same information, but *excludes* payments made on insurance claims associated with the mutual fund trading scandal of 2003-2004.

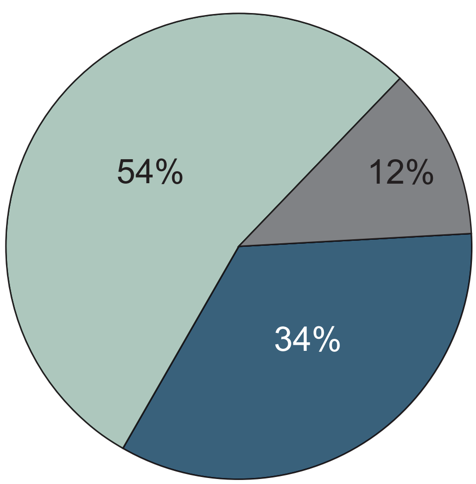


(2000-2011, *including* scandal-related claims)

Defense Costs

Settlements & Judgments

Costs of Correction



(2000-2011, *excluding* scandal-related claims)

Endnotes

[1] At the time this *Claims Trends* went to press, the motion to dismiss remained pending in In re Reserve Primary Fund Secs. & Derivative Class Action Litig., No. 1:08-cv-8060 (S.D.N.Y. filed Sept. 17, 2008).

[2] Yu v. State Street Corp., 774 F. Supp. 2d 584 (S.D.N.Y. 2011) (The court had first dismissed the lawsuit in early 2010, but permitted the plaintiffs to file an amended complaint, which was dismissed in the March 31, 2011 order.); Yu v. State Street Corp., No. 11-1908 (2d Cir. Nov. 10, 2011) (remanding the case to the district court for the limited purpose of considering and approving a settlement reached by the parties).

[3] In re Oppenheimer Rochester Funds Group Secs. Litig., 2012 U.S. Dist. LEXIS 6975 (D. Colo. Jan. 20, 2012); Zametkin v. Fidelity Mgmt. & Research Co., No. 1:08-cv-10960 (D. Mass. Nov. 16, 2010); In re Morgan Keegan Secs., Derivative & ERISA Litig., 2010 U.S. Dist. LEXIS 104246 (W.D. Tenn. Sept. 30, 2010); In re Evergreen Ultra Short Opportunities Fund Secs. Litig., 705 F. Supp. 2d 86 (D. Mass. 2010); Gosselin v. First Trust Advisors L.P., 2009 U.S. Dist. LEXIS 117737 (N.D. Ill. Dec. 17, 2009); In re Charles Schwab Corp. Secs. Litig., 257 F.R.D. 534, 2009 U.S. Dist. LEXIS 8125 (N.D. Cal. 2009).

[4] *See*, *e.g.*, In re Oppenheimer Rochester Funds Group Secs. Litig., 2012 U.S. Dist. LEXIS 6975 (D. Colo. Jan. 20, 2012) (court "unconvinced by [*Yu*'s] holding that misrepresentations in open-end mutual fund prospectuses are categorically excluded from investors' reach under the 1933 Act").

[5] In re Oppenheimer Champion Fund Secs. Fraud Class Actions, No. 1:09-cv-00386 (D. Colo. Sept. 30, 2011) & Ferguson v. OppenheimerFunds, Inc., No. 1:09-cv-01186 (D. Colo. Sept. 30, 2011) (final settlement of both lawsuits); Zametkin v. Fidelity Mgmt. & Research Co., No. 1:08-cv-10960 (D. Mass. Nov. 16, 2010) (settlement awaiting final court approval); Gosselin v. First Trust Advisors L.P., 2009 U.S. Dist. LEXIS 117737 (N.D. Ill. Dec. 17, 2009) (final settlement); In re Charles Schwab Corp. Secs. Litig., No. 3:08-cv-1510 (N.D. Cal. Apr. 19, 2011) (final settlement).

[6] Stoopler v. Direxion Shares ETF Trust, No. 1:09-cv-8011 (S.D.N.Y. Mar. 6, 2012) (denying motion to dismiss third amended complaint); In re ProShares Trust Secs. Litig., No. 1:09-cv-6935 (S.D.N.Y. filed Aug. 5, 2009) (motion to dismiss pending).

[7] Rafton v. Rydex Series Funds, No. 5:10-cv-1171 (N.D. Cal. Jan. 5, 2011) (order granting in part and denying in part motion to dismiss); Rafton v. Rydex Series Funds, No. 5:10-cv-1171 (N.D. Cal. Feb. 10, 2012) (final approval of settlement).

[8] Janus Capital Group v. First Derivative Traders, 131 S. Ct. 2296 (2011).

[9] *See*, *e.g.*, John D. Donovan & Rodman K. Forter, Jr., *Keep Calm and Carry On, Janus Doesn't Change Much*, BOARDIQ (June 21, 2011) ("Mutual fund investors have always been able to sue their funds and directors for misrepresentations under both the '33 Act and Rule 10b-5. Nothing in Janus alters that existing framework, and nothing in Janus suggests any further expansion of the scope of that potential liability.").

[10] *See, e.g.,* SEC v. Daifotis, 2011 U.S. Dist. LEXIS 83872 (N.D. Cal. Aug. 1, 2011) (declining to apply *Janus* to securities fraud claims under section 17(a) of the '33 Act).

[11] 15 U.S.C. § 80a-35(b) (2007).

[12] Jones v. Harris Assocs. L.P., 130 S. Ct. 1418, 1426 (U.S. 2010). This standard was first articulated by a federal appellate court in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982).

[13] Jones v. Harris Assocs. L.P., No. 07-1624 (7th Cir. filed Mar. 20, 2007), *remanded from* Jones v. Harris Assocs. L.P., 130 S. Ct. 1418 (U.S. 2010).

[14] Gallus v. Ameriprise Fin., Inc., 2012 U.S. App. LEXIS 6424 (8th Cir. Mar. 30, 2012); Steinberg v. Janus Capital Management, LLC, 2011 U.S. App. LEXIS 24053 (4th Circ. Dec. 2, 2011) (unpublished per curiam decision); In re Am. Mut. Funds Fee Litig., No. 10-55221 (9th Cir. Aug. 24, 2011) (unpublished decision).

[15] *See* In re Salomon Smith Barney Mut. Fund Fees Litig., 425 Fed. Appx. 25 (2d Cir. 2011), *dismissed per stipulation*, No. 1:04-cv-4055 (S.D.N.Y. Oct. 20, 2011).

[16] Bennett v. Fidelity Mgmt. & Research Co., No. 1:04-cv-11651 (D. Mass. Jan. 27, 2012); In re Federated Mut. Funds Excessive Fee Litig., No. 04-cv-00352 (W.D. Penn. May 2, 2011).

[17] Turner v. Davis Selected Advisers, L.P., No. 4:08-cv-421 (D. Ariz. June 1, 2011) (order granting motion to dismiss).

[18] *See* Curran v. Principal Mgmt. Corp., LLC, No. 09-cv-433 (S.D. Iowa Mar. 4, 2011) (order denying motion for reconsideration); Curran v. Principal Mgmt. Corp., LLC, No. 11-cv-555 (S.D. Iowa filed Nov. 23, 2011) (complaint re-filed).

[19] Specifically, in the underlying lawsuit, the plaintiffs claimed that the defendants charged certain retirement plans and, indirectly, plan participants, "unreasonable and excessive fees," and thereby breached their fiduciary duties under ERISA and engaged in prohibited transactions in violation of ERISA. Santomenno v. John Hancock Life Ins. Co., 2011 U.S. Dist. LEXIS 55317 (D.N.J. May 23, 2011). On appeal, the Third Circuit affirmed the lower court's dismissal of the ICA claims, but vacated the dismissal of the ERISA claims and remanded the lawsuit for further proceedings. Santomenno v. John Hancock Life Ins. Co., 2012 U.S. App. LEXIS 7545 (3d Cir. Apr. 16, 2012).

A similar case was filed in early 2011 by the same plaintiffs' lawyers against another insurance company and certain affiliated investment advisers. That lawsuit also challenges fees under ERISA and seeks to recover advisory fees, but, rather than alleging violation of section 36(b), the lawsuit seeks to recover certain fees based on the allegation that one defendant acted as an unregistered investment adviser in violation of IAA section 203. A motion to dismiss in the case remains pending. Santomenno v. Transamerica Life Ins. Co., No. 11-cv-00736 (D.N.J. filed Feb. 8, 2011).

[20] Southworth v. Hartford Inv. Fin. Servs. LLC, No. 10-cv-878 (D. Del. Nov. 7, 2011) (following the court's Sept. 2011 order granting in part and denying in part the motion to dismiss, the lawsuit was voluntarily dismissed with prejudice in Nov. 2011); Kasilag v. Hartford Inv. Fin. Servs. LLC, No. 11-cv-01083 (D.N.J. filed Feb. 25, 2011) (following the court's Sept. 2011 order granting in part and denying in part the motion to dismiss, an amended complaint was filed; the motion to dismiss the amended complaint is pending).

[21] Reso v. Artisan Partners Ltd. P'ship, 11-cv-873 (E.D. Wisc. Nov. 18, 2011) (order denying motion to dismiss); Sivolella v. AXA Equitable Life Ins. Co., No. 11-cv-4194 (D.N.J. filed July 21, 2011) (motion to dismiss pending).

[22] Halebian v. Berv, 631 F. Supp. 2d 284, 289 (S.D.N.Y. 2007).

[23] Halebian v. Berv, 644 F.3d 122 (2d Cir. 2011).

[24] Smith v. Franklin/Templeton Distribs., No. 10-17648 (9th Cir. June 15, 2011).

[25] Wiener v. Eaton Vance Distribs., Inc., No. 11-1446 (1st Cir. June 24, 2011).

[26] Smith v. OppenheimerFunds Distrib., Inc., Nos. 1:10-cv-7387 & 1:10-cv-7394 (S.D.N.Y. June 14, 2011).

[27] *See* UBS Global Asset Management (Americas) Inc., Adm. Proc. No. 3-14699, ICA Release No. 29920 (SEC Jan. 17, 2012) (SEC finds that adviser failed to cause fixed-income securities in fund portfolios to be valued in accordance with fund fair valuation procedures); Lisa B. Premo, Adm. Proc. No. 3-14697, ICA Release No. 29919 (SEC Jan. 17, 2012) (SEC institutes proceeding against fund portfolio manager, alleging that portfolio manager failed to inform valuation committee of material information regarding a collateralized debt obligation held by the fund).

[28] *See* Alpine Woods Capital Investors, LLC and Samuel A. Lieber, Adm. Proc. No. 3-14233, ICA Release No. 3154 (SEC Feb. 7, 2011) (SEC finds that IPO allocation practices at fund adviser resulted in two small, recently-opened funds participating in a disproportionate number of IPOs compared to other existing funds, and that adviser failed (i) to disclose to fund board or fund investors the extent to which the smaller funds invested in

IPOs and the impact IPO trading had on their performance, and (ii) to implement appropriate IPO allocation policies and procedures).

[29] *See* SEC v. Charles Schwab Inv. Mgmt., No. 11-0136 (N.D. Cal. Feb. 16, 2011); SEC v. Daifotis, No. 11-0137 (N.D. Cal. filed Jan. 1, 2011) (in companion credit crisis-related lawsuits, the SEC charges fund adviser, certain senior advisory personnel, and certain affiliates with, among other things, offering and selling a fixed-income fund as a "cash alternative" without adequate disclosure, and with deviating from the fund's concentration policy); *see also* Charles Schwab Inv. Mgmt., Adm. Proc. No. 3-14184, ICA Release No. 29522 (SEC Jan. 11, 2011).

[30] *See* Morgan Stanley Inv. Mgmt. Inc., Adm. Proc. No. 3-14628, ICA Release No. 29862 (SEC Nov. 16, 2011) (SEC finds violations of ICA and IAA in connection with fees paid to foreign sub-adviser for services that were not provided.).

[31] *See, e.g.,* Robert L. Burns, No. 3-12978, ICA Rel. No. 29746 (SEC Aug. 5, 2011) (affirming ruling of administrative law judge in censuring equity trader at fund adviser, and ordering trader to cease-and-desist and pay moneys in disgorgement and as a civil penalty, where trader accepted gifts from brokerage firms to which he sent orders on behalf of client funds).

[32] *See* Kimball L. Young, Adm. Proc. No. 3-14178, ICA Rel. No. 29549 (SEC Jan. 7, 2011), Thomas S. Albright, Adm. Proc. No. 3-14179, ICA Rel. No. 29550 (Jan. 7, 2011) (SEC finds that co-portfolio managers breached their fiduciary duties by improperly charging bond issuers "credit monitoring fees" on certain private placement and non-rated bond offerings in fund portfolio.).

[33] *See SEC Charges Morgan Stanley Investment Management for Improper Fee Arrangement*, SEC, Press Release (Nov. 16, 2011), http://www.sec.gov/news/press/2011/2011-244.htm; *see also Fund Fee Investigations Under Way: SEC Official*, IGNITES.COM (Nov. 15, 2011), http://www.ignites.com/ignites/index.php/c/274801/32621/fund_investigations_under_official (quoting co-chief of the Enforcement Division's asset management unit as saying "Fee issues for mutual funds are a priority for the unit …. We have a number of investigations ongoing.").

[34] SEC v. Citigroup Global Mkts. Inc., No. 1:11-cv-07387 (S.D.N.Y. Nov. 28, 2011).

[35] SEC v. Citigroup Global Mkts. Inc., No. 11-5227 (2d Cir. Mar. 15, 2012).

[36] The coverage also requires the insured to obtain ICI Mutual's advance consent before incurring any costs for which the insured may seek reimbursement. *See generally* ICI Mutual's 2009 risk management study, *Mutual Fund D&O/E&O Insurance* (at pp. 35-36, discussing insurance for the costs of correcting operations-based errors).

[37] Efforts by the plaintiffs' bar to utilize state law class actions and state law derivative actions may reflect the narrowing in recent years of other legal avenues available to them for attacks on the fund industry. In particular, the courts, in a number of decisions over the past decade, have refused to find "implied" rights of action under various provisions of the ICA. 2011 saw additional decisions favorable to the industry in this regard. *See* Smith v. Oppenheimer Funds Distrib., Inc., No. 10 Civ. 7387, 10 Civ. 7394, (S.D.N.Y. June 6, 2011) (ICA sections 47(b) and 36(a)); Wiener v. Eaton Vance Distribs., Inc., No. 10-10515 (D. Mass. Mar. 30, 2011) (same).

[38] As reported in prior editions of *Claims Trends,* in an earlier wave of ARPS lawsuits, initiated in 2008-2009, ARPS holders themselves pursued litigation against funds, fund officers and directors, and/or fund advisers. Only one of these lawsuits appears to remain active. *See* Kastel v. Nuveen Invs. Inc., No. 1:09-cv-646 (M.D.N.C. filed Aug. 21, 2009) (motions to dismiss, filed in June and July 2010, remain pending).

[39] *See* Safier v. Nuveen Asset Mgmt., No. 2010-ch-32166 (Ill. Cir. Ct. Dec. 16, 2011); Klein v. Cohen & Steers Capital Mgmt., Inc., No. 651467-2010 (N.Y. Sup. Ct. Apr. 15, 2011); Gammon v. Cohen & Steers Capital Mgmt., Inc., No. 651378-2010 (N.Y. Sup. Ct. Apr. 14, 2011); Richelson v. John Hancock Advisers, LLC, No. 10-3355A (Mass. Super. Ct. Mar. 3, 2011).

[40] *See* Curbow v. BlackRock Advisors, LLC, No. 651104-2010 (N.Y. Sup. Ct. filed July 27, 2010); Curbow Family LLC v. Morgan Stanley Inv. Advisors, Inc., No. 651059-2010 (N.Y. Sup. Ct. filed July 22, 2010); Rotz v. Van Kampen Asset Mgmt., Inc., No. 651060-2010 (N.Y. Sup. Ct. filed July 22, 2010)

[41] *See* Rutgers Enhanced Ins. Co. v. Esty, No. 10-4111 (Mass. Super. Ct. July 25, 2011); Manuszak v. Esty, Nos. 10-3456 & 10-3457 (Mass. Super. Ct. July 6, 2011); Beckham v. Keith, No. 10-cv-3574 (Mass. Super. Ct. June 15, 2011).

[42] *See* Brown v. Calamos, No. 10-cv-6558 (N.D. Ill. Mar. 14, 2011), *aff'd*, 664 F.3d 123 (7th Cir. 2011).

[43] *See* Brown v. Calamos, 664 F.3d 123 (7th Cir. 2011), *petition for cert. filed* (U.S. Mar. 26, 2012) (No. 11-1173).

[44] In another important 2011 case involving mutual funds and SLUSA, the Sixth Circuit affirmed a dismissal of shareholder state law claims in a credit crisis-related lawsuit. The Sixth Circuit ruled that SLUSA precluded these state law claims, and rejected the plaintiff's argument that SLUSA was inapplicable by reason of an exception in the SLUSA statute known as the "Delaware carve-out." *See* Atkinson v. Morgan Asset Mgmt., Inc., 2011 U.S. App. LEXIS 18612 (6th Cir. Sept. 8, 2011).

[45] *See* Rutgers Cas. Ins. Co. v. Calamos, No. 11-cv-462 (N.D. Ill. Mar. 15, 2012); Bourrienne v. Calamos, No. 10-cv-07295 (N.D. Ill. Aug. 4, 2011) (appeal to Seventh Circuit voluntarily dismissed by parties).

[46] *See* McBrearty v. Vanguard Group, Inc., 353 Fed. Appx. 640 (2d Cir. 2009), *cert. denied*, 130 S. Ct. 3411 (2010); Seidl v. Am. Century Cos., 427 Fed. Appx. 35 (2d Cir. 2011), *cert. denied*, 132 S. Ct. 846 (2011).

[47] Hartsel v. Vanguard Group, Inc., 2012 Del. LEXIS 23 (Del. 2012).

[48] *See* Gomes v. Am. Century Co., No. 4:10-cv-0083 (W.D. Mo. Feb. 16, 2012) (order granting motion to dismiss).

[49] *See* Seidl v. Am. Century Co., No. 4:10-cv-04152 (W.D. Mo. filed July 15, 2010) (motion to dismiss pending); Gamoran v. Neuberger Berman LLC, No. 1:11-cv-7957 (S.D.N.Y. filed Nov. 8, 2011) (motion to dismiss pending).

[50] *See* Halebian v. Berv, 644 F.3d 122 (2d Cir. 2011); Ryskamp v. Looney, 2011 U.S. Dist. LEXIS 41506 (D. Colo. Apr. 15, 2011) (denying motion to dismiss).

[51] Prudential Ret. Ins. and Annuity Co. v. State St. Bank and Tr. Co., 2012 U.S. Dist. LEXIS 13556 (S.D.N.Y. Feb. 3, 2012).

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

[53] Tussey v. ABB Inc., No. 2:06-cv-04305 (W.D. Mo. Mar. 31, 2012).

[54] *See*, *e.g.*, Off. Comm. of Unsecured Creditors of Tribune Co. v. JPMorgan Chase Bank, N.A., 1:10-ap-55841 (Bankr. D. Del. filed Dec. 6, 2010) & Off. Comm. of Unsecured Creditors of Tribune Co. v. Fitzsimons, No. 1:10-ap-54010 (Bankr. D. Del. filed Nov. 1, 2010) (both adversarial proceedings in In re Tribune Co., No. 1:08-bk-13141 (Bankr. S.D.N.Y. filed Dec. 8. 2008)); Weisfelner v. Morgan Stanley & Co., Inc., No. 10-ap-04609 (Bankr. S.D.N.Y. filed Dec. 1, 2010) (adversarial proceeding in In re Lyondell Chemical Co., No. 1:09-bk-10023 (Bankr. S.D.N.Y. filed Jan. 6, 2009)).

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