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MUTUAL FUNDS

The Market Meltdown and Mutual Fund Investors: Likely Claims and Several Potential Defenses

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According to the Financial Industry Regulatory Authority (FINRA), 2009 witnessed a significant increase in arbitration filings and complaints by mutual fund investors. Contrary to past experience, mutual funds now make the largest single product source for customer complaints, outpacing claims arising from investments in common stocks and corporate bonds. Overall, FINRA reports that the total number of new arbitration claims filed in 2009 approached the level of activity last witnessed in the ''tech wreck'' era of 2001–2004.[1]

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One likely reason for this surge of claims by fund investors is alleged losses from funds with exposure to structured finance products often associated with the subprime, ''Alt-A'' or commercial real estate markets. By 2006, the market for issuance of mortgage-backed

[1] ''Summary Dispute Resolution Statistics'' reported at http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/.

securities (MBS) swelled to the point that it eclipsed the municipal bond market in dollar amount.[2] Many of these securities carried investment grade ratings issued by the credit rating agencies, and later were purchased by mutual fund portfolio advisors.

Beginning in 2007, the mortgage markets in the United States buckled under the weight of the subprime mortgage sector. It has been estimated that by January 2008 more than half of the structured finance securities issued in the United States in 2006 and 2007 had been downgraded by the rating agencies. Former Securities and Exchange Commission (SEC) Chairman Christopher Cox has noted that, as of February 2008, Moody's Investors Service had downgraded at least one portion, or tranche, of more than 94% of the subprime residential mortgage-backed securities it rated in 2006.[3] These downgrades caused a precipitous drop in the credit markets and adversely affected the values of both investment grade and non-investment grade instruments, including the holdings in mutual funds. The net asset value (NAV) of many mutual funds holding MBS eroded, and litigation followed soon thereafter as plaintiffs initiated class action lawsuits as well as FINRA arbitrations. This article will examine the common law claims filed by these investors, along with causes of action arising under the federal securities laws, and the most common defenses available to these claims.

Typical Investor Claims

Common Law Claims: Breach of Fiduciary Duty and Suitability. FINRA reports that breach of fiduciary duty was the most frequent legal claim asserted in cases filed during 2009. It is likely that most of the cases styled as a fiduciary duty claim involve allegations of unsuitable investment recommendations, under NASD (National Association of Securities Dealers) Rule 2130, or that the broker should have advised the customer when to sell the security at issue.

As a general rule, federal case law holds that a fiduciary relationship does not arise between a broker-dealer and a customer in the absence of a discretionary or fee-based account.[4] The majority view is that a broker-dealer has no continuing duty to a customer after execution of a recommended transaction.[5] Claimants often argue such a continuing obligation exists under the guise of ''fiduciary duties.''

Although mutual fund investors commonly include a claim for breach of fiduciary duty, or unsuitable recommendations, this is typically accompanied by claims of alleged misrepresentation or omissions in the written disclosure documents that accompany the purchase of shares in a mutual fund. These claims usually fall within the purview of the Securities Act of 1933, the Securities Exchange Act of 1934, or comparable provisions under state ''blue sky'' securities laws.

The Securities Act of 1933. A common theme running through actions brought by mutual fund investors is the allegation that registration statements and prospectus materials of the mutual funds contain material misrepresentations giving rise to liability under §§ 11(a) and 12(a)(2) of the Securities Act.[6] Although in court actions these claims typically are asserted against the mutual fund issuer, it is not uncommon to see such claims asserted against broker-dealers in arbitrations.[7]

Sections 11(a) and 12(a)(2) address misrepresentations made in registration statements or prospectus materials. Under these sections, claimants argue that civil liability attaches based simply on material misrepresentations contained in registration statements or prospectus materials. A material misrepresentation occurs when there is a ''substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.''[8] It should be noted that the 1933 Act applies to the initial issuance of a security, rather than transactions in the secondary market.

Section 11(a) provides for civil liability against every person who signs a mutual fund's registration statement (including the fund itself), every person who was a director or partner in the issuer at the time of the filing, every person who is named in the registration statement, the fund's auditors, and the fund's underwriters when ''any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.''[9] The measure of damages available for a violation of § 11(a) is the difference between the amount paid for the securities and the value of the securities on the date suit was brought or the amount for which the securities were sold prior to the suit.[10]

Similarly, § 12(a)(2) provides for civil liability against any person who sells a security ''by means of a prospectus . . . which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.''[11] The measure of damages available for a violation of § 12(a)(2) is ''the consideration paid for such security with interest theron, less the amount of any income received thereon.''[12]

The Securities Exchange Act of 1934. Plaintiffs commonly allege misrepresentations based on verbal or written representations regarding the fund's objectives

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[2] Securities Industry and Financial Markets Association (SIFMA), reported at http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USMortgageRelatedIssuance.pdf.

[3] SEC Chairman Christopher Cox, *Testimony Concerning Oversight of Nationally Recognized Statistical Rating Organizations*, Securities Regulation Alert (April 22, 2008).

[4] In 2007, SEC Rule 202 was interpreted to provide that a fiduciary relationship applies to most fee-based brokerage accounts, as well as investment advisory accounts. *Financial Planning Association v.SEC,* 482 F.3d 481 (D.C. Cir. 2007).

[5] *de Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002).

[6] 15 U.S.C. §§ 77k(a) and 77l(a)(2).

[7] This situation occurs because FINRA arbitration panels have jurisdiction over broker-dealers, but not the funds themselves, which typically are not FINRA member firms, and the FINRA Code of Arbitration Procedure prohibits arbitration of shareholder derivative actions. FINRA Rule 12205.

[8] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[9] 15 U.S.C. § 77k(a).

[10] 15 U.S.C. § 77k(e).

[11] 15 U.S.C. § 77l(a).

[12] *Id.*

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or describing the fund's holdings. Investors allege that the registration statement's stated objectives did not align with the fund's actual investments, or that the registration statement did not fully disclose the nature of the fund's holdings, or valuation or liquidity issues. In order to prevail on a claim arising under Rule 10b-5, a plaintiff must prove (1) the issuer made a material representation (2) that was false (3) knowing that the statement was false, or without any knowledge of its truth, (4) which was made with the intention that plaintiff rely on the representation, (5) upon which plaintiff did justifiably rely, (6) that proximately caused damages to plaintiff, and (7) that plaintiff acted with due diligence.[13]

Several Viable Defenses

Despite the seemingly expansive scope of federal securities law claims, there are a number of viable defenses available. Several of these are summarized below.

The ''Bespeaks Caution'' Defense. Mutual fund prospectuses and marketing materials usually include cautionary or disclaiming statements that may effectively negate the purported misrepresentation. For example, statements of a fund's objectives accompanied by a statement that it is not guaranteed that those objectives will be met, or that it is possible that an investor may lose his/her investment, render it unreasonable for the investor to consider the statement of the fund's objectives without contemporaneously considering the cautionary statements. Similarly, if a fund is compared to a benchmark index, it may be unreasonable for an investor to disregard an explanation for inclusion of the benchmark index and to conclude that the benchmark index reflects the credit risk of the fund.[14] Finally, if a fund's registration statement describes its holdings in detail and outlines the specific risks associated with its holdings, an investor cannot reasonably ignore such a description in reliance on alleged misstatements concerning the fund's holdings contained elsewhere in the registration statement. ''Documents. . . which clearly bespeak caution, are not the stuff of which securities fraud claims are made.''[15]

The Unforeseeable Nature of the Credit Market Meltdown. Most, if not all, of the mutual funds brought to market were premised upon the assumption that markets will continue to operate in an orderly fashion, that credit ratings on investments are appropriate, and that the financial system has sufficient safeguards to avoid a widespread market calamity. All of these assumptions were put to the test with the market meltdown that began in the subprime markets in 2007 and then spread throughout the credit and equity markets. While this crisis had a devastating effect on many mutual funds, the improbable nature of these events provides a defense to most investor claims.

The fact that an investment decision, in the exercise of hindsight, simply proves to be unprofitable does not give an investor a right to recover his/her losses. As the U.S. Court of Appeals for the Second Circuit Court explained:

> It is hardly a sound argument . . . to say that some other unspecified income funds performed better. That is only to say in hindsight that the managers of those funds turned out to be more skillful in their predictions.
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> * * *
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> But *any* investment that turns out badly can appear to be – in hindsight – a low return, high risk investment. Not every bad investment is the product of misrepresentation.[16]

Loss Causation. Loss causation requires ''a causal connection between the material misrepresentation and the loss.''[17] This is essentially an issue of proximate causation. To establish proximate cause, a plaintiff must show ''that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered'' and that ''the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security.''[18] The loss cannot be attributable to a downturn in the market, such as the mortgage market meltdown.[19]

Both §§ 11 and 12 provide for the affirmative defense of ''loss causation.'' Section 11 provides that ''if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.''[20] Section 12 contains a similar defense for sellers of securities.[21]

Even though loss causation is an affirmative defense to §§ 11 and 12, courts have granted defendants' motions to dismiss when it appears on the face of the complaint that the plaintiff cannot recover due to the absence of loss causation.[22]

The value of a mutual fund share is calculated according to a statutory formula: each day the fund's NAV is determined by totaling the fund's assets and then subtracting the aggregate liabilities. The per-share NAV is determined by dividing the NAV by the number of outstanding shares. Open-end mutual fund shares differ from shares of ordinary stock in that no secondary market exists for mutual fund shares; they are offered continuously and redeemed by the fund. Thus, a mutual

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[13] *See* 17 C.F.R. § 240.10b-5; *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1046-47 (11th Cir. 1987).

[14] *Hunt v. Alliance North Am. Gov't Income Trust*, 159 F.3d 723, 730 (2d Cir. 1998).

[15] *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991) (internal quotations omitted).

[16] *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 8-9 (2d Cir. 1996) (emphasis in original).

[17] *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

[18] *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 173 (2d Cir. 2005).

[19] *See, e.g.*, *In re Mutual Funds Inv. Litig.*, 384 F. Supp. 2d 845, 866 (D. Md. 2005).

[20] 15 U.S.C. § 77k(e).

[21] 15 U.S.C. § 77l(b).

[22] David M. Geffen, *A Shaky Future for Securities Act Claims Against Mutual Funds*, 37 Sec. Reg. L.J. 20 (2009) (citing *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 289 F. Supp. 2d 429, 437 (S.D.N.Y. 2003); *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 253-254 (S.D.N.Y. 2003); *In re DoubleClick, Inc. Privacy Litig.*, 154 F. Supp. 2d 497, 508 (S.D.N.Y. 2001) (''a court may properly dismiss a claim on the pleadings when an affirmative defense appears on its face'')).

fund's NAV turns, not on statements in its registration statement or prospectus materials, but on the valuation of its underlying investments. Any misstatements in a fund's registration statement or prospectus materials cannot inflate the shares' NAV or, when revealed, diminish the shares' NAV.[23] Since decreases in the shares' NAV are the only measure of damages available under §§ 11 and 12, plaintiffs cannot prove loss causation for §§ 11 and 12. For purposes here, investors' losses from mutual funds holding MBS arise from the devaluation of the funds' underlying investments in MBS, not from alleged misstatements in the registration statements or prospectus materials, and no damages are available under §§ 11 or 12.

Conclusion

Investors who lost money in mutual funds holding MBS are suing the funds' issuers and distributors to recoup their losses, alleging that the funds' registration statements contained material misrepresentations in violation of §§ 11 and 12 of the Securities Act. The bases for the plaintiff investors' claims are subject to several general defenses, including the ''bespeaks caution'' doctrine and the loss causation requirement. These defenses will often provide the first line of defense to actions brought by investors under §§ 11 and 12 against issuers of mutual funds.

[23] *Id.*

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