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by David M. Geffen
Dechert LLP

Published in *Securities Regulation Law Journal*
Spring 2009

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A Shaky Future For Securities Act Claims Against Mutual Funds

By David M. Geffen*

Investors who purchase shares of a mutual fund[1] while the fund's registration statement contains a material misleading statement have broad legal recourse under § 11(a)[2] and § 12(a)(2)[3] of the Securities Act of 1933.[4] These shareholders can prevail in a lawsuit to recover any subsequent decrease in the shares' value without claiming they relied on the misleading statement or that a defendant was at fault with respect to the misleading statement. Moreover, the shareholders' § 11(a) and § 12(a)(2) claims do not have to meet heightened pleading requirements that apply solely to fraud-based claims.

However, § 11 and § 12 each provide a "loss causation" affirmative defense that defendants have used to defeat § 11(a) and § 12(a)(2) claims at the pleading stage of a lawsuit. The affirmative defense is available to a defendant who can show that the prospectus' material misstatement or omission[5] did not cause the plaintiff's losses. This article explains why, for a mutual fund and related defendants, establishing a loss causation defense is uncomplicated.

Further, when it is obvious from the pleadings in a lawsuit that a plaintiff cannot recover his alleged losses due to the defendant's loss causation defense, dismissal of the plaintiff's claims under § 11(a) or § 12(a)(2) is proper. Accordingly, investor-plaintiffs will find it increasingly difficult to prevail in § 11(a) and § 12(a)(2) claims based on a fund's prospectus misstatements. In turn, this should deter investors from instigating these Securities Act claims against mutual funds and related parties. Perhaps, funds may become less inclined to make rescission offers to cut off Securities Act liability.

Part I of this article describes the elements of Securities Act claims under § 11(a) and § 12(a)(2), including the price-depreciation measure of damages within both statutes. Under that measure of damages, there is no liability for depreciation in the value of the plaintiffs fund's shares if the defendant can show that the depreciation was not caused by the misstatements identified by the plaintiff in the fund's registration statement (prospectus).[6] Part II then

* Counsel, Dechert LLP, Boston, Massachusetts; J.D. Harvard Law School 1987; S.B. Massachusetts Institute of Technology 1984. The author wishes to acknowledge the helpful comments of Margaret Bancroft and Ned Dodds, both of Dechert LLP, New York City. However, any errors herein are the author's, and any opinions or conclusions expressed herein are not necessarily those of Dechert LLP.

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provides a primer on the causation terminology used in the reported loss causation decisions.

Part III contains the core analysis of this article. Unlike an ordinary share of stock traded on a stock exchange, the value of a mutual fund share is calculated according to a statutory formula. The absence of a secondary market for a mutual fund's shares means that there is no mechanism for a misstatement in the fund's prospectus or the revelation of that misstatement to affect a fund shares' value and, therefore, there is no mechanism to cause a plaintiff's losses. The fact that any depreciation in the shares' value *cannot* be caused by any misstatement identified by the plaintiff means that a fund defendant can prevail by establishing a loss causation defense. Part IV presents the practical implications of these conclusions.

Part V.A of this article discusses the reported decisions, beginning in 2003, in which a court relied on the same conclusions in Part III to dismiss § 11(a) or § 12(a)(2) claims against mutual funds and related defendants. Part V.B discusses two outlier cases that rejected the conclusions in Part III of this article. The two cases are presented to remind practitioners that the structure and operation of mutual funds may not be obvious to a court. To avoid a spurious causation analysis by the court, counsel should educate the court about fund structure and operation and about how the value of a fund's shares is determined.

Prospectively, other courts may seek to reject the analysis in this article's Part III due to the increased ease with which a fund or a fund-related defendant could escape liability under § 11(a) or § 12(a)(2). Part VI.A of this article presents the counter-arguments on which such courts probably would rely to reject the analysis in this article's Part III in order to deprive a fund defendant of a loss causation defense. Part VI.B then explains the weaknesses of each of these counter-arguments.

Finally, this article's conclusions are summarized in Part VII.

I. Civil Liability under the Securities Act § 11(a) and § 12(a)(2)

The purpose of Securities Act § 11(a) and § 12(a)(2) is to protect investors who make investments based on material misstatements.[7] These two statutes provide for civil liability based solely on a misstatement in a prospectus.

Section 11(a) provides that every person signing a mutual fund's registration statement (which, under § 6(a) of the Securities Act, includes the fund), every director or trustee of the fund, the fund's executive officers, the auditors certifying the financial statements in the fund's registration statement and the fund's underwriter may be liable if "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 neces-

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sary to make the statements therein not misleading." The statutory measure of damages for violating § 11(a) is the purchase price paid by a plaintiff for the fund's shares less the value of the shares on the date suit is instigated or the shares redeemed.[8]

Section 12(a)(2) similarly provides that a mutual fund shall be liable to any investor who purchases the fund's shares by means of a prospectus that includes a material misstatement of fact or omits a fact necessary to make the statements therein not misleading. The statutory measure of damages for violating § 12(a)(2) is the purchase price paid by a plaintiff for the fund's shares less the proceeds received by the plaintiff upon redemption of the shares.[9]

A plaintiff can prevail under § 11(a) or § 12(a)(2) without showing that he relied on a prospectus' misstatements or that there was fault on the part of any defendant with respect to the misstatements. In stark contrast, in order to succeed in a claim under Rule 10b-5,[10] a plaintiff must evidence the defendant's scienter – an "intent to deceive, manipulate, or defraud".[11]

Finally, because a plaintiff's claims under § 11(a) and § 12(a)(2) do not require any allegation of fraudulent intent, the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure[12] do not apply to these Securities Act claims.[13]

In sum, if a mutual fund's prospectus contains a material misstatement, § 11(a) and § 12(a)(2) offer a shareholder broad legal recourse against a number of potential defendants, as well as a lower pleading threshold relative to a shareholder who alleges fraud. These statutes shift the burden to the defendants[14] to establish one of the affirmative defenses under § 11(a) or § 12(a)(2).[15] In view of the burden-shifting that each statute engenders, courts have stated that a defendant's liability under § 11(a) or § 12(a)(2) for a material misstatement is one of strict liability.[16] With the burden shifted to the defendants, a plaintiff increases his probability of prevailing in a motion for dismissal or summary judgment. In turn, the settlement value of the case to a plaintiff increases if the plaintiff can withstand defendant's motions for dismissal or summary judgment.[17]

Both § 11 and § 12 contain an affirmative loss causation defense that can defeat § 11(a) and § 12(a)(2) claims. Subsequent parts of this article analyze why, in the case of a mutual fund, establishing a loss causation defense should be relatively straightforward.

Before undertaking that analysis, it is necessary to understand the often-confusing terminology found in the reported loss causation decisions. Then, we can undertake the analysis that leads, in the case of mutual funds, to some interesting conclusions.

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II. The Loss Causation Decisions' Terminology

The damages formula in § 11 and § 12 is based upon the tort measure of damages, whereunder a plaintiff can recover losses proximately caused by a defendant. A finding of "loss causation" means that a misstatement in a prospectus caused the plaintiff's economic harm. The term is synonymous with the tort law concepts of "legal cause" and "proximate cause."[18] Loss causation also has been described in terms of common law fraud's concept of proximate cause, in that a plaintiff must allege a causal connection between a defendant's misstatements and the plaintiff's harm.[19] Thus, a plaintiff fails to show loss causation if an intervening cause, rather than the prospectus' misstatement, is the proximate cause of the plaintiff's economic harm.[20]

In contrast, "transaction causation" (merely) means that the misstatement caused the plaintiff to engage in the transaction for which the plaintiff seeks redress.[21] The term is synonymous with the tort law concept of "but-for cause"[22] or "cause-in-fact."[23] Transaction causation only requires a plaintiff to allege that "but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction."[24]

In *Huddleston v. Herman & MacLean*,[25] the court gave the following example to demonstrate the difference between the two types of causation:

> [A]n investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstances, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but that it did not cause the loss.

Understanding the difference between loss causation and transaction causation is important because establishing transaction causation, by itself, does not result in legal liability.[26]

III. Loss Causation, a Misstatement and a Share's Price

The value or price of an ordinary share of stock is typically determined on a stock exchange by buyers and sellers without the involvement of the stock's issuer. In contrast, the value of a mutual fund share is calculated according to a statutory formula. Specifically, each day, the values of the fund's assets (principally securities and cash) are totaled. From that total, the fund's aggregate liabilities are subtracted (*e.g.*, accrued fees payable to fund service providers) to arrive at the fund's net asset value (NAV). The fund's per-share

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NAV is simply the fund's NAV divided by the total number of shares that the fund has outstanding that day.

Mutual fund shares are also unlike an ordinary share of stock traded on a stock exchange because fund shares are offered for sale by the fund continuously[27] and redeemed by the fund when a fund shareholder chooses. Thus, shares of a mutual fund have *no secondary market*. Moreover, as required under the Investment Company Act of 1940,[28] a mutual fund's sales and redemptions of its shares must occur at a price equal to the then-current per-share NAV.[29]

It follows that, for purposes of the damages formula in both § 11 and § 12, the *maximum* amount recoverable by a plaintiff is the depreciation in the mutual fund's per-share NAV (price), measured from the time the plaintiff purchased the shares from the fund.[30] This is simply a reflection of the fact that NAV depreciation is the only amount recoverable as damages under the price-depreciation damages formula in § 11 and § 12.[31]

Section 11(e) offers a loss causation defense to a § 11(a) defendant, and is available to eliminate liability if the defendant can prove that the depreciation in the mutual fund share's NAV was not caused by the misstatements in the fund's prospectus indicated by the plaintiff.[32] Section 12(b) offers a similar loss causation defense to a § 12(a)(2) defendant who can prove that the depreciation in the fund share's NAV was not caused by the misstatements in the fund's prospectus identified by the plaintiff.[33]

A plaintiff who claims under § 11(a) or § 12(a)(2) that the NAV of his fund shares was inflated by misstatements in the fund's prospectus misses the mark due to the absence of a secondary market for the shares. The absence of a secondary market for a mutual fund's shares means that any misstatements in a fund's prospectus *by themselves* can neither inflate the shares' NAV (price) nor, when revealed, diminish the shares' NAV. Such "fraud on the market" theories cannot apply to mutual funds[34] because a misstatement in a fund's prospectus and revelation of the misstatement do not affect a fund share's NAV.[35] One court put this succinctly:

> Unlike an ordinary share of stock traded on the open market, the value of a mutual fund share is calculated according to a statutory formula. Share price is a function of "Net Asset Value", the pro-rata share of assets under management, minus liabilities such as fees. Plaintiffs explain no mechanism by which a mutual fund share's price could differ from its objective "value." The cases plaintiffs cite to support this proposition are inapposite, because they deal with securities whose price is not set by statute and therefore can be affected by market manipulations.[36]

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From the premises above, it follows that a fund defendant in a claim under § 11(a) or § 12(a)(2) can establish a loss causation defense under § 11(e) or § 12(b). The loss causation defense relies on the fact that any misstatements in the fund's prospectus and revelations of the misstatements cannot decrease the shares' NAV – such decreases are the only damages recoverable under the price-depreciation damages formula in § 11 and § 12 – and the plaintiff's inability to show otherwise.[37]

This does not mean that § 11(a) and § 12(a)(2) defendants can escape liability for prospectus misstatements. Plaintiffs still may bring suit against the same defendants and the fund's adviser under Rule 10b-5, state law and under various sections of the Investment Company Act. Instead, the conclusion offered here is narrower but, nevertheless, important: mutual fund defendants in claims under § 11(a) and § 12(a)(2) can escape liability under *those statutes* by making out a loss causation defense − *i.e.*, the prospectus misstatements and related revelations identified by the plaintiff did not cause a fund's NAV to depreciate and, therefore, did not cause the plaintiff's losses.

Two hypothetical examples will underscore these points.

Equity Fund's prospectus states that the Fund operates as a diversified fund.[38] The adviser invests Equity Fund's assets such that the Fund becomes non-diversified and, thereafter, a significant decrease in Equity Fund's NAV occurs. The adviser's misfeasance is subsequently revealed (say, in a periodic report), but that revelation does not affect the Fund's NAV.

Bond Fund's prospectus materially overstates the past performance of Bond Fund. There are no other misstatements in Bond Fund's prospectus. Nevertheless, a significant decrease in Bond Fund's NAV follows the effective date of the prospectus. The prospectus' misstatement is subsequently discovered and corrected, but neither the discovery nor the correction affects the Fund's NAV.

Equity Fund's shareholders bring a suit against Equity Fund and its directors and officers in which the shareholders seek to recover their losses under § 11(a) and § 12(a)(2) of the Securities Act based on the prospectus' misstatement concerning Equity Fund operating as a diversified fund. The plaintiffs also include claims under Rule 10b-5, various sections of the Investment Company Act and state law.

With respect to the § 11(a) and § 12(a)(2) claims, the Equity Fund defendants assert a loss causation defense, claiming that the prospectus' misstatement and related revelation did not cause Equity Fund's NAV to depreciate. The defendants highlight that the *adviser's misfeasance*, rather than the prospectus' misstatement, was the intervening and proximate cause of the plaintiffs' losses.[39]

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Bond Fund's shareholders bring a suit against Bond Fund and its directors and officers in which the shareholders seek to recover their losses under § 11(a) and § 12(a)(2) of the Securities Act based on the prospectus' misstatement concerning Bond Fund's past performance. The shareholders also include claims under Rule 10b-5, various sections of the Investment Company Act and state law. The Bond Fund defendants assert a loss causation defense, claiming that the past-performance misstatement and subsequent revelation did not cause the Fund's NAV to depreciate.

For the reasons described above, dismissal of the shareholders' Securities Act damages claims in both lawsuits is proper due to the absence of loss causation. The critical point is that, in each suit, neither the prospectus' misstatement nor the revelation thereof decreased the fund's NAV. Therefore, the misstatement and related revelation in each case did not cause the shareholders' losses under the price-depreciation damages formula in § 11 and § 12. Whether either set of plaintiffs can succeed in their claims under Rule 10b-5, various sections of the Investment Company Act or state law is a separate matter.

An actual case underscores these points. *Consolidated Market Timing Cases*[40] involved motions to dismiss § 11(a), § 12(a)(2), Rule 10b-5 and other shareholder claims against various mutual funds involved in the market-timing scandals. The plaintiffs' misrepresentation claim was that that the funds failed to disclose that they were permitting favored customers to engage in late trades and market-timed transactions.[41] The plaintiffs' Rule 10b-5 claims, which were based on a damages theory different from the price-depreciation formula in § 11 and § 12, survived the motion to dismiss.[42] However, because plaintiffs shares' NAVs had increased during the relevant period,[43] the court dismissed the plaintiffs' Securities Act claims:

> There is a more fundamental defect, however, in plaintiffs' claims under the Securities Act: they do not . . . allege facts demonstrating they have suffered harm within the meaning of either Section 11 or Section 12(a)(2). . . Further, any difference between the price paid and the later lower value or price . . . *must be attributable to the misrepresentation and not depreciation resulting from some other cause*, such as a general downtrend in the market.
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> [T]he only damages recoverable under Sections 11 and 12(a)(2) are based upon price differentials, and plaintiffs therefore have not stated any cognizable harm under those statutes.[44]

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In both hypothetical examples and in *Consolidated Market Timing Cases*, the dismissal of the shareholders' § 11(a) and § 12(a)(2) claims is not surprising, provided the price-depreciation damages formula of both statutes is kept in mind. That tort-based formula allows a plaintiffs to recover only the price depreciation caused by a prospectus misstatement. In the case of a mutual fund, there is no mechanism for a misstatement to cause a fund's NAV to depreciate and, therefore, no mechanism to cause a plaintiff's losses. Accordingly, the dismissal of the Securities Act § 11(a) and § 12(a)(2) claims, due to the absence of loss causation, is appropriate and understandable.

IV. Practical Implications for Mutual Funds

The practical implications of the conclusions in Part III of this article are important. Section 11(a) provides that every person who signs a fund's registration statement, which includes every director or trustee of the fund, is a potential defendant. The directors and trustees can be held personally liable.

When it is obvious from the pleadings in a lawsuit that a plaintiff cannot recover his alleged losses due to the defendant's loss causation defense, dismissal of the plaintiff's claims under § 11(a) or § 12(a)(2) is proper.[45] Further, if a plaintiff cannot make out a claim under either § 11(a) or § 12(a)(2), then the plaintiff may be relegated to claims under Rule 10b-5, the Investment Company Act and state law. More generally, a plaintiff's inability to make out a claim under either § 11(a) or § 12(a)(2) should deter plaintiffs from instigating lawsuits under the Securities Act against mutual funds and related defendants based on prospectus misstatements. Perhaps, mutual funds may become less inclined to make rescission offers to cut off Securities Act liability.

Finally, plaintiffs' Securities Act claims against mutual funds under § 11(a) or § 12(a)(2) are often accompanied by a claim under Rule 10b-5. In 1995, the PSLRA[46] codified the requirement that a plaintiff in a 10b-5 case must show loss causation. Therefore, the logic underlying a successful loss causation defense to a Securities Act misstatement claim may be useful, from a fund defendant's perspective, with respect to the Rule 10b-5 claim.[47]

V. Relevant Decisions

A. Cases in Accord with the Conclusions in Part III

By themselves, prospectus misstatements do not affect a mutual fund's NAV and, therefore, cannot be the cause of losses specified by the price-depreciation formula in § 11 and § 12.[48] However, not until 2003 did a court rely, in whole or in part, on these conclusions to dismiss § 11(a) or § 12(a)(2)

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claims against mutual funds and related defendants. Consider the following five cases.

Morgan Stanley[49] involved a motion to dismiss in a class action under various securities laws, including § 11(a) and § 12(a)(2) of the Securities Act. The *Morgan Stanley* plaintiffs sought damages from various mutual funds and their affiliates arising from undisclosed "shelf-space" compensation schemes to intermediaries who sold the funds' shares to the plaintiffs.[50]

The *Morgan Stanley* court dismissed the plaintiffs' § 11(a) and § 12(a)(2) claims.[51] The court's rejection of the plaintiffs' damages theory is a good articulation of the lack of a causal connection between misstatements in a fund's prospectus and changes to the fund's NAV. Specifically, Judge Owen's decision in *Morgan Stanley* stated:

> Plaintiffs plead neither cognizable losses, nor loss causation. Plaintiffs allege that they somehow were injured by overvaluing proprietary fund shares. The overvaluation is purportedly explained by the following:
>
>> Had Plaintiffs known that a substantial portion of those charges [the fees associated with the proprietary mutual funds] was not a legitimate outlay for services that would benefit the [proprietary] Funds, but was merely being used to finance the programs challenged in this lawsuit without benefit to the Fund shareholders, the value placed on those shares at the time of the purchase would have been less.
>
> This theory is incorrect as a matter of law. Unlike an ordinary share of stock traded on the open market, the value of a mutual fund share is calculated according to a statutory formula. Share price is a function of "Net Asset Value", the pro-rata share of assets under management, minus liabilities such as fees. *Plaintiffs explain no mechanism by which a mutual fund share's price could differ from its objective "value."* The cases plaintiffs cite to support this proposition are inapposite, because they deal with securities whose price is not set by statute and therefore can be affected by market manipulations.
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> All fees charged to the shareholder were disclosed in the offering prospectuses, which are incorporated by reference into the consolidated amended complaint. The allocation of the fees is immaterial, because it could have no effect on share price.[52]

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Merrill Lynch Funds,[53] decided in July 2006 by Judge Owen two months after *Morgan Stanley*, involved a similar motion to dismiss in a class action under various securities laws, including § 11(a) and § 12(a)(2) of the Securities Act. The *Merrill Lynch Funds* plaintiffs sought damages from various mutual funds and their affiliates arising from undisclosed shelf-space compensation schemes to Merrill Lynch "Financial Advisors," who sold the funds' shares to the plaintiffs.[54] Relying on the same analysis presented in *Morgan Stanley*, Judge Owen's opinion in *Merrill Lynch Funds* dismissed the plaintiffs' § 11(a) and § 12(a)(2) claims due to the plaintiffs' failure to plead a loss caused by the alleged misstatements; specifically, Judge Owen wrote:

> It is apparent on the face of the complaint that plaintiffs have not pleaded losses, let alone a loss fairly traceable to defendants. The fees charged to shareholders, which were disclosed, do not constitute a "loss", and plaintiffs have not tied the investment performance of any fund to the alleged misrepresentations and omissions. Plaintiffs offer no way the alleged [undisclosed] threats and incentives to brokers, or the "shelf space" payments made by the funds, caused them a loss.[55]

Salomon Funds[56] was the last of the Southern District's 2006 shelf-space decisions. In an opinion by Judge Crotty, the court granted the defendants' motion to dismiss the plaintiffs' § 11(a) and § 12(a)(2) claims.[57] The opinion applied the same logic that Judge Owen applied in *Morgan Stanley* (and later, in *Merrill Lynch Funds*), stating:

> The "loss suffered" of course refers to diminution of value of the mutual fund share and, here, Plaintiffs make no such allegations and, indeed, they cannot. First, disgorgement of the claimed excessive fees falls entirely outside of the federal securities scheme as Plaintiffs have not linked these fees in any way to a diminished value of the mutual fund shares. Second, where Defendants at all times disclosed the total fees in the Fund Prospectuses, allocation of fees would not affect mutual fund share value.[58]

Consolidated Market Timing Cases[59] and related proceedings involved § 11(a), § 12(a)(2) and other claims against various mutual funds and their affiliates caught in the mutual fund market-timing scandals. In *Consolidated Market Timing Cases*, the plaintiffs did not allege that they redeemed their shares (or could have redeemed their shares at the time suit was filed) for an amount less than they paid for the shares.[60] In fact, the opposite was true.[61] The court dismissed the § 11(a) and § 12(a)(2) claims because, as the court stated: "the only damages recoverable under Sections 11 and 12(a)(2) are

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based upon price differences, and plaintiffs therefore have not stated any cognizable harm under those statutes."[62]

The court then noted the loss causation requirement: "[A]ny difference between the price paid and the later lower value or price – whether at sale or at the time of suit – must be attributable to the misrepresentation and not depreciation resulting from some other cause, such as a general downtrend in the market."[63]

Finally, *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*[64] was a class action growing out of the analyst research scandals. A shareholder in a Merrill fund that invested in technology stocks sued the fund, its directors, its adviser and affiliated Merrill entities. The plaintiff alleged that the fund's registration statement and prospectuses failed to disclose several material facts, including the facts that the fund was investing in companies with which a Merrill affiliate had an investment banking relationship or about which a Merrill affiliate had issued analysts reports. The plaintiff alleged that the fund invested in the subject companies at prices that were inflated by Merrill analysts in order to assist a Merrill underwriter in obtaining investment banking business from the companies. The plaintiff's claims included claims under § 11(a) and § 12(a)(2) of the Securities Act.

The *Merrill Research Reports* court recognized that the defendants' loss causation defense under § 11(e) and § 12(b) precluded recovery of damages for decreases in the price of the shares that were not caused by material misstatements.[65] The plaintiff claimed losses stemming from the fund shares' NAV depreciation during the class period, which ended in October 2002.[66] The plaintiff claimed that information concerning investment banking conflicts, which was omitted from the fund's prospectus, was first disclosed by the New York Attorney General's instigation of proceedings against Merrill Lynch on April 8, 2002.[67]

With respect to the class period before April 8, 2002, the court dismissed the plaintiff's § 11(a) and § 12(a)(2) claims because the plaintiff's losses occurred before the Attorney General's proceedings. Prior to the Attorney General's proceedings, the fund's NAV already had declined approximately 76.5% (which was an amount proportional to the decline in the entire technology sector). Thus, the court concluded, no portion of the NAV decline could be attributed to the alleged non-disclosure and, therefore, the NAV decline could not be charged to the defendants under § 11(a) or § 12(a)(2). The plaintiff did not allege that, on April 8, 2002, the fund held shares in any of the companies mentioned in the New York Attorney General's April 8, 2002 complaint. Thus, according to the court, any decrease in the share price of those companies after April 8, 2002 would not have affected the fund's NAV

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and, therefore, could not lead to damages under § 11(a) or § 12(a)(2) for the period after April 8, 2002.[68]

B. Two Cases not in Accord with the Conclusions in Part III

While acknowledging the difference between the two types of causation, two courts seemingly merged transaction causation with loss causation as a means to reject the conclusions in Part III.

Siemers v Wells Fargo & Co.[69] was a shelf-space suit outside of the Southern District of New York in which the plaintiff alleged a violation of § 12(a)(2) based on the defendants' failure to make adequate disclosure concerning "secret" compensation paid to brokers for steering customers toward certain mutual funds. The defendants moved to dismiss the § 12(a)(2) claim on loss causation grounds.[70] Specifically, the defendants argued, because compensation to brokers is not reflected in the NAV of the funds' shares, no decrease in the price of the shares can ever be attributed to a failure to disclose shelf-space arrangements.[71]

The court rejected the defendants' loss causation defense, stating:

> The secret paybacks to the broker-dealers came out of the mutual funds' assets. Without any such secret diversion, the net assets of the fund would have been greater, thus saving investors money and increasing their net return on their investment.
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> Defendants counter this theory by asserting that the program was financed by the funds' investment advisers, not the investors. The investment advisers got their fees from the funds, however, so the cost was ultimately borne by investors holding the funds' shares. Defendants also say that the *amount* of all fees paid to investment advisers was fully disclosed even if the particular uses to which those fees were put were not revealed. Defendants contend that, since plaintiff bought shares with knowledge of the amount of the fees, he cannot now claim that he suffered a cognizable loss from them. Plaintiff is not, however, alleging a failure to disclose the overall amount of all fees. Instead, he claims that defendants deceived him into thinking the fees were for worthwhile investment advice or something else of value to shareholders when, in fact, these fees were merely a cover for funneling kickbacks to broker-dealers.[72]

In *Siemers,* the court merged transaction causation – the plaintiff would not have purchased the funds' shares if the kickback scheme had been dis-

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closed – with loss causation. The court overlooked that the non-disclosure and revelation concerning revenue sharing payments being "a cover for funneling kickbacks to broker-dealers" did not change the NAV (*i.e.*, the value of the pool of assets minus liabilities) of any fund. Therefore, it is (respectfully) submitted that the *Siemers* court was wrong as a matter of law in rejecting the defendants' loss causation defense. The non-disclosure and revelation of the fact that the payments were "kickbacks" could not cause a mutual fund's NAV to depreciate, and such depreciation represents the only recoverable damages under the price-depreciation damages formula in § 12.[73]

Ultimately, the *Siemers* plaintiff's § 12(a)(2) claim was dismissed on unrelated grounds,[74] but not before *Siemers*' flawed logic was relied upon by another court in another revenue-sharing case.

In re: AIG Advisor Group Sec. Litig.[75] was a mutual fund shelf-space suit brought under § 12(a)(2) outside of the Southern District of New York against various AIG brokers, but not against any specific funds. The defendants moved to have the suit dismissed, alleging, among other things, a loss causation defense to the effect that the undisclosed revenue-sharing payments had not resulted in any economic loss to the plaintiffs.[76]

The *AIG* court, citing *Siemers* and expressly rejecting the Southern District's decisions in *Morgan Stanley, Merrill Lynch Funds* and *Salomon Funds,* rejected the defendants' loss causation defense:

> [P]laintiffs claim that defendants misled them into buying Shelf-Space Funds "at an artificially inflated value." This theory appears to be that defendants misled plaintiffs into thinking certain fees and commissions they paid were "legitimate outlays for services" accruing to the benefit of plaintiffs, whereas in fact the fees went to Shelf-Space promotional services, accruing to the benefit of the defendants . . . Defendants argue that the relevant prospectuses and SAIs disclosed the total amount of Shelf-Space Fund fees, so any complaint of "loss" is really just a complaint about the allocation of particular fees within that total amount.
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> The plaintiffs allege that they assumed wrongly – because of defendants' nondisclosure and misrepresentation – that they were paying . . . only fees for services that accrued to their benefit. . . . In reality, plaintiffs' principal was funding the Shelf-Space system of payments . . . Accordingly, plaintiffs sufficiently allege that the Shelf-Space system of payments caused them an economic loss: absent those payments, plain-

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> tiffs' total amount of fees, and thus the resulting diminution of their investment's asset value, would have been smaller.[77]

The *AIG* plaintiffs subsequently dropped their § 12(a)(2) claims, and the court dismissed the remaining Rule 10b-5 claims.[78]

AIG can be understood as another example of a court conflating transaction causation – the plaintiffs would not have purchased the funds' shares if the real use of the fees had been disclosed – and loss causation. The court missed that the non-disclosure and subsequent revelation concerning fees paid by the plaintiffs for which they would accrue no benefit did not change the NAV of any fund. Therefore, the *AIG* decision, like the *Siemers* decision on which it relied, wrongly rejected the defendants' loss causation defense. The non-disclosure and revelation of the fact that no benefits would accrue to the plaintiffs for some of the fees paid by the plaintiffs could not cause a fund's NAV to depreciate, and such depreciation represents the only recoverable damages under the price-depreciation damages formula in § 12.

At a minimum, *Siemers* and *AIG* underscore the need for counsel to ensure that a court understands the structure and operations of mutual funds and the pricing of fund shares. The *Siemers* and *AIG* courts either did not understand that the money used to make the revenue-sharing payments belonged to the adviser and its affiliates,[79] or the courts overlooked this fact.

Siemers and *AIG* remind us that, in any discussion of loss causation, which, after all, is derived from the common law tort concept of proximate causation, we must be wary of the fact that proximate cause can be understood in "purely instrumental terms – as the name that lawyers give to a doctrinal space with which judges . . . can attempt to do equity or make macro-level social policy."[80] Under this reading, in both *Siemers* and *AIG,* the court was merely attempting to achieve what the judge perceived as a just result, and used flawed logic to give plaintiffs their day in court.

In the future, when attempting to establish a loss causation defense for a mutual fund or related defendants, counsel may appear before an unsympathetic court like those in *Siemers* and *AIG*. Citing the decisions summarized in Part IV.A, above, and explaining the rationale of those decisions, as described in Part III, above, should help. Beyond that, counsel must educate the judge, to whom the structure and operation of mutual funds and the pricing of fund shares may not be obvious, in order to avoid a spurious causation analysis by the court.

VI. Reception by the Courts

This article's conclusions are that a fund defendant in a claim under § 11(a) or § 12(a)(2) can establish a successful loss causation defense under §

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11(e) or § 12(b) because: (1) a misstatement in a fund's prospectus and revelation of the misstatement cannot cause a fund's NAV to depreciate; and (2) such depreciation represents the only recoverable damages under the price-depreciation damages formula in § 11 and § 12. From these conclusions, it follows that, due to the increased ease with which a fund or a fund-related defendant can escape liability, plaintiffs should be deterred from instigating lawsuits against these defendants under § 11(a) or § 12(a)(2).

This article's conclusions may not sit well with some judges – witness *Siemers* and *AIG* – or with potential plaintiffs and their lawyers. Accordingly, it is worthwhile to anticipate the counter-arguments that will be offered to reject this article's conclusions and, then, examine the validity of each counter-argument.

A. The Probable Counter-Arguments

The article's conclusions should be rejected because "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes'".[81] Interpreting § 11(e) and § 12(b) in the manner indicated by the article's conclusions is precisely the type of technical and cramped interpretation of the federal securities laws that the Supreme Court has consistently rejected. Instead, contrary to the article's conclusions, § 11(e) and § 12(b) should be interpreted in a manner that effectuates the statutes' remedial purpose of protecting investors.

The article's conclusions also should be rejected because they upset long-standing judicial interpretations of § 11 and § 12 applying the statutes to mutual funds and investor expectations based on those interpretations. If investor expectations are upset, then investor confidence in mutual funds will be diminished.

Finally, Rule 10b-5 also contains a loss causation requirement.[82] In lawsuits brought under Rule 10b-5, courts have held that a plaintiff, in pleading loss causation, does not have to claim that a misstatement was the sole cause of a plaintiff's losses; rather, liability attaches if the fraudulent misstatement causes the losses "in some reasonably direct, or proximate, way"[83] or if the losses were foreseeable and arose due to the "materialization of the concealed risk."[84] Thus, courts have shown flexibility for purposes of the loss causation requirement applicable to Rule 10b-5 claims, and the courts should show similar flexibility for purposes of the loss causation requirement applicable to Securities Act § 11(a) and § 12(a)(2) claims.[85] This requires the article's conclusions to be rejected.

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B. Responses to the Probable Counter-Arguments

1. The Limits of Generalized References to the Securities Act's Remedial Purposes

In its 1980 *Aaron* decision, the Supreme Court determined whether the language of § 17(a) of the Securities Act indicated that Congress contemplated a scienter requirement under § 17(a)(1).[86] In holding that scienter was required based on the plain language of § 17(a)(1),[87] the Court stated:

> Though cognizant that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes," the Court has also noted that "generalized references to the 'remedial purposes" of the securities laws "will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.'" Thus, if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary "to examine the additional considerations of 'policy' . . . that may have influenced the lawmakers in their formulation of the statute."[88]

Thus, *Aaron*, by rejecting the broader reading of § 17(a)(1) urged by the SEC, highlights that merely referencing the remedial purposes of the securities laws is not dispositive when interpreting specific provisions of the Securities Act. The same holds true with respect to the interpretation of § 11(e) and § 12(b) offered by this article's conclusions. *Aaron* mandates that the language of § 11(e) and § 12(b) is the starting point and, if that language is clear in its context and not at odds with the legislative history of the statutes, it is incorrect to turn to the public-policy questions that influenced Congress in choosing that language.

The loss causation language in § 11(e) and § 12(b) is clear. More specifically, the language in § 11(e) and § 12(b), which is virtually identical, permits a defendant to reduce its liability by the amount that the depreciation in a mutual fund share's value is due to causes other than the prospectus misstatements indicated by the plaintiff.

The similarity of the language in § 11(e) and § 12(b) is not accidental. In 1995, the PSLRA added § 12(b) to § 12, and the legislative history of the PSLRA states that the "amendment to Section 12(2) [adding § 12(b)] is modeled after Section 11 of the Securities Act".[89] The re-enactment of that language in § 12(b) in 1995, approximately sixty years after the enactment of the same language in § 11(e),[90] evinces Congress' belief that the language was clear and was not being misinterpreted by the courts.

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Determining whether the language of § 11(e) and § 12(b) is at odds with the relevant legislative history is straightforward.[91] The legislative history of § 11 and § 12 evidences the market-price mechanism by which Congress believed a prospectus misstatement harms investors. According to the House Committee Report, the presumption of reliance in § 11(a) and §12(2) (now § 12(a)(2)) is justified, even if an individual investor did not read and rely on a prospectus, because the misstatements affect the market price underlying an investment decision:

> Liability is imposed upon [defendants under § 11 and § 12] as a condition of the acquisition of the privilege to do business through the channels of interstate or foreign commerce. The statements for which they are responsible, although they may never actually have been seen by the prospective purchaser, because of their wide dissemination, *determine the market price of the security*, which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase.[92]

Elsewhere in the House Report, market price impact is offered as the justification for the breadth of § 11's applicability:

> Inasmuch as *the value of a security* may be affected by the information given in the registration statement, irrespective of whether a particular sale takes place in interstate or intrastate commerce, the civil remedies accorded by this subsection against those responsible for a false or misleading statement filed with the Federal Trade Commission are given to all purchasers regardless of whether they bought their securities in an interstate or intrastate transaction and regardless of whether they bought their securities at the time of offer or at some later date.[93]

In brief, the legislative history of § 11 and § 12 manifests Congress' belief that a prospectus misstatement distorts the market price of securities. Such misstatements are "bad" and give rise to liability based on the economic theory that such misstatements lead investors to over-estimate the value of a security, making the investors victims of the misstatement. Accordingly, the price-depreciation damages formula of § 11(e) and § 12(b) is both clear in its context and perfectly congruent with the legislative history.

However, unlike securities that are offered publicly and have a secondary market, mutual fund shares are priced according to a statutory formula that precludes a misstatement in a prospectus or a correction of the misstatement from affecting the price of a fund's shares.[94] This does not mean that the language of § 11(e) and § 12(b) is at odds with the legislative history when the issuer is a mutual fund. Rather, it suggests that, when Congress was drafting

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§ 11(e) and § 12(b), the mechanism used to price shares of a mutual fund probably was not contemplated by Congress.[95]

Applying the *Aaron* approach, the language of § 11(e) and § 12(b) is clear and not at odds with the legislative history. Therefore, as the Supreme Court stated in *Aaron*, "it is unnecessary to examine the additional considerations of policy . . . that may have influenced the lawmakers in their formulation of the statute."[96] This means that, as in *Aaron*, references to the remedial purposes of the securities laws are not dispositive. Instead, § 11(e) and § 12(b) are properly interpreted according to their plain meaning, without reference to the statutes' remedial purpose. The remedial-purposes counter-argument to this article's conclusions does not withstand close scrutiny.

2. The Possibility of Crafting a Defensible Interpretation of § 11(e) and § 12(b) to Further Remedial Purposes

If a court were determined to reject this article's conclusions, the court could offer an alternative interpretation of § 11(e) and § 12(b), which applies only to mutual fund issuers and denies the loss causation defense to the fund and related defendants. The court could be seeking to further the remedial purposes of the Securities Act (or otherwise). The alternative interpretation of § 11(e) and § 12(b) would have to be logically consistent and defensible. In particular, the alternative interpretation of § 11(e) and § 12(b) would have to provide a mechanism by which a misstatement in a fund's prospectus can be the proximate cause of the depreciation in a fund's NAV.

The most salient point that a court would have to confront is that § 11(e) and § 12(b) are each part of a statutory scheme and cannot be simply ignored by a court. There is, after all, "the common-sense principle of statutory construction that sections of a statute generally should be read 'to give effect, if possible, to every clause . . .'"[97]

As noted, the legislative history does not provide a basis to justify reading § 11(e) and § 12(b) in an alternative manner when the issuer is a mutual fund. Certainly, the language of § 11(e) and § 12(b) does not make any distinction among issuers, which could support an alternative interpretation when the issuer is a mutual fund.

Finally, the absence of a secondary market for a mutual fund's shares means that any misstatement in a fund's prospectus or the subsequent revelation of the misstatement by themselves cannot cause a fund shares' NAV to depreciate.[98] Such "fraud on the market" theories cannot apply to mutual funds.[99]

In view of these facts, a court could *not* offer a logically consistent and defensible alternative interpretation of § 11(e) and § 12(b), which denies a loss causation defense to a mutual fund issuer. This is an additional reason

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why a remedial-purposes counter-argument to this article's conclusions does not withstand close analysis. Again, this article's conclusions remain valid.

3. Upsetting Longstanding Judicial Interpretations

The judicial interpretations of the anti-fraud provisions of the federal securities laws have been neither fixed nor predictable.

It was only in 1976, in *Ernst & Ernst v. Hochfelder*,[100] that we learned whether a private cause of action for damages will lie under Exchange Act § 10(b) and Rule 10b-5 thereunder absent any allegation of scienter.

In 1988, in *Pinter v. Dahl*,[101] the Supreme Court finally settled who is an "offer[or] or sell[er]" under § 12(1) of the Securities Act.[102]

In 1995, in *Gustafson v. Alloyd Co., Inc*.[103] the Supreme Court finally determined that § 12(a)(2) is limited to investors who purchase shares in a distribution to which a statutory prospectus is directed (as is the case under § 11), and not to investors who purchase shares in secondary market trading.

In 2005, in *Dura Pharmaceuticals, Inc. v. Broudo,*[104] the Supreme Court determined that, in an action under Rule 10b-5, investors who purchase an issuer's shares while the share price is inflated due to a fraudulent misrepresentation must also plead or prove that the artificial price inflation was removed from the stock price – *i.e*., the purchaser had suffered an economic loss – while the purchaser owned the shares.

Finally and most important, § 12(b) was added to § 12 by the PSLRA in 1995.

In sum, it is easy to show that the anti-fraud provisions of the federal securities laws have not been static. To claim that the judicial interpretations of these provisions, including interpretations of § 11(a) and § 12(a)(2), have been longstanding is simply erroneous, particularly in view of the fact that the latter statute dates only from 1995. Thus, any purported effect on investor expectations does not provide a basis to reject this article's conclusions.

4. Courts' Flexibility in Measuring Damages in a Rule 10b-5 Claim

It is true that, with respect to claims under Rule 10b-5, courts are flexible in the manner in which they will permit a plaintiff to prove his losses. However, critically, unlike claims under § 11(a) and § 12(a)(2), Rule 10b-5 claims are not constrained by a statutory price-depreciation damages formula.

Consider *Consolidated Market Timing Cases*, in which the plaintiffs did not allege that they redeemed their shares (or could have redeemed their shares at the time suit was filed) for an amount less than they paid for the

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shares.[105] The court dismissed the § 11(a) and § 12(a)(2) claims because, as the court stated: "the only damages recoverable under Sections 11 and 12(a)(2) are based upon price differences, and plaintiffs therefore have not stated any cognizable harm under those statutes."[106] However, the court refused to dismiss the Rule 10b-5 claims on loss causation grounds, and permitted the plaintiffs the opportunity to show that the market timing had diminished the value of their mutual fund shares by, among other things, "siphoning off from the funds profits to which shareholders were entitled [and] substantially increasing transaction expenses and fees . . . ."[107]

The purpose of Securities Act § 11(a) and § 12(a)(2) differs from the purpose of the Exchange Act's Rule 10b-5. Not surprisingly, the measure of damages in one regime differs from the measure of damages in the other regime.[108]

> Rule 10b-5 is a catch-all provision that provides a remedy for any misleading conduct made in connection with the purchase or sale of securities, provided that the defendant possessed fraudulent intent, or scienter. The broad "loss causation" standard applied in the Rule 10b-5 cases . . . is judicially created to deter fraudulent conduct.
>
> * * *
>
> By contrast, Section 11 is not a fraud provision. Section 11 applies to any misleading statements that appear in a prospectus. Section 11 does not require the plaintiff to prove fraudulent intent, or even negligence, on the part of the defendant. In order to balance the harsh, strict liability features of Section 11, Congress expressly has limited the damages to those directly caused by the defendant's misleading conduct. The remedy and the loss causation defense are provided by statute, and stand in stark contrast to the judge-made remedy for Rule 10b-5 violations.[109]

Sections 11(e) and 12(b) incorporate Congress' determination of the appropriate measure of damages applicable to a defendant who was only negligent in preparing a prospectus. In contrast, in order to violate Rule 10b-5, a defendant must act with scienter.[110] Thus, even if § 11(e) and § 12(b) did not constrain a court, the rationale for a broader, more-flexible remedy in a case of fraud does not carry over obviously to a case of negligence.[111]

In sum, for violations of § 11(a) and § 12(a)(2), the remedy is provided by statute. The remedies for violations of Rule 10b-5 are judge-made. Even if this were not a constraint, the differences between a scienter-based fraud regime and a negligence-based regime, including the regimes' different allocations of burden of proof, militate against facilely importing from Rule 10b-5 to Securities Act § 11(a) and § 12(a)(2). Accordingly, the greater flexibility

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that a plaintiff may have to prove damages in a claim under Rule 10b-5 does not affect the validity of this article's conclusions.

VII. Conclusions

Securities Act § 11(a) and § 12(a)(2) offer a shareholder broad legal recourse against a number of defendants if a mutual fund's prospectus contains a misstatement. However, a defendant in a claim under § 11(a) or § 12(a)(2) can prevail at the pleading stage of a lawsuit by establishing a loss causation defense. Simply stated, misstatements in a mutual fund's prospectus and revelations of the misstatements cannot decrease the fund shares' NAV, which are the only damages recoverable under these statutes' price-depreciation formula.

Section 11(a) provides that every director or trustee of a mutual fund can be held personally liable for any misstatements in the fund's prospectus. Therefore, the ready availability of a loss causation defense should be especially welcomed by existing and potential board members.

If a plaintiff cannot make out a claim under either § 11(a) or § 12(a)(2) of the Securities Act, then the plaintiff may be relegated to claims under Rule 10b-5, the Investment Company Act and state law. However, the inability to make out a claim against mutual funds and related parties based on prospectus misstatements should deter plaintiffs from instigating such lawsuits under the Securities Act.

Prospectively, while some courts may seek to reject these conclusions due to the increased ease with which a fund or a fund-related defendant could escape liability under § 11(a) or § 12(a)(2), the counter-arguments on which such courts are likely to rely do not withstand close scrutiny.

Both the language and the legislative history of § 11 and § 12 evidence the market-price mechanism by which Congress believed a prospectus misstatement harms investors. Even if a defendant's misstatement is merely negligent (*i.e.*, no scienter), and the investor did not rely on the misstatement, liability arises under § 11 and § 12 because misstatements lead the market to over-estimate the value of a security, making the investor victims of the negligent misstatement. Thus, to establish § 11 or § 12 liability, Congress lightened the plaintiff's burden by providing that a plaintiff is not required: (i) to show that the prospectus' misstatement caused the plaintiff's loss; (ii) to claim reliance on a prospectus' misstatement; and (iii) to show that a defendant was at fault with respect to the misstatement.

In contrast, the absence of a secondary market for a mutual fund's shares means that a misstatement in a fund's prospectus cannot cause the fund shares' NAV to be over-estimated. Therefore, it is not obvious that such a light burden on the plaintiff to establish § 11 or § 12 liability is as justified

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with respect to a mutual fund and related defendants. While it would be a stretch to infer that this was Congress' intended endpoint for mutual funds in 1995, when the PSLRA added § 12(b) to § 12, this article has shown, nevertheless, we are at that endpoint today.

NOTES

1. The discussion in this article is limited to open-end registered investment companies (mutual funds), excluding such companies that are exchange-traded funds.

2. 15 U.S.C. § 77k(a) (2000).

3. 15 U.S.C. § 77l(a)(2) (2000).

4. 15 U.S.C. § 77a *et seq.* (2000) [hereinafter, the "Securities Act"].

5. For brevity, throughout this article, material misstatements and omissions are referred to as "misstatements."

6. The principal part of a registration statement is the prospectus. Therefore, for brevity, throughout this article, the term "prospectus" is used as shorthand for the mutual fund's registration statement, including a "summary" prospectus. *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28,504 (Jan. 13, 2009).

7. *See Shaw v. Digital Equip. Corp.* 82 F.3d 1194, 1204 (1st Cir. 1996) (discussing the purpose of § 11(a)); *Shuman v. Sherman,* 356 F. Supp. 911, 917 (D. Md. 1973) (discussing the purpose of § 12(2), now renumbered as 12(a)(2)).

8. Section 11(e), 15 U.S.C. § 77k(e) (2000), in pertinent part, states:

> The suit . . . may be to recover such damages as shall represent the difference between the amount paid for the security . . . and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the [difference recognized by (1)] . . . .

9. Section 12(a)(2), 15 U.S.C. § 77l(a)(2) (2000), in pertinent part, states that a purchaser may sue:

> to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

10. Rule 10b-5, promulgated by the SEC pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq*. (2000), [hereinafter, the "Exchange Act"] prohibits fraudulent conduct in the sale and purchase of securities.

11. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12; 96 S. Ct. 1375 (1976).

12. In pertinent part, Fed. R. Civ. P. 9(b), states: "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake." This requirement resulted from the enactment of The Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.), which added § 21D(b)(1), 15 U.S.C. § 78u-4(b)(1) (2000), to the Exchange Act.

13. *See Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004).

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[14.] *See In re Fortune Systems Sec. Litig.*, 680 F.Supp. 1360, 1364 (N.D. Cal. 1987) (§ 11); *Stone v. Fossil Oil & Gas*, 657 F.Supp. 1449, 1460 (D.N.M. 1987).

[15.] For example, under § 11(a), a defendant other than the issuer can establish that he had after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

Similarly, under § 12(a)(2), a defendant can avoid liability if it can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . . ."

[16.] *See e.g.*, *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp.2d 804, 867 (S.D. Tex. 2004) (§ 11); *Neubauer v. Eva-Health USA*, 158 F.R.D. 281, 284 n.1 (S.D.N.Y. 1994) (§ 12(2)).

[17.] *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975).

[18.] *See Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489,1495-1496 (2d Cir. 1992); *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 19-20 (2d Cir. 1986), *cert. denied sub nom*. *Arthur Andersen & Co. v. Manufacturers Hanover Trust Co.*, 479 U.S. 1066 (1987).

[19.] *See Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161, 173 (2d Cir. 2005), *cert. denied* 546 U.S. 935 (2005).

[20.] *See Unterberg Harris Private Equity Partners, L.P. v. Xerox Corp.*, 995 F.Supp. 437, 441 (S.D.N.Y.1998) (investment group plaintiff failed to demonstrate that failure to disclose CEO's gambling addiction was proximate cause of loss in start-up company's value). *Accord First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 772 (2d Cir. 1994), *cert. denied* 513 U.S. 1079 (1995) (loss causation not established where plaintiff did not plead facts to show that its loss was caused by defendants' misstatements as opposed to intervening deterioration in real estate market); *Bastian v. Petren Resources Corp.,* 892 F.2d 680, 685 (7th Cir. 1990), *cert. denied* 496 U.S. 906 (1990) (cause of the plaintiffs' losses was intervening industry-wide crash instead of defendants' misrepresentations concerning managerial competency).

[21.] *See In re Mutual Funds Inv. Litig.*, 384 F.Supp.2d 845, 864 (D. Md. 2005) [hereinafter, *Consolidated Market Timing Cases*].

[22.] *See id*.

[23.] *See Wilson v. Comtech Telecommunications Corp.,* 648 F.2d 88, 92 n. 6 (2d Cir. 1981).

[24.] *Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 16, 172-173 (2d Cir. 2005), *cert. denied* 546 U.S. 935 (2005), quoting *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.,* 343 F.3d 189, 197 (2d Cir. 2003).

[25.] 640 F.2d 534, 549 n. 24 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds* 459 U.S. 375 (1983).

[26.] *See e.g*., *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 343 (2d Cir. 1987) (§ 11(a) claim dismissed where misstatement was barely material, public failed to react adversely to its disclosure, and plaintiffs failed to produce any evidence suggesting that share's price decline resulted from misstatement).

[27.] To engage in a continuous offering of its shares, the fund maintains an updated or "evergreen" prospectus. *See* 17 C.F.R. 270.8b-16(a) (2007).

[28.] 15 U.S.C. §§ 80a−1 *et seq*. (2000) [hereinafter, the "Investment Company Act"].

[29.] *See* Rule 22c-1(a), 17 C.F.R. § 270.22c-1(a) (2007).

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[30] *See* § 11(a) and § 12(a)(2).

[31] *See Consolidated Market Timing Cases,* 384 F.Supp.2d at 866-867.

[32] Section 11(e), 15 U.S.C. § 77k(e), in pertinent part, states:

> 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.

[33] The PSLRA amended Section 12 by adding Section 12(b), 15 U.S.C. § 77l(b) (2000). In pertinent part, Section 12(b) states:

> if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

[34] *See In re Morgan Stanley and Van Kampen Mutual Fund Sec. Litig.*, 2006 WL 1008233, *35-36 (S.D.N.Y. (2006) [hereinafter, *Morgan Stanley*]; *In re Van Wagoner Funds, Inc. Sec. Litig.*, 382 F.Supp.2d 1173, 1188 (D. Cal. 2004) [hereinafter, *Van Wagoner*]; *Young v. Nationwide Life Insurance Company*, 183 F.R.D. 502, 510 (S.D. Tex. 1998); *Clark v. Nevis Capital Mgmt., LLC*, 2005 WL 488641, *57 (S.D.N.Y. 2005).

[35] *See Young v. Nationwide Life Insurance Company*, 183 F.R.D. 502, 510 (S.D. Tex. 1998) (fraud-on-the-market does not apply because the share price of a mutual fund is not affected by alleged misrepresentations or omissions); *Clark v. Nevis Capital Mgmt., LLC*, 2005 WL 488641, *57 (S.D.N.Y. 2005) (same).

[36] *Morgan Stanley*, 2006 WL 1008233, *35-36 (emphasis added). *Accord* Mercer E. Bullard, *Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?*, 76 U. Cin. L. Rev. 559, 560-561 (2008) [hereinafter, *Bullard*]. Professor Bullard is President and Founder of Fund Democracy, Inc., which describes itself as "the mutual fund shareholders advocate". See http://www.funddemocracy.com (last visited Jul. 11, 2008).

[37] *See Morgan Stanley,* 2006 WL 1008233 at *35-36; *In Re Merrill Lynch Inv. Mgmt. Funds Sec. Litig.,* 434 F.Supp.2d 233, 238 (S.D.N.Y. 2006) [hereinafter, *Merrill Lynch Funds*]; *Van Wagoner*, 382 F.Supp.2d at 1183.

[38] Investment Company Act § 5(b) divides mutual funds into "diversified" and "non-diversified" funds. Section 5(b)(1) of the Investment Company Act limits the portion of a diversified fund's assets that can be invested in the securities of a limited number of issuers. A diversified fund presents less risk than a non-diversified fund.

[39] *See Nutis v. Penn Merchandising Corp.*, 615 F.Supp. 486, 489 (E.D. Pa. 1985), *aff'd* 791 F.2d 919 (3d Cir. 1986) (no loss causation where, in minority shareholders' Rule 10b-5 claim against company's directors, the directors' breach of fiduciary duty was the intervening cause of change in the securities' value rather than any non-disclosure on directors' part); *Warner Communications v. Murdoch*, 581 F.Supp. 1482, 1495 (D. De. 1984) (in 10b-5 claim, no loss causation where management's breach of fiduciary duty, rather than misstatements concerning entrenchment scheme, was the cause of claimant's loss). *See also*, *Bastian v. Petren Resources Corp.,* 892 F.2d 680, 685 (7th Cir. 1990), *cert. denied* 496 U.S. 906 (1990) (cause of the plaintiffs' losses was intervening industry-wide crash instead of defendants' misrepresentations concerning managerial competency).

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One court described § 11(e)'s loss causation defense as the "mirror image" of the loss causation that a Rule 10b-5 plaintiff is required to prove. *See In re WorldCom, Inc. Sec. Litig.,* 388 F.Supp.2d 319, 346 (S.D.N.Y. 2005). In *Merrill Lynch Funds*, the court equated a loss causation defense under § 12 with the plaintiff's affirmative obligation to show loss causation under Rule 10b-5. *See Merrill Lynch Funds*, 434 F.Supp.2d at 238. More generally, it is instructive to review the Rule 10b-5 arena because the PSLRA codified the loss causation requirement by amending Exchange Act § 21D(b)(4) to provide that the plaintiff in a Rule 10b-5 claim must show loss causation. *But see Worlds of Wonder Sec. Litig.*, 814 F.Supp. 850, 876-877 (N.D. Cal. 1993) (describing how the purpose of § 11 and § 12 differs from the purpose of Rule 10b-5).

[40.] 384 F.Supp.2d 845.

[41.] *Id*. at 864.

[42.] *Id*. at 864-865.

[43.] *Id.* at 867.

[44.] *Id.* at 866-867 (emphasis added).

[45.] *See 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), citing *Pani v. Empire Blue Cross Blue Shield*, 152 F.3d 67, 74 (2d Cir. 1998), *cert. denied* 525 U.S. 1103 (1990) ("An affirmative defense may be raised by a pre-answer motion to dismiss under Rule 12(b)(6), without resort to summary judgment procedure, if the defense appears on the face of the complaint"); *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").

[46.] *See supra* note 39.

[47.] *See supra* note 39. *See e.g., Morgan Stanley,* 2006 WL 1008233 at *34-39; *Merrill Lynch Funds*, 434 F.Supp.2d at 238-239; *In re Salomon Smith Barney Mutual Fund Fees Litig.*, 441 F.Supp.2d 579, 588-591 (S.D.N.Y. 2006) [hereinafter, *Salomon Funds*]. *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.,* 272 F.Supp.2d 243, 262 (S.D.N.Y. 2003). *But see Consolidated Market Timing Cases,* 384 F.Supp.2d at 864-865, in which the court held that other damages – *e.g*., profits siphoned from market-timed funds to which shareholders were entitled – while not recoverable under the price-difference formula in § 11(a) and § 12(a)(2), may be recoverable under Rule 10b-5.

[48.] *See supra* Part III.

[49.] 2006 WL 1008233 (S.D.N.Y., Apr. 14, 2006) (Owen, J.).

[50.] *See id*. at *21-22.

[51.] *See id*. at *35-39.

[52.] *Id*. at 35-36 (internal citations omitted, brackets in original, emphasis added).

[53.] 434 F.Supp.2d 233 (S.D.N.Y. 2006).

[54.] *See id*.

[55.] *Id.* at 238 (internal citations omitted).

[56.] 441 F.Supp.2d 579 (S.D.N.Y. 2006).

[57.] *See id.* at 591.

[58.] *See id.* at 589-590.

[59.] 384 F.Supp.2d 845.

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[60] *See id.* at 867.

[61] *See id.* at 866.

[62] *Id.* at 867.

[63] *Id.* at 866.

[64] 272 F.Supp.2d 243 (S.D.N.Y. 2003) [hereinafter, *Merrill Research Reports*].

[65] *See id.* at 253.

[66] *Id.* at 246.

[67] *Id.* at 254.

[68] *Id.*

[69] 2006 WL 2355411 (N.D. Cal.) [hereinafter, *Siemers*].

[70] *See id*. at *16.

[71] *See id.* at *33-34.

[72] *Id.* at *34-35.

[73] *See Consolidated Market Timing Cases*, 384 F.Supp.2d at 866-867 (only damages recoverable under § 11(a) and § 12(a)(2) are based upon the statutes' stated price difference).

[74] *See Siemers v. Wells Fargo & Co.*, 2007 WL 1456047 (N.D. Cal.). The remaining claims under Exchange Act Rule 10b-5 and Investment Company Act § 36(b) were compromised for a gross payment of approximately $1.1 million by the defendants. *See Siemers v. Wells Fargo & Co.*, Frequently Asked Questions http://www.mutualfundfeesettlement.com/faq.html (last visited Mar. 30, 2008).

[75] 2007 WL 2750676 (E.D.N.Y) [hereinafter, *AIG*].

[76] *See id.* at *35.

[77] *Id.* at *41-44 (internal citations omitted).

[78] *See In re AIG Advisor Group Secs. Litig.*, 2007 WL 1213395.

[79] Apparently, both courts were either unaware or disregarded the SEC's statements in connection with the adoption of Rule 12b-1:

> There is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources. In determining whether there is an indirect use of fund assets, it is appropriate to relate a fund's payments pursuant to the advisory contract to the adviser's expenditures for distribution and to view such expenditures as having been made from the adviser's profits, if any, from the advisory contract. To the extent that such profits are "legitimate" or "not excessive", the adviser's distribution expenses are not an indirect use of fund assets.

Investment Company Act Rel. No. 11414, 1980 WL 25666 (Oct. 8, 1980).

[80] John C.P. Goldberg et al., *The Place of Reliance in Fraud*, 48 Ariz. L. Rev. 1001, 1007 (2006). In the same vein, Professor Horowitz cites Judge Andrews dissent in *Palsgraf v. Long Island Railroad Company*, 162 N.E. 99, 102-104 (N.Y. 1928), "as clear a statement of the Legal Realist position on [the false objectivity of] causation as any uttered by a judge."

> What we do mean by the word "proximate" is, that because of convenience, of public policy, of a rough sense of justice, the law arbitrarily declines to trace a series of events beyond a certain point. This is not logic. It is practical politics. . . . It is all a question of

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> expediency. There are no fixed rules to govern our judgment. . . . There is in truth little to guide us other than common sense.

Morton Horowitz, The Transformation of American Law 1879-1960: The Crisis of Legal Orthodoxy 61 (1992), quoting 162 N.E. 99, 102-104.

[81.] *Aaron v. Securities and Exchange Commission*, 446 U.S. 680, 695 (1980) [hereinafter, *Aaron*] quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

[82.] *See supra* note 39.

[83.] *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997).

[84.] *See Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 173 (2d Cir. 2005), cert. denied 546 U.S. 935 (2005).

[85.] One commentator has made this very argument. *See Bullard*, 76 U. Cin. L. Rev. at 579.

[86.] In pertinent part, § 17(a)(1), 15 U.S.C. § 77q(a) (2000), provides: "It shall be unlawful for any person in the offer or sale of any securities . . . directly or indirectly . . . to employ any device, scheme, or artifice to defraud".

[87.] *Aaron*, 446 U.S. at 695-696. The Supreme Court found the language of § 17(a)(1), which makes it unlawful "to employ any device, scheme, or artifice to defraud," plainly manifests Congress' intent to prohibit only knowing or intentional misconduct.

[88.] *Id.* at 695 (internal citations omitted). *Accord Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (no private remedy implied in Exchange Act § 17(a) despite the invocation of the "remedial purposes" of the Exchange Act); *Versyss Inc. v. Coopers & Lybrand*, 982 F.2d 653. 657 (1st Cir. 1992), *cert. denied* 508 U.S. 974 (1993) (§ 11's "very stringency suggests that, whatever the usual rule about construing remedial securities legislation broadly, some care should be taken before section 11 is extended beyond its normal reading.")

[89.] S. Rep. 104-98 104th Cong., 1st Sess. 23 (Jun. 19, 1995).

[90.] *See* 73 P.L. 291; 48 Stat. 881(Jun. 6, 1934).

[91.] The legislative history of the Securities Act is silent on the application of § 11(a) and § 12(a)(2) in cases in which the issuer is a mutual fund. It is helpful to keep in mind that, as late as the end of 1932, closed-end funds still dominated open-end investment companies (mutual funds). At the end of that year, closed-end funds and open-end funds, in aggregate, had total assets of approximately $800 million, of which approximately $750 million was held in closed-end funds. *See* Securities and Exchange Commission, Holding Company Act Rel. No. 1179; 1938 WL 32594 (Jul. 28, 1938).

[92.] H. Rep. 73-85 73d Cong. 1st Sess. 10 (May 4, 1933) (emphasis added).

[93.] *Id.* at 22 (emphasis added).

[94.] It would be a stretch to infer that Congress was aware of these facts, even as late as 1995 when the PSLRA added § 12(b) added to § 12.

[95.] Perhaps, in 1995, when the PSLRA added § 12(b) to § 12, Congress considered Investment Company Act § 34(b) to offer sufficient protection to investors. In pertinent part, § 34(b) provides that it is unlawful "for any person to make any untrue statement of a material fact in any registration statement [or] . . . to omit to state therein any fact necessary in order to prevent the statements made therein . . . from being materially misleading."

[96.] *Accord Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986).

[97.] *Heckler v. Chaney*, 470 U.S. 821, 829 (1985) quoting *United States v. Menasche*, 348 U.S. 528, 538-539 (1955).

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[98] *See Young v. Nationwide Life Insurance Company*, 183 F.R.D. 502, 510 (S.D. Tex. 1998) (fraud-on-the-market does not apply because the share price of a mutual fund is not affected by alleged misrepresentations or omissions); *Clark v. Nevis Capital Mgmt., LLC*, 2005 WL 488641, *57 (S.D.N.Y. 2005) (same).

[99] *See Morgan Stanley*, 2006 WL 1008233, *35-36; *Van Wagoner*, 382 F.Supp.2d at 1188; *Young v. Nationwide Life Insurance Company*, 183 F.R.D. 502, 510 (S.D. Tex. 1998); *Clark v. Nevis Capital Mgmt., LLC,* 2005 WL 488641, *57 (S.D.N.Y. 2005).

[100] 425 U.S. 185, 193 n.12 (1976).

[101] 486 U.S. 622 (1988).

[102] 15 U.S.C. § 77l(a)(1) (2000). Now renumbered as § 12(a)(1), the section imposes strict liability on persons who offer or sell securities in violation of § 5, the registration requirement, of the Securities Act.

[103] 513 U.S. 561, 569 (1995).

[104] 544 U.S. 336 (2005).

[105] *Consolidated Market Timing Cases,* 384 F.Supp.2d at 867.

[106] *Id.*

[107] *Id.* at 864.

[108] *See Worlds of Wonder Sec. Litig.*, 814 F.Supp. 850, 876-877 (N.D. Cal. 1993).

[109] *Id.*

[110] *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 545 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds* 459 U.S. 375 (1983).

[111] *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-388 & n.22 (1983).

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