

May 2010 / Special Alert

A legal update from Dechert's Financial Services and White Collar and Securities Litigation Groups

## Second Circuit Rules Securities Fraud Claim of Mutual Fund Shareholders Relating to Affiliated Transfer Agent Arrangements May Proceed, But Upholds Dismissal of Breach of Fiduciary Duty Claim

A two-judge panel of the U.S. Court of Appeals for the Second Circuit (the "Court") on February 16, 2010 vacated the dismissal of a putative class action securities fraud claim brought by shareholders of the Smith Barney family of funds (the "Funds") under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and remanded the case to the district court. The Court also affirmed the district court's dismissal of the shareholders' claim alleging breach of fiduciary duty under Section 36(b) of the Investment Company Act of 1940. The shareholders brought the action against Smith Barney Fund Management, LLC ("SBFM") and Citigroup Global Markets, Inc. ("CGMI"), the Funds' advisers, for accepting undisclosed compensation from a transfer agent to the Funds.<sup>1</sup> The district court had dismissed the securities fraud claim, holding that the alleged disclosure failures were immaterial because the Funds disclosed the total fees paid by the Funds, and the Section 36(b) claim, holding that the claim could only be brought derivatively on behalf of the Funds.<sup>2</sup>

Both SBFM and CGMI were part of Citigroup Asset Management ("CAM"). From 1994 to 1999, First Data Investors Services Group

("FDIS"), an outside contractor, served as transfer agent to the Funds. In 1999, after conducting a formal study of the transfer agent functions, CAM decided to create a transfer agent affiliate (the "Affiliated Transfer Agent") and contract with the Affiliated Transfer Agent to provide transfer agent services. The Affiliated Transfer Agent then subcontracted FDIS to continue providing most of the transfer agency services it had previously provided but at a substantially lower rate. Based on this arrangement, the Affiliated Transfer Agent's actual role as transfer agent to the Funds was limited. Plaintiffs alleged that CAM concealed critical aspects of this arrangement from the Funds' board of directors and shareholders, including that the third-party transfer agent would have provided the same services at a lower rate and that the Affiliated Transfer Agent entered into a "side letter" with FDIS which allegedly guaranteed CAM "millions of dollars in additional revenue, without providing commensurate benefit to the Funds."<sup>3</sup>

In 2005, the U.S. Securities and Exchange Commission ("SEC") investigated SBFM and CGMI for violations of the Investment Advisers Act of 1940 by "failing to disclose to the Funds' boards that [FDIS] had offered to do the same work for substantially less and by failing to disclose the contents of the [s]ide [l]etter to the

<sup>1</sup> *Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Management LLC*, 2010 WL 520896 (2nd Cir. 2010) ("*Operating Local 649*").

<sup>2</sup> *In re Smith Barney Fund Transfer Agent Litigation*, 2007 WL 2809600 (S.D.N.Y. 2007).

<sup>3</sup> *Operating Local 649*, 2010 WL 520896 at 2.

Funds' boards."<sup>4</sup> In May 2005, the SEC settled with SBFM and CGMI, who agreed to disgorgement, interest, and civil money penalties in an aggregate amount of approximately \$208 million. Based on these allegations, shareholders filed a series of civil suits in district court which were ultimately consolidated into a class action suit.

The Court held that the plaintiffs adequately alleged that SBFM and CGMI made material misrepresentations necessary to support a securities fraud claim and that the plaintiffs sufficiently alleged loss causation. However, the Court found that plaintiffs were required to seek damages derivatively on the Funds' behalf with regard to the alleged breaches of fiduciary duty. The Court noted that the district court had dismissed the Section 10(b) claims because the district court concluded that if an investment adviser discloses the total amount of fees paid by a fund to a service provider, neither the fees' allocation nor the service provider's profit margin are material.<sup>5</sup> However, the Court disagreed with the district court and ruled that the plaintiffs properly alleged material misrepresentations, stating that, "[f]irst and foremost, what the Fund investors could not divine from the disclosures was that they were at the mercy of a faithless fiduciary."<sup>6</sup>

The Court's opinion emphasized the fiduciary duty and disclosure obligations of investment advisers to mutual funds, noting that CAM, acting through SBFM, owed a "duty of 'uncompromising fidelity' and 'undivided loyalty' to Funds' shareholders."<sup>7</sup> Highlighting the materiality of the misrepresentations, the Court stated that "[a]ny rational mutual fund investor would be highly leery of dealing with a fiduciary such as CAM and its affiliates who, in violation of the law, lined their pockets at the expense of investors whose interests they were obligated to protect. The district court's analysis did not engage this reality."<sup>8</sup> The Court also analyzed the SEC disclosure rules and held that the Funds' prospectus disclosure incorrectly included fees to the Affiliated Transfer Agent

as "Other Expenses," when in essence the advisors were receiving kickbacks.<sup>9</sup>

The Court also found that the plaintiffs had adequately alleged loss causation. The plaintiffs alleged that the defendants' misrepresentations "caused investors to make *and maintain* investments in Funds that were subject to excessive fees and expenses, and that the periodic deduction of those fees and expenses reduced the value of their investments over time."<sup>10</sup> Based on these findings, the Court vacated the district court's judgment with respect to the Section 10(b) and Rule 10b-5 claims, which were remanded to the district court.

The Court did affirm the district court's dismissal of the plaintiffs' claim alleging breach of fiduciary duty with respect to advisory compensation under Section 36(b) of the Investment Company Act of 1940. The district court held that the breach of fiduciary duty claims must be brought derivatively on behalf of the Funds. The Court agreed with the district court that Section 36(b) does not permit the plaintiffs to seek damages that "inure to their own benefit and not to the Funds'."<sup>11</sup> As a result, the Court affirmed the district court's holding that the Section 36(b) claim must be brought derivatively.

Filed in the wake of a large regulatory settlement, *Operating Local 649* involved egregious alleged facts and unusual circumstances. The Court's decision does not purport to break new legal ground and should not change existing jurisprudence with respect to Rule 10b-5 and loss causation. However, defense counsel should be prepared to address this decision in connection with a motion to dismiss a securities fraud claim, particularly one involving an alleged breach of fiduciary duty as the basis for a putative duty to disclose.

It should be noted that, while the Court upheld the dismissal of the Section 36(b) claim, it did so on the ground that a Section 36(b) claim may be brought directly by a fund shareholder only for the benefit of the fund.

This case is a reminder that when proposing to provide a service "in-house" a fund adviser should have a solid business rationale for doing so and should engage in a full dialogue with the fund's board regarding the proposal. Failure to disclose material information regarding

<sup>4</sup> *In re Smith Barney Fund Management LLC*, SEC Order, Release No. 34-51761, Release No. IA-2390, File No. 3-11935 (May 31, 2005).

<sup>5</sup> *Operating Local 649*, 2010 WL 520896 at 5.

<sup>6</sup> *Id.* at 5.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 7.

<sup>10</sup> *Id.* at 8.

<sup>11</sup> *Id.* at 11.

such an arrangement could be significant in the context of a Section 36(b) claim,<sup>12</sup> as well as a claim under the

Securities Act of 1933 or the Securities Exchange Act of 1934.

<sup>12</sup> Although a defect in the Section 15(c) process is not itself a violation of Section 36(b), such a defect could affect the degree of deference that a court gives to the independent directors' approval. See *Jones v. Harris Associate L.P.*, No. 08-586, 2010 WL 1189560, 10 (U.S. Mar. 30, 2010) (noting that greater scrutiny is justified when an investment adviser fails to disclose material information to a board).

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This update was authored by William K. Dodds (+1 212 698 3557; [william.dodds@dechert.com](mailto:william.dodds@dechert.com)), Brian S. Vargo (+1 215 994 2880; [brian.vargo@dechert.com](mailto:brian.vargo@dechert.com)), and Nivedita V. Betkerur (+1 202 261 3467; [nivedita.betkerur@dechert.com](mailto:nivedita.betkerur@dechert.com)).

## Practice group contacts

If you have questions regarding the information in this legal update, please contact one of the authors or any Dechert attorney with whom you regularly work. Visit us at [www.dechert.com/securities](http://www.dechert.com/securities) or [www.dechert.com/financialservices](http://www.dechert.com/financialservices).

### Karen L. Anderberg

London  
+44 20 7184 7313  
[karen.anderberg@dechert.com](mailto:karen.anderberg@dechert.com)

### Sander M. Bieber

Washington, D.C.  
+1 202 261 3308  
[sander.bieber@dechert.com](mailto:sander.bieber@dechert.com)

### Stephen H. Bier

New York  
+1 212 698 3889  
[stephen.bier@dechert.com](mailto:stephen.bier@dechert.com)

### Thomas C. Bogle

Washington, D.C.  
+1 202 261 3360  
[thomas.bogle@dechert.com](mailto:thomas.bogle@dechert.com)

### Catherine Botticelli

Washington, D.C.  
+1 202 261 3368  
[catherine.botticelli@dechert.com](mailto:catherine.botticelli@dechert.com)

### Julien Bourgeois

Washington, D.C.  
+1 202 261 3451  
[julien.bourgeois@dechert.com](mailto:julien.bourgeois@dechert.com)

### G. Eric Brunstad, Jr.

Hartford  
+1 860 524 3960  
[eric.brunstad@dechert.com](mailto:eric.brunstad@dechert.com)

### Kevin F. Cahill

Newport Beach  
+1 949 442 6051  
[kevin.cahill@dechert.com](mailto:kevin.cahill@dechert.com)

### Christopher D. Christian

Boston  
+1 617 728 7173  
[christopher.christian@dechert.com](mailto:christopher.christian@dechert.com)

### Robert A. Cohen

New York  
+1 212 698 3501  
[robert.cohen@dechert.com](mailto:robert.cohen@dechert.com)

### Elliott R. Curzon

Washington, D.C.  
+1 202 261 3341  
[elliott.curzon@dechert.com](mailto:elliott.curzon@dechert.com)

### Douglas P. Dick

Washington, D.C.  
+1 202 261 3305  
[douglas.dick@dechert.com](mailto:douglas.dick@dechert.com)

### William K. Dodds

New York  
+1 212 698 3557  
[william.dodds@dechert.com](mailto:william.dodds@dechert.com)

### Michael S. Doluisio

Philadelphia  
+1 215 994 2325  
[michael.doluisio@dechert.com](mailto:michael.doluisio@dechert.com)

### Joseph F. Donley

New York  
+1 212 649 8724  
[joseph.donley@dechert.com](mailto:joseph.donley@dechert.com)

### Ruth S. Epstein

Washington, D.C.  
+1 202 261 3322  
[ruth.epstein@dechert.com](mailto:ruth.epstein@dechert.com)

### Joseph R. Fleming

Boston  
+1 617 728 7161  
[joseph.fleming@dechert.com](mailto:joseph.fleming@dechert.com)

### Brendan C. Fox

Washington, D.C.  
+1 202 261 3381  
[brendan.fox@dechert.com](mailto:brendan.fox@dechert.com)

### Robert M. Friedman

New York  
+1 212 649 8735  
[robert.friedman@dechert.com](mailto:robert.friedman@dechert.com)

### David J. Harris

Washington, D.C.  
+1 202 261 3385  
[david.harris@dechert.com](mailto:david.harris@dechert.com)

### Christopher P. Harvey

Boston  
+1 617 728 7167  
[christopher.harvey@dechert.com](mailto:christopher.harvey@dechert.com)

**Robert W. Helm**

Washington, D.C.  
+1 202 261 3356  
robert.helm@dechert.com

**David S. Hoffner**

New York  
+1 212 649 8781  
david.hoffner@dechert.com

**Richard Horowitz**

New York  
+1 212 698 3525  
richard.horowitz@dechert.com

**Robert J. Jossen**

New York  
+1 212 698 3639  
robert.jossen@dechert.com

**Jane A. Kanter**

Washington, D.C.  
+1 202 261 3302  
jane.kanter@dechert.com

**Geoffrey R.T. Kenyon**

Boston  
+1 617 728 7126  
geoffrey.kenyon@dechert.com

**Michael L. Kichline**

Philadelphia  
+1 215 994 2439  
michael.kichline@dechert.com

**David A. Kotler**

Princeton  
+1 609 955 3226  
david.kotler@dechert.com

**Cheryl A. Krause**

Philadelphia  
+1 215 994 2139  
cheryl.krause@dechert.com

**Matthew L. Larrabee**

San Francisco  
+1 415 262 4579  
matthew.larrabee@dechert.com

**Andrew J. Levander**

New York  
+1 212 698 3683  
andrew.levander@dechert.com

**Kathleen Massey**

New York  
+1 212 698 3686  
kathleen.massey@dechert.com

**George J. Mazin**

New York  
+1 212 698 3570  
george.mazin@dechert.com

**Gary J. Mennitt**

New York  
+1 212 698 3831  
gary.mennitt@dechert.com

**Jack W. Murphy**

Washington, D.C.  
+1 202 261 3303  
jack.murphy@dechert.com

**Kevin J. O'Brien**

New York  
+1 212 698 3697  
kevin.obrien@dechert.com

**John V. O'Hanlon**

Boston  
+1 617 728 7111  
john.ohanlon@dechert.com

**Jeffrey S. Poretz**

Washington, D.C.  
+1 202 261 3358  
jeffrey.poretz@dechert.com

**Jon S. Rand**

New York  
+1 212 698 3634  
jon.rand@dechert.com

**Robert A. Robertson**

Orange County  
+1 949 442 6037  
robert.robertson@dechert.com

**Keith T. Robinson**

Hong Kong  
+1 852 3518 4705  
keith.robinson@dechert.com

**Kevin P. Scanlan**

New York  
+1 212 649 8716  
kevin.scanlan@dechert.com

**Neil A. Steiner**

New York  
+1 212 698 3822  
neil.steiner@dechert.com

**Stuart Strauss**

New York  
+1 212 698 3529  
stuart.strauss@dechert.com

**Patrick W. D. Turley**

Washington, D.C.  
+1 202 261 3364  
patrick.turley@dechert.com

**Claude M. Tusk**

New York  
+1 212 698 3612  
claudio.tusk@dechert.com

**Jennifer Wood**

London  
+44 20 7184 7403  
jennifer.wood@dechert.com

**Anthony H. Zacharski**

Hartford  
+1 860 524 3937  
anthony.zacharski@dechert.com

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