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DEVELOPMENTS OF NOTE

Second Circuit Vacates Dismissal of Mutual Fund Shareholder Securities Fraud Claim Regarding Affiliated Transfer Agent Arrangements, But Affirms Dismissal of Related Excessive Fee Claim

The US Court of Appeals for the Second Circuit (the “Court”) vacated the dismissal of a class action securities fraud claim brought by investors in a family of mutual funds against affiliates of the organization sponsoring and providing advisory services to the family of funds (such organization and its affiliates being generically referred to as the “Sponsor/Adviser”) and executives of the Sponsor/Adviser regarding transfer agency arrangements for the funds (the “Affiliated Transfer Agent Arrangements”) made with another Sponsor/Adviser entity (the “Transfer Agent Affiliate”). The Court’s decision followed an appeal by the plaintiffs from a judgment of the US District Court for the Southern District of New York dismissing the plaintiffs claims that inadequate disclosures regarding the Affiliated Transfer Agent Arrangements that appeared in regulatory filings by the funds violated the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”), as amended, and Rule 10b-5 thereunder, and that the Sponsor/Adviser breached its fiduciary duty with respect to compensation paid under the Affiliated Transfer Agent Arrangements and violated Section 36(b) of the 1940 Act, which permits certain actions by fund shareholders against the fund’s adviser, its affiliates and certain other related persons regarding the receipt of compensation from the fund.

Background. For purposes of its decision, the Court accepted as true the plaintiffs’ allegations, detailed as follows. From 1994 to 1999, the funds had engaged a transfer agent unaffiliated with the Sponsor/Adviser (the “Unaffiliated Transfer Agent”). In 1999, upon the recommendation of personnel of the Sponsor/Adviser, the funds engaged the Transfer Agent Affiliate to provide transfer agent services. The Transfer Agent Affiliate, which operated only a 15-person call center, engaged the Unaffiliated Transfer Agent to perform

most of the same duties it performed when it was directly engaged by the funds, but at a much lower rate. The Transfer Agent Affiliate retained the difference between what it received from the funds and what it paid to the Unaffiliated Transfer Agent.

The plaintiffs allege that the Sponsor/Advisor concealed critical aspects of the Affiliated Transfer Agent Arrangement from the boards and shareholders of the funds. During presentations to the boards regarding the Affiliated Transfer Agent Arrangement, representatives of the Sponsor/Advisor did not disclose details about the arrangement with the Unaffiliated Transfer Agent, instead circulating a memo representing that the goal of the new contract with the Transfer Agent Affiliate was to reduce fees and promote growth. In addition, while the funds' prospectuses disclosed the subcontract between the Transfer Agent Affiliate and the Unaffiliated Transfer Agent, the prospectuses did not disclose that the Unaffiliated Transfer Agent continued to perform the same services it had previously performed at a substantially reduced rate. In addition, the prospectuses did not disclose that the Transfer Agent Affiliate retained the difference in fees.

SEC Administrative Proceedings. In 2005, the SEC settled administrative proceedings against the two entity defendants in this suit over alleged violations of the anti-fraud provisions of the Investment Advisers Act of 1940, as amended, for failure to disclose to the funds' boards (A) the discounted fees at which the predecessor third party transfer agent provided services under the Affiliated Transfer Agent Arrangements and (B) the nature of the side-letter agreement with the predecessor third party transfer agent. The SEC subsequently settled administrative proceedings against an executive of the Sponsor/Advisor, who was not one of the individual defendants in the instant suit, regarding his involvement in negotiating the Affiliated Transfer Agent Arrangements. The SEC also filed suit in federal district court against the two individual defendants in this suit regarding their role in the Affiliated Transfer Agent Arrangements; that case was dismissed in 2007.

The District Court Decision. The district court dismissed the plaintiff's complaint holding that the mischaracterization of the fees paid to the Transfer Agent Affiliate was not a material misrepresentation under Section 10(b) and Rule 10b-5. It observed that where the total amount of fees paid by a mutual fund for services was disclosed, other information about the fees, such as their allocation or the transfer agent's profit margin, was not material; the amount of fees, not their allocation or the transfer agent's profit margin, was relevant to the price and value of the funds being purchased. Because the plaintiffs were in possession of all material information, there was no material omission. Having found that there was no underlying primary violation of federal securities law, the district court dismissed the plaintiffs' claim for control person liability under Section 20(a) of the 1934 Act. It also dismissed the plaintiff's 36(b) claims on the ground that the harm alleged constituted a harm not distinct to the plaintiffs but a harm generally to the funds that could only be brought derivatively on behalf of the funds. As a result, the district court dismissed this count of the complaint but gave the plaintiffs leave to replead it as a derivative claim. The District Court's opinion is discussed in more detail in the [October 16, 2007 Alert](#).

The Court's Analysis – Section 10(b)/Rule 10b-5. With respect to the plaintiffs' claims under Section 10(b) and Rule 10b-5, the Court disagreed with the district court finding that the omissions were not material, instead concluding that disclosures that shareholders were being grossly overcharged for transfer agent services and that the Sponsor/Advisor was reaping the benefits of the predecessor third party transfer agent's discounts would have significantly altered the total mix of information made available to an investor. Without this information, the Court stated that "investors could not divine from the disclosures that

they were at the mercy of a faithless fiduciary.” In making this determination, the Court noted the SEC’s requirement to distinguish management fees from other fees and expenses in mutual fund registration statements and the fiduciary duty that Congress imposes with respect to such fees under Section 36(b) of the 1940 Act. The Court concluded that, given the importance that both the SEC and Congress has placed on such fees, the Court concluded that there was a substantial likelihood that a reasonable investor would consider it important that her fiduciary was, “in essence, receiving kickbacks.”

The Court also found that the omissions caused losses to the defendants by causing investors to make and maintain investments in the funds, which were subject to excessive fees and expenses that reduced the value of their investments over time. The Court viewed it as premature to conclude that the plaintiffs had been fully compensated as a result of the SEC settlement in which the defendants disgorged “essentially all” profits received through the Affiliated Transfer Agent Arrangement because on a motion to dismiss for failure to state a claim, no factual record existed on which the Court would base such a conclusion. (Note that the [January 26, 2010 Alert](#) discussed a case where offset was allowed in a mutual fund excessive fee case at the summary judgment stage.) The Court was unpersuaded by the defendants’ arguments that the plaintiffs had alleged transaction causation, but not loss causation, because the transfer agency fees were fully disclosed. The Court noted that the plaintiffs alleged “that the defendants’ misrepresentations caused investors to make and maintain investments in [the funds] that were subject to excessive fees and expenses, and that the periodic deduction of those fees and expenses reduced the value of the investments over time” and that “the defendants’ misrepresentations proximately resulted in the regular deduction of identifiable amounts that would not have been deducted had defendants conformed their conduct to what the law required. The defendants’ losses were real ones because the deductions used to fund the transfer agent “fees” diminished for [the plaintiffs] (and other shareholders) money under management and, as a result, negatively and predictably impacted returns.”

Based on the foregoing, the Court vacated the judgment of the district court with respect to the claims under Section 10(b) and Rule 10b-5, which were remanded to the district court.

The Court’s Analysis – Section 36(b). The Court affirmed the district court’s decision that any claim by the plaintiffs under Section 36(b) must be pled derivatively, on behalf of the funds, with damages going to the funds rather than directly to shareholders. The plaintiffs had cited prior conclusions by the same Court that Rule 23.1 of the Federal Rules of Civil Procedure, which applies to actions in which the right claimed by the shareholder is one the corporation could itself have enforced in court, does not apply to Section 36(b) claims because Section 36(b) only permits the SEC and shareholders to sue. They contended that, because Rule 23.1 would be applicable in typical derivative actions but not for Section 36(b) claims, there was no derivative action available. The Court rejected that view holding that, “while section 36(b) claims are not derivative for purposes of Rule 23.1 . . . , they are derivative, in the general sense of the word, because they are asserted on behalf of all shareholders and result in no direct benefit to the individual plaintiff shareholders.” Accordingly, the Court affirmed the district court’s holding that the Section 36(b) claim would need to be brought derivatively.

FRB Increases Interest Rate Charged at Discount Window and Reduces Maturities of Discount Window Loans

In actions designed to bring borrowing from the FRB's discount window closer to terms and conditions that prevail in a normal, stable economic environment the FRB announced that it would: (i) increase the primary credit rate at the FRB discount window to 0.75% from 0.50% effective February 19, 2010; (2) reduce the maximum maturity of most discount window loans to overnight (from maturities of 28 days) as of March 18, 2010; and (3) raise the minimum bid rate for the FRB's Term Auction Facility ("TAF") from 0.25% to 0.50%. The FRB also announced that its final TAF auction will be held on March 8, 2010. Primary credit is short-term funding provided by the FRB on a fully secured basis to depository institutions that are in a "generally sound condition." The FRB intends that primary credit be used by borrowing depository institutions as a backup source of funding.

The FRB said that it was able to make these changes to discount window practices because of "continued improvement in financial market conditions." The FRB also noted in its announcement that it expects that as a result of these changes, depository institutions will use private funding sources (rather than the discount window) for normal short term credit needs. Moreover, the FRB stated that its changes in discount window rates and maturities are not expected to lead to tighter financial conditions for households and businesses "and do not signal any changes in the FRB's outlook for the economy or for monetary policy."

OTHER ITEM OF NOTE

Goodwin Procter Issues Client Alert on Recent SEC Staff Guidance Regarding Section 13 and Section 16 Compliance

Goodwin Procter's M&A/Corporate Governance Practice issued a [Client Alert](#) that discusses compliance and disclosure interpretations ("CDIs"), recently issued by the staff of the SEC's Division of Corporation Finance, concerning Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 (the "Exchange Act"). The Client Alert also addresses recent developments under Section 16 of the Exchange Act that are consequences of the Section 13 CDIs, as well as recent case law involving Sections 13 and 16.

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